

# NIGERIA'S BANKING SECTOR: BEYOND THE REFORMS, WHAT ROLE FOR CBN?

Ahmad Bawa Abdul-Qadir

## Abstract

*Nigeria is undertaking another round of financial reforms as a result of crisis experienced in the sector post consolidation. The paper reviews the bank consolidation policy introduced in 2004 and the crisis that followed it. It was concluded that weak supervision was the major cause of the crisis which suggested a need for review of not only the structure of the banking system but also the regulatory architecture and the laws and regulations governing operations of the financial sector. It is suggested that a specialized agency be established to take over the prudential supervision of all deposit taking institutions and a council to oversee the co-ordination of the activities of all regulatory agencies in the financial sector.*

## Introduction

Nigeria is undertaking another round of financial reforms. This is coming at the heel of a financial crisis experienced by the sector. The reforms are being introduced just three years after an earlier round of reforms which saw the consolidation of the banking sector.

Banking consolidation policy, which started in 2004, was informed by the general state of the Nigerian banking industry which was fragile with a number of banks classified as unsound (Soludo, 2004). The banks had persistent liquidity problems coupled with

poor asset quality. The new policy was aimed at addressing the challenges faced by the sector so that it could be saved from collapse. In addition to consolidation which involved increase in minimum capital requirement, the issue of diversification was to be addressed in the second phase of the policy. Furthermore, post-consolidation banking industry operators were expected to adopt best practices in corporate governance and improve on self-regulation.

Post-consolidation banking sector in Nigeria was a greatly improved one which witnessed dramatic growth. The policy implementation was adjudged to be successful, though as noted by Sanusi (2010), "neither the industry nor the regulators were sufficiently prepared to sustain and monitor the sector's explosive growth".

But as Nigerians and the Nigerian authorities were counting the gains of consolidation, some disturbing trends started manifesting themselves. These trends made the system vulnerable to crisis. It was this situation that the global financial crises and recession met and worsened (Sanusi, 2010).

This paper aims at reviewing the bank consolidation policy and role played by the supervisory authorities during and after the consolidation. The post consolidation crisis will be reviewed taking into

consideration, the action or inaction of the Central Bank. The supervisory structure of the financial sector will also be assessed and suggestion will be proffered.

The paper is divided into five sections. Section one is this introduction. Section two discusses the consolidation of the Nigerian banking sector, its implementation and its aftermath. Section three reviews the supervision of the Nigerian financial system and the institutions involved, while section four discusses the post-consolidation crisis in the financial sector and the attempt by the authority to handle the crisis. Section five, which is also the last, draws some conclusion and offers suggestions. The suggestions include the need to review the legal framework for financial sector supervision and the supervisory architecture.

#### **Banking Sector Consolidation**

Banking reforms generally have resulted from deliberate policies aimed at ensuring healthy banking environment. The measures could include reforming the regulatory and supervisory framework or deposit insurance, and resolution mechanism. Issue of capital adequacy is also given prominence as it is believed that loss absorption capacity of the banks could be enhanced with optimum capital level. Consolidation is one way of achieving this. Consolidation leads to reduction in the number of banks while at the same time increasing the size and concentration of the emergent banks. It, thus reduces industry risk by eliminating weak banks and creating opportunity for diversification.

Motivation for consolidation, however, varies from country to country and is time specific (Berger, et al, 2003). The motive for consolidation in Nigeria as noted by Soludo, (2004) was to build a competitive and healthy financial system that could support Nigeria's development efforts while at the same time avoiding systemic risks. What prompted the introduction of bank consolidation was thus the noticeably weak structural and operational base of the banking system. The system was characterised by a number of inadequacies which include low capital base, large number of small and weak banks with relatively few branches (CBN, 2005). Many banks were also found to be involved in unethical banking practices which resulted in huge insider related non-performing credits. As a result of these inadequacies, the banking sector was not capable of meeting the

country's needs. It was to correct these inadequacies that the consolidation policy was initiated. The policy had three components.

- a) Review of the capitalization of the financial institutions
- b) Improving the financial infrastructure
- c) The reform of the regulatory and supervisory framework.

When implemented fully the reforms were expected to deepen the financial system both in terms of volume and diversity in the products offered.

The consolidation policy was started in the middle of 2004 with the review of the minimum capital requirement. Banks were now required to have N25billion as minimum capital and all banks were expected to comply with the new requirement before the end of December, 2005.

In implementing the reform, the Central Bank took certain decision aimed at ensuring that the objectives of the policy were achieved within the stipulated time frame (CBN, 2005). At the end of the period given to banks to consolidated, 25 emerged having met the new minimum capital; achieved mostly through mergers and acquisition. Of the 89 banks existing before the introduction of the policy, 14 were not able to scale through inspite of frantic efforts to do so. The banking licenses of the 14 banks were withdrawn and the banks slated for liquidation. The 14 were however, marginal banks that accounted for 6.5% of the total deposit of the industry (CBN, 2005:36). Winding up orders were sought from the courts by the NDIC in accordance with the existing laws. Final winding orders were flouted by the courts for 9 banks and a provision order was granted for two (NDIC, 2006).

In the resolution of the banks for which winding up orders were got from the courts, CBN and NDIC adopted the purchase and assumption (P&A) resolution option under which "arrangement healthy banks were invited to take up private sector deposit liabilities in exchange for a portion of the failed bank's assets." Four banks have been acquired by December 2007 under this arrangement (CBN, 2006: 28). However there are still legal issues and challenges to overcome in the resolution of the banks.

Consolidation in Nigeria was adjudged to be successful. The post-consolidation banking sector is

a greatly improved one. Reports show significant improvements in a number of financial indicators. The quality of banks assets improved considerably. Ratio of non-performing credits to total credits reduced between 2004 and 2006. It was 23.08% in 2004; it reduced to 20.13% in 2005 and 7.92% in 2006. The drastic decrease in 2006 "was partly due to the fact that the greater proportion of the non-performing loans in 2005 belonged to some of the

insured banks that were closed in 2006" (NDIC, 2006:17). Serious efforts at debt recovery by the banks also contributed to the drop in the ratio of non-performing credits to the total credits. This improvement in asset quality is also reflected in the drop in the ratio of non-performing loans to stakeholders' funds. This and other indicators are shown in table 1.0 below:

**Table 1.0: Banks' Assets' Quality Indicators**

	2004	2005	2006
Total Credit (Nbn)	1519.76	1832.18	2840.10
Non-Performing Credits (Nbn)	350.82	368.76	225.08
Ratio of Non-Performing Credits/Total Credit (%)	33.08	20.13	7.92
Ratio of Non-Performing Credits/ Stakeholders' funds (%)	105.30	59.01	22.06

Sources: NDIC 2004, 2005, 2006.

In addition to the above, NDIC also reports improvements in the banks' capital adequacy (NDIC 2005, 2006). Furthermore, some of the bigger banks recorded significant growth in deposit base depicting improved level of depositors' confidence (NDIC, 2006: X). As a result of these developments, there was an improvement in the operational capacity of the banking sector after consolidation. But these developments came with new challenges.

The increase in capital base and growth in deposit encouraged banks to move into such areas as infrastructure and oil and gas financing. Banks also diversified their businesses into other sectors of the economy and across the borders into other countries. Most of the new banks have investment in insurance and capital market undertaken through subsidiaries. A number of them also have operation in other countries which operations expanded rapidly.

Banking consolidation encouraged the development of diversified, large and increasingly complex financial institution in the country. Under pressure some of these institutions shifted to riskier portfolios across financial products and services which though beneficial could also affect the risk to both individual financial institution and the financial system as a whole.

Banks were put under tremendous pressure to deliver high returns to meet stakeholders' expectations. This came in the face of decreasing profitability owing to declining margins due to the increase in capital. Both return on asset (ROA) and return on equity (ROE) had declined considerably (NDIC 2005; 2006). Banks were, therefore induced to move into new and riskier areas where their competence was sometime limited. This called for greater monitoring by the authorities to prevent these activities from threatening the stability of the system.

The Central Bank and other authorities made efforts to strengthen the system which included the following:

- 1) Discouraging banks from granting loans to the public sector.
- 2) Issuance of new prudential guidelines.
- 3) Amendments to banks and other financial institutions Act (BOFIA) to limit the amount of loans granted to one borrower and requiring insiders to declare their interest in any such loans.
- 4) Developing framework for systemic distress management.

Despite these efforts, more needed to be done; framework for the supervision of the emerging complex and diversified banking structures needed.

further strengthening. This need was emphasized by the NDIC in its 2006 report. In that report, the NDIC faulted the risk management systems of most of the consolidated banks. It observed that most of the consolidated banks had not yet instituted appropriate risk management system to monitor and control the risks inherent in their operation. This and some unresolved issues in some of the banks meant that there was a need for "close monitoring by the regulatory/supervisory authorities in order to ensure the safety and soundness of the banking system" (NDIC, 2006:44).

#### **Financial Sector Supervision In Nigeria**

Banking supervision has the primary objectives of promoting and developing sound banking system that is secured and able to meet customer needs through the provision of wide range of financial services. This is made possible through ensuring that banks comply with extant prudential regulations and laws that ensure high standard of banking and professional conducts.

Traditionally, financial regulation and supervision have been conducted through the Central Bank, Ministry of Finance and some other specialised supervisory agencies. But many countries have, in recent times, carried out some regulatory reforms, in a number of cases due to crisis experienced by the system. Some reforming countries have consolidated the regulatory institutions, in instances creating one regulator for the financial system. Many countries however, still retain multiple supervisors; at least one each for banks, insurance and securities. Debates are however, still going on in a number of countries as to 'whether the supervisory structure should be reformed, and if so, in what direction' (Masciandaro, et al, 2007).

The debate on the type of banking supervision architecture to be established revolves around the need for an appropriate structure with adequate and clearly defined scope of activities to be supervised. The supervisory agency should also be independent of political manipulation. The argument is whether to have a single regulator for the whole financial system or have a system of multiple regulators each handling a segment of the system. There are arguments for and against both stands (Barth et al 2002; Braiult, 1999).

In Nigeria, a system of multiple regulators exists in which each segment of the financial sector has its

regulatory agency with a committee, Financial Services Regulation Coordinating Committee (FSRCC), coordinating the activities of the various agencies. The regulatory structure for the financial institutions remained largely unchanged overtime even though the financial environment has undergone fundamental changes. The regulatory framework is thus not good enough to be able to monitor the now greatly enhanced banking sector. No effective oversight was provided by the CBN and other regulators.

The establishment of the FSRCC was facilitated by the Central Bank to ensure a holistic approach to the supervision of the financial sector through coordination of the activities and consultation among the various regulatory agencies. It was an off shoot of financial services coordinating committee. The committee, which remained dormant until 1999 when it was revamped following legal recognition accorded it by the CBN Act of 1991 (as Amended) has the following members (Ogunleye, 2000:14)

- CBN Governor – Chairman
- Federal Ministry of Finance
- Securities and Exchange Commission
- National Insurance Commission
- Corporate Affairs Commission

In addition, following sit in the committee as observers:

- Nigeria Deposit Insurance Corporation
- Nigerian Stock Exchange.

The mandate of the Committee is the co-ordination of supervision of financial institutions and the articulation of strategies for the promotion of sound and safe practices in the financial system. Five sub-committees were established to handle activities of the committee. These are sub-committees on:

- Financial sector distress
- Harmonization and co-ordination
- Legal and enforcement
- Information sharing
- Financial market development.

For the regulatory structure to be effective there should be effective co-ordination between the various financial sector regulators. There was however, little co-ordination between the various financials section regulators. Sanusi (2010) writes that inspite of "widespread knowledge of banks malpractice, and propensity for regulatory arbitrage,

FSRCC, the coordinating body for financial regulators did not meet for two years during the time". The problem was further compounded by absence of a framework for consolidated bank examination.

#### **Post-consolidation Banking Crisis And New Banking Reform**

Not long after concluding the consolidation process, some disturbing trends started manifesting themselves in the Nigerian banking system. There were crises in a couple of banks while the whole banking sector was not settled to the task of financing the real sector of the economy. Many banks kept going back to the capital market to raise more money even as their internal structure seemed weak.

Most of the new banks, it was found, were yet to put appropriate risk management framework that would enable them monitor and control the risks inherent in their operations. This was reported by NDIC who further indicated that there were still unresolved issues in some consolidated banks. NDIC reported that audit of these banks revealed material misrepresentations of financial positions of some constituent banks (NDIC, 2006).

According to NDIC, the adverse effect of these misrepresentations now and in the future would be enormous and called for "close monitoring by the regulatory/supervisory authorities" (NDIC, 2006:44). Not long after, these adverse effects started manifesting themselves in two banks: Spring Bank and Wema Bank.

Crisis started in Spring Bank in May 2007, a few months after the completion of the consolidation. CBN sacked the board of the bank and took over control. Insolvency was cited as reason for the removal of the directors and takeover of the bank through a notice issued by the Central Bank dated 5<sup>th</sup> June, 2007. This was contrary to earlier confirmation by the Central Bank that Spring Bank, as at 1<sup>st</sup> January, 2007 had N30.6 billion share capital contributed in varying proportion by the six banks that merged to form the new entity. Central Bank, however, assured the nation that any director of Spring Bank found culpable would be prosecuted and that depositor funds in the bank were safe.

The crisis in Wema Bank manifested itself before the Central Bank was able to resolve the crisis in Spring Bank. The Chief Executive of the bank was sent on

compulsory leave to allow the Central Bank and NDIC inspect the book of the bank. The allegations were that the management of the banks misrepresented the quality of their assets. The newspapers were full of claims and counter claims on these issues; but whatever the case, this and the case of Spring Bank call to question the acclaimed success of the banking consolidation programme and the role played by the Central Bank in the process.

FinBank Plc is another case which strengthens the suspicion that the CBN did not perform its role well. Though the bank was not in crisis, like the other two banks, Central Bank in a letter dated 24<sup>th</sup> December, 2007 confirmed that First Inland Bank (as FinBank was then known) did not meet the mandatory N25 billion capital requirement. A portion of the letter reads.

*The banks shareholders' funds were N22 billion and N18 billion as at April 2007 and 25<sup>th</sup> February 2006 respectively. These balances fall short of the capital requirement of licensed bank.*

This contradicted CBN report that "as at the end of December 2006 all the 25 banks, met the required minimum shareholders funds of N25 billion

(CBN, 2006:79). It was not surprising therefore, that FinBank Plc was one of the banks that were found to be in dire situation. It was one of the banks taken over by the Central Bank after sacking the executive management and providing liquidity support.

From these cases it would be taken that some banks could not meet the minimum capital requirements and CBN could not detect or if detected, CBN, for whatever reasons allowed them to pass as successful. It was this vulnerable banking structure that was to face the global financial crisis.

By August 2008 some banks were in serious liquidity problems and Central Bank had to give them some financial support. An Expanded Discount Window (EDW) was put in place through which the CBN extended credit facilities to the banks. The facilities were collateralised using, commercial papers and bankers acceptances. A number of banks were reported to be near permanent borrowers from the window due to the extreme situation they found

themselves in.

Attempts were also made by the CBN to assure the nation that the banking sector in the country was not in too serious a situation. In a special presentation, the CBN Governor, in March 2009, tried to allay fears of Nigerians about the global financial crisis as it affected the system. He further listed responses of the authorities to the crisis (Soludo, 2009).

The Central Bank Governor, in his presentation, indicated that the Central Bank had tightened regulations and supervision of the banking sector. The responses included the enforcement of code of corporate governance, the strengthening of co-ordination between financial sector regulators and the introduction of consolidated and risk based supervision. These are in addition to the introduction of International Financial Reporting Standards (IFRS). To strengthen regulatory capacity, The Banks and Other Financial Institutions Act (BOFIA) was reviewed.

Some statistics were also provided during the briefing which was all in efforts to show that the banking system was not in too bad a shape. Banks' total loan as at the end of February, 2009 was put at N8.13 trillion with only 10% being non-performing. It was also estimated that by the end of 2009 about 7.4% of total banking credit would be non-performing. Average capital adequacy ratio was 22% according to the Central Bank. This was among the highest in the world (soludo, 2009). By June, 2009 a new CBN Governor was appointed. On assumption of duty, he found that the situation was far from one portrayed by the CBN in March of the same year. In view of this, special examination of five banks was undertaken jointly by CBN and NDIC.

The banks were found to have high level of non-performing loans, most of it insider related. The percentage of non-performing loans to total loans ranged from 19% to 48%. Additional provision for loan loss was therefore required. Aggregate loans for the five banks stood at N1, 143 billion representing 40.81% of total loans. The five banks according to Central Bank accounted for "39.93% of loans, 29.99% of deposits and 31.47% of total assets as at May 31, 2009" (Sanusi, 2009). The Central Bank, therefore went ahead to remove the Managing Directors and Executive Directors of the concerned banks and appointed new ones to head the banks.

The scope of the special examination was widened to cover all the 24 banks. This led to the sacking of the board of additional three banks and the appointment of new CEOs and Executive Directors. This brings to eight banks taken over by the Central Bank. The directors were subsequently charged to court. In addition to the eight, two more banks that were found to be in distress were given time to recapitalise and restructure their operations.

After the reviews, the CBN decided to start a new regime of reforms which seeks to review the current banking model which was considered to have exposed the banks to greater risks. The reform was built around four pillars (CBN, 2010).

1. Enhancement of the quality of Bank.
2. Establishing financial system stability.
3. Evolution of healthy financial sector.
4. Ensuring that the financial sector contribute effectively to the development of the real sector of the economy.

It is hoped that the new reform will ensure effective depositor protection and effective regulation of banks. The existing universal banking model is to be reviewed and a new model introduced.

Universal banking which allows banks to venture into other subsectors of the financial system was introduced in 2001. The policy expanded the range of financial services banks can engage in. In addition to traditional banking services, universal banking allows banks to engage in investment banking and other capital market activities and insurance. It, thus, allows single bank to meet total financial needs of a customer. This has great implication for the regulation of the system (Ogunleye, 2000). Under the universal banking model, especially after consolidation, Nigeria banks grow in size and aggressively expanded their operations both domestic and international.

The new model returns the sector to "narrow banking" in which retail banking is separated from corporate banking. This is expected to facilitate better risk management and supervision, in addition to isolating risks associated with other activities within the system. It is provided in the reform documents that banks wishing to hold interest in non-bank institutions, must transform into non-operating holding company to hold investment in the subsidiaries. Without holding company (HOLD CO.)

it will be impossible for banks to have direct ownership of non-bank subsidiaries.

The new model comes into effect in 2011 and consists of the following:

- Global bank – N 100 billion capital required
- National Banks N25 billion capital
- Regional Banks (these are allowed to operate in 5-10 contiguous states) require N15 billion share capital.
- Specialised Banks (include Mortgage Banks, MFBs, Interest Free Banks) are required to have N5 billion capital.

Banks have already started taking position in readiness for the implementation of the new banking regime. Some banks have established a holding company while some, like GTBank have divested from their subsidiaries. One bank, Wema Bank, was reported to be preparing to apply for license to operate as regional bank.

#### **Conclusions And Recommendations**

From the foregoing, one can conclude that weak supervision had contributed greatly to the crisis in the financial sector. The cost of the crisis to the Nigerian economy is also enormous. This suggests a need for a review, not only of the structure of the banking system, but also of the regulatory architecture and the rules and regulations that govern the operations of the financial system.

Universal banking model which the new structure seeks to replace is not completely to blame for the crisis. The new model will also not be a solution if the regulatory system is weak. It is suggested that a comprehensive review of the financial system be conducted. In addition to the structure, all major legislations governing banking business be reviewed after which supervisory architecture will be designed for the new system. The following Acts are to be reviewed.

- Banks and Other Financial Institutions Act (BOFIA)
- Central Bank of Nigeria Act (CBNACT)
- Nigerian Deposit Insurance Corporation (NDICACT)

Where necessary, other related acts like the Securities and Investment Act should also be appropriately amended. Provisions should be made in an

appropriate legislation to make it difficult for any government agency to change the banking system without public debate and or recourse to the National Assembly. This will prevent the agency from turning the country's banking system into a laboratory for testing ideas held by leadership of the agency even when such ideas may not be appropriate for the needs of the country.

Going hand in hand with the review of the laws will be a review of the supervisory architecture. It is recommended that the responsibility for the prudential supervision of the banking system be delegated to a specialised independent agency. It will be the responsibility of the agency to issue all the needed prudential and other guidelines to help strengthen the system and make it more efficient. Though Central Bank will lose direct supervision of the banking institution, it will still retain responsibility for maintaining financial stability including provision of liquidity support. This will be in addition to its role in the payment system.

Co-ordination of the activities of all regulatory agencies in the sector can be improved by the establishment of a coordinating council to replace FSRCC. The council should be independent of the Central Bank with members drawn from each of the regulatory agencies. It should also have some independent members. The chairman of the council, who should be a person of knowledge and high integrity, will be appointed by the President and confirmed by the National Assembly.

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