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# The Relationship between Liquidation and Banking Industry Stability in Nigeria.

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**ABSTRACT:** *The relationship between liquidation and banking industry stability has helped to sustain public confidence in the solvency of the bank. The purpose of this project work was to investigate the relationship between liquidation and banking industry stability in Nigeria. The study used quantitative time series data and special package for social sciences (SPSS) method during analysis. The result of the test indicates long run relationship between dependent and independent variables. The result of our analysis shows that there is long run relationship between the level of bank failure and stability of Nigerian banking industry. The study also found that efficient management of non-performing loan is necessary for the stability of Nigerian banking industry. The implication of this is that if the policy makers did not control the level of non-performing loan, it will continue to bring about bank failure. We therefore recommend that, there is an urgent need for effective monitoring of the level of bank failure in Nigeria to allow for acceleration of banking industry stability. This is necessary for its positive effect on the bank stability.*

**KEYWORDS**: Liquidation, Banking Industry, Stability, Bank Failure, Non-performing Loan.

## INTRODUCTION

Since distress crept into the banking system in the early 1990$_s$ culminating in liquidation of some banks, depositors have been the major casualties whenever a bank ails terminally. According to the CBN report, by June 2004, about 25 of the 89 banks in the system were dead. This confirms rumour making the round over seven years ago that there was widespread distress in the banking sub-sector. Many banks reportedly recourse to name dropping of other banks at that time. It is quite unimaginable what would have happened to the economy if over a quarter of the banks had gone down with depositor's money.

Emma, (1997) stated that between 1892 and 1952, the issue of dominance of the industry by expatriate banks and that of setting up of a viable and strong indigenous bank was the main problem. As many as 25 indigenous banks were set-up between 1972 and 1952 with only 3 surviving beyond 5 years of their inception. Most banks failed in this period as a result of inadequate capital, poor management fraud, rapid expansion of branches and over trading aggressive competition by expatriate banks and inadequate supervision by the government. This period has come to be known as the first fall of banking in Nigeria.

Since the 1960's bank failure or liquidation seemed to have no doubt become a Siamese twin of the critical economic effects on the banking industry in Nigeria. However the number of banks officially classified as problem banks especially in recent times have continually to be of serious concern to the government and the regulatory authorities. By the end of 1991 for example 8 banks (more than 6% of the insured banks in Nigeria) were officially classified as distressed (ie technically insolvent) (CBN, 2010). By the end of 1996 the number of banks



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have increased to 50. A situation which was in no double a visible expression of a complex set of inter-related problems. This pathetic situation led to the recapitalization increase in 1996, and eventual liquidation of about 26 of these banks in 1997, among which were financial merchant bank. Alpha Merchant Bank, capital Merchant Bank and United commercial Bank whose licenses were withdrawn even before the liquidation date. This calamity has created fear not only on the customers of the banks affected but also on all banks customers about the general instability and illiquidity threatening the sector which has led to loss of confidence in the sector (Ajayi, 1996)

Chambers dictionary defined liquidation as the termination of a business operation by using its assets to discharge its liabilities. Hori and Takahashi (2005) define liquidation as the process of converting a business real assets into cash. This definition means that when a business is terminated or bankrupt. Its assets are sold and proceeds pay to creditors. By law, liquidation is the process by which a company or part of a company is brought its liabilities.

Banking crises may have cause serve macroeconomic consequences in Nigeria but a framework for convincingly demonstrating that consequence in the real economies has proven abortive. Hence, the issue of how banking failures are liked to liquidation is of a great interest in banking industry stability. As in mason (2005), when a bank fails a trustee is charged with selling and assets maximizing creditors returns. Hence, each period the trusted can sell assets at the current market price or waits another period and incur a positive opportunity cost. In this manner bank failures transform liquid deposits into inliquid investment with uncertain maturity. The longer it takes to return funds to depositors, the longer funds remain unavailable for investment or consumption. Hence, longer slower liquidation should be associated with stronger business cycle persistence (Olukotun, James and Olorunfemi, 2013).

In bank liquidation, everybody loses because it reflected in stock values, asset values and price increases for normal everyday items. The effect of liquidation on banking industry stability as opines by Adegboye (2012) has helped to sustain public confidence in the solvency of the bank. The level of liquid assets available to the public in assessing the ability of a banks to honour obligations enhances the depositors confidence in the banking industry, John, (2004) and Urich (2000) states that monetary authorities are generally concerned about how liquidation will help in banking industry stability. This is because excess liquidity in banking industry serve as a serious problem to monetary management and the achievement at aggreagate economic performance Ali, James and Joseph (2008) opine that inadequate liquidate leads to liquidation and cause bank instability.

The increase incidents of banks failure and the level of non-performing loan has resulted the monetary authorities to show more interest in bank liquidation on and its effect on bank stability. This is why sanusi (2011) state that liquidation is the last option and still remain last opting in ensuring banking industry stability. In the light of the above mentioned issues, this study aims at examining the effect of liquidation on the stability of the Nigeria banking industry.

The adoption of liquidation in Nigeria banking industry in terms of bank failure and non-performing loans which supposed to improve, the stability of Nigerian banking industry rather resulted to the bank failure. Some authors says that liquidation has helped to sustain public confidence in banking industry but the effect of bank failure and non-performing loans as an indicators of liquidation has not been established. The problem of bank failure on bank


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stability within the economy could be described as how will banking industry be stable and contribute to the growth of the economy. Ali (2008) opined that inadequate liquidity leads to liquidation and cause banking industry instability and the increase level of non-performing loan has resulted monetary authorities to show more interest in bank liquidation and it effect on stability. The problem here is on how to establish the link between non-performing loans and bank stability considering the statement or pronouncement by CBN that liquidation is the last option in banking industry. Stability calls for the study.

## REVIEW OF RELATED LITERATURE

### Conceptual Framework

The issue of liquidation in the Nigeria banking industry is not a recent development but a phenomenon that has existed in the industry right from the beginning of banking in Nigeria, only it has been in different forms at one time or the other (Imala, 2005).

According to the Central Bank of Nigeria Annual Report (1995), financial distress is defined as that which occurs in financial institutions which among other things:

- Fail to meet capitalization requirement;
- Have weak deposit base and
- Are afflicted by mismanagement

Therefore, there is distress in a situation, in which the bank is having operational, managerial and financial difficulties. The term ‘distressed banks’ entered into the lexicon of banking in Nigeria in the period from 1990 and 1995, though it has been in existence since early 20$^{th}$ century. The term to the general public connotes unmanageable, unviable and insolvent bank that is lending towards liquidation. In ordinary parlance, distress means ‘being in danger or difficulty and in need of help.

Prof. Charles Soludo, CBN former Governor in a report presented to the former President of Nigeria, Obasanjo on Wednesday, December 21, 2005 in Abuja. The report titled towards a New Monetary Authority and Financial System: Interim progress Report, highlighted developments in the on-going reform in the banking sub-sector of the Nigerian economy called verification and valuation, about 11 banks would be liquidated, as the first phase of the banking reforms anchors. But depositors have very little to fear, because they will be treated as king in the liquidation process.

It is widely accepted in both developed and developing world like Nigeria that bank failures have negative and positive effects of the customers of the failed bank. The customers of a failed bank lose an efficient relationship based source of funding that mitigates asymmetric information problem that are intrinsic to finance. Recent studies that analyzed liquidation reactions to bank failures have pounded evidence that bank failures adversely affect the market value of the bank’s corporate borrowers (Slovin, 1999) and (Murakain 1999, Ongena, Smith and Michalse, 2003).


ISSN 2053-5821(Print), ISSN 2053-583X(Online)

**Evolution Development of Banking Industry in Nigeria**

The financial system of any society is the framework within which capital formation takes place, whereby the savings of some members of the society are made available to other members of the society for productive investment. The process is made possible by the intermediation of financial institutions. The primary institution concerned with this function are the banks. The banking system mostly practiced in Nigeria is the branch banking system which is common in all commonwealth and European countries. Banking development can be traced back as far as 1892.

**Causes of Liquidation in Nigeria Banking Industry**.

This study opines that there are three major factors accountable for bank distress and liquidation which consequently ends up in bank failure. Each of these factors is reviewed in the following sub sections.

**Inadequacy of Capital**

C.B.N (1995) claims that banks are expected to maintain adequate capital to meet their financial obligation, operate profitably and contribute to promoting a sound financial system. It is for these reasons that the CBN prescribes minimum capital requirements. This minimum ration of capital adequacy has been increased from 6 percent in 1992 to 8 percent 1996. It is further stipulated that at least 50 percent of the component of a bank's capital shall comprise paid-up capital and reserves, while every bank shall maintain ratio of not lese that one to ten (1:10) between its adjusted capital funds and its total credit. When a bank's capital falls below the prescribed ratio, it is an indication that the bank may be heading for distress. Bank examination reports showed that a good number of banks operating in Nigeria were grossly undercapitalized.

This situation has been attributed to the low level of initial capital, the effect of inflation, the adverse operating results mainly due to their inability to make appreciable recoveries from their non-performing assets and the large portfolio of non-performing loans maintained by some banks. These factors have combined to erode the capital base of many banks. With the introduction of prudential guidelines, banks were required to suspend interest due, but unpaid, on classified assets and to make provisions for non-performing credit facilities, a good proportion of which was subject to losses. Inability to meet stipulated higher minimum capital requirements was one of the criteria used for classifying banks into either "healthy" or "unhealthy" and the latter category was barred from the foreign exchange market (Ike and Jonathan, 2014).

In describing capital inadequacy, Ogundina (1999) argues that capital in any business whether bank or company serves as a mean by which losses may be absorbed. It provides a cushion to withstand abnormal losses not covered by current earnings pattern. Unfortunately, a good number of banks are grossly undercapitalized. This situation could partly be attributed to the fact that many of the banks were established with very little capital. This problem of inadequate capital has been further worsened by the huge amount of non-performing loans which have eroded the capital base of some of these banks. Available statistics on banks' capitalization reveal that as at the end of 1992, 120 Operating banks in the country required the aggregate additional capital to the tune of N5.6 billion to meet the statutory minimum capital funds set by bank regulators for 1992.



ISSN 2053-5821(Print), ISSN 2053-583X(Online)

Ogubunka (2003) contends that when a bank is undercapitalized, it ought not to continue with its magnitude of operations prior to the depletion of capital. If it does without the introduction of increased capital, distress could ensue many banks that became distressed were affected by inadequacy of capital. Consequently, they could not sustain their operations, first, as a result of overtrading and second, due to their inability to absorb losses arising from costs of operations. A function of capital in a bank is to serve as a mean by which losses can be absolved. Capital provides a cushion to withstand abnormal losses not covered by current earnings, enabling banks to regain equilibrium and to re-establish a normal earnings pattern. The need for adequate capital largely informed the decision of the regulatory authorities to raise the minimum equity share capital of banks over the years. As a 2002, the minimum paid-up equity share capital is 2 billion for a new bank to be licensed and the existing universal banks had the deadline of December, 31 2002 to beef up their paid up equity share capital to 1 billion. This problem of inadequate capital has been further accentuated by the huge amount of non-performing loans which has eroded some banks' capital base. It has even been discovered that many of the closed banks in Nigeria started with fictitious capital through the use of commercial paper. Such debt instruments were paid back soon after commencement of business with deposits. Many of such so called bank owners contributed nothing to own a bank, yet they use the means to amass wealth and ruin the bank at the end of the day (Ike and Jonathan, 2014).

Imala (2004) opines that banks are expected to maintain adequate capital to absorb operational shocks or unexpected losses, support their level of operation, operate profitably and consequently contribute towards promoting a sound financial system. It is these reason that the CBN. Periodically prescribes minimum capital requirements in the form of minimum paid-up and the capital to risk weighted asset ratio.

The minimum capital adequacy ratio requirement has remained at the international standard of 8% and this was expected to become 10% from January 2004. Inability to meet the minimum capital requirement was one of the criteria used for classifying banks as unhealthy one.

**Lack of Disclosure and Transparency**

Sanusi (2002) posits that disclosure and transparency are key pillars of a corporate government frame work, because they provide all the stakeholders with the information necessary to judge whether or not their interest are being served. He sees transparency and disclosure as an important adjunct to the supervisory process as they facility banking sector market discipline. For transparency to be meaningfully, information should be accessible, timely, relevant and qualitative.

According to Anameje (2007), transparency and disclosure of information are key attributes of good corporate governance which banks must culture with new zeal so as to provide stakeholders with the necessary information to judge whether their interest are being taken care of Sanusi (2003) opines that lack of transparency undermines the ethics of good corporate Governance and the prospect for effective contingency PKN for managing systemic distress.

Anya (2003) obscured the way many financial and economic activities are conducted and has contributed to the alarming proportion of economic/financial crimes in the financial. Industry. 'Trust' and the fiduciary principle, which was the cornerstone of banking , has been


ISSN 2053-5821(Print), ISSN 2053-583X(Online)

completely jettisoned as bank now engage in all forms of sharp practices. Some of these share practices involve the deliberate manipulation or distortion of records to affairs.

These records which form the bedrock of supervisory oversight by the regulatory authorities in monitoring the soundness of the system has thus been undermined. Such distortions therefore, would necessarily result in wrong information being sent to the regulatory authorities, which should have been in a position to take adequate measures to prevent further deterioration of the bank's position. The regulatory authorities are thus handicapped by such concealment until the bank hit the irreversible point of total collapse. Thus lack of transparency has been identified as one of the most catastrophic modern societal problems plaguing banks today (Ike and Jonathan, 2014).

Imala (2004) contends that the issue of transparency has to be taken seriously in the new dispensation. Transparency has been a recurring problem in the financial industry in Nigeria, and unless improved upon, has the potential of making nonsense of the efforts of the supervisors in implanting the new Accord. It is hope that the Bankers committee's efforts, through its ethics and professionalism subcommittee and the new code of corporate governance, would greatly assist in laying a solid foundation for transparency in the industry, being one of the pillars of the new capital Accord. The evolutionary nature of the new accord increasingly cedes more responsibilities in the measurement of capital adequacy to the operations. Consequently, a bank has to convince the supervisor of improvement techniques in order to rise to a higher level in the evolutionary ladder. With the present situation in the banking industry, many banks may remain at the lowest rung of the ladder of sophistication in the capital measurement approach.

**Non-Performing Loans**

A major revelation showed that many owners and owners and defectors abused or misused their privileged position or breached their fiduciary duties by engaging in self-serving activities the abuses included granting of unsecured credit facilities to owners, directors and related companies which in some case were in excess of their banks' statutory lending limits in violation of the provisions of the law (Oluyemi, 2005). A critical review of the nation's banking system over the years has shown that one of the problems confronting the sector had been that of poor corporate government. From the closing reports of banks liquidated between 1994 and 2002, there were evidences that clearly established that poor corporate governance led to their failures (Ayodele, 2015).

Ogundina (1999) observes that the Nigerian Financial system over the years has been under severe stress as a result of large amounts of non-performing loans. The classified loans and advances of the whole banking industry in 1990 amounted to ₦ 11.9 Billion, representing 44.1 percent of the total loans and advances. The problem of bad debts is usually exacerbated by the negligence on the part of the lending officers. Some of these loans were not granted without regard to the basic tenets of lending, nor do they comply with any ration lending criteria. This makes it extremely difficult or impossible to recover a substantial part of the loans. Also the devaluation of the naira in the wake of structural Adjustment programme has its toll on the ability of borrowers to repay. A devaluation by more than 600 percent since the introduction of SAP shore up foreign manufacturing input prices, leading to greater domestic capacity underutilization and reduced inability of business borrowers to repay their bank loans and advances.


ISSN 2053-5821(Print), ISSN 2053-583X(Online)

According to CBN (1997 several of the distressed banks suffer from poor asset and liability management. The portfolios of assets of the majority of these banks were concentrated on loans and advances that became non-performing. Other assets such as treasury securities, investments and cash accounted for a small proportion of their asset portfolio furthermore; Marchant banks that were expected to source medium to long-term funds relied mainly on short-term deposits whose tenor ranged between call/overnight funds to 3months. These funds were obtained at excessively high rates of interest. In some cases, some banks and finance houses borrowed short and lent long, resulting in mismatch of assets and liabilities. The deterioration in asset quality was not provided for through adequate loan –loss provisions. This situation increased the vulnerability of the banks to external shocks. The profile of poor asset and liability management exposed the banks to liquidity risk which weakened the confidence that the public had in the banking sector.

**Empirical Review**

Babalola (2011) conducted a study on Bank failure in Nigeria consequence of capital inadequacy, lack of transparency and non- performing loans. Simple percentages were used to described the data presented and the study identified capital inadequacy, lack of transparency and huge non-performing loans as major causes of bank failure in Nigeria. And further recommended that full disclosure of all financial transaction and the separation of the post of the chairman from that of the managing director for all the banks.

Mayuku, Ogude, Ibeh and Ohwofasa (2012), on their research work on an appraisal of the impact of Bank distress on Nigerian Economy, I986-2010. An Empirical investigation of two linear regression models was used to analysis the research variable and founds out that inflation rate, exchange rate, broad money supply and corruption in the banking industry were potent sources of bank distress in Nigeria and as well growth for the Nigerian economy the various macroeconomic variables that constituted impediments to growth should be well managed while corruption at all levels in the industry must be dealt with.

Sani (2010), on his paper work on liquidation in the Nigerian banking industry: A critical assessment of its nature causes and extent, Data for the study was drawn from both primary and secondary source. The questionnaire instrument was used in collecting data for the study. The data generated was analyzed using simple descriptive statistics (frequency analysis) and percentage. The study confirmed the presence of distress in the banking industry as sign of insolvent which brings about liquidation of banks, but generalized that the distress could not be describe as systematic since a good number of banks remain health to which many customers flown for safety. On the whole, 80.9% of the banks are believed to be healthy, 11.1% believed to be mildly distressed and 8.09% confirmed to be severely distressed, the study further recommended that central bank should always carry out their regulatory exercise properly in order to maintain a healthy situation in the banking industry.

Olukotun, James and Olorunfemi (2013) in a study of Bank Distress in Nigeria and its relation on the Nigerian Deposit Insurance Corporation Intervention using correlation coefficient and r-test as methodology. It was discovered that due to the increase in deposit guarantee, there is an increase in deposit mobilization. It was also discovered that the NDIC has transmitted from the flat rate premium assessment system to a differential premium assessment system. It is therefore recommended that from time to time, the deposit cover should be reviewed in conformity with the happenings in the economy.


ISSN 2053-5821(Print), ISSN 2053-583X(Online)

Ike and Jonathan (2014) in a study of the impact of bank liquidation on the Nigerian Society using descriptive survey. It was discovered that the gains of the Nigerian banks consolidation have gone beyond the traditional mobilization of funds for investment to employment generation, stability of the micro/macro business environment and grass root re-orientation on investment culture of the Nigerian society.

Ayodele (2015) used descriptive survey to study the emerging structure of Nigerian Banking Industry from 2007 to date. The study found that the structure of Nigerian Banking industry stability is the way in which the parts of banking industry are been connected together, arranged or organized so that the goal of the establishment will be attained. This is because the aim of arrangement of the banking industry is to ensure stability and quality services providing in the banking industry of the country so as to meet up with the vision 2020.

## METHODOLOGY

### Research Design

The study of the effect of liquidation on the stability of the banking industry is an empirical work, we will adopt quantitative research design while regression technique will be used for analysis. Research design is a systematic process of collecting, presenting, analysing and interpreting data for the purpose of arriving at dependable Solutions to human problems. This study will exclusively use secondary sources of data. We will generate time series date on the effect of liquidation on stability of Nigerian bank from Central Bank of Nigeria Publications, Nigeria stock Exchange Fact Book, etc.

### Model Specification.

To determine the relationship between dependent and independent variable in this study, the research adopted quantitative, research design and employ regression analysis in analyzing data generated in other to test hypotheses stated in chapter one above. The aim of this regression mother is to regress the nature or level of impact of independent variables on dependent variables.

**Model specified was modified and stated as follows.**

Y=b0+b,x,+b2x,+N…(1)

And the equation for the computation of the estimate area are as follows:

Bs=F (NPL,BF)

Where

Bs=Bank stability

NPL = Non-performing Loan

Bf = Bank failure


ISSN 2053-5821(Print), ISSN 2053-583X(Online)

## RESULT AND ANALYSIS

### Descriptive Results.

In this chapter, we focus on the analysis of the time series characteristics of the chosen data during the period 2003- 2014. We had undertaken some test with statistical tool like special package for social sciences regression on the variables or our model to determine the effect of liquidation on banking industry stability in Nigeria.

**Table 1: Pearson Moment Correlation Matrix**

| Variable | $A_1$ | $A_2$ | $B_1$ |
|---|---|---|---|
| **$A_1$** | 1 | 0.995* | 0.985* |
| **$A_2$** | 0.985* | 0.999* | 0.978* |
| **$B_1$** | 0.975* | 0.969* | 0.988* |

*Sources: SPSS 15.0*

* Correlation is significant at the 0.05 level

Table 2 above explains the correlation coefficients between the dependent variable and the independent variables. The correlation coefficients above do not only show strong positive relationships but are also significantly high. Here the highest coefficient being that of bank failure ($A_1$) which is 1 at 0.05 level of significant. The lowest relationship is that of non performing loan ($A_2$) which is 0.985 at 0.05 level of significant.

Table 1 above also shows the analysis of the relationships among the dependent and independent variables. Both the independent and the dependent variables showed strong positive relationship in both short and long run.

For the dependent variable, the correlation coefficient (r) between $B_1$ and $A_1$ is 0.985 at 0.05 level of significant. With these high levels of cross sectional relationships that exist among the variables, there is consistency and stability among the variables used in this study.

**Table 2: Transformed Person Correlation Coefficient (r) between bank failure ($A_1$) and bank stability ($B_1$).**

| R $A_1B_1$ | $R^2$ $A_1B_1$ | Tr $A_1B_1$ |
|---|---|---|
| 0.989 | 0.988 | 18.25 |

SPSS 15.0

Correlation is significant at the 0.05 level.

Based on the table 2 above, the transformed correlation coefficient (tr) calculated value is 18.25, while the tabulated value of tr at 0.05 level of significance and 9 degree of freedom (df) is 1.514.

Decision: From the tables above, the t-calculated values of 18.25 is greater than the t-tabulated value of 1.514. The null hypothesis is rejected while the alternative hypothesis is accepted. It is therefore concluded that there is significant long run relationship between bank failure and bank stability in Nigerian banking industry. The result shows that the regime of high bank failure counteracts the stability of Nigerian banking industry.



ISSN 2053-5821(Print), ISSN 2053-583X(Online)

**Table 4: Transformed Pearson Correlation Coefficient (tr) between non-performing loan ($A_2$) and bank stability $B_1$.**

| R $A_2B_1$ | $r^2$ $A_2B_1$ | tr $A_2B_1$ |
|---|---|---|
| 0.999 | 0.969 | 7.145 |

*Source: SPSS 15.0*

Correlation is significance at 0.05

From the table above, the t-calculated value is 7.145, while the t-tabulated value at 0.05 level of significance and 9 degree of freedom is 1.514.

Decision rule: From table above, the t-calculated values of is greater than the t-tabulated values at 0.05 level of significance and 9 degree of freedom. Based on this, the null hypothesis is rejected while the alternative hypothesis is accepted with a conclusion that there is significant relationship between non performing loan and stability of Nigerian banking industry. It also shows that proper management of non-performing loan is necessary for the stability of Nigerian banking industry.

From the above, it appears that banking crisis may have caused several macroeconomic consequences in Nigeria and the framework for demonstrating that consequence in the real sector of economy through bank industry stability has proven abortive. Hence, the issue of how banking failure and the level of non-performing loan linked to liquidation is of a great concern in Nigerian banking industry stability. This is shown as the two independent variables shows positive with bank stability.

## CONCLUSION AND RECOMMENDATIONS

### Conclusion

This study contributes to the literature on the impact of liquidation on the stability of Nigerian banking industry by using ordinary least square estimate. This study set two objectives and actually achieved them. From the research findings, the study concludes that there is long run relationship between bank failure and bank stability in Nigeria and that there is significant positive relationship between non-performing loan and bank stability.

From the test of the hypothesis, it was derived that our null hypothesis were not true and therefore rejected while the alternatives were accepted. The key problem set to be address on this study is to ascertain the impact of liquidation on the stability of Nigerian banking industry. From the research findings, the results obtained from this study support both theoretical and empirical evidence that liquidation has impacted positively on the stability of Nigerian banking industry.

### Recommendations

From the finding of this study, the following recommendations were made:


ISSN 2053-5821(Print), ISSN 2053-583X(Online)

1. There is an urgent need for effective monitoring of the level of bank failure in Nigeria to allow for acceleration of banking industry stability. This is necessary for its positive effect on the bank stability.
2. This study also recommends that the monetary policies aimed at reduction of non-performing loan be strengthened through effective supervision and regulatory framework of financial system by the monetary authorities. Hence, continuous monetary policies that will achieve the desire macroeconomic stability in banking industry, increase private sector credits and investments to boost economic growth in Nigeria.
3. Finally, there is need for further management of liquidation in Nigeria banking industry because the more liquidation management, the more the level of banking industry stability in Nigeria.

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