

Role of Bank Capitalisation in Economic Expansion. Opportunities for You as An Investor

Nigeria's economic growth story is built on a strong foundation – well-capitalised banks. These banks act like well-stocked irrigation systems, channeling essential funds towards critical sectors and ensuring the economy flourishes.

Strong capital reserves empower banks to lend with confidence, directing those funds like life-giving water to propel growth.

This becomes especially clear when looking at the staggering growth of electronic transactions in Nigeria, reaching a massive **N600 trillion in 2023** (a 55% increase year-over-year according to NIBSS data).

Banks act as intermediaries, bridging the gap between savers and borrowers. providing liquidity, facilitating payments, and supporting investment and growth. This is evident in the Central Bank of Nigeria (CBN) records which show that banks extended a total credit of N44.54 trillion in 2023.

Why Bank Capital Matters for Financial Stability



Banks are like a bridge, connecting lenders (depositors) with borrowers. Strong, well-maintained pillars are crucial for a safe passage. In the world of banking, these pillars are bank capital.

Bank capital refers to the financial resources a bank sets aside to act as a buffer against potential losses and to support its day-to-day operations. Imagine it as a safety net. It is comprised of several key components:

- **Common Equity:** This is the money that shareholders have invested directly in the bank. It represents the ownership stake in the bank and is the first line of defence if losses occur. Think of it as the foundation of the bank's financial strength.
- **Retained Earnings:** This is the profit a bank has earned and decided to keep rather than paying out as dividends to shareholders. These retained earnings are like accumulated savings, growing the bank's financial reserves over time.
- **Certain Types of Loans:** While most loans are considered liabilities for a bank (money owed to depositors), some specific types of loans, particularly those that can be converted into equity if necessary, can contribute to a bank's capital. These act as a secondary line of defence if the primary capital is depleted.

In essence, higher capital levels make banks more resistant to financial challenges, enabling them lend more confidently and potentially offer better loan terms.

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How is Bank Capital Categorised?



The **Basel III framework** categorizes bank capital into tiers based on their loss-absorbing capacity:

- **Tier 1 capital** - a bank's core capital, which consists of shareholders' equity and retained earnings; it is of the highest quality and can be liquidated quickly.
- **Tier 2 capital** - supplementary capital, i.e., less reliable than tier 1 capital. A bank's total capital is calculated as a sum of its tier 1 and tier 2 capital.

Leading banks go beyond minimum regulatory requirements, assessing their specific capital needs based on their risk profiles.

This proactive approach ensures they have enough resources to navigate market fluctuations and challenges, contributing to a more stable financial system.

Why is Bank Capital Important?



Strong bank capital is crucial for several reasons:

- **Absorbs Losses:** If a borrower defaults on a loan or the bank experiences unexpected losses due to economic downturns or market fluctuations, the bank can use its capital to absorb these losses without impacting depositors' funds.

- **Maintains Confidence:** Adequate capital reserves project stability and inspire confidence in depositors and investors. This allows the bank to operate smoothly and continue attracting new business.
- **Supports Lending Activity:** Banks with strong capital can lend more confidently. They have the resources to back new loans, which fuels economic growth by providing businesses and individuals with the capital they need to invest and grow.

Bank Capitalisation and its Effect



Recognising the importance of well-capitalised banks for Nigeria's economic growth, the CBN launched the **Banking Sector Recapitalisation Programme 2024**.

This initiative requires banks to increase their minimum paid-in common equity capital according to their licence category:

- Commercial Banks with international authorisation: ₦500 billion.
- Commercial Banks with national and regional authorisation: ₦200 billion and ₦50 billion, respectively.
- Merchant Banks and Non-Interest Banks: ₦50 billion and ₦10 billion, respectively.

These requirements were set after reviewing banks' risk profiles, global and domestic challenges, as well as the results of stress tests. The program aims to create stronger, more resilient banks that can support Nigeria's goal of a US\$1 trillion economy by 2030.

Historically, the **2005 consolidation of the Nigerian Banking sector**, which required banks to raise their capital base to ₦25 billion, led to significant restructuring, including mergers and acquisitions.

Importantly, metrics like domestic sector lending to the private sector increased as a percentage of gross domestic product (GDP) from 8.1% in 2006 to 19.6% in 2009 (World Bank data).

In 2005, banks' new issues were worth ₦517.6 billion, representing about 75% of the total new issues value of ₦692.86 billion in the capital market (Al Faki M, 2006; NSE data). There was increased availability of funds for SMEs, with banks getting the opportunity to explore expansion to other regional and international markets. The recapitalisation efforts also attracted \$652 million in foreign direct investment in 2005.

Global Comparisons: Learning from Peers



Nigeria's focus on bank recapitalisation is well-founded, drawing insights from **India's public sector bank recapitalisation**.

A 2022 study highlighted the positive impacts of the Indian government's recapitalisation efforts in 2016 and 2017, which injected INR 2,33,915 crore into public sector banks. The results included:

- Reduced Non-Performing Assets (NPAs), indicating better management of bad loans.
- Improved Return on Assets (ROA), reflecting more efficient use of resources.

- Enhanced investor confidence and a stronger economic environment.

India's experience underscores the potential benefits of bank recapitalisation, leading to a more robust banking system and contributing to economic growth.

In a 2022 article, **Science Direct writes**: "We find strong evidence in favour of both the financial stability and bank lending channels. When banks hold more capital, financial stability improves, and this is followed by higher levels of economic growth. Lending also increases when banks expand their capital base, similarly raising real GDP growth."

How are Banks likely to raise Capital?



Banks can raise capital through various methods:

- **Issuance of new shares:** Public offers, rights issues, or private placements. The 2005 consolidation saw Nigerian banks raise capital through new share issuances.
- **Mergers and Acquisitions (M&A):** Combining resources to improve efficiency and expand market reach.
- **Divestitures:** Selling non-core assets, and focusing on core banking activities to raise capital.

Sources of capital include:

- **Domestic Investors:** Local institutional investors, like pension funds, can provide significant capital.

- **Foreign Investors:** Foreign portfolio investors play a major role.
- **Eurobond Issuances:** Increasingly used by Nigerian issuers to raise capital.
- **Digital Issuances:** Leveraging digital platforms to attract retail investors, including Millennials and Gen Z.

Coronation Securities' Perspective



Coronation Securities views the recapitalisation initiative as a timely boost for economic growth. Adequately capitalised banks can undertake larger transactions, enhancing the resilience of the banking sector and the broader economy.

With **Coronation Wealth**, investors gain access to a diverse range of investment options, including the companies ability to purchase shares in undertaking **rights issues** or platform serves as a gateway for retail investors to engage in the capital market, providing them with the tools, resources, and support needed to make an informed investment decisions.

Download the Coronation Wealth App to Start Investing Today

Advice for Successful Investors



To benefit from the bank recapitalisation policy, HNI (and Ultra HNI) investors should consider:

- **Diversification:** Include shares of well-capitalised banks and related sectors like real estate and infrastructure.
- **Long-term investment:** View investments in the banking sector as long-term opportunities.
- **Monitor regulatory developments:** Stay informed about regulatory changes and economic policies.

By following these strategies, investors can leverage potential benefits of the recapitalization policy and contribute to Nigeria's economic growth.

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