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Volume 6. Number 1 September, 2007

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PREDICTING POTENTIAL OF FAILURE IN NIGERIAN BANKING SECTOR A COMPARATIVE ANALYSIS OF FIRST BANK PLC, AND TRADE BANK PLC.

**Olaniyi Taiwo Azeez,*

The consequential disruption of the payment system, that spirally reduce employment level, per capital income and Gross Domestic Product (GDP) which hampers the growth of small scale businesses are the concomitants of bank failure which if not timely addressed might worsen the poverty level of Nigerians.

This study evaluates the susceptibility of Nigerian banks to failure with a view to discriminate between sound and unhealthy banks as a guide to investment decisions using First Bank and Trade Bank as case studies.

Multivariate Analysis of Z Scores was carried out on the Secondary data obtained from the banks annual reports and accounts between 1998 and 2003 and it was concluded the model can measure accurately potential of failure of unhealthy banks but inaccurately the failure status of sound banks. A more rigorous study involving more healthy and unsound banks is recommended to establish the accuracy of prediction of the model.

INTRODUCTION

The financial sector with special reference to banking has come under the searchlight in recent years not only because of its strategic role as mediator of funds between the surplus and the deficit units but also as a result of the problem rocking the industry in terms of failure and eventual death (Bankruptcy).

Although, the banking sector serves as the nerve center of any modern economy, being the repository of people's wealth and supplier of credits which lubricates the engine of growth of the entire economic system. The failure experienced in the sector over the years can be captured by the number of failed banks, the debt and extent of required capitalization, the proportion of non-performing credits, loss of depositor's funds and the general impact on the economy all of which underscores the importance of the sector.

While the targeted end results of banking business are to be achieved through adherence to laid down rules and regulations, the causes of the

**Olaniyi Taiwo Azeez, Department of Accounting and Finance, University of Ilorin, Ilorin. Nigeria.*

unhealthy deviation from set rules have been discussed at various times to include Inadequate Supervision Weak Management and offensive government policies. Ogunleye (2002) classified the causes of bank failure into Institutional, Economic and Political factors as well as regulatory and Supervisory inadequacies while Ebhodaghe (1995) attributed bank failures to economic downturn, inhibitive policy environment and management problems.

The impact of ill health in the banking sector left nobody untouched ranging from the government, the regulatory authorities the bankers as well as the general public. It is in this spirit that predicting the potential of failure in the sector becomes imperative if these actors/players are to be rightly guided in their decision making ventures.

A good manager therefore must be conversant with such tools that will enable him measure performance and trend over time for the achievement of the desired organizational and decision making objectives especially in an unstable economic environment like ours. In this connection therefore, the use of bankruptcy prediction model for determining the current and potential business failure proves handy and appropriate. This will afford effective resource management instead of distress classification that amounts to medicine after death.

Statement of the Problem

While the banking failures of the Pre-90s could acceptably be blamed to inadequate regulatory frameworks, such failure grows unabated even when regulations like: Banks and other Financial Institutions Decree (BOFID) OF 1991, Prudential Guidelines on asset classification and Provision for loan losses (SAS 10) as well as Failed banks (Recovery of debts) and other Financial Malpractices' Acts of 1994 were all in existence.

Such failure had underscored public confidence in the system and had resulted in massive withdrawal of funds from failed banks to healthy ones, a phenomenon known as flight to safety This inability has wrecked most business units while many homes have been negatively affected by loss of funds. However, some households and businesses that opted for alternative means of keeping their funds at offices and homes lose such funds to bandits and at worst cases their lives inclusive.

The spiral effects of bank failure creates difficulty in raising funds/ credits and the deteriorating interests in safekeeping with banks acts as disincentive to savings and investments, which of course, hindered the performance of the small and medium scale industries that serves as the engine of growth to the economy.

The federal government through the National Deposit Insurance Corporation (NDIC) and Central Bank of Nigeria (CBN) also wrestle with

this bank failure since the sector serves as channel for implementing its monetary policies. Any instability in the sector therefore may render monetary policy efforts ineffective.

What then is the way out?. Does it mean the economy will keep suffering in contradistinction with the functions of the banking sector as the nerve center of a nations economic growth?.

Justification for the Study

The worrisome nature of bank failure in our economy calls for a pressing need for assessing the performance of banks to identify those that need the attention of supervisory authorities most so that banks ill- health could be arrested to prevent failure. In like manners, the management of banks needs to be guided as to the determination of probability of failure so that remedial action could be taken for safe and sound-keeping of funds and income earning purposes. It is in the satisfaction of these needs that this study is justifiable.

Additionally, while other studies for instance, Adefila (2002) uses only one bank and his study covered three (3) years, Olaniyi (2006) enlarged Adefila' study up to five years but also involved only one bank. This study is an extension of these two studies as it uses two banks as case studies and it covers more recent years.

Objectives of the study

Bank liquidation does not happen in a day, it's always preceded by one form of lachrymal performance or the other whether obvious or obscured. In this spirit, this study therefore evaluates the bankruptcy status of Nigerian banks using First bank Plc and Trade bank Plc with a view to determining their probability of failure. It also assesses the stock market performance/ investor ratios of these banks within a period of 5 years covered (between 1998 and 2003).

Conceptual framework and literature review

Manifestations and features of ill-health were given by the Central bank of Nigeria Economic Review (1994) to include: Liquidity problems, distress borrowing, and resort to risky and speculative activities as well as technical insolvency among banks. However, Theodossior (1993) was of the opinion that the determination of solvency of banks is an obstacle to prompt action since financial distress may not be apparent in the first instance. They asserted that:

Ordinarily as long as a bank can meet all of its Obligations over the long run, it is considered viable. Measuring such

stream of income involve calculating the Net Present Value of the expected cash flows and it provides the economic measure of solvency. However, such estimation can be very difficult to undertake and subjective at best. On the other hand, the reliance on the book value solvency or the market value of the bank as a proxy for Net Present Value is a very imperfect measure of its arbitrary nature and the possibility that the bank can manipulate the manner in which such activities are presented.

This deficiency prompted the CBN and NDIC to develop a standard rating system for revealing the extent of distress in any bank in a composite measure categorized into sound, satisfactory, marginally distressed and distressed. The parameters that enabled this categorization is called (CAMEL): Capital Adequacy, Asset Quality, Management Competence, Earning Strength and Liquidity.

Banks adjudged to be distressed by this system are placed on strict supervision or liquidated, but no sooner than later banks rated as sound by this system enters the distress region. This however translates to mean that distress classification is equally a medicine after death. This therefore calls for preventive rather than curative measures in terms of predicting probability of failure for effective decision making capable of jumpstarting the deteriorating performance of the banking sector.

Methodology for the study

Previous studies identified in problem bank identification in Nigeria include Jimoh (1993) who employed Logit and Regression Models in Early Warning Signal determination and Adefila (2002) who employed Multiple Discriminant Analysis. There is also Olaniyi (2006) that extends Adefila's study but also adopted the same model as Adefila due to acclaimed accuracy of prediction of the model. At the international scene, the studies of Altman (1998), Beaver (1972), Charitou et al (2004) and Rose et al (1984) predicted bankruptcy status using Multiple Discriminant Analysis. In the same vein, Kolari et al (1996) employed the use of trait recognition in bank failure prediction while Mizuno et al (1998) adopted the use of Neural Networks in bankruptcy prediction.

This study employs the same Multiple Discriminant Analysis Model in assessing the bankruptcy/failure potential/status of Nigerian banks using First bank Plc, (being the bank with the longest banking experience and enviable track record of consistent good performance) and Trade Bank Plc; a bank adjudged to be financially sick and unhealthy (see Olaniyi (2006). This study covers a period of five accounting years between 1998/1999 as the cases may be and 2003.

To achieve the objectives of this study, the data required are those of the discriminating variables that include: Working capital, Retained earnings, Earning before interest and tax, Equity as well as Total assets and Total book debts. These are obtained from the annual audited accounts and reports of the banks under assessment.

The model used in this study is given as Zeta "Z"

$$Z = 1.02X_1 + 0.14X_2 + 0.033X_3 + 0.006X_4 + 0.999X_5, \text{ Where:}$$

X_1 = Working Capital to Total Assets

X_2 = Retained Earnings to Total Assets

X_3 = Earnings Before Interest and Taxes to Total Asset

X_4 = Value of Equity to Total Book Debt

X_5 = Gross Earnings to Total Assets

The decision rule is that:

- (i) For $Z < 1.81$ Bankruptcy region
- (ii) For $1.81 < Z < 2.675$ High bankruptcy potential
- (iii) For $2.675 < Z < 2.99$ Low bankruptcy potential
- (iv) For $Z > 2.99$ Strong (No sign of bankruptcy at all)

Data Presentation and Analysis of Results

Table 4.1 Extracts from Annual Audited Accounts of First Bank of Nig Plc,

	Years	1999	2000	2001	2002	2003
		N-m	N-m	N-m	N-m	N-m
1	Total assets	129503	189553	212901	266356	320578
2	Earnings before interest and tax	5950	9274	10007	8141	10428
3	Working capital	4886	6828	9583	9731	16423
4	Retained Earnings	7642	8721	9223	10264	15531
5	Equity	11307	14519	17093	17747	25040
6	Book Debt	118196	166034	195808	248609	341900
7	Gross Earnings	17767	26856	29098	41717	51318
8	Interest Paid	2026	2239	4162	3806	3054
9	Interest Earned	8789	11814	20038	20663	31195

Table 4.2 Computed 'Z' Scores for First Bank Plc,

	Years	1999	2000	2001	2002	2003
X ₁	Working capital to total Assets	0.048	0.036	0.036	0.036	0.024
X ₂	Retained Earnings to Total Assets	0.008	0.008	0.007	0.006	0.006
X ₃	EBIT to Total Assets	0.017	0.017	0.017	0.017	0.010
X ₄	Equity to Total Book Debts	0.007	0.006	0.005	0.005	0.004
X ₅	Gross Earnings to Total Assets	0.140	0.140	0.140	0.160	0.080
	Zeta Values (Z)	0.22	0.21	0.22	0.21	0.21

Table 4.3 Extracts from Annual Audited Accounts of Trade Banks Plc,

	Years	1998	2000	2001	2002	2003
		N-m	N-m	N-m	N-m	N-m
1	Total assets	5921	6730	10792	11304	11825
2	Earnings before interest and tax	488	1014	1255	1858	1826
3	Working capital	459	497	552	1364	1387
4	Retained Earnings	107	169	225	354	386
5	Equity	635	698	774	1666	1725
6	Book Debt	4655	6032	10018	9638	10120
7	Gross Earnings	1068	2000	2245	3387	3279
8	Interest Paid	391	946	1045	1447	1529
9	Interest Earned	736	2000	2245	3274	3345

Table 4.4. Computed 'Z' Scores for Trade Bank Plc,

	Years	1998	2000	2001	2002	2003
X ₁	Working capital to total Assets	0.09	0.07	0.05	0.12	0.12
X ₂	Retained Earnings to Total Assets	0.02	0.03	0.02	0.03	0.03
X ₃	EBIT to Total Assets	0.09	0.15	0.12	0.16	0.15
X ₄	Equity to Total Book Debts	0.14	0.12	0.08	0.17	0.17
X ₅	Gross Earnings to Total Assets	0.20	0.30	0.20	0.30	0.28
	Zeta Values (Z)	0.22	0.31	0.21	0.32	0.41

Table 4.5 Stock Market Performance Summary of First Bank Plc.

	Years	1999	2000	2001	2002	2003
1.	Earnings Per Share (EPS)	158K	283K	346K	312K	235K
2.	Dividend Per Share (DPS)	72K	64K	100K	130K	130K
3.	Ratio of Interest Earned to Interest Paid	4.3:1	5.3:1	4.8:1	5.4:1	10.2:1

Table 4.6 Stock Market Performance Summary of Trade Bank Plc.

	Years	1998	2000	2001	2002	2003
1.	Earnings Per Share (EPS)	9K	7K	18K	19K	14K
2.	Dividend Per Share (DPS)	5K	-	10K	10K	6K
3.	Ratio of Interest Earned to Interest Paid	1.88:1	2.11:1	2.15:1	2.17:1	2.19:1

Discussion of Results

Table 4.2 and 4.4 above presents the summary of the 'Z' Zeta Scores for First Bank and Trade Bank respectively. On the other hand, the stock market performance summary of the two banks was also shown in table 4.5 and 4.6 in that order.

As can be seen in table 4.4, the Z scores of Trade Bank Plc, were 0.22 and 0.21(almost the same) in 1998 and 2001. The difference in these values for 2000 and 2002 were almost nil.(0.31 and 0.32) respectively. However, the Z value for 2003 recorded an improved performance over the previous years (0.41). Notwithstanding, the overall implication of these Z values is that the probability of failure of this bank was high for the period covered because all the Z values were below 1.81 which is the cut off point for failure (the bankruptcy region).

The bank's state of ill-health was vindicated by the study of Olaniyi (2006) who predicted that the bank was unlikely to operate beyond 2005. In actual fact, the bank collapsed in 2006.

In the same vein, the potential of failure of First Bank Plc, is also very high, indeed if falls within bankruptcy region. This is in line with the Z score (0.21) for all the years covered except 1999 which records a slightly different figure of (0.22).

Investors performance ratio of the two banks were also examined as shown in table 4.5 and 4.6. Table 4.5 shows an increasing trend for Earnings Per Share (EPS) over the years for First Bank, specifically (97.5%) increment between 1999 and 2002. The slight drop in EPS in 2003 was attributed to the banks investment in Information Technology (IT) ongoing but yet to be completed. This does not impact negatively on customers happiness in terms of Dividend Per Share(DPS) as the same 130kobo was declared in 2002 and in 2003 after an 81% growth recorded between 1999 and 2003. This result is at variance with the failure assessment status of the bank that reveal an unsatisfactory performance.

As regards Trade Bank, its investors ratio performance assessment coincide with its Z score rating as a bank operating in failure zone. This was revealed in table 4.6 where the Earnings Per Share doubled between 1998 and 2001, but dropped by 22% between 2002 and 2003. This also affected the Dividend Per Share (DPS) record of zero kobo in 2000, 10kobo in 2001 and

2002 and later nosedived to 6 kobo in 2003.

Aside the investor's expectation performance analysis of these banks, their Earning Strength in terms of the ratio between the major source of operating income (Interest Earned) and major route of expenses (Interest Paid) was also evaluated. As shown in table 4.5, First Bank Plc, reveals an ever increasing /upward coverage of interest paid by interest earned 4.3, 5.3 and 4.8 times in 1999, 2000 and 2001 respectively, while it jumped to 10.2 times in 2003.

Contrary to this outstanding performance by First Bank Plc, the ratio of interest earned to interest paid by Trade Bank Plc, was shown in table 4.6. This table shows that the bank was only able to cover its interest paid by interest earned two times throughout the years covered. No wonder why the remaining interest earned is insufficient to cater for other expenses and make investors smile home with good returns (Dividend). The gloomy nature of these performances probably explains why the banks last share offer before its failure was greeted with impunity.

Conclusion and Recommendation

In view of the above analysis and results discussion, it can be concluded that:

- (a) As regards Trade Bank Plc, the totality of its performance is poor and unspeakable to justify the public lack of confidence (Share offer neglect before failure). Is it the Z scores that were all below 1.81 (the point above which a bank must score to be outside failure region) or the earning per share or dividend per share that were all nothing to write home about compared to current investors expectation.

Worse still, the bank could not generate sufficient interest earnings to cover its interest payment obligations not to talk of other expenses. These results are in concordance with the conclusion of Olaniyi(2006) study and also proves the validity of Operating Income Concept which says that a company that could not generate sufficient Operating Income to cover operating expenses is bound to fail/die(Husband 1946)

Also, the analysis of this study as regards Trade Bank Plc is also in agreement with real life situation of the bank.

- (b) Although the Z scores of First Bank Plc classified the bank to be operating within failure region (relatively 0.2 for the five accounting years covered. This result was contrary to real life situation as the bank is one of the survivors of the current N25b capital base reform in Nigeria. The bank is also the largest in terms of asset base and won the bank of the year award in 2003.

In furtherance of justifying this contradictory result, First Bank was able

to generate enough Earnings to pay its interest obligations and also pay sumptuous dividend to its shareholders. This further enlisted everyday investor loyalty (oversubscribed share offer in 2004). More so, First Bank in reality is doing well in terms of employee remuneration, customer satisfaction and investors/shareholders wealth maximization

It can therefore be concluded that the bankruptcy model adopted in this study is only capable of accurately predicting the failure status of unsound banks but incapable of measuring accurately the failure potential of sound and healthy banks. Notwithstanding, the management of banks, the employees, the shareholders alike as well as depositors deserve a warning tool capable of measuring failure potential of any bank before making an unguided decision of putting their deposits, investment fund or accepting an offer for employment in order to avoid the impact of imminent collapse of such a bank.

It is also in this spirit recommended that a more elaborate study involving more failed banks and existing banks should be conducted to validate or reject the accuracy of prediction of this methodology.

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