Capital Adequacy Ratio and Bank Profitability in Nigeria: A Linear Approach

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Abstract: The capital base (#2 billion) which has become grossly inadequate to meet domestic and global realities in the financial system and hence, has been upwardly reviewed to #25billion. It examined whether or not capital adequacy ratio affects bank profitability, it also analyzes the effect of loans and advances on bank profitability as well as the impact of capital adequacy ratio on banks' exposure to credit risk. The study utilized secondary data covering five years financial statement taking case studies of five selected commercial banks. The positive and significant relationship between capital adequacy and bank's profitability suggests that banks with more equity capital are perceived to have more safety and such advantage can be translated into higher profitability. The higher the capital ratio, the more profitable a bank will be. It was recommended that there should be a constant review of minimum capital requirement of deposit money banks in Nigeria to the optimal level and Nigeria banks should be capitalized to enable them enjoy assess to cheaper sources of funds with subsequent improvements in profit levels. This would go a long way in helping the public maintain confidence in the banks with the latter acquiring corresponding enablement to accommodate the credit needs of customers and safeguard depositors' funds.

Keywords: Capital Adequacy, Bank profitability, Nigerian Commercial Banks, Credit Risk Exposure, Regression Analysis.

1. INTRODUCTION

The major concern of bank regulators worldwide remains the safety of depositor's and the biggest achievement in the Financial Sector has been the upward review of the of the capital base of banks. Banks provide both liquid and relatively low risk savings facilities and credit in flexible amount to households, business concern and government and promote the payments system both by providing major form of exchange such as demand depository (Kaufman 2000). Capital adequacy refers to the amount of equity capital and other securities which a bank holds as reserves against risky assets as a hedge against the probability of bank failure. Capital adequacy is used to determine whether a bank has enough capital to support the risk on its balance sheet i.e. it is used to mitigate bank solvency problem. However, the assessment of capital adequacy for precautionary purposes is problematic at best due to rapidly changing economic and financial services industry. Capital level is used by most regulators to restrict credit expansion. That explains why bank management are inspired to determine the correlation between variables like Total credit loan, Demand deposit, Inflation rate, Political instability, Money supply, Liquidity risk, Investment etc.

Hence indicate whether large capital is negatively or positively compel banks to meet the capital adequacy requirement or seek additional capital so as to meet their credit expansion target.

Basle Accord was initiated and an agreement was reached among stakeholders on what should be the minimum capital requirement of banks in the participating countries. Apart from the global effort in recent years, The Central Bank of

Nigeria has consistently enforced flat capital requirements in terms of minimum paid-up capital in the Nigerian banking sector. The Basle Committee's work on regulatory convergence had two fundamental objectives in establishing a new framework for capital requirements. These were, firstly, that the new framework should serve to strengthen the soundness and stability of the international banking system; and secondly that the framework should be fair and have a high degree of consistency in its application to banks in different countries with a view to diminishing an existing source of competitive inequality among international banks. The framework developed is mainly directed towards setting capital adequacy in relation to credit risk (the risk of counterparty failure). Other risks that need to be taken into account by supervisors in assessing overall capital adequacy were identified but have not been allowed for. In particular the Committee noted a continuing investigation into possible approaches in relation to interest rate risks and the investment risks on securities.

Since bank's play an important role in the operation of an economy, the stability of banks is of paramount importance to the financial system. As such, an understanding of the factors that determine their profitability is essential and crucial to the stability of the economy. In banking literature, the determinants of profitability are empirically well explored although the definition of profitability varies among studies. Disregarding the profitability measures, most of the banking studies have noticed that capital adequacy, market share, loan-loss provisions and expense control are important factors in achieving high profitability. There is thus a need to empirically analyze the impact of capital adequacy on deposit money bank's profitability in Nigeria. In order to situate this research in the right perspective, the following pertinent issues are raised for investigation:

i. Does bank's capital adequately ratios contribute to bank profitability?

ii. Is there any relationship between loan and advances and bank profitability?

iii. What is the relationship between capital adequacy ratio and bank's exposure to credit risk?

The broad objective of the study is to examine the significance of bank capital adequacies for the enhancement of financial institutions and to ensure that the Accord must evolve along with the changes in the market. The specific objective is to determine the effect of capital adequacy ratio on bank profitability. Other objectives are: i. determine whether bank's capital adequacy ratio contributes to bank profitability; ii. examine the effects of loans and advances on bank profitability; iii. to determine the impact of capital adequacy ratio on bank's exposure to credit risk.

This study covers a period of five years from 2010-2014. The context of this study entails the measure of profitability of the subject matter of the Nigerian banks, namely; First Bank of Nigeria Plc., Guarantee Trust Bank, Wema Bank Plc, United Bank for Africa Plc and Access Bank Plc.

2. LITERATURE REVIEW

A high capital adequacy ratio (HCAR) can enable the bank increase its scope of profitable investments. On the other hand, a bank with a low capital adequacy ratio (LCAR) will most likely have a narrow scope of profitable investments. Therefore, potentially, a HCAR is more profits enhancing than a LCAR. Hence, the ability of a bank management to ensure bank capital is effective determines how adequate the capital is. Capital adequacy is used to determine the solvency of a bank to determine whether a bank has enough capital to support the risk in its statement of financial position. Bank capital is regulated by the apex bank i.e. the Central Bank to mitigate bank solvency problem. The Basle Accord is regularly updated to meet the changing conditions of the global financial system which serves as a key instrument for the safety and sound practices of the capital adequacy ratio. By promoting the needed lubrication of the global financial system from time to time in accordance with the paradigm shifts, the bank for international settlements based in Basle, Switzerland has become the anchor home of global financial stability.

2.1 Empirical Literature:

Capital ratio has long been a valuable tool for assessing capital adequacy and should capture the general safety and soundness of banks. It is generally believed that well-captured bank's face lower expected costs of financial distress and such advantage will then be translated into high profitability. In the study of banking profitability across eighteen

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countries for the period 1986-1989, Molynexu and Thornton(1992) also found out that capital ratio impacts bank's performance positively, although such relationship is confined to just the state-owned banks.

Ngo (2006) attempted to find out the effect of endogenous capital and profitability in banking. He investigated the relationship between bank capital and profitability. According to his study and the best of his knowledge, no previous paper had analyzed the problem in two-equation structural model. Contrary to what is often reported with surprising frequency in this field of research, his results showed no satisfying significant relationship between capital and profitability. Given non-binding capital requirements his finding was consistent with the view that, while raising capital is costly for banks, it is associated with compensating benefits that offset these additional costs. Consequently, when capital structure is endogenously determined in a profit maximizing equilibrium, no systematic relationship between capital and profit expected.

Demirguc-Kunt and Huizingz (1999) conducted a more comprehensive study which examined the determinants of banking performance for 80 countries, both developed and developing, during the period 1988-1995. They concluded that foreign banks have higher profitability than domestic banks in developing countries while the opposite holds in developed countries. Nevertheless, their overall results showed support for positive relationship between the capital ratio and financial performance. Hassan et al. (2008) analyzed how bank characteristics and the overall financial environment affected the performance of Islamic banks. Utilizing bank level data, that study examined the performance indicators of Islamic bank's worldwide during 1994-2001. A variety of internal and external banking characteristics were used to predict profitability and efficiency. In the genera, their analysis of determinants of Islamic bank profitability confirmed previous findings.

Flamini, Calvin and Liliana (2009) used a sample of 389 banks in 41 SSA countries to study the determinants of bank profitability. They found out that apart from credit risk, higher return on assets are associated with larger bank size, activity diversification, and private ownership. Bank returns are affected by macroeconomic variables, suggesting that macroeconomic policies that promote low inflation and stable output growth do boost credit expansion. Their results also indicated moderate persistence in profitability.

Sanusi (2010) was even more satirical in answering the question of how much capital a bank needs to ensure the confidence of depositors, creditors, investors and regulators in a country of high inflation rate and economic instability, when he noted "that in banking and finance literature, this question is noted as the issue of capital adequacy.

3.   METHODOLOGY

Data required for this study were secondary and sourced from Central Bank of Nigeria Statistical Bulletin and Annual Financial Reports of the selected banks. The data collect from the covers the period of 2010-2014 reporting years only. Therefore, from the population of commercial banks in the country (i.e. 24 banks) only five selected banks were used based for this purpose. The banks are: - United Bank of Africa (UBA) Plc, First Bank of Nigeria (FBN) Plc, Access Bank Plc, Zenith Bank Plc, GTBank Plc and WEMA Bank Plc.

The variables to be tested in the hypotheses are; capital adequacy ratio and bank profitability; loans and advances and bank performance as well as capital adequacy ratio and bank's exposure to credit risk. Therefore, capital adequacy will be measured by using the amount of equity capital the selected bank's hold as reserve as proxy, profitability will be measured by using profit after tax of the selected bank's; loans and advances will be measured by using the amount of loans and advances in the financial report of the bank's while bank's exposure to credit risk is measured by using the amount of loans and advances classified as non-performance at the selected banks.

The regression analysis was employed as tool to empirically test for correlational relationship among the variables of interest using SPSS 6.0. The functional relationship of the models is specified below:

$$y = \alpha 0 + \alpha 1 X + ut −(1)$$

Where, y=dependent variable, that is, Bank profitability (BP). Also, α1 and α2 are the regression parameters, $_X$=independent variable, that is, capital adequacy (CAPAD)

$_{Ut}$=random error.

By substituting BP and CAPAD into equation 1, we have

$$y(BP) = \alpha 0 + \alpha 1 CAPAD + ut - - - - - - - - - - - - - - - (2)$$

Also,

$$y = \alpha 0 + \alpha 1 X + ut - (3)$$

Where, y=dependent variable, that is, bank profitability (BP), and X= independent variable, that is, Loan and advances (LAA).

Substituting, BP and LAA into equation 3, we have;

$$y(BP) = \alpha 0 + \alpha 1 LAA + ut - - - - - - - - - - - - - - - - - (4)$$

More so,

$$y = \alpha 0 + \alpha 1 X + ut - (5)$$

Where,

Y= dependent variable, that is, credit risk (CR)

And α0 = intercept, that is, constant. This is the value of credit risk in the absent of capital adequacy while α1= slope or gradient, that is the amount of credit created by the bank's, that dependents on capital adequacy, X=independent variable, that is, capital adequacy (CAPAD)

By substituting CR and CAPAD into equation five (5), we have;

$$y(CR) = \alpha 0 + \alpha 1 CAAD + Ut - - - - - - - - - - - - - - - - (6)$$

The a-priori expectation is given as: $0 < \alpha > 1$

4.   DATA ANALYSIS AND DISCUSSION OF FINDINGS

4.1 Presentation of Original Data:

The data collected for the study based on the reported annual financial reports of the selected banks are presented in the tables below.

Table 4.1: Total Equity reserve (billion naira)

Banks'/Years	2010	2011	2012	2013	2014
FBN	23.56	45.67	67.89	69.00	69.78
UBA	12.67	19.45	19.67	19.87	34.56
ACCESS	7.89	8.22	9.56	12.56	18.67
GTB	6.78	11.11	13.56	23.76	25.78
WEMA	3.67	4.23	5.55	6.72	11.56
Average TIER	10.91	17.74	23.25	26.38	32.07

Table 4.2: Profit after Tax (billion naira)

Banks'/years	2010	2011	2012	2013	2014
FBN	123.34	154.67	167.11	178.23	213.23
UBA	50.67	67.89	88.67	103.23	156.45
ACCESS	23.45	33.56	56.78	78.88	90.56
GTB	20.89	34.56	45.89	55.78	78.00
WEMA	5.78	7.89	10.56	11.55	14.78
Average PAT	44.83	59.714	73.80	85.53	110.60

Table 4.3: Profit before Tax (Billion Naira)

Banks'/years	2010	2011	2012	2013	2014
FBN	136.89	167.45	172.56	186.77	230.67
UBA	65.67	76.34	96.34	108.67	176.11
ACCESS	27.00	35.67	67.11	88.23	106.66
GTB	23.77	38.66	55.11	67.45	105.17
WEMA	6.11	8.56	12.09	14.99	18.11
Average PBT	51.89	65.34	80.64	93.22	127.34

Table 4.4: Loans and Advances (Billion Naira)

Banks'/years	2010	2011	2012	2013	2014
FBN	34.78	56.78	66.90	88.45	102.33
UBA	34.00	52.67	55.88	69.00	98.00
ACCESS	23.89	45.00	55.78	55.78	65.00
GTB	10.00	12.11	14.56	16.78	23.66
WEMA	3.67	4.67	6.78	8.56	16.11
Average	21.27	34.25	39.98	47.71	61.02

Source: Annual Financial Reports of the Selected banks 2010-2014

Table 4.5: Loans and Advances classified as Non-performance (in Billion Naira)

Bank's/years	2010	2011	2012	2013	2014
FBN	8.90	9.12	10.00	10.00	15.78
UBA	3.78	4.89	4.89	5.23	8.12
ACCESS	0.78	0.98	1.23	1.23	2.22
GTB	0.45	0.45	0.67	0.98	1.11
WEMA	0.34	1.12	1.12	2.00	2.12
Average	2.85	3.31	3.58	3.89	5.87

Source: Assets Management Company of Nigeria (AMCON)

Table 4.6: Average Profit after tax(y) and Equity capital (x)

Years	APAT (Y)	AAEQC (X)
2010	44.83	10.91
2011	59.71	17.74
2012	73.80	23.25
2013	85.53	26.38
2014	110.60	32.07

Table 4.7: Average PBT(y) and ALAA (X)

Years	APBT (Y)	ALAA(X)
2010	51.89	21.27
2011	65.34	34.25
2012	80.64	39.98
2013	93.22	47.71
2014	127.34	61.02

Table 4.9: AANPL (Y) and AEQC (X)

Years	AANPL (Y)	AEQC (X)
2010	2.85	10.91
2011	3.31	17.74
2012	3.58	23.25S
2013	3.89	26.38
2014	5.87	32.07

Source: Author's Computation, 2015

4.2: Test of hypotheses:

The hypotheses formulated for the study are tested using ANOVA and its test statistics of; t-test, F-test and coefficient of determination (R^2).

4.2.1: Test of hypothesis one

Ho$_1$: there is no significant relationship between capital adequacy and bank profitability

(a) Model specification for testing bank profitability on capital adequacy

$$y = \alpha 0 + \alpha 1X + ei − (1)$$

Where, y= profitability. This is measured by using average profit after tax (APAT) at the selected banks for the periods 2010-2014. Also, α0 and α1 are the regression parameters. In addition X is the independent variable, that is, capital adequacy. This is measured by using average amount of equity capital (AAEQC) which is held as reverse at the selected bank.

By substituting AAEQC and APAT into equation 1, we have

$$y(APAT) = \alpha 0 + \alpha 1AAEQC + ei − − − − − − − − − − − − − − − − − − − (2)$$

Table 4.9: ANOVA result for influence of Capital Adequacy on Profitability

SV	SS	DF	MS	F-RATOIO	SIGN
Regression	2448.510	1	2448.510	97.774	0.002
Error	75.127	3	25.042		
Total	2523.638	4			

Table 4.10: T-test calculated for influence of Capital Adequacy on Profitability

Variables	Unstandardized coefficient B Std.error		Standardized coefficients Beta	T-Calculated	Sign
Capital adequacy (X)	3.050	0.308	0.985	9.888	0.002
Constant	7.587	7.165		1.059	0.367
R		R^2		Adjusted R^2	Standard Error of the Estimate
0.985		0.970		0.960	5.004

Source: Author's Computation, 2015

Tables 4.9 to 4.10 above present the empirical results obtain for the test of hypothesis one. From table 4.9 the p-value of the F-test calculated of 0.002 is less than critical value, this implies that the joint null hypothesis which states that there is no significant relationship between capital adequacy and bank profitability is rejected. This indicates that there is a significant relationship between capital adequacy and bank's profitability. In fact, the higher the level of equity reserve possessed by bank's the more confident the bank will be in a case of unexpected loss and its eventuality. Therefore, for banks in Nigeria to continue to be relevant in term of reported profit, there is need to adequately growth up their capital especially equity reserve. Also, in table 4.10 the p-value of the t-statistics calculated of 0.002 is less than the critical value of 5%, this means that the null hypothesis which states that capital adequacy is not significant on bank's profitability will

be rejected. Therefore, one can infer that capital adequacy is significant on bank's profitability. More so, the coefficient of determination (R^2) obtains of 0.970 implies that 97% of selected bank's profitability is as a result of capital adequacy. Therefore, capital adequacy is a good predictor for bank's profitability.

4.2.2: Test of hypothesis two:

H_{O2}: There is no significant relationship between loans and advances and bank profitability.

(b)   Model for testing the influence of loans and advances on bank profitability

$$y = \alpha 0 + \alpha 1 X + ei - (3)$$

Where y= dependent variable, that is, bank profitability. This is measured by using average profit before tax (APBT) at the selected banks. Also, α0 and α1 are the regression parameters. In addition, X=independent variable, that is, average loans and advances (ALAA) at the selected bank's and

ei = error term.

By putting APBT and ALAA into equation 3, we have;

$$y(APBT) = \alpha 0 + \alpha 1 ALAA + ei - - - - - - - - - - - - - - - - - - - (4)$$

Table 4.11: Result of ANOVA test for influence of loans and advances on bank profitability

SV	SS	DF	MS	F-RATIO	SIGN
Regression	3248.200	1	3248.200	92.622	0.002
Error	105.209	3	35.070		
Total	3353.408	4			

Table 4.12: Testing the influence of loans and advances on bank's profitability

Variable	Unstandardized coefficient B std.error		Standardized coefficient	T-calculated	Sign
Loans and advances (X)	1.920	0.199	0.984	9.624	0.002
Constant	5.282	8.566		0.617	0.581
R		R^2		Adjusted R^2	Standard error of the estimate
0.984		0.969		0.958	5.922

Source: Author's Computation, 2015

In table 4.11, the p-value of the F-calculated of 0.002 is less than the critical value, for this, the null hypothesis which states that there is no significant relationship between loans and advances and bank performance is rejected. This implies that there is a significant relationship between loans and advances and bank performance. Therefore, the higher the ability of the commercial banks to create loans and advances the better for their performance in term of profitability before tax. Also, since the ability of commercial banks to create advances and loans for interested clients is a function of how adequate their capital reserve is, for this, one can infer that since there is a significant relationship between loans and advances and profitability, there is also a significant relationship between adequacy of capital and ability to create loan and advances.

Also, the p-value of the t-calculated in table 4.12 is less than the critical value at 5%, for this, the null hypothesis which states that loans and advances are not significant on bank's performance is rejected. This reveals that loans and advances are significant on bank's performance in Nigeria. This assertion is based on the fact that a unit increase in loans and advances will lead to 92% increase in bank's profitability. In addition, the coefficient of determination (R^2) obtained indicates that 96.90% of bank's reported profitability is caused by the ability of the banks to create loans and advances for their customers. Therefore, loans and advances are a good predictor for bank's profit before taxation and also they are directly related.

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4.2.3: Test of hypothesis three:

H_{O3}: There is no significant relationship between capital adequacy ratio and bank's exposure to credit risk.

(c)   Model specification for influence of capital adequacy on bank's exposure to credit risk

$$y = \alpha 0 + \alpha 1 X + ei - (5)$$

Where, y=dependent variable, that is, bank's exposure to credit risk. This is measured by using the average of amount of non-performance loans (AANPL) for the periods 2010-2014.

Also, α0= intercept, that is, the value of credit risk in the absent of capital adequacy.

X= independent variable, that is, capital adequacy. This is measured by using average equity capital (AEQC) for the periods 2010-2014 while ei = error term.

By substituting AANPL and AEQC into equation five (5), we have;

$$y(AANPL) = \alpha 0 + \alpha 1 AEQC + ei - - - - - - - - - - - - - - - - - (6)$$

Table 4.13: ANOVA result for testing influence of Non-performance on capital adequacy

SV	SS	DF	MS	F-RATIO	SIGN
Regression	4.276	1	4.276	11.079	0.025
Error	1.158	3	0.386		
Total	5.434	4			

Table 4.14: Testing the significant of bank's exposure to credit risk on capital adequacy

Variable	Unstandardized coefficient B std.error		Standardized coefficient Beta	T-calculated	Sign
Capital adequacy (X)	0.127	0.038	0.887	3.328	0.025
Constant	1.087	0.890	-	1.222	0.309

R	R^2		Adjusted R^2	Standard error of the estimate
0.887	0.787		0.716	0.621

Source: Author's Computation, 2015

From table 4.13, the p-value of the F-calculated of 0.025 is less than the critical value. This implies that the null hypothesis which states that there is no significant relationship between capital adequacy ratio and bank's exposure to credit risk is rejected. Then, one can infer that there is a significant relationship between capital adequacy ratio and bank's exposure to credit risk. In fact, the higher the selected banks are exposed to credit risk as a result of non-performance loan the higher their capital adequacy ratio in reserve will be affected. Adesoji (2009) concludes that the existence of non-performance loans in Nigeria Commercial bank's does not only expose the banks to non-activities in term of granting of credit to performing customers but also expose the banks to risk of going out of business as a result of capital in reserve being heavily eroded.

Moreover, in table 4.14, the p-value of the t-statistics calculated of 0.025 is greater than the critical value of 5%, this indicates that the null hypothesis which states that bank's exposure to credit risk is not significant on bank's capital is rejected. This means that bank's exposure to credit risk is significant on bank's capital. So, bank's exposure to credit risk and capital are directly related. The regression coefficient obtains for capital adequacy of 0.127 means that a unit increase in bank's exposure to credit risk without adequate cover will lead to 12.7% reduction in capital reserve. The coefficient of determination obtains of 0.787 in table 4.14 reveals that 78.7% of selected bank's capital will be affected if they are unreasonably exposed to credit risk due to incidence of non-performance loans. Therefore, capital adequacy is a good explanatory variable for bank's exposure to credit risk.

5. CONCLUSION AND POLICY RECOMMENDATION

Based on the findings of this study, the followings conclusions are made: There is a significant relationship between capital adequacy ratio and bank's profitability. In fact the higher the capital the more the profitability of banks. Since there is a significant relationship between loans and advances and bank performance, it can be concluded that loans and advances that are performing are significant on bank's performance. Finally, bank's exposure to credit risk will erode the adequacy of capital significantly.

Since capital adequacy ratio has positive effect on bank profitability, it can be instrumental in promoting bank soundness and safety. Hence, the study recommends that: banks' capital regulation must be anchored on a sound monitoring system which regularly assesses the economy and establishes the level of capital requirements by the banking sector; a prudently established new capital requirement must be promptly and rigorously enforced; there should be a constant review of minimum capital requirement of deposit money banks in Nigeria to the optimal level and Nigerian banks should be capitalized to enable them enjoy assess to cheaper sources of funds with subsequent improvements in profit levels. This would go a long way in helping the public maintain confidence in the banks since the latter can now accommodate the credit needs of customers and keep depositors' funds safe.

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