

# GLOBAL FINANCIAL MELTDOWN AND THE NIGERIAN FINANCIAL SECTOR

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## Abstract

After recession comes depression. The depression in the US affected most of the industrialized nations of the world. It was a cumulative effect of the 1<sup>st</sup> World War. Sixty five years after the depression comes recession in America that has equally engulfed the world economy. The Global Financial Meltdown caused by sub-prime lending and inadequacies in US financial market operation caused recession in most of the big economies and emerging markets. Nigeria is not an exemption, though the situation in Nigeria could have been worse if not the banking consolidation of 2005. Social funds are used to bail out the mistakes of capitalism and to check the recession from getting to depression. However, capitalism remains supreme; all what is required is to fine tune and reform the system as much as the system demands.

## Introduction

A greater understanding of the causes and nature of financial crisis is essential for their better management as well as for designing policies to reduce their likelihood. The root of these crises can be traced to the imprudent financial liberalization and the subsequent failure to adequately manage

and control the resultant capital surges (UNCTAD, 2007). The present global financial meltdown is not surprising; for it is a result of human failure in managing man and his resources.

The Great Depression in US which lasted from 1929 to early 1940s was the worst and the longest economic collapse in the history of the modern industrial world. The Depression spread to most of the world's industrial countries, which in the 20<sup>th</sup> century had become economically dependent on one another. It saw rapid decline in the production of goods and services and a sudden, severe rise in unemployment. Businesses and banks closed their doors, people lost their jobs, homes and savings, and many depended on charity to survive (McElvaine, 2008)

## Causes of the Depression

The Depression was caused by a number of serious weaknesses. The lingering effects of World War I caused economic problems in many countries as Europe struggled to pay war debts and reparations. These problems contributed to the crisis that began the Great Depression: the disastrous US stock market crash of 1929 which ruined thousands of

investors and destroyed confidence in the financial sector.

International problems weakened the economy. After World War I, the US became the world's chief creditor as European countries struggled to pay war debts and reparations. The US lent heavily and unwisely to borrowers in Europe, especially Germany, who had difficulty repaying the loans. The huge debts made the international banking structure extremely unstable (McElvaine, 2008).

McElvaine observed that prices of stocks rose far beyond the worth of the shares of the companies they represented, especially between 1927 and 1929 in US. People paid inflated prices with the hope of selling their stocks at a profit. Investors bought millions of shares on margin, a common practice of buying products on credit. They paid a part of it cash and borrowed the rest to complete payment. This is a gambling that they could sell the stocks a high enough for profit. It was a speculative bubble scheme; the prices expanded until they burst. This day was October 29, 2009; stocks lost \$10bn to \$15bn in value. By mid November, it reached \$30bn loss. To add to the difficulty, the 1920s produced another innovation 'credit', an attractive name for consumer debt. People were allowed to 'buy now and pay later'. But this only put off the day to 1929 when they could no longer buy up the products coming up the assembly lines.

He further observed that the crash affected the economy the way exposure to cold affects the human body, lowering the body's resistance to infectious agents that are already present. The crash reduced the ability of the economy to fight off the underlying sickness of unevenly distributed wealth, unemployment, agricultural depression and banking problems.

#### **International Effects of the Depression**

Germany struggled to pay reparations imposed by the peace settlement after World War I, though it

suffered to a large extent more than any industrial nation. In 1932, about 40 per cent of German workforce was out of job. The Germans started listening to the tirades of Adolf Hitler who became the Chancellor of Germany in 1933. He blamed the economic woes of Germany on the Jews and the communists and promised to restore Germany to its economic and military strength.

In Britain the effects of the Depression was not as much as in Germany because it was living with high unemployment through much of 1920s. And during this period, it had institutionalized unemployment insurance and other welfare schemes to ease the burden of unemployment, unlike the US. France was less hit by the Depression because it was less developed than the US, Germany and Britain. France lost most of its workforce during the World War I; hence it had little effects on unemployment on its population (McElvaine, 2008).

#### **Global Financial Meltdown**

The Great Depression which started from the largest economy, the US, soon spread to other industrial nations of the world. The US maintained high tariffs on goods imported from other countries and at the same time it was involved in giving loans to other countries and had the drive to export more goods. This double combination could not be sustained. Other industrial countries followed suit to advance their own interests without regard to international consequence.

Nearly 65 years after the Great Depression is a recession nicknamed "Global Financial Meltdown 2008". It all started in US with the phenomenon of weak economy unemployment, low demand for goods, bank failures and stock market crash. By 2007 there were warning signs of pending recession in US and in 2008 the economy took a different turn with sub-prime lending coming to a halt. Sub-prime lending is a mortgage lending scheme in US to people who under normal

business conditions

are not qualified for bank loans. This brought down Lehman Brothers, one of the oldest banks in US, to bankruptcy

The banks are interconnected and quickly the bankruptcy virus spread among the banks as well as their overseas partners in the industrial nations. Britain, France, Germany and even the emerging economies of China, India and Brazil were affected. As Americans could no longer consume as usual, factories in far away places of China laid off workers as their products could no longer find market in US. In May 2009, US employers cut 345,000 jobs, the fewest since September and far less than forecast (Intercontinental Bank Weekly, 2009). Apart from several financial stimuli by President Obama, his key banking reform takes the form of

- Tougher capital requirements for big banks
- Regulation of securitised assets
- Consumer mortgage protection
- Power to take over failing banks
- Global regulatory standards

Britain, France, Germany, Japan, China and other industrial nations have different approaches in their stimulus and bailing out packages of their economies.

#### **Effects on the Emerging Markets**

As stated by Intercontinental Watch Of June 20, 2009, the World Bank reported that the Private capital flows to developing countries will fall almost three quarters this year to \$363bn from a \$1,200bn peak in 2007. This drop of 70 per cent in credit flows will undermine investment in emerging and developing economies with a consequent hit on rich country exports of capital intensive goods. "This is one of the sectors hardest hit in the global recession," concluded the report.

The World Bank estimated that the destruction of

private capital flows alongside current account deficits and the need to refinance maturing debts will leave emerging and developing countries short of up to \$635bn.

#### **Impact of the Sub-prime Crisis on Banks in SSA**

Sub-Saharan Africa (SSA) is affected by the sub-prime crisis of US. It spread rapidly across the globe, hurting the European and Asian companies. Whilst few African financial services companies have had direct exposure to the crisis, the secondary impact is that GDP growth is declining. South Africa's GDP contracted in the last quarter of 2008 while Nigeria's growth slumped from 8 per cent in 2008 to 3 per cent in 2009 (Intercontinental Weekly, 2009a).

Secondly, as the major currencies of Southern, Eastern and Western major countries (South Africa, Kenya and Nigeria) experienced rapid depreciation, foreigners sought to repatriate funds to their home countries and collapsing demand for the continent's mining and manufacturing goods followed. The South African rand depreciated 40 per cent against the US \$ in 2008 while the Nigerian naira and Kenya shilling depreciated 25 per cent and 23 per cent respectively. The impact of this became unbearable on most infrastructure projects which were hitherto viable with high and rising commodity prices are no longer attractive, and hence many have been shelved, either for lack of funding, or due to the reduced economic rationale.

The situation in Africa has been similar across the three main regions (East, South and West), whereby resource price collapses have caused layoffs and reduced growth prospects. While most South African banks are for the most part well capitalized, Nigerian authorities have intervened directly by capping interest rates and may yet purchase the bad debts in the industry. The Eastern region which is less resource dependent has not faced as dramatic an impact on its banking sector

as the other regions.

### **Nigerian Financial Sector**

In Nigeria, policy makers have implemented preventive measures designed to avert distress rather than remedial measures intended to resolve crisis once they occur. Institutional arrangements and legal processes have had a negative effect on efforts to resolve financial distress, reducing the incentives of regulators, managers, shareholders, depositors, employees and borrowers to take the necessary actions. It has been observed that remedial measures are designed to take effect once the bank is in distress but the framework for their execution must be adopted beforehand (Glaesner and Mas, 1995).

During the SAP era (beginning from 1986), there was proliferation of banking sector. Many banks were licensed to operate. Between 1986 and 1992, the number of banks in Nigeria increased from 45 to 120. With this development, the sector became more competitive than ever. The main commodity of these banks was foreign exchange which was a quick profit-making venture, hence, the rush to enter the industry then (Ndubuisi, 1997).

Sooner or later, all these developments accumulated to distress banking, especially since the withdrawal of treasury funds from the banks. Bank liquidity and insolvency, incidence of bad debts, frauds and forgeries emerged and worsened the distress condition in the banking system. By December 1992, 16 banks had been identified as distressed and there was a high incidence of inter-bank defaults in the inter-bank transactions, a situation that rendered the banking system a high risk environment (Ebhodaghe, 1993). The challenges to the banking sector is obvious. The liberalization and increase in the number of banks have given way to stiff competition for fund, business and skilled and executive manpower, and the risk of general failure of financial institutions is ever threatened now than before. This situation

calls for regulatory and supervisory responses according to Ebhodaghe (1993).

### **Bank Rehabilitation**

Rehabilitating insolvent banks entails three types of actions (Glaessner and Ignacio, 1995). These actions are recapitalization scheme that covers all existing losses and provides the institutions with an adequate level of capital; restoring profitability by restructuring the institution's staff, operations, cost structure, and physical infrastructure and finally upgrading management making, risk management, and control systems. According to them, they are bailouts, nationalization, assisted mergers, and purchases and assumptions.

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The number of banks in 1992 rose to 120 and by 2005 the number dropped to 89. To be efficient, reliable and credible, a policy framework for resolving bank distress must establish incentives that preserve financial discipline, induce cooperative solutions and protect the rights of claimants (Glaessner and Ignacio, 1995). They are of the strong opinion that the framework for resolving bank failures must be insulated from political influence and vested in an appropriate regulatory group such as CBN, NDIC and NSEC with professional trained staff who can identify problems before they get out of hand. One of such approaches is consolidation.

### **Consolidation**

Consolidation is the survival of the fittest. It may take the form of horizontal or vertical fittings or

both. It is aimed at a bigger, more efficient, better capitalized and more skilled industry. It is the reaction of reinvesting a capital gain made on a speculative share. In another sense, it is the selling of equities at a gain and reinvesting of the proceeds in fixed interest securities (Adeyemi, 2005). Further, consolidation is the investment and coming together of banks as a single entity for a larger size, larger shareholder bases and larger number of depositors that will translate into reliable, strong and big bank (Adeyemi, 2005)

### **Pre-consolidation Features of Nigerian Banking Sector**

At the end of March, 2004, the Central Bank's ratings of all the banks, classified 62 banks as sound/satisfactory, 14 as marginal and 11 as unsound while two of the banks did not render any returns during the period (Soludo, 2004). The weaknesses of these ailing banks were as a result of their overdrawn positions with the CBN, high incidence of non-performing loans, capital deficiencies, weak management and poor corporate governance.

In summary, the major problems of Nigerian banks were (Soludo, 2004 and CBN, 2005):

- 1. Weak corporate governance, evidenced by high turnover of the Board and management staff, inaccurate reporting and non compliance with regulatory requirements, falling ethics and de-marketing of other banks in the industry.
- 2. Late or non publication of annual accounts that obviate the impact of market discipline in ensuring banking soundness.
- 3. Gross insider abuses, resulting in huge non-performing insider related credits.
- 4. Insolvency as evidenced by negative capital adequacy ratios and shareholders' funds that had been completely eroded by operating losses.
- 5. Weak capital base, even for those banks that have met the minimum capital

requirements which stood at N1.0bn or US\$7.53 million for existing banks and N2.0bn or US\$15.06 million for new banks, and compared with the RM2.0bn or US\$526.4 million in Malaysia.

- 6. Over dependency on public sector deposits, and neglect of small and medium class savers.

The situation was not encouraging in the banking sector that in the year 2004, the CBN Governor started sensitization campaign of N25bn capital base of each bank from a mere base of N1.0bn for existing banks or N2bn for new banks. Seminars and workshops were held with stake holders of banks, captains of industries, manufacturers, economists and business communities on the need for consolidation, the effective date being December 25, 2005. Consolidation took place in form of acquisition, merger or absorption.

During this intervening period, the Nigerian capital market boomed to the extent that some banks were over subscribed. From 89 banks that started the race 25 banks emerged through acquisition and merger.

### **Effects of Global Financial Meltdown on Nigerian Economy**

Particularly, the sub-prime crisis has affected the Nigerian banking sector. Foreign investment inflows as well as private capitals from Nigerians working abroad are grossly affected. The inflow is reduced to about 20 per cent. The reduced foreign investment inflows and the crash of Nigerian capital market as a result of marginal trading has also seriously affected the banking sector which lent heavily to marginal investors in the capital market.

Foreign banks are not left out in the liquidity crunch as they curtailed credit to the perceived Nigerian emerging market. The impact became unbearable on most infrastructure projects which were hitherto viable. As a result, many of such

projects have been shelved, either for lack of funding or due to the reduced economic rationale (Intercontinental Bank Weekly, 2009a)

According to Economic Intelligence Unit (EIU) report, the Nigerian real GDP growth is forecast to be 2.7 per cent in 2009 with banking sector suffering from the global financial sector, though it is expected to improve to 4.4 per cent in 2010. The report further stated that the oil sector will continue to operate below potential and inflation will fall to an average of 11.4 per cent in 2009 and 8.5 per cent in 2010.

- The resume has the following implications for business in Nigeria:
- Low capital commitment to long term projects.
- Conservation of cash and tight expense control
- Reallocation of growth expectation to sectors offering basic necessities.
- Government attention to shift to aggressive tax generation

### **Challenges and Implications to Nigerian Economy**

While it took South Africa about 10 years to rebrand its banking sector, it took Nigeria about 16 months to consolidate the sector to N25bn minimum per bank. While South Africa has five consolidated banks, Nigeria has 25 such banks, though one mega bank in South Africa is worth more than 10 banks in Nigeria in terms of value.

With out consolidation, Nigeria could have plunged into serious economic crisis in the advent of sub-prime lending in US. Most of the banks that were on marginal performance could have gone bankrupt and it could not have been easy for government to bail out the banks, let alone the private capital so agitated to do so.

A strong and vibrant capital market denotes a strong economy. Therefore, the Nigerian stock

market needs to be revitalized. To start with, the market should command the confidence of the public. Without trust, the market cannot prosper. The insider activities and manipulators must put to a stop and there is need for stringent monitoring and supervision of both the money and capital markets.

The Nigerian Telecommunication sector is rated the fastest in Africa and eight in the world and it has attracted more than \$12bn into the economy in seven years. The Federal Government generated revenue of about \$2.5bn over the same period, representing an average annual growth rate of 125 per cent since 2000 (AFDB, 2009). With high degree of expectation for consolidation, it has opportunities for mergers and acquisitions and this will boost the capital market if they become public limited companies rather than their present private limited company postures.

Further, the shareholders of public quoted companies should be made to have a say on the bonuses and allowances of chief executives, proper regulatory bodies institutionalised and a functional Central Security Clearing System installed.

### **Conclusion**

Many economists are of the view that the Breton Wood scheme has failed and that there is need for new world economic order. And it is also argued that capitalism having failed, socialism is used to bail out the failures of capitalism in US, Britain, France, Germany, Japan and elsewhere. The fact is that the market economy remains supreme; what is required is to fine tune, regulate and reform the system in accordance with prevailing circumstances.

Consolidation of banking sector in Nigeria has helped to avoid unforeseen economic crisis in Nigeria after the sub-prime lending crisis in US that has engulfed the world. What are required is

reforms to suit the 21<sup>st</sup> banking system. In so doing, there is need to have a policy to checkmate the freedom of banks to fix the salaries of their top executives. This is in direction to sanitize the sector, restrict the excesses of the executives and stabilize stakeholders' confidence in the financial services industry.

Nigerian economy is superficial, a reverse of an ideal situation. In a striving economy, businesses are expected to be on high in growth and value and the profits made trickle into the financial sector. Rather, the banks are booming while businesses are collapsing or operating below 50 per cent capacity. The time has come to put the banks in their right perspective. Window dressing must stop; transparency and over exposure to untidy credits to take its place. The common year-end financial report, a situation that will expose the rot in the system is a welcome measure. A double-year end report for banks is an invitation to abuse. The policy of resolution, disclosure and diagnosis will strengthen the banks and instill confidence in the stakeholders.

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