

# THE CONTRIBUTIONS OF BANKS REFORM TO ECONOMIC DEVELOPMENT IN NIGERIA

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## ABSTRACT

*Banking system occupies a unique position in every economy and that is why it often attracts more than a casual regulatory attention. The banks act as catalyst to economic development. This review examined the contributions of banks to the economic development in Nigeria. The study highlighted banks as efficient mechanism for mobilizing financial resources and allocating same for productive investment. Given the key roles that banks play in facilitating economic growth and financing developmental projects, particularly key infrastructure, agriculture and industry, most emerging market economies have been known to use the domestic financial institutions to execute real sector big ticket projects. Therefore, it is recommended that Nigerian banks to compete favourably in the competitive global financial system, the current reforms in Nigeria banking system must be sustained and strengthened.*

**Keywords:** *Economic development, contributions, banks, economy*

## INTRODUCTION

It is incontrovertible that the banking system is the engine of growth in any economy. Banks facilitate capital formation, lubricate the production engine turbines and promote economic growth. However, banks' ability to engender economic growth and development depends on the health, soundness and stability of the system. The need for a strong, reliable and viable banking system is underscored by the fact that the industry is one of the few sectors in which the shareholders' fund is only a small proportion of the liabilities of the enterprise. It is, therefore, not surprising that the banking industry is one of the most regulated sectors in an economy (Adeyemi, 2006).

Economic development is concern with the process of enhancing the productive capacity of an economy by using available resources to reduce risks, remove impediments which otherwise could lower costs and hinder investment. Many economists have acknowledged that the financial system, with banks as its major component, provide linkages for the different sectors of the economy and encourage high level of specialization, expertise, economies of scale and a conducive environment for the implementation of various economic policies of improving productivity, technical change and the rate of economic growth. (Sanusi, 2011) believes that efficient allocation of savings through identification and funding of entrepreneurs with the best chances of successfully implementing innovative products and production processes are tools to achieve this objective. The endogenous growth literature also supports the argument that financial development has a positive impact on growth. Well functioning financial systems are able to mobilize household savings, allocate

resources efficiently, diversify risk, and enhance the flow of liquidity, reduce information asymmetry and transaction cost and provide an alternative to raising funds through individual savings and retained earnings. These functions suggest that financial development has a positive impact on growth. The creation of a pool of investment funds is the objective of deposit money bank. Banks through credit creation provides a pool of investment funds for borrowers. But the ability of banks to create credit to a large extent depends on the development of the nation's financial system. The procedure which banks engage in to change or transform their deposit into loanable funds is the Fund Transmission Process (FTP). Banks receive majority of their funds from depositors in small units lower than the requirement of their loan customers. Fund Transmission Process is made possible by the use of Fund Transmission Mechanism, a tool that assists bank to combine all funds that come to it and form a large pool.

As the main source of external funding, banks are highly placed, given the importance of financial intermediation in the development process, particularly, the strategic role of banks as the prime mover of the economy. Banks are efficient mechanism for mobilizing financial resources and allocating same for productive investment. Efficient Financial intermediation contributes to higher level of output, employment and income, which invariably enhances the living standard of the population thus, bringing about economic growth. The banking sector remains at the centre of this intermediation process, even in economies with highly developed financial markets. Banks provide important positive externalities as the mobilisers of savings, allocators of resources, and providers of liquidity and payment services, as well as a fulcrum for monetary policy implementation.

Simply put, banks influence the savings - investment process in order to accelerate the rate of economic growth and poverty reduction. Towards this goal, the soundness of intermediation is as important as its volume. To address the weakness of intermediation, that is, the incidence of disintermediation, the Central Bank of Nigeria (CBN) has, over the years made concerted efforts to ensure a sound and stable banking system through effective surveillance and enforcement of prudential standards.

Also, the licensing procedure places emphasis on the proper and fit criteria, among other factors, to ensure that bank owners are trustworthy. Professionalism and enforcement of high ethical standards in the banking industry is highly germane in order to sustain public confidence, without which the bank's ability to mobilize and deploy savings as the means to promote economic growth and raise living standards will be undermined. It has been established that a sound banking system in a competitive market environment provides financial intermediation at low cost. Hence, there is need to reduce the cost of borrowing and thereby, satiate investment and output growth in an economy. According to Gorton (2002), financial intermediaries (Banks) in this context produce services that are not easily replicated in capital market. Major theories have been put forward as explanation for the existence of financial intermediation. These theories are not mutually exclusive:

***Banks as delegated Monitors:*** Diamond (1984) offers the first coherent explanation for the existence of financial intermediaries; Diamond's intermediaries monitor borrowers. Since monitoring is costly, it is efficient to delegate the tasks to a specialized agent, the

bank. The notion of monitoring borrowers has become an influential idea, which subsequent researchers have further developed. Not only do Diamond's intermediaries contain most of the important elements of a theory of intermediation but also identifies and solves a fundamental problem at the root of intermediation theory. In Diamond (1984), the intermediary monitors borrowers on behalf of investors who lend to the intermediary. But, then, the lenders to the intermediary have to monitor the intermediary itself.

***Banks as Information Producers:*** According to Gorton (2002), if information about investment opportunities is not free, then economic agents may find it worthwhile to produce such information. There will be an inefficient duplication of information production costs if multiple agents choose to produce the same information. Alternatively, a smaller number of agents could produce the information, becoming informed, and then sell the information to the uninformed agents. This, however, introduces the "reliability problem" originally identified by Hirshleifer (1971). It may be impossible for the information producer to credibly ensure that he has, in fact, produced the valuable information. A related problem concerns resale of the information. If the information producer could credibly produce valuable information, and then sell it to another agent, there is no way to prevent the second agent from selling it to a third agent, and so on. In other words, purchasers of information can sell or share the information with others without necessarily diminishing its usefulness to them.

***Banks as Consumption Smoothers:*** Bryant (1980), Diamond and Dybvig (1983) develop a role for bank liabilities without stressing any particular features of banks assets. Bank liabilities do not function as a transaction medium. Rather, banks are vehicles for consumption smoothing. They offer insurance against shock to a consumption path. The Diamond and Dybvig model assumes that the pay offs from the available investment opportunities are inconsistent with the possible consumption paths desired by consumers. In particular, consumers have random consumption needs, and satisfying these needs may require them to prematurely end investments unless they save via intermediation so that they can to some extent diversify these consumption shocks.

***Banks as Liquidity Providers:*** According to Gorton (2002), Bank liabilities function as a medium of exchange. This basic observation leads to ideas and models concerning "Liquidity" that are quite distinct and perhaps more natural than viewing bank liabilities as allowing consumption smoothing. A medium of exchange is a set of claims or securities that can be offered to other agents in exchange for goods. Such claims can dominate barter and may dominate government supplied money. Without money, agents must barter, and this is clearly inefficient. Thus, this generates a need for a payment system, essentially a trading centre or bank that can produce and net claims.

***Banks as Commitment Mechanisms:*** Gorton (2002) asserts that an important question concerns why illiquid bank assets are financed by demand deposits that allow consumers to arrive and demand liquidation of those illiquid assets. Calomiris and Kahn (1991) and Flannery (1994) link the fragility of bank capital structure to the roles of banks. They argue that bank demand deposits include the right to withdraw at anytime at par along with a sequential service constraint in order to control the risk taking activities of bankers.

Flannery (1994) makes a related argument when he says that bank creditors cannot effectively control bank's asset substitution because of the ease of flexibly altering the bank portfolio, but they can estimate a bank's riskiness at any point in time. To control bankers, short-term debt is used because changes in bank risk will be reflected in financing costs.

According to Sanusi (2011), actions taken by Central Bank of Nigeria (CBN) to improve bank performances include:

- i. Enhancing the quality of banks entails the initiation by the CBN of a five part programme to enhance the operations and quality of banks in Nigeria. This programme consists of the following: industry remedial programmes to fix the key causes of the crisis; risk-based supervision; reforming the regulatory framework; enhanced customer protection; and internal transformation of the CBN. Issues such as effective corporate governance, data quality, and financial crime have seen increased attention.
- ii. More so, consumer confidence is also being tackled in the reform programme as complaint desks have been opened to ensure that financial services are delivered to customers as transparently and fairly as possible.
- iii. Establishing financial stability entails conscious actions by the CBN, and other regulatory agencies to stem wide fluctuations in the key macroeconomic indicators. The high points of this pillar include, strengthening the Financial Stability Committee within the CBN, establishment of macro-prudential rules, development of directional economic policy and counter-cyclical fiscal policies by the government and further development of capital markets as alternative to bank funding. It is hoped that the new macro-prudential rules would leverage on the following:
  - a. Limiting capital market lending to a set proportion of bank's balance sheet;
  - b. Prohibiting banks from using depositors' funds for proprietary trading, private equity or venture capital investment; and
  - c. Adjusting capital adequacy and forward looking capital requirements driven by stress tests by the CBN.
- iv. Enabling healthy financial sector evolution entails the CBN reviewing the basic one-size-fits-all model of banking. This has made possible the emergence of international, national, regional, mono-line and specialized banks such as non-interest banks, etc, with different capital requirements commensurate to the depth of their operations.
- v. The CBN have been underpinned by a new engagement with the Banking industry through the Bankers' Committee by adopting a more collaborative approach for financial services led national economic development and transformation. The Bankers' Committee has identified 3 key sectors: Power, Transportation and Agriculture, as most critical to development of the real economy, as well as the change that will drive other sectors and contribute to economic development of Nigeria. We work by identifying initiatives in each of the focus sectors that the financial system will support, determine requirements for success including funding and engage in advocacy to effect government policy changes. The Bankers'

Committee also supports industry-wide capacity-building and work on the development of regulation and legislation to support lending to these three key sectors.

- vi. From the recent experience it is discovered that the preponderance of toxic assets in bank portfolios have largely contributed to liquidity challenge facing some banks. However, the operation of AMCON has started to strengthen the balance sheets of the deposit money banks. It is important that the banking system should learn to strictly to comply with the BASLE requirements in their operations in order to safeguard their stability. Therefore, bank managers must be guided by professionalism and good corporate governance principles in their day to day activities so that our banks can remain safe, sound and competitive in the global market.

### **THE CONTRIBUTIONS OF THE BANKS TO THE ECONOMIC DEVELOPMENT OF NIGERIA**

Some of the contributions of banks towards Economic development in Nigeria are:

- i. The CACS was established by the CBN in collaboration with the Federal Ministry of Agriculture. It is being funded through the issuance of FGN Bond worth N200 billion, by the Debt Management Office (DMO) in two tranches. The first tranche of N100 billion had been raised and passed on to participating banks for on-lending to farmers. Loans made under this scheme are at single digit interest rate subject to a maximum of 9.0 per cent, while the CBN bears the 10 interest subsidy at maturity. The scheme was initially to promote commercial agricultural enterprises but was later expanded to accommodate small scale farmers through the on-lending scheme of the state governments. The sum of N96.81 billion has been disbursed to 104 projects through 11 banks and 18 State governments including the Federal Capital Territory, as at end of December 2010.
- ii. Under the Power and Aviation Intervention Fund, the CBN made available the sum of N300 billion to stimulate credit to the domestic power sector and the troubled airline industry. The amount was part of the initial N500 billion intervention fund sourced to catalyze financing of the real sector of the Nigerian economy. The main objective of the initiative was to help finance badly needed power projects and to allow banks to refinance loans to the heavily-indebted airline industry. The programme operates in such a way that borrowers will be able to access the fund at an interest rate of 7 percent payable on a quarterly basis including all charges in order to refinance existing loans and leases and provide working capital for the two sectors. The fund is managed by the Bank of Industry (BOI) while the Africa Finance Corporation (AFC) serves as the technical adviser to the fund.
- iii. As part of efforts towards unlocking the credit market and to ensure that credit flows to the real sector of the economy, the CBN made available N200 billion for refinancing/restructuring of banks' existing loan portfolios to the manufacturing sector and SMEs. The main objective of the fund is to fast-track the development

of the manufacturing sector by improving access to credit by manufacturers as well as improving the financial position of the DMBs. The types of facilities under the fund include long term loans for acquisition of plant and machinery, refinancing of existing loans, resuscitation of ailing industries, working capital and refinancing of existing leases. The loan amount for a single obligor is 11 a maximum of N1 billion in respect of refinancing/restructuring with an interest rate of 7 per cent payable on quarterly basis. All commercial banks and Development Finance Institutions (excluding BOI) had all been enlisted to participate in the scheme. As at the end of December 2010, N199.6 billion had been disbursed to 539 beneficiaries across twelve different sectors of the economy.

- iv. The N200 billion Small and Medium Scale Enterprises guarantee Scheme established by the CBN in 2010 aims at promoting access to credit by SMEs in Nigeria. The scheme provides guarantees on loans by banks to the sector in order to absorb some of the risk elements that inhibit banks from lending to the real sector. The activities covered under the scheme include manufacturing and agricultural value chains; SMEs, processing, packaging and distribution of primary products. The maximum amount that can be guaranteed is N100 million and is in the form of working capital, term loan for refurbishment, equipment upgrade, expansion and overdraft. The guarantee covers 80 per cent of the amount borrowed and is valid up to the maturity date of the loan, with maximum tenor of 5 years.
- v. A new financing framework for agriculture, the Nigerian Incentive-Based Risk Sharing System for Agricultural lending (NIRSAL) is being introduced. This model of financing agriculture is different in many ways from the current model which has not yielded the desired impact of making adequate credit available in the sector. NIRSAL is a demand driven credit facility rather than the current supply driven funding. It would adopt a value chain approach to lending and banks would be free to choose which part of the chain they would be interested in lending. It would build the capacity of banks to engage and deliver loans by providing technical assistance, reduce counterpart risks facing banks through innovative crop insurance products, reward performance in 12 agricultural lending and would be managed with performance based incentives. NIRSAL would pool the current resources in CBN's agricultural financing schemes and other investor funds and transfer these into the different components of the programme. In other words, our existing agricultural financing and insurance scheme would be assessed, modified and integrated into NIRSAL.
- vi. Available data shows that the macroeconomic environment has improved considerably. Inflation rate has moderated at a low double digit while the prime lending rate has gone down significantly. The exchange rate has been relatively stable. All these have impacted on the growth of the real economy.

## CONCLUSION

This study aimed at reviewing the contribution of banking reforms to economic development in Nigeria. It was observed that banks are efficient mechanism for mobilizing financial resources and allocating same for productive investment. Given the key roles that banks play in facilitating economic growth and financing developmental projects, particularly key infrastructure, agriculture and industry, most emerging market economies have been known to use the domestic financial institutions to execute real sector big ticket projects and financial institutions in Nigeria should not be an exception if we hope to achieve our developmental objectives. Therefore, for our banks to be globally competitive, the current reforms in the banking sector must be sustained and strengthened.

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