

UNDERSTANDING THE A.B.C. OF THE FINANCIAL SYSTEM

**BY
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INTRODUCTION

Mr. Vice-Chancellor, Sir, my special study area of interest is financial economics. I developed interest in financial economics because of the way my course lecturer, Prof. Ibi Ajayi conducted his lectures. I was also greatly inspired by Prof. Emma Edozien. These lecturers did not know me personally until after the degree result.

When I graduated, I was deployed to the present Ondo state then Oyo state for the national youth service corps programme. As I was about settling down at Odeirele for my primary assignment, I received a letter from the department informing me of an award of a Rockefeller scholarship as one of the best graduating students for that year to do an M.Sc. degree. I was consequently recalled from N.Y.S.C. to do a two year M.Sc. degree programme in economics.

I was very happy but needed to have the consent and blessing of my parents who were expecting me to help shoulder some of the financial burden of the family. There were my other six brothers and six sisters one of who was already in the university and the rest in

secondary and primary schools. Unfortunately or fortunately, I happen to be the first surviving child of my father who had had other children before me. Unexpectedly, my parents were happy for the scholarship and encouraged me to take it up. My two-year stay at Ibadan for the M.Sc degree was not interesting at all despite the unreserved effort I put in. But for God's timely intervention I would have abandoned the programme.

I joined the University of Nigeria on October 4th 1976. In 1981 I was awarded another scholarship- The Commonwealth Academic Scholarship to undertake M.Sc/Ph.D degree in Financial Economics. This was tenable at the University of Wales. I did not like the 'M.Sc' attached to the 'Ph.D' particularly when I learnt that my proceeding to the Ph.D programme depended on my successful completion of the M.Sc degree. Besides I already had an M.Sc degree. I was not very keen taking the offer because I would not like a repeat of the Ibadan experience. But the then Dean of the Social Sciences Professor Ogbu Kalu encouraged me to proceed to Wales. I left and it was good.

In Wales I met a very wonderful hardworking man, Professor J.R.S Revell (May his soul rest in peace). Prof. Jack Revell was the director of the Institute of European Finance attached to the School of Accounting, Banking and Economics (SABE) and also

the head of the school. He became my supervisor and rekindled my interest in Banking and Finance.

When the M.Sc. course work examinations result was released my name was not in the list of successful candidates. Mr. Vice-Chancellor, Sir, the way I felt that day and what went in my mind could only be imagined. The next morning, however, I was relieved of the burden and confusion in my mind when I got a letter from the school congratulating me for my performance in the examinations and I was asked to proceed to the Ph.D. programme. I was given a date for the presentation of my Ph.D proposal. My Ph.D programme was indeed more exciting, enjoyable and easier than my M.Sc programme.

Mr. Vice- Chancellor, Sir, the topic of my lecture is '*Understanding the A B C of the Financial System*'

The Structure of a Financial System

What is a financial system? A financial system no matter how rudimentary is a complex system. It is complex in its operation neither the system itself nor its operation can be measured accurately. Because of its complexity a simple definition can not adequately capture what a financial system is. A financial system comprises financial institutions, financial markets, financial instruments, rules, conventions, and norms that facilitate the flow of funds and other financial services within and outside the national economy.

The Committee set up by the Federal Government of Nigeria in 1976 to review the Nigerian financial system defined the financial system as ‘the congeries of financial institutions and arrangements which serve the needs of the economy. The service is rendered through

- (a). the provision of financial resources to meet the borrowing needs of individuals and households, enterprises and governments;
- (b). the provision of facilities to collect and invest savings fund, and;
- (c) the provision of a sound payment mechanism’

Financial system includes the ‘environment of rules and regulations governing the interaction of the different categories of the institutions among themselves and with others’ Okigbo(1981).

It is clear from these definitions that a financial system embraces more than the institutions and markets that operate in the financial sector. As Revell (1973), argues financial institutions and financial markets ‘are not the whole of financial system, and they are not even an essential feature of any financial system. He further contends that ‘ the essential feature of any financial system consists of a number of financial inter-relationships between the persons and bodies that make up an economy, and the basic structure of a financial system has three features:

1. the extent of these inter-relationships;
2. the forms of the financial claims in which the inter-relationships are expressed; and
3. the pattern of relationships between persons and bodies of different kinds, between independent 'economic units'

In summary, therefore, a financial system is a web of organized and regulated financial interrelationship among financial institutions of various kinds and between and among the various economic units and persons and bodies, namely households(consumers /savers), businesses (producers/borrowers), governments (regulators, producers, lenders, borrowers), and external bodies and persons that make up an economy. These relationships are expressed by the menu of financial claims available to the system. The financial institutions and economic units and bodies interact in the different financial markets where financial instruments are sold and bought thereby creating a web of assets and liabilities, shares and debts.

A financial system is a super structure erected on the basis of the wealth of an economic system. Goldsmith (1969) refers to this as the relationship between the super structure (a set of financial institutions, intermediaries and instruments) and financial infrastructure (real wealth or national income). This

ratio is known as financial inter-relation's ratio (FIR). The ratio differs markedly between countries, even between highly developed countries with sophisticated financial systems. Under normal circumstances a high ratio should signify financial development. However, a number of factors affect this ratio and it is only when we understand these factors that one appreciates its interpretation. The factors include

- The extent of dependency on 'external finance'. The greater the extent to which independent economic unit depend on funds from outside to finance their capital formation the larger the claims issued hence the increase in the numerator of the ratio, therefore the value of the ratio will increase. Conversely the greater the reliance of the economic units on their own internal savings, the smaller the volume of claims issued. This implies a decline in the value of the numerator of the ratio and consequently a fall in the value of the ratio.
- Involvement of the financial institution in transactions. The more the financial institutions are involved in economic transactions in the system the more claims are issued hence the increase in the ratio. If greater economic activities take place without financial intermediaries, less financial claims will be issued thereby reducing the value FIR.

- Effect of inflation. The values of some financial claims rise with inflation. For instance, ordinary shares have values which rise with inflation. In such cases the value of FIR will be high because the numerator of the ratio will be high. The value of some other claims tends to decline with inflation. For instance the value of bonds falls with inflation. In such cases the value of FIR will decline. Generally however the value of physical assets fully reflects the general price level.

The Development of A Financial System

We have tried to explain the structure of a well developed financial system. It is necessary to state that it is not possible to have a well developed financial system in a less developed economy. Generally, a financial system cannot develop more than the economy in which it serves. In order to appreciate the significance of the various elements in the financial structure – the financial inter-relationships between economic units, the types of financial claims, the markets in which the claims are traded and the financial institutions- we can approach the question of financial structure historically to show the various stages of development through which the complex financial system has passed. We recall that the economy can be grouped into two viz, the Surplus Spending Units (SSU) and the Deficit Spending Units

(DSU). The SSU are those whose current incomes exceed their current expenditures. These are usually the individual households and governments. The DSU, on the other hand, are those who spend more than their current income. These are usually businesses and governments.

We shall distinguish four main stages of development of a financial system. The process of development is, of course, discussed in a highly schematic way. No financial system has ever gone through the four stages exactly in the order postulated. Some times the stages overlap; some times the system doubles back on itself for a while and some times stages are missed out.

The first stage started with the demise of the barter system and the introduction of commodity money whether in the form of silver, gold or copper, or in the form such as cowries, shells or animal skins or grains. With the use of commodity money it was possible to separate the acts of sale and purchase. In this rudimentary financial system borrowing was not possible except in kind. Expenditure by any economic unit was limited to the share of income accruing to it. However, economic units could save and therefore expenditure of the economic units could exceed its current income if it had accumulated savings in the past. The other alternative was for an economic unit such as business firms to sell one form of physical asset in order to purchase another form of physical

asset. Consequently, in such a financial system deficit financing is severely restricted and therefore economic development is restricted.

Man in his desire to improve his environment devised various expedients to overcome the constraints of the first stage. There was the need to accumulate savings. Business units formed partnerships in order to pool accumulated savings. However, it was the governments which led the way most often. Taxation was perhaps the most primitive form of accumulation, but government devised various other means of obtaining their share of accruing income. The issue of legal tender money (fiat money) was such a device because it could be obtained only by surrendering commodity money. Lotteries either organized directly by government or by private individuals under government licence, served the same purpose as long as the total price money was less than the total of contributions.

The third stage emerged with a clear separation of sales and purchases, saving and borrowing. With this development deficit financing became possible. Economic units were no longer limited in their expenditure by the amount of income accruing to them. Deficit units issued interest-bearing financial claims direct to surplus spending units in the form of bonds, loans and mortgages, thus creating financial instruments. The financial claims are known as

primary securities. Those economic units which have a desire to run business risk for profit were able to have under their control physical assets to a greater total value than their networth. Surplus economic units were able to hold wealth in a form that was far less risky than the ownership of physical assets, although it was less liquid than money balances.

Furthermore, the development of borrowing in this stage separated the decision to save and invest thus creating both portfolio preference gap and a financial preference gap between the savers and the investors. Thus the mechanism to bridge the gaps became essential. The mechanism to bridge the financial preference gap can take two forms. First, the creation of financial liabilities on primary securities whereby funds of the surplus economic units are transferred to deficit economic units. This is the direct channeling of funds from savers to borrowers. The second is the issue of indirect financial claims consisting of the liabilities of the financial system (e.g. demand and savings deposits via financial intermediaries from where funds of the savers are made available to those wishing to spend real capital investment.

It is noteworthy that for a variety of reasons such as the risk of default, risk of capital loss, risk of loss of value due to inflation and risk of liquidity, the first method had declined in importance. Furthermore, the availability of wide menu of portfolio choice of

instruments to the public has made the method less attractive. Besides, while borrowers tend to be few and often need large sums of money in one single arrangement savers tend to be many and in most cases making available small amounts of funds individually. The portfolio preference gap exists because the savers want to hold a large portfolio of their financial assets in a form that ensures liquidity and reasonable yield. The borrowers on the other hand want to make use of the funds for a relatively long period of time. A financial system ensures that the asset preferences of the savers can be appropriately matched with the types of liabilities that those with deficits are able and willing to incur “partly through changes in the relative interest rate and security prices and partly through the operations of the entire system” (Mullei and Ng’elu 1990).

With the issue of primary securities came the development of *markets*, where these securities or claims could be traded after they have been issued. Once again it was the governments which led the way. They were often the first to issue primary claims and their claims were often the first to have organized markets. Such a development greatly enhanced the desirability of primary securities to surplus units because it increased the liquidity of the claims. Left to them surplus units would generally like to hold a large proportion of short-term claims in their portfolio of assets because they are not certain when they would

have need of money balances. The development of these markets encouraged the surplus units to lend long thereby satisfying the asset portfolio preferences of the deficit units. The surplus units could turn these long-term securities into money balances at any time by selling them in the market to other surplus units.

The next stage of financial system's development was when the administration of business could be divorced from their ownership through the development of *equity securities*. Surplus units could obtain title to a share of the profits of a business without having the trouble of managing it. By the device of incorporation of the business, the shareholders became owner of the business with their liabilities limited to the amount of money which they subscribed. Because of limited liability, equity claims were considerably less risky than direct ownership of business; and the risk to surplus units could be still further reduced by holding a portfolio of equity claims in several different companies. To meet the divergent asset portfolio needs of the surplus units (for liquidity, less risky and more convenience) and the deficit units (for longer period and more convenience) there was the need for specialized bodies which issued relatively risk-free, convenient and liquid claims to surplus units and acquire primary securities from deficit units. The specialized bodies are financial institutions or *financial intermediaries* as it is more appropriately to call them

in this context. The securities which they issue are termed *indirect claims or secondary claims*

Financial intermediaries can be split into two groups: monetary and non-monetary. Monetary financial intermediaries issue claims which are generally acceptable as money; they are banks and they issue bank notes and deposits. In most financial systems they are the first to develop, and they often, in fact, become important even before primary securities were issued. There is no loss of liquidity in holding the claims that they issue once these claims have become generally acceptable as a complete substitute for commodity or legal-tender money. The non-monetary intermediaries consist of savings banks and mortgage banks. These concentrate on providing close substitutes for bank money in the form of deposits withdrawable on demand or short notice at their face value. The other financial institutions that issue claims which suited the convenience of surplus units in other ways (giving them shares in a large diversified portfolio of primary claims) are investment trust companies and unit trusts or providing income or capital on retirement are insurance companies and pension funds.

From the forgoing we can see that the participants in the financial system can be classified into five broad groups: savers, investors, and other borrowers, financial intermediaries, brokers and advisers and regulators. At one edge of the financial system are savers; opposite them are the investors who want to

borrow money in order to buy capital goods or increase the scale of their business and other borrowers who want to spend more than their incomes. In between are the financial institutions and markets to facilitate the flow of money through instruments to the savers and borrowers.

At every stage, the system will develop its rules and norms to regulate the flow of funds, the interaction and interrelationship among the various participants in the market.

Financial System and the Economy

The importance of the financial system as a catalyst in economic development is widely recognized by both monetary and development economists. In fact the need to develop domestic financial system and patterns of behaviour necessary to generate and mobilize scarce capital funds as a key condition to economic growth and development originated in the classic work of Schumpeter(1934). Since then such great interest has been aroused among students that the role of financial system in the economic development of African countries has come under increasing scrutiny by students (see Abdi (1977), Agu (1984), Akinboade (1998), Odhiambo (2004)).

A financial system engages in the creation of the types of assets that both the banking and non-banking public

wish to hold from the kind of financial liabilities that debtors are willing to incur. Consequently, if well adapted and efficient, a country's financial system can play an important role in an economy's development. It can facilitate capital accumulation by acting as an intermediary between borrowers and lenders; it can transform the size maturity and risk characteristics of assets, thus enhancing the willingness of savers with short-term perspective to buy long-term assets. In other words, any variations in the composition and size of financial system's assets and liabilities, as well as changes in the manner in which it offers service will induce other sectors not only to alter their portfolio allocation decisions but also to change their decisions to save and invest. While enhancing economic growth and development, the financial system, a complex market for financial assets, liabilities and services, is distinctive in the way its markets, prices, institutions and policies affect other sectors of the economy (Mullei and Ng'elu 1990).

The crucial role of a financial system in economic development of countries has been well established. The controversy that has since not settled is the relationship between financial development and economic development that is the Patrick's (1966) "supply-leading versus demand-following hypothesis". A number of empirical works has been done on this hypothesis. Three groups exist in the literature. First, is the group that argues that financial development leads

to economic development (supply – leading). The second group opines that economic development leads to the development of the financial sector (demand following). The third group however contends that both financial development and economic development granger cause one another. This implies that the causal relationship is bi-directional. Works that support supply-leading hypothesis include Adewunmi (1981), Agu (1984) for Nigeria, Choe and Moosa (1999) for Korea and Crichton and De silva, for Trinidad and Tobago. One recent study which contends for demand following hypothesis was done by Odhiambo (2004) for South Africa. In view of the recent reforms and development in the financial system in Nigeria we carried out further study and found out that the choice of financial deepening variables has great influence on causality outcome (see Agu and Chukwu 2008).

The Structure of the Nigerian Financial System

The Nigerian financial system consists of banks and non-bank financial institutions which are regulated by the central bank of Nigeria (CBN) and the Federal Ministry of Finance, Nigeria deposit insurance corporation (NDIC), securities and exchange commission (SEC), the national insurance commission (NIC), and the federal mortgage bank of Nigeria (FMBN)

Generally, the Nigerian financial system has undergone remarkable changes in terms of ownership, structure of its institutions, the menu of instruments traded, and the regulatory framework within which the system operates. The deregulation introduced in 1978 under the structural adjustment programme provided powerful incentives for the expansion of both the bank and the non-bank financial institutions of all sizes, structure and complexity. For instance, the number of commercial banks rose from 41 in 1986 to 115 in 1996, and the branches rose also sharply from 1367 in 1986 to 2551 in 1996 (CBN, 1997). By December, 2003 the number of branches was 3247. In addition, 401 community banks 145 mortgage institutions and 618 finance houses were established within this period (CBN, 1997).

With the increase in the number of financial institutions in the system one would have assumed that the concentration level would have decreased thereby increasing both the actual and potential competition in the relevant banking markets as well as enhancing the benefit to consumers in the form of gains in convenience and needs. Unfortunately, despite the growth in the number of financial institutions the financial system remained highly concentrated. For instance, as observed by Soludo (2004), commercial banking sector is 'rather structurally concentrated as the ten largest banks account for 50 percent of the industry's total assets/liabilities.

At the apex of the financial development is the Central Bank of Nigeria (CBN). The chain of financial developments in Nigeria started with the establishment of the central bank in 1958. Since then the CBN has become a dynamic agent and a catalyst of investment and economic growth in the economy. The expansion of the financial assets of the CBN attests to its dynamic role in the economy.

Between 1960 and 1989, with the exception of the war years 1967-70, when the assets of the CBN declined and of 1974 when the oil revenue rose dramatically thereby leading to an equally dramatic increase in the financial assets of the CBN, the CBN has maintained a fairly stable expansion in its assets. See table 1. Table 1 also indicates that the assets of the CBN rose with every increase in oil revenues. Compare, for example the period 1978 -1986 when there was no significant change in oil revenue and the period 1990-2003 when the oil revenue was on the increase.

Although, great diversity marks the activities of central banks throughout the world, it is through the conduct of monetary policy that the central bank has its most pervasive impact on the economy. Monetary policy allows central banks to have a significant impact on a broad range of macroeconomic developments including inflation, employment, growth, interest rates, exchange rates, and balance of payments (Erb1989).

Besides performing the traditional function of issuing the means of payments and controlling the money supply, the CBN has been able to implement monetary and exchange measures aimed at strengthening the institutional infrastructure of the financial system and expanding the nascent domestic financial markets.

Modern commercial banking started in Nigeria before the central bank. Being the oldest unit of the Nigerian financial system, it has been one of the most advanced of the financial institutions. The other financial intermediaries are restricted both in their capital resources and their scope of activity. Most of them are relatively new developments. This gives the commercial banks an edge over the others, particularly the other similar institutions such as the federal savings bank, merchant banks, and mortgage banks in collecting deposits and extending credit to the economy. This dominant role of the commercial banks in the financial system can be seen in Table 1. Commercial banking has undergone radical changes since independence. Commercial banking in Nigeria developed from an industry which, in 1960, was dominated by a small number of foreign owned banks into one in which public sector ownership predominated in the 1970s and 80s and finally, one in which private sector is in control.

The period 1990 was a turbulent one for the Nigerian commercial banks. The period witnessed a dramatic

rise in asset quality problems and a wave of bank distress and failures. By March 1994, for instance, of the 118 commercial banks in Nigeria 40 were distress. These developments in addition to virulent inflation, persistent economic downturn, frequent reversal in public policies, heightened political instability, and increased incidence of fraud and embezzlement, resulted in a highly risky and volatile financial environment (Udegbum, 2004). Meanwhile by 2001 universal banking commenced and therefore merchant banking activities were abolished.

The current commercial banking consolidation initiated by CBN in June 2004 is aimed at strengthening the financial system. The exercise has been a huge success. The paid - up capital base of the bank was raised from N2billion to N25billion. The banks met this requirement through mergers and acquisition. At present there are about 25 strong and reliable commercial banks in the country. Total assets/liabilities of the banks has grown almost five fold between 2003 and 2007 as banks balance sheet increase from N2,707.8 billion in 2003 to N10,431.0 billion in 2007. Currently there are about 4,579 bank branches an increase from 3,247 branches within the period 2003 – 2007.

Table 2 shows the number of commercial banks and their respective paid – up capital as at the end of 2006. it is seen that all the banks except the Nigerian

international bank limited exceeded the N25 billion paid – up capital prescribed by the Central Bank.

Table: 2

Banking Capitalisation In Nigeria As At 2006

Institution	Capital Amount (N' billion)
1. Union bank of Nigeria plc.	100.10
2. Zenith bank plc.	116.50
3. First bank of Nigeria plc.	83.40
4. UBA Group plc.	41.70
5. Intercontinental bank plc.	156.90
6. Guaranty Trust bank plc.	37.30
7. IBTC Chartered bank plc.	32.70
8. Oceanic bank international plc.	37.70
9. First City Mounment bank plc.	25.20
10. Skye bank plc.	30.00
11. Spring bank plc.	30.00
12. Fidelity bank plc.	25.70
13. Afribank Nigeria plc.	29.00
14. Wema bank plc.	28.20
15. Access bank plc.	28.80
16. Diamond bank plc.	35.00
17. First Inland bank plc.	28.00
18. Ecobank Nigeria plc.	29.30
19. Unity bank plc.	27.00
20. Sterling bank plc.	27.00
21. Equitorial Trust bank plc.	28.40
22. Standard Chartered bank Limited	26.00
23. PlatinumHabib bank plc.	28.40
24. Stanbic bank Limited	26.60
25. Nigeria International bank Limited	25.00

866.40 billion

Source: Business World, Sept. 2007.

Mr. Vice-Chancellor, Sir, we shall in the next section examine the performance of the Nigerian commercial banking sector. Commercial banks are the most important financial institutions in the Nigerian financial system, in fact, in any country's financial system, in terms of the variety of assets held, savings mobilization, sources of investment capital, credit creation and payment mechanism. Furthermore, commercial banks perform the three main functions of the financial system as outlined earlier.

Performance Efficiency of the Nigerian Banking Sector

Attempts to measure and compare bank efficiency are bedeviled by the absence of any coherent yardstick of output, changing economic conditions, and valuations in bank mix of business. As a consequence, therefore, various approaches have been adopted by various researchers. Two factors seem to determine the approaches adopted by researchers in this field. First, the particular approach depends on the object of the study. For instance, Powers (1969), noted that while Benston's (1965) measures of bank output, namely , the number of deposit accounts or loans and the average account of loan balance for various services, suited his study of banking operations, such measures

were not appropriate for his (Powers) study of branch versus unit banks efficiency. Vittas (1991), warns about the danger of comparing operating cost ratios which are determined by differences in capital structure, business mix and accounting practices across countries , among individual banks and overtime. The second determinant of the measures of bank efficiency is the availability of data and relevant information

Generally, many of the previous studies in this area used balance sheet items as proxies for measures of efficiency. Revell's analysis used gross margin as a measure of allocation efficiency. Most of the research in this area has been carried out in the US. For review on literature in bank efficiency in the US see Berger et al (1993). The review suggests varying degrees of efficiency of the banks. Khatkhate and Riechel (1980), opined that the economies of scale in financial intermediaries arise from portfolio diversification and management and the minimization of information and transaction costs. Thus Khatkhate and Riechel were thinking of operational efficiency. Bryan (1972) found that the most important single factor explaining the operational efficiency in terms of profitability performance is the ratio of savings and time deposits to total deposits. The argument is that the deposit mix, by determining the liquidity needs of the banking sector, affects the volume of the earning assets. Howard and Haynes (2001), maintain that operational efficiency is determined by the market structure and the regulatory

framework of the financial Intermediaries. Operational efficiency refers to the provision of financial resources to meet the borrowing needs of individuals and households, enterprises and governments at least cost. According Howard and Haynes (2001), operational efficiency can be measured by the ratio of total operating cost to average total assets. The lower the ratio the smaller the spread between net returns to savers and gross cost to lenders. Intermediation efficiency is likely to be achieved when a banking system achieves allocation efficiency and vice versa. Intermediation cost can therefore be used as a measure of allocation efficiency. Revell (1981) defines intermediation cost as the sum of non-interest operating cost, pre-tax profits and other cost like provisions for depreciations and loan losses. Intermediation costs are identically equal to gross profit margins defined as the net interest earnings plus other incomes. High gross income indicates allocation efficiency. One problem with using profit rates as a measure of efficiency is that, although banks are commercial business firms, they have erroneously been regarded as profit maximizers. A profit objective is only one of the potentially number of objectives which might generally be pursued by management. Perhaps, the assumption that banks behave as if they are profit maximizers is an inappropriate explanation of bank behaviour. Nonetheless, a bank would be likely to pursue other objectives without keeping a close watch on profits.

In our definition and explanation of a financial system above, the role of financial system is stated as follows:

- The provision of financial resources to meet the financial needs of individuals and households, enterprises and governments;
- The provision of facilities to collect and invest savings fund;
- The provision of a sound payment mechanism.

We shall examine the Nigerian banking sector's efficiency in the context of the above functions. The first function relates to the intermediation or allocation/operational efficiency. The second function is simply emphasizing the main microeconomic function of financial intermediaries which is intermediation. The last function deals solely with efficient delivery of payment mechanism.

Intermediation or Allocation Efficiency

In performing the function of provision of funds to meet the borrowing needs of individuals and households, enterprises and governments on the one hand and the provision of facilities to collect and invest savings fund on the other hand, commercial banks provide liquidity, safety and monetary changes. Consequently, deposits reflect the degree to which these functions are being performed. We therefore, use deposits to have an idea of the bank intermediation efficiency. The level of deposits therefore, determines

the intermediation efficiency. Bell and Murphy (1976) found that 5.7 percent of employment in a typical bank in the US is absorbed by services associated with deposits. The percentage is likely to be more in the Nigerian banking sector because of the greater labour intensive, lower technology nature of banking operations in the country despite the current age of internet banking. To further support the use of deposits as one of the measures of bank intermediation efficiency Revell (1980) has this to say “Strictly speaking, it is best to measure increases in [bank] business by the growth of deposits and other funds available for lending . . .’

However, a fundamental difficulty arises in the treatment of bank deposits. Considerable debate in the literature surrounds the input-output status of deposits. Traditionally, deposits are regarded as the main ingredients for loan production and the acquisition of other earning assets. On the other hand, high value-added deposit products like integrated savings and chequing accounts, investment trusts and foreign currency deposit accounts tend to highlight the output characteristic of deposits (Leong,Wai Ho, 2003). Ho further argued that “Indeed, high value-added deposit services are an important source of commissions and fee for specialised commercial banks such as trust and private banks. In the context of these specialized institutions one cannot afford to ignore the output nature of deposits.” Deposits are therefore,

simultaneously an input into the loan process and an output in the sense that they are purchased as a final product providing financial services to varying extent. As shown in table 3 the volume of deposits held by the Nigerian banks registered over 33-fold increase during the period 1990-2003. When compared to earlier years, 1980-94, the increase was fourteen-fold. The period 1990-2003 recorded an average annual growth rate of 31.5 percent thus indicating increasing intermediation efficiency.

Deposits and the growth in deposits are not an unambiguous measure of bank output efficiency because changes in the level of deposits may not always reflect the same directional changes in output. Inflation produces an automatic increase in bank deposits so that bank deposits outstanding may increase because of inflation without any increase in the quantity of services provided by the banks. Left to itself, however, the process would result in a fairly steady increase in deposits in line with inflation, at least in the short –run, but the efforts of the government to control inflation by operating on the money supply lead to rather more spasmodic growth of bank deposits. It is thus necessary to distinguish between inflation induced increase of deposits and real growth of deposits. To correct the current deposit series for price effect the index of consumer prices was used as a price deflator.

The deposit series recorded an annual growth of 31.5 percent when measured at current prices but when the effect of inflation was removed the annual growth rate fell drastically to 5.6 percent. The decline in productivity and intermediation efficiency can be explained by the fact that apart from the effect of inflation the period 1990s was particularly turbulent one for the banking sector. As table 3 indicates, the period 1992-1996 shows intermediation inefficiency when account is taken of inflation. The period 1999-2002 witnessed increasing intermediation activity. This is as a result of tremendous increase in government earnings from crude oil exports. The increase in government wealth and expenditure led to a general rise in income level in the economy. Since there is a positive relationship between income and economic activity savings bank productivity and intermediation increased.

The influence of other distorting factors on deposit series was examined to establish the validity of deposits as one of the measures of allocation or intermediation efficiency. Deposit mix changes affecting deposit activities influence bank output without changing the level of deposits outstanding. The time plus savings deposits to total deposits ratio indicates the directional effects of deposits mix changes on output. The time and savings deposits use fewer banks services because of their lower turn over. Consequently, an increase in the proportion of time and

savings deposits to total deposits implies a lower level of real output and allocation efficiency

Table 3 further shows the absolute amount of time and savings deposits as well as their proportion to total deposits. In absolute terms, time plus savings deposits increased steadily during the period 190-2003. The growth rate shows the volatile behaviour of these deposits over the period. The average annual increase is 31.2 percent.

The criticism that may be levied against the use of deposit series is that deposits represent the capacity rather than output of banks. The divergence between capacity and output level is not serious for service industries like banks because inventory accumulation is not possible and excess demand exists in such industry as banking. Thus, capacity measure can serve as a proxy for bank output.

An alternative approach for measuring bank intermediation efficiency is the use of earning assets. The approach rests on the premise that output of financial institutions, particularly commercial banks are viewed as financial services provided to depositors and borrowers and that since output generates revenue, earning assets, by far the most important source of bank revenue may serve as a yardstick of bank output and therefore of bank intermediation efficiency.

The fact that the output of financial firm is viewed as a financial flow and physical units of this flow are measured by earning assets that are generally thought to be a stock variable may at first be inconsistent. The view that earning assets and certain other balance sheet entries are stock is an implication of a portfolio approach to bank behaviour. However, as Pesek (1970), stated that the view that balance sheet entries are stock does not accurately reflect economic realities since 'by its very nature bank money is constantly sliding into abyss of non-existence, either as it is returned to the bank for conversion into currency or as rentals ('or loans') of it expires'. The continuing existence of earning assets or deposit entries on the bank balance sheet requires continuing activity on the part of the banker to prevent the 'ever changing stock or rather flow' of these entries from being destroyed. To further quote Pesek (1970), if balance sheet entries are to be considered as a stock, they are not comparable to a stock of Rembrandt paintings but rather to a river constantly renewed in the mountains and constantly disappearing down the valley with the banker controlling the sluice'. Therefore, banks can maintain a stock of earning assets or deposits on their balance sheet only by constantly incurring costs

In objecting to the use of earning assets as a measure of bank output and intermediation efficiency, Mackara (1975), contended that viewing earning assets as a bank output is analogous to regarding inventories as

output for the manufacturing firms. He argued that looking at the firm's stock of inventories yields little information about the firm's production activities without information such as net change and turn over of inventories over a specific period of time. Observably, however, there are distinct differences between inventories held by manufacturing firms and earning assets held by banks. First, as noted earlier, most balance sheet items are 'perishables' in the sense that costs must be constantly incurred to maintain a given level of earning assets. Second, and equally important, it is the fact that inventories yield no direct revenue to the manufacturing firm, while earning assets are the banks source of revenue. Thus the behavioural process involved in making inventory decisions on the part of the manufacturing firm is distinctly different from the banks decision-making process concerning the production of services of what the earning assets are the physical measure.

Table 4 shows that the earning asset of the Nigerian banks has been increasing, rising over 113 times the 1990 level in 2003. The average growth rate is 59.4 percent indicating that the intermediation role of the banks has been improving. Since earning asset series suffer from the same shortcoming as deposits as a measure of bank intermediation, weights were deduced to make our measure of each earning asset reflect not only the money value of assets outstanding but also the expected yield of assets. All assets have an average

expected yield that must be considered in the evaluation of the bank performance. In this case, an easily measured quantity that can serve as a proxy for the expected average yield of each type of earning asset is the rate of interest actually paid for each earning assets. The formular is

$$Q_i = \sum r_{ij}x_{ij}$$

Where Q_i is the total output of the i th bank;
 r_{ij} is the interest rate charged by bank i for j th type of earning assets;
 x_{ij} is the amount of the j th type of earning assets outstanding during a given year by the i th bank.

It might be reasoned that greater disaggregation of earning assets with loans and advances divided into sub-categories could have refined the weighting process. For the Nigerian banking sector, loans and advances represent a fairly homogeneous category of short term business loans. Consumer finance is virtually non-existence and banks are not yet active in mortgage lending. For these reasons loans and advances were treated as a single broad category. Investment could have been divided between government securities and other investments. But because treasury bills and treasury certificates constitute over 50 percent of all investment; classifying investment is therefore unnecessary. The average

annual growth rate for the weighted assets is 62.7 percent which is higher than that of the unweighted.

Efficiency of the Payment Mechanism.

The most basic function of the financial intermediary is to facilitate payments in the economy. Satisfactory payment facilities are something which we are inclined to take for granted, but a productive economic system is dependent upon their existence. Payment efficiency depends on technology and other institutional factors affecting cheque clearing processes. It measures the ease and speed of money transfer between and among transactors.

A number of measures can be used to ascertain the degree of payments efficiency of a banking sector. The number of cheques processed by the banks, and clearing efficiency, defined as the monthly average number of cheques cleared in a year to the monthly average number of working days in the year are good measures. The advantages of these measures are that as a volumetric measure, the number of cheques processed is fairly sensitive to price changes. On this Hodgman (1969), agrees with Gorman's (1969), observation that

The vast bulk of observable activities in commercial banks are related to the processing of cheques and other transactions: banks would

need a very small Labour force indeed if nobody spent their deposits. Therefore, on this view the function of a bank is to help depositors spend their money, and the volume of commercial bank output is proportional to the volume of transactions handled.

The other measures are the ratio of cheque clearing to demand deposits, the demand deposits turnover rate, and the level of technological innovations in the industry (Howard and Hayness, 2001). Demand deposits turnover rate is defined as the average demand deposits over a given time period divided by the total value of debits to demand deposits over the same period. The higher the demand deposit turnover rate the higher is the output as well as payment efficiency.

Table 5 shows that both the value and number of cheques cleared have been on the increase. The average clearing efficiency shows an increasing trend from 1990 to 1993 and a decreasing trend from 1994 to 1997 and thereafter indicates a dramatic increase from 1998 to 2003. The downturn in average clearing efficiency in the period 1994-1997 was the impact of the distress in the banking sector and the attendant general economic depression in the nation during the period. Conversely, the increasing payment efficiency in the period 1978-2003 is a consequence of the financial sector reform to arrest the financial sector distress and the economic recovery that followed. The

demand deposit turnover rate indicates unexplainable fluctuations.

The other measure of payment efficiency is technological innovations. Technological innovations reduce the cost of, and increase the speed of payment delivery. Besides, technological innovations will not improve customer access but will facilitate the offering of more services and reduce customer attrition.

Nigerian banks have invested a lot in technology and according to Ezeoha (2005), have widely adopted electronic and telecommunication networks for delivering a wide range of services. The introduction of mobile phone in 2001 and improved access to personal computers (PCs) and internet facilities have been a very big boost to e-banking in Nigeria. The result of a survey carried out by the central bank of Nigeria in September 2002 showed that out of 89 banks in the country, 17 were offering internet banking, 24 were offering basic telephone banking, 7 had automatic teller machines (ATMs) services while 13 of the banks were offering other forms of e-banking. With these innovations, albeit in their nascent stages payments and other delivery services are enhanced in terms of costs, speed and market share.

The Structure Performance of the Banks

Mr. Vice-Chancellor, Sir. Ladies and gentlemen, one interesting area of this research on the performance of the Nigerian banking sector is the examination of some of the issues concerning the evolving structure of the banks. The main hypothesis here is that the economic performance of a banking sector is a function of its market structure and policy variables. The hypothesis is consistent with and is based on the acceptance of the relevance of the structure-conduct-performance (S-C-P) to the commercial banking industry. The s-c-p hypothesis states that the structure of the market will influence the conduct or behaviour of the firms in the market and that the resulting behaviour will be reflected in the price and profit performance of the firms in the market. More explicitly, markets with a relatively small number of firms and high barrier to entry will produce pricing decisions aimed at joint profit maximization by collusion, price-leadership, or some other forms of tacit behaviour. Traditional microeconomic theory of the firm behaviour suggests that tacit behaviour among firms directed at joint profit maximization should lead to high price and greater profit than would be found in a market characterized by greater competition. Thus the s-c-p hypothesis implies that market concentration as an indicator of competition is an important determinant of the observed price and profit performance of the firms in the market. More particularly, the s-c-p performance leads to the expectations that price and profit will be greater the more highly concentrated the relevant

market. Consequently, following microeconomic theory, a banking industry with a competitive structure is the one consisting of many competing banks, and therefore such a banking system will perform better in terms of output and price than a banking system consisting only of a few banks.

We carried this research by specifying a reduced form econometric model of the form

$$Y = g(x_1, x_2)$$

Where

Y represents the dependent variables reflecting the banking system's economic performance;

x_1 represents the variables proxying the structure of the banking industry;

x_2 represents the policy variables reflecting the results of operational decisions regarding the input-output mix

These variables are deduced and tested with annual time series data.

At the outset of this study, it was noted that the accumulated evidence relating to the ability of the Structure-Conduct-Performance hypothesis to characterize commercial banking system behaviour was relatively weak when compared with similar evidence acquired from the industrial sector. It was suggested that the apparent weakness of s-c-p

hypothesis might be, at least partly, a result of the pursuit of bank objectives. Further, it was suggested that such things as increasing bank size and revenue and reducing bank risk exposure might be reasonable objective for bank management to pursue.

A number of interesting results were obtained from the estimation of the empirical models. The test results imply that relatively simple description of structure such as number of bank offices matters. Expansion of bank branches is therefore desirable for increased bank performance. There is, however, a limit to such expansion. The expansion will be tolerated as long as it leads to greater incremental revenue to the bank than incremental expenses.

On the balance, the impact of market structure on performance is not found to be strong and stable. There is therefore no strong evidence to accept the Structure- Conduct-Performance hypothesis in the experience of the Nigerian banking sector.

Conclusions

Mr. Vice- Chancellor, ladies and gentlemen we have tried to appreciate what a financial system is, its development and its role in the development of the economy. We have also gone further to examine specifically the Nigerian financial system's performance in terms of intermediation and operational

efficiency, payment delivery efficiency, prices and profits and output.

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Table 1: Distribution of assets of the financial system
(Percentages)

	1970	1974	1978	1980	1984	1990	1995	2000	2003
A. Monetary Sector (1+2)	87.1	91.6	89.3	89.8	88.3	88.7	91.9	94.1	98.7
1. Central Bank	24.5	51.8	35.2	36.4	28.5	54.7	57.8	49.0	40.7
2. Commercial Banks.	62.5	39.7	54.1	53.4	59.8	34.0	34.1	45.1	58.0
B. Other Banks (a+b)	0.7	0.9	2.6	3.9	9.0	11.2	7.1	4.5	-
a. Merchant Banks. ²	0.4	0.8	2.5	3.9	8.9	11.2	7.1	4.5	-
b. Federal Savings Bank	0.3	0.06	0.05	0.03	0.1	0.0	-	-	-
Non-bank financial institutions ¹	12.2	7.5	8.1	6.3	2.7	-	1.0	1.4	1.4
	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0

Source: CBN 1. *Annual Report and Statement of Accounts* of various years.

2. *Statistical Bulletin* of various years.

Notes :

1. Include mortgage banks, community banks, finance houses, insurance companies.
2. With effect from 2001 universal banking commenced and hence, merchant banking activities were abolished.

Table 3: Deposits of the Nigerian banking system at current and constant prices 1990 - 2003.

Year	(Nmillion)		(Percentages)		(Nmillion)	(Ratio)	(Percentages)
	Deposits at current prices	Deposits at 1985 constant prices	Growth rate of deposits at current prices	Growth rate of deposits at constant prices			
1990	38777.3	13225.6	-	-	20188.5	0.52	-
1991	52288.7	16104.2	38.0	22.0	30359.7	0.57	50.4
1992	75847.7	15854.5	43.0	- 2.0	41784.2	0.55	37.6
1993	110453.6	14689.9	46.0	- 8.0	60530.0	0.55	44.9
1994	140839.3	11928.5	22.0	-19.0	75490.6	0.54	24.7
1995	171569.8	8408.6	22.0	-30.0	92100.4	0.54	22.0
1996	208680.7	7918.3	22.0	- 6.0	112776.7	0.54	22.4
1997	274521.0	9587.6	32.0	21.0	140555.1	0.51	24.6
1998	304888.8	9681.5	11.0	1.0	162636.7	0.53	15.7
1999	441283.0	13142.8	45.0	36.0	239130.7	0.54	47.0
2000	664031.6	18494.1	51.0	41.0	319030.7	0.48	33.4
2001	928329.0	21750.9	40.0	18.0	458259.7	0.49	43.6
2002	1100710.3	22477.2	19.0	4.0	556010.7	0.51	21.3
2003	1294472.8	21516.8	18.0	-5.0	655739.7	0.51	17.9
Average annual growth rate			31.5	5.6	31.2		

Source: CBN *Statistical Bulletin vol.14*, December, 2003

Table. 4: Earning assets of the Nigeria banking system, 1990-2003

Year	(N'Million)				(Percentages)		
	Loans and advances	Investments	Total earning assets unweighted	Total earning assets weighted	Growth rate of total assets unweighted	Growth rate of earning asset weighted	
1990	31970.1	10067.8	42037.9	10719.7	-	-	
1991	37279.2	7453.5	44732.7	8951.0	6.4	-16.5	
1992	48712.8	6767.0	55479.8	16533.0	24.0	84.7	
1993	71644.3	31192.0	102836.3	37113.6	85.4	124.5	
1994	66127.6	40444.0	106571.6	22380.0	3.6	-39.7	
1995	120868.9	22695.0	143569.9	28972.4	34.7	29.5	
1996	175425.1	49751.0	225176.1	44449.8	56.8	53.4	
1997	391541.5	42861.5	434403.0	58818.2	92.9	32.3	
1998	278889.5	52993.8	331883.3	60701.5	-10.3	3.2	
1999	1265984.4	193412.9	1459397.3	311143.6	339.7	412.6	
2000	1795768.3	285294.4	2081062.7	374175.1	42.6	20.3	
2001	2796112.2	192731.8	2988844.1	546659.6	43.6	46.1	
2002	3606229.1	435601.0	4041830.1	836254.6	35.2	53.0	
2003	4339443.0	434299.0	4773742.0	934698.7	18.1	11.8	
Annual average growth rate					59.4	62.7	

Source: CBN Statistical Bulletin December, 2003

Table 5 Payment efficiency measures of the Nigerian banking system

Year	Number of cheques cleared.	Amount of cheques cleared (N' million)	Average clearing efficiency	Average demand deposits (N' million)	Rate of turnover (Percentage)
1990	5066202	57839.2	84.0	15588.8	27.0
1991	5652178	124891.0	94.3	22849.0	18.3
1992	7358580	170235.3	128.4	33263.5	19.5
1993	5151561	205420.3	101.7	49923.6	24.3
1994	4910565	310176.6	80.0	65348.7	21.1
1995	4826155	466598.7	79.0	79469.4	17.0
1996	4050401	406318.2	64.9	95904.0	23.6
1997	3665107	391924.1	58.6	133335.9	34.0
1998	7754672	1198647.8	497.5	142252.1	11.9
1999	8620745	1413125.5	551.7	202152.1	14.3
2000	10297889	2095478.1	667.1	345001.4	16.5
2001	10193442	2256381.7	649.1	470067.3	20.8
2002	5339419	2325719.1	336.2	544699.6	23.4
2003	5023159	133874274.0	325.5	638733.1	0.4

Source: CBN *Statistical Bulletin vol. 14 Dec. 2003*

May I use this opportunity to appreciate my Vice – Chancellor the chief executive of this University for the relief given to a number of academic staff whose promotions have been unnecessarily and deliberately delayed. During these inaugural lecture series we have heard of a number of released delay in promotions. We have had cases of promotions back dated over ten years. In this university the idea that our predecessors sold to us which some of us experienced is that before a lecturer is promoted to the rank of Reader/Professor he or she must be tortured and delayed.

We needed a sole administrator in the person of Professor Gonwalk to dismantle the ‘pyramid’. This obnoxious structure held some of us for over ten years in the same post. When the idea of impact factor was mutated I recalled the pyramid structure and I said to myself that we are at it again. Mr. Vice – Chancellor Sir, I thank you for stepping down the idea of the impact factor. I know that the whole idea is to pursue excellence in research and teaching. However, the problem with the impact factor is the likelihood of misinterpretation and abuse. We must encourage and mentor our young and brilliant lecturers in other ways.