



# PERSPECTIVES ON THE NIGERIAN FINANCIAL SAFETY-NET:

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**GANIYU ADEWALE OGUNLEYE, OFR**

Managing Director/Chief Executive Officer  
Nigeria Deposit Insurance Corporation  
(1999 - 2009)

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**AN NDIC BOOK**

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# Foreword

**T**he safety and soundness of the financial sector is a critical objective of any government. Hence the importance of strong and viable financial safety nets is being increasingly recognized in the vast majority of nations. Safety nets are set of institutions, laws, and procedures that seek to promote an efficient and stable banking system during normal times and to manage the eventuality of a financial crisis. The components of a financial safety net are prudential regulation and supervision - the monitoring of banks and their business so as to enhance bank soundness and reduce the risk of bank failure; the lender of last resort (LLR) – facilities of Central Bank to address financial institutions’ liquidity problems; and deposit insurance – to deal with a bank solvency problems.

The book - *Perspectives on the Nigerian Financial Safety-Net* is to make available to the wider public a compendium of written articles and papers on economic and financial issues inspired by the author’s exposure to practical banking operations and personal involvement in policy design and implementation. The book is designed to throw some light on major developments which had occurred in the Nigerian financial sector with respect to bank regulation/supervision as well as deposit insurance.

The author, **Mr. Ganiyu Adewale Ogunleye, OFR**, can aptly be described as an “oracle” on issues that affect the nation’s banking industry. After working in the Central Bank of Nigeria (CBN), for 25 years, rising to the position of Director, Banking Supervision Department in 1992, he was appointed in October, 1999 as the Managing Director/Chief Executive Officer (MD/CEO) of the Nigeria Deposit Insurance Corporation (NDIC) and re-appointed in 2004. What is more, Mr Ogunleye was a pioneer Council member of the International Association of Deposit Insurers (IADI) and pioneer Chairman, Africa Regional Committee of the same Association, (i.e. IADI). It is therefore, obvious that he is eminently qualified to write on bank regulation/supervision and deposit insurance in Nigeria. His perspective and his rich store of experience as a bank supervisor, central banker and deposit insurer, have served him well.

The book’s contents have been organized in such a manner as to provoke the interest of the reader from chapter to chapter. From issues relating to deposit insurance and banking system stability to a review of the banking sector and its regulatory framework, universal banking, banking consolidation, causes of bank failures, ethics and professionalism in banking, bank frauds and measures to guard against them, small and medium scale enterprises as foundation for rapid economic development in Nigeria, the role of regulatory institutions in the management of capital flows and the lessons for deposit insurance systems (DIS) from the global financial crisis; the book can best be described as reader’s companion for banking practitioners, students as well as lecturers of banking and finance.

Without doubt, the author’s argument on the need and rationale for the establishment of a deposit insurance scheme in Nigeria leaves no one in



doubt. He articulates brilliantly the concept and relevance of Deposit Insurance and its role in promoting financial system stability in Nigeria. The author also examined the modus operandi of fraudster in perpetrating fraud in our environment and identified the needed measures to be taken in order to deter, prevent and detect fraud in a timely and effective manner.

Over the last 3 decades, the Nigerian banking industry had undergone substantial structural changes due to series of reforms in terms of the number of institutions, ownership structure, as well as depth and breadth of operations. Among the various reforms were deregulation, implementation of universal banking as well as the introduction of banking sector consolidation. In spite of their proclaimed potentials, the author as shown in the book, enumerated some of the challenges posed by those developments and that dealing with the challenges was crucial for the efficient and effective functioning of the nation's financial system. Recent developments in the banking system, which warranted Central Bank's regulatory intervention in the later part of 2009 have no doubt, vindicated the author.

Among other issues, the recent global financial crisis and lessons for deposit insurance also featured in the book. In examining the global financial crisis, the author discussed the nature, causes and its impacts on the Nigerian economy. Based on the developments in other countries, an attempt was made to highlight some of the measures taken in some selected countries aimed at reducing the effects of the crisis on their economies and the lessons for deposit insurance systems in developing countries.

There is hardly any aspect of banking supervision/regulation and deposit insurance that was left untreated in the book. Even the future of banking

business as contained in Nigeria's visioning process for an effective and efficient payment system is interestingly discussed as to be easily discernible, even to the uninitiated. Policy makers, bankers and the academic community cannot resist reading this book. Apart from serving as a veritable literature on some of the developments which have taken place in the banking industry over the years, the book is a credible source of information for researchers.

The author laid bare his experience over the years in the nation's banking industry. His thoughts as contained in the book are like words coming from an oracle. No one can ignore them. Perhaps the greatest contribution that the author has made is to present these papers in lucid and non-technical language that the wider public will have no difficulty in understanding.

Having read the book and found it very informative and educative, I do not hesitate in recommending it to all stakeholders in the financial sector and the wider reading public. The book will definitely serve as an invaluable reference material to members of the public who may from time to time need to know more about issues relating to bank regulation and deposit insurance in Nigeria.

**Mallam Adamu Ciroma, CFR**

*Former Central Bank Governor and*

*Former Minister of Finance*

*Federal Republic of Nigeria*

***December, 2010.***

# Preface

**D**uring the course of my engagements as the Director of Banking Supervision in the Central Bank of Nigeria (CBN) and as a member of the NDIC Board representing CBN before ascending to the position of Managing Director/Chief Executive Officer of NDIC, I was deeply involved in the business of regulation, supervision and the implementation of Deposit Insurance system in the nation's financial system. As a result of that, I acquired a lot of knowledge and experience, for which I was often called upon to share with the public at different fora within and outside the country. Having recently completed my tenure as the Managing Director and Chief Executive Officer of NDIC, I felt there was the need to put together in a book form some of the presentations I made on topical issues regarding regulation, supervision and deposit insurance for wider readership as well as to add to the existing literature particularly on deposit insurance that is still scarce both in Nigeria and other African countries.

It would be difficult to present readable materials that would cover my experiences on the topics in this book. However, I have made some efforts to cover certain areas that I consider relevant and important in banking regulations and supervision as well as the practice of Deposit Insurance Management in Nigeria. I have carefully chosen the selected topics in an attempt to avoid repetition which is common in a text of this nature.

The book, “*Perspectives on the Nigerian Financial Safety-net*” which is organized into fifteen chapters and written in lucid and simple language, serves as my own humble contribution to the dissemination of knowledge on banking regulation and supervision as well as propagating the gospel of deposit insurance in Nigeria. It must be appreciated that public awareness remains a major challenge not only to the deposit insurance in Nigeria but also to other systems even in advanced economies, hence the need to propagate it at any given opportunity.

This book project could not have been successful without the support of the Acting Managing Director/CEO, Alhaji Umar Ibrahim, *mni*. To him, I express my sincere gratitude. I also wish to acknowledge the experiencing-sharing platform provided through IADI. In particular, I wish to thank all my colleagues (past and present) in the Governing Council of the Association whose wealth of experience in deposit insurance had assisted me in no small way in up-grading my knowledge in the field. Furthermore, I wish to appreciate the efforts of the research team led by Dr. J. Ade Afolabi (Director of Research Department) that did the selection of the articles as well as carried out editorial work on the book. Other members of the research team are Mr. Sunday A. Oluyemi (Deputy Director, Research), Mr. Rotimi W. Ogunleye (Assistant Director, Research) and Mr. Hashim I. Ahmad (Assistant Director, BEU). I wish to acknowledge the team members for exhibiting high sense of professionalism and for their invaluable contributions in ensuring that the book project became a reality.

The members of my family deserve special mention for their encouragement. I sincerely appreciate my darling wife, Fehintola for her cooperation and understanding throughout my working career and in particular for her steadfastness in the belief of my value system. I also

thank all my children: Hakeem, Folashade, Abimbola, Folake and Jumoke for their unflinching support and love for me. Finally, I wish to thank almighty Allah for his mercies and grace over me throughout my career, in particular, and my life, in general.

It is my believe that regulators/supervisors, the banking public, academia and the general public would find this book useful.

**Ganiyu A. Ogunleye, OFR**  
*Managing Director/CEO*  
*Nigeria Deposit Insurance Corporation*  
*Abuja (1999 – 2009)*

***December, 2010***



# My Youth, Education And Career

## **My Youth**

I was born in Lagos. My father worked in the Nigerian Railway Corporation (NRC) before moving to Nigerian Ports Authority (NPA). At that time, we were all living in NPA quarters. I grew up in a cosmopolitan environment. When we were living in Apapa, we had our own association of boys and girls that organised football matches and indoor games.

## **My Education**

Based purely on my father's decision, my siblings and I schooled in the village and not in Lagos. In those days, before we started formal school, we passed through a preparatory school where we learnt alphabets. So I had to go to school at home, that is, at Baptist Day School, Ijagbo. When the time came for me to go to Secondary School, I thought I would go to school in Lagos but my father decided otherwise. So I had my Secondary School education at Provincial Secondary School in Ilorin, Ilorin Province. The school later became Government Secondary School, Ilorin. That was where I did examinations for both O' Level School Certificate and Higher School Certificate. After my higher school, I worked briefly at the Nigerian Ports Authority (NPA) before proceeding to University of Ibadan, where I studied and obtained a B.Sc (Hons) in Economics in 1973.

## **My Career**

### ***In The Central Bank of Nigeria (CBN)***

Shortly after my graduation, I started my career at the Central Bank of Nigeria (CBN). I worked in various Departments, first at the Loans office. I also worked in such other Departments as Accounts and Banking Operations Department. From Banking Operations Department, I was transferred to Jos Branch of the CBN. However, in 1981, the Management transferred me from Jos Branch to Banking Supervision Department (BSD) in Lagos. I was in BSD for a period of 18 years. It was in BSD that I rose to the status of a Director.

In BSD, we had three divisions which included Field Examination (which handled on-site examination of licenced banks). That time we had Commercial and Merchant Banks. I was in Field Examination for seven years before moving to another division called Central Supervision. My main responsibility while in the Central Supervision Division (CSD) was processing of applications for banking licence. All banking licence applications, particularly after the deregulation of the financial services industry, a part of the Structural Adjustment Programme of the Federal Government in 1986, passed through me.

The era of deregulation witnessed a significant increase in the number of licenced banks. As at 1987, we had 47 banks, but by 1990, the number of banks had increased to 120 merchant and commercial banks. That was a busy period for us indeed. The job schedule of staff in my Department then was very tight. We were working everyday of the week. The CBN was under the Federal Ministry of Finance (FMF) then. When the CBN Management was satisfied that the requirements for a banking licence had



been met, a recommendation would be made to the Minister of the Federal Minister of Finance. The Minister would prepare a Council Memo for the Armed Forces Ruling Council (AFRC) for consideration and approval. Processing of applications for banking licence was a delicate exercise and anyone doing the job needed to be very careful. Most of the bank promoters were powerful individuals who had connections with the highest authority. Oftentimes such people would complain of delays in processing their applications without disclosing that they did not provide all the requirements.

There were challenging assignments we faced in BSD. In the case of Societe Generale Bank of Nigeria (SGBN), there was a serious ownership tussle between Dr. Olusola Saraki and Chief Sokoye. I handled that investigation. We also had the case of Pan African Bank (PAB) where the State Government had contracted a management firm, ABC Fund, to manage and turn around Pan African Bank. We had petitions as to the competence of ABC Fund to turn around the bank. I also handled that investigation. At the end of the investigation, we were not satisfied that the ABC Fund had the managerial capacity to turn around Pan African Bank. The report I wrote warranted the State Governor to come to CBN to present his case. He presented his case and made some claims that our report was based on rumours and not on facts. As it were, he did not provide any new information. After his presentation, the response of the CBN Governor was very motivating to all of us who were examiners. The CBN Governor made it clear that any information that was not in the bank would not be used as evidence. In fact, the CBN Governor then informed the State Governor that he could not change the contents of the report. At that point, it became clear to the State Government that they had no case to present. The CBN stood by its position. Later the bank continued but as we all know, it never survived.

Also in 1989, the Federal Government decided that all public sector funds should be withdrawn from commercial banks and deposited with the CBN. That decision caused a major liquidity crisis in the banking industry. The CBN needed to respond to the liquidity crisis that ensued and that led to the setting up of a Liquidity Crisis Management Committee. The report of that Committee provided a basis for the intervention that took place, whereby the CBN and NDIC provided accommodation bills to banks that were in dire need of liquidity. Of course, the CBN discounted the bills. In fact, NDIC was very young then, just only three months old when that decision was taken.

In the late 1980s up to the 90s, there were observed weaknesses in financial reporting by banks. At a point the CBN decided to make banks have a uniform basis for assessing bank performance. That decision gave rise to the crafting of the Prudential Guidelines for income recognition and asset classification by banks. I played a very, very key role in crafting the Prudential Guidelines which are still in use today, with little or no revision, except for emergency reactions or responses. The recent revision was when CBN stipulated one percent for general provisioning and that was just for 2009 audited accounts. That document is still virtually what we had in 1990. To give the Guidelines the necessary legal backing, the CBN also collaborated with the Nigerian Accounting Standards Board (NASB) which issued statement of Accounting Standards (SASs) S. 10 for banks. That gave legal status to Prudential Guidelines. It was necessary to collaborate with NASB because it was not the responsibility of CBN to issue accounting standards. These were some of the major events or activities I can recollect we had while I was at the Banking Supervision Department.

We also had challenges in getting banks comply with rules and regulations. There were cases where banks preferred to pay penalties for infractions

rather than do the right things because the benefit of committing such infractions far outweighed the penalties. Over the years, one had advocated that the penalties were inadequate to discourage unethical behaviour in banking practices. A case in point was that of Union Bank. The government had taken over that bank as part of sanctions against Apartheid South Africa. After the sanctions were lifted, during the era of sectoral allocation of credit, the bank took a position that they would rather violate those guidelines and pay penalty; that they needed to regain market share which they had lost over the period. That is an illustration of the attitude of some of our bankers. But the then Managing Director of Union Bank, Dr. Paul Ogwuma later became the CBN Governor.

We also had cases with banks that were disputing examiners' recommendations for provisioning just because they wanted to declare huge profits. At that point in time, many banks including some accounting firms were not consistent in the way they treated financial transactions. Some banks were treating provisions as an operating expense while others were treating it as appropriation of profit. They would declare profit and then transfer it to provision. In the industry as a whole, there was no consistency in the treatment of financial transactions until the Prudential Guidelines were articulated. I was the Director of BSD for 7 years.

### ***In The Nigeria Deposit Insurance Corporation***

My association with NDIC was right from its formative stages. In fact, it appears that I was destined to work in NDIC. When the Corporation was about to take-off, the pioneer Managing Director of the Corporation, the late Mr. John Ebhodaghe, OFR, (who was a staff of CBN), selected some CBN staff to join him. I was number one on the list of staff he selected, but I chose to stay back in CBN. In spite of my staying back in CBN, I still

worked closely with him. Sometimes, when he had cause to ask for my opinion, I also obliged him. It is worthy of note that a team of International Monetary Fund (IMF) officials actually came and wrote a report, justifying the establishment of NDIC. When BSD was to comment on that report, it was given to two of us (Mr. Olaniran Alogba and I) to comment on. We made useful comments on the Report which the Management adopted. In view of my position as the Director of Banking Supervision Department, I had a close association with the NDIC.

As may be recalled, the first time I was appointed as the Managing Director/Chief Executive Officer (MD/CEO) of NDIC, I was not even in Nigeria. I was in Washington, D.C., USA. It was at the airport that someone said congratulations to me. That was during the administration of Gen. Abdulsalami Abuabakar (rtd). But when the democratic dispensation came into being, a panel was set up to review all appointments. We all know what happened then. In fact, I had to return to CBN. By October 1999, I was formally appointed by the democratic administration of Chief Olusegun Obasanjo.

By the NDIC Act, the tenure of the MD/CEO of the Corporation is 5 years, subject to reappointment. By virtue of my reappointment, I was in NDIC for a period of 10 years.

## **Challenges I Encountered In NDIC**

### ***Limited Public Understanding of Deposit Insurance***

One of the daunting challenges I faced at the NDIC as the MD/CEO was that of limited public understanding of deposit insurance. In other words, the public lacked proper understanding of the mandate of the Corporation. The public did not understand the difference between deposit insurance

and conventional insurance which is purely a commercial contract between 2 parties. Experience has shown that this limited understanding of Deposit Insurance System (DIS) is a challenge not only in Nigeria but also in other jurisdictions. Inadequate understanding is the major reason why many stakeholders do not appreciate why you do not provide full coverage for all bank deposits.

### ***Inadequate Legal Framework***

Even the legal framework of the Corporation had been a challenge. When the Corporation was established, both the CBN and NDIC were under the Federal Ministry of Finance. But in 1991, CBN got autonomy via the Banks and Other Financial Institutions Act (BOFIA). But NDIC was still under the Ministry of Finance. Initially, when the Corporation had a Board structure that had the CBN Governor as its Chairman, it was a lot easier to get certain policies implemented. At a later stage, the arrangement changed. Since the Ministry of Finance became the supervisory authority, things also changed.

### ***Lack of Enforcement Powers***

Another challenge bordered on the fact that the Corporation cannot implement the recommendations in its own examination reports. It relies on the CBN to implement those recommendations. But there were times CBN held a different view from those of the NDIC. That posed a challenge indeed. So an organization that has a mandate should have the necessary statutory powers to carry out the mandate.

Later, we initiated a review of the Act which culminated in the new Act. Yet it was not all the proposals we articulated that were reflected in the new Act. For example, we wanted the legal framework to be amended so as to enable the Corporation reimburse depositors once banks fail. But that was

not reflected. In 1998 when the CBN revoked the operating licences of 26 banks, the bank owners rushed to court to challenge the revocation. It would have been better if bank promoters could claim damages, if they felt their licence was wrongly revoked. They frustrate the Corporation's efforts to discharge its mandate by resorting to unending litigation. The cases of three banks, namely, Peak, Triumph, and Fortune are still in court.

### ***No Legal Protection for Officers and Directors of the Corporation***

Furthermore, the initial Act did not give legal protection to the officers and directors of the Corporation. Without that, directors and officials might be unwilling to take action because of fear. But that has been addressed in the NDIC Act 16, 2006. In any case, that should be tested. The legal protection states that officials of the Corporation should not be held liable for whatever actions they take in good faith in the normal course of their assignment.

It is still necessary for the Corporation to take action based on its own findings after examining banks, rather than relying on CBN's disposition. Sometimes, CBN prefers applying other sanctions. There was a case where an operator should have been sacked by NDIC, but CBN simply sanctioned him by making him pay some financial penalty.

### ***Capacity Building***

In terms of capacity building, there were challenges in getting staff of the Corporation to acquire certain skills. We made efforts in improving IT skills of staff. There was need for NDIC staff to be able to interrogate banks' systems and make an objective assessment of their operations. I heard that we have started implementing Risk-Based Supervision (RBS). I also heard that some banks do not have Risk Management Framework. How can you implement RBS in such a situation? We shall see how effectively that can be done.

### ***Ignorance on the Part of other Regulatory Agencies***

We have other supervisory authorities. Such agencies need to understand financial transactions. We once presented a paper to the Ministry of Finance for approval on interest waiver for bank debtors. But the Accountant General of the Federation said he could not waive government money. Even when he was told that it had nothing to do with government, he found it difficult to accept. In fact, we had to cite the case where government itself had been granted interest waiver. Such limited understanding on the part of supervisory authorities/agencies causes undue delays or outright denial of approvals.

### ***The Problem of Favour Seekers***

Again, the general view is that NDIC has a lot of money. Oftentimes people attempt to use their position to get what they do not deserve or to make us do what should not be done. There was the case of a man who came to me claiming that the Minister of Finance said I should grant him a favour. But when I spoke with the Minister, he said I should ignore him.

### ***My Impression About the Bank Consolidation Programme***

There are many reasons why some objectives of the consolidation programme were not realized. For instance, the short time frame given to banks and the speed with which the programme was executed were some of the contributory factors. The Asset Management Company (AMC) was a part of the 13-point agenda. But the company never materialized. I believe some of the reasons why the objectives were not realized was because when the policy was announced, some banks were terminally ill. But the author of consolidation decided to give every bank the same time frame of 18 months within which to recapitalize. Of course, some of the banks went to the capital market. Besides, most of the CEOs wanted to remain in the system as CEOs. So they resorted to desperate measures.

There are critical steps that must be taken before banks can merge. One of such steps is due diligence. In the process of carrying out due diligence, some banks were found to be illiquid and insolvent. Their financial condition was far worse than whatever they presented. That was why some of such groups crumbled. A good example was the first group that came out which was made up of Gulf, All States Trust Bank, Hallmark Bank and others. Consolidation presupposes that merger partners should be truthful. But many were not. Besides, the deadline was short. Ordinary market-based combinations take a long time period. But during the consolidation programme, everyone was under pressure. For instance, the group that gave rise to Spring Bank came together during the last week of the programme even without any due diligence. Up till now, we all know the condition of Spring Bank. If we have illiquid banks coming together, what kind of synergy will they produce? You don't build a structure on a weak foundation. The case of Finbank was also problematic. If you have a group that came together without proper due diligence, you can imagine what the outcome would look like. In the case of Spring Bank, the CBN had to intervene.

The requirement that banks desiring to manage a portion of the nation's foreign reserves must have \$1 billion also made many banks to go back to the capital market. If banks have capital they have not been able to deploy and at the same time they are raising more capital, what is the use? Our consolidation was a bit different from that of Malaysia, for instance. The banks in Malaysia made input into the policy document before it was released. But here in Nigeria, operators made no input whatsoever. Any major reform programme like that requires that the public and operators be adequately sensitized. That is the background to the non-realisation of some of the objectives of consolidation programme.



The consolidation programme increased the risk appetites of banks. As a result, the banks opened branches in several countries. They also began giving themselves accolades, claiming to be the best in different areas. The issue of consolidation could also be faulted in the sense that it placed undue emphasis on banks having huge capital. Also, by the time you have diversified ownership, it was expected that there would be stronger corporate governance arrangement and there would be more emphasis on risk management. But that did not happen. If you have a trillion dollars capital, a reckless management will mismanage it. So it is not just an issue of having huge capital.

### ***The Most Difficult Decisions I took In NDIC***

I did not have any easy decision. Every decision I took was in the best interest of the Corporation. In the case of Savannah Bank, we had discussions with CBN. I know what I went through at that time. Some people even advised me not to sleep in my house. But I ignored them, no matter whatever anybody wanted to do. All sorts of spurious allegations were made, but as far as I was concerned, they had no basis. Societe Generale Bank of Nigeria (SGBN) was an issue between CBN and the owners of the bank. We know that the financial condition of the bank was weak. Initially, the CBN threw the bank out of the clearing system. The owners tried to return to clearing, but the CBN Governor then stood his ground. The risk exposure of CBN would have continued to increase if the bank had not been thrown out clearing. Both SGBN and AIB were thrown out of clearing the same day. Later CBN gave SGBN some conditions like the amount of money they should bring before they could return to clearing. They were not able to raise the money. The amount they raised is still with the CBN till today. The bank later went to court.

In the case of Savannah Bank of Nigeria (SBN), the court awarded general damages against the three respondents, namely, CBN, NDIC and the Police. It was CBN that revoked the bank's licence and not NDIC. So since NDIC does not revoke banking licence, we appealed. We appealed because we (the Corporation) did not do anything wrong. That appeal is still at the Supreme court. It was not NDIC that revoked the bank's licence, so why should we pay damages? I know that some people are not happy about the decision we took.

### ***My Notable Achievements in NDIC***

First, the fact that we amended the enabling Act was a major achievement, considering the process of law-making in Nigeria. We know what we went through to get the Act amended.

Second, we also increased the maximum deposit insurance coverage (MDIC) limit from ₦50,000 to ₦200,000 per depositor.

Third, we extended deposit insurance coverage to other deposit-taking financial institutions such as the Micro-Finance Banks (MFBs) and Primary Mortgage Institutions (PMIs). This development has widened the financial safety-net arrangements.

Fourth, in terms of the organisation and its culture, we also tried to promote professionalism in the Corporation. As far as I know, the Corporation is highly respected in the industry. That is not a mean achievement, especially in the examination function. When we were bank examiners, we were very open with ourselves. There was nothing happening in the bank that we would not tell our colleagues. We normally would disclose all our findings with the banks. There was no room for

surprises. When you advise banks to make provision, they would tell you that the customer in question owns all the houses in his street. If a customer repays his debt, there should be evidence. Many bankers know that NDIC examiners will not compromise. That is a great achievement. We need to try and sustain that type of culture.

Fifth, in terms of networking, the NDIC is better known world-wide now than before. We are a pioneer member of the International Association of Deposit Insurers (IADI). That is a notable achievement. That also provided opportunity for us to benchmark with other organizations.

Sixth, the adoption of Differential Premium Assessment System (DPAS) is also an achievement. Banks had in the past agitated against paying premium based on the flat rate system, arguing that they do not pose the same risk to the Deposit Insurance Fund (DIF). We have responded to that by implementing the Differential Premium Assessment System. I believe that the premium assessment system should be improved upon to make the process more robust.

### ***My Unachieved Goals in NDIC***

In terms of operational independence or autonomy for NDIC, there is need for us to be able to take certain actions without having to rely on CBN. In which case, I sought but was unable to get independent enforcement powers for the NDIC. I however, believe that this would be achieved in due course.

I also believe that giving the nature of the function the Corporation performs, the remuneration package of staff should be tailored towards the industry instead of the ministry or civil service.

### ***My Advice for the In-coming MD/CEO of the NDIC***

Whoever wants to be CEO of NDIC will need a lot of courage, high commitment and should be professional in all his actions either in taking decisions or analyzing issues. This is because we live in an environment where people have diverse interests. People like to read meanings into whatever actions one takes. So you have to be factual to face those who will challenge you. That is my advice.

### ***My Advice to People Serving the Public***

My advice is that people should realize that they are serving the public when they are in positions of authority. They should try to meet or manage stakeholders without being rude or impolite. One should be accommodating too. When you are serving the public, be accessible so that people can get a feedback on issues affecting them, not through intermediaries or making their own imagination or all that. You should also try to maintain a high degree of accountability and transparency in rendering service.

### ***My Life After Retiring from NDIC***

Essentially, I have been trying to unwind, so to speak, and I am relaxing. Since I retired, I have not had any stressful situations. I still try to read some magazines to keep abreast of developments. While reading the Banker Magazine recently, I read an article captioned “Before the Storm”, which was about the condition of Nigerian banks. That took me down memory lane. So I have been resting before I decide on what next to do.

*Lessons that life has taught me*

My greatest lesson of life is that fingers are not equal. In life, you do not have equal opportunities. In society, you grow with people and yet find yourself in a different situation. One should be accommodating and helpful to people who might be in need. If you ask my secretary, he would tell you the number of letters I get from people asking for help. I try to help them, even when I do not know many of them. God has been kind to me. We should not neglect people who are less endowed.



# Chapter 1

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## **A REVIEW OF BANKING ACTIVITIES AND ITS REGULATORY FRAMEWORK IN NIGERIA: THE PAST, PRESENT AND FUTURE**

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### ***1.0 Introduction***

Banks whether in a developed or developing nation, are looked upon to perform the crucial roles of financial intermediation, provision of an efficient payment system and facilitate the implementation of monetary policies. In consonance with these traditional roles, the Okigbo Committee (The Financial System Review Committee of 1978) recommended that banks should be structured to:

- Achieve greater mobilization of savings in an efficient and effective manner;
- Ensure that no viable project is frustrated due to lack of funds; and
- Assist in achieving greater integration and linkages in the various sectors of the economy.

The Nigeria's Fourth National development Plan sought to enforce the recommendations of Okigbo Committee by directing the banking system to ensure:

- The mobilization of available savings through the provision of efficient

- banking services and bringing of the services nearer to the people;
- To manage the financial resources of the country skillfully;
- Channelization of adequate credit to the key productive sectors like agriculture and manufacturing; and
- Improvement in services offered to customers.

The literature is also very rich on the importance of banks in economic development. Schumpeter (1934) was the first proponent of the view that financial institutions are necessary condition for economic development. His view has been supported by scholars like Goldsmith (1969), Cameron et al (1972), Patrick (1966) and several other scholars.

The importance of the banking sector in the economic development of any nation underscores the need for regulatory structures to beam a search-light on its activities with a view to ensuring that operators play by the rules of the game and imbibe sound and safe banking practices as bank failures, if not well managed, can become systemic and could result in economic dislocation.

Over the years, there have been some complaints about over-regulation of the banking sector by the Regulatory Authorities. The germane question at this stage is, can we live this crucial sector to the whims and caprices of the operators? The answer to this question is an obvious No! Our experience as a nation, from 1892 when banking started in Nigeria to early 1950s when all but only 3 out of 25 registered banking institutions in that era failed was instructive. That was an era of little or no banking regulation. The truth is that in view of the significance of banking system to economic growth and development, governments the world over do regulate them more than any sector in an economy to ensure their efficiency and their safety and



soundness in order for them to provide the required support to economic activities, as failure to regulate them appropriately could spell doom for an economy. It should be emphasized that banks (unlike other business entities) rely heavily on deposits mobilized from public at large to sustain their operations. Hence, the need to ensure judicious utilization of depositors' fund remains imperative.

This chapter takes stock of the past, analyze the present and in a conscious attempt, make the best out of the threats and opportunities the future portend for the nation's banking system. The rest of the chapter has been divided into four parts. A review of the banking activities is undertaken in part 2 before a discussion of its regulatory framework in part 3. These two parts review the past and what obtains today. A glimpse into banking activities and their regulation in the future is attempted in part 4. The chapter has part 5 as conclusion.

### ***1.1 Overview Of Banking Activities***

The traditional business of banks, which has held sway till date is financial intermediation. By financial intermediation is meant the mobilization of funds from the surplus spending units at a cost for on-lending of such funds to the deficit spending units at a price both within and outside the shores of a country. This implies that in the absence of banking institutions, individuals or corporate bodies that want to invest would first accumulate enough funds overtime to be able to realize their desired objectives. In a similar fashion, those individuals or institutional investors with surplus funds would have to search and identify the deficit units that need their funds. The two processes would be too cumbersome, expensive and very inefficient. The banking system has come handy to play this vital intermediation role

efficiently since banking commenced in Nigeria in 1892 to date. Given this primary activity of banks in Nigeria, the following performance indicators are relevant to appreciate the extent to which they have performed:

- i. Volume of savings;
- ii. Volume of credits to end-users;
- iii. Tenor structure of credits delivered;
- iv. Trend of interest rates on savings/loans and the spread; and
- v. Monetary policy transmission.

**Table 1.1**  
**Deposit Mobilization By Banks 1970 – 2008**  
(×' Billion)

Year	Total Deposit of Banks
1970	0.6
1975	2.9
1980	10.3
1985	19.4
1990	43.9
1991	60.3
1992	86.7
1993	129.8
1994	162.9
1995	196.9
1996	239.3
1997	295.1
1998	349.3
1999	569.8
2000	838.59
2001	1,017.19
2002	1,226.62
2003	1,415.78
2004	1,814.74
2005	2,469.07
2006	3,412.27
2007	5,337.17
2008	8,702.99

*Source: CBN and NDIC Annual Report & Statement of Accounts (Various Issues)*

As evidenced in Table 1.1, the volume of deposits mobilized by banks has been on the increase over the years. It even witnessed a much higher volume and rate of growth in the post deregulation era, i.e. after 1986.

**Table 1.2**  
**Banks Credits to the Economy**  
**(1970 – 2006)**

Year	Private Credits	Government Credits	Total Credits
1970	0.17	0.25	0.424
1975	1.51	0.57	2.08
1980	6.43	2.64	9.07
1985	14.08	10.14	24.22
1990	35.23	7.36	42.59
1991	43.03	6.37	49.40
1992	57.1	2.16	59.26
1993	87.84	37.91	125.75
1994	109.2	41.66	150.86
1995	147.97	30.97	178.94
1996	212.05	53.89	266.44
1997	265.79	36.53	302.32
1998	331.79	46.3	379.09
1999	400,704.9	117,451.8	518,156.7
2000	530,373.4	(7,659.2)	522,714.2
2001	764,961.5	(22,077.7)	742,883.8
2002	930,543.6	141,609.8	1,072,153.4
2003	1,164,664	589,054.8	1,753,412.3
2004	1,421,664.0	448,536.1	1,870,216.6
2005	1,838,376.2	512,840.4	2,351,216.6
2006	2,327,995.2	(258,038.5)	2,069,956.7
2007	5,056,720.9	(2,368,484.3)	2,688,236.6
2008	8,059,548.9	(3,107,661.4)	4,951,887.5

Source: CBN Statistical Bulletin (Various Issues) and CBN & NDIC Annual Report & Statement of Accounts (Various Issues)

The delivery of credit to the end-users as shown in Table 1.2 indicates the performance of banks in their extension of credits to both the private and public sectors. In channeling funds mobilized by banks to the end users, they tend to operate at short-end of the market because most deposits are short-term. Before the advent of universal banking in Nigeria, merchant banks, which were required to extend long-term credits were unable to do so apparently to avoid or minimize asset/liability mismatch. In the case of the commercial banks, the distribution remained fairly constant and in favour of short-tenored credits. That explains why only about 10% on the average of loan portfolio of commercial banks was directed towards projects of more than 3 years gestation. Following the same pattern, loans of less than one year maturity extended by merchant banks gradually increased from about 31% in 1980 to above 60% in the 1990s (CBN, 1991).

The spread between the cost of funds and the pricing of loan products, which widened after deregulation, did not translate wholesale into higher profits for banks due to a number of other factors such as inflation and cost of operations, provision for non-performing credits, competition from non-bank financial institutions especially finance companies, which invaded the money market with unsustainably high “up-front”, “back-end” interest rates. Expectedly, some distressed banks were offering and paying unrealistic high interest rates on deposits just as they priced their loans to the extent that borrowers could not meet re-payment obligations. This has been identified as one of the major factors which led to huge non-performing loans and the financial distress in the Nigerian banking system before the revocation of the licences of 26 banks in 1998.

The banks had over the years facilitated the implementation of monetary policy. They had been used as vehicle to direct credit to preferred sectors

such as agriculture, manufacturing, housing, small and medium - scale enterprises, export producing companies and mining activities. Banks had also been made to play other developmental roles by operating branches in the rural areas. Of course, such monetary policy requirements impacted negatively on the profitability of commercial banks, which had to lend at concessionary interest rates. Many of the rural branches were also unprofitable as they were mere loss-centres to some banks as well as avenues for frauds in some banks.

The Nigerian banks had also been involved in other services, which included financial advisory services, foreign trade finance dealings and remittance services. In addition, banks provided ancillary services such as safe custody of valuables such as jewellery and certificates of occupancy.

#### *1.1.1 Bank Lending*

It is a paradox that lending which is the core business of banking has become the bane of many of them today. The paradox is attributable to a combination of factors including non-adherence to canons of lending, poor documentation, weak collateral protection, poor borrowing culture and difficulties in enforcing creditor rights. As a result, banks are apparently disposed to trade financing. It is therefore, not surprising that bank lending to finance imports has increased substantially. The real sector of the economy particularly, agriculture and small and medium scale enterprises are virtually crowded out of the credit market.

#### *1.1.2 Deposits Taking*

Prior to the liberalization of the financial market, Nigerian banks typically waited for depositors to walk into their banking halls to deposit money.

That was an era of armchair banking. These days, banks are competing intensively for deposits and that has led to a proliferation of products aimed at sourcing funds. The erosion of confidence, which the industry suffered in the wake of mass bank failures, manifested in flight to safety. Most depositors patronized banks perceived to be healthy thereby exacerbating the survival prospects of weak or marginal banks. Some depositors prefer to hedge against inflation by investing in real estate or holding hard currency.

#### *1.1.3 Money Market Operations*

Over the years, the money market underwent the boom and bust cycle. Currently, the riskless nature of government securities made them the preferred option. Banks therefore, switched loanable funds into investment in government securities.

#### *1.1.4 Money Transfer*

Money transfer has become a major banking service. Electronic purse, electronic banking and internet banking facilities are widely used. In particular, the inward transfer of money by Nigerian banks through the use of Western Union, Money Gram, Vigo, Ria, et cetera has eased the international payment mechanism considerably and has contributed to capital in-flow.

### ***1.1 Regulatory Framework***

Regulation of banks has been defined by Liwellyn (1986) as a body of specific rules or agreed behavior either imposed by some government or other external agency or self imposed by explicit or implicit agreement within the industry that limits the activities and business operation of financial institutions. In a nutshell, it is the codification of public policy

towards banks. Supervision on the other hand, is the process of monitoring banks to ensure that they are carrying out their activities in accordance with laws, rules and regulations and in a safe and sound manner. It is a means of ensuring compliance with laid down rules and regulations and to determine their financial condition at any given time. Bench (1993) asserted that effective supervision leads to healthy industry. Dimitri Vitas (1990) also believed that good regulation and supervision will minimize the negative impact of moral hazard and price shocks on the financial system thereby leading to a reduction in bank failure and financial system distress.

The objectives of banking regulation were advanced by Giddy (1984) to be monetary policy, (i. e., the ability of banks to create money through the extension of credit; credit allocation function of banks); the need to ensure competition and innovation by the prevention of cartels; and because banks are depositories of public savings, managers of payments mechanism, they are very vulnerable to collapse. On his part, Sheng (1990) stated the objectives of supervision as: promotion and development of sound and wide range of financial services to meet the needs and complaints of customers; ensuring high compliance with laid down rules and regulations, which are germane to ensuring high standards of banking, and to achieve important developmental and social goals through their compliance with monetary and credit allocation policies. Sinkey J. R. (1989) states the goals of regulations as:

- The protection of depositors;
- The protection of the economy from the vagaries of the financial system; and
- The protection of banks' customers from the monopolistic power of banks.

In both developed and developing economies, the finance industry determines the financial services available to the economies. Hence, regulation is necessary to break this monopolistic power and prevent abuse. Moreover, in developing economies, banks play their traditional intermediation roles as well as being used as a vehicle of achieving developmental and social goals. Banks in third world countries have to develop indigenous entrepreneurs by channeling credits to their uses. As result of this, the World Bank (1989) noted that banks in these economies have to be regulated to ensure that they play their proper role in economic development.

In a nutshell, the rationale for bank regulation can be summarized as follows:

- Efficiency
- Diversity of choice
- Competition
- Stability of financial system
- Macro-economic stability
- Developmental and social objectives

Prudential regulations have been classified into three by Dale (1986) as preventive, protective and supportive. While preventive regulations are designed to limit the risk incurred, the protective regulations offer protection in the event of failure. The supportive regulation is in form of lender of last resort.

Four approaches to bank supervision have also been identified. *The first approach* relates to information disclosures which are of two types. One, disclosure to the general public through the announcement of operating results and full disclosure to bank supervisors where public disclosure may not be necessary in order to protect the clients' secrecy. *The second approach*



is self regulation though the use of internal audit and controls, external auditors and board audit committee. Self regulation and self discipline are supposed to be more effective than regulation by a government agency because it is based on the conviction of self. It is also developed from industry norms; hence the stigma of noncompliance with peers and competitors are enough to encourage compliance. Self regulation works in advanced financial markets where market leaders impose market discipline. Though self regulation normally fails when market leaders themselves are weak or through competition and innovation. At such periods, self regulation becomes ineffective; indecision and self interest become a determinant. The third approach is through bank examination. This is the on-site surveillance to ascertain the financial condition of a bank. It also aims at verifying the accuracy of the reports of a bank's performance rendered to the Regulatory Authorities as well as confirming compliance with laid down laws, rules and regulations. If the examination report of a bank shows deficiency, corrective measures would be taken depending on the degree of the deficiency. In extreme cases, the Regulatory Authorities may intervene to stem further deterioration in its financial condition and protect the depositors' interest.

Finally, explicit deposit insurance scheme reinforces bank supervision through differential premium system. Ignacio Mas (1995) argued that moral hazard increased with the existence of deposit insurance scheme. This is because bank management tends to take higher risks with the assets of banks. It is therefore, desirable that risk-based premium be adopted to moderate risky behaviour by bank management.

Having laid the foundation for regulation, the remaining ensuing sub-parts of the chapter, review the trend in bank regulation in the country. This would be capped up with “a peep” into the future in part 4.

### *1.2.1 Post Nigerian Banking Ordinance (1952 – 1958)*

This period as earlier mentioned represented the pre-CBN era when there was little or no form of regulation in existence. Banking then was all comers’ game. Thus between 1892 and 1952 no fewer than 25 banking companies were registered.

What came to be the first form of regulation of the sector came into being with the adoption in 1952 of the Paton Commission’s report. That report was the bedrock of the banking ordinance enacted in 1952. The Ordinance spelt out conditions which must be met before banking licence could be granted to any institution to operate as a bank in the country. It indeed stipulated a minimum capital base of 25,000 pound sterling and 200,000 pound sterling respectively for indigenous and expatriate banks. Ironically by the time the Ordinance came into effect, all but 3 of the 25 banks had collapsed. The survivors then were the National Bank, ACB and Agbomagbe Bank (now Wema Bank). The stories of National Bank and ACB are very familiar to most people. The demise of indigenous banks was linked to mismanagement, low capital base, inadequate patronage, fraud and inadequate regulation.

### *1.2.2 Post CBN Establishment Period (1959-1986)*

The lessons of the massive failure of the indigenous banks made it imperative to have a critical look at the sector with a view to preparing ground for a robust banking sector prior to independence. Consequently, the Banking Ordinance of 1958 was enacted. The Ordinance led to the establishment of

the CBN in 1959. The establishment of the CBN ushered in the beginning of banking regulation in the country.

The CBN came with series of regulation parameters that changed the operating turf for good. Those regulations ranged from minimum capital standards, cash reserve requirements, rigorous screening and stipulations of conditions for bank directorships, restrictions on the operating and closing of branches, acquisition and disposal of assets, liquidity requirements, credit expansion and sectoral allocation, among others.

The driving force for the banking regulation and reform of that era was the need to promote the real sector which was necessary to nurture the infant Republic. The above considerations also led to the decision by the Federal Government to acquire controlling interest in foreign-owned banks vide the indigenization decree. Some specialized banks (NIDB, NBCI, FMBN, NACB, etc) were also set up to provide the much needed funding in the real sector of the economy. That was necessary in order to bridge the funding gap created by the foreign owned banks which concentrated their resource allocations on short-term trade finance for foreign owned companies. Thus, the regulatory focus at that time was the implementation of economic development through direct credit allocation. Very little attention was then paid to what came to be known as prudential regulations today.

### *1.2.3 The Post-Deregulation Era*

The collapse of the international oil price in the 1980s necessitated the restructuring of the economy in order to address the distortions in the system. One of the key areas of the structural adjustment programme introduced in July 1986 was the financial sector reform. The thrust of the programme was to deregulate and allow the emergence of new institutions in the sector in

order to remove the imperfection in the operations of the financial market particularly the banking sector.

Bank licensing was consequently liberalized such that by the time embargo was placed on the issuance of new banking licence in 1991, a total of 79 new banks had been licensed, which brought the total number of banks operating in the country to 120, with a network of 2,107 branches. Thus, against the background of the economic deregulation policy of that era and upsurge in the number of licensed banks, it became imperative to restructure and beef up the regulatory apparatus in order to prevent a reoccurrence of the massive bank failures of the early 1950s, which brought untold hardship to the banking public.

In furtherance of the government's objectives of having a virile banking sector, Decree 22 of 1988 (the NDIC decree) was promulgated to pave way for the establishment of an explicit deposit insurance scheme in the country. That was in consonance with the government's decision among other reasons to shift emphasis from bail-out of shareholders and management of banks to the protection of depositors whose interest might be jeopardized due to stiff competition that ensued.

The CBN laws were also reviewed in 1991 to give the apex bank more powers to regulate a more aggressive banking sector. The same year, Decree 25, Bank and Other Financial Institutions Decree (BOFID) was promulgated. The decree gave powers to the CBN on matters of regulation and the supervision of the licensed banks especially in relation to the granting of banking licence, resolution of problem or failing banks, which before then were the responsibilities of the Minister of Finance. Other reforms brought

about by the decree was the empowerment of the CBN to increase the minimum paid up capital of commercial and merchant banks as it deemed fit. Today for a new bank to be licensed, its promoters must have a minimum paid up capital of ₦25 billion before they can operate in the country.

Another major reform that had a profound impact on regulatory practice in the country was the issuance of Prudential Guidelines for licensed banks in November 1990 by the CBN. That document spelt out objective criteria for income recognition, asset classification and provisioning. It sought to ensure uniformity and comparability of the audited financial statements of licensed banks.

The policy shocks occasioned by the banking reforms entrenched in the Structural Adjustment Programme (SAP), the CBN adoption of the Basle Committee report on capital adequacy, the harmonization of accounting practice by banks vide the issuance of SAS 10 and the directive that required public sector deposits to be transferred to the CBN, exposed the precarious liquidity positions of some banks and the distress that was inherent in their operations. The distress level was so pervasive that no fewer than 60 banks were classified distressed by the regulatory authorities as at the end of 1995. As a matter of fact, it took the timely intervention of the Regulatory Authorities to prevent what could have been a systemic failure. To date, there are 48 banks in liquidation. Contrary to expectation that the bank consolidation programme, initiated in 2004, would ensure the emergence of stronger banks and a more resilient banking system, distress syndrome still pervades the banking system.

### ***1.3 Banking Activities and its Regulation in the Future***

The banking system would continue to harbour inherent risks. Hence, the need for change of focus by both the operators and the regulators has become pertinent. It is imperative that regulation should be upgraded through the consolidated supervision and risk – focused supervision of banks while prudential standards should be made stringent

The rapid development in information technology and globalization has had serious impact on banking practices in the country. Those factors are also expected to continue to drive the way businesses are conducted worldwide. Today we talk of the internet, E-commerce, E-banking etc. Also, it is no longer news today that somebody could stay in the comfort of his room and move millions around the globe. While this is convenient, it equally carries with it the risk of computer fraud and encroachment of privacy of the individuals. In the light of these inherent challenges, it behooves us all to be more proactive in the discharge of our responsibilities. Even though effective risk management has always been central to safe and sound banking activities, it has become even more important as new technologies, product innovation, diversification especially with bank consolidation, and the size as well as speed of financial transactions have changed the nature of banking markets.

### ***1.4 Conclusion***

An attempt has been made in this chapter to review the nation's banking activities over the years as well as its regulatory framework. As shown in this chapter, there are many reasons why the nation's banking system like

in many other nations is being regulated. A principal rationale has been to ensure the safety and soundness of the banking system. As noted in the chapter, the future holds a lot of opportunities and challenges for the nation's banking system, especially with the emergent globalized financial system made possible by modern information technology. In this regard, the chapter has indicated that the Regulatory Authorities and other stakeholders, especially banks management would have a lot to contend with. While the chapter shares the school of thought that says regulation is not a guarantee against bank failure, there is the need to quickly add that good regulation and supervision remains invaluable as it serves to minimize the adverse impact of moral hazard and relative price shocks on the banking system, thus decreasing the likelihood of bank failures and banking system distress.





# Chapter 2

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## THE REGULATORY IMPERATIVES OF IMPLEMENTING UNIVERSAL BANKING CONCEPT IN NIGERIA<sup>1</sup>

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### **2.0 Introduction**

In view of the acclaimed benefits of universal banking, which has become a global phenomenon with the advent of trade liberalisation and financial deregulation, the Central Bank of Nigeria (CBN) had reviewed the operating environment for the system and approved its introduction in Nigeria. In a Circular (Ref No. BSD/DO/Cir/Vol.I/10/2000), dated 22 December, 2000 addressed to all licensed banks, insured banks were now free to choose which activity or activities to undertake (money or capital market activities or insurance marketing services or a combination thereof) and are expected to comply with guidelines specified for such activity or activities. The Circular defines banking business in Nigeria as

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<sup>1</sup> Original paper was presented at the Year 2001 Bank Directors' Seminar organized by the FITC in Abuja, June 2001.

*“the business of receiving deposits on current, savings or other accounts; paying or collecting cheques drawn or paid in by customers; provision of finance, consultancy and advisory services relating to corporate and investment matters; making or managing investment on behalf of any person; and the provision or insurance marketing services and capital market business or such other services as the Governor of the Central Bank of Nigeria, may, by regulation, designate as banking business”.*

The announcement of the guidelines generated a lively debate. While some commentators do not see anything wrong with the new arrangement, others believe that permitting banks to engage in securities and insurance marketing businesses could increase their overall risk profile. They also believe that universal banking could be more susceptible to conflicts of interest than conventional banking. Furthermore, a few commentators challenged the legality of the procedure adopted in introducing universal banking in Nigeria. Notwithstanding the diverse reactions to its introduction, the position in this paper is to accept it as a *fait accompli*, highlight the challenges posed by it as well as its regulatory imperatives.

Dealing adequately with these challenges is crucial because an efficient financial system is a prerequisite for the effective functioning of any nation's economy. Owing to this fact, countries have established policies for the regulation and supervision of their banking system. It is envisaged that the emergence of financial conglomerates offering both banking and non-banking services as a result of the implementation of universal banking in Nigeria will engender a lot of challenges to all actors in the nation's financial services industry. The new concept is expected to pose some supervisory challenges as a result of diverse exposure by the group, possible contagion effects with respect to intra-group exposures and increased likelihood for reduced transparency as a result of complex group structures.

Other envisaged challenges are ensuring effective information-sharing mechanism between the different regulators/supervisors responsible for the different entities within the conglomerates and minimising supervisory arbitrage. All of these make the choice of regulatory imperatives in the successful implementation of the universal banking concept in Nigeria for discussion, timely and relevant.

In discussing this topic further, I shall examine in section 2, the concept of universal banking. Section 3 will address the regulatory imperatives of implementing universal banking concept in Nigeria, and section 4 will conclude the discussion.

### ***2.1 The concept of Universal Banking***

Several countries of the world have adopted various forms of universal banking in consonance with their definition of the concept and adaptation to the peculiar characteristics of their respective financial system. For instance, in Germany, the Netherlands, and Switzerland, banks engage in a wide range of banking and underwriting business activities. In addition, varieties of commercial-financial relationships exist whereby banks establish or acquire and control non-financial corporate entities and vice versa. In South Africa, the monetary authorities through the instrumentality of the Banking Act, issue uniform licences to banks and do not distinguish between classes/types of licences.

In Japan, there is the “Keiretsu” framework which allows for the existence of linkages between financial and non-financial entities in such a way that may not necessarily entail direct ownership. In the USA, through a number

of statutory amendments, banks and bank holding companies have in recent years, been allowed to expand their investment banking activities into areas such as brokerage and financial advisory services, mutual funds services and securities' underwriting. There has been a steady movement towards universal banking in Canada with the separation of functions among different financial institutions becoming blurred and penetration by each group into the others' primary areas of business. Banks in Britain, being broad-based and diversified financial institutions, may engage in almost any type of financial activity. Indeed the clearing banks are permitted to develop into diversified financial service groups that engage in universal banking, although most British banks conduct their securities' activities through separate subsidiaries.

Globally, although there is no consensus on how to practice universal banking, there seems to be agreement on its salient features. For instance, it removes the restrictions between money, capital and insurance markets such that a banking institution can offer integrated financial services. These include deposit taking and lending, underwriting of new debt/equity issues, stockbroking, insurance, investment management, etc.

## ***2.2 Regulatory Imperative of Implementing Universal Banking Concept***

### ***2.2.1 Bank Regulation***

There is a general consensus that banking system regulation/supervision by relevant authorities is not only a legitimate function but also imperative. This viewpoint is premised on banks' pivotal role in the development process of the economic system. Moreover, in a developing nation like ours, banks play their traditional intermediation roles in addition to being used as vehicles for achieving developmental and social goals.

Regulation of banks according to Llwellyn (1986), involves a body of specific rules or agreed behaviour either imposed by government or other external agencies or self imposed by explicit or implicit agreement within the industry that control the scope of activities and business operations of financial institutions. Dimitiri (1990) posits that good regulation and supervision will minimise the negative impact of moral hazard and price shocks on the financial system thereby leading to a reduction in bank failure as well as financial system distress.

The goals of bank regulation, include the protection of depositors, the protection of the economy from the vagaries of the financial system as well as the protection of banks' customers from the monopolistic power of banks (Sinkey, 1989).

Prudential regulation can be classified into three – preventive, protective and supportive. While preventive regulations are designed to limit the risk incurred, the protective regulations offer protection in the event of failure. The supportive regulation on the other hand is essentially in form of lender of last resort role of the central bank. These regulations are usually backed up with supervisory efforts to monitor safety and soundness as well as ensure that prompt remedial steps are taken in identified cases of delinquencies.

### *2.2.2 The Regulatory Imperatives Of Implementing The Universal Banking Concept In Nigeria*

The adoption and implementation of universal banking concept in Nigeria as earlier noted, will engender the emergence of financial conglomerates and large banking groups that will require the attention of different

regulatory/supervisory agencies in the system. The implementation of the new concept is bound to pose challenges to all parties viz the different regulatory/supervisory authorities and operators in the system. Below we examine some of these regulatory imperatives.

#### *2.2.2.1 Public Safety Net*

The implementation of universal banking concept requires a strong safety net. The main components of the safety net are basically, effective supervision, deposit insurance as well as the lender of last resort role of the central bank. Apart from the deposit insurance scheme implemented through the Nigeria Deposit Insurance Corporation (NDIC) for licensed banks, there is presently no protection for the users of the other components of the nation's financial services industry in the event of insolvency and failure of any of the institutions operating in those sub-sectors.

As a deposit protection agency, NDIC is concerned as to whether banks can prudently diversify into securities and insurance businesses without jeopardising depositors' or our Deposit Insurance Fund (DIF). For instance, banks could utilise depositors' funds to make bad loans either to assist securities affiliates or to protect the securities underwritten by such affiliates. It is also possible that depositors fund could be utilised by banks to purchase equity securities or for proprietary trading in stocks.

#### *2.2.2.2 Risk Segregation*

As I already indicated, there is need for effective **“firewalls”** between banking and non-banking financial services rendered by universal banks. I have also opined that the use of separate legal entities is not sufficient guarantee for the safety and soundness of banks that are members of financial

conglomerates. It is therefore imperative to have regulatory restrictions on risk taking. In pursuance of this approach, the following issues are presented for consideration by the banking and securities regulators:

- i) Banks should not guarantee or enhance the marketability of securities or debt instruments underwritten by their own affiliates or subsidiaries.
- ii) Banks should not grant loans to clients for the purpose of repaying obligations relating to securities underwritten by their affiliates or subsidiaries.
- iii) Affiliates/subsidiaries of banks should not be permitted to serve as issuing houses for stocks affecting their parent or affiliated banks.
- iv) Banks' affiliates should publicly disclose that their liabilities are not insured by NDIC.
- v) The existing Prudential Guidelines for banks which place greater emphasis on credit risk, asset classification, income and loss recognition requires a comprehensive review to accommodate other risks to which universal banks will be exposed.
- vi) There is need for clear guidelines for banking intra-group transactions such as sale and lease back, swaps, back-to-back transactions.
- vii) There is need for the adoption of risk-based supervision by all the regulators of the financial services industry.

- viii) Disclosure requirements by financial institutions should be reviewed and enhanced to facilitate market discipline. The above list is by no means exhaustive.

#### *2.2.2.3 Executive Capacity*

The emergence of financial conglomerates and large banking groups under the universal banking concept is expected to pose problems which will include large exposures at group level as well as contagion with respect to intra-group exposures. As we all know, financial institutions in the various segments of the financial system are exposed to different types of risks. To ensure effective supervision under the new dispensation there is the need for well defined roles and shared responsibilities amongst regulatory/supervisory agencies in the system. Also, under universal banking, the need for information sharing among financial services regulators cannot be over-emphasised.

The strong linkage between the various sub-sectors of the financial system makes activities in and policies of one segment to impact on other segments. Adequate information sharing will improve the information data bank of the regulators, thereby enhancing their regulatory and supervisory activities/roles at all times and could provide an early warning signal to regulators for mitigative actions to be taken to avert adverse events. Efforts should be made to remove all legal and other obstacles to the flow of information between different regulators/supervisors that are typically related to the issues of confidentiality. Adequate arrangements that engender free flow of information between regulators/ supervisors would ensure prompt and timely harnessing of all available information necessary for evaluating the financial condition of the institutions for timely and effectively decision making.



It is imperative that the flow of information among various regulators/supervisors should be encouraged as a way of cross-referencing on claims on the health conditions of regulated entities within the financial conglomerate should be encouraged and sustained.

#### *2.2.2.4 Adequate Legal Framework For Implementing Universal Banking*

The nation's financial services industry is presently characterised by an array of legislation on banking, insurance as well as securities businesses. It is therefore imperative that the existing enabling laws in the financial services industry be amended and/or repealed so as to harmonize the procedures for licensing of institutions under the new dispensation. This is necessary to ensure that only those firms (and where appropriate, individuals) who meet specified standards of integrity, financial capacity and competence are permitted to operate in the nation's financial services industry.

Another major challenge presently, is the inadequacy of enforcement powers for regulatory/supervisory agencies in the system. With universal banking, the need has arisen for the regulators/supervisors to be given adequate enforcement powers that would ensure the implementation of recommendations made concerning the operations of an institution under the new dispensation. Over the years the inability or unwillingness of the Board and Management of most banks examined for example, to implement faithfully the recommendations contained in examination reports constituted a major draw back towards enthroning a safe and sound banking practices. It is therefore imperative that necessary amendments are carried out in the various laws in the system so as to make their enforcement and compliance processes more effective than hitherto.

#### 2.2.2.5 *Consolidated Supervision*

Given the present multi-regulatory/supervisory structure in the system, it has become necessary to work out modality by which supervisory responsibilities are clearly streamlined and optimised for effectiveness and efficiency in the system. In the Circular of December 22, 2000 (guidelines for implementing universal banking in Nigeria), three major apex regulatory agencies are recognised. The agencies are the CBN, NAICOM and SEC for the regulation of banking, insurance and securities businesses respectively. These three institutions in addition to the NDIC, would be involved in the supervision of the various institutions under the new arrangement.

The development has no doubt made it necessary for consolidated supervision that requires consultation and cooperation amongst the various regulatory/supervisory institutions in the system. The need for such a consolidated supervision is to minimise regulatory arbitrage, facilitate information sharing as noted above, as well as joint supervisory action where necessary. Presently, banks and other financial institutions report their activities to their respective supervisors in the system, utilising formats approved by each regulator. The implementation of universal banking will require a more comprehensive format to capture all the activities of a banking firm while on-site examination should cover all the operations of financial conglomerates.

It is imperative that the present reporting format of banks be reviewed so as to incorporate all the possible activities that banks are likely to undertake under universal banking. This will make it possible for supervisors to obtain a global view of the bank's operations as well as prevent the submission of different sets of returns to the different regulatory bodies which would give a misleading picture of the affected bank's activities. And I am fully

convinced that an enhancement of the automated Banking Analysis System (BAS) to cover the expected new areas of banks' activities under the universal banking will go a long way to assist in this regard.

#### *2.2.2.6 Market Discipline*

With the implementation of the universal banking, it is imperative that accounting as well as disclosure requirements of financial institutions be enhanced. There is also the need for the regulatory agencies to review information disclosure requirements so as to minimize information asymmetry between banks and the investing public. This is necessary to ensure that business decisions by the investing public, are well informed under the new dispensation. Adequate information disclosure requirement will force banks to pay greater attention to reputational risk that could result in loss of confidence as well as patronage. As a necessary step to promote market discipline, it is imperative that the full weight of the provisions of applicable laws be brought to bear on erring operators in the order to help promote safe and sound banking practices under the universal banking concept.

#### *2.2.2.7 Self- Regulation And Self- Discipline*

Given the range of permissible activities under Universal Banking, regulation and supervision of the financial services industry should be the joint responsibility of both the regulators and market participants. That is, statutory regulation should be complemented by self-regulation. Self-regulation and self-discipline are likely to be more effective than regulation by a government agency because it is based on the conviction of self. It is therefore imperative for regulatory/supervisory authorities to continue to encourage market operators to adopt self regulation practices.

Regulators/supervisors in the system must continue to encourage banking institutions under the universal banking scheme to draw up and bind all their staff to a code of ethical and professional practice. Effective self-regulation as we all know, require probity, transparency and accountability, which are yet to be fully entrenched in the system. The regulatory supervisory authorities must take necessary steps to encourage these virtues and operators must be made to appreciate the need for compliance with rules and regulations to promote healthy competition since self-regulation does not amount to a total elimination of regulatory controls and supervision. It only confers some measure of confidence and trust in the ability of organizations to regulate themselves in the public interest.

#### *2.2.2.8 Responsive Corporate Governance*

Another regulatory imperative for the implementation of the universal banking concept is the need to ensure the transparency and accountability of management of banking institutions and the curtailment of their risk appetite, Regulatory/supervisory authorities must continue to encourage banks to put in place responsive corporate governance structure for risk management and to minimize conflict of interests. Also, additional responsibilities must be placed on the Board of Directors. In this connection, it is advocated that certain requirements, such as the establishment of audit committee of the Board (which is presently mandatory for public limited liability companies only) are made mandatory for universal banking. Also it should be mandatory for a bank to establish a conduct review committee, which will develop procedures for the review of transactions with related parties. Such transactions, which should be at arms length, must be subject to the committee's prior approval.

### **2.3 Conclusion**

The implementation of the universal banking concept in Nigeria is another bold step to further the diversification process of the financial system. However, for a smooth operation of universal banking concept, the need for unrestricted inter-agency co-operation among the financial system regulatory/supervisory authorities is required, more than ever before. In view of the fact that the concept of universal banking is not a panacea for eliminating bank distress or outright bank failure, it is considered imperative for banks to undertake the noble responsibility of self-regulation. Other imperatives that would go a long way in enhancing the implementation of the concept in Nigeria as highlighted in this paper are a reform of the present banking enabling laws, a strong public safety net, responsive corporate governance as well as market discipline.

It is my firm belief that if the foregoing imperatives are upheld, the benefits of universal banking will be fully realized. In view of the diverse policy issues likely to be associated with the new concept, it may be necessary to set up a high level committee to design a framework for issues relating to the appropriate structure as well as the supervision (especially as it relates to the issue of consolidated supervision) of institutions in the system. This could be done under the auspices of the Financial Services Regulation Coordinating Committee.

On a concluding note, given the experience of some other countries that have successfully practiced it, universal banking will have a positive fall-out for the Nigerian economy. Apart from creating a level playing field, engendering competition and better delivery of customers' service, the

implementation of the universal banking concept will go a long way to create economies of scale and efficiency which invariably will impact positively on the economic growth of the country.

# Chapter 3

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## **REGULATORY CHALLENGES IN A CONSOLIDATED NIGERIAN BANKING SYSTEM: NDIC PERSPECTIVE<sup>1</sup>**

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### ***3.0 Introduction***

Over the last decade, the international banking industry, particularly in emerging market economies, has undergone substantial structural changes. Particularly noticeable is the tendency toward consolidation which has the effect of reducing the numbers of banks and other deposit-taking financial institutions with a simultaneous increase in size and complexity of the consolidated entities in the sector. Among other factors, these changes have been initiated and sustained by technological innovation, deregulation of financial services industry at the national level, and opening up of countries to international competition. In Nigeria, the most notable contemporary banking policy issue that recently received a great deal of attention is bank consolidation and its implications for the economy, and the banking system as well as regulatory agencies like NDIC.

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<sup>1</sup> *Original paper was presented at the 14<sup>th</sup> Delegates Conference/Annual General Meeting of the Money Market Association of Nigeria, February 2005.*

The decision of the CBN to strategically place the nation's banking system in regional and international context and promote soundness, stability and enhanced efficiency of the system led to the proposed increase of minimum capital base of universal banks to ₦25 billion in July, 2004. No doubt, the development had in turn prompted a regulation-induced restructuring in the form of consolidation through Mergers and Acquisitions (M & A). Consolidation of banking institutions aims, among others, at strengthening the banking sector to more meaningfully protect depositors, play developmental roles in the nation's economy, and become a competent and active player in the African regional and global financial system. It is also envisaged that the reform would, overtime, guarantee higher returns to the shareholders and other stakeholders of the banking industry.

The new policy initiative will, no doubt, pose some challenges to both the economy as well as the banking system. As a deposit insurer, a consolidated banking industry could pose some risks to the NDIC. For example, the deposit insurance funds could face larger potential losses from the failure of a single large consolidated institution.

Also, insurance is based on the concept of diversifying risk and, as the banking industry becomes more concentrated as a result of consolidation, NDIC's risk, as the deposit insurer, becomes less diversified. Larger institutions also are more complex and tend to deal in sophisticated financial products. Very large banks pose challenges when they are in danger of failure, both because of their systemic impact and the operational challenges that the NDIC would face in resolving their failure.



The objective of this paper is to enumerate some of the challenges that the Nigerian consolidated banking system could pose to the NDIC as an important component of the nation's financial safety-net. In order to achieve the objective of the paper, the next section gives an overview of the Nigerian banking system while section 3 briefly reviews the on-going bank consolidation programme in Nigeria. This is followed in section 4 by a brief discussion of NDIC's role in the nation's banking system. In section 5, we enumerate some of the challenges posed by the consolidation of the Nigerian banking system to NDIC. Section 6 summarizes and concludes the paper.

### ***3.1 Overview Of The Nigerian Banking System***

A review of developments in the Nigerian banking and financial system indicates that the banking sector has undergone remarkable changes over the years, in terms of the number of institutions, ownership structure, as well as the scale of operations driven largely by the deregulation of the financial sector in line with the global trend. As at the end of 2004, insured banks stood at 89 of various sizes and degrees of soundness. The sector generally enjoyed a stable operating environment until the July 6, 2004 announcement of the CBN which introduced a major policy initiative affecting the sector.

The foregoing notwithstanding, the market share, based on the industry's total assets distribution, shows that the sector was (and still is) highly concentrated with the top ten banks accounting for more than 50% of the total assets. Many of the 89 banks are small in size and unable to effectively compete with the bigger ones. Many of the small banks are closely held and

are plagued by low capital base, weak corporate governance as manifested in meddlesome interference in management function by principal shareholders, and poor risk management. The banking industry remains largely oligopolistic. Besides, when the nation's banking sector is compared with the banking sectors of the emerging economies, our banking sector could be rightly described as fragile, poorly developed and extremely small as illustrated by the CBN Governor in his July 6, 2004 address to the Bankers Committee.

As observed by Bossone, Honohan and Long (2001) small banking systems under-perform. They suffer from a concentration of risks. The smaller the banking system, the more vulnerable it is to external shocks. Small banking systems provide fewer services at higher unit costs, largely because they cannot exploit economies of scale, and partly because of lack of effective competition. Regulation and supervision of small banking systems have also been observed to be disproportionately costly.

The foregoing weakness and the global trend of competition and internationalization of finance informed the decision to reposition the Nigerian banking industry by raising the minimum capitalization requirement for banking business with consolidation through mergers and acquisitions as a major objective.

### ***3.2 Consolidation Of The Nigerian Banking Industry***

In general terms, consolidation of banking firms involves either a combination of existing banks, organic growth of the leading banks or exit from the industry of weak banks. The consolidation programme recently introduced and being implemented in Nigeria takes the form of mergers

and acquisition as well as organic growth. According to the Central Bank of Nigeria (CBN), the reform became necessary because of the observed fundamental problems in the industry, which include, among others:

- Significant asset quality problems;
- Undercapitalization of a number of industry players;
- Significant corporate governance issues;
- Late or non-publication of annual accounts that obviates the impact of market discipline in ensuring banking soundness;
- Over-dependence on public sector deposits (accounting for over 20 percent of total deposit liabilities of deposit money banks and over 50 percent in some banks). The implications are that the resource base of such banks are weak and volatile, rendering their operations highly vulnerable to swings in government revenue, which in turn is equally plagued by uncertainties of the international oil market;
- Inadequate risk management practices; and
- Neglect of small and medium scale enterprises by the banking industry.

In the main, the policy aims at developing a more resilient, competitive and dynamic banking system that supports and contributes positively to the growth of the economy with a core of strong and forward looking banking institutions that are technology-driven and ready to face the challenges of liberalization and globalization. The reform essentially entails the build-up of capital, size and business scale of the banking institutions, at the end of which smaller number of, but much stronger, institutions will emerge.

At this juncture, it is important to indicate that the announcement and the implementation of the policy have induced a shake-out in the industry, which has posed a new set of challenges to the NDIC. For example, following the

announcement, the inter-bank market was adversely affected as inter-bank placements by the big players in the market were withdrawn from smaller banks as a precautionary measure. There was also a wave of flight to safety by depositors who were apprehensive of the survival of their banks. The development coupled with the planned phased withdrawal of public-sector funds from the universal banks made the liquidity position of some banks precarious. Apart from the shock-induced problems, the fact remains that some of the banks, particularly the marginal ones, may be unable to get a merger partner and/or be acquired by a stronger bank before the end of 2005 and that would compound the problems of such banks and could lead to their eventual demise post December 2005. These and other emerging challenges would put severe pressure on the Corporation's financial and human resources. Currently, the Corporation is considering applications for liquidity support from three banks. Before enumerating some of these challenges, the role of the NDIC, as highlighted by the provisions of its enabling Act, is briefly discussed below to enable us better appreciate the challenges facing the Corporation from the recent development of bank consolidation.

### ***3.3 The NDIC And Its Role In The Nigerian Financial Safety-Net***

A deposit insurance scheme (DIS) is one of the components of the official safety-nets. The other components are effective supervision and lender-of-last resort facility by a central bank through the provision of temporary liquidity support to solvent depository institutions. Essentially, a deposit insurance scheme (DIS) is a financial guarantee to the depositors, particularly the small ones, in the event of a bank failure. Bank deposit insurance schemes developed out the needs to protect depositors, especially the uninformed,

from the risk of loss; and to also protect the banking system from instability occasioned by runs and loss of confidence. A DIS is different from a conventional insurance where cover can be up to 100% whereas explicit in a DIS, coverage is usually limited. Also, while deposit insurance premium is paid by the insured institutions, depositors are the direct beneficiary of the scheme.

The practise of the DIS in Nigeria commenced with the promulgation of decree 22 of 1988 now Cap. 301 laws of the federation 1990, as amended, which established the Nigeria Deposit Insurance Corporation (NDIC). The NDIC commenced operation in 1989. The scheme was introduced to provide a further layer of protection to depositors and complement the role prudent bank management as well as the Central Bank Of Nigeria's (CBN's) supervisory activities in ensuring a safe and sound banking system. It was also considered as additional framework to serve as vehicle for addressing some of the challenges that followed the deregulation of the financial system under the Structural Adjustment Programme (SAP) which was introduced in 1986. Prior to the establishment of the NDIC, the government was playing the role of an implicit insurer as it had to bail out troubled banks in its bids to protect depositors. With deregulation, an explicit DIS became imperative.

The establishment of NDIC was also informed by the change in government bank-support policy, the bitter experiences of prior banks failure in Nigeria and the lessons of other countries with bank deposit insurance scheme.

The scheme therefore, envisions increasing the competitive efficiency of the banking system's vulnerability to destructive, panic-induced shocks by reinforcing depositors' confidence in the nation's financial system. At inception of the NDIC, Nigeria was the second African country after Kenya

to establish a deposit insurance scheme. The Nigerian scheme has however become prominent, partly because of the large size of the Nigerian economy and partly because of the enormity of the challenges faced by the Nigerian scheme at the inception, particularly the level and extent of banking distress. In addition, the DIS being implemented by the NDIC was designed as a **Risk Minimiser**, (as against the **Pay-Box** in other African countries), with powers and responsibility to guarantee payment to depositors of insured institutions, monitor the health of insured institutions through supervision and serve a mechanism for orderly resolution of failing and failed insured institutions.

It is gratifying to note that the Corporation has played the above roles creditably well over the years and that has gone a long way in engendering depositors' confidence in the nation's banking system.

### ***3.4 Bank Consolidation-Induced Challenges to NDIC***

One of the functions of capital is to serve as a symbol of confidence in banking institutions. Therefore, the strong capital base prescribed under the consolidation programme is consistent with the Corporation's mandate of promoting public confidence in the banking system. The increase in the minimum capitalization requirement for banks will, to a large extent, engender public confidence in the banking system as it will enhance banks' capacities to absorb operating losses and minimize recourse to depositors' funds for acquiring "brick and mortar" or "marble façade". However, as a deposit protection agency, NDIC is concerned with the likelihood of a shake-out in the banking industry following the policy shift, at least in the short-run, as well as the need to put in place appropriate strategies to ensure

adequate depositor-protection under a consolidated banking environment. These challenges can be discussed under two broad sub-headings, namely: Pre-consolidation Challenges and Post consolidation challenges. Some of these challenges are as presented below.

### *3.4.1 Pre-consolidation Challenges*

#### **a) Liquidity Problems**

The new minimum capital requirement of N25 billion, which prompted the on going consolidation exercise, has led to panic in the inter-bank market. Following the new policy direction of the CBN, particularly as it relates to consolidation and increase in banks' capital base, the big players in the inter-bank market withdrew their funds from the market with the attendant liquidity problem for the marginal banks. Currently, some banks have been thrown out of the clearing system as a result of their weak liquidity position. This situation becomes a concern for the NDIC as a few banks are currently unable to meet their obligations to their depositors. If the development is not properly managed, what begins as a mere liquidity problem may cause runs on these banks and other banks and may well lead to the failure of some banks. The situation may warrant the provision of financial assistance by the Corporation to eligible banks. Eligibility criteria for accessing financial assistance from the NDIC include, among others, the following:

- Solvency;
- Good corporate governance;
- Credible turn-around plan;
- Credible repayment plan; and
- Acceptable collateral.

**b) Raising of Bank Capital Using Laundered Financial Resources**

With the minimum capitalization of ₦25 billion, banks are continually flooding the capital market to raise additional capital funds either to meet up with the minimum requirement or to position themselves for mergers and acquisition. To date, all the banks that were in the capital market to source funds have been reporting over-subscription. The regulatory challenge here relates to money laundering. How can the Regulatory Authorities prevent massive money laundering in banks during consolidation period, especially when the instruments for payment for such investments might have been “coloured” beyond recognition by the various issuing houses and receiving agents? This may lead to another concern which relates to compatibility of co-investors. To what extent are co-investors compatible? The on-going process may create ownership structures that may make management of emerging banks very complex as it may be difficult to identify “fit and proper persons” and/or compatible partners during the process of consolidation. Therefore, all banks should adopt the “**Know-Your-Co-investors**” (KYC) principle in pursuing the consolidation programme.

**c) Raising Capital Using Depositors’ Fund**

There are indications that depositors’ funds have been utilised to grant loans for share acquisition in the pursuit of the consolidation programme. Such a practice, apart from being a violation of CBN guidelines, may lead to asset/liability mis-match if depositors’ funds are locked into equity investment. Such risks could threaten the safety of depositors’ fund and it is an issue of serious concern to the NDIC because of its role as a deposit insurer. It is hoped that such share acquisition will be identified and disqualified by the CBN through its capital verification exercise.



**d) Increased Level of Risk during the Integration Process**

During the consolidation process, the overall risk profile of the new entity could increase because of the integration risk and the complexity of the optimization process. Common reasons for possible escalation of the risk profile of the consolidated entity, especially initially, include failure of control system, lack of management focus and poor understanding of “adopted” risks. The degree of escalation will depend upon the circumstances surrounding the merger, in particular whether the merger is friendly or hostile. This situation poses a challenge to the Corporation to the extent that the safety of depositors’ funds could be adversely affected.

*3.4.2 Post-Consolidation Challenges*

**a) Possibility of Bank Failure**

Some banks that could neither be merged nor acquired, (either because of their poor financial condition or the observed ownership culture in our environment), run the risk of liquidation. The possibility of multiple bank failure would inevitably task the financial resources and executive capacity of the Corporation. This is because the Corporation, as deposit insurer, is required to pay all insured deposits of failed insured institutions as soon as their licences are building revoked by the CBN. The challenge of multiple bank failure becomes an issue of concern when account is taken of the impending upward review of the maximum deposit insurance coverage (MDIC), from ₦50,000.00 to ₦200,000 before the National Assembly and the clamour for downward review of the premium rate paid by insured institutions. While the upward review of the MDIC has the effect of increasing the liability of the Corporation when a bank fails, a downward review of the premium rate has the effect of reducing the premium collectible from insured institutions (the major source of the deposit insurance fund, from where the obligation of payment of insured deposits is met).

**b) Inadequate Executive Capacity**

Management of banks should be fit and proper, competent, properly skilled and prudent. The ability of executive management to build and mould a management team that is able to lead the merged banking entity through the painful process of merging IT systems, business lines and products, cultures and people is of critical importance and particular concern to NDIC. In that regard, the management of the merged entity needs to have the ability to identify the integration risks at an early stage and manage them effectively in the shortest possible time. Given that banking is all about risk management, whatever circumstance that adversely affects the ability of any bank management to effectively manage risks facing it, would inadvertently constitute a challenge to the Corporation given its primary function of deposit insurance.

The foregoing implies a change of orientation, attitudes, value system and above all, capacity building by the operators at all levels particularly, at the top management level, in order to address the issue.

**c) Weak Corporate Governance**

Responsive corporate governance is always an aspect that is closely monitored by the regulatory authority in order to ensure the transparency and accountability of management of banking institutions and the curtailment of their risk appetite. Responsive corporate governance involves the entrenchment of mechanisms, processes and systems for ensuring that:

- There is appropriate direction and oversight by directors and senior management
- There is transparency and accountability to the various stakeholders;
- The organisation complies with the applicable legal and regulatory requirements;

- There is disclosure of all material information to stakeholders such as investors, depositors, regulatory authorities, etc; and
- The organisation's viability and solvency is sustainable through adequate internal controls and audits as well as appropriate risk management framework.

Good corporate governance requires probity, transparency and accountability. It often helps to assure that business strategies are consistent with safe and sound operations and thus can act as the first line of defence against excessive risk-taking.

With the emergence of mega banks, weak or poor corporate governance becomes an issue as it can cause a rapid collapse of an institution. In view of the fact that the systemic repercussion of the failure of a big banking institution is grievous, there should be responsive corporate governance structure for effective risk management both during and after consolidation by banks.

#### **d) Supervisory Approach**

The current supervisory approach in Nigeria, which is transaction and compliance based, is narrow in scope and uniformly applied to all supervised institutions. With consolidation, there is the need to adopt a robust, proactive and sophisticated supervisory process, which should essentially, be based on risk profiling of emerging big banks. In other words, the adoption of an appropriate risk-based supervisory approach is imperative with consolidation. The approach entails the design of a customized supervisory programme for each bank and it should focus more attention on banks that are considered to have potentially high systemic impact. The approach should enable the supervisory authorities to optimize the utilization of supervisory

resources. That necessarily requires that supervisors should have a clear understanding of the risk profile of the emerging big, and sometimes, complex banks and that the risk management processes adopted by the banks are adequate. There is therefore, the need for capacity building in this area.

Furthermore, consolidation has, no doubt, brought to the fore, the need for consolidated supervision that requires consultation and cooperation amongst the various regulatory/supervisory institutions in the system. It is equally imperative that the present reporting format of banks be reviewed so as to incorporate all possible activities that banks undertake under the present dispensation. This will make it possible for supervisors to obtain a global view of the bank's operations. The current efforts of the CBN/NDIC in the development of an electronic Financial Analysis Surveillance System (e-FASS) and the activities of the Financial Services Regulation Coordinating Committee (FSRCC) would go a long way to assist in this regard.

**e) Information Asymmetry between Banks and Investing Public**

The current information disclosure requirements in the industry are grossly inadequate to effectively bridge the information asymmetry between the investing public and the banks that consolidation may create. With consolidation, it is important that the accounting as well as disclosure requirements of consolidated banks be reviewed. There is also the need for the regulatory agencies to review information disclosure requirements so as to minimize information asymmetry between banks and investing public. In this regard, advertisements in respect of some of the Initial Public Offers (IPOs) are misleading and worrisome. Appropriate actions on the part of Regulators need to be taken to ensure that business decisions by the investing public, are well informed under the on-going dispensation. Adequate

information disclosure requirement will force banks to pay greater attention to reputational risk that could result in loss of confidence as well as patronage. As a necessary step to promote market discipline, it is important that the full weight of the provisions of relevant laws be brought to bear on erring operators in order to help promote safe and sound banking practices under the consolidated banking environment. The policy of zero-tolerance against unethical behaviour should be strictly applied.

**f) The Establishment of Asset Management Company**

A key element of the 13-point agenda for the on-going banking reform programme is the establishment of an Asset Management Company (AMC). While the idea is good, its success is hinged on the adequacy of the legal system and responsiveness of the judicial process. For as long as the abuse of court processes, which has made the foreclosure of collaterals an herculean task, remains unchecked, the effectiveness of AMC will remain a challenge. The NDIC as a liquidator of banks has not had any appreciable success in the courts since the scrapping of the Failed Banks Tribunals Besides, issues pertaining to Savannah Bank Plc have been in the courts for over three years while the depositors of the bank are unable to retrieve their trapped funds. The NDIC, on its part has not been able to discharge its obligations to the depositors because of the protracted litigations. This is a challenge that must be resolved for the entire nation in general and the banking system in particular. In many countries, including the United States of America (USA) where similar intervention institutions were established, they were given some special emergency powers to enable them discharge their mandates effectively. There is the need for similar powers for our AMC in order for it to realize the objectives of its establishment.

### **3.5 Conclusion**

In the paper, we have indicated that the on-going consolidation of the Nigerian banking industry has become imperative so as to evolve a strong and resilient banking system and by implication, to put the macro-economy of the nation on the path of sustainable growth. An attempt has been made in the paper to enumerate some of the main challenges posed by the on-going regulation - induced bank consolidation for the NDIC. The discussion of the challenges has been done under pre-consolidation challenges and post-consolidation challenges. Some of the pre-consolidation challenges indicated in the paper include liquidity problems, threat posed to depositors' funds by using such funds for raising capital and possible increase in integration risks, among others. Some of the post-consolidation challenges enumerated in the paper include possibility of bank failure, weak corporate governance and inadequate executive capacity and inadequate legal system and/or judicial process, among others.

In conclusion, while consolidation has the potential of evolving a strong and resilient banking system for the nation, it also poses a number of challenges both to the operators and regulators/supervisors. In order to harness the opportunities of bank consolidation, the regulators/supervisors should review the supervisory approach as well as the information disclosure requirements by banks while the NDIC should, on its own, put in place some specific deposit insurance design features that will ensure adequate depositor protection. On the part of the operators, they should enhance their risk management capacity, enthrone responsive corporate governance and embrace the right culture that would promote market discipline, among others.

# Chapter 4

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## **THE CAUSES OF BANK FAILURE AND PERSISTENT DISTRESS IN THE BANKING INDUSTRY<sup>1</sup>**

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### ***4.0 Introduction***

I am delighted to have the opportunity to discuss the causes of bank failures at such a distinguished gathering. Let me start by congratulating the House Committee on Banking and Currency on this initiative. The hearing today is being held against the background of a relatively healthier banking industry. The distressed banks taken over by the Supervisory Authorities or under their close supervision have either been closed or successfully sold to investors who had since recapitalised them. It is also appropriate at this time that we look back and analyse the causes of the recent bank failures which were of a magnitude not experienced since the early 1950s and since the advent of bank regulation and supervision in Nigeria. Only then can we have the opportunity to learn from the unique experience of the banking

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<sup>1</sup> Version of the paper presented to House of Rep Committee on Banking and Currency on June 7, 2001.

crisis and take appropriate measures to prevent its future re-occurrence. This is more relevant as many of the reasons that caused bank failures in the 1950s were prevalent in the recent banking crisis.

I wish to also commend the House Committee for bringing together very distinguished and experienced personalities with varied perspectives to participate in today's hearing. It is my expectation that the forum will provide the opportunity for a very objective and constructive discussion on this fundamental issue in our banking system. At the conclusion of our deliberations, it is my hope that far-reaching policy proposals would be made which would lead to appropriate legislative reforms.

It is against the foregoing background that this paper would focus on the major causes of banking distress. In the course of discussion, bank failures, banking crises or distress will be used interchangeably as they all refer to the severity of the stress our banking system went through. The discussion will also focus largely on banks as they have the largest proportion of the aggregate assets of the financial system. In section 2, an attempt is made to identify and analyse the causes of the bank failures. The lessons learnt and the challenges of ensuring safe and sound banking system are discussed in section 3 and the concluding remarks are in section 4.

#### ***4.1 Causes of Bank Failures***

No country could be said to be insulated from the wave of financial sector crisis in the 1980s and 1990s. It has been reported that two-third of member countries of the International Monetary Fund (IMF) both developed and developing country members, had significant banking problems. The extent of the banking crisis in Nigeria as compared with other countries is shown in Table 4.1 below.



**Table 4.1**  
**Banking Crisis In Some Selected Countries**

S/No	Country	CrisesPeriod	Non Performing Loan As a % Total Loan	Estimate of Total Loses/Cost
1	BENIN	1988-1999	80%	17% of GDP (CFA95 bn)
2	COTE D'IVOIRE	1988-1991	90%	52% of GDP (CFA677 bn)
3	GHANA	1982-1989	-	
4	SENEGAL	1988-1991	20 – 30%	6% of GNP
5	TANZANIA	1987-1995	73%	17% of GDP (US\$830m)
6	MEXICO	1981-1987	-	10% of GNP
7	ARGENTINA	1981-1991	9.3%	3% of GDP (19.1bn pesos)
8	VENEZUELA	1980-1982	51%	12.15% of GDP
9	SPAIN	1994-1995	30%	55.3% of GDP
10	MALAYSIA	1990s	Official US\$ 469 bn;-Unofficially US\$ 1 Trillion	18% of GDP Rescue costs probably higher than US\$100bn
11	PHILIPPINES	1977-1985	-	16.8% of GNP
12	JAPAN	1985-1988	7.8%	4.7% of GNP
13	USA	1981-1991	-	3.2% of GNP (US\$180bn)
14	NIGERIA	1989-1995	40.9%	2% of GDP (38bn)

**Source:** Annual Bank Conference on Development Economics  
A World Bank Publication; April 1996

It is a well known fact that our banking system had between 1989 and 1995 witnessed unprecedented level of distress as reflected in the large volume of non-performing loans; insolvency; liquidity problems and defaults in meeting depositors and inter-bank obligations. The extent and depth of distress in the banking system can better be appreciated by closely reviewing Table 4.2 below.

**Table 4.2**  
**Trend Of Financial Indices In The Banking Industry**  
**(1989 – 2000) Parameters**

<b>Period</b>	<b>Number of Distressed Banks</b>	<b>Total Loans &amp; Leases of Distressed Banks</b> (×' Billions)	<b>Non-performing Loans &amp; Leases of Distressed Banks</b> (×' Billions)	<b>Amount Required for Recapitalisation of Distressed Banks</b> (×' Billions)
1989	7	4.3	2.9	1.1
1990	9	6.4	4.7	2.0
1991	15	5.4	4.1	2.4
1992	16	15.7	6.8	5.5
1993	38	29.1	18.4	13.6
1994	55	39.4	26.2	23.4
1995	60	66.5	44.5	38
1996	50	51.8	40.8	42.5
1997	47	49.6	39.7	42.4
1998	15	24.2	18.6	16.2
1999	13	29.1	20.9	15.3
2000	7	26.4	20.0	10.3

Source: NDIC Annual Report and Bank Returns

As shown in the table above, the number of distressed banks increased from 7 in 1989 to 60 in 1995 before it dropped to 7 in 2000. The seven (7) distressed banks as at December 2000 included five (5) that were recently sold and were being restructured. The recapitalization requirement increased from  $\times 1.1$  billion in 1989 to  $\times 42$  billion in 1997 and dropped to  $\times 10$  billion in 2000. At the peak of the banking crisis in 1995 the ratio of the assets of the distressed banks to the total assets of the banking industry was 18 per cent and ratio of the non-performing assets of the distressed banks to their total assets was as high as 40.9 per cent.

There has always been a debate about the major causes of bank failures, while bankers usually blame failures on external factors such as inappropriate government policies; supervisors attribute bank failure to poor management and depositors invariably blame inadequate supervision and weak management. However, the identification of the principal factors of bank failures is usually an empirical issue.

Distress in the Nigerian banking system had been known to emanate from a number of inter-related factors. For the purpose of this paper, the causes of bank failures have been grouped into Institutional factors; Economic and Political factors; and Regulatory and Supervisory measures. I will discuss each of the factors in the following paragraphs.

#### *4.1.1 Institutional Factors*

These are endogenous factors which are largely within the control of the owners and management of the banks. They are also the most profound factors that led to the distressed conditions of most of the banks in our banking industry. This assertion is corroborated by the findings of an empirical study on the causes and depth of distress in the financial services

industry conducted by the CBN and the NDIC in 1995. According to the study, most of the financial institutions surveyed attributed the distress conditions to institutional factors as shown in Table 4.3 below.

**Table 4.3**  
**Financial Institutions' Assessment**  
**of the Causes of Distress in the Industry**  
**(Percentages)**

Causes	All Financial Institutions	Commercial Banks	Merchant Banks	Community Banks	Finance Houses
Bad Loans & Advances	19.5	30.1	12.9	17.2	20.3
Fraudulent Practices	16.7	16.4	18.8	18.5	18.9
Under Capitalisation	11.8	7.6	9.6	12.7	9.0
Rapid Changes in Govt Policies	10.8	9.8	5.5	16.9	13.5
Bad Management	17.9	13.1	21.7	14.0	16.4
Lack of Adequate Supervision	16.9	20.1	29.4	17.5	17.5
Undue Reliance on Forex	6.4	2.9	2.1	3.2	4.4
<b>Total</b>	<b>100.0</b>	<b>100.0</b>	<b>100.0</b>	<b>100.0</b>	<b>100.0</b>

Source: A CBN/NDIC Collaborative Study of Distress in Nigerian Financial Services Industry: October 1995: P 58.

Furthermore, distressed financial institutions; assessment of factors responsible for their being severely distressed points to the institutional factors which are summarised in Table 4.4.

**Table 4.4**  
**Analysis Of Financial Institutions' Assessment**  
**of Factors Responsible For Their Being Severely Ditressed**  
**(Percentage)**

<b>Causes</b>	<b>All Financial Institutions</b>	<b>Commercial Banks</b>	<b>Merchant Banks</b>	<b>Community Banks</b>	<b>Finance Houses</b>
Economic Recession	25.0	323.5	-	-	33.3
Political Crisis	17.9	17.6	33.4	50.0	-
Bad Credit Policy	25.0	29.4	33.3	-	40.4
Undue Interference from Board Members	32.1	29.5	33.3	50.0	26.3
<b>Total</b>	<b>100.0</b>	<b>100.0</b>	<b>100.0</b>	<b>100.0</b>	<b>100.0</b>

*Source: A CBN/NDIC Collaborative Study of Distress in Nigerian Financial Services Industry: October 1995: P 64.*

The major institutional factors and the extent to which they contributed to distress in the banking industry has been analysed as follows:

**a) Abusive Ownership And Weak Board of Directors**

In Nigeria, the extent of abusive tendencies varies with the nature of the ownership of distressed banks and they include the following:

- i) The government-owned banks suffered frequent changes in board membership usually associated with changes in the federal and state Governments. Many appointments were based on political patronage rather than merit. Board members saw themselves as representatives of political parties, the states or local governments and had little or no loyalty to the banks they served. As a result, political and social considerations pervaded the decision-making processes. This situation promoted indiscipline in such banks as decisions are influenced by extraneous considerations.
- ii) On the other hand, the privately-owned banks were afflicted by undue interference and pervasive influence of the dominant shareholder(s). Such shareholders were unable to recruit and or retain competent management teams. The problem of appointing incompetent management is aptly described by G. K. Olufon (1992) as follows :..... “Since the owner-managers regard banking as an extension of their business empires, they invariably try to dominate their operations by appointing their relatives or friends to key positions instead of relying solely on professional managers. In some banks, major shareholders appointed their children or friends to key positions without due regard to their level of experience and competence. Even where Regulatory Authorities declined approval of such appointments, the persons were sometimes made to remain in the positions either in acting capacity or under different names such as Chief Operating Officer”.

- iii) Many of the privately-owned banks were characterised by series of shareholders quarrels and boardroom squabbles. While in a few banks the Regulatory Authorities were able to intervene and resolve the crisis, in others the crisis became protracted and significantly contributed to the eventual liquidation of the banks. The crises were attributed to many reasons. Some shareholders were mere strange bed-fellows who came together to meet the requirement of geographical spread for ownership of banks and the ceiling on individual shareholding. There was also the problem associated with the raising of initial capital of some of the banks which as a result of the crisis, it was discovered that the share capital was contributed by a few “well – to – do” individuals. As soon as the banks commenced operations, the minority or nominee shareholders felt marginalised. In some cases, it was discovered that the major promoters raised commercial papers for statutory paid-up capital and used depositors’ funds to liquidate such facilities.
- iv) The consequences of the crises included irregular board meetings; lack of management cohesion as members and officers represented different and opposing interest group; confusion and chaos in the bank; high labour turnover; and loss of public confidence, all of which adversely affected the banks.
- v) Most of the directors remained ill-informed about the banks they oversighted. Even where some of them were willing and interested in the affairs of their banks, they were not provided with useful and relevant information by the management.

**b) Insider Abuse**

In most of the banks especially the 34 banks in liquidation, insider abuse is perhaps the most significant factor that led to their failure. Many owners and directors abused or misused their privileged positions or breached their fiduciary duties by engaging in self-serving activities. The abuses included the following:

- i granting of unsecured credit facilities to owners, directors and related companies which in some cases were in excess of their banks statutory lending limits in violation of the provisions of the Banks and Other Financial institutions Act (BOFIA) of 1991 as amended;
- ii granting of interest waivers on non-performing insider-credits without obtaining CBN prior approval as required by BOFIA;
- iii diversion or conversion of banks resources to service their other business interests such as allocation of foreign exchange without Naira cover to insiders which later crystallised as hard-core debts;
- iv compelling their banks to directly finance trading activities either through the banks or other proxy companies, the benefits of which did not accrue to the banks. Where losses were incurred, they were passed to the banks.

The magnitude of insider abuse in lending in some of the banks in liquidation is shown in Table 4.5 below:



**Table 4.5**  
**Highlights of Facilities Granted to Owners And Directors**

S/No	Banks(In-Liquidation)	No. of Directors Involved	Amount as At Closure (×)	% of Total Risk Assets
1	Alpha Merchant Bank Plc	11	1,314,418,700.43	33%
2	United Commercial Bank Ltd	5	741,755,808.86	30%
3	Financial Merchant Bank Ltd	1	383,061,096.00	100%
4	Highland Bank of Nig. Plc	12	33,197,157.58	38%
5	Commercial Trust Bank Ltd	1	247,749,719.10	38%
6	ABC Merchant bank Ltd	8	272,981,634.00	49%
7	Royal Merchant Bank Ltd	7	646,940,182.23	69%
8	North-South Bank of Nig. Ltd	13	240,668,637.62	32%
9	Abacus Merchant Bank Ltd	14	568,888,254.11	47%
10	Credite Bank Nig. Ltd	6	379,634,611.47	76%
11	Prime Merchant Bank Ltd	1	539,292,310.00	64%
12	Amicable Bank of Nig. Ltd	7	149,854,896.00	56%
13	Century Merchant Bank Ltd	5	272,072,261.00	32%
14	Group Merchant Bank Ltd	13	595,836,077.20	80%
15	Commerce Bank Plc	4	1,294,851,665.64	52%
16	Pinnacle Commercial Bank Ltd	10	298,766,751.76	20%
17	Republic Bank Ltd	1	161,375,466.00	38%

Table 4.5 shows that in a bank like Financial Merchant Bank Limited, all the loans in the bank were insider-related. In Group Merchant Bank, 80 percent of the loans were extended to Directors and in Credite Bank Nigeria Ltd the ratio was 76 per cent. Many of the directors found to be involved in the insider abuse have either been prosecuted or are being tried for such offences under the Failed Banks' (Recovery of Debts) and Financial Malpractices Act of 1994. The various cases and amount involved in the criminal prosecution are summarised in Table 4.6 below:

**Table 4.6**  
**Statistics on the Implementation of the Failed Banks' Act,**  
**In Respect of Criminal Cases Only, As At December 31, 2000**

Details	Number/Value
Number of cases filed at the failed Banks' Tribunal	139
Number of Judgements delivered	44
Number of people convicted	104
Number of cases struck out	8
Number of appeals filed	19
Number of appeals disposed off	19
Amount involved in the cases filed at the Federal High Court	×18.362 billion US\$63.885 million £5.12 million DM379,000
Amount recovered through the federal High Court	N718 million
Judgement debts in the process of collection	×2,316 billion US\$67.04 million £5.021 million

Source: Returns to NDIC

**c) Weak Corporate Governance**

Corporate governance provides structure and processes within which shareholders, directors and management conduct the business of a bank with the ultimate objective of realising long-term shareholders value while taking into account the interests of other stakeholders. Good corporate governance demands not only transparency, accountability and probity, but also a sense of conviction and commitment to ensure that the interests of all parties are protected. Weak corporate governance and/or mismanagement played a major role in bank failure in Nigeria. A number of factors which contributed to mismanagement included the following:

- i) Inexperienced and incompetent personnel were recruited to hold key positions in banks. As a result, most of them lacked the ability to respond to the rapidly changing economic conditions and regulatory framework. The recently issued guidelines by CBN on minimum qualifications for top management of banks is therefore a welcome development.
- ii) Significant deterioration in management culture, as the distressed condition of the banks got worse, manifested in most banks. Deterioration involved several stages. Initially, it involved inadequate policies, procedures and practices which resulted in over extension of credit, disregard of single obligor limits and poor lending procedures. As the losses increased, the management of some banks tried to hide losses so as to buy time and remain in control. This led to manipulation of profits; under provisioning for losses through ever greening procedures or revaluation of fixed assets. When the banks became severely insolvent, management resorted to desperate strategies to boost liquidity

or income levels. The practices included abuse of the clearing system through the issuance of phantom up-country cheques, purchasing high cost funds at rates above the market levels, lending to marginal or fringe borrowers at excessive rates or engaging in speculative transactions. Furthermore, where the banks became insolvent and illiquid, the management engaged in massive fraudulent practices. These included outright theft and diversion of banks assets to related companies or fictitious companies. The culture of fraud was elevated to corporate level and permeated all layers in the organisations.

- iii) Weak internal control systems characterised the operations of many distressed banks. Even where the controls were in place, they were not being complied with. Internal Audit or Inspection functions were weak and sanctions were not imposed on erring officers. The consequences of weak internal controls were clearly reflected in the volume of frauds and forgeries.
- iv) Non-compliance with laws and prudential standards. Management of many banks failed to comply with prescribed code of conduct and also failed to keep proper books and accounts in contravention of applicable banking laws, rules and regulations.

**d) Weak Risk Assets Management Practices**

A number of banks had poor credit policies and in cases where good policies were in place, they were not faithfully implemented. Loans were granted without due regard to ability of borrowers to repay. Several loans were granted without collateral and even where secured, the collaterals were found

to be inadequate or non-existent. Credit Administration was also found to be weak as credits were not being properly appraised and monitored.

Consequently, these weaknesses largely impaired the quality of the loan portfolios of the banks as shown in Table 4.7.

**Table 4.7**  
**Quality Of Assets In The Banking Industry (1989 – 2000)**

PERIOD		PARAMETERS		
	Total Loans & Leases of Distressed Banks(N' b)	Total Non-Performing Loans & Leases of Distressed Banks(N' b)	Ratio of Non-Performing Loans & Leases of Distressed Banks to Total Loans & Leases of Distressed Banks(x' b)	Ratio of Non-Performing Loans to Total Loan Assets of the Industry(%)
1989	4.3	2.9	67.4	40.8
1990	6.4	4.7	73.4	44.1
1991	5.4	4.1	76	39
1992	16	7	43	45.5
1993	25	15	58	51
1994	39	26	67	43
1995	91	45	50	32.9
1996	52	41	79	33.9
1997	50	40	80	25.81
1998	224	19	79	19.35
1999	29	21	72	35.61
2000	26	20	77	21.50

Source: NDIC Annual Report and Bank Returns

As can be seen from Table 4.7 above, the proportion of non-performing loans in the distressed banks had during the period 1989 – 2000, been consistently high, reaching about 80 per cent of their loan portfolio. This ratio significantly exceeded the prudential maximum ratio of 20 per cent. Lending to governments and their related agencies also contributed to the distressed conditions of many banks. As part of the supervisory measures aimed at addressing distress in the banking system, the NDIC negotiated on behalf of creditor banks and got the Federal Government to repay the principal portion of debts in 1997. NDIC disbursed a total sum of ₦3 billion to 74 creditors' banks. However, by the time the funds were released, it was too late to address the twin problems of illiquidity and insolvency in some of the distressed banks.

In most of the banks that failed little attention was paid to sound assets and liability management. Loans were granted without regard to the tenor and nature of the funding base of the banks. As a result, in 1989 the withdrawal of public sector deposits from the banks and transfer of same to the CBN triggered serious liquidity crisis as manifested in the overdrawn positions of many banks and cross-defaults in the inter-bank market. It would be recalled that in order to ameliorate the situation, the CBN and NDIC had to provide liquidity support through accommodation bills guaranteed by the NDIC and later discounted by the CBN. Majority of the beneficiaries, though were able to stabilise with the financial assistance, could not remain healthy and were eventually closed.

Some of the banks had no funding or placements policies which would have placed limits and discriminate against unsound banks. This weakness resulted in massive cross-defaults in the inter-bank market. Indeed, some

banks resorted to seeking redress in court as a result of which various valuable bank assets were carted away. The CBN had to intervene again to settle the principal portions of the debts by debiting the defaulting banks with their net obligations to the system. This measure (netting of obligations) assisted immensely in returning sanity to the inter-bank market.

Another asset-liability management problem was the inability of some bank management to recognise the inherent risks in the portfolio of contingent liabilities especially the NEXIM and NERFUND facilities they brokered on behalf of their customers. Following the failure of the borrowers to honour their obligations and the continued depreciation in value of the Naira, the defaulting banks' accounts with CBN were debited with the maturing obligations in accordance with the promissory notes they issued. The 34 banks in liquidation collectively owed the sums of ₦2,041,093,241 and ₦2,504,030,177 to NEXIM and NERFUND respectively. The management of the NDIC is currently working with NEXIM and NERFUND to find mutually acceptable solution to the crystallised obligations of the banks in liquidation.

**e) Inadequacy of Capital**

The banking industry witnessed a steady and large scale deterioration in capital positions until 1998 when a large number of banks were closed. The trend of recapitalisation requirement for the industry is shown in Table 2. The capital deficiency is a result of many factors. First, some of the banks were established with inadequate capital and failed to increase their capital base to meet the growth in their risk assets portfolios. Increased provisions for loan losses as a result of increasing level of non-performing loans further eroded the capital funds of many banks. Some shareholders whose banks

were insolvent refused or were unable to recapitalise them. They also made unrealistic offers to new investors who sought to acquire and recapitalise them.

#### *4.1.2 Economic And Political Factors*

There is no doubt that the banking industry remains the nerve centre of the economy being the supplier of credit which facilitates economic growth. Since the early 1980s, a number of factors, national and international, had induced greater instability in the economic environment for the Nigerian banking industry. While prudently managed banks are expected to plan to cope with normal and reasonable degree of volatility, many banks found it difficult to survive under greater and sometimes unusual macroeconomic volatility. Some of the changes and their impact on the banking industry are summarised as follows:-

- a) The Nigerian economy, especially after the collapse of oil prices in the mid-1981 had witnessed large fiscal deficits, large debt burden, high rate of inflation and low rate of economic growth. These adverse conditions made it difficult for borrowers to service their debts resulting in higher levels of non-performing loans. The flows of new loans were in some instances interrupted. The instability introduced made it difficult for many banks to attract viable clients or source long term funding.
- b) As part of the Structural Adjustment Programme (SAP) introduced in 1986, the CBN initiated a wide range of reforms which included the liberalisation of licensing of banks, deregulation of interest rates and exchange rate; gradual removal of credit allocation and the introduction of Open Market Operations (OMO) in place of direct



monetary control tools. While the deregulation of interest rates resulted in substantial increase in lending rates, the liberalisation of the exchange rates led to substantial depreciation of the Naira. The combined effects of these changes impacted adversely on the ability of borrowers to service their debts which increased the rate of defaults. Also, with large exchange rate premium between the official and parallel markets, many banks arbitrated between the two markets, the benefits of which in many cases accrued to owners and managers of the banks. In fact, it is a widely held view that phenomenal growth in the number of banks was as a result of rent seeking tendencies of promoters of banks.

- c) The banking industry was also adversely affected by the political crisis resulting from the aborted attempt to return the country to democratic rule in 1993. There was massive withdrawal of funds especially from banks located in Lagos due to the prevailing political uncertainty. This was further compounded by the apparent loss of public confidence which resulted in withdrawal of funds from banks perceived to be distressed to healthy banks, a phenomenon known as flight to quality and safety.
- d) Until the promulgation of the Failed Banks (Recovery of Debts) and Financial Malpractices Act in 1994, the legal framework for recovery of debts and prosecution of cases of financial malpractices had been inadequate. Consequent upon that, borrowers had exploited the inadequacies in the system and failed to honour their obligations while principal shareholders, directors and managers of banks engaged in an unprecedented level of frauds and other malpractices.

Although the implementation of the Failed Banks Act had assisted in recovery of loans as shown in Table 6 above, execution of judgement and trial of cases appeared to have slowed down especially after the transfer of cases to the Federal High Courts sequel to the abolition of the Failed Banks Tribunals in 1999.

- e) The attitude of some Nigerian borrowers further accentuated the poor financial condition of some banks. Some of these borrowers would wilfully default in servicing their credit even when they are known to have the means to do so. Another category of borrowers regard such credit as their share of the national cake which was not meant to be paid back.

#### *4.1.3 Regulatory and Supervisory Measures*

The various policy reforms introduced by the government and the CBN in rapid succession and the technological changes appeared to have put the regulatory and supervisory framework under severe stress. The regulatory framework was unable to keep pace with the rapid changes in the banking industry. Supervisory resources were overstretched especially as a result of phenomenal growth in the number of banks and non-bank financial institutions.

- a) There was initial delay in prompt identification of emerging problems in the banks as a result of many factors which include:
  - Inadequate regulatory capacity. Given the phenomenal growth in the number of banks, the supervisory expertise and the number of supervisors were inadequate. Examination cycle which is the interval between one on-site examination and another was between two and

three years as a result of which problems in banks were not being detected on time. However, with the establishment of NDIC and recruitment of additional examiners, the CBN and NDIC are now able to examine most banks once in a year.

Another problem related to supervisory capacity is the inadequate skills especially in information Technology. With improved IT capacity, some banks were able to window - dress their records thereby hiding losses and fraudulent transactions. CBN and NDIC have intensified efforts to make all examiners IT proficient especially in the use of Audit Command Language (ACL) software.

- Until recently the supervisory focus of CBN and NDIC place greater emphasis on credit risks. But in keeping with international supervisory standards, risk-based supervision is now being adopted which allows for effective evaluation of safety and soundness of a bank by focussing supervisory resources on the banks major risks.
  - There had been inadequate disclosure of information especially through the audited financial statements until the release of the Statement of Accounting Standard No. 10 in 1990.
- b) Some of the supervisory and monetary policies introduced though intended to address emerging problems and sanitise the system, had to some extent adversely impacted on the performance of many banks. These include:
- The introduction of the Prudential Guidelines on assets classification and provisioning for loan losses exposed weak and

poorly managed banks. Banks that hitherto posted large paper profits reported heavy losses resulting in under-capitalisation because of the substantial increase in provisions for loan losses as required by the Prudential Guidelines. This was in spite of the fact that banks had the option to spread the shortfalls in provisions over a four-year period. The Prudential Guidelines had assisted in ensuring timely recognition and provision for delinquent credit facilities thereby assuring the reliability of published accounting information and operating results.

- The use of stabilisation securities, as a monetary policy tool exacerbated the illiquid positions of some banks.
- c) Failure resolution measures adopted by the CBN and NDIC, though understandably protracted, delayed early resolution of problems banks. Distressed banks were therefore left open for a longer period which further increased losses and the eventual cost of resolution. The stalemate and the lingering problem of distress undermined public confidence in the banking system. Perhaps one needs to examine the environment and constraints the CBN and NDIC faced in addressing the banking crisis in order to appreciate the modest achievement made in this regard.
- Inability to take prompt corrective actions. Until mid 1991 when BOFIA and CBN Act were promulgated, the CBN did not have adequate powers to apply remedial action on failed bank. Even then, the powers provided in BOFIA were exercised subject to the approval of the President. Consequently, failure-resolution proposals were not approved due to lack of political will. For

example, no approval for revocation of banking licence was granted until 1994. Indeed, until 1994 a policy of free entry, no exit was pursued unwittingly. However, the amendment made in 1999 has removed this obstacle.

- Unnecessary delay was experienced in obtaining court orders to acquire banks for the purpose of sale. In few cases the erstwhile shareholders employed all sort of delay tactics to frustrate the grant of court orders while at the same time refused to recapitalise them.

d) External Auditors had also come under criticism for not being able to report many irregularities which appeared to have contributed to the distressed conditions of many banks. Chief (Mrs) O. O. Olakunri, FCA (1996), a past President of the Institute of Chartered Accountants of Nigeria, expressed the concern on the performance of bank auditors by acknowledging that:

*“We must accept part of the blame for the failed banks as Auditors for all of them, but also in many cases as part of management, our duties as Auditors should be reviewed and, if necessary, extended to adequately serve the needs of this community at this time. An Audit Report which absolves us from all blame does not give value for the fees charged, the community expects to have full confidence in the Accounts and the operations once the Auditor has given a clean report”.*

In order to strengthen the supervisory framework, the CBN and NDIC recently initiated a number of measures to improve cooperation between Bank Supervisors and Auditors which include inviting auditors to attend Board meetings where examination reports are presented.

#### ***4.2 Lessons and Challenges Of Handling Bank Failures***

Even though we can often understand what happened in retrospect, taking the necessary concrete actions to prevent recurrence is much more challenging. There are a number of lessons to be learnt from the recent past bank failures and these include the following:

- a) Stability of the banking system depends on strong and stable economy.
- b) Deregulation programmes must be properly sequenced. For instance, rapid trade liberalisation created trade shocks for the previously protected companies resulting in large unsold stocks, under capacity utilisation leading to huge credit defaults.
- c) Banking reforms should be supported by strong regulatory and supervisory framework including effective prudential supervision.
- d) Weak corporate governance, poor risk management and fraud played a significant role in bank failures.
- e) Strong and comprehensive legal framework is imperative in fighting financial malpractice and recovering debts owed to banks.
- f) The failure to act promptly and decisively as a result of lack of political will or regulatory forbearance increased the losses and eventual cost of resolution of distress as well as undermined confidence in the banking system.

The challenges in handling future bank failures, for all stakeholders in the banking industry include the following:

- a) Establishment of a very strong supervisory framework. This will involve the enhancement of the supervisory capacity, adoption of risk-based supervision, consolidated supervision, and strict enforcement of laws and regulations.
- b) Establishment of an Early Warning System as well as an effective failure resolution structure. In this regard, the CBN and NDIC are finalising a Contingency Planning Framework. The framework consists of policies and measures for the prevention, management and containment of banking crisis. The implementation of the plan will assist Regulatory Authorities to reduce the likelihood of the occurrence of systemic crisis and provide transparent and objective criteria for intervention thereby reducing the incidence of regulatory forbearance. The CBN/NDIC also intends to submit proposed amendment to BOFIA and NDIC Act to facilitate effective resolution of distress.

At the institutional or bank level, a number of issues would need to be considered. There will be need for stronger corporate governance, more trained and skilled operators and greater improvement in risk management practices.

- c) There will be need for stronger and well funded Deposit Insurance Fund to strengthen the public safety net.

- d) Government ownership of banking institutions should be discouraged.
- e) There will also be the need to promote greater accounting and disclosure requirements to minimise information asymmetry between banks and the public to ensure that business decisions are well informed. This is even more relevant in view of the New Capital Accord which emphasizes greater market discipline.
- f) Better and stronger credit or borrower culture must be promoted and sustained. There must be better understanding between debtors and creditors that they have duties and responsibilities toward each other. The judicial process must also be supportive in this regard. It is also expected that the web-enabled Credit Risk Management System managed by CBN will facilitate credit risk management.
- g) Need to promote and encourage self-regulation among market participants. This is to promote healthy competition and put peer pressure on participants to ensure compliance with rules and regulations.



### **4.3 Conclusion**

We cannot have a failure-free banking system and must accept some inherent instability in the system. However, to fail or refuse to learn lessons from errors or mistakes of the past, is to be doomed to repeat them. Therefore, we strive to do better in handling future banking crisis.

The ultimate responsibility for the health of a bank largely rests with its Board and Management. There is no check-list of quick-fix measures for ensuring the soundness of a bank. The most important guarantee is sound management. If the management is competent and effective, the bank can remain profitable and sound, such that the banking system in particular and the economy in general will be spared the pains of distress. It is therefore necessary for us to appreciate that banking supervision cannot prevent bank failures. Rather, it can only minimise the impact of crisis.



# Chapter 5

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## **ETHICS AND PROFESSIONALISM IN BANKING: LESSONS FROM THE RECENT DISTRESS IN THE NIGERIAN BANKING SYSTEM<sup>1</sup>**

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### ***5.0 Introduction***

It is a well known fact that the distress which ravaged the financial services industry particularly the banking sector, in the recent past had brought to the fore the need for professionalism and adherence to high ethical standards in the management of banking institutions in Nigeria. Imprudent management contributed significantly to the distress which engulfed our banking system sequel to the adoption of liberalisation and deregulation as the cornerstone of the Structural Adjustment Programme (SAP) in 1986. In this regard, references have to be made to the joint CBN/NDIC Study on the Distress in the Nigerian Financial Sector carried out in 1995. One of the major findings of that study was that, even though both exogenous and endogenous factors accounted for the distress, endogenous factors were

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<sup>1</sup> *Original Paper presented at the 2000 Mid-Year Lecture/Dinner organized by the Chartered Institute of Bankers of Nigeria (CIBN).*

more profound. The endogenous factors included management ineptitude, insider abuses and malpractices, meddlesome interference by principal shareholders, weak internal controls, under-capitalisation and so on.

Contrary to the empirical findings of the Regulatory Authorities, the managers of some failed banks had sought to attribute the failure of their banks to exogenous factors such as macro-economic instability and policy-induced shocks. However, it is pertinent to note that the key factor to business success is the quality of management as adequacy of capital alone cannot guarantee success. Consequently, banking as a serious professional occupation should be run by credible professionals with proven track record, who should be guided by the established ethical standards, if we must learn from the lessons of the recent distress. There should be no room for charlatans in the management of our banks.

For ease of discussion, the rest of the paper has been structured as follows: Section 2 reiterates ethics of the banking profession, while Section 3 discusses the contributory factors to our banking sector distress. Section 4 highlights the efforts of the Regulatory Authorities in promoting ethics and professionalism in banking. Section 5 enumerates some lessons learnt from recent distress, while Section 6 concludes the paper.

## ***5.1 Ethics of Banking Profession***

### *5.1.1 What Do We Mean By Professionalism?*

Ethics according to Webster's dictionary are moral principles which determine the rightness or wrongness of particular acts or activities, while ethics standards involve conforming with accepted standards of good behaviour. Therefore, ethical behaviour occurs when one acts with equity,

fairness and impartiality and respects the right of individuals or put simply, when one does what is morally right. On the other hand, unethical behaviour occurs when decisions enable an individual or organisation to derive some benefits at the expense of the society.

Essentially, a profession is an occupation or vocation involving special learning and usually carries some social prestige. Professionalism therefore entails the adherence to the ethics of ones profession.

#### *5.1.2 Why Ethics and Professionalism in Banking?*

The need for ethics in banking stems from the critical importance of banking to the economy. Banking is essentially a service business of intermediation. Of necessity banks mobilise funds from the public at large to perform this role. Consequently, banking is built on trust and confidence which can be easily eroded by unethical practices and it is for this reason that banking is the most regulated industry in the economy, be it market or command economy.

Every organisation derives its ethical values from a combination of corporate and professional ethics. While corporate ethics are derived from organisation's own values and culture (i.e. standard industry practice), professional/occupational ethics are for members (individual or corporate). Bankers are expected to exhibit integrity, accountability and transparency in conducting banking business. The consequence of non-compliance would only bring the profession into disrepute.

#### *5.1.3 CIBN Code of Banking Practice*

The Chartered Institute of Bankers of Nigeria (CIBN) had long recognised the need to uphold integrity of the Banking Profession. The CIBN Decree

12 of 1990 endows it with certain powers to regulate the practice of banking in Nigeria. In particular, Section 13 gives it the power to constitute an Investigating Panel and a Disciplinary Tribunal to consider cases of professional misconduct levelled against its members.

In pursuance of its mandate, the CIBN issued a code of Banking Practice which sought to promote professionalism and high ethical standards in the conduct of banking business. The highlights of the Code include:

- Banks and bankers will operate within the legal framework.
- Banks and bankers will follow the best professional practice in the global industry.
- Banks will always place their depositors' interest before all others.
- Banks will always meet their commitments. Such commitments will not be lightly given, and should never be broken.
- Banks will repay depositors at maturity on the agreed terms.
- Banks will meet their trade engagements.
- Banks will meet delivery on their trading contracts at maturity at agreed rates.
- Banks will always lend on agreed terms.
- Banks will deal only with respectable parties. They will take all reasonable steps to establish that all parties they deal with are bona-fide. Individual bankers should not ask for, nor even accept, any form of gratification, either in cash or in kind, for performing their normal services.
- Banks should not pay brokerage to members of their staff.
- Banks and employees will follow only the best professional practice in their recruitment and employment policies.

- Banks should not undermine other banks' stability in the process of marketing so that competition is healthy.

Undoubtedly, the above Code emphasises compliance with applicable laws, professionalism, honouring of commitments, fairness to customers and healthy competition. If one may ask. How many bankers are aware of the existence of the CIBN Code of Banking Practice? Did practitioners adhere to the requirements of the Code? If the standards set by the CIBN had been upheld, would the distress syndrome not have been avoided?

## ***5.2 Contributory Factors To Banking Sector Distress***

As earlier indicated, endogenous factors (that is factors within the control of bank owners and management), contributed significantly to the failure of the 31 banks now in liquidation. Some of the factors are highlighted below:

### ***5.2.1 Abusive Ownership***

The inability to separate ownership from control resulted in meddlesome interference in the day- to-day management of many banks. In this context, control entails the power or authority to guide or manage. Rather than setting broad policies, targets and monitoring performance, many principal shareholders were involved in decision making on issues that fell within the competence of management. Where they were not directly involved, they ensured that their surrogates were appointed into top management. In some cases, members of the top management were appointed to represent different groups of shareholders. Hence, such members of the management team had allegiance to the group they represented. In such cases, management was not only polarised, it lacked cohesion and exhibited disharmony of perception.

### *5.2.2 Insider Abuses*

In some banks, shareholders/directors abused or misused their privileged positions by engaging in self-dealing activities. Such abuses include:

- Diversion or conversion of bank's resources to service their other business interests. The incidence was quite common in the allocation and utilisation of foreign exchange acquired by their banks. There were insiders who were allocated foreign exchange without the naira cover which later crystallised into hard-core debts.
- Directors' drawings in some banks were neither booked as loans nor overdrafts. Such unauthorised facilities were held in suspense accounts.
- Granting of unsecured credit facilities to directors in contravention of the provision of the Banks and Other Financial Institutions Decree (BOFID). In some cases, such loans were also granted at concessionary interest rates.
- Granting of interest waivers on non-performing insider credits without obtaining CBN's prior approval as required by BOFID.

### *5.2.3 Weak Corporate Governance*

Corporate governance refers to the system whereby business is conducted and performance reported to the stakeholders (shareholders, depositors, supervisory authorities, et cetera) requiring on one hand, appropriate controls and on the other, adequate disclosure.

The problem of weak corporate governance appeared to have started with the way and manner most of the directors were appointed to the boards of



their banks. Directors to be appointed to boards of banks are supposed to be “fit and proper persons” with qualities that include general probity, competence and soundness of judgement and loyalty and there are sufficient provisions in CAMA and BOFID on those who cannot be appointed. Without regard for these statutory provisions, in most government-owned banks, appointments were based on political patronage, rather than on competence and integrity. In some privately-owned banks, the directors appointed were strange bed-fellows who were more interested in the benefits that could be derived from such appointments rather than in maximising stakeholders’ values.

Some of the features of the resultant weak and undesirable corporate governance included boards led by dominant personalities with self-serving disposition to the detriment of their banks; irregular board meetings which bothered on abdication of board responsibilities; too frequent board meetings to the extent that the executive management became ineffective or irrelevant; self-serving tendencies and frequent disregard or override of the internal control systems.

As a consequence of weak corporate governance, the banking sector witnessed various types of abuses and mismanagement which included the application of depositors’ funds to acquire fixed assets or to finance branch expansion; mismatching of assets and liabilities; automatic rescheduling or roll-over of past-due loans (ever-green loans); under-provisioning for non-performing risk assets; levying of arbitrary charges on customers to boost income; distress borrowing either through upfront payment of interest or at uncompetitive interest rates in order to attract new deposits; use of phantom upcountry cheques to abuse the clearing system; the use subsidiaries or “secret accounts” to deny the banks of their legitimate earnings; under-

reporting of volume of deposits to evade insurance premium; and granting of unsecured credit facilities to insiders or related parties, in contravention of BOFID.

#### *5.2.4 Weak Internal Control System*

As a corollary, weak internal control system characterised the operations of many distressed banks. In many of the failed banks, there was inadequate segregation of functional responsibilities. Indeed there were few instances where banks' foreign correspondent accounts were operated by sole signatories. Hence, misapplication of funds was carried out unimpeded. Internal Audit or inspection function was not accorded the priority it deserved. It is either that such departments were not adequately staffed or inspection coverage did not cover areas of operation that are prone to greater risks. Inspection reports were treated with levity in many of the failed banks.

#### *5.2.5 Absence of Risk Management Framework*

The balance sheet of many distressed banks reflected a large portfolio of non-performing credits. The proportion of insider credits ranged between 40% and 90% of the credit portfolio of many of the failed banks. Credit administration machinery was very weak as credits were either poorly appraised or not appraised at all. In general, greater emphasis was placed on asset volume rather than quality.

In many of the failed banks, little or no attention was paid to liability management. Some banks had no funding or placement policies. Treasury staff were given deposit target which must be met. At the same time no guidelines were issued as to pricing of such funds. Worse still, banks were not categorised on the basis of their risk profile for fund placement purposes.

Thus in some cases management only became aware of placement when their counter parties could not meet obligations at maturity.

Some bank management hardly recognised that there were inherent risks in the portfolio of contingent liabilities especially the NEXIM/NERFUND facilities brokered by them. It was after the projects had failed or project promoters could not meet their obligations as contracted, that the management of some of the failed banks realised that their banks were liable to meet such contractual obligations.

### ***5.3 Efforts of the Regulatory Authorities in the Promotion of Ethics and Professionalism in Banking***

It is imperative to note that the regulatory authorities have always made concerted efforts not only to contain the incidence of distress, but also to ensure that the established ethical standard are complied with and that greater discipline is maintained by the banking institutions in their dealings, with the banking public. In this connection, the regulatory efforts include:

#### ***5.3.1 Issuance of Prudential Guidelines***

In the wake of proliferation of banks, the CBN issued the Prudential Guidelines for Licensed Banks in 1990 to facilitate uniformity in asset classification, provisioning and income recognition. Furthermore, the Regulatory Authorities collaborated with the Nigeria Accounting Standard Board (NASB) to issue the Statement of Accounting Standard (SAS) No. 10 in order to reinforce the requirements of the Prudential Guidelines. Before then, banks had different approaches to reporting their performance.

### *5.3.2 Enhanced Legal Framework*

- (a) The promulgation of the Failed Banks (Financial Malpractices) Decree No. 18 of 1994 and the subsequent establishment of the defunct Failed Banks Tribunals (FTBs) made possible the trial and prosecution of the directors and officers who either directly or indirectly contributed to the failure of their respective banks. The objective was to promote professionalism, ethical behaviour, probity and accountability.
- (b) The amendment of BOFID up till 1997 with a view to enjoining directors to declare their interest in loans and contracts in which they have direct or indirect interest, prohibiting insider abuse of information, position of authority to take decisions, prohibition of activities that may be socially and economically undesirable, enjoining banks to make reports as required and to keep proper records of accounts. Furthermore, there are provisions to discourage excessive risk-taking by banks.
- (c) The NDIC Decree requires banks to obtain Fidelity Insurance Cover as a safeguard against fraud and defalcation by bank workers.
- (d) The promulgation of the Money Laundering Decree made it obligatory for banks to make routine reports that may expose money laundering activities, as well as to report suspicious transactions of any amount.

### *5.3.3 Code of Banking Practice*

The CBN required bank directors to complete Code of Conduct Forms which spells out in detail their duties and responsibilities as well as unethical practices they should not indulge in.

#### *5.3.4 Establishment of Financial Services Regulation Coordinating Committee (FSRCC)*

In recognition of the need to harmonise supervisory standards and minimise arbitrage opportunities which could be exploited by market participants, the Financial Services Regulation Coordinating Committee (FSRCC) was established under the Chairmanship of the CBN Governor. The regulators of both the insurance and securities sub-sectors are also members of the FSRCC.

#### *5.4 Lessons from the Recent Distress in the Banking System*

The lessons to be learnt from the recent distress are legion. A few of them are highlighted hereunder:

- a) Bank owners should realise the need to separate ownership from control. They should therefore endeavour to set broad policies, install effective Board composed of knowledgeable, experienced, resourceful and responsible members.
- b) The Board of Directors should hire competent professionals with track-records, formulate board policies, set performance targets and monitor performance. Meddlesome interference by shareholders have been found to inhibit professionalism as well as being counter-productive.
- c) Every bank needs to have in place a responsive corporate governance structure which should be driven by appropriate mission and vision statements. There should be a clear sense of direction founded on strategic planning and continuous review of business processes. Banks

should anticipate developments in their business environment rather than reacting to same. Put differently, bank management should be proactive rather than reactive.

- d) Every bank should have in place an articulated risk management framework. Both the Board and Management should be conversant with the array of risks to which their banks are exposed and be satisfied that their banks are adequately measuring and managing them. Indeed, concentration of risk contributed to failure of some of the banks presently under liquidation, as reflected by the volume of non-performing insider-credits.
- e) Every bank employee should uphold the ethical standards enunciated in the Code of Banking Practice issued by the CIBN. Similarly, bank directors should adhere strictly to the Code of Conduct issued by the CBN.
- f) Given the prevalence of weak internal control system in banks, it is hereby advocated that the establishment of Audit Committees should not be limited to only banks that are public limited liability companies. It should be mandatory for all banks to have an Audit Committee of the Board to be chaired by a non-executive director, who must be conversant with banking operations.
- g) The Regulatory Authorities should upgrade their supervisory framework to enable them undertake risk-based supervision. Early detection of risks and close monitoring of the risk appetite of bank management are imperative for effective supervision.

- h) Supervision should be accepted as responsibilities by both the Formal Regulators and the operators. Consequently, the CIBN should take urgent steps to make it play the role of an effective Self-Regulatory Organisation (SRO) while through responsive corporate governance, each bank can complement the efforts of the Regulatory Authorities by maintaining high ethical standard and professionalism. For us to minimise the incidence of distress self-regulation has to complement statutory-regulation.
- i) Users of banking services especially depositors should be circumspect in deciding where to place their funds or maintain accounts. They should not only look at the returns on their funds, they should also bother about the safety of their funds. This is one way to promote market discipline.

### **5.5 Conclusion**

This paper has attempted to establish the need for banks to put in place a sound corporate governance structure in order to ensure the observance of ethical standards and strict compliance with statutory regulations in their quest, to succeed in a dynamic and innovative banking environment. In this regard, it is to be reiterated that the directors and managers of a bank have the responsibility of ensuring that banks are managed prudently. However, prudent management can be facilitated by adherence to professionalism and high ethical standards.

With respect to the lessons which the recent distress had shown, it is expected that banks should not only demonstrate astute professionalism and imbibe

the concept of good corporate governance, but also show concern for credibility, responsiveness, integrity, transparency and greater sense of accountability, if they must restore their respectable image in this millennium.



# Chapter 6

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## **BANK FRAUDS: CHALLENGES AND SOLUTIONS<sup>1</sup>**

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### ***6.0 Introduction***

Bank fraud, the seemingly intractable malaise in the nation's banking industry, can simply be described as an act of dishonesty, deceit and imposture. According to Kirk Patrick (1985) a person who pretends to be something that he is not is a fraud, a snare, a deceptive trick, a cheat and a swindler. Thus, by extension, with reference to banking, frauds include embezzlement, theft or any attempt to steal or unlawfully obtain, misuse or harm the assets of the bank (Bank Administration Institute, 1989). It thus follows that fraud can be committed by employees, customers or others, operating independently or in conjunction with others inside or outside the bank.

In Nigeria, the injustice and structural dislocation caused by frauds to the nation's value system, economic and socio-political order is very large. It is

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<sup>1</sup> *Version of a paper presented at the First Annual Service & Exhibition of the American Society for Industrial Society – Nigerian Chapter 206 held in Lagos, Nigeria, June 2000.*

against this background that the effort of the Obasanjo Administration for social rejuvenation and national rebirth is most welcome. Examining the issue of 'Bank Frauds', is therefore, germane as the country strives to reposition its banking system for the challenges of the emerging world order.

While banking frauds are not peculiar, either in magnitude or sophistication, to our terrain it has nevertheless become pervasive as fraudsters become more sophisticated and daring in their approaches. Our recent experience with many of the banks in liquidation speaks volume about the damaging impact of frauds to our banking system. Most of those banks were run aground by a few greedy directors and officials who perpetrated frauds and all kinds of unethical practices against their institutions. The backlash of that was to crystallise in macro-economic dislocation and loss of confidence in banks, the adverse effects of which was minimized by the pragmatic approach to the management of banking distress adopted by the Regulatory Authorities.

Empirical evidence has shown that many of the banks in liquidation and those struggling for survival had suffered a great deal from frauds. Having been charged with the responsibility for the safety and soundness of the banking system, the Regulatory Authorities have taken the challenge to lead others in the campaign against malpractices in our banks. Fortunately for the NDIC, there are some legal apparatus at its disposal to wage a battle against fraudsters.

For instance, Section 35 of the NDIC Act No 16, 2006 require the insured banks in Nigeria to render to the Corporation monthly returns on frauds, forgeries or outright theft occurring during such month and notify the Corporation of any staff dismissed or terminated on account of such

malpractices. Also, the Failed Banks (Recovery of Debts) and Financial Malpractices in Banks Decree of 1994 provided an enabling environment for the prosecution of fraudulent bank officials and bank customers upon information from the bank and/or the Regulatory Authorities, I have serious doubt if any meaningful success could be achieved without the collaborative endeavour of all concerned. In particular, the management of our banks must learn to report their erring staff as provided for by law instead of allowing such staff to resign their appointments only to pick up new jobs in other banks.

The main focus of this paper is therefore to rekindle the consciousness of participants about the endemic problem of frauds in our financial system in order to fashion out a collective agreement on the best strategies to adopt to reduce its grip on our national life.

The rest of the paper has been divided into four parts. In part two, an attempt is made to highlight the common causes, types and extent of bank frauds in Nigeria. In part three, the recent phenomenon of frauds in Nigeria is reviewed. Part four looks at the strategies to curb the devastating effect of bank frauds while the concluding remarks form the subject of part five.

## ***6.1 Major Causes, Types and Extent of Frauds***

### ***6.1.1 Major Causes of Frauds***

The causes of frauds in banks have been classified under two generic factors namely: institutional or internal factors and environmental or societal factors.

Institutional causes of frauds could include excessive workload, poor staffing – in terms of technical competence and staff strength, inadequate or lack of

staff training, poor management culture, frustration, inadequate infrastructure, poor accounting and internal control systems.

Environmental causes of frauds on the other hand could include poor and warped social values, the penchant to get rich quick, slow and tortuous legal process, lack of effective deterrent or punishment and at times redundancy on the part of the individual bank to report frauds due to the perceived negative publicity it could create for the image of the institution.

### *6.1.2 The Traditional Bank Frauds*

The traditional scheme of the fraudsters as highlighted by the Bank Administration Institute (1989) would be discussed at this stage. They are discussed in the ensuing sub-parts.

#### *6.1.2.1 Advance Fee Fraud (“419”)*

This usually involves an agent approaching a bank, a company or an individual with an offer to access large funds for services purportedly rendered or contracts executed. The collaboration of an accomplice is sought through the agent who must receive a fee or commission “in advance”. As soon as the agent collects the fee, he disappears, and the funds never get to the bank. This is popularly known as “419” in Nigeria, - a euphemism for the section of our law covering such criminal activities.

#### *6.1.2.2 Cheque Kiting*

Kiting is defined by the US Comptroller of the Currency’s Policy Guidelines for National Bank Directors as “a method where a depositor utilises the time required for cheques to clear to obtain an unauthorised loan without any interest charge”. Cheque kiting involves the unauthorised use by depositors of undeserved credits in their accounts. The goals of the cheque

kiter may be to use the collected funds interest-free for a short time to overcome a temporary cash shortage or to utilize the funds permanently.

#### *6.1.2.3 Account Opening Fraud*

This involves the deposit and subsequent cashing of fraudulent cheques. It usually starts with a person asking to open a transaction account such as current or savings account with false identification but unknown to the bank. The person opens the account with a small initial deposit of cash or cheque. Generally, within a few days, the person will deposit a number of dud cheques and obtain cash in return, either by cashing the fraudulent items outright or by withdrawing cash as soon as funds are available with the connivance of bank staff.

#### *6.1.2.4 Letters of credit Fraud*

Letters of credit (CL) are generally used in international trade to facilitate payment for goods and services. Most letters of credit frauds are perpetrated by beneficiaries of the CL using forged or fraudulent documents. In these cases, forged or fraudulent documents are presented to the confirming or issuing bank and payment is demanded against the credit.

#### *6.1.2.5 Money Transfer Fraud*

Money transfer services are means of moving funds to or from a bank to a beneficiary account at any banking point worldwide in accordance with the instructions from the bank's customers. Some common means of money transfer are mail, telegraphic, over-the-counter, electronic process and telex. Fraudulent money transfers may result from a request created solely for the purpose of committing a fraud or the alteration of a genuine funds transfer request. A genuine request can be altered by changing the beneficiary's name or account number or changing the amount of the transfer.

#### *6.1.2.6 Loan Fraud*

Loans and other forms of credit extension to corporate and individual customers constitute traditional functions of banks. In the process of credit extension, fraud may occur at any stage, from the first interaction between the customer and the bank to the final payment of the loan. Loan fraud occurs when credit is extended without due authorisation or to a borrowing customer who has exceeded his credit ceiling. Some fraudulent staff in a bid to conceal such transactions could present falsified statements and documents to Examiners or feed such accounts with fictitious entries to portray them as being serviced. Other categories of loan fraud include granting of credits on the strength of overvalued or non-existent, multiple-pledged, stolen or counterfeit collaterals and extension of credits in violation of regulatory stipulations. Loan fraud could also be perpetrated by bank customers where loan is obtained on the strength of false financial statement or where the loan proceeds are diverted.

#### *6.1.2.7 Counterfeit Financial Instruments*

Most of the financial crimes are perpetrated through illegal counterfeiting of commercial and financial instruments. Modern photographic and printing equipment have greatly aided criminals in reproducing good quality forged instruments. The documents may be total counterfeits or may be genuine documents that are copied, forged or altered as to amount, pay out date, payee or terms of payment. Some of the security instruments commonly counterfeited are: stock or bonds, treasury notes, cashiers' cheques, bankers acceptances, or certificates of deposits.

#### *6.1.2.8 Cheque Fraud*

Cheques have remained a major vehicle for the operation of the payment system world-wide. Little wonder that the fraudsters have found a haven in

it through which millions of naira is lost annually. Cheque frauds are perpetrated through stolen cheque books/leaves and subsequent forging of account holder's signature or alteration of payee or amount payable; substitution of clearing cheques et cetera.

#### *6.1.2.9 Money Laundering Fraud*

This is a means by which source or use of money illegally obtained are concealed by converting the cash into untraceable transactions in banks. At times in a desperate effort to disguise such transactions the funds could be moved between several institutions and across boundaries.

#### *6.1.2.10 Clearing Fraud*

Most clearing frauds hinge on suppression of payment instrument so that at the expiration of the clearing period applicable to the instrument the collecting bank will give value as though the paying bank had confirmed the instrument good for payment. Clearing cheques can also be substituted to enable the fraudster divert the fund to a wrong beneficiary. Mis-routing of clearing cheques can also assist fraudsters to complete a clearing fraud. In other words, a local clearing item can be routed to an up-country branch. In the process of re-routing the instrument to the proper branch, the delay entailed will give the collecting bank the impression that the paying bank had paid the instrument.

#### *6.1.2.11 Telex Fraud*

Transfer of funds from one location to another can be effected through telex. The message, though often coded, can be altered to enable diversion of funds to an account not originally intended.

#### *6.1.2.12 Computer Fraud*

The rapid development in information technology and globalization has had serious impact on banking practice in the country. Those factors are expected to continue to drive the way banking businesses are conducted in the country as more and more banks move to automate their back office and clients' services. Also with the advent of the Internet, E-commerce, E-banking, etc, it is no longer news that somebody could stay in the comfort of his home and move millions around the globe. Some banks in Nigeria now offer on-line services for some of their clients. While this is convenient, it equally carries with it the risk of computer fraud as there seemed to be no longer discernable boundary nor perimeter along which to erect the defences to keep corporate data within and inaccessible to computer hackers outside. While computer frauds more especially those perpetrated by hackers, are yet to be reported to the Regulatory Authorities in Nigeria, reports from on-site examination of banks have continued to draw attention to the poor attitude of some banks to the issue of computer security.

#### *6.1.3 Extent of Frauds in the Nigerian Banking System*

The incidence of frauds in our banking system has continued to be of grave concern to the Regulatory Authorities going by the magnitude of loss recorded by the system to the fraudsters over the years (see Tables 1 and 2). The incidence of frauds in our banking system has continued to be of grave concern to the Corporation going by the magnitude of losses recorded by the system over the years. The experience with those banks that were closed between 1994 and date clearly showed the trends as well as the damaging impact of frauds on the affected banks and the entire Nigerian financial services industry. In one of such closed banks, over ×1.6 billion was outstanding in its books as frauds/unauthorised lending distributed among



its several branches. Also, in another failed bank, the sum of over ×461 million was outstanding in its book as amount lost through fraud.

Many of the banks-in-liquidation as well as many still in operation had suffered a great deal from the impact of frauds. For example, in 2008, there was a total of 2,007 reported cases of attempted frauds and forgeries involving over ×53.0 billion compared with 1,553 reported cases of frauds and forgeries involving ×10.01 billion in year 2007. The expected loss components of the reported cases of frauds and forgeries, that is, those whose probability of recovery was low as well as those not fully covered by Fidelity Insurance Bond amounted to over ×17.0 billion in 2008.

Balanced against the argument that perhaps only a fraction of such incidences are reported, the heavy toll frauds have had on the vibrancy of the banking system have become evident. Ironically, while the Regulatory Authorities are busy exploring and fashioning out strategies to curtail the strange-hold of frauds on the banking system, the fraudsters are busy “engineering new methods and tricks” to further wreck havoc on the system through fraud.

**Table 6.1**  
**Fraud in Banks**

<b>Year</b>	<b>Total No. Of Fraud Cases</b>	<b>Total Amount Involved (N'm)</b>	<b>Total Expected Loss (N'm)</b>
1995	141	1,011	229
1996	606	1,601	375
1997	487	3,778	228
1998	573	3,197	692
1999	195	7,404	2,730
2000	403	2,851	1,081
2001	943	11,244	906
2002	796	12,920	1,300
2003	850	9,384	857
2004	1,175	11,754	2,610
2005	1,229	10,606	5,602
2006	1,193	4,832	2,769
2007	1,533	10,006	2,871
2008	2,007	53,523	17,543
	<b>12,131</b>	<b>144,111</b>	<b>39,793</b>

Source: NDIC Annual Reports (1995 – 2008)

**Table 6.2**  
**Bank Staff Involved in Fraud**

S/No	Rank	2005	2006	2007	2008
1	Supervisors & managers	169	118	84	48
2	Officers, Accountants & Executive Assistants	124	90	89	127
3	Clerks & Cashiers	54	50	34	48
4	Typists, Technicians & Stenographers	16	16	21	20
5	Messengers, Drivers, Cleaners, Stewards & Security Guards	12	7	-	-
6	Temporary Staff	3	50	45	70
	Total	378	331	273	313

Source: NDIC Annual Reports (2005 – 2008)

### 6.2 The Recent Phenomenon In Bank Frauds

The traditional bank fraud as we used to know it would appear to be a gross underestimation of the extent of malpractices within the banking system today. Apart from fraudulent malpractices that could occur as a result of weak internal control and inadequate computer securities there has been a new dimension to bank frauds in the recent years. The phenomenon which is popularly called “management fraud” is characterised by lack of transparency on the part of Board, management and officers of some banking institutions in financial reporting and in transactions with their clients and unsuspecting members of public. Indeed, some of the banks whose Foreign

Exchange Authorised Dealership Licences were suspended by CBN recently were found to have used the accounts of some customers to bid for foreign exchange without the knowledge or consent of such customers. Such fraudulently acquired foreign exchange was subsequently round-tripped and sold in the parallel market.

Reports of on-site examinations of banks have continued to reveal the growing trends in unethical balance sheet management by banks. These days, end of month or end of year “financial engineering” involving window dressing of financial reports by banks is common place. Just as banks engage in legitimate activities, some of them are known to indulge in illegal and unauthorised activities. Such no doubt, have the potential of increasing risk to depositors’ funds. For example, it is now common knowledge that some banks became distressed because depositors’ funds were used for real estate development or trading directly in supposedly fast-moving commodities such as cement, fish, sugar, et cetera. As some banks are not experienced in trading in these commodities they lost depositors’ funds through trading losses or through 419 scams. Even when some banks made huge profits from such activities, because they are unauthorised activities, they are never disclosed as they are treated “off- balance sheet” and the banks never got to benefit from such profits while a few officials of such banks often at the Board and top management levels benefited from such deals. As a matter of fact, some banks use phoney companies to perpetrate and conceal such unauthorised activities.

We have also had instances where purported recapitalisation of some banks were nothing but mere book entries. One of such practice was to feed some accounts with phoney credits against which various cheques were raised to fulfil capital requirement. At times the funds were initially transferred to

another bank from where they were later rechannelled to the bank. Some banks were also known to have financed their supposed recapitalisation through short term funds such as Commercial Papers (CPs) raised from the money market.

In another breath, some related banks were known to have perfected the strategy of “cross dealings”. That is done in order to conceal violations of single obligor limits, in particular, in those banks. For example, bank “A” which has lent more than the required limit to client “X”, in anticipation of routine examination of the bank by the Regulatory Authorities could contact bank “B” (both related banks) to facilitate issuance of payment instruments which is fed into the loan account of customer “X” through clearing. Customer “X”, could be a customer of bank “B” but not necessarily with adequate funds. Such transactions would immediately bring the outstanding balance in the account within prescribed limit only to revert to the status quo soon after the exit of the Examiners. That could also be done to forestall loan loss provisioning on the affected accounts.

Furthermore, there were several reported cases of unfair dealings by banks against customers. Some banks were reported to operate transactions at value dates to the detriment of their customers, some cheat their customers by manipulating insider information against them while taking undue advantage of their ignorance. Not to mention all kinds of illegal charges being debited to customers’ accounts by some banks. Countless number of such petitions have been filed with the Regulatory Authorities by those who felt shortchanged by banks. At the risk of cataloguing further the sharp practices in the industry, suffice to say at this juncture, that the industry is replete with a lot of under-the-table dealings. The question is why do bank managements embark on such unethical acts and frauds?

The answers could be summarised as follows:

1. To hide illiquidity;
2. To evade sanctions for breach of the regulatory lending limits;
3. To hide capital deficiency;
4. To minimise payment of premium to NDIC, cash reserve obligation to the CBN and tax to the relevant Tax Authorities;
5. To present healthy credit portfolio and hide the weaknesses which the risk assets surreptitiously harbour;
6. To meet up with peer standards and industry performance benchmarks and paint rosy pictures of their state of affairs before the investing public and potential depositors;
7. To shrink deposits and reduce their loan portfolio;
8. To obtain arbitrage income from round-tripping of foreign exchange which are acquired from the CBN with fictitious documentation; and
9. Associate and subsidiary companies are often set up as conduit pipes to siphon funds through questionable contracts and fund transfers.

### ***6.3 Strategies For Controlling Frauds In Banks***

The challenges posed by the growing trends in frauds in our banks is no doubt enormous and would require the genuine endeavour of all concerned to curtail its damaging impact on our banking system. To this end, information sharing amongst all the stake-holders would be a welcome development.

While the traditional type of frauds mentioned in this paper could be minimised by the institution of sound accounting and internal control systems by the banking institutions, management frauds could only be minimised through paradigm shift and enforcement of sanctions/due process. It would involve a change from the current penchant for short-term profitability and self gains to long term orientation and stability. In any case while a bank may succeed in covering its track through record falsifications and financial engineering in the short term, such over bloated performance ratios would sooner than later crystallise in illiquidity and insolvency of the banking institution. It is against this background that the Regulatory Authorities would continue to support self-regulation by banking organisations as a first step to achieving the desired paradigm shift. The Regulatory Authorities would also continue to encourage discussion forums to enable all the stakeholders share information and map out strategies to address issues of collective interest. It must however be emphasised that all hands must be on deck.

On the part of the Regulators we shall continue to improve on the prudential regulation of banks designed to encourage the adoption of best practices in the industry. In realisation of that objective, on-site and off-site supervision capacity of the Regulatory Authorities is currently being reviewed in order

to make them more robust. To improve off-site supervision, which involves prudential analysis of returns from banks to monitor their safety and soundness on an on-going basis as well as identify weaknesses that require prompt supervisory attention, an automated Bank Analysis software has been designed for this purpose. The software has fields for analytical and logical review that is expected to detect returns that contain inconsistent data. off-site surveillance would continue to be supported with on-site examination of the books and affairs of banks in order to provide the Regulators with the opportunity to verify the various reports received from banks and conduct evaluation of risks management, accounting and internal control, information technology and corporate governance. The current direction of on-site supervision is to focus attention and resources on the perceived areas of risks of the individual banking institution. That approach is called Risk Based Examination.

Consolidated examination has also been evolved as a strategy to deal with the issue of banking group with diverse interest in subsidiaries or associate financial institutions. Consolidated examination involves the simultaneous examination of all the companies in the banking group.

Furthermore, the issue of the independence of the internal auditor is being critically looked into by the Regulatory Authorities with a view to providing the internal auditor with some level of protection against victimisation that could impair their independence. The internal auditor must be truly independent in order to enhance objectivity in financial reporting. It may also interest the reader to know that in some countries it is being suggested that internal audit function should be out-sourced in order to among others, enhance the independence of the internal auditor.



In the same vein, external auditors of banks would be expected to exercise higher degree of integrity, objectivity and independence in the discharge of their responsibilities. In order for banks not to exercise undue influence on the external auditors, their appointments and termination would continue to be subject to prior approval of the regulatory Authorities.

The implementation of the Failed Banks (Recovery of Debts) and Financial Malpractices in Bank Decree of 1994 is another milestone in our efforts to cleanse the banking system of fraudsters. All the cases hitherto being handled by Failed Banks Tribunals have now been transferred to dedicated divisions of the Federal High Court. That consideration (i. e. cleansing the system of fraud) also informed the enactment of the Money Laundering Act of 1995. The Act makes it mandatory for banks to report any transaction in excess of ₦500, 000.00 in case of an individual and ₦2 million in case of a corporate body to the Regulatory Authorities.

The Credit Risk Bureau is also established by the CBN to provide centralised information on bank loans within the system. This is needed to frustrate the activities of predatory borrowers who had hitherto capitalised on the absence of such database to commit loan frauds in the system. Under the current dispensation every loan in excess of ₦1 million must be registered with the Bureau.

Given that no meaningful achievement could be recorded without the collaborative efforts of all concerned, the Regulatory Authorities would continue to encourage such collaborations. That has become necessary in order to facilitate understanding and reduce areas of distrust on the one hand and nurture opportunity for information sharing on the other hand.

#### **6.4 Conclusion**

An attempt has been made in this paper to highlight some negative impacts of frauds on our banking system. The paper also delved extensively into the various tricks in use by the fraudsters. It is unfortunate that the menace has found its way into the realm of corporate governance in our banks, which is characterised by lack of transparency, insider dealings and outright looting which had led to the collapse of many banks with serious macro-economic implications. Apart from inflicting severe financial difficulty on banks and their customers, frauds would also lead to the depletion of shareholders' funds and banks' capital base as well as loss of confidence in banks. In view of the devastating effect of frauds on our economic well being, it only behoves all the stakeholders of the nation's banking system to resolve to cooperate together to curb its menace in our economy.

# Chapter 7

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## **PROACTIVE MEASURES TO GUARD AGAINST FRAUD/CASH THEFT IN THE BANKING INDUSTRY AND IN ORGANISATIONS<sup>1</sup>**

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### ***7.0 Introduction***

Fraud is recognized as a significant threat facing Government Businesses and Individuals all over the world. In our own environment fraud appears to have assumed a tragedy of epic dimension. Fraudsters are not only becoming more sophisticated, innovative and refined in their planning and execution of their nefarious acts, but are becoming daring as well. Our everyday living experiences are awash with reports of fraudulent acts being committed in our businesses and on individuals.

Fraud losses impact every business and every household. It results in huge financial losses to banks and other organizations, the shareholders and customers. In particular, fraud leads to loss of confidence in business,

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<sup>1</sup> *Original paper was delivered at a one-day Security Enlightenment Forum organized by Police Community Relations Committee, Garki Division, Garki Abuja.*

insolvency or winding up of business, bankruptcy, failure of creditors' business with attendant loss of employment, revenue to the government, lenders and investors. The costs of fraud are always passed on to society in the form of increased customer inconvenience, opportunity costs, unnecessary high prices of goods and services. It was established that fraud was one of the main causes of distress in our banking system that led to the closure of many banks in the 1990s. As a matter of fact, some recent bank failures were caused by fraud.

The subject of fraud is of great concern to an organisation like the Nigeria Deposit Insurance Corporation (NDIC) that is saddled with the responsibility of protecting depositors of banks and other financial institutions. Section 35 and 36 of NDIC Act No. 16 of 2006 require all insured banks in Nigeria to render to the Corporation, returns on frauds and forgeries or outright theft occurring in their organizations and also report on any staff dismissed, terminated or advised to retire on the grounds of fraud. The purpose of obtaining these information is not only for statistic, but to assist the Corporation in understanding the tricks, antics and tactics employed by fraudsters to perpetrate their nefarious acts with a view to devising counter measures that will checkmate and frustrate their efforts. The information is to also assist in ensuring that fraudsters are not allowed to circulate in our financial system.

What is fraud? There is no precise legal definition of fraud just as there is no single offence that can be called fraud. Nevertheless, it is usually taken to have certain elements including an intentional and unlawful misrepresentation which causes prejudice, most often misappropriation, which is the removal of cash, or asset to which the fraudsters is not entitled as well as false accounting in which records and numbers reported are

falsified to give and create false impression. Black's Law Dictionary defines fraud as "an intentional perversion of truth for the purpose of inducing another in reliance upon it to part with some valuable thing belonging to him or surrender a legal right". Fraud is therefore a false representation intending to mislead, whether by word, conduct that deceives and is intended to deceive another so that he shall act upon it to legal injury. From the definition, it is obvious that the subject matter of fraud is very wide ranging from the simple theft or petty cash or cheques fraud to a major one. Fraud can be committed by employees, customers or other operating independently or in conspiracy with others inside or outside the organisation.

The purpose of this paper is to examine the modus operandi of fraudsters in perpetrating fraud in our environment with a view to creating a high level of awareness and a sense of urgency in order to stem its tide in our businesses by way of developing and implementing proactive measures. The Second part of this paper therefore examines the causes of fraud in our environment while Part Three looks at the nature and various types of frauds. The paper in Part Four identifies the needed measures to be taken in order to deter, prevent and detect fraud in a timely and effective manner. The conclusion is given in Part Five.

### ***7.1 Factors Causing Fraud and its Extent***

There are many factors that cause fraud in Nigeria and these can be classified into three main groups, namely: institutional, social and individual.

#### ***7.1.1 Institutional Factors***

Many institutions unconsciously create conditions that allow fraud to flourish. In such institutions a lot of loopholes are allowed to exist which

fraudsters easily identify and exploit to commit their acts. The common institutional causes of fraud are highlighted hereunder.

**a. *Inadequate Internal Control***

Internal control has long been prescribed as an antidote against fraud. As such, poor internal control creates incentive and fertile grounds for fraud to thrive. Weaknesses occur where the controls designed to prevent people using the system, for an improper or unauthorized purpose, do not operate effectively and efficiently. The simplest example would be a failure in access controls that allow unauthorized individuals into the premises or sensitive areas of business, for instance computer network. Ineffective internal audit, poor staff supervision, absence of segregation of duties and lack of dual control over sensitive documents and keys are all manifestations of inadequate internal control which aid fraud.

**b. *Inexperience of Staff/Inadequate Staff Training***

In instances where organization recruit and place their staff in positions far beyond their capacities and competence for reasons ranging from political patronage to family connection, fraud becomes easy to perpetrate through such staff. Because of their lack of experience and knowledge fraud easily pass through them without being detected.

Lack of adequate training and re-training of staff on their job schedules result in poor performance which breeds fraud. Failure to give staff on-the-job training as well as sending them to relevant courses also lead to unsatisfactory performance which eventually creates room for fraud.

**c. *Employment Disaffection***

The motivation for fraud is often due to staff disaffection, based on being passed over for promotion, inadequate pay reward, or a feeling of carrying more than a fair workload. The number of employees who feel threatened and therefore could turn into potential malefactors has been on the increase mainly due to management practices that are considered negative and inhibitive. Management practices bordering on reorganization, restructuring, reengineering and downsizing or rightsizing have resulted in employee lay-offs. In fact, restructuring in some organizations seem to have become a way of life with its attendant loss of jobs. This creates job insecurity in the minds of the generality of employees which in turn increases the population of potential fraudsters and breeds fraudulent practices as well.

**d. *Poor Management***

It is the responsibility of board and management to ensure the security and integrity of the business assets by putting in place appropriate control and procedures. Where a management is ineffective, incompetent or self-serving, the tendency is for the controls not to be in place or to be overridden and compromised thereby allowing fraud to flourish. In such organizations, managements are not only facilitators but active collaborations in perpetrating fraud. It is therefore not surprising that those organizations record higher incidence of fraud than those with effective management.

Management style is also known to be a factor in committing fraud. An autocratic, aggressive or domineering management facilitates overriding of controls and prevents questioning by others. This style may end up permeating the whole organization thereby creating a closed environment where corporate policies and culture yield to individual's whims and

caprices, and fraud in this circumstance can go unchallenged. Where performance goals set by management appear overly aggressive given conditions in the marketplace, for instance the unrealistic deposit targets being given by banks to their staff, breed all sorts of fraud.

*e. Negligence of Staff/Customers*

Staff negligence is found to be a cause of fraud in many instances. Negligence itself is a product of several factors, including poor supervision, lack of technical knowledge, apathy, workload, pressure, etc.

Similarly, negligence by customers is also a great factor in perpetrating fraud. Customers who fail to adequately secure documents and other assets related to their business transactions, e.g. cheque books, stock records, company seals, etc, create conducive environment for fraud. Failure to also carry out accounts reconciliation assists in facilitating fraud.

*f. Automation and Computerization*

Computerization and automation of business processes are known to facilitate fraud especially where there is no proper project planning and execution including adequate training of people to use the system. Computers have become powerful instruments and ready tools in the hands of fraudsters for perpetrating fraud because of ease in usage and difficulty in audit trail.

*7.1.2 Social Factors*

*a. Societal Values*

The value system in our society today is such that reputation, respect, honour and other social status are conferred on people mainly on the basis of their material wealth. Access to political power, chieftaincy titles, religious positions and influence are easily acquired by “money bags”. Recognition



is accorded to materialism. People are therefore, driven to commit fraud as a means of easy acquisition of money and property which in our today's world translate into recognition and power.

**b. *Poor Economy***

It is being argued that the poor state of our economy has been a contributory factor to fraud perpetration. The level of unemployment and poverty in the polity due to recession has been a major cause for concern to all and sundry. Hash economic conditions can drive people to commit fraud. The individual must necessarily satisfy the basic needs of food, clothing and shelter otherwise he will readily succumb to fraud if opportunity presents itself.

**c. *Slow and Tortuous Legal Process***

The law enforcement and judicial process of bringing fraudsters to justice has been extremely slow and tortuous. Cases of fraud reported to the police take a long time to investigate and prosecute. Many other cases are not investigated for prosecution to serve as deterrent. The delay in investigation and prosecution can perhaps be explained because the police and courts are poorly equipped and remunerated. However, the perception that our laws are weak in promptly bringing fraudsters to justice send wrong signals that people can commit fraud and get away with it.

*7.1.3 Individual Factors*

These are factors that pertain to the person, that is, those that are peculiar to the individual and may encourage him to live a fraudulent life. These factors include;

- i) Biological make-up – e.g. kleptomania
- ii) Poor moral upbringing

- iii) Criminal background, and
- iv) Weak mind

## ***7.2 Nature and Types of Fraud***

It is of importance to understand the nature and types of fraud as that will be of great assistance to organizations in checkmating and combating it. Generally, fraud is categorized on the basis of its perpetrators. This way, it could be internal, external or mixed. Internal perpetrators of fraud are staff under the employment of the organization either as directors, management staff, officers, supervisors or other employees while the external ones are those outside the organization. Mixed perpetrators are those involving members of staff of an organization colluding with outsiders to carry out their fraudulent activities. Another way of classifying fraud is on the basis of methods employed in perpetrating it. Given the sophistication, inventiveness and ingenuity of fraudsters in devising ways to carry out their trade, it will be practically impossible to list and discuss all of them. However, the most important and common ones are highlighted hereunder.

### ***7.2.1. Theft***

Theft involves the removal of cash or assets to which fraudster is not entitled. Any business asset can be stolen by staff or other parties. The nature of theft may vary according to the asset being misappropriated and identity of the perpetrator. The most common types of theft in our system are:

- i) Direct theft of cash or any asset of the business, e.g. stock, computer equipment, stationary, intellectual property, price lists or customer lists, etc.
- ii) False expense claim which can be anything from claiming for private entertainment expenses to large scale projects.

- iii) Payroll fraud involving the diversion of ex-employees or fictitious employee payments to the benefits of perpetrators.
- iv) Rolling debtors' receipts that is misappropriating debtors' receipts and substituting subsequent receipts.
- v) Payments against fictitious jobs or supplies.
- vi) Inflation of contracts.

### *7.2.2 False Accounting*

The main aim of false accounting is to present the results and affairs of an organization in a better light than the reality. Frequently, there are deliberate decisions to report an unrealistic level of earnings. Whatever the purpose, the features that are common to all cases of false accounting are the window-dressing or falsification of records, alteration of figures, and in some cases, maintenance of multiple records.

The reasons for all these include:

- i) to obtain more financing from banks and creditors;
- ii) to manipulate share prices;
- iii) to improve results over the year-end and generate performance related remuneration to which the perpetrator would not otherwise be entitled;
- iv) to cover up a theft;
- v) to attract customers by appearing to be more successful than in reality; and
- vi) to prevent or delay intervention by supervisors/regulators.

### *7.2.3 Advance Fee Fraud (“419”)*

This is a very popular type of fraud in our environment. It is internationally referred to as “Nigerian scam”. A method of perpetrating this type of fraud

is for numerous letters to be sent to unsuspecting individuals by fraudsters soliciting for assistance to transfer large sum of money belonging to them but which is being held by government. The assistance requested will be in the form of advance fee which will be used to induce government officials and the details of the off-shore foreign accounts of such individuals.

#### *7.2.4 Computer Fraud*

Computer fraud includes:

- i) Disguising the true nature of a transaction by manipulating input and or data including tampering with programme.
- ii) Hacking into an organization's computer system to steal or manipulate information.
- iii) Unauthorised electronic transfer.
- iv) Posting of business opportunities on the internet to defraud the public.
- v) Theft of intellectual property, e.g. engineering drawings, trade secrets, e-books, music, etc.

#### *7.2.5 Foreign Exchange (FX) Fraud*

Foreign exchange transactions have been veritable source of fraud as a result of sharp practices involving banks or their customers. The most common types include:

- i) Round Tripping – This arise in a situation where banks obtain foreign exchange through official sources at a cheap exchange rate for qualified transaction and simply sell to autonomous users at a black market exchange rate.
- ii) Documentary credit fraud – This can be quite varied and will involve forgery of foreign exchange documents, such as import

duty receipts, shipping documents, Clean Report of Inspection and attested invoices. It can be carried out with the objective of transferring foreign exchange for non-existent transaction or by way of over invoicing.

- iii) Travellers' Cheque (TC) Fraud – This is done by illegal purchase of TCs which are then sold in the black market.

#### *7.2.6 Loan Fraud*

Loans and other forms of credit extensions to business and individual customers constitute the main function of financial institutions. In the process of credit extension, fraud may occur at any stage, from the first interaction between the customer and the bank to the final disbursement of the credit. Diversion of loan for other uses different from that for which it is given constitutes fraud. Also, there are instances of credit fraud whereby credit facility approved for one customer is diverted to the credit of another who is often unrelated to the first customer. That is to say, a credit facility for a customer "A" yet to be drawn down is diverted to a customer "B" for utilization.

#### *7.2.7 Cheque Fraud*

Cheque fraud is now common involving billions of naira annually. The most common cheque fraud involves those that are stolen, forged, counterfeited, altered or cloned.

#### *7.2.8 Money Laundering Fraud*

This is a means to conceal the existence, source or use of illegally obtained money by converting the cash into untraceable transactions. The cash is disguised to make the income appear legitimate. Fraudsters are known to employ various means in order to launder their money. These include using

illegally-obtained money either to purchase stocks in the capital market, or to acquire real estate.

#### *7.2.9 Identity Fraud*

This type of fraud is committed by individuals who assume names and identities of others living or dead with a view to gaining employment or using their stolen credit or value cards to secure some monetary benefits.

#### *7.2.10 Insurance Fraud*

In this type of fraud, insurance agents sell policies to clients and refuse to deliver premium collected to the insurance companies, or stage-manage accidents in order to replace old or defective vehicles, or causing mysterious fire incidents after previously removing choice items of value for the purpose of making undue claims from the insurance companies.

### ***7.3 Measures to Guard Against Fraud***

The best defences against the risk of fraud in any organization are proactive measures. For an organization to create a corporate environment that prevents, deters and timely detects fraud, it needs to understand why fraud occur, types and methods of perpetration as well as identify its business areas that are at risk and implementing appropriate procedures to address them. It is a well established fact that before fraud can take place there must be:

- i) an item worth stealing;
- ii) a potential perpetrator willing to steal; and
- iii) an opportunity for the crime to take place.

It follows therefore that successful prevention of fraud in an organization lies in the isolation of the perpetrators from the assets and from the

opportunity and knowledge required for access. In other words, walls of policies, procedures, devices and controls need to be erected to surround and isolate each factor in the equation to combat fraud. It is for this reason that the system of internal control is identified as very critical in minimizing the incidence of fraud in any business organization.

Management has overall responsibility for ensuring the security and integrity of the assets of a business by putting in place appropriate controls and review procedures. However, it needs to be emphasized that the controls required for each business will be specific to that business, depending on the way in which departments or processes function, the systems in place, the number of personnel and so on. That is to say, every organization needs to assess and determine the area in which fraud could occur and implement the controls that are considered necessary to mitigate it. Some of the direct controls that need to be considered include:

- i) Timely and periodic reconciliation of bank accounts, cash in hand, inventory and other items of value.
- ii) Dual signatories and authorization limits.
- iii) Segregation of duties.
- iv) Management review.

### *7.3.1 Other Organizational Measures*

Other measures that should be adopted in the fight against fraud are those relating to the attitude and culture of the organization and the way in which it deals with fraud. These are indirect controls which convey the message that fraud will be detected, that action will be taken and that the repercussions could be severe. Some of these measures include:

***a. Physical Security/Access Controls***

Operating effective access controls is essential, be it within the premises themselves, particular departments or offices, computer systems, database, bank accounts or other areas critical to the business. The role of security tags, which allow someone's movement around the building to be monitored, CCTV cameras or other surveillance equipment, should not be underestimated. Particular attention should be paid to access controls over computer systems, which should include the rigorous use of passwords, firewalls and/or other measures to prevent or detect hacking into the system.

***b. Effective Internal Audit***

An effective internal control functions is very critical in managing fraud risk in any organization. For maximum effectiveness, internal audit department should have enough resources to carryout its functions, that it is focussing on the most important risk area of business, that it is independent and free to establish the scope of its activities without let or hindrances by management, and that it is reporting fully and directly to the highest authority, ideally the board of directors or its audit committee. Internal auditors should be given comprehensive training in fraud prevention and detection.

***c. Pre-employment Screening***

The fight against fraud should start even before a new employee joins the organization. There should be an effective recruitment policy which ensures that employees are recruited based on their capabilities, competence and integrity. References must be obtained from previous employers. Background checks should be conducted on employees to assure of their integrity.

***d. Conducive Working Environment***

The motivation for internal fraud is often employee dissatisfaction. A favourable working environment would ensure that employees are not placed under undue duress and that they are not intimidated by supervisors or



superior officers. There should be a culture of openness, transparency and trust as against that of secrecy, mistrust and autocracy.

***e. Fraud Policy***

There should be fraud policy in organizations. Fraud policy is a formal, written statement recording the organization's attitude to fraud. It may be part of general ethics statement or code of conduct that records the way in which the organization deals with its customers, suppliers and staff. In particular, the policy should make it clear that fraud is unacceptable and that all instances of suspected fraud will be investigated with dispatch.

***f. Fraud Resolution***

When fraud occurs, it should be resolved promptly and effectively. Resolution should be communicated to employees, while care should be taken to avoid defamation. Communication of the outcome reinforces in employees the organisation's zero tolerance for fraud.

***g. Fraud Training***

Organisations should promote fraud training. All new employees should be provided with the organisation's fraud policy statement. Fraud deterrence, prevention and detection programs that deal with practical issues should be included in induction and continuous career training.

***h. Whistle-blowing Policy***

Employees and third parties should be encouraged to report their suspicions of fraud or other irregular activity without fear of reprisal. To encourage reporting, whether anonymous or not, an E-mail or telephone fraud hotline can be implemented. The existence of such facilities should be well publicized and their roles in deterring or detecting fraud should be made

known to all. Information should be treated on a confidential basis to reassure whistle blowers, and management should be seen to be fair and just in handling such confidential information.

***i. Controls over the IT Environment***

Significant amounts of information are now held in database and other formats to aid communication within companies. If improperly managed, this concentration of information provides an increased risk. Sensitive data could be compromised and end up in the hands of unauthorised individuals. Necessary physical and logical access control over the computer system should be provided.

***j. Insurance Policy***

In addition to taking measures to minimize the risk of fraud, management should ensure that, should frauds occur, the business has appropriate and adequate insurance cover.

***7.3.2 Role of Government***

Government in every society plays a key role in the protection of life and property of its citizens. It is for this reason and in order to ensure a disciplined society that government promulgates appropriate statutes, establishes relevant institutions and ensures enforcement of various legal provisions. Amongst such relevant statutes and institutions that exist in Nigeria are Central Bank of Nigeria (CBN), Banks and Other Financial Institutions Act No 25 of 1990 as amended, NDIC, Securities and Exchange Commission (SEC), National Insurance Commission (NAICOM), Companies and Allied Matters Act No. 1 of 1990 as amended, EFCC, ICPC and Money Laundering Act, Police, Judiciary, NAFDAC, and Standard Organisation of Nigeria

(SON) among others. These government agencies have been involved in the fight against fraud.

***a. The CBN/NDIC***

The subject of fraud in the financial system is of special concern to the monetary and supervisory authorities, particularly the CBN and NDIC. These government agencies are concerned about the safety of individual institution and the soundness by the banking system. The prudential regulations/supervision put in place by the CBN/NDIC are also aimed at monitoring fraud incidents. A Black Book is maintained for bank employees found to have committed fraud. Such employees are black-listed and declared ineligible to continue to work in the banking industry.

***b. Other Government Agencies***

The agencies in this category include the Securities and Exchange Commission (SEC) for the capital market operators, the National Insurance Commission (NAICOM) for insurance companies, National Communications Commission (NCC) for telecommunication operators, National Agency Food and Drugs Administration and Control (NAFDAC) for drug and food manufacturers, Standard Organization of Nigeria (SON) for industrial goods manufacture, Economic and Financial Crimes Commission (EFCC) for economic and financial crimes including money laundering. All these governmental organisations supervise the relevant institutions/industry for their safety and soundness and equally curtail fraud in entities under their purview.

***7.3.3 Role of General Public***

The general public on its part must be vigilant and cooperate with government and related agencies in efforts to rid the nation and its institutions

of fraud. Many a time people with knowledge of fraud being planned or committed against others will not raise alarm on the belief that it does not concern them and that they are not the victims. That is far from being correct. We are all victims and the fight against fraud is our fight. We need not to wait to be direct victims before we take action. If today is the turn of an anonymous victim, tomorrow may be our turn. It is therefore necessary for everybody in the society to be at alert about fraud. Its fight should be a collective responsibility of the businesses, citizens, police, judiciary and other government agencies.

## **7.5 Conclusion**

Fraud in our environment no doubt is on the increase and one can safely state that it has reached a disturbing proportion so much that it constitutes veritable threat to the financial health of our banking institutions and other organizations and by extension, the economy at large. Fraud costs businesses a lot of money every year. It is one of the causes of banking distress and collapse of many of the banks that are presently under liquidation by the NDIC.

The threat of fraud in our organizations can be contained by taking the right steps. A business organization that is alert to the risks that affect its business, that puts in place appropriate controls and procedures, monitors the effectiveness of these controls, creates favourable working environment and maintains an anti-fraud culture, is going to be better placed to deter, prevent, and detect fraud promptly. Above all, the fight against fraud requires a holistic approach through the efforts and cooperation between individuals, organizations, law enforcement agencies and other stakeholders.

# Chapter 8

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## CONCEPT AND RELEVANCE OF DEPOSIT INSURANCE IN AFRICA<sup>1</sup>

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### **8.0 Introduction**

Deposit-taking financial institutions serve as intermediaries between the surplus and deficit units of the economy. The intermediation process essentially entails risk-taking, with the risks assuming different forms such as credit operational, liquidity, reputational, et cetera. Because the operations of financial institutions affect all stakeholders including the general public, there is no government that does not utilize various means, both direct and indirect, to minimize any damage that might be inflicted on the rights and interests of depositors as a result of failure of financial institutions. In the past, by closely supervising financial institutions and maintaining strict controls over the scope of their business operations, the government had implicitly safeguarded depositors' fund.

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*1 Being Text of a paper presented at the 10<sup>th</sup> Meeting of the Committee of Banking Supervisors of West and Central Africa in Abuja, Nigeria on 9<sup>th</sup> September, 2004*

More recently however, many countries have adopted deposit insurance or guaranteed deposit systems with a view to explicitly safeguarding the rights and interests of depositors, especially small ones. A deposit insurance scheme is a financial guarantee to protect depositors, especially the small ones in the event of a bank failure. By so doing, confidence in the banking system is engendered and the stability of the system facilitated. Deposit insurance serves as one of the complementary measures employed by the monetary authority for effective management and orderly resolution of problems associated with both failing and failed deposit-taking financial institutions. The scheme provides government with a framework for intervention and sterilisation of the disruptive effects on the economy of failures of deposit-taking institutions.

Without a deposit insurance system, many countries particularly in Africa have extended implicit deposit protection to depositors on a discretionary ad hoc basis. Explicit deposit insurance systems have several advantages over these implicit protection schemes. By replacing discretion with rules, explicit deposit insurance provides a faster, smoother and more consistent administrative process for extending protection to depositors and for protection against bank runs. Although, there are arguments against deposit insurance schemes, on balance the merits outweigh the demerits and therefore, it is hardly surprising that there is almost unanimous advocacy for deposit insurance in developing countries by the IMF, the World Bank and other such policy advisors (McKinnon, 1991)

Explicit deposit insurance schemes have a great potential for enhancing the effectiveness of a nation's financial system. My presence at your meeting today is to discuss the concept as well as the relevance of deposit insurance in Africa. It is hoped that our discussion will go a long way to shed light on

the importance of this unique though relatively new scheme in Africa. It is also hoped that the discussion would encourage those countries yet to embrace the scheme to do so.

In discussing this topic further, the next section focuses on the concept of deposit insurance. After that, I shall discuss the potential roles of deposit insurance scheme. This shall be followed by our discussion on the relevance and desirability of deposit insurance in Africa and experiences from some countries with explicit deposit insurance in place before I conclude the discussion.

### ***8.1 Concept of Deposit Insurance***

A deposit insurance scheme (DIS) is a mutual insurance system supported by insured banks and administered either through a government-controlled agency or a privately held one@ (Fres-Felix, 1991). The agency, guarantees deposits in the insured institutions and stands ready to reimburse depositors promptly in the event of failure of an insured bank. Deposit insurance schemes developed as a result of the need to provide some form of protection to depositors who stood the risk of losing their hard-earned money in the event of bank failures. Coupled with this was the need to insulate the banking system from instability that could result from runs and loss of depositor's confidence.

The practice of deposit insurance differs from one jurisdiction to another. Over the years however, some best practices have emerged to guide countries that have established deposit insurance schemes or countries wishing to create one. Essentially, the practices of deposit insurance schemes deal with the issues of ownership/administration, membership, funding, coverage,

pricing and failure resolution. All these features have been extensively discussed in extant literature.

Deposit insurance was first introduced by some states in the United States of America (USA) around the 1840s. However, Norway was the first country to establish a nationwide DIS for its savings and commercial banks in 1921 and 1938 respectively. Finland and the former Czechoslovakia established theirs in 1924 whilst the nationwide scheme in the USA was established in 1933 following the great depression of that year. In Canada, a compulsory DIS was adopted in 1967 (Leaven 2004). In Asia, India was the first country with a DIS in 1961 followed by the Philippines in 1963. In Africa, the first scheme was established in Kenya in 1985 followed by the Nigerian scheme in 1988.

Deposit insurance differs from general forms of conventional insurance. Commercial insurance, on the one hand, is profit-oriented and only serves to safeguard the property of an individual. Deposit insurance, on the other hand, is a safety-net vehicle designed to stabilise financial systems and safeguard the rights and interests of depositors in financial institutions by encouraging cooperation between the government and businesses in relation to the provision of credit. It is not profit-oriented. In addition, deposit insurance also serves to guard against financial loss up to a specified limit. In other words, deposit insurance does not merely passively wait for a catastrophe to happen before providing compensation, but adopts all kinds of preventive measures to promote sound operations of insured institutions. This is where deposit insurance and commercial insurance in general fundamentally differ.



There are basically two types of deposit insurance schemes. These are **implicit deposit insurance scheme** and **explicit deposit insurance scheme**. The implicit form is a discretionary approach adopted by government to prop up some failing deposit-taking institutions in the absence of an explicit statutory obligation on the part of government to protect depositors. The government is therefore, at liberty to decide whether or not to grant any relief to depositors and the amount of such relief. The approach is not desirable because it creates uncertainty in the minds of depositors which in turn can intensify runs on other banks.

An explicit DIS is created by a legal instrument. The enabling statute usually states the objectives of the scheme and other operational guidelines relating to such issues as ownership, funding, extent of coverage, membership, supervisory and resolution powers, amongst others. Specifically, an explicit DIS provides a formal framework with clear-cut rules and procedures for providing protection to depositors as well as for assessment and management of failed and failing deposit-taking institutions.

An explicit DIS can be designed as a **risk minimizer** or as a **pay box**. It is logical for the administrator of the DIS to want to know and minimize the extent of risk it is exposed to and to monitor the changes in the composition and extent of such risk through close supervision of the insured institution. This is the risk minimization responsibility of the deposit insurer. For effectiveness, the statute establishing the scheme in countries where risk minimization is the focus of the DIS usually provides powers for supervision to the deposit insurer. In some countries, such powers cover on-site examination and off-site surveillance of insured institutions as is the case in Nigeria. The off-site supervision involves the receipt and analysis of periodic statutory returns from insured institutions to ascertain compliance

with prudential standards and other regulations, whereas the focus and scope of bank examination are dictated by the perceived levels of risk posed by the insured institution to the insurance fund. In developing countries where the quality of information supplied by insured institutions has generally been observed to be low, on-site examination becomes a relevant tool to confirm the accuracy of information contained in bank returns.

In some countries however, the deposit insurer is not empowered to supervise insured institutions, rather the DIS in such jurisdictions operate as a pay-box that is, pays insured depositors in the event of a bank failure. In several African countries, the DIS is designed as a pay box.

## ***8.2 Potential Roles of a Deposit Insurance Scheme***

The decision to establish a DIS is usually influenced by the potential roles of the scheme. Some of these roles include the following:-

### ***8.2.1 Provision of Deposit Protection to Financially Unsophisticated Depositors***

The less-financially sophisticated depositors are often distinguished by the small size of their deposits. This class of depositors is singled out for protection because they do not have the means and/or capability of carrying out the complex task of monitoring and assessing the condition of their financial institutions. This is often not the case with financially sophisticated depositors with large volume of deposits. A DIS is therefore put in place to address the inequity that exists between financially sophisticated and unsophisticated depositors.

Proponents of deposit insurance argue that it is neither reasonable nor fair to expect unsophisticated individuals to monitor banks whose portfolios of assets consist largely of loans. The costs of monitoring a bank for small depositors may outweigh the benefits and therefore, it may be rational for them to not actively monitor the condition of their banks. Instead, ignorant small depositors will seek to protect their interests by withdrawing their deposits whenever they are presented with information that causes them to question the solvency of their banks - that is, they will run on their banks. Ignorance by small depositors may also prevent them from distinguishing between good information on the condition of their depository institution and false rumors; hence, they may participate in runs on solvent banks.

It is however, important to indicate that although a DIS protects depositors against the consequences associated with the failure of an insured institution, it is not designed to protect banks and/or any other deposit-taking financial institution from failing.

#### *8.2.2 Contribution to Financial Stability by Promoting Confidence and the Stability of the Banking System*

This objective is based on a concern that depositors may lose confidence in an institution under certain circumstances. A well designed DIS contributes to the stability of a country's financial system. A protected depositor is not likely to be a panicky one at the first sign of a problem in his/her bank. That such a depositor does not rush to withdraw his/her deposit and in the process precipitate a run on the bank and contagiously on other banks, ensure banking stability.

### *8.2.3 Other Deposit Insurance Roles*

In addition to the provision of deposit protection to less financially sophisticated depositors and contribution to financial stability by promoting confidence in the banking system, DIS are also designed to play the following roles:

#### *a. Provision of a Formal Mechanism for Dealing with Problem Financial Institutions*

A DIS, in conjunction with the other regulatory arrangements, provides government with a formalised mechanism for dealing with problem financial institutions with a view to protecting depositors. The introduction of a deposit insurance system may be linked to a country's attempt to put in place laws and mechanisms that deal with failed institutions. Experience suggests that the failure of depository institutions must be handled in unique ways to deal with the tendency of troubled institutions to deteriorate rapidly, while minimizing adverse effects on the overall financial system. The introduction of deposit insurance may be linked to the creation of a country's failure-resolution framework for its deposit-taking financial institutions.

#### *b. Contributing to an Orderly Payment System*

Deposit Insurance helps to promote financial stability by contributing to the smooth functioning of the payments system. Depository institutions allow individuals and businesses to save and withdraw money when it is needed. By promoting confidence in the system, deposit insurance facilitates the smooth transfer of deposits between parties.

Some deposit insurance systems are also able to provide a form of short-term financial assistance, which may involve guaranteeing the payment

obligations of troubled institutions. Such assistance may help to avoid interruptions in payment and settlement flows. In so doing, such assistance provides time for safety-net participants to devise long-term solutions to resolve troubled institutions.

*c. Facilitating the Transition from Full Guarantee to Limited Coverage*

Countries may introduce an explicit, limited-coverage deposit insurance system as a way of facilitating the transition away from a full deposit guarantee provided by the government or other public entity. Full coverage is often adopted if the public-policy objective emphasis is to give the banking system protection against contagious runs. Blanket coverage, on the other hand, is usually applied during systemic crisis that threatens the payments system. To transit from full coverage, deposit insurance systems may allow governments to reduce coverage, and also provide a mechanism for managing the required change in public and market attitudes toward deposit protection.

### *8.3 The Relevance of Deposit Insurance in Africa*

Against the myriad of social, economic, political and other developmental problems facing the African continent, a pertinent question to ask ourselves is whether the deposit insurance objective of protecting depositors, preventing bank runs, sustaining confidence in banks and promoting financial stability is relevant in the continent?

Economic literature no doubt, is replete with studies which find significant contributions of the financial sector to economic development and the primacy of banking in the financial system. In order to make the needed contributions to development, banks in particular require deposits which

can be described as their life blood. In many African economies, banks are the dominant and the most developed entities in the financial system. In Nigeria for example, banks' total assets in relation to that of the financial services industry currently stood at over 90 percent.

Whilst there is a clear need for diversification of financial service providers, no doubt, banks and other deposit-taking financial institutions should be encouraged to mobilize more savings for development. In such an endeavour, a scheme to protect small savers who provide the bulk of the funds deserves consideration and adoption. Globally, there is ample evidence to show that the presence of an effective deposit insurance scheme to protect depositors engenders confidence in depository institutions, minimizes bank runs as well as contributes to financial stability. Bank runs are contagious and the most pernicious effect of a panic is that it may result in the closing down of sound financial institutions along with the unsound ones.

One major argument against deposit insurance is the issue of moral hazard. The problem of moral hazard arises from the distortion in incentives induced by deposit protection. The presence of protection could affect the behaviour of the economic agents involved, particularly their willingness to assume greater risk. If deposit insurance is achieved by bailing out banks and their shareholders, shareholders may be subject to moral hazard by betting on the government's or the insurer's fund. However, if the deposit protection is structured so that shareholders and managers do not benefit from deposit protection, the introduction of this protection would not increase the moral hazard of bankers. To get the full benefit of deposit insurance scheme, the extent of protection to depositors should be such that allow the DIS to achieve its objectives without inducing significant moral hazard.

Presently, while all African countries license banks and some welcome international banks, only a few countries have established explicit deposit insurance schemes to protect depositors. The countries without explicit deposit protection schemes tend to rely on implicit protection of depositors through bank support to prevent failure. However, the prevention of banking failures is a herculean task. A well-managed bank can fail because of factors beyond the bank management's control. For example, factors exogenous to the bank such as economic downturn, political upheavals, war et cetera can bring down a bank. If the deposits of such a bank were not insured, government would be forced to use tax-payers money to reimburse the depositors or as had been the case in some African countries in the past, Nigeria included, government could allow the depositors to carry their burden alone.

There is no doubt that the well-being of nations particularly, developing ones like ours in Africa, is critically dependent on its economic growth and development which are in turn, significantly dependent on the stability of the financial services industry particularly, the banking sub-sector. A stable banking system is likely to guarantee a stable financial system given the dominance of banks in many financial systems in Africa. All things being equal, a stable financial system is required for a stable economy in developing our continent, with all its rewards.

### *8.3.1 Explicit DIS in Africa*

In spite of the great potentials of financial sector stability and development held out by explicit deposit insurance schemes, it is still rather unfortunate that only a handful of African countries have the scheme in place. Those

countries with no explicit deposit insurance in place often have extended protection to depositors on a discretionary, ad hoc basis. Such absence no doubt, could result into uncertainties in the system concerning when and how a failing or failed bank should be handled.

Presently, out of the over 50 countries in Africa, only eight (8) countries have explicit deposit insurance schemes in place. Table 8.1 below presents some of the features of the schemes in some countries that have explicit deposit insurance schemes in Africa. As shown in the table, the first scheme was in Kenya (1985), followed by Nigeria (1988) and the latest was Zimbabwe (2003).

**Table 8.1**  
**Formal DIS in Africa**

Country	Year of Establishment	Administration	Membership	Supervision
Kenya	1985	Public	Compulsory	No
Nigeria	1988	Public	Compulsory	Yes
Uganda	1994	Public	Compulsory	No
Tanzania	1994	Public	Compulsory	No
Sudan	1996	Joint	Not Compulsory	Yes
Zimbabwe	2003	Public	Compulsory	No

Source: SEDESA (2002), **General Review**, Seguro de Depositos, S. A., Argentina.  
IADI (2003) Basel, Switzerland.



The agency implementing the DIS in Kenya, the Deposit Protection Fund Board (DPFB), was established in 1985 following the banking crisis of the early 1980s. The failure resolution process under the scheme required that the Central Bank should appoint the DPFB as the liquidator as soon as a winding-up order was made. Thereafter, the responsibility to reimburse the depositors, asset liquidation as well as the payment of dividends becomes that of the DPFB.

In Nigeria, deposit insurance scheme was established in 1988 to strengthen the existing safety-net of the banking system following the adoption of the Structural Adjustment Programme (SAP) in 1986. The establishment of the Nigeria Deposit Insurance Corporation (NDIC) marked an important milestone in bank depositor protection in Nigeria. Born during an era of deregulation, the Corporation commenced operations in March 1989 with the mandate to maintain stability and public confidence in the banking sector, by guaranteeing payments to depositors in the event of failure of insured institutions as well as promoting safe and sound banking practices through effective supervision. In other words, NDIC was designed as a risk minimizer with powers and responsibilities to insure deposits, supervise insured institutions and provide orderly mechanism for failure resolution.

The Corporation had, since its establishment justified the purpose for which it was set up. The Corporation has on record several achievements that are noteworthy. These achievements relate to activities which can be classified into four, namely: deposit guarantee, supervision, distress resolution and other numerous activities undertaken by the Corporation with the aim of insulating the industry from destructive runs and instability.

The Deposit Insurance Board (DIB) was established in Tanzania for the purpose of providing policies for, and managing deposit insurance. The DIB, commenced operation in January, 1994. The primary objective of the Board was to protect small savers in the event of bank failure. The DIB collects premiums from members, which should not be less than one-tenth of one percent of the average twelve months of total deposit liabilities prior to the date of the notice served by the DIB for premium collection. The Board also had the duty to provide financial assistance to ailing banks, partake in liquidation and pay-out exercises.

The establishment of the DIS in Zimbabwe came at a time when the macroeconomic environment was showing signs of distress in 2003. Hitherto, a bank had failed and some were placed under curatorship. However, the experience from that failure informed the decision to put in place a system to protect depositors. The DIS in Zimbabwe was being implemented by the Deposit Protection Board (DPB) with the objectives of orderly compensating small savers in the event of a financial institution becoming insolvent and the prevention of contagion or the risk of rumor-driven bank runs. The DIS was run as a pay-box system but with powers to resolve failing or failed banks through structured early resolution.

A well designed DIS is a valuable addition to the financial safety-net. For the African countries wishing to establish a deposit insurance scheme, they could learn from the experiences of these countries. It is therefore my strong believe that a meeting of this nature can provide such an avenue.

The relevance as well as the growing importance of explicit deposit insurance worldwide has led to formation of the International Association of Deposit

Insurers (IADI) with the vision of **sharing deposit insurance expertise with the world**. The IADI was formed in May 2002 in Basle, Switzerland with the objective of contributing to the stability of financial system by promoting international cooperation and interaction amongst deposit insurers and other interested parties. The Association has 25 Founding Members of which two (Kenya and Nigeria) are from Africa. The Managing Director/CEO of the NDIC is a member of the Executive Council and Chairman of the Africa Regional Committee of the Association.

As part of its activities for 2004 and in order to encourage the introduction of explicit deposit insurance scheme (DIS) as well as strengthen the existing DISs in the African continent, the Africa Regional Committee of the IADI organized its first international conference on deposit insurance between 21<sup>st</sup> and 23<sup>rd</sup> of June, 2004 in Abuja, Nigeria. The conference was organised in line with that objective and particularly to share experiences and discuss issues that affect the region with respect to deposit insurance practices. For IADI, institutions can be Members, Associates, Observers or Partners. For interested countries, IADI stands ready to provide invaluable technical assistance. All of you participants are urged to sensitize your institutions to join IADI in one of the categories enumerated above.

#### **8.4 Conclusion**

Distinguished Banking Supervisors, the financial environment in recent times has rapidly changed and liberalisation, internationalisation and increasing competition have become the norm in most African economies. From all indications, the erstwhile restrictions in the operations of financial institutions have gradually been lifted with the result that the risks inherent in the financial sector have substantially increased. The implication of this

is that there is an urgent need for more African nations to adopt deposit insurance systems not only to protect depositors but also to protect their respective payment systems and economies.

In this discussion, we have presented details, with justifications, of essential components of a deposit insurance scheme. Although deposit insurance was first established in Africa barely twenty years ago, its relevance to the African continent is not in doubt. The safety-net of the DIS adequately complements those of the central bank in ensuring a safe and sound financial system. By protecting depositors, particularly the small ones who are usually ignorant of financial matters, deposit insurance encourages banking habit. This is particularly important in a continent where the informal financial sector looms quite large with a large proportion of currency in circulation outside the formal banking system. By every reason, deposit insurance is very relevant to the continent. It is a necessary accompaniment of a safe and sound financial system that is capable of enhancing development in Africa both socially and economically.

# Chapter 9

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## THE ROLE OF DEPOSIT INSURANCE IN THE STABILITY OF FINANCIAL SYSTEM<sup>1</sup>

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### 9.0 *Introduction*

The recent global financial crisis brought to the fore the vital role of deposit insurance schemes (DIS) in promoting financial system stability. Government in various countries particularly in America, Europe and Asia were obliged to either increase deposit insurance coverage or declare temporary blanket guarantees to bank depositors in order to restore or sustain public confidence in their financial systems. Of course, deposit insurance is an important component of the financial safety-net put in place by government as a means of intervening in the financial system. The other components are the lender-of-last-resort function of a central bank; and effective prudential regulation and supervision of market participants. It is therefore, imperative that inter-relationships amongst the three components should be mutually reinforcing.

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<sup>1</sup> Version of the paper presented at the IADI Africa Regional Committee's Conference on "The Role of Deposit Insurance in the Stability of Financial System" held at the Sarova Whitesands Beach Resort & SPA in Mombasa City, Kenya, July 2009.

Deposit insurance may be justified on two separate grounds, namely: the protection of depositors and the prevention of bank runs thereby contributing to financial system stability. The former may be viewed as an aspect of consumer protection and is linked to the presumed inability of ordinary depositors to monitor the riskiness of banks in which they place their funds as well as the potentially severe cost of deposit losses to individual savers. However, given the political sensitivity of losses arising from bank failures, formal deposit insurance may also be used to limit the payout to depositors in a situation where there would otherwise be demands for full compensation.

The financial stability rationale for deposit insurance has gained more appreciation since the on-set of the recent global financial crisis than hitherto. Particularly in the event of threat of or actual occurrence of financial crisis, greater focus is placed on the macro objective of financial system stability. In fact, with globalization, advances in information and communication technology as well as inter-connectivity of financial systems, it is imperative that the DIS can no longer restrict its focus to protection of small savers. It must of necessity seek to contribute to financial stability at all times. The issue of concern in this chapter is: How can DIS play a value-adding role to the stability of financial system? The adequacy or otherwise of the design features of a DIS would be critical to its ability to contribute to financial system stability. In that regard, some key elements of the design features of a DIS will be highlighted in this chapter. They will include Mandates and Powers; Funding; Coverage; Oversight, Intervention Powers and Failure Resolution. In view of the fact that a DIS agency must of necessity interact with other safety-net players (SNP), inter-relationship mechanism and inherent agency conflicts are also commented upon. Also, the need for effective public awareness and financial literacy are highlighted.

## ***9.1 Major Design Features of DIS***

### *9.1.1 DIS Mandate and Powers*

DIS mandate falls into two major categories, namely: narrow mandate; and broad mandate. A good example of a DIS with narrow mandate is a 'Pay Box' DIS which only has powers to reimburse depositors after bank failure like the DIS in Kenya and Tanzania. A typical example of a DIS with broad mandate is a Risk (or cost) minimizer DIS which has powers ranging from monitoring insured institutions to intervention and resolution or liquidation like the DIS in Nigeria and U.S.A. Broad mandate enhances ability to contribute to financial stability while the pay-box is ill-equipped to contribute to financial system stability. A DIS with broad mandate is typically conferred with operational independence by its enabling legislation. The recent global financial crisis has revealed that only deposit insurers with sufficiently wide mandates, appropriate powers and operational independence have been found to be more effective in building and maintaining public confidence as well as dealing with financial crisis.

It is not surprising that deposit insurance is regarded as the weakest link within the safety-net framework. Today, many deposit insurers are still limited to being pay-box agents. When a bank fails, their only responsibility is to reimburse depositors. They therefore, cannot contribute effectively to the stability of the financial system. In order to forestall such a situation, deposit insurer should have a risk (cost) minimizer mandate with prompt and extensive resolution powers to contribute to the stability of the financial sector. As a chain is only as strong as its weakest link, strengthening the safety net framework would require strengthening deposit insurance arrangements.

### *9.1.2 Funding*

Adequate funding is crucial to the effective implementation of a Deposit Insurance System (DIS) regardless of the type of mandate. DIS must have access to adequate sources of funding to meet its obligations when they fall due, for it to be effective. Funding for a DIS influences, to a large extent: the credibility of the scheme and the confidence it elicits from its participants and the banking public at large; its stabilizing capacity; the way the cost of providing insurance is finally allocated among depository institutions, users of financial services and taxpayers; and the balance of risks among the financial institutions themselves as well as the insurer's exposure vis-à-vis different insured depository institutions.

DIS funding is either ex-ante or ex-post. An ex-ante funding typically comprises initial capital subscription and premium contribution by member institutions. This funding approach ensures availability of funds to meet a deposit insurer's obligations. Premium contribution by insured institutions can be achieved by operating either a flat rate premium assessment regime or a differential premium assessment approach. For deposit insurers to supplement and complement bank supervisors in promoting sound risk management in banks, deposit insurers have an extremely powerful tool in the form of a differential premium assessment system (DPAS) that requires riskier banks to pay higher premiums. Supervisors can leverage on and complement their powers with the DPAS to influence change in banks' corporate behaviour, such as improving risk behaviour by member institutions.

Ex-post funding does not guarantee adequacy of funding. Also, a failed institution does not contribute to cost of failure resolution. It is less efficient compared to ex-ante funding. Furthermore, a stand-by guarantee or



borrowing window from the government or a Central Bank to meet resolution cost would enhance DIS ability to contribute to financial stability.

### *9.1.2 Coverage*

Coverage is a fundamental issue in designing a deposit insurance system. Coverage has two dimensions, namely: scope and level. While the scope deals with institutions and instruments that are covered, the level relates to the amount over which cover is extended. Determining the appropriate coverage scope and level is crucial because it determines the potential liabilities under the DIS and also influences the extent to which depositors' confidence can be promoted and sustained in the financial services industry.

Limited coverage is consistent with best practice except in times of crisis. A deposit insurance agency should have the discretion to increase both the coverage scope and level without resort to legislative approval. In that regard, flexibility to access or to call upon a wide and different range of stabilization tools is very important as it would enable deposit insurers to react quickly to meet the challenges presented by fast changing circumstances. Those tools would include the authority to increase coverage limit up to a temporary blanket guarantee, broadening the range of deposit products insured and extending coverage to institutions not previously covered by deposit insurance.

As a precautionary measure to minimize external contagion risks from building up in their own financial systems many countries either increased their coverage levels and expanded their coverage scope or even implemented blanket guarantees as a response to the recent global financial crisis. These pre-emptive confidence sustaining measures highlight the need for even more pre-emptive measures that should be taken especially

when there are emerging signs of problem. An obvious deficiency noted in this regard was that many deposit insurers could not raise the level of deposit insurance coverage and limit without going through the legislative processes which have been observed to be very cumbersome. That resulted in unnecessary delays and the potential for impairing the effectiveness of DIS's role in promoting financial system stability. In Nigeria, the enabling law permits NDIC to review the coverage level upwards without recourse to legislative approval.

On coverage scope, A DIS should be accorded the power to broaden the range of insured deposit products and/or extend coverage to more institutions. In Nigeria, coverage was extended to micro-finance banks and primary mortgage institutions in 2008. The framework for extending DIS coverage to non-interest bearing deposit products is currently being developed.

### *9.1.3 Oversight of Insured Institutions*

A DIS should have the authority to monitor its risk exposure to insured institutions in terms of access to information and independent risk assessment. In that regard, deposit insurers should be empowered to undertake separate and independent risk assessments of their member institutions which are currently being conducted by a few deposit insurers. Such assessments would supplement and not replace the supervisors' assessment. The increasing complexity, diversity, bank size and global nature of banking business warrant oversight from supervisor as well as the deposit insurer and the findings of both agencies would be shared from a four-eye perspective. In most cases, reliance on supervisors' assessment is a weak proxy for determining DIS exposure. Deposit insurers must know the risks inherent in providing deposit insurance so they can mitigate such risks,

ensure that premiums are accurately assessed and appropriate actions are taken when institutions deserve them. Access to reliable information on the risk profile of insured institutions enhances DIS ability to contribute to financial system stability.

#### *9.1.4 Intervention Power/Failure Resolution*

A DIS agency should be accorded adequate intervention and resolution powers by its enabling law to enable it contribute to financial system stability. In that regard, a deposit insurer should have the power to effect prompt corrective action (PCA) on insured institutions. The PCA should be based on clearly defined trigger mechanisms. For purposes of engendering financial stability, intervention power should also include a menu of options comprising open bank assistance, restructuring, assisted mergers and even nationalization, when required. Other options include Purchase and assumption (P & A) transactions, Bridge bank, asset purchase, receivership and liquidation. For effect, a DIS agency should be empowered to litigate against managers and directors who caused failure of insured institutions.

## **9.2 *Inter-Relationship/Agency Conflict***

Given that most DIS agencies are neither regulators nor supervisors, they encounter daunting challenges in their relationships with the Central Banks and Supervisors. The challenges range from access to information to delayed intervention or even non-intervention by other safety-net players. Yet it has been observed that financial crises often involve problems of coordination amongst relevant agencies. However, because of turf issues, forging the required cooperation and collaboration has been observed not to be easy in many jurisdictions, even in good times. Given that multiple but independent agencies perform safety-net functions in many countries,

it is imperative that a formal mechanism to manage relationship and minimize conflict is established. Such a mechanism would provide clarity of roles, set accountability, and sharing of relevant and timely information. That would promote clear understanding of each other's role and set out how actions amongst different operational and decision making functions could be coordinated. The absence of such a mechanism would nurture vague responsibility which is a perfect recipe for trading of accusations and buck-passing, resulting in increasing financial instability. In Nigeria, the Central Bank Act provided the legal basis for the establishment of the Financial Services Regulation Coordinating Committee (FSRCC).

### ***9.3 Public Awareness/Financial Literacy***

#### ***9.3.1 Public Awareness***

Having an effective deposit insurance system in place and implementing credible public awareness programmes about it is critical to maintaining depositors' confidence. It has been observed that an effective public awareness programmes serves as an anti-dote to bank runs, build capacity of depositors to make informed choices and allay fears during a bank failure or a wave of failures. Members of the public should be well informed of the design features, benefits and limitations of DIS. The rationale for limited coverage should be clearly communicated. Where temporary blanket guarantee has been introduced, the process for transitioning to limited coverage requires effective advocacy. Furthermore, members of the public should be made to appreciate that DIS cannot prevent bank failure neither does it cover all deposits/depositors nor is it capable of handling systemic crisis all by itself.

### 9.3.2 *Financial Literacy*

A DIS agency should actively promote financial literacy because increased financial literacy could enhance market discipline. Financial literacy amongst individuals results in a stronger, safer banking system as financially literate individuals are more likely to engage in sound financial planning and decision. Such knowledge can help to minimize the occurrence of uninformed decisions and underpin market discipline and financial stability. Ability to appreciate the trade-offs between risk and rewards, made possible only through heightened financial literacy, could contribute to financial system stability.

## 9.4 *Conclusion*

This chapter has clearly indicated that the ability of DIS to contribute to financial system stability is no longer in doubt. That ability however, depends on the DIS design features such as mandate and powers, funding, coverage, oversight, intervention and resolution. A broad mandate (essentially risk/cost minimization), supported with operational independence, enhances DIS ability to contribute effectively to financial system stability. Similarly, adequate funding and flexibility to access or to call upon a wide range of stabilization tools such as authority to increase level of coverage and expand its scope would enable deposit insurers to react quickly to rapidly changing circumstances which are capable of threatening the stability of the financial system. In the same vein, adequate legal powers to effect PCA, intervene in troubled banks as well as effective resolution powers will enhance DIS contribution to financial system stability. In addition to the design feature, a clearly defined framework for managing relationship amongst safety-net players would help minimize agency conflict

as well as promote financial system stability. Finally, effective public awareness campaign and promotion of financial literacy would enhance appreciation of DIS benefits and limitations as well as promote rational consumer behaviour thereby enhancing financial system stability.

# Chapter 10

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## **THE ROLE OF DEPOSIT INSURANCE IN PROMOTING FINANCIAL SYSTEM STABILITY IN NIGERIA**

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### *10.0 Introduction*

Prior to the establishment of the Nigeria Deposit Insurance Corporation, there were only two major formalized government-provided safety nets for the Nigerian banking industry. These were the lender of last resort facility by the Central Bank (through the provision of temporary liquidity support to solvent depository institutions) and bank supervision. The government provided implicit guarantee to depositors and, by extension, other stakeholders by bailing out troubled banks. Thus, there was no explicit deposit insurance scheme. The government used its discretionary powers to prop up some failing deposit-taking financial institutions which were mainly state-owned banks.

Under implicit insurance, the government provided protection to depositors, creditors and shareholders alike – a form of blanket insurance. There was also no formal arrangement regarding how the implicit protection could be funded. Funding was largely provided through government budget. Thus,

the scheme was a contingent liability on the Federal Government budget and was characterised by uncertainties about the level and scope of coverage. The implicit scheme could not therefore provide the required public confidence. Other problems associated with the implicit scheme included slow response to crisis due to debate on required budgetary provision and government's sole burden to resolve banking distress.

In 1986, The Nigerian Government commenced the implementation of a Structural Adjustment Programme (SAP) which entailed liberalization and deregulation of the Nigerian economy. As a result, the number of banks increased phenomenally from 48 in 1988 to 120 in 1990. The development triggered keen competition as well as increase in the risks to which banks and consequently depositors were exposed. An explicit deposit insurance system (DIS) was therefore considered necessary to protect the depositors, particularly the small ones, from the adverse consequences of risks being taken by banks in the process of competition. The phenomenal growth in the number of banks over-taxed the available managerial capacity in the banking system.

The fore-going necessitated the introduction of an explicit DIS in Nigeria through the enactment of Act 22 of 1988, which established the Nigeria Deposit Insurance Corporation (NDIC), the Agency vested with the responsibility of implementing the system in the country. The NDIC commenced operations in March 1989. The scheme was introduced to provide a further layer of protection to depositors and complement the Central Bank of Nigeria's (CBN's) supervisory activities in ensuring a safe and sound banking system. The DIS in Nigeria like most other explicit schemes, has specified maximum insured sum, a clearly defined ex-ante funding arrangement, and a specified administrative structure. Participation



in the scheme is compulsory for all licensed deposit-taking financial institutions while the implementing agency is owned by government. The implementing agency, NDIC also has responsibilities for monitoring the health of insured institutions as well as the risk exposure of the Deposit Insurance Fund (DIF) and providing an orderly failure resolution mechanism, as clearly enunciated in the Corporation's enabling law. In effect, the DIS in Nigeria was designed as a risk minimizer.

To fully appreciate the role of the DIS in ensuring the financial system stability in Nigeria, the next section (Section 2) of this paper takes an overview of the regulatory framework and information-sharing arrangement in Nigeria while Section 3 discusses the functions of the NDIC and the design features of the DIS in Nigeria. In Section 4, we highlight the main contribution of the NDIC to financial system stability in Nigeria. Section 5 summarises and concludes the paper.

### ***10.1 Regulatory Framework In Nigeria***

The critical areas of regulation can be broadly grouped into three, namely: entry, risk evaluation and containment; and failure resolution. In essence, regulatory activities in Nigeria span from cradle of a financial institution to its grave.

The main activity in entry is licensing. Regulators should have ability to screen access to ownership and management so as to ensure that only individuals with requisite qualifications, professional competence, experience, financial capacity, and sound ethical standards are allowed to obtain a banking licence. In most emerging markets, this responsibility of licensing is either that of the central bank, or a separate regulatory body or

Ministry of Finance for banks and other deposit-taking financial institutions and other regulatory authorities in the capital and insurance markets.

In the case of Nigeria, the Central Bank of Nigeria (CBN) is the apex regulatory authority for the banking industry as enshrined in the Banks and Other Financial Institutions Act (BOFIA) 1991. Under the Act, the CBN has the powers to license banks and other deposit-taking financial institutions and supervise licensed institutions. While under BOFIA, the CBN had licensing power, it was required to obtain the approval of Mr. President to de-license a banking institution. That requirement subjected revocation of banking licence or de-licensing to approval of the political authority. Consequently, between 1988 and 1998, NDIC was confronted with the agency problem associated with delays in granting approvals for the revocation of the licences of terminally distressed banking institutions. Indeed, a scenario of “free entry, no exit” prevailed over the period as illiquid and insolvent banks remained open. The requirement of Mr. President’s approval for de-licensing was however removed in 1998 through an amendment to BOFIA, thus giving the CBN full failure resolution powers. Furthermore, up to 1998, the CBN had the power to appoint NDIC as provisional liquidator of failed banks and such appointment was deemed to have been made by the Federal High Court (FHC). That arrangement ensured effective exit mechanism. Unfortunately, CBN lost that power when BOFIA was amended in 1998 and NDIC was required to apply to the FHC to be appointed as liquidator. The new dispensation created opportunities for legal challenges and protracted litigations.

Banking supervision in Nigeria is the joint responsibility of the CBN and NDIC. The responsibility is carried out through on-site examination and off-site surveillance. In order to avoid duplication of efforts and/or role-

conflict, the two institutions engage in consultations. In particular, the two institutions meet at the beginning of every year to agree on bank examination programme. This arrangement has guaranteed that a bank is examined once a year. At the end of each examination by any of the institutions, the examination report is sent to the other institution. Banks examined by an institution in a year are allocated to the other institution in the following year to minimise over-familiarity with employees of examined institutions as well as promote peer review mechanism.

In the case of off-site surveillance, the two institutions use the same set of prudential bank returns for appraising financial condition and performance of both the industry and individual institutions. The two institutions also developed a Bank Analysis System software as a tool for off-site surveillance. This has been enhanced to electronic Financial Analysis and Surveillance System (e-FASS). Bank ratings generated individually by the two institutions are compared to harmonize the results of their off-site analysis.

The two institutions have also established joint committees on supervision both at the executive and technical levels which meet on a regular basis. This arrangement enables the two institutions to review developments in the banking industry and pro-actively address emerging supervisory challenges.

The NDIC shares the responsibility of failure resolution with the CBN. In order to delineate the roles of individual institutions in that regard, the two institutions jointly developed a Contingency Planning Framework for Banking Systemic Crisis, with thresholds for intervention indicating when and how each institution is to intervene. In order to avoid conflict of role in provision of liquidity support, the two institutions also jointly developed a

framework for liquidity support. This framework clearly demarcates when the NDIC liquidity support is needed as against the lender-of-last-resort role of the CBN. When a banking licence is revoked by the CBN, the NDIC serves as Liquidator.

Given that the licensed banks in Nigeria are universal banks engaging in money, capital and insurance markets' activities with different regulatory authorities, the need for co-operation amongst the regulatory agencies became imperative. The Financial Services Regulation Coordinating Committee (FSRCC) with the CBN Governor as Chairman was therefore, established. Other members of the committee are the Chief Executive Officers of the NDIC; the Securities and Exchange Commission, the apex regulatory body for the capital market; the National Insurance Commission, regulatory agency for Insurance business; the Corporate Affairs Commission; and a representative of the Federal Ministry of Finance. The specific objectives of the Committee are to:

- i) co-ordinate the supervision of financial institutions especially conglomerates;
- ii) minimize arbitrage opportunities usually created by differing regulations and supervision standards among supervisory authorities in the economy;
- iii) deliberate on problems experienced by any member in its relationship with any financial institution;
- iv) eliminate any information gap encountered by any regulatory agency in its relationship with any group of financial institutions;
- v) articulate the strategies for the promotion of safe, sound and efficient practices by financial intermediaries; and
- vi) deliberate on such other issues as may be specified from time to time.

In order to facilitate access to prudential information, a Memorandum of Understanding (MOU) was executed by all the members of the FSRCC. The MOU contained safeguards for confidentiality of information. The above arrangements are put in place to ensure effective supervision and promote financial system stability in Nigeria.

Furthermore, in recognition of the inherent fragility of the banking system, the CBN in July 2004, announced a bank consolidation programme through mergers and acquisition. Under the programme, each bank is required to attain a minimum shareholders' Fund of ₦ 25 billion (about US\$180 million) by 31<sup>st</sup> December, 2005. It is envisaged that with a stronger capital base, banks will be able to support economic development as well as compete effectively both domestically and off-shore. Based on the current groupings of the consolidating banks, the number of banks that will emerge from the existing 89 banks is not likely to exceed 30.

It is expected that the government or the CBN will provide the financial resources required by the impending shake-out arising from the bank consolidation programme as the DIS was not designed to address systemic crisis. As part of the institutional support for the bank consolidation programme, the CBN and NDIC are jointly proposing the establishment of an Asset Management Corporation (AMC). The AMC is designed as a vehicle for the resolution of non-performing assets of the banking system.

## **10.2**      **Functions of The NDIC and the Design Features of DIS in Nigeria**

### **10.2.1**      **Functions of the NDIC**

Section 5 of the NDIC Act stipulates the following functions for the Corporation:

- i)** insuring all deposit liabilities of licensed banks and such other financial institutions operating in Nigeria so as to engender confidence in the Nigerian banking system;
- ii)** giving assistance in the interest of depositors, in case of imminent or actual financial difficulties of banks particularly where suspension of payments is threatened; and avoiding damage to public confidence in the banking system;
- iii)** guaranteeing payments to depositors, in case of imminent or actual suspension of payments by insured banks or financial institutions up to the maximum amount specified in the Act;
- iv)** assisting monetary authorities in the formulation and implementation of banking policy so as to ensure sound banking practice and fair competition among banks in the country; and
- v)** pursuing any other measures necessary to achieve the objects of the Corporation provided such measures and actions are not repugnant to the objects of the Corporation.

### *10.2.2 Design Features of DIS in Nigeria*

The design features of DIS as being practised by the NDIC in accordance with its enabling Act, in terms of the, ownership, governance, participation, insured deposits and the level of coverage, funding, investment policy of the deposit insurance fund (DIF), and coverage are highlighted below.

### *10.2.3 Ownership*

The DIS in Nigeria is wholly owned by the Federal Government through the Central Bank of Nigeria and the Federal Ministry of Finance in the ratio of 60:40 shareholding structure, respectively. That is, it is publicly owned.

#### *10.2.4 Governance*

The governing body of the Corporation is the Board of Directors which is responsible for policy formulation and oversight of its affairs. Members of the Board are appointed by the President of the Federal Republic of Nigeria. The Corporation is under the supervisory purview of the Federal Ministry of Finance.

#### *10.2.5 Participating Institutions*

Participation in the scheme is compulsory for all licensed banks and other deposit-taking financial institutions in Nigeria. However, the Corporation has since inception extended the deposit insurance coverage to licensed universal banks only. With the recent licensing of community banks (CBs) and primary mortgage institutions (PMIs) by the CBN, the Corporation is in the process of extending deposit insurance coverage to those deposit-taking financial institutions. It has therefore established a full-fledged department to handle the insurance and supervision of other financial institutions. The Corporation has also proposed amendment to Section 8 of its Act to create separate insurance funds for each category of insured institutions.

#### *10.2.6 Insurable Deposits and The Level of Coverage*

By virtue of Section 20 of the NDIC Act, all deposits of a licensed bank or other deposit-taking financial institutions shall be insured with the exception of the following:

- a. Insider deposits, that is, deposits of staff including directors of the licensed bank or financial institution;
- b. Counter-claims from a person who maintains both deposit and loan accounts, the former serving as a collateral for the loan; or

- c. Such other deposits as may be specified from time to time by the Board.

The Corporation guarantees the payment of the insured deposits up to a maximum of ₦50,000.00 to a depositor in the event of failure of an insured financial institution. The maximum coverage, which translated to US\$10,860 in 1988 is currently worth US\$382 as a result of depreciation of the national currency (the Naira) over the years. The Corporation has submitted a proposal for upward review of the maximum insured claim from ₦50,000 per depositor per bank to ₦200,000 per depositor per bank and ₦100,000 per depositor per Community Bank or Primary Mortgage Institutions to the National Assembly (i.e Legislature) to reflect developments in the industry and the macro-economy. Coverage has to be limited to avoid moral hazard. While an unduly large coverage could encourage excessive risk-taking, a very low coverage could undermine the credibility of the scheme.

#### *10.2.7 Funding*

The discharge of the Corporation's core mandate of deposit guarantee and provision of financial/technical assistance are funded by the deposit insurance fund (DIF), which is generated from the periodic premium paid by insured institutions. Premium is presently assessed on a flat rate basis even though the ultimate goal is to shift to differential premium assessment. The operations of the Corporation are, however, financed solely from the interest earned from the investment of the DIF in government securities such as Treasury Bills (TBs). The Corporation's investment policy is guided by the need to ensure safety and liquidity. In that regard and in accordance with its enabling Act, the funds of the Corporation are invested in Federal



Government securities. It should be noted that the Corporation is self-financing as it does not receive government budgetary appropriations for its operations. Unlike in some jurisdictions, the funding is ex-ante in order to ensure the credibility of the scheme.

### ***10.3 Contribution of the NDIC To Financial System Stability In Nigeria***

The contribution of the NDIC to the stability of the financial system can be examined within the context of its activities in the discharge of its statutory mandate. The activities undertaken by the Corporation with the aim of insulating the industry from destructive runs and instability are as highlighted below:-

#### ***10.3.1 Deposit Guarantee***

This is perhaps the most significant and distinct role of the Corporation. As a deposit insurer, the Corporation guarantees payment to depositors in the event of failure of an insured bank. At the commencement of the scheme, the maximum insurance limit was set at ₦50,000.00 per depositor and that was applied to settle claims of insured depositors of all banks closed to date. That maximum limit was based on the fact that small depositors with balances up to that amount constituted over 85% of total depositors as at that time and since DISs are intended to protect small savers, that limit was considered adequate. However, based on a study conducted by the Corporation in 2004, an increase to ₦200,000.00 per depositor per bank has been recommended and reflected in the amendments to the Corporation's enabling legislation.

The Corporation had paid about ₦3.29 billion to depositors, representing 63% of total insured claims of ₦5.2 billion to the depositors of 34 closed

banks as at the end of October 2005. The owners of the remaining 37% of the insured deposits are being encouraged to come for their deposits through periodic media campaign. Statutorily, if a depositor fails to file claims within eighteen (18) months after the appointment of the Corporation as the Liquidator of the failed institution, such deposit shall fall within the uninsured category. However, due to poor depositors' response, the claim-filing period had been extended with a view to sustaining confidence in the system. These efforts have, no doubt, gone a long way in engendering depositors' confidence in the nation's banking system thereby promoting the stability of the nation's financial system.

Despite the series of efforts made by the NDIC to reach out to the public through publications, seminars, workshops, press briefings and advertisement, the general public seems inadequately aware of the benefits and limitations of the system. For instance, there had been clamour for full coverage as against the best practice of limited coverage. Furthermore, it is still common to find stakeholders confusing deposit insurance with the conventional insurance business. All these depict inadequate understanding of the workings of a DIS. Public ignorance cuts across all sections of the populace including depositors, the primary beneficiary of the scheme. For the deposit insurance to be effective, it is important that the public is well and adequately informed of its benefits and limitations.

Ensuring prompt payment of the insured deposit is necessary for maintaining credibility and confidence in the DIS. However, the provisions of the NDIC Act make it difficult for the Corporation to pay insured deposits even when they (depositors) have ceased to have access to their money. Unless a bank's licence has been revoked, it is practically impossible for the Corporation to

pay insured deposits. Even where licences have been revoked, litigations by erstwhile shareholders/directors have frustrated payment of insured deposits. For example, the law suits instituted by the shareholders/directors of Savannah Bank whose licence was revoked in 2002 is still before the Courts as at November 2005.

### *10.3.2 Ensuring Financial Stability through Banking Supervision*

Banks are supervised to protect depositors, ensure monetary stability and promote an effective and efficient payment system. Banking supervision provides the oversight required to preserve the integrity of, and promote public confidence in, the banking system.

The Corporation carries out its supervisory responsibilities through the on-site examination and the off-site surveillance of insured institutions. As indicated in Section 2, the NDIC shares the responsibility with and adequately complements the efforts of the CBN in the supervision of banks. The establishment of the NDIC in 1989 and its involvement in on-site examination have significantly shortened the examination cycle such that despite the increase in the number of banks and their branches, banks are now examined annually as against once in two to three years prior to the establishment of the Corporation.

However, the bane of this important supervisory function in Nigeria, (especially off-site surveillance), has been the perennial issue of inaccurate and unreliable prudential returns being received from the supervised institutions. Many of such returns fail to reflect the true state of affairs of the reporting institutions. There were instances of banks that were unable to meet matured obligations but still recorded high liquidity ratios. Inaccurate returns impair assessment of banks' financial condition and

hinder identification of potential problems which require prompt corrective action.

In order to enhance the effectiveness of its supervisory activities, the Corporation has been vigorously pursuing supervisory capacity building through focused-training and acquisition of relevant tools. In that regard, more staff in the On-site and Off-site supervision departments of the Corporation have been exposed to new techniques of banking supervision at both local and reputable foreign regulatory institutions such as Federal Reserve System, Federal Deposit Insurance Corporation, Office of Comptroller of the Currency, U.S.A., Toronto Leadership Centre (Canada), Financial Stability Institute (Switzerland), Financial Services Authority of UK, et cetera. In addition, through the customized training on Audit Command Language (ACL) and Computer Assisted Audit Technique (CAAT), the quality of IT Examination by the Corporation has improved considerably as acknowledged by the examined banks.

The existing tool for off-site surveillance, Bank Analysis System (BAS) which was jointly developed with the CBN, is being enhanced to electronic Financial Analysis and Surveillance System (e-FASS). Upon completion of the project, the Corporation will have access to banking information on an on-line, real-time basis and that will help to enhance access to accurate and reliable data for bank analysis.

In conjunction with the Central Bank of Nigeria (CBN), the Corporation is in the process of adopting and implementing the new Basle Capital Adequacy Measurement Framework known as Basle II Capital Accord. When it comes into effect in January 2007, the New Capital Accord will replace the existing 1988 Capital Accord or Basle I. The activities of the two institutions in preparation for the implementation of the new capital accord also include the development of the framework for risk-based supervision which has

now become imperative in view of current developments in the financial services industry at both the domestic and international levels.

All the activities stated above are expected to further enhance the effectiveness of the supervisory activities of the Corporation in promoting safe and sound banking practices and hence contributing to the stability of the financial system. Our examiners have been carrying out their duties with the sole aim of ensuring sound financial system and this has been demonstrated in their findings over the years. For instance, NDIC's Examiners' findings facilitated the removal of the Chief Executive Officers of two banks in 2004 on accounts of unsafe and unsound banking practices. Also the foreign exchange malpractices perpetrated in one of the nation's banks, which led to the removal of the Chairman, Vice Chairman and Executive Director of the bank in 2004, were first uncovered by NDIC Examiners as far back as year 2000. The Corporation maintains a policy of zero tolerance against unprofessional and unethical behaviour.

Examiners now place emphasis on risk management frameworks of banks. Focus is also on non-financial risks such as reputational and operational risks, which had not received adequate attention.

### *10.3.3 Distress Resolution*

One of the primary roles of NDIC is to ensure that failing institutions are resolved in a timely and efficient manner. This presupposes the existence of legal powers that support early intervention and prompt corrective action, the ability to close troubled banks promptly, and legal provisions for the prompt and orderly liquidation of assets and resolution of creditors' claims.

The Corporation is empowered to provide financial and technical assistance to failing or distressed banks in the interest of depositors. The financial assistance can take the form of loans, guarantee for loan taken by the bank or acceptance of accommodation bills. Similarly, the technical assistance may include take over of management and control of the bank, changes in management or assisted merger with another viable institution.

The responsibility for distress resolution is also shared with the CBN. Consequently, NDIC has over the years worked closely with CBN in resolving distress in the banking System. The Contingency Planning Framework for Banking Systemic Crises introduced in 2002 by the NDIC and CBN is expected to facilitate prompt resolution of problem banks. The framework seeks to reduce the incidence of systemic distress by improving the supervisory processes, providing transparent and objective thresholds for regulatory intervention and promoting self-regulation among banks.

It is worth noting that the Corporation was established when the banking system was already in distress. As a matter of fact, there were about seven technically insolvent state-owned banks in the system in 1988. The NDIC was nevertheless statutorily required to insure all licensed banks. It, therefore, had to grapple with the resolution of distressed banks at an early stage of its existence.

Depending on the severity and peculiarity of the situation, NDIC in collaboration with the CBN, had, over the years, successfully adopted the following measures, among others, to address bank distress:-

- i Accommodation facilities were granted to ten (10) banks which had serious liquidity crises to the tune of ×2.3 billion ( about US\$500 million) in 1989 following the withdrawal of public-sector deposits

- from commercial and merchant banks and the transfer of same to CBN during that year. The disruption to the banking system as a result of the policy-induced shock largely reflected the financial fragility of the system. The crisis occurred barely 3 months after NDIC commenced operations.
- ii Take-over of management and control of twenty-eight (28) distressed banks by CBN/NDIC to safeguard their assets. The most recent intervention was the removal of the respective Boards and Managements of three banks in 2005 and their replacement with new Boards and Managements to save the banks from reckless mismanagement and dissipation of depositors' funds.
  - iii Acquisition, restructuring and sale of seven (7) distressed banks to new investors.
  - iv Closure of 36 terminally distressed banks that failed to respond to various regulatory/supervisory initiatives. While the liquidation of Savannah Bank of Nigeria and Peak Merchant Bank were suspended due to court action, it is noteworthy that all the banks were closed with minimal disruption to the banking system. In this regard, the closure of 26 banks on 16<sup>th</sup> January 1998 was particularly significant.

The combined effect of these measures prevented deposit runs that would have created instability in the financial system.

#### *10.3.4 Bank Liquidation*

Another core function of the Corporation is bank liquidation. Section 28 (1) of the NDIC Act states that the Corporation shall be appointed as the liquidator of a failed insured institution Bank liquidation is always adopted by the Corporation and the CBN when found to be the most effective when compared with other distress resolution measures. However, it is adopted as a last resort.

Liquidation process involves orderly and efficient closure of the failed institutions with minimum disruption to the banking system, cost-effective realisation of assets and settlement of claims of uninsured depositors and creditors. Depositors are given priority over all other creditors in consonance with the primary objective of the deposit insurance system.

The Corporation's achievements in this regard include the following:

***a) Payment of Liquidation Dividend to Depositors***

In addition to the payment of insured depositors of the closed banks, depositors with credit balances in excess of the guaranteed sums were paid liquidation dividends based on the volume of proceeds of the closed banks' assets realised by the Corporation. As at 31<sup>st</sup> October, 2005, the sum of ₦5.95 billion had been paid out to the depositors of 32 of the 34 banks in liquidation. This is more than half of the ₦10.75 billion declared as liquidation dividends. Out of the 32 banks, the Corporation had declared 100% dividend (i.e full recovery) for all uninsured depositors of ten banks while recovery is as high as 93% in some other banks.

***b) Payment Of Liquidation Dividend to General Creditors***

In keeping with the priority of claims under the Companies and Allied Matters Act (CAMA), liquidation dividends had also been paid to some general creditors of some of the banks. For example, the general creditors of five banks-in-liquidation, namely: Alpha Merchant Bank Plc, Amicable Bank Ltd, Nigeria Merchant Bank Ltd, Pan African Bank Ltd and Rims Merchant Bank Ltd had received the sum of ₦659.56 million out of ₦753.31 declared in their favour as at the end of October, 2005.



***c) Payment of Liquidation Dividend to Shareholders***

After settling the claims of depositors and creditors, whatever funds that are left are appropriated to shareholders of failed banks in the form of dividends in keeping with the provisions of CAMA. Consequently, shareholders of liquidated Nigeria Merchant Bank Ltd (i.e United Bank for Africa Plc and Ministry of Finance Incorporated) were paid liquidation dividends totaling ₦620 million based on their ownership ratio of 40:60. Similarly, the sum of ₦293 million had been paid to former owners of Pan African Bank Ltd (Rivers and Bayelsa State Governments) as liquidation dividend. The Corporation has commenced payment of dividends to the shareholders of the defunct Alpha Merchant Bank Plc for whom ₦600 million had been declared.

***d) Recovery of Debts Owed Failed Banks***

In order to encourage debtors of failed banks to repay their debts, balances as at the date the banks were closed were frozen and accorded non-accrual status. All the interests accrued after liquidation were reversed while several requests for interest waivers were considered on their merit. Indeed, in 2000, post-liquidation interest amounting to ₦5.16 billion (about 14.6% of the aggregate debt portfolio of failed banks) were written off which made aggregate debt portfolio of failed banks to reduce from ₦35.37 billion to about ₦30.21 billion. The strategies adopted had assisted in the area of debt recovery. As at the end of October 2005, a total of about ₦5.47 billion had been recovered from the debtors of the closed banks. The Corporation also facilitated the repayment of ₦3.10 billion debts owed by governments and their agencies to both healthy and distressed banks in 1997. That exercise improved the liquidity of many banks.

The Corporation is still being faced with some constraints in its debt recovery efforts. Some of the constraints in debt recovery include business failures, unwillingness to honour obligations and large volumes of unsecured or fraudulently granted loans. Instead of seeking ways to settle their debts, some debtors had challenged the jurisdiction of the Federal High Courts to adjudicate in matters between them and the closed banks while the Court of Appeal gave a ruling in their favour. It is heart warming to indicate that the NDIC had successfully challenged the ruling of the Court of Appeal at the Supreme Court which affirmed that the Federal High Court has jurisdiction over debt recovery matters. It is important to stress that unless debts are expeditiously recovered, uninsured depositors and creditors cannot be paid most of their claims. This has serious consequences for public confidence in, and stability of, the nation's banking system.

*e) Disposal of Fixed/Tangible Assets*

NDIC had achieved appreciable success in the disposal of fixed/tangible assets of closed banks. Nevertheless, there are a few prime-landed properties yet to be sold. The inability to dispose of these properties is attributable to certain problems. The legal title of some of the assets are subjects of litigation while some of the assets are located in towns or communities where there is low demand for such purpose-built properties. As at October 2005, a total sum of about ₦4.52 billion had been realized from sale of fixed/tangible assets of the closed banks.

*f) The Implementation Of The Failed Banks' Act*

The Corporation, in its capacity as a liquidator, facilitated the enactment of the Failed Banks (Recovery of Debts and other Financial Malpractices in Banks) Act No. 18 of 1994, which was enacted to expedite recovery of

debts owed banks as well as subject perpetrators of financial malpractices in banks to due process of the law. The Corporation facilitated the implementation of the Act in the following areas:-

- Collating information and supporting documents on bank frauds and financial malpractices.
- Lodging criminal complaints to the police for investigation.
- Providing necessary technical and logistic support for police investigation.
- Maintaining liaison with prosecutors appointed by the Honourable Attorney-General of the Federation for the successful prosecution of criminal cases.
- Appointing solicitors to file applications before the Tribunals to recover debts owed to failed banks.
- Coordinating and monitoring of criminal and civil cases.

Following the implementation of the Act, about ₦4.3 billion was recovered.

#### *10.3.5 Challenges Facing NDIC as Liquidator*

As a Liquidator of failed banks, the Corporation is faced with a number of challenges. Prominent among these are:

##### *i. Cumbersome Procedure For Appointment As Liquidator*

A deposit insurer, while acting as a liquidator of closed banks is expected to be vested with special powers. The special powers are to expedite the liquidation process in order to maintain confidence and stability of the banking system as well as ensure cost effectiveness of the liquidation process. Up to 1998, the CBN had the power to appoint NDIC as provisional liquidator of a failed bank and such appointment was deemed as having been made by the Federal High Court. Unfortunately, the CBN lost that

power in 1998. In the same vein, NDIC was required to apply to the Federal High Court to be appointed as a liquidator. NDIC is also subject to the general companies winding-up rules, which, among others, require that winding-up petitions should be advertised before appointment. Predictably, the shareholders/directors of two banks, whose licences were revoked in 2002 and 2003, challenged NDIC's application for appointment as Liquidator. Regrettably, the cases were still pending in court as at the end of November, 2005. The law suits challenging the revocation of the banks' licences were equally pending in court. The trend if not checked, can threaten the stability of the banking system and erode confidence of the banking public. The damage that is associated with protracted litigation is incalculable.

*ii) Lack of Legal Protection for NDIC Staff and Directors*

The directors, officers and staff of the NDIC are not currently protected by law against civil liability in suits that might be brought against them in connection with decisions or actions taken in good faith on behalf of the Corporation. This has the tendency of undercutting the independence that the Corporation should have as fear of personal liability could deter its staff from taking needed actions. However, the Corporation is seeking such protection as part of the amendment to its Act pending before the National Assembly.

#### ***10.4 Conclusion***

In 1988, the Nigerian government proactively reacted to the imperatives of the wave of economic deregulation by establishing a deposit insurance system in Nigeria as another component of the financial safety-net.. The NDIC, the agency charged with the responsibility of managing the system,

has spent the last 16 years putting in place various measures designed to protect the economy from the risk of deposit runs and thus contributing to the stability of the financial system. Apart from insuring the deposit liabilities of all licensed banks, the establishment of NDIC has no doubt, generated the required stability and confidence through its activities. However, the system is still being faced with many challenges which include inability to recover liquidated banks' loans through the courts, wrong public perception of deposit insurance, cumbersome judicial process, weak corporate governance in banks which manifested in insider abuse and mismanagement, and inadequate legal powers for the NDIC for failure resolution, among others. In spite of the challenges, the prospects for a better and stronger deposit insurance scheme in Nigeria are quite bright. The prospects are hinged on the following developments, amongst others: the amendment of the NDIC Act to increase deposit insurance coverage, facilitate prompt corrective actions and ensure effective liquidation process; the bank consolidation programme of the CBN; the current efforts of the Corporation to enhance public awareness about its activities as well as the benefits of the scheme to the economy; and the commitment of the Management and staff of the Corporation in running an efficient institution that is responsive to the needs of the stakeholders in a bid to promote stability and confidence in the nation's banking system.



# Chapter 11

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## THE ROLE OF DEPOSIT INSURANCE IN PROMOTING ECONOMIC INCLUSION IN NIGERIA<sup>1</sup>

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### *11.0 Introduction*

Extant literature on economic development has recognized the need to engage all sectors (urban and rural or formal and informal) in economic activities as a strategy for achieving rapid and sustainable economic growth and development. The goal has been achieved in many countries by putting in place a well focused programme to reduce poverty through empowering the people by increasing their access to factors of production, especially credit. It is believed that by increasing their access to finance, through the provision of micro-finance, the latent capacity of the poor for entrepreneurship would be significantly enhanced thereby paving way for their increased participation in economic activities and consequently reduce poverty, increase employment and overall standard of living.

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<sup>1</sup> The original paper was presented at the 7th Annual Conference of the International Association of Deposit Insurers (IADI) hosted by the Federal Deposit Insurance Corporation (FDIC), Arlington, VA Washington DC, USA October, 2008.

Over the years, one way successive administrations in Nigeria had responded to the need for enhancing the participation of rural community in economic activities was the creation of micro credit schemes. The main aim of these schemes was to increase the productive capacity of the poor and the vulnerable basically through the provision of credit facilities thereby enhancing the pace of economic development in the country. This is based on the fact that in Nigeria, for instance, for “poor small-scale agricultural producers and enterprises have long been identified to account for a large share of the economic activity in developing countries,” Babalola (1991). It is also generally believed that financial support for this group is crucial for effective economic management and the process of economic development, Umoh and Ibanga (1997).

The most recent addition to the stream of measures aimed at enhancing economic inclusion was the micro finance policy which was launched in December 2005. The micro-finance framework provided for the establishment of micro-finance banks (MFBs) which are to serve as vehicle for providing financial services to the economically active poor in the society. In other to ensure the success of the initiative, the need for effective safety-net, including deposit insurance was considered imperative.

The purpose of this chapter is to indicate the role of deposit insurance in promoting economic inclusion in Nigeria. In order to appreciate the discussion better, the next section reviews the concept of economic inclusion.

### ***11.1 Concept of Economic Inclusion***

Economic inclusion describes the process of overcoming the barriers that prevent people from participating in the economic growth of the society to



which they belong. An inclusive society promotes economic, human and social development. The elements of economic inclusion cover a whole range of areas encompassing health, income, employment, education, community and environment.

There is growing realization that while the ‘trickle down’ effect of economic growth works, it takes too long a time. Hence there is a need to focus on “inclusive growth”. Inclusive growth is a little more than just the benefits of growth being distributed equitably; it is the participation of all sections and regions of society in the growth process and their reaping the benefits of growth. In a country like Nigeria, where a large section of the society is still deprived of the benefits of growth, inclusive growth and the resultant prosperity of the hitherto under-privileged would lead to substantial increase in demand for the goods and services produced by the expanding corporate sector, which will ultimately lead to a much faster growth of the economy.

While economic inclusion is a broader concept and needs to be addressed through various fiscal measures, one of the ways in which the financial system can support economic inclusion is through ‘Financial Inclusion’. Financial inclusion may be defined as the process of ensuring access to financial services and timely and adequate credit, where needed, by vulnerable groups at an affordable cost, (Prahlad, 2005). Both theoretical and empirical researches highlight the role of financial development in facilitating economic development (Rajan and Zingales, 2004). At the cross-country level, evidence indicates that various measures of financial development are positively related to economic growth (King and Levine, 1993 ; Levine and Zervous, 1998). Even the recent endogenous growth literature, building on ‘learning by doing’ processes, assigns a special role to finance (Aghion and Hewitt, 1998 and 2005).

While in developed countries, the formal financial sector, comprising mainly the banking system, serves most of the population, in developing countries, a large segment of the society, mainly the low-income group, has little access to financial services, either formal or semi formal. As a result, many people have to necessarily depend either on their own sources or informal sources of finance, which are generally at high cost. Most of the population in developed countries (99 per cent in Denmark, 96 per cent in Germany, 91 per cent in the USA and 96 per cent in France) have bank accounts (Peachy and Roe, 2004). However, formal financial sectors in most developing countries serve relatively a small segment, often no more than 20-30 per cent of the population, the vast majority of whom are low income households in rural areas (ADB,2007).

### ***11.2 Linkages Between Economic Inclusion, Financial Stability and Deposit Insurance***

Financial intermediation through formal and well regulated financial institutions is required to efficiently intermediate between savings and investment. Apart from providing an intermediation role between savings and investments, financial inclusion is important for ensuring economic inclusion. Currently the financially excluded people tend to avail themselves of savings services provided by mutual benefit groups and in some cases by cooperative societies or by some get-rich-quick operators who lure the savings from such excluded groups. Loan services are similarly provided by indigenous moneylenders or other informal lenders, who might be charging outrageously high interest rates or adopt harsh recovery practices. Nevertheless such groups do depend heavily on informal sources as they are readily willing to give loans without collateral at any time and also possess intimate knowledge about the repayment record.

By ensuring access to formal financial system, the un-banked and under-banked households can build savings and promote asset accumulation, which ultimately would contribute to financial stability, all things being equal. Thus, financial inclusion promotes financial stability by facilitating inclusive growth. However, with more and more hitherto excluded households coming within the fold of banking, the relevance of deposit insurance gets more pronounced in as much as such households need to be assured that their hard earned savings, kept as deposits with banks, are protected. Without such assurance, financial / economics inclusion may not be sustained. Thus, financial/economic inclusion, financial stability and deposit insurance are inter- related and mutually supportive.

### ***11.3 Economic Inclusion Through Microfinance Policy Framework In Nigeria***

The Nigeria economy is characterized by a large informal sector. Only about 35% of economically active population has access to financial services while about 65% rely on the informal sector. In fact, less than 2% of rural households have access to formal financial/banking services. The aggregate micro-credit facilities account for about 0.2% of the Gross Domestic Product (GDP) and less than 1% of total credit to the economy.

In response to the foregoing, successive administrations in Nigeria had intervened through supply-led subsidized credit strategy. Notable among such programmes were the Rural Banking Programme, sectoral allocation of credits, concessionary interest rate, and the Agricultural Credit Guarantee Scheme (ACGS). Other institutional arrangements were the establishment of the Nigerian Agricultural and Cooperative Bank Limited (NACB), the

National Directorate of Employment (NDE), the Nigerian Agricultural Insurance Corporation (NAIC), the People Bank of Nigeria (PBN), the Community Banks (CBs), and the Family Economic Advancement Programme (FEAP). In year 2000, Government merged the NACB with the PBN and FEAP to form the Nigerian Agricultural Co-operative and Rural Development Bank Limited (NACRDB), to enhance the provision of finance to the agricultural sector. It also created the National Poverty Eradication Programme (NAPEP) with the mandate of providing financial services to alleviate poverty. Most of the intervention agencies had no sustainable sources of funding, hence, virtually all the initiatives could not be sustained.

The ineffectiveness of the government economic inclusion strategies obviously left a huge gap which the non-governmental organizations (NGOs) sought to fill. For instance, since the 1980s, NGOs have emerged in Nigeria to champion the cause of the micro and rural entrepreneurs, with a shift from the supply-led approach to demand-driven strategy. Most of the NGOs are charity, capital lending and credit-only membership based institutions. They are generally registered under the Trusteeship act as the sole package or part of their charity and social programmes of poverty alleviation. The NGOs obtain their funds from grants, fees, interest on loans and contributions from their members. However, they have limited outreach due, largely, to unsustainable sources of funds. To a large extent, the NGOs' initiatives through demand-driven strategy had generated little impact on economic inclusion just like the government supply-led credit strategies.

The observed ineffectiveness of both supply-led and demand-driven credit strategies in broadening economic inclusion on the one hand, and the existence of huge unserved and savings opportunities in the country, on the other hand, largely informed the introduction of the micro-finance policy

in 2005. The policy was introduced to complement the banking sector reforms introduced in 2004 with a view to enhancing economic/financial inclusion in the country.

According to the micro-finance policy framework, MFBs were promoted to provide financial services to the economically active poor in the society. The policy was targeted at creating an environment of financial inclusion to boost capacity of micro, small and medium enterprises (MSMEs) to contribute to economic growth and development through job creation that would lead to improved standard of living and poverty reduction.

The specific objectives of microfinance policy are as follows:

- Make financial services accessible to a large segment of the potentially productive Nigerian population which otherwise would have little or no access to financial services;
- Promote synergy and mainstreaming of the informal sub-sector into the national financial system;
- Enhance service delivery by microfinance institutions to micro, small and medium entrepreneurs;
- Contribute to rural transformation; and
- Promote linkage programmes between Universal/Development banks, specialized institutions and microfinance banks.

The Microfinance Policy permits the establishment of two categories of MFBs, namely:

- MFB operating as a unit bank with a minimum capital requirement of ×20 million; and
- MFB operating in a State with a minimum capital requirement of ×1.0 billion.

The policy framework also specifies the objectives of the creation of microfinance banks as:

- a. Providing diversified, affordable and dependable financial services to the active poor, in a timely and competitive manner, that would enable them to undertake and develop long-term, sustainable entrepreneurial activities;
- b. Mobilizing savings for intermediation;
- c. Creating employment opportunities and increase the productivity of the active poor in the country, thereby increasing their individual household income and uplifting their standard of living;
- d. Enhancing organized, systematic and focused participation of the poor in the socio-economic development and resource allocation process;
- e. Providing veritable avenues for the administration of the micro credit programmes of government and high net worth individuals on a non-recourse basis. In particular, this policy ensures that state governments shall dedicate an amount of not less than 1% of their annual budgets for the on-lending activities of microfinance banks in favour of their residents; and
- f. Rendering payment services, such as salaries, gratuities, and pensions for various tiers of government.

Community Banks (CBs) hitherto in existence were allowed to convert to MFBs provided they met the licensing requirements. Of the 1,259 CBs in operation as at December 31, 2007, the total number that met the minimum capital requirement of  $\times 20$  million Shareholders' Funds, unimpaired by losses, and converted to MFBs were 607 as at the end of 2008. An analysis of the CBs that converted to MFBs showed that 308 CBs had completed the process and obtained final licence, while 299 were still carrying provisional approval as at December 31, 2008. Delays in registering increases in capital,

change of name and registration of new directors at the Corporate Affairs Commission (CAC), due to non-payment of penal charges for non-submission of statutory returns by the institutions (despite the concessions granted by the CAC), were largely responsible for the slow conversion of their provisional approvals to final licence during the year.

In addition to the 607 CBs converted to MFBs, a total of 138 new micro-finance banking licences were granted, while 95 approvals-in-principle (AIPs) had been granted as at December 31, 2008. With that development, the total number of approved MFBs as at the end of year 2008 were 840. Presented in Table 11.1 is the distribution of the 840 MFBs on a state-by-state basis, including the Federal Capital Territory, Abuja.

**Table 11.1**  
**Distribution of the MFBs on State Basis As At December 2008**

State	CBs Converted to MFBs			New Investors			TOTAL
	<i>Final Licence</i>	<i>Provisional Approval</i>	<i>Sub Total</i>	<i>Final Licence</i>	<i>AIP</i>	<i>Sub Total</i>	
Abuja FCT	7	1	8	14	9	23	31
Abia	7	10	17	1	6	7	24
Adamawa	3	4	7	1	0	1	8
Akwa Ibom	4	3	7	3	2	5	12
Anambra	59	16	75	3	1	4	79
Bauchi	2	7	9	1	2	3	12
Batelsa	1	0	1	2	0	2	3
Benue	6	1	7	2	0	2	9
Borno	-	3	3	1		1	4
Cross River	10	5	15	0		0	15
Delta	10	15	25	3	1	4	29
Ebonyi	1	4	5	1	0	1	6
Edo	11	12	23	2	0	2	25
Ekiti	5	8	13	-	-	0	13
Enugu	14	6	20	1	1	2	22
Gombe	2	1	3		1	1	4
Imo	13	26	39	3	1	4	43
Jigawa	1	3	4		2	2	6
Kaduna	4	14	18	2	3	5	23
Kano	-	5	5	1	0	1	6
Katsina	2	2	4	1	0	1	5
Kebbi	1	5	6			0	6
Kogi	9	12	21			0	21
Kwara	9	9	18	2	2	4	22
Lagos	30	30	60	79	50	129	189
Nasarawa	2	1	3		1	1	4
Niger	7	2	9	1		1	10
Ogun	29	21	50	2	2	4	54
Ondo	4	12	16	0	1	1	17
Osun	19	9	28	3	1	4	32
Oyo	19	24	43	3	2	5	48
Plateau	4	7	11		1	1	12
Rivers	10	8	18	6	6	12	30
Sokoto	2	3	5			0	5
Taraba	-	4	4			0	4
Yobe	-	1	1			0	1
Zamfara	1	5	6			0	6
<b>Total</b>	<b>308</b>	<b>299</b>	<b>607</b>	<b>138</b>	<b>95</b>	<b>233</b>	<b>840</b>

Sources: Committee on the Implementation of the National Microfinance Policy



As evidenced in the above table, the highest concentrations of MFBs, as at December 2008, were in the urban and semi-urban areas of the country. The analysis shows that the MFBs were concentrated in Lagos (189), Anambra (79), Ogun (54), Oyo (48) and Imo (43) States. The five states accounted for 413 or 49.17 per cent of the total number of approved MFBs. The remaining 31 states and Abuja, FCT accounted for 427 or 50.83 per cent of the total number of approved MFBs as at the end of 2008. In terms of the spread across geo-political zones, the Northern states had few MFBs with Yobe state having only one MFB in 2008. Similarly, about 42% or 353 MFBs were located in the South West geopolitical zone followed by South East with 20.7% or 174 MFBs. North East Zone had the least with 3.9% or 33 MFBs in 2008.

Nine (9) out of the 840 MFBs as at the end of 2008, were licensed as state-wide MFBs. The list of the state-wide MFBs is presented in Table 11.2.

**Table 11.2**  
**List of State-wide Microfinance Bank in 2008**

S/NO	Name	Status	Dominant State of Operation	Branch Expansion to Other States
1	NPF Microfinance Bank Ltd.	Converted CB	Lagos	Abuja, Rivers
2	Integrated Microfinance Bank Ltd.	New MFB	Lagos	Ogun, Oyo
3	UBA Microfinance Bank Ltd.	Subsidiary of a DMB*	Lagos	None yet
4	FBN Microfinance Bank Ltd	Subsidiary of a DMB*	Lagos	None yet
5	Blue Intercontinental Microfinance Bank Ltd	Subsidiary of a DMB*	Lagos	None yet
6	AB Microfinance Bank Ltd	New MFB Foreign Ownership	Lagos	None yet
7	Afribank Microfinance Bank Ltd	Subsidiary of a DMB; AIP granted	Lagos	None yet
8	LAPO Microfinance Bank Ltd	Transforming NGO-MFI AIP granted	Edo	18 Others
9	COWAN Microfinance Bank Ltd	Transforming NGO-MFI AIP granted	Ondo	16 Others

Sources: *Committee on the Implementation of the National Microfinance Policy*

\* DMB is deposit money bank

Table 11.3 shows ten (10) universal banks with interest in MFBs. As shown in the table, three (3) of the universal banks had established microfinance units at their Head Offices, whilst the remaining seven (7) had ownership interest in various proportions in MFBs.

**Table 11.3**  
**Universal Banks With Mfbs As Subsidiaries/Windows As At December 31, 2008**

S/N	Universal Bank	Subsidiary/Window	Ownership	Status
1.	UBA Plc	UBA MFB Ltd	UBA – 100% (Wholly Owned)	Final Licence approved
2.	First Bank of Nigeria Plc	FBN MFB Ltd	FBN – 100% (Wholly Owned)	Final Licence approved
3.	Intercontinental Bank Plc	Blue Intercontinental MFB Ltf	Intercontinental Bank – 35%	Final Licence approved
4.	Ecobank Plc	ACCION Ltd	Ecobank – 18.47%	Final Licence approved
5.	Zenith Plc	ACCION Ltd	NIB – 10.00%	Final Licence approved
6.	NIB (Citibank)	ACCION Ltd	NIB – 19.90%	Final Licence approved
7.	Afribank Nigeria Plc	Afribank MFB	Afribank – 100% (Wholly owned)	Underprocessing
8.	Oceanic Bank Plc	Microfinance Unit/ Dept	N/A	N/A
9.	Diamond Bank Plc	Microfinance Unit/ Dept	N/A	N/A
10.	Union Bank of Nigeria Plc	Microfinance Unit/ Dept	N/A	N/A

Sources: *Committee on the Implementation of the National Microfinance Policy*

In order to ensure easy entrance into the market place by microfinance banks, some regulatory incentives were provided either directly by government or through the relevant regulatory authorities. Some of these measures included, but not limited to the, following:

- a. Tax exemption:
  - Value added tax (VAT)
  - Non – taxable interest income
- b. Central Bank liquidity support through a Rediscount and Refinancing Facility (RRF);

- c. Creation of ₦50 billion Micro-credit Fund in February 2008 mainly funded by the universal banks; and
- d. The requirement on the part of State Governments to allocate not less than 1% of their annual budgets for micro-finance activities.

#### ***11.4 Role of Deposit Insurance In Financial Inclusion- The Nigeria Experience***

One of the important pre-requisites for building confidence of the depositors, even among the under-privileged, in the formal banking system, is deposit insurance. In that regard, the Nigeria Deposit Insurance Corporation (NDIC) becomes the tool through which such service can be rendered. Fortunately, the NDIC was established to perform functions such as the following, among others:

- i. insuring all deposit liabilities of all licensed banks and such other deposit – taking financial institutions, such as micro-finance banks, operating in Nigeria, so as to engender confidence in the Nigerian banking system;
- ii. giving assistance in the interest of depositors, in case of imminent or actual financial difficulties of banks particularly where suspension of payments is threatened; and
- iii. guaranteeing payments to depositors, in case of imminent or actual suspension of payments by insured banks or financial institutions up to the maximum deposit insurance coverage.

It was based on that statutory requirement that the NDIC extended deposit insurance cover to MFBs in 2008. Even before the extension of formal deposit insurance to MFBs in 2008, the Corporation had participated actively in the supervision of the erstwhile Community Banks (CBs), many of which

transformed to MFBs in order to ensure safe and sound management practices in those institutions and boost depositors' confidence most of whom belonged to the under-privileged members of the society.

The extension of deposit insurance services to MFBs by the NDIC involves the following:

#### *11.4.1 Membership*

By the provision of the NDIC Act of 2006, membership of the MFBs in deposit insurance is mandatory/compulsory. This is in line with the dictate of best practice in deposit insurance so as to avoid the problem of adverse selection. That requirement also helps in engendering public confidence in the MFBs.

#### *11.4.2 Coverage*

All deposit products of the MFBs are insured up to a maximum of ×100,000 per depositor per insured institution. With that level of coverage over 95% of depositors in MFBs are fully covered.

#### *11.4.3 Funding*

The NDIC established a separate Deposit Insurance Fund (DIF) known as Special Insured Institutions Fund (SIIF). The fund is generated through the annual premium contribution by the insured institutions. In order to give some kind of incentives for the MFBs, their premium rate was reduced to 50 basis points instead of the maximum of 80 basis points payable by an insured universal bank. All deposit products of the MFBs are insured up to a maximum of ×100,000 per depositor per insured institution. In order to ensure a rapid build-up of the SIIF, the sum of ×5 billion was made available to it from the NDIC's 2007 operating surplus.

#### *11.4.4 Supervision*

A separate department known as Special Insured Institutions Department was created for off-site surveillance and on-site examination of the MFBs. Through that department, the NDIC has been carrying out on-site examinations, premium assessment and off-site surveillance of licensed Microfinance Banks (MFBs) and Primary Mortgage Institutions (PMIs). It had also participated in joint and special investigations and examinations of the institutions with the CBN. During the routine examinations of these institutions, their books and records are perused with a view to identifying, analyzing and measuring the risks the institutions are exposed to and recommending mitigating measures that could reduce or eliminate such risks.

The Corporation has also been carrying out off-site surveillance of licensed MFBs and PMIs on a quarterly basis. In that respect, the prudential returns of the reporting institutions are analyzed and reports generated. The off-site surveillance framework provides the basis for early detection of problems which could facilitate timely intervention.

#### *11.4.5 Capacity Building*

Microfinance was a novel idea in the country and both regulators and operators did not have adequate knowledge and skills for microfinance operations. In that regard, the Corporation during the year under review, partnered with the CBN to build capacity of its staff. In 2008, some examiners were sent to The Philippines and Bangladesh (which had recorded great success in microfinance), to learn about the operations of microfinance. In addition, facilitators were invited from Social Enterprises Development Partnerships Incorporated (SEDPI) Anteneo De-Manila University of

Philippines for implant courses organized by the Corporation to train the bulk of examiners in 2008. A total of forty (40) examiners benefited from the courses.

#### *11.4.6 Public Awareness/Advocacy*

Public awareness about the deposit insurance cover available to depositors and related procedural/legal aspect are also necessary for promoting financial inclusion by strengthening public confidence in this banking sub-sector. This is also underlined by International Deposit Insurance Association. The NDIC uses various methods for spreading awareness about Deposit Insurance in Nigeria. In the case of the MFBs, public awareness of extension of DIS to MFBs was conducted in 2008 through sensitization workshops for Board Management and External Auditors of MFBs at various centres nationwide. In addition, a sensitization workshop was held for Finance Correspondents Association of Nigeria (FICAN) to enhance public advocacy. Furthermore, advertisements on introduction of DIS for MFBs were placed in print and electronic media, while stickers (decals) were provided for MFB offices/business premises.

#### *11.4 Challenges of MFBs*

The Microfinance bank sub-sector is faced with a number of challenges which have restricted its effectiveness in enhancing economic inclusion. Some of these challenges are enumerated as follows:

##### **i. Skewed Distribution of MFBs**

As shown in Table 11.1, the MFBs, as at December 2008, were concentrated mainly in the urban and semi-urban areas of the country. That development runs counter to the basic objective of the microfinance policy of enhancing economic inclusion in the country.

**ii. High Operating Cost**

Majority of the MFBs operate as if they are in competition with the universal banks. The cost of office accommodation mostly in urban centres, heavy wage bills and fringe benefits have resulted in very high operating costs thereby reducing the loanable funds available to most of the MFBs.

**iii. Inadequate Executive and Regulatory/Supervisory Capacity**

Microfinance is a novel idea in the country, therefore majority of the staff of MFBs do not have requisite knowledge and skills in microfinance. Most of the MFBs staff had universal banking job experience and that explains why some of them focus mainly on conventional banking products with little efforts in developing products for the desired target members of the society. In the same vein, there is dearth of capacity on the part of regulators and supervisors to effectively discharge their role. That has limited the effectiveness of the safety-net arrangement in ensuring safe and sound practices in the institutions, a situation which threatens the stability of the sub-sector in particular and the entire financial system in general.

**iv. Lack of Exit Mechanism for CBs that Failed to Meet the Requirements for MFB licence**

Some community banks that failed to meet the requirements for MFB licence are still operating as community banks even when many of them are exhibiting distress symptoms of which most unsuspecting depositors are not aware. Even for those CBs that are viable, the fact remains that the legal framework for their existence is no longer tenable. There is therefore, the need on the part of the regulators to address this problem by working out an appropriate exit mechanism for the affected CBs with minimal interruption to the operations of the MFB sub-sector in particular and the entire financial system in general. Such mechanism is currently not available.



**v. Inhibited Ability to Mobilize Deposits**

As a result of the high failure rate of community banks, finance houses and “wonder banks” in the recent past, members of public have been weary of patronizing MFBs. That has to a great extent created problems in deposit mobilization by the MFBs, thereby inhibiting their intermediation process. In addition, there is inadequate access to sustainable source of funding as most State Governments are yet to make good the requirement of contributing 1% of the annual budgets to microfinance credits through the instrumentality of micro-finance banks.

**vi. Challenge of Management Information System**

Many of the MFBs are yet to be computerized. That could be expected since the cost of computerization could be too much for MFBs to bear at inception, hence, most of them resort to manual operation with attendant adverse consequences on accurate record keeping.

**vii. Poor Corporate Governance**

The Boards of MFBs should be responsible for establishing strategic objectives, policies and procedures that would guide and direct the activities of the banks. These are lacking in most of the existing MFBs, as revealed by Examination Reports. Majority of the existing MFBs operate without strategic plans, policies and procedures. Also, there are issues of self-serving practices and insider abuse by the owners, board and management of some of the MFBs.

**viii. Loan Recovery Challenges**

Various Examination Reports of these institutions have revealed a rapid build-up of non-performing loans in the sub-sector. The subsisting legal and judicial system has equally made it difficult for the MFBs to recover loans and realize collaterals obtained to secure loans.

### **ix. Collateral Security Challenge**

In other jurisdictions where microfinance operations have been successful, emphasis has not been laid on collaterals for micro credit. Many MFBs in Nigeria are yet to embrace that lending practice because of the poor borrowing culture in Nigeria. That challenge has been exacerbated by the slow judicial processes in adjudicating loan recovery cases.

### **11.5 Conclusion**

Even though still evolving in Nigeria, micro-finance has been recognized as a veritable tool for economic inclusion. It has a great potential for savings mobilization, economic empowerment, poverty reduction and accelerated economic growth and development. In this chapter the experience of Nigeria in that respect has been discussed. The chapter has equally demonstrated that the provision of deposit insurance helps to enhance the effectiveness of microfinance policy via the creation of micro-finance banks by reinforcing public confidence in MFBs. In order to derive maximum benefits from the initiative, concerted efforts are still required to address some of the daunting challenges facing the MFB sub-sector. In that regard, there is urgent need for the MFBs to design customized financial products for the target members of society. Also, there is the need funding of the MFBs from sources other than money and credit market. Furthermore, the need for requisite skill acquisition by managements of MFBs as well as for their regulators/supervisors cannot be overemphasized. Finally, there is the need to heighten the pace of financial literacy for the clientele of the financial sub-sector.

# Chapter 12

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## **POST-CONSOLIDATION BANKING ERA AND THE NIGERIA DEPOSIT INSURANCE CORPORATION: ISSUES AND CHALLENGES<sup>1</sup>**

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### ***12.0 Introduction***

This year's workshop which is the fifth in the series organized for members of the Finance Correspondents Association of Nigeria (FICAN) and their business editors by the Nigeria Deposit Insurance Corporation. The workshop is an assurance of the fact that the Corporation remains resolutely committed to the goal of further enriching and enhancing the capacity of financial reporters to enable them adequately cope with the ever increasing challenges of their profession.

The theme for this year's workshop - "Post-Consolidation Banking Era and the Nigeria Deposit Insurance Corporation"- is considered apt in view of the peculiar role of the NDIC in contributing to banking system stability. Gentlemen of the press, let me take this opportunity to make some comments

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<sup>1</sup> Original version of this paper was delivered as a Keynote Address at the Fifth NDIC-sponsored FICAN Workshop which was held in Benin City, Edo State from 28<sup>th</sup> to 30<sup>th</sup> November, 2006.

on deposit insurance system (DIS). DISs are set up in many jurisdictions mainly to enhance macro-economic and financial system stability by minimising or preventing incidences of bank runs. This is done through an up-front promise to pay depositors a guaranteed sum should a bank fail. The primary objective of such promise is to build confidence in the banking system. The actual pay-out to depositors in the event of bank failure is a secondary objective which serves to reinforce the primary objective of building confidence. As long as the public believes in the ability and capability of the deposit insurer to fulfill its promise, the financial stability objective is met.

Basically, there are three models of the DIS namely the pay-box, least-cost and risk minimiser. The pay-box is saddled with payout to depositors of failed banks while the least-cost DIS seeks to minimise the cost of bank resolution. In the case of a risk minimiser DIS, a continuous assessment of insured institutions is made in order to monitor the risk exposure of the deposit insurer. In this regard, it should be noted that the Nigerian DIS was designed as a risk minimiser. Hence, its enabling Act gave it the power to supervise insured institutions. It is widely acknowledged that NDIC's supervisory activities have effectively complemented the regulatory function of the CBN.

Following the conclusion of the bank consolidation programme, the two major products of that process were the emergence of 25 bigger banks and the revocation of the operating licences of 14 technically insolvent banks that could neither raise the minimum capitalization requirement of  $\times 25$  billion nor find merger partners/acquirers. In order to minimize the sufferings of innocent depositors of the 14 failed banks and boost confidence in the banking system, the Regulatory Authorities (i.e. CBN and NDIC),

adopted the Purchase and Assumption (P & A) failure resolution option as against the pay-out option which the Corporation had adopted over the years. Under the new option, the depositors, particularly the private sector depositors are guaranteed full recovery of their deposits and would enjoy continuity of banking services as the banks acquiring the closed banks would meet the banking obligations of the affected depositors as and when due.

The emergence of 25 banks of more comparable sizes than the 89 banks that hitherto existed at the commencement of the reform agenda in July 2004 has created a level playing field for keen competition amongst market participants.

### ***12.1 Implications of Increased Competition in the Banking Industry***

In this paper, the implications of the increased competition in the banking industry are discussed in Section Two whilst the paper ends with a conclusion in Section Three.

Whereas, competition is good for individual banks, the customers, and the banking system, increased competition has implications which should be carefully identified and accorded the necessary attention. In a broad sense, some of the implications of increased competition in the banking industry, which have direct bearing on the system's stability include the following, among others:

- Effective supervision;
- Effective risk management;
- Strong corporate governance;
- Market discipline;

- Self-regulation; and
- Enabling legal and judicial environment.

Each of these implications is briefly discussed hereunder.

### *12.1.1 Effective Supervision*

The current supervisory approach in Nigeria which is transaction- and compliance-based is narrow in scope and uniformly applied to all supervised institutions. With consolidation, there is the need to adopt a robust, proactive and sophisticated supervisory process that should essentially be based on risk profiling of the emerging big banks. In other words, the adoption of an appropriate risk-based supervisory approach is imperative with consolidation. The approach entails the design of a customized supervisory programme for each bank and it should focus more attention on banks that are considered to have potentially high systemic impact. The approach should enable the supervisory authorities to optimize the utilization of supervisory resources. That necessarily requires that supervisors should have a clear understanding of the risk profile of the emerging big, and sometimes, complex banks. There is therefore, the need for capacity building in this area.

Furthermore, consolidation has, no doubt, brought to the fore the need for consolidated supervision that requires more regular consultation and closer cooperation amongst the various regulatory/supervisory institutions in the financial system. This is because the larger banks are going to be more complex as they are likely to engage in non-traditional activities that are permissible under universal banking. It is equally imperative that the present reporting format of banks be reviewed so as to incorporate all possible

activities that banks would undertake after the consolidation. This will make it possible for supervisors to obtain a global view of the bank's operations. The current efforts of the CBN/NDIC in the development of an electronic Financial Analysis Surveillance System (e-FASS) and the activities of the Financial Services Regulation Coordinating Committee (FSRCC) would go a long way to assist in this regard.

#### *12.1.2 Effective Risk Management Systems*

Although effective risk management has always been central to safe and sound banking practices, it has become even more important in the post consolidation banking era than hitherto as a result of the on-going bank consolidation programme. It is important to indicate that the ability of a bank to identify, measure, monitor and control risks under the emerging banking environment can make the critical difference between its survival and collapse. For a bank to efficiently and effectively play its role under the emerging dispensation therefore, the deployment of an effective risk-management system with the following key elements is imperative:

- Active board and senior management oversight;
- Adequate risk-management policies, procedures and exposure limits;
- Effective risk identification, measurement, monitoring and control framework;
- Comprehensive management information system; and
- Efficient internal controls.

It is on the basis of the foregoing that the Regulatory Authorities recently issued guidelines for the development of risk management systems by banks. The adequacy or otherwise of the developed risk management systems will be assessed on an on-going basis by the Regulatory Authorities (i.e. CBN and NDIC).

### *12.1.3 Strong Corporate Governance*

While good corporate governance has remained imperative in the banking system, its importance in our nation's emerging banking environment is based on the fact that managements of most of the 'new' banks would be insulated from abusive ownership. Besides, there are many other stakeholders with goals, interests and expectations that do not necessarily coincide, and as a result, they constitute major areas of frictions. A bank is therefore expected to put in place a governance structure that will seek to balance all stakeholders' interest, goals and expectations. This is the essence of a good corporate governance.

Corporate governance is about building credibility, ensuring transparency and accountability as well as maintaining an effective channel of information disclosure that would foster good corporate performance. It is also about how to build trust and sustain confidence among the various interest groups that make up an organization. Indeed, the outcome of a survey by Mckinsey and Company in collaboration with the World Bank in June 2000 attested to the strong link between corporate governance and investors' confidence. In fact, it has been amply demonstrated that, with the possible exception of massive macroeconomic instability, no one single factor contributes more to institutional problems than poor corporate governance.

Disclosure and transparency are key pillars of a corporate governance framework, because they provide all the stakeholders with the information necessary to judge whether or not their interests are being served. I see transparency and disclosure as an important adjunct to the governance process in banks as they facilitate banking sector market discipline. For transparency to be meaningful, information should be reliable, accessible, timely, relevant and qualitative.



With the emergence of bigger banks in Nigeria, weak or poor corporate governance becomes a more serious issue as the failure of large banks could cause systemic problems while posing operational difficulties to the supervisory authorities in resolving them. In view of the fact that the systemic repercussion of the failure of a big banking institution is grievous, the Regulatory Authorities recently issued a new code of corporate governance tagged “Code of Corporate Governance for Banks in Nigeria: Post Consolidation”. The new code was developed to compliment the earlier ones and ensure the enthronement of responsive corporate governance in the banking industry.

#### *12.1.4 Market Discipline*

The current information disclosure requirements in the industry are grossly inadequate to effectively bridge the information asymmetry between banks and investing public that consolidation has inevitably created. Under the consolidated banking environment, it is important that the accounting as well as disclosure requirements of the consolidated banks be reviewed. In that regard, the Regulatory Authorities are currently reviewing information disclosure requirements so as to minimize information asymmetry between banks and investing public. This has become necessary to ensure that business decisions by the investing public are well informed under the new dispensation. Adequate information disclosure requirement will make banks to pay greater attention to reputational risk that could result in loss of confidence as well as patronage. As a necessary step to promote market discipline, it is important to indicate that the full weight of the provisions of relevant laws would be brought to bear on erring operators in order to help promote safe and sound banking practices under the consolidated banking environment. The policy of zero-tolerance against unethical behaviour would be strictly applied.

### *12.1.5 Self-Regulation And Self-Discipline*

Given the size and the envisaged complexity of operations of the emerging banks post-consolidation, regulation and supervision of banks have been made the joint responsibility of both the Regulators and operators. That is, statutory regulation has to be complemented by self-regulation through strong corporate governance arrangement. This development has become necessary in view of the realization that self-regulation and self-discipline are critical to the promotion of a sound, transparent, accountable and efficient financial market.

Given our conviction on the efficacy of self-regulation, the Regulatory Authorities will continue to encourage banking institutions in a consolidated banking environment to draw up and bind all their staff to a code of ethical and professional practices. Effective self-regulation as we all know, requires probity, transparency and accountability, which are yet to be fully entrenched in the system. Necessary steps are being taken by the regulatory/supervisory authorities to encourage these virtues and operators have also appreciated the need for compliance with rules and regulations to promote healthy competition since self-regulation does not amount to elimination of regulatory controls and supervision. It only confers some measure of confidence and trust in the ability of organizations to regulate themselves in the public interest. In this regard, it is noteworthy that the Bankers' Committee had issued a code of Ethics and Professionalism to guide their officers and employees in discharging their duties. Also, Committees such as Board Ethics and Good Governance are becoming a regular feature of the Board Structure of Nigerian Banks.

### *12.1.6 Responsive Legal and Judicial Environment*

Without an effective legal and judicial process, the effectiveness of the Corporation in its bid to contribute to the banking system stability would be severely impaired. As the deposit insurer, NDIC requires a responsive legal and judicial system to enhance its effectiveness. Adequate legal powers for the Corporation will facilitate prompt payment of insured depositors and guarantee speedy debt recovery and realisation of assets in the event of bank failure as well as minimize losses to the Deposit Insurance Fund (DIF). In this regard, I am happy to indicate that the Corporation's proposed amendments to its enabling Act have been passed by the National Assembly and it is awaiting Presidential assent. It is my belief that the new Bill, when signed into law, will enhance the Corporation's ability to execute its mandate.

With regard to the judicial environment, it is on record that most lawyers exploit the subsisting judicial processes and procedures to cause undue delay in the dispensation of justice when they know they have bad cases. Most of the times you witness lawyers obtain ex-parte orders from courts, these are orders sought without putting the other party on notice for frivolous reasons. In most instances, interim and interlocutory injunctions, stay of proceedings are obtained only to stall proceedings. Also, frivolous appeals and other forms of abuse of court processes are some of the tactics employed by lawyers to pervert the cause of justice. A good example of abuse of judicial process is the Savannah Bank's case, where the plaintiff who went to court to stop the liquidation of the bank after the Central Bank of Nigeria (CBN) had revoked its operating licence in 2002 had kept prolonging or delaying the proceedings through various types of applications in court. It was only in September this year that the Federal High Court dismissed the case against the plaintiffs who have again filed an appeal in the Appeal Court. The

litigation instituted by the erstwhile owners of the failed Peak bank whose licence was revoked in 2003 also still remains in court.

Again, out of the 13 banks whose licenses were revoked in January 2006, following the bank consolidation programme of the Federal Government, the Corporation has to date been appointed liquidator of only 8 of the banks and provisional liquidator of 3. The owners of the remaining 3 closed banks are currently challenging the revocation of their licenses in court, thereby frustrating the process of paying the affected depositors by the Corporation.

## ***12.2 Conclusion***

In this chapter, an attempt has been made to discuss the implications of the increased competition occasioned by the regulation-induced consolidation programme of the banking industry. In the main, some of these implications identified to have direct bearing on the system's stability are related to supervision, risk management, corporate governance, market discipline, self-regulation and an enabling legal and judicial environment. Notwithstanding the enormous challenges posed by the keen competition in the industry as a result of consolidation, there is no doubt that the regulatory/supervisory authorities shall continue to be proactive and put in place policies to guarantee safety and soundness of the banking industry. This is especially achievable through collaborative efforts of all stakeholders.

# Chapter 13

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## **SMALL AND MEDIUM SCALE ENTERPRISES AS FOUNDATION FOR RAPID ECONOMIC DEVELOPMENT IN NIGERIA**

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### ***13.0 Introduction***

The Central Bank of Nigeria (CBN) in its Monetary Policy Circular No. 35 for the year 2001 stated the new initiative that evolved under the aegis of the Banker's Committee to give impetus to current efforts aimed at ensuring adequate financial assistance to Small and Medium Scale Enterprises (SMEs). This initiative requires banks to set aside 10% of their profit before tax for the financing and promotion of SMEs in Nigeria. Obviously, this scheme adds to the long list of schemes that had been established to give support in various forms to SMEs in recognition of their relevance to the development process. The relevance of SMEs to economic development of our nation is further underscored by the recent bill on the establishment of the Small and Medium Industries Development Agency (SMIDA) sent by the Executive to the National Assembly.

SMEs are particularly relevant in creating employment opportunities, producing import substituting machinery and equipment, mitigating rural urban drift, producing specialized items in small quantities to meet diverse needs, mobilization of local resources as well as stimulation of technological development and innovation, among others. In view of the importance of the SMEs in the development process, this chapter highlights the major efforts taken at various times to stimulate the development of SMEs in Nigeria. It further focuses on the new initiative for financing SMEs in Nigeria through the banking system and indicates some plausible implications for the safety and soundness of the Nigerian banking system.

The rest of the chapter is organized into five sections. Section two explores the concept of SMEs, while section 3 highlights various efforts aimed at facilitating the promotion of SMEs in Nigeria. Section 4 examines the size and performance of SMEs in Nigeria, while section 5 explores the safety and soundness and implications of funding SMEs through the banking system particularly under the new initiative. Section 6 summarizes and concludes the paper.

### ***13.1 The Concept Of Small And Medium Scale Enterprises***

#### *12.1.1 Definition and Characteristics*

There is no consensus on the definition of Small and Medium Scale Enterprises (SMEs) as the terms small and medium are relative and they differ from industry to industry and country to country. The difference amongst industries could be ascribed to the different capital requirements of each business whilst those among countries could arise as a result of differences in industrial organizations of countries at different levels of economic development. What might therefore be defined as SME in a

developed country can be regarded as a large scale enterprise in a developing country using the parameters of fixed investment and employment of labour force. It is important to also recognize that definitions change over a period of time and hence even in a developing country what was previously classified as SME could be regarded as a large scale industry when economies of scale set in during the course of production.

In Nigeria, several attempts have been made to define and classify SMEs and probably due to differences in policy focus, different government agencies apply various definitions. For instance, the Centre for Industrial Research and Development (CIRD) of the Obafemi Awolowo University, Ile-Ife defined Small Scale Enterprise as an enterprise with a working capital base not exceeding  $\times 250,000$  and employing on full time basis, 50 workers or less. The Nigerian Bank for Commerce and Industry (NBCI) (now merged with others institutions to become Bank of Industry) adopted a definition of small scale business as one with total capital not exceeding  $\times 750,000$  (excluding cost of land but including working capital). The Federal Ministry of industry's guidelines to NBCI defined a small scale enterprise as one with a total cost not exceeding  $\times 500,000$  (excluding cost of land but including working capital). The Nigerian Industrial Development Bank (NIDB now part of Bank of Industry) defined small scale enterprise as an enterprise that has investment and working capital not exceeding  $\times 750,000$ , while it defined medium scale businesses as those operating within the range of  $\times 750,000$  to  $\times 3.0$  million. In 1979, the Central Bank of Nigeria (CBN), in its credit guidelines to commercial banks, stated that small scale enterprises were those with annual turnover not exceeding  $\times 500,000$ , while the merchant banks were to regard small scale enterprises as those with capital investment

not exceeding ×2 million (excluding cost of land) or with maximum turnover of not more than ×5 million.

It is arguable whether these criteria could hold in the present day Nigeria given the higher operational costs as a result of the continuous depreciation of the national currency and the resultant inflationary impacts. A definition that is close to reality of today is the one adopted by the World Bank. In implementing its programme of \$270 million loan assistance to Nigeria's SMEs, the World Bank defined SMEs as those with fixed assets (excluding land) plus cost of the investment project not exceeding ×10 million in constant 1988 prices. This definition was adopted by the National Economic Reconstruction Fund (NERFUND), the agency saddled with the responsibility of financing SMEs. In the Industrial policy for the country, small scale industries are defined as those enterprises with total investment of between ×100,000 and ×2.0 million excluding the cost of capital but including working capital.

Despite the disparity in the comparative definitions of SMEs, the enterprises are bounded by some common characteristics. First amongst these features is that ownership and management are often held by one individual/family and hence decisions are often subjective. Secondly, SMEs require small capital base in general regardless of the industry and the country where they are based. However, they have difficulty in attracting funds for expansion as a result of which they have to rely heavily on personal sources. Thirdly, the manager/proprietor hardly can separate his private funds from the company's funds and this contributes to the inefficiency and non-performance of many SMEs. Fourthly, most SMEs operate labour-intensive technology. They find it less easy to shift from one product line to something radically different. In fact most SMEs tie their objectives more closely to the product line than to other matters such as the use of



capital. In most SMEs, there is less organizational differentiation, higher employee turnover and higher labour investment ratio. Finally, the rate of business mortality is high probably due to reasons of low capital, inadequate market information, lack of appropriate technology and low level of operation, amongst other factors.

### *13.1.2 Relevance*

The relevance of SMEs can never be over emphasized especially in a developing country like Nigeria. In most countries where SMEs are specially promoted by government, the main expected role of these institutions can be summarized as follows:

- Supply of potential entrepreneurs
- Creation of employment opportunities
- Mobilization of local resources
- Mitigation of rural urban migration
- Distribution of industrial enterprises

As indicated above, SMEs are primarily expected to serve as bedrock of supply of promising entrepreneurs who would be ready to take chance on the exploration of new ideas or favourable market development. They are expected to assist in further entrepreneurship and skill development. Secondly, SMEs create more jobs per unit of invested capital. In most developing economies, unemployment is the greatest threat to economic growth and development. Hence, the proliferation of SMEs could be an antidote to large scale unemployment in these economies. This could be specially helpful in mitigating the rural urban drift, a burgeoning socio-economic problem in the developing economies. This is because most of the enterprises in the rural areas are small scale in nature and increased

chances of their survival could spell their greater ability to sustain the rural dwellers.

In addition to the above, the promotion of SMEs is expected to ensure the structural balance in terms of large and small industrial sectors as well as rural and urban areas. SMEs are expected to ensure the supply of high quality parts and components, and intermediate products, thereby minimizing the dependence on imported raw materials. Thus SMEs would not only encourage indigenous technology but also promote the establishment of import substitution industries. They are expected to produce for exports thereby generate additional foreign exchange and hence help to strengthen the national currency and the balance of payment position. Finally, apart from ensuring effective mobilization of resources, SMEs are expected to ensure better use of scarce financial resources and appropriate technology.

### *13.1.3 Experience of Other Countries*

SMEs which are usually referred to as Small Businesses in developed economies, have contributed to the growth and development of those economies, especially in terms of employment, contribution to GDP, export, et cetera. For instance, in the United State of America (USA), small business is seen as a means for enhanced economic opportunity, innovation and growth. Also, it is commonly accepted that there is a role in the US economy for independent enterprises that stay small. Historically, these values have been reflected in the legislative and regulatory considerations given to small businesses, as well as in antitrust policies that aim to limit the concentration of economic power (Samolyk, 1997). It is as a result of these concerted efforts that the USA currently has a small business sector that has about 22 million enterprises, generating more than a half of the country's GDP, employing about 53% of the total private workforce and is responsible for creating vast majority of all new jobs. Of the 3.3 million jobs created in

1994, small scale industrial and business enterprises produced an estimated 62%.

Also in China, the number of township enterprises increased from 1.52 million in 1978 to 19 million in 1991. During this period, their employees increased from 28 million to 96 million. They equally employed 22.3% of the total rural labour force.

The greater value addition has even occurred in the developing economies where the SMEs have become the bedrock of development. This is especially true in the Middle East and Asia regions. For instance, in Iran, the Small and Medium Enterprise Sector contributed more than 62% of industrial output and more than 75% of total employment in 1996. Similarly, in Israel, SMEs accounted for 97% of Israel' enterprises in 1996, employing some 50% of the country's workforce. Recently, 4,500 new jobs were created in the sector through assistance given to new immigrants. Over 50,000 people have been assisted in opening their businesses and there is a high record of take off success (estimated at more than 70%) of small businesses after one year of operation.

Of greater impact is the contribution of SMEs to the growth and development of the Indian economy. India took advantage of the Industrial Policy Resolution of 1949 and paid more attention to the development of Small Scale Industries (SSIs). Throughout the 1950s and 1960s, the government offered the sector subsidies, reservations and direct support. Over the years, SSIs have grown all over India. The sector comprises of tiny units, small scale industrial undertakings, small scale services and business enterprises, export-oriented units and women entrepreneurs enterprises all totaling 3.1 million units as at the end of 1998-1999.

SSI units grew from 1.95 million in 1990-1991 to 3.01 million in 1997-98. SSIs employed 13.4 million in 1992-93 and this increased to 17.16 million in 1998-99. In 1990-91, the total industrial output was US\$64.42 billion out of which SSIs' output was US\$36.11 billion. In 1997-98, industrial output reached US\$192.93 billion with SSIs accounting for US\$108.18 billion in 1998-99. Total exports in the SSI sector witnessed substantial growth from US\$5.39 billion to US\$11.89 billion in 1997-98.

In India, while the banking system essentially provides short-term working funds, specialized financial institutions provided long-term funds. The capital market helps to raise funds through equity and debt instruments. Due to weak capital base and limitations on entering the stock market, most SSIs rely heavily on borrowing capital from specialized financial institutions to finance fixed assets.

SSIs are no longer small in size or importance in India. They have become the backbone of the industrial development of the country. Their contribution can be judged from the fact that they account for:

- 95% of the total industrial units;
- 40% of total industrial output;
- 80% of employment in the industrial sector;
- 35% of total exports; and
- 35% of value-added by the manufacturing sector.

### ***13.2 Efforts made to Facilitate Financing of SMEs In Nigeria***

As earlier noted in this chapter, SMEs have contributed greatly to the growth and development of many of the developed nations in terms of employment,

contribution to GDP as well as export. In a developing nation like ours, SMEs have been recognized as a foundation for achieving rapid economic growth and development through their output as well as employment potentials. However, despite the recognized numerous advantages of SMEs, the contribution of this sector to the overall economic development of the country has over the years, remained low. The main reasons for the low contribution of the sector could be attributed to the various problems being faced by the SMEs in the system. Some of the problems, as noted by the Vision 2010 Committee, include:

- Poor access to credit and other financial support or incentives
- Poor public sector support and policy inconsistency
- Poor account keeping habits, weak financial planning
- Poor infrastructure which significantly increases the cost of doing business
- Inability to hire highly skilled personnel
- Inadequate or lack of research
- Poor linkages among vibrant SMEs, large-scale enterprises and the rest of the domestic sector of the economy generally
- Policy incentives are tilted in favour of large scale industries, etc.

In view of these problems and in recognition of the numerous advantages of the SMEs, the Federal Government has continued to play pioneering and active roles since the 1970s in stimulating SMEs. Notable past and present measures of creating virile SMEs that are capable of sustaining growth included:

- Provision of strong institutional support
- Ensuring easy access to credit facilities at reasonable rates
- Provision for industrial banks

- Provision of continuous training and research
- Provision of an enabling monetary and fiscal policies, etc.

Some of these measures are further discussed below.

### *13.2.1 The Establishment of the Small Scale Industries Credit Scheme (SSICS)*

In 1971, the then Federal Military Administration started to provide a more direct form of financial assistance to SMEs. As a first step, government established a Small Industries Development Programme to provide technical and financial support for the SMEs. Later, it established the Small Industries Credit Committee (SICC) to administer Small Industries Credit Fund (SICF) all over the federation. The scheme was operated as a matching grant between the Federal Government and the State Governments and designed to make credit available on liberal terms to enterprises with capital investment outlay not exceeding ₦150,000.00. The Fund was to operate as a revolving loan scheme. However, the scheme became progressively starved of fund owing to numerous abuses and it had to be discontinued by the Federal Government in 1979.

### *13.2.2 The Establishment of Industrial Development Centre (IDC)*

This was another important effort of the Federal Government to promote SMEs under the Second National Development Plan (1970-1975). Under the Plan, ₦800,000.00 was allocated for setting up IDCs in various parts of the country. The establishment of the IDCs no doubt, made it possible for government to provide extension services to the SMEs, especially as it relates to product development, entrepreneurial training, and technical appraisal of loan applications as well as managerial assistance.

### *13.2.3 The Role of State Governments*

Over the years, State Governments have been promoting the development of SMEs through their Industrial Development Centres (IDCs) as well as States' Ministry of Commerce and Industries. For example, in their annual budgets, certain sum of money are usually set aside by State Governments as an industrial fund that would help facilitate the development of SMEs in their respective states. In addition, some State Governments have been promoting SMEs through state-owned Finance and Investment Companies. These investment companies were established at various times to specifically render technical advice as well as provide some form of financial assistance to small-scale industrialists.

#### *13.2.4 The Establishment of the National Directorate of Employment (NDE)*

The establishment of the National Directorate of Employment in 1986 constituted another channel by which government aimed at promoting SMEs in Nigeria. Through the Directorate, a number of programmes such as Small Scale Industries (SSI), Youth Employment and Vocational Skills Development, etc., were embarked upon to boost employment. Two other schemes that were established under the NDE were the Open Apprenticeship Schemes and the Waste to Wealth Programmes. About 70,000 apprentices were trained in different skills all over the country by the end of 1987. With respect to the Waste to Wealth Programme, small scale business operators were trained on how to convert discarded materials such as plastics, jewelry, shoes, cardboard, etc to useful raw materials. Under the various schemes, some form of financial assistance was provided to beneficiaries.

#### *13.2.5 Working for Yourself Programme (WFYP)*

British Council and the International Labour Organization (ILO), the Federal Ministry of Industries established this programme as a means of improving the skills of business operators. Under the programme, a six-week intensive

training was conducted in several centers to impart technical skills to business entrepreneurs. Some form of financial assistance is provided to beneficiaries under the scheme.

*13.2.6 The Nigerian Industrial Development Bank (NIDB)*

The establishment of NIDB in 1964 was aimed at ensuring that credit facilities were provided for medium and large-scale enterprises. It also had the responsibility of funding small-scale businesses with total capital outlay of not more than ₦750,000.00. The bank could grant loans ranging from a minimum of ₦50,000.00 to a maximum of ₦15 million or 15 percent of NIDB's equity base but not more than 75 percent of the fixed assets of the business being financed. The bank's loans were usually soft.

*13.2.7 The Nigerian Bank for Commerce and Industry (NBCI)*

In furtherance of its objective to ensure availability of financial resources to indigenous entrepreneurs, the Federal Government established the NBCI in 1973. The bank was charged with the responsibility of disbursing to SMEs funds obtained from the Federal Government.

*13.2.8 National Economic Reconstruction Fund (NERFUND)*

The NERFUND was set up through Decree No. 2 of 1989 to provide medium to long-term funds for wholly Nigerian-owned SMEs. Through the NERFUND, SMEs had access to local and external loans over a period of five to ten years. Any entrepreneur who desired to obtain NERFUND loans had to go through a bank which acted as the primary obligor to NERFUND. The NERFUND Decree specified that eligible SMEs must be 100% owned by Nigerians, must have fixed assets plus cost of new investments (land excluded) not exceeding ₦10 million; in the case of a manufacturing project, not less than 40 percent of the raw materials were to be sourced locally; and



a Participating Bank (PB) must accept on behalf of the SME to assume the credit risk.

### *13.2.9 The Central Bank of Nigeria (CBN)*

The Central Bank of Nigeria, as the apex financial institution has, over the years, been playing a leading role in the promotion of SMEs. The CBN, especially during the regime of direct monetary control, was determining the rates for lending to specified sectors of the economy with the aim of encouraging lending to those sectors. The Bank ensured that the lending rates to SMEs were lower than the rates for other sectors of the economy. It also required mainstream banks to make available to indigenous industrialists a certain percentage of their credit portfolio. Recently, a new scheme was approved for the financing of the SMEs. The new scheme referred to as the Small – and Medium - Scale Industries Equity Investment Scheme (SMIEIS) requires banks to set annually, 10 percent of their Profit Before Tax (PBT) for the financing and promotion of small - and medium -scale industries in the system. The SMIEIS was an initiative of the Bankers' Committee.

### *13.2.10 Funding of SMEs Through Multilateral Financial Institutions*

In order to accelerate the development of SMEs, some international multilateral organizations like the International Finance Corporation (IFC), the World Bank and the African Development Bank (ADB) have at different times provided foreign capital to Nigerian small and medium scale businessmen. The provision of such foreign finance has been greatly enhanced by guarantees given by the Federal Government.

#### *a. African Development Bank (ADB)*

In 1988, the ADB advanced a loan of US \$230 million, called the Export Stimulation Loan (ESL), to NERFUND to assist in stimulating non-oil

exports. The loan was intended to ameliorate the foreign exchange difficulties confronting Nigerian industrialists and thus make the procurement of some vital raw materials, capital equipment and other inputs a less onerous task. The loan was thus used to support export-oriented agricultural products; and encourage the utilization of local raw materials and intermediate goods by industrial enterprises, so as to conserve foreign exchange.

***b. World Bank***

In its efforts to accelerate the development of SMEs in the private sector, the World Bank grants loans to Nigeria. For instance, in 1989, the World Bank gave Nigeria a facility of \$270 million. Out of this amount, a total of US \$267.7 million was set aside for on-lending to SMEs through eligible participating banks. The money was used to support existing enterprises, restructure and modernize their operations. In addition, the loan assisted in the establishment of new viable investments in the private productive sector and social services.

*13.2.11 Other Policy Measures to Reduce the Financial Burden of the SMEs*

Through the use of fiscal policy measures, government has also provided incentives that would stimulate the general development of SMEs in the system. Some of the fiscal measures included:

- i) Pioneer status or Income Tax Relief Act
- ii) Import Duty Relief
- iii) Capital Allowance to aid capital formation
- iv) Tax relief for investments in economically disadvantaged local government areas
- v) Tariff measures, effective protection with import tariff to ensure that locally produced goods are efficiently processed and

- made competitive in both domestic and export markets.
- vi) Export promotion incentive, and
- vii) Foreign exchange facility

### ***13.3 Size and Performance Of SMEs in Nigeria***

The task of assessing the size and performance of SMEs in the Nigerian economy is handicapped by:

- a. The definition as to what are SMEs in the first place; and
- b. Lack of adequate and reliable data on the activities of SMEs.

As pointed out earlier in this chapter, various definitions of SMEs exist and our estimation of their size and performance can be influenced significantly by what definition we adopt. Besides, adequate and reliable data on their activities are required to assess their size and performance. However, such data are not available.

In spite of these shortcomings, our analysis is based partly on data from the Federal Office of Statistics (now National Bureau of Statistics). For the purpose of this analysis, we have restricted our definition of SMEs to number of employees because there is no reliable data on turnover, invested capital and total assets of such enterprises in Nigeria. We have therefore adopted the definition of SMEs as enterprises employing not more than 50 full time workers.

#### ***13.3.1 Size of SMEs in Nigeria***

Table 1 presents the number of establishments by activity group and by employment size in Nigeria. Using the above adopted definition for SMEs,

it is obvious that 96.43 per cent of enterprises in the country are small and medium scale enterprises, employing less than 50 full time workers.

According to the table, there are 58,665 establishments in all the 11 economic activity groups in the country. Considering the distribution of establishments by employment size bands, the group of establishments engaging 5-9 persons recorded the highest concentration with 37,808 (64.45%) establishments. In this class, manufacturing sector takes a controlling share with 11,352 (30.03%) establishments. Other services, Wholesale and Retail Trade followed with 10,512 (27.80%) and 7,522 (19.90%) establishments respectively. Mining and Quarrying takes the rear in this group with only 60 (0.16%) establishments listed.

The class of establishments engaging 50 persons and above (which are regarded as large scale enterprises) constitute only 3.5% of all establishments in the country. The proportion of enterprises (96.43%) that are SMEs, indicate the importance of these enterprises in the economic development of Nigeria. Therefore, any development programme that ignores this sector of the economy is not likely to have a significant impact on the economy.

**Table 13.1**  
**Distribution Of Establishments By Activity Group And By Size (Nigeria)**

Activity Group	Number Of Employees										Total	
	0-4	5-9	10-19	20-49	50-99	100-199	200-499	500-999	1000+	NO.	%	
Agriculture & Forestry	5	693	364	276	92	47	25	6	7	1,513.00	2.58	
Mining & Quarrying	3	60	37	50	16	10	2	1	4	183.00	0.31	
Manufacturing	130	11,352	3,012	1,224	341	202	172	58	51	16,542.00	28.20	
Electricity, Gas & Water	5	73	31	43	20	8	10	1	3	194.00	0.33	
Building & Construction	24	311	144	136	62	33	33	11	7	761.00	1.30	
Wholesale & Retail Trade	179	7,522	1,944	541	94	42	12	10	0	10,344.00	17.63	
Hotel & Restaurant	46	3,301	931	258	52	30	9	6	0	4,633.00	7.90	
Land Transport	9	355	208	111	29	21	9	0	0	742.00	1.26	
Other Transport	7	192	108	67	16	14	4	3	0	411.00	0.70	
Private Prof. Services	1,546	3,437	1,699	893	170	48	23	4	3	7,823.00	13.34	
Other Services	854	10,512	3,061	814	144	77	39	11	7	15,519.00	26.45	
Total	2,808	37,808	11,539	4,411	1,036	532	338	111	82	58,665.00	100.00	
%	4.79	64.45	19.67	7.52	1.77	0.91	0.58	0.19	0.14	100.00		

Source: Federal Office of Statistics

### *13.3.2 Performances of SMEs*

The performance of SMEs can be assessed by their contribution to: GDP, employment, industrial output and export (Pradjan 2001). Unfortunately, comprehensive data on these indicators are not available in Nigeria. The need to build and maintain data on these indicators cannot be overemphasized.

In any case, what is available at the Federal Office of Statistics (now National Bureau of Statistics) are data on the contribution of small scale manufacturing firms to GDP (see Table 13.2).

**Table 13.2**  
**Gross Domestic Product at Current Factor Cost**  
**Percentage Distribution 1987-1998**

Activity Sector	1987	1988	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998
Manufacturing	6.76	7.52	5.29	5.54	5.90	4.04	5.52	6.91	5.36	4.84	5.08	5.15
Large-Scale	5.75	6.44	4.53	4.75	5.05	4.15	5.73	5.92	4.59	4.15	4.35	4.41
Small-Scale	0.79	1.08	0.76	0.79	0.85	0.69	0.79	0.99	0.77	0.69	0.73	0.74

Source: Federal Office Of Statistics

Table 13.2 shows that small scale manufacturing enterprises contributed between 0.69 and 1.08 percent of total GDP between 1987 and 1998, about 14 percent of the total contribution of manufacturing firms to total GDP. From the table, it is obvious that the contribution of the SMEs to the nation's manufacturing sector remains very low in spite of the various efforts of government. This is unlike what obtains in most developed and some Asian countries. For instance, in most countries in Asia, SMEs constitute the major export earners and the bedrock of their industrial sectors. For instance, small scale industries in India contribute 95 percent of total industrial units, 40 percent of total industrial output, 80 per cent of employment in the industrial sector, 35 percent of value-added by the manufacturing sector.

It is perhaps the realization of the potential role in the development process of a nation and the relative ineffectiveness of the past efforts that informed further initiatives from the relevant authorities aimed at stimulating the sub-sector. Examples of these recent initiatives are the bill for the establishment of the Small and Medium Industries Development Agency (SMIDA) sent by the Executive to the National Assembly; and the Small Scale Industries Equity Investment which requires banks to set aside 10 percent of their Profit Before Tax for the financing of SMEs.

#### ***13.4 Safety And Soundness Implications Of Funding SMEs Through The Banking System***

Banking activities leading to the creation of risk assets usually prompt regulatory authorities concern for safety and soundness of the depositories. This is because such risk assets have risk profile that is either complementary to or compounding existing portfolio risk. The safety and soundness implication of undertaking additional risk assets is therefore better analyzed



in terms of contribution to overall portfolio risk. This is the analytical framework that will be employed in the discussion of the issue of safety and soundness of banks extending finance to SMEs.

Basically, under the prevailing regulations, funds from the banking system can be extended to the SMEs either directly as normal credit or as equity investment under the recent initiative of the Bankers' Committee. A basic difference between these two sources is the structure of incentives. The risk return profile of the two options is significantly different notwithstanding the fact that they are both market driven. In the case of the normal credit line to SMEs, the risk has a floor while the return has a ceiling. On the other hand, while the risk exposure under the equity investment also has a floor, the return is open ended. The equity option is therefore normally more attractive. This difference in incentive structure i.e. the risk return profile has significant implication for the quantum of resource flow to SMEs, sustainability of this flow and the safety and soundness of the banks. Our discussion will however, be limited to the safety and soundness issue.

Funds to SMEs through the normal credit lines have proven to be grossly inadequate especially since 1997 following government abrogation of the mandatory allocation of 20 percent of banks total credit to SMEs in October 1996. In fact, it is the worrisome dwindling flow of funds from this source that in the main, prompted the Bankers' Committee's initiative to support the government efforts at channeling funds to the SMEs. The major factors responsible for the paucity of funds flowing to the SMEs is the relative unattractiveness of the returns on loans to SMEs and the limited prospect of recovering such loans from collaterals offered which are invariably inadequate. The prevailing prudential framework for identifying and providing for delinquent credits has adequately taken care of the nature and

magnitude of possible credit risk from this source of fund. Moreover, banks have very well developed internal mechanism for appraising and administering credits to SMEs. This funding source therefore, does not pose any special or extra-ordinary risk to licensed banks overall portfolio risk given the size of fund presently flowing to the SMEs from this source.

The second option of financing the SMEs through equity participation by licensed banks as proposed under the Bankers' Committee's initiative is not entirely new. A number of development finance institutions in the country, notably the Nigeria Industrial Development Bank (NIDB), have employed this strategy in the discharge of their mandate. Also, licensed banks, within the limit of permissible activities during the era of directed credits, extended some funds to some enterprises (though not only the SMEs) by way of equity participation. The bankers' proposal of devoting 10% of Profit Before Tax (PBT) of licensed banks to equity participation in SMEs is commendable initiative with a lot of potential benefits to both the banks and the SMEs.

This approach to funding of SMEs appears to have the potential of mobilizing sizeable financial resources for the SMEs on a sustainable basis. Compared with normal bank lending to the SMEs, banks committing funds to such enterprises through equity investment are likely to show greater concern for the success of the SMEs being invested in because of the open-endedness of the derivable returns. Furthermore, as shareholders in the SMEs, investing banks would have representation on the decision-making organ of the enterprise through which the bank's interest can be protected. This prospect for investing banks to be able to directly protect their investment by influencing decision-making in the SMEs is an important risk-mitigating factor for this financing arrangement. On the other hand, some have cautioned that banks with equity interest in SMEs are likely to feel compelled

to unduly extend credit to such firms when they are in financial difficulty and that such credits may become nonperforming. However, it does not seem that such credit could amount to what will come to threaten the safety and soundness of the entire banking system.

An important feature of the Bankers' Committee's initiative is the fact that the fund is from bank's profit before tax which in principle and except for tax liability, is an unencumbered earning. Losses arising from investing such unencumbered fund in SMEs will not on their own compound safety and soundness of the investing bank. However, normal appropriation of the profit before tax would have added to the shareholders' fund and by extension, provided additional capital cushion for absorbing operational losses. The deprivation of this additional capital cushion is the extent to which this funding option could impair the safety and soundness of the investing banks.

### ***13.5 Conclusion***

An attempt has been made in this chapter to indicate the place of SMEs in the development process of any economy. In doing this, the chapter observes that what constitutes an SME varies from one country to another and even in the same economic environment, definition varies from industry to industry. However defined, SMEs share some similar characteristic such as single/family membership, inadequate capital, labour-intensive technology, lack of meaningful delineation between owner's private fund and business capital. The chapter also indicates that in countries where SMEs are given a primary place in the development process, they are expected to help in the mobilization of local resources, create employment for a large number of employable persons, assist in entrepreneurship and skill development,

amongst others. Experience from various countries, developed and developing, attest to the relevance of SMEs in the development process.

The chapter recognizes inadequate finance as one of the major banes of SMEs in the country in spite of various government policies aimed at facilitating financial and technical support for the promotion of SMEs. In particular, the chapter examines the role of some government agencies such as NIDB, NBCI, CBN and Federal Ministry of Finance in encouraging the survival of SMEs in Nigeria. Also, financial assistance from the World Bank, the African Development Bank, and other external donors has been observed to have constituted a major boost to the development of SMEs. In spite of all the previous efforts however, the performance of SMEs in Nigeria in terms of the sub-sector's contribution to GDP, exports and employment, among others, has been less than satisfactory.

The chapter therefore views the recent initiative of the Bankers' Committee, which requires all licensed banks to set aside 10 percent of their profit before tax specifically towards the funding of SMEs (particularly as equity investment), as a bold step in the right direction, as the initiative appears to have the potential of mobilizing sizeable financial resources for the SMEs on a sustainable basis. However, given the deprivation of additional capital cushion which the initiative necessarily entails, the failure of such SMEs where such funds are invested could constitute a risk to the investing bank.

# Chapter 14

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## **THE ROLE OF REGULATORY INSTITUTIONS IN THE MANAGEMENT OF CAPITAL FLOWS**

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### ***14.0 Introduction***

Recent changes in technology, along with the opening up of many regions previously closed to investment, have led to explosive growth in the international movement of capital. Flows from foreign direct investment and debt and equity financing can bring countries substantial gains by augmenting local savings and by improving technology and incentives. But, as was underscored recently by the economic and financial crises in several Asian countries, capital flows can also bring risks. Hence the need to evolve appropriate policies that will enable the monetary authorities to determine the optimal level of the capital flow that will support any economic agenda being pursued at a point in time.

In Nigeria today, there is no doubt that the economy requires an optimal amount of capital flow (net) in order to bridge the gap between the desired level of investment and domestic savings in order to accelerate the pace of

economic growth and development on a sustainable basis under the ongoing macro-economic reform programme – National Economic Empowerment and Development Strategy (NEEDS). However, because of the inherent risks involved in such flows, there is therefore the need for the relevant regulatory institutions to devise means and ways of managing such flows so as to minimize such risks bearing in mind the overall objective of seeking to promote rapid economic growth and development.

Apart from this introduction, this chapter is divided into four other sections. In Section 2, we examine some conceptual issues and experiences of other countries. In Section 3, we review the legal framework in Nigeria while Section 4 highlights development with respect to capital flows in Nigeria. In Section 5, the regulatory institutions and capital flows in Nigeria were discussed. Section 6 summarizes and concludes the chapter.

## ***14.1 Conceptual Issues and Experience of Other Countries***

### *14.1.1 Composition of Capital Flows*

Capital flows basically consist of foreign direct investment (FDI), portfolio equity and debt flows, commercial lending and official flows. Available data from the World Bank shows that whilst medium income countries experienced more portfolio equity inflows as a percentage of total capital inflows in recent years, low income countries like Nigeria and other countries in Sub-Saharan Africa relied heavily on official debt flows.

There is no clear consensus on reasons for the existence of different forms of capital flows or why some form are dominant in one region or the other. Most empirical studies available tend to examine the composition of flow from the position of desirability. Pontes (1999) argue that FDI is a desirable

form of capital flow to the host country as it may bring position externalities such as technology and management expertise. Griffith-Jones (2003) concurs with those reasons and adds that FDI tends to be more long-term and less easily reversible. On the other hand, a foreign investor may be motivated to invest in another country other than his own by other non-financial strategic reason such as market share.

Portfolio equity flows to countries with well-developed macroeconomic policy instruments and strong banking institution though they can be less stable than FDI. Short-term bank lending are often ranked the most volatile whilst long-term bank flows are considered least volatile though there has not been any statistical support for such ranking.

#### *14.1.2 Causes of Capital Flows*

Beyond the primary motives of higher returns and risk diversification, several potent factors have motivated the rapid growth of capital flows among nations. Chief amongst these reasons are the removal of statutory restrictions on capital account transactions, macroeconomic stabilization and policy reforms in the developing nations, the multi-lateralization of trade and the revolutionary changes in information and communication technologies. These factors and many more are discussed below under broad categories of internal and external factors.

##### **a. Internal Factors**

One of the key internal factors driving capital flows especially to recipient emerging economies is the improved private risk-return characteristics in these countries. Pontes (1999) identifies two of such characteristics to include the improved credit worthiness in most recipient countries as a result of debt restructuring and productivity gains occasioned by structural reforms

in these countries. The latter led to reduction in large deficits, depreciation in the local currency and overall decrease in the rate of credit expansion in these economies. In some of the countries which enjoyed rapid capital flows, adjustment policies were followed by measures that opened the economy to foreign trade and also reformed financial system. Generally and as also evidenced by the World Bank (1997), countries with strongest fundamentals, that is, high investment-to-GDP ratio, low inflation and low real exchange rate variability received the largest flows as percentage of GDP whereas countries with low fundamentals could not attract private flows.

**b. External Factors**

In addition to the internal factors above, two types of external factors have been identified as being responsible for the capital surge from industrial nations to Less Developing Countries (LDCs); these are cyclical and structural. On the one hand, some writers have suggested that cyclical conditions such as the decline in the interest rates in industrial nations in the earlier 1990s drove investors to the LDCs in search for higher returns. The recession in these nations further reinforced the search for higher returns in the emerging economies. On the other hand, a study by the World Bank (1997) viewed this development as being due to structural factors because in spite of the failure experienced in some emerging economies like Mexico, capital flows from developed economies to LDCs have been on the increase. Pontes (1999) and Lopez Mejia (1999) identify some of the structural developments that drove capital flows to include falling communication costs, strong competition, technology and the growth of derivative markets amongst others. Particularly, revolutionary changes in information and communication technologies have played a tremendous role. Computer links enable investors to follow developments affecting different countries and companies much more efficiently. The advent of new technologies also



makes it increasingly difficult for governments to control either inward or outward capital flows.

Another development identified was the growing importance of institutional investors in the industrial nations. These investors were more willing and able to invest abroad because of higher long-term expected rates of return in developing countries and to wider opportunities of risk diversification.

#### *14.1.3 Benefits of Capital Flows*

Economists tend to favour the free flow of capital across national borders because it allows capital to seek out highest rate of return. Beyond that unrestricted capital flows may also offer several other advantages. First, international flows of capital reduce the risk faced by owners of capital by allowing them to diversify their lending and investment. Second, the global integration of capital markets can contribute to the spread of best practices in corporate governance, accounting rules, and legal traditions. Third, the global mobility of capital limits the ability of governments to pursue bad policies.

In addition to these advantages, which in principle apply to all kinds of private capital inflows, Feldstein (2000) and Razin and Sadka (forthcoming) note that the gains to host countries from FDI can take several other forms:

- FDI allows the transfer of technology particularly in the form of new varieties of capital inputs – that cannot be achieved through financial investments or trade in goods and services. FDI can also promote competition in the domestic input market.
- Recipients of FDI often gain employee training in the course of operating the new businesses, which contributes to human capital development in the host country.

- Capital mobility creates valuable opportunities for portfolio diversification, risk sharing and inter-temporal trade.

By lending to foreign countries, households and firms can protect themselves against the effects of disturbances that impinge on the home country alone. Companies can protect themselves against cost and productivity shocks in their home countries by investing in branch plants in several countries. Capital mobility can thereby enable investors to achieve higher risk-adjusted rates of return. In turn, higher rates of return can encourage increases in saving and investment that deliver faster rates of growth.

#### *14.1.4 Risk of Capital Flows*

Despite the strong theoretical case for the advantages of free capital flows, the conventional wisdom now seems to be that many private capital flows pose countervailing risks. Hausman and Fernande-Arias (2000) suggest why many host countries, even when they are in favour of capital inflows, view international debt flows, especially of the short-term variety, as “bad cholesterol”. Most recent empirical works including Grabel (1995), and Clerke (1996), Corrigam (1989), argued that the processes of deregulation, globalization, and innovation have increased both the efficiency of, and volatility in, the financial markets. Volatility adds another source of risk, not only making the pricing of financial assets more difficult but also generating portfolio flows that are potentially more unstable.

Tesar and Werner (1995) have also argued that some components of capital flows such as short-term lending is driven by speculative considerations based on interest rate differentials and exchange rate expectations, not on long-term considerations. According to them, “its movements are often the result of moral hazard distortions such as implicit exchange rate guarantees or the willingness of governments to bailout the banking system. It is the

first to run for the exits in times of trouble and is responsible for the boom-bust cycles of the 1990s”.

Capital flow in form of FDI is not only a transfer of ownership from domestic to foreign residents but also a mechanism that makes it possible for foreign investors to exercise management and control over host country firms that is, it is a corporate governance mechanism. The transfer of control may not always benefit the host country because of the circumstances under which it occurs, problems of adverse selection, or excessive leverage. Krugman (1998) notes that sometimes the transfer of control occurs in the midst of a crisis and asks: Is the transfer of control that is associated with foreign ownership appropriate under these circumstances? That is, loosely speaking, are foreign corporations taking over control of domestic enterprises because they have cash and the locals do not? Does the fire sale of domestic firms and their assets represent a burden to the afflicted countries, over and above the cost of the crisis itself?

Even outside of such fire-sale situations, FDI may not necessarily benefit the host country, as demonstrated by Razin, Sadka, and Yuen (1999) and Razin and Sadka (forthcoming). Through the FDI, foreign investors gain crucial inside information about the productivity of the firms under their control. This gives them an informational advantage over “uninformed” domestic savers, whose buying of shares in domestic firms does not entail control. Taking advantage of this superior information, foreign direct investor will tend to retain high-productivity firms under their ownership and control and sell low-productivity firms to the uninformed savers. As with other adverse-selection problems of this kind, this process may lead to overinvestment by foreign direct investors.

Excessive leverage can also limit the benefits of FDI. Typically, the domestic investment undertaken by FDI establishments is heavily leveraged owing to borrowing in the domestic credit market. As a result, the fraction of domestic investment actually financed by foreign savings through the FDI flows may not be as large as it seems (because foreign investors can repatriate funds borrowed in the domestic market), and the size of the gains from FDI may be reduced by the domestic borrowing done by foreign-owned firms.

Beyond the points explained above, there are some other cases in which FDI might not be beneficial to the recipient country for instance, when such investment is geared towards serving domestic markets protected by high tariff or non-tariff barriers. Under these circumstances, FDI may strengthen lobbying efforts to perpetuate the existing misallocation of resources. There could also be a loss of domestic competition arising from foreign acquisitions leading to a consolidation of domestic producers, through either takeover or corporate failures.

#### *14.1.5 Experiences of Selected Countries in Capital Flows*

After the oil shock of 1973, Brazil's reliance on commercial loans to finance both public investment and the more expensive oil led the country to the debt crisis of the early 1980s. Following a trend common to other emerging markets, private capital inflows to Brazil disappeared in the 1980s and increased dramatically after 1991. By 1993, the fall of international interest rates had eased the external debt burden and led to an agreement with creditor banks that were concluded in April 1994 with the exchange of instruments that covered over \$50 billion in debt stocks and arrears.

Since 1992, net foreign capital flows to Brazil have been sufficient to finance small current account deficits while contributing to an increase in foreign reserves (Cardoso, 1997). During this period the capital consisted primarily of short-term resources tied to portfolio investments and other short-term investments. In 1995, for instance, net capital flows amounted to more than US \$40.2 billion, of which US \$20 billion was short-run capital: US \$2.3 billion was equity and special investment funds, and approximately \$18 billion consisted of short-run capital not classified under a specific category.

In Chile, strong and well designed prudential regulations complement capital account restrictions in protecting the financial system from capital flow swings. Banks cannot lend domestically in foreign exchange, with the exception of the foreign trade-related credits. Moreover, there is a limit on the open foreign exchange position set at 20 per cent of banks' capital and reserves, and there are other limitations on maturity mismatches (Eyzaguire and Lefort, 1998). Some observers have argued that the combination of these prudential measures and capital account restrictions has accomplished two objectives. First, it has limited the foreign exchange exposure of both bank and non-bank entities. Second, in the event of sudden capital outflows, the limitation on maturity mismatches would allow the central bank to defend the exchange rate parity by raising the interest rate, without damaging banks' profitability.

Financial liberalization in Kenya is a recent development and international financial liberalization is even more recent. Offshore borrowing by domestic residents has been permitted only since early 1994, and portfolio capital inflows from abroad were restricted until January 1995 while supporting structural and institutional reforms have yet to be fully implemented. Many

banks remain publically owned and competition among them is limited. Although it is too early to evaluate the success of liberalization of capital account in Kenya, the lack of accompanying institutional and structural reforms suggest that financial sector reforms will provide only modest benefits to the overall Kenyan development strategy.

Finally, almost all the countries that suffered financial turmoil in recent years had one thing in common: large ratios of short-term foreign debt to international reserves. In Mexico, in 1995, Russia in 1998, and Brazil in 1999, government owed the bulk of the debts. In Indonesia, the Republic of Korea, and Thailand in 1997 private banks and firms owed most of the debt. But in all cases the combination of large short-term liabilities and scarce internationally liquid assets made these countries extremely vulnerable to crises of confidence and reversals of capital flows. For instance, the capital account reversal in East Asia caused a collapse in asset prices and exchange rates in that region.

#### ***14.2 Legal Framework for Capital Flows in Nigeria***

Nigeria operated an exchange control regime, which gave way to deregulation of the foreign exchange market in the wake of the Structural Adjustment programme adopted in 1986. Since then, other legislations such as Foreign Currency (Domiciliary Account) Act, the Second-Tier Foreign Exchange Market Act governed capital flows management. However, with the enactment of the Foreign Exchange (monitoring and Miscellaneous Provision) Act 1995 all previous legislations were repealed. The FEM Act sought to make Nigeria attractive for inflow of foreign investment. It established an Autonomous Foreign Exchange Market (AFEM). Some of its salient provisions include:

- i. Non-disclosure of sources of imported foreign currency except as may be required under any enactment or law (e.g. Money Laundering Act).
- ii. Transactions at mutually agreed rates between the parties involved.
- iii. Eligible transactions should be supported by appropriate documentation.
- iv. Investment in any enterprise or security in foreign currency permissible.
- v. Authorized dealers must issue certificate of capital importation within 24 hours and advise the CBN within 48 hours thereafter.
- vi. Guaranteed unconditional transferability of foreign currency invested in freely convertible currency in the form of:
  - a) Dividends or profits (net of taxes) attributable to the investment;
  - b) Payments in respect of loan servicing where foreign loan had been obtained; and
  - c) Remittance of proceeds (net of all taxes) and other obligations in the event of sale or liquidation of the enterprise or any interest attributable to the investment.

The FEM Act is largely foreign investor-friendly. It is further complemented by the Nigerian Investment Promotion Commission (NIPC) Act, 1995, whose primary mandate was to encourage, promote and coordinate investment in the Nigerian economy. In particular, NIPC was expected to initiate and support measures, which shall enhance the investment climate in Nigeria for both Nigerians and non-Nigerian investors.

An objective appraisal will suggest that the legal provisions are largely adequate if faithfully implemented by all stakeholders. However, concerns have been expressed with regard to inadequate infrastructural facilities such as power, water supply, motorable roads as well as insecurity of life and property as inhibiting factors in attracting capital flows.

### ***14.3 Developments in Respect of Capital Flows in Nigeria***

Like in other LDC's the desire to accelerate the pace of economic growth and development in Nigeria necessitated the quest for external capital flow to complement the variable domestic capital. By 1950s, industrial nations and multilateral agencies also started extending official assistance to Nigeria.

In recognition of its importance and role in the nation's economic growth process, the government has over the years put in place series of policies and incentives to attract external capital into the country. For instance, the government expressed its readiness in the 1997 budget, to enter into investment protection agreements with foreign governments or private organizations wishing to invest in Nigeria, as well as discuss additional incentives with prospective investors. In that regard, the government established the Nigerian Investment Promotion Commission, as a one-stop agency that would facilitate the inflow of FDI into the country. The industrial Development Coordination Committee (IDCC) was established in 1998 for the purpose of fostering a conducive regulatory environment and serve as the first port of call to potential investor. The Nigerian Investment Promotion Act No. 16 of 1995 reflected the new enhanced liberal foreign investment policy of government. There were also tax related incentive measures such as: pioneer status; tax relief for research and development, which provides for a graduated amount of tax-allowances to be deducted



from profit; company income tax, which has been amended to encourage potential and existing investors; tax-free dividends as well as tax relief for investments in economically disadvantaged local government areas (Salako & Adebuseyi, 2001).

The Debt Conversion Programme (DCP) was also introduced as a major vehicle for the inflow of foreign investment. The Privatization and Commercialization Programme through which government disengaged from activities that could be effectively undertaken by private sector was among others meant to encourage the inflow of foreign investment. Similarly, the establishment of export processing zones was aimed at attracting more foreign investments through provision of infrastructural facilities and elimination of bureaucratic bottlenecks. The repeal of the Nigerian Enterprises Promotion Decree (NEPD) of 1972 and the Exchange Control Act of 1962 were aimed at making the investment climate more conducive for foreign investors.

The recent debt relief by the Paris Club was a major development in the management of the country's capital flows. With that development, the country should be able to free itself from the huge debt burden that had hitherto impacted negatively on the country's credit rating, slowed down the rate of growth and development as a result of huge resources devoted to debt servicing, among others.

However, these measures are observed not to have yielded the desired results in terms of attracting FDI inflow, in particular. For instance, aggregate FDI inflow into Nigeria through existing foreign/jointly owned companies during the 1970's averaged US\$562.3 million yearly in nominal terms (Salako &

Adebusuyi, 2000). As a proportion of the Gross Domestic product (GDP), it accounted for 3.6% during the period. Before the introduction of the Structural Adjustment Programme (SAP) in 1986, total foreign investment inflow for 1980s averaged US\$178.2 million annually and represented 4.3% of GDP. During the period 1987-1990 average annual foreign investment inflow rose to US\$183.6 million, representing 3.0% of GDP, while the average inflow was US\$15,402.5 million or 1.4% of GDP during 1991-1998 (Salako & Adebusuyi, 2001). Specifically, Nigeria has not benefited significantly from this vital resource during the last two decades in spite of its high potential for the attraction of foreign investments because some aspects of its investment policies have not been generally investor-friendly.

#### ***14.4 Regulatory Institution and Capital Flow Management***

In order to appreciate the role of the regulatory institutions in the management of capital flows in Nigeria, it is pertinent to identify the relevant regulatory institutions involved in the issues of capital flows, their broad objectives in relation to capital flows, the associated risks posed by capital flows and the role of the institutions in managing such risks. In view of the fact that capital flows involve cross – border transactions and are carried out mainly through the financial system, particularly, the banking system, the main regulatory institutions in the case of Nigeria will include the Federal Ministry of Finance, the National Planning Commission, the Nigeria Customs Service, the CBN, SEC, FIRS and the Debt Management Office as well as the law enforcement agents such as the Nigeria Police and the Economic and Financial Crimes Commission (EFCC) among others. These regulatory institutions would aim at achieving the following objectives in relation to capital flows:

- a. Attain optimal level of capital flow that will ensure the achievement of the desired investment level with a view to accelerating the pace of economic growth and development;
- b. Ensure the safety, soundness and stability of the nation's financial system;
- c. Ensure price stability, that is, ensure the stability of general prices of goods and services, exchange as well as interest rates in the domestic economy;
- d. Ensure the protection of investors; and
- e. Minimize the incidence of financial crimes associated with capital flows.

Having identified the regulatory institution and their broad objectives in relation to capital flow, the next logical step is to highlight inhibiting factors (both direct and indirect) against capital flows and which could threaten the achievement of the regulatory objectives. Some of these factors include:

- i. Money Laundering;
- ii. Weak corporate governance in banks;
- iii. Malpractices in Foreign Exchange operations;
- iv. Over-invoicing or under-invoicing of imports;
- v. Overheating of the economy; and
- vi. Financial system instability

In order to promote capital flows, the regulatory institutions should evolve appropriate means of monitoring and verifying the genuineness of capital flows. The role of the institutions in that regard will involve the adoption of the following tools:

#### *14.4.1 Adoption of Sound Monetary Policy*

Where the net capital inflow into a country exceeds the absorptive capacity of the economy, the monetary authorities should adopt appropriate monetary

policies to sterilize the excess funds in order to forestall overheating of the economy, which directly threatens the attainment of price stability. The use of open market operation, and reserve requirement become instruments of monetary policy to manage such excessive net inflow.

#### *14.4.2 Effective Supervision*

All the relevant regulatory institutions, particularly the CBN and the NDIC should strengthen their supervisory capability by ensuring strict compliance with the applicable regulations on capital flows. In particular, restrictions could be placed on the quantum of short-term capital as this is highly volatile and could threaten stability of the banking system. A good number of large banks in the East Asian countries were driven to the brink of insolvency in the 90s as a result of large volume of inflow of short-term capital, which turned out to be highly volatile. Besides, where banks engage in cross border transactions, the regulatory institutions should ensure that the capital base of such institutions is adequate to support the additional risks being carried by such financial institutions. In other words, the regulatory institutions should enforce sound capital requirements. This is in addition to the fact that banks should be compelled to put in place appropriate risk management systems in order to align their regulatory capital more closely to their economic need for capital. The ongoing strengthening of risk management capability of banks through the issuance of guidelines by the CBN for the development of risk management frameworks in banks is a step in the right direction.

Given the critical role of banks in the management of capital flows certain measures were adopted since the late 1990s to promote optimal capital flows in the financial system. Such measures included:

- establishment of open foreign exchange positions for each bank;
- mandatory issuance of certificate of capital importation within 24 hours;
- Approval of money transfer products such as Western Union, Money Gram, et cetera.
- uninhibited remittance of dividends;
- access to foreign currency loans from multilateral institutions like IFC, ADB, Afrexim Bank, US Exim Bank for on – lending;
- Utilization of unconfirmed letters of credits for industrial raw materials.

In spite of the afore-mentioned measures, foreign exchange leakages through the parallel foreign exchange market constitute a major challenge to the effective management of capital flows. Combating the unwholesome parallel market foreign exchange activities requires close collaboration between the bank regulators and the law-enforcement agencies.

#### *14.4.3 Strengthening of the Financial Superstructure*

A healthy domestic banking system is a pre-requisite for ensuring an optimal capital flow in any economy as it improves a country's attractiveness to foreign investors. The Nigerian economy, like many other developing countries, prior to the on-going banking reform programme, had many weak banks and a relatively underdeveloped financial system. The banks had small capital base. The banking system was also prone to carrying excessive credit risks by having large proportions of non-performing loans and advances. As a consequence it would not take more than a marginal shift of funds in the massive and fluid international markets to overwhelm the absorption capacity of these banks. In fact, a handful of individual private institutions can also recall the Asian crisis when as the funds flowed in the

prospect of healthy expansion soon became a bubble. Something triggered an outflow, lenders ran to the door, and a financial crisis resulted.

The on-going banking sector reform programme which aims at strengthening Nigerian banks to more meaningfully protect depositors, play developmental roles in the nation's economy, and become a competent and active player in the Africa regional and global financial system will enhance the capacity of banks to absorb shocks that cross-border transactions could cause. The banking sector reforms have occasioned the increase in the required capital base of banks to N 25 billion through consolidation. The reform will among other things, promote soundness, stability, and enhance the efficiency of the institutions. A stable, sound and efficient banking system will, overtime, guarantee higher returns to shareholders or portfolio investors.

#### *14.4.4 Strengthening Corporate Governance Practices*

Responsive corporate governance remains a critical success factor for the viability and survival of banking institutions. Many banks in the country are yet to imbibe the cannons of good corporate governance. The apparent lack of transparency and accountability on the part of some operators may make tracking of capital flow a lot difficult thereby making its management a herculean task.

Given the foregoing, the regulatory authorities should review the existing code of conduct for Directors of licensed banks to include highest standard of ethical conduct and behaviour and create a conducive environment for whistle blowing. In this regard, the whistle-blowing legislation has to be pursued with vigour. Guidelines to monitor conflict or likelihood of conflict of interest should be issued in collaboration with other stakeholders. A zero

tolerance for unethical behaviours and breaches of rules and regulations must be strictly enforced. Generally, sanctions should be targeted at the directors and officers rather than the institutions.

#### *14.4.5 Effective Co-ordination of External Debts.*

Experience has shown that the economy became neck-deep in external debt problems by the lack of effective co-ordination by successive administrations in the country. As a result, many external debts were contracted for projects whose feasibility studies were suspect and hence many were not available such that the determination of the exact quantum of external debts of the country became a debatable issue. This made management of capital flows from this source difficult. The present administration, since inception has given due recognition to this problem and has taken some pragmatic steps at addressing the issues. One of such efforts was the creation of the Debt Management Office. The Office was charged specifically with the Management of all public debts, including the external debts. Recently, the Federal Government, through the activities of the Hon. Minister of Finance and the Debt Management Office was able to secure a major debt relief for the country. The establishment of DMO will guarantee effective co-ordination of this source of capital flows in the country.

#### *14.4.6 Thorough Inspection of Imported Materials*

One of the means through which many developing countries, including Nigeria, experienced capital flight is over invoicing. This requires that the Nigeria Custom Service should address this challenge through thorough inspection of imported materials so as to determine the actual value of what

is imported. This requires capacity building in the form of skill enhancement and acquisition of necessary infrastructures. It also requires close collaboration between our custom officials and their counterparts in the countries of origin of the imported items.

#### *14.4.7 Strict Enforcement of Laws*

The law enforcement officers are constantly being challenged by the frequent incidences of threat to life and property, perpetration of financial crimes such as money laundering, outright fraud and corruption. Every investor, local or foreign, requires conducive socio-political environment where there is absence of bribery and corruption, effective enforcement of property right, and security of life and property, among others. Nigeria is generally believed not to have a good record on these variables and this has accounted for her relative unattractiveness to foreign investors, donors and creditors. Using the frequency of corrupt payments, the value of bribes, and the resultant obstacles to business, Transparency International has consistently ranked the country as one of the most corrupt countries in the world. Corruption tends to raise transaction costs, increase uncertainty and instability. Directly related to this is the problem of advance fee fraud for which Nigerians have become notorious. Threats to lives and property have become a common phenomenon through the activities of armed robbers and ethnic militia. These vices reinforce uncertainty, instability and increase risk thereby adding to the risk of investing in Nigeria relative to other countries. There is therefore the need for our law enforcement agencies such as the Nigeria Police and the Economic and Financial Crimes Commission to strictly enforce the relevant laws in order to reverse the negative image problem.

It is instructive to note that the present administration has never hidden its determination to stamp out from our national life, corruption, nepotism and



other practices that compromise transparency, accountability, and probity. The establishments of the Independent Corrupt Practices Commission (ICPC) in 2000 and the Economic and Financial Crimes Commission (EFCC) in 2002 are notable efforts geared towards eradicating corruption, money laundering and other related crimes. So far, these Commissions have addressed cases involving highly placed individuals in society. At the moment, the international community is beginning to acknowledge the seriousness of government in this regard, and hopefully, it will assist in attaining the optimal level of capital flow. These efforts should therefore be sustained.

#### ***14.5 Conclusion***

An attempt has been made in this chapter to highlight the role of the relevant regulatory institutions in the management of capital flows in Nigeria. The chapter has described capital flows to consist of foreign direct investment, portfolio equity and debt flows, commercial lending and official flows. The paper also identifies the concerned regulatory institutions to include the Federal Ministry of Finance, the Nigeria Customs Service, CBN, NDIC and the Debt Management Office as well as the law enforcement agents such as the Nigeria Police and the Economic and Financial Crimes Commission (EFCC). While capital flows in any country has its obvious merits, there is the need to ensure their effective management in order to minimize the associated risks by such flows to the regulatory objectives. These objectives have been identified in the chapter to include the attainment of optimal level of capital flow that will ensure the achievement of the desired investment level with a view to accelerating the pace of economic growth and development; ensuring the safety, soundness and stability of

the nation's financial system; ensuring price stability in the domestic economy; ensuring the protection of investors; and minimizing incidence of financial crimes associated with capital flows. The paper concludes with the specific roles of the regulatory institutions in the management of capital flows in Nigeria. Some of these roles include effective supervision, adoption of sound monetary policies, strengthening the financial superstructure, strengthening corporate governance practices, strict enforcement of laws and effective co-ordination of external debts. It is our belief that efforts in the direction of measures indicated above will go a long way in ensuring that the economy derives the expected maximum benefits from capital flows.

# Chapter 15

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## THE GLOBAL FINANCIAL CRISIS: LESSONS FOR DEPOSIT INSURANCE SYSTEMS (DIS) IN DEVELOPING COUNTRIES<sup>1</sup>

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### *15.0 Introduction*

The financial crisis of the sub-prime mortgage market in the United States of America (U.S), which started manifesting itself in 2007, had engulfed the entire global financial system. From what appeared to be a crisis that could be contained by the American monetary authorities, the crisis went wild while its contagion effects spread into other countries/regions of the world. The crisis started when millions of homeowners in the US who had taken mortgages started defaulting on their loan obligations in what later became the sub-prime mortgage crisis.

The impact of the financial crisis rippled across the globe, prompting concerns and eliciting responses from various national authorities. As the

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crisis deepened, governments in many nations had to intervene to save their affected financial systems and in some cases took over previously public liability companies. In developing countries, because of the interconnectedness of the global financial system, various governments and their respective citizens became apprehensive about the effects of the crisis on their economies.

The advent of the crisis also brought to the fore the importance and relevance of deposit insurance system (DIS) as many jurisdictions with explicit DIS revised some of the features of their systems with a view to stemming panic and restoring confidence in their respective financial systems. Worldwide, depositor protection has become an important feature of financial safety-net arrangements put in place by various countries to minimize the occurrence of financial system instability or reduce its impact whenever it occurs. Although there are several options available to all nations in their desire to protect the interest of the depositors of deposit-taking financial institutions in their domains, deposit insurance of the explicit type stands out as the preferred alternative. It is defined as a financial guarantee to protect depositors in the event of bank failure and also to offer a measure of safety for the banking system (NDIC, 1997).

This chapter examines the global financial crisis, enumerates some of its impact on various economies, including those of the developing countries, highlights major responses to the crisis, particularly those relating to deposit insurance, by some nations and draws some lessons for DIS in developing countries.

### ***15.1 Nature, Causes and Impact of the Crisis***

The root of the global crisis which started in the US began with the collapse of the American mortgage market when for several reasons the value of properties went down drastically, leading to inability to refinance individual home mortgage because the banks were reluctant to lend. Banks that had a lot of money tied up in loans to house owners who were no longer able to pay went bankrupt or near bankrupt, with that came the credit crunch. Banks and other lending institutions were no longer willing to lend. Some of the mortgage loans were sold by the banks to two giant banking institutions, namely Freddie Mac and Fanny Mae, which served as holding financial institutions for mortgage loans. The problem of the sector led to the collapse of the two giant financial institutions, which the American government reluctantly took over. Even after that, the problem persisted. The crisis manifested itself mainly in the form of banking crisis, currency crisis and stock market crashes.

There were diverse opinions on the causes of the crisis. Many had blamed the crisis on speculation based on false assumption of an unending increase in housing prices occasioned by long period of easy monetary policy. Other causes were identified to include greed, outright fraud, lax oversight/regulatory regimes and uncoordinated and late interventions by governments. According to Zingales (2008), the roots of the crisis were sown during the real estate boom. A prolonged period of real estate increases and the boom of securitization relaxed lending standards.

During the real estate boom, delinquency rates dropped due to sustained real estate price increase. During boom years, mortgage brokers, enticed by the lure of big commissions, talked buyers with poor credit rating into

accepting housing mortgages with little or no down payment and without credit checks. Also, the availability of innovative mortgage options, allowed buyers to purchase houses for which they could not sustain the mortgage payments at higher prices. The quality of these mortgages were neither adequately checked by the regulators nor the market.

Also, the massive amount of mortgage securities issuance by a limited number of players changed the fundamental nature of the relationship between credit rating agencies and the investment banks issuing these securities. As a result, instead of submitting an issue to the rating agency's judgment, investment banks shopped around for the best ratings and even received handbooks on how to produce the riskiest security that qualified for best rating (Scorese, 2008).

The pooling of mortgages, while beneficial for diversification purposes, became a curse as the downturn worsened. The lack of transparency in the issuing process made it difficult to determine who owned what. Furthermore, the complexity of the repackaged mortgages was such that small differences in the assumed rate of default could cause the value of some tranches to fluctuate widely. With illiquidity as well as lack of adequate information on the quality and hence the value of banks' assets, banks stopped lending and even recalled some of their loans.

The impact of the crisis and its severity varied among nations depending on the degree of interconnectedness of nations. For economies whose financial systems are dominated by internationally active banks, the impact was swift, direct and severe. Countries in this category include the USA, United Kingdom, Japan, Western European countries and some emerging economies like Taiwan and Malaysia. In developing economies with a few or no

internationally active banks, the effect has been less swift but nonetheless, potentially severe unless concerted efforts are made to ameliorate the adverse impact of the crisis on such economies. Most developing nations, particularly in Africa, Latin America and Asia fall into this category.

For the first category of countries (i.e. advanced and emerging economies with internationally active banks), the impact included, among others, declining real output growth; weakened financial systems, loss of jobs; loss of confidence in financial markets, leading to inability to carry out their intermediation role in their respective economies; and declining stock market prices. For instance in the USA, the crisis led to bankruptcy of major banks while unemployment continued to rise. The stock market in the USA fell by a cumulative 44.7% between December 2007 and December 2008. In Europe, housing prices crashed while manufacturing activities also declined. There was stock market instability across Europe as stock market declined by about 41.7% in the UK, 42.2% in France and 52.9% in Germany between end of 2007 and 2008. In Taiwan, the crisis caused a run from private banks to the state-run Bank of Taiwan. Also, Taiwan stock market suffered a slump with banks being the main victim of the stock market crash. The situation was made worse by the pull-out of foreign investment funds. In Japan, vital export industries were hard hit by the credit crunch, as export declined by 1.7% in 2008 while export to the US declined by 15.4% and to Europe by 11.2% during the same period. The benchmark Nikkei Index lost a cumulative 63.3% between December 2007 and end of 2008. In South Korea, the crisis raised the cost of borrowing and reduced access to funds as global lending dried up. The stock market experienced significant declines with the Kospi Index falling by about 52.8% between December 2007 and December, 2008. There was a pervasive loss of confidence in the banking and capital market in the country as a result of the crisis.

Being part of the global economy and given the problems in the economies of some of their major trading partners, the economies in the second category, (i.e. developing economies) could not have been insulated from the effects of the global financial crisis that rocked the US and other advanced economies. For these economies, the impact of the crisis, which has not abated, include crash in commodity (oil, tradable agricultural and mining products) prices; contraction of revenue accruing to governments since most of those commodities were the major revenue earners to their respective governments; de-accumulation of foreign reserves with attendant pressure on exchange rates; and limited foreign trade finances for banks as credit lines either dry up or re-priced at much higher rates. Others include capital market downturn arising from divestment by foreign investors with attendant adverse feedback effects on the balance sheet of banks; and contraction in home remittances by citizens in diaspora, among others. In Nigeria for example, the price of crude oil, the highest foreign exchange and revenue earner for the country, crashed in the international market. Oil prices fell by more than 66% from \$147 per barrel peak in July, 2008 to below \$45 per barrel by the end of the same year in the international market. That led to a drastic contraction in revenue accruing to the country with its attendant adverse effects on government fiscal operations. Similarly, the exchange rate of the Naira had witnessed consistent depreciation since the adverse effect of the crisis on the price of crude oil became manifest in the country. For instance, between September 2008 and end of January 2009, the official exchange rate of the Naira had depreciated by about 42.24% while there was equally a slump in the capital market as the market capitalization crashed by about 67.5% between February 2008 and corresponding month of 2009. In South Africa, there was a declining growth rate while the Rand depreciated by about 41.43% within a year.



### ***15.2 Reactions to the Crisis from Some Jurisdictions***

In response to the global financial crisis, governments and authorities in various nations took various actions to stabilize and save financial institutions in their economies. While some of the actions taken to bolster liquidity and restore market confidence in some jurisdictions included one or more of the following – state guarantee of wholesale debt obligations, recapitalization of banks/partial nationalisation; asset purchases; and central bank liquidity schemes, the focus in this chapter will be on enhanced depositor protection.

One of the immediate responses of governments in some of the industrialized nations to the ensuing financial crisis was to increase their respective DIS coverage limits as a confidence boosting measure. In an effort to address the situation in the United States of America, the Congress of the US, in addition to other measures, increased the deposit insurance coverage from \$100,000.00 to \$250,000.00 (i.e. 150%) up to the end of 2009. In addition, the Federal Deposit Insurance Corporation (FDIC) announced a Temporary Liquidity Guarantee Programme, which within the time set would increase the scope of coverage. The programme, expected to have the potential for strengthening confidence, would involve the following:

- a. Full coverage for some categories of unsecured debt (such as promissory notes issued by banks, thrifts, and certain holding companies, newly issued on or before June 30, 2009, in the event the issuing institution fails or its holding company files for bankruptcy. The coverage would be limited to June 30, 2012, even if its maturity exceeds that date; and

- b. Full coverage for non-interest bearing deposit transaction accounts (such as pay-roll accounts), regardless of dollar amount

The funding of the programme was to be sourced through special fees charged the participating institutions only. Fees of 75-basis point would be charged against the new debt issues while 10-basis point would be charged against the non-interest bearing deposit transaction accounts.

All FDIC-insured institutions were to be covered under the programme for the first 30 days without incurring any cost. After the initial period, however, institutions not wishing to participate must opt out or be assessed for future participation. If an institution should decide to opt out, the guarantees would be good only for the first 30 days.

In the UK, the deposit insurance coverage level was also increased to £50,000.00 from a maximum of £35,000.00. In addition, co-insurance was abolished. In a swift reaction to the crisis, the EU increased its deposit insurance coverage from €20,000.00 to at least €50,000.00 in the first instance and ultimately to €100,000.00.

In Iceland, given the likelihood of failure of its financial system as a result of the crisis, the Iceland government had to declare a blanket guarantee as a way of restoring confidence in the system.

The Governments of Republic of Ireland and Greece, in reaction to the crisis also declared blanket coverage for 2 years, an indication that all depositors in those countries were fully covered in the event of bank failure.

Furthermore, Denmark, Austria, Portugal, Singapore, Australia, Germany, Taiwan and Malaysia, among other countries, introduced blanket guarantee up to 2009 to restore public confidence.

Beyond the increase in coverage level and in some places scope, there were intensive public awareness campaigns about DIS in various countries and particularly on higher scope and levels of coverage. That became imperative in order to assure depositors of the safety of their hard-earned savings and facilitate the effectiveness of the measures.

In order to ameliorate the adverse effects of the crisis on the Nigerian financial system and the economy at large, the authorities took some measures. For example, the Central Bank of Nigeria (CBN) in response to the developments in the global financial system, had introduced the following measures aimed at boosting liquidity in the nation's financial system:

- a. Reduction in the monetary policy rate from 10.25 per cent to 9.75 per cent;
- b. Reduction in the Liquidity Ratio from 40 per cent to 30 per cent;
- c. Reduction in the Cash Reserve Ratio from 4 per cent to 2 per cent; and
- d. Allowing Banks to buy back their securities
- e. Lending window extended to 365 days as against overnight lending and eligible instruments expanded to include Bankers Acceptances (BAs), Certificate of Deposits (CDs) and Commercial Papers (CPs).

These measures taken were projected to inject  $\times 1.05$  trillion into the economy thereby enhancing the liquidity situation of banks in the system.

In a bid to reduce the impact of the slide in the capital market on the balance sheets of banks, the CBN granted reprieve to banks with large portfolio of margin facilities (which stood at ₦336 billion or US\$2.32 billion) by allowing them to restructure such facilities for a longer period. There was also the establishment of capital market stabilization fund, which would serve as intervention funds.

### ***15.3 Lessons for the DIS in Developing Countries***

The developments in the global financial system particularly with regard to the nature and causes of the crisis as well as the various measures taken to douse the ensuing tension and anxiety in some jurisdictions in the developed economies ushered in a number of lessons for DIS in developing countries. Some of the lessons included:

#### ***15.3.1 Appreciation of the Role of DIS***

The relevance and importance of the DIS as a critical component of the financial system safety-net came out sharply as many governments made efforts to resolve the global financial crisis. Unlike what obtains in developed and most emerging economies that have embraced the institutionalization of DIS, most developing countries are yet to appreciate the role and place of the DIS in their respective financial systems. In fact, out of the 100 DIS in operation as at the end of 2008, only about one-third were in the developing economies. In addition to the twin main DIS public policy objectives of protecting small depositors and contributing to financial system stability, DIS also offers a mechanism for resolving problem deposit-taking financial institutions and also prevents outflow of savings from the banking system in periods of crisis, among others. In developing countries, one of the identified factors constraining development is inadequate financial

resources in the form of savings to achieve the desired level of investment that will propel and support growth on a sustainable basis.

A prolonged outflow of savings from the banking system arising from impaired confidence, as opined by Sabourin (2006), would severely undermine the capacity of the system from performing its intermediation role. In addition, for smaller banks, which are mostly feasible in developing countries, prolonged liquidity shortages, precipitated by panic withdrawals among other factors, could have a destabilizing effect on the overall banking system. The principal underlying reason for retaining and stabilizing savings within the banking system is to protect and maintain the stability of the financial system. A stable financial system, engendered by confidence-induced DIS, enables banks to carry out their role efficiently as intermediaries of funds. Such confidence is critical to the financial and macroeconomic development, which all economies in general and the developing ones in particular, are yearning to achieve.

In order to retain deposits within the banking system at the on-set of the crisis, many countries had to institute blanket guarantee for a temporary period. Even where blanket coverage had been introduced, it was only a temporary measure to restore public confidence and its transition to limited coverage could be made smooth with the existence of their DI agencies. The importance and efficacy of instituting blanket coverage in reducing runs and ensuring seamless transitioning to limited coverage via a DI agency, had been demonstrated in Japan and Korea which instituted blanket coverage during the 1998 East Asian financial crisis. The blanket guarantee had long been removed by the two countries and replaced with limited coverage without adverse effects on public confidence through their respective DI agencies.

It is instructive at this stage to note that the introduction of blanket guarantee at the instance of government comes with the challenge of agency problem as the decision to introduce the measure is usually taken sometimes, without consulting the DI agency. The DI agency is nevertheless expected to ensure a smooth transition. Ensuring a seamless transition therefore requires intensive public education and enlightenment with a clear understanding of public expectation.

### *15.3.2 Emphasis of DIS Public Policy Objective (PPO)*

Another lesson that can be learned from the various jurisdictions' responses to the crisis is that the emphasis of DIS public policy objective (PPO) is not static as it depends on macro-economic and financial environment of the jurisdiction involved. In a situation of macro-economic and financial system stability, the PPO will emphasize the protection of small depositors. However, during financial crisis, public confidence in the banking system is usually impaired. Under that situation, the emphasis of the public policy objective of the DIS will logically be to ensure the stability of the financial system.

One of the potent instruments at the disposal of a DIS as a major component of the safety-net is the coverage level and scope. In such a situation, high or relatively generous coverage limits (without compromising the need to take into account the incentives for wealthy and sophisticated depositors to exert market discipline) will be the attractive option. This is consistent with one of the IADI Guidance Points (2002), which indicates that the setting and/or adjustment of coverage limit should synchronize with the public policy objectives of the DIS and be capable of maintaining depositors' confidence with a view to enhancing macroeconomic and financial stability in the system, among others.

Even when the formal coverage limits appear adequate for the objective of protecting small depositors, it might become inadequate when the emphasis of the public policy objective becomes the stability of the financial system. In that regard, a more generous coverage limits (or blanket guarantee by government) that could boost public confidence and ensure stability in the system would be recommended. This indeed was one of the approaches adopted by a number of countries with DIS such as the USA, UK, EU Countries, Ireland, Greece Taiwan, Germany, Denmark, Austria, Portugal, Singapore and Australia, in dealing with the financial crisis they faced.

The lesson for the DIS in developing countries from this was that notwithstanding the adequacy of the existing design features, particularly DIS coverage, when financial crisis deepens to the extent of threatening the stability of the system, coverage scope and level should be more generous in order to restore confidence as well as ensure stability of the system. This is also in conformity with the argument that the public policy objectives of DIS should depend on the state of the financial system at any point in time. That is, when there is relative stability of the economy and the financial system, the emphasis is on protecting small depositors and in that regard, the scope and level of deposit insurance coverage may be less generous. However, when there is instability of the financial system and there is crisis of confidence, the focus is on ensuring financial system stability and engendering public confidence. In that regard, both the scope and level of deposit insurance coverage would be more generous in order to restore confidence.

### *15.3.3 The Need for Effective Public Awareness*

The place of effective public awareness about coverage limits/scope, other design features of the DIS and the robustness of the entire financial safety-net arrangement during financial crisis cannot be over-emphasized. As a result of the global financial crisis, investors and lenders in some of the industrialized nations lost confidence in their financial systems. This was why those countries focused attention on enhanced communication about the benefits of the DIS. In particular, the Authorities in USA, UK, EU and some Asian countries had intensified efforts in their public awareness activities about the capability of their respective financial safety-net arrangements to effectively protect financial system and ultimately, the depositors.

This is a lesson the DIS in developing countries could learn by intensifying efforts in their public awareness campaigns. Efforts of the DIS at educating the public, particularly depositors, about the benefits and limitation of DIS should be intensified and sustained. During period of crisis, there should be enhanced public awareness about the robustness of the financial safety-net arrangement in place in general, and that of the DIS in particular to resolve the crisis in an orderly manner.

### *15.3.4 The Need to Strengthen the Regulatory/Supervisory Apparatus*

As evidently clear in the global financial crisis, financial innovation without effective regulation does not work well. In the new world of more sophisticated financial products and markets, dangers lurk in hidden or minute places if adequate precaution is not taken. The global financial crisis especially as it affected the US was an indication that a set of rigid rules could allow resourceful financial institutions to mask riskiness in their portfolio or shift things around to make standard risk metrics appear better



than they really were. The failure of some banks in the USA and UK points to the fact that regulators/supervisors must always be on their toes as reliance on self-regulation had proved to be ineffective in the emerging complex financial institutions. In fact, the crisis faced by the Northern Rock questioned the effectiveness of the activities of the Financial Services Authority (FSA). Also, the US experience was a clear manifestation of relaxed regulation/supervision. The lesson for the DIS in developing countries is to ensure the design of adequate regulatory/supervisory framework that will facilitate the effectiveness of their respective deposit insurance systems.

*15.3.5 Need for Close Inter-Agency Cooperation and Collaboration*

The need for a well-coordinated effort by all the relevant authorities, including the central government, to resolve financial crisis of systemic nature, was clearly demonstrated by all the jurisdictions that were hit by the financial crisis. Accordingly, developing countries should take a cue from these jurisdictions to address a situation of financial crisis. In that regard, a formal arrangement that will facilitate close cooperation and collaboration amongst relevant authorities should be encouraged even before the on-set of financial crisis. Such arrangement will ease information sharing amongst the relevant authorities and will facilitate adequate and timely attention when the need arises.

*15.3.6 Encouraging Sound Corporate Governance Practices in Insured Institutions*

The need to continue to encourage insured banks to imbibe sound corporate governance practices was yet another lesson to be learnt from the global financial crisis. The first line of responsibility for soundness and solvency of a bank lie with the directing minds – the institution’s Board of Directors

and its Senior Management. The onus should be placed squarely on them to ensure the safety and soundness of their institutions, through sound risk management, internal controls, and effective public disclosure. The failure of Indy Mac Bank in the US, Northern Rock in the UK, and some other institutions were due to complete disregard to corporate governance issues despite their advanced disclosure regimes.

#### ***15.4 Conclusion***

In this chapter, we have examined the causes of the on-going global financial crisis and highlighted major responses to the crisis, particularly those relating to deposit insurance, by some nations and drew some lessons for DIS in developing countries. As part of the lessons, the need to appreciate the role and place of DIS as a component of the financial safety-net by developing countries has been clearly brought out. The chapter has also emphasized the need to engage in massive public awareness campaigns on the robustness of the safety-net arrangement in place, particularly the role of the DIS so as to restore public confidence in the nation's financial system at all times in general and in periods of crisis in particular. In addition, the chapter has indicated the importance of amending the DIS design features like coverage as the need arises to reflect changing macroeconomic and financial conditions (or changing emphasis of DIS PPO) so as to ensure the continuous relevance of the DIS put in place. Finally, the importance of sound corporate governance practices in deposit-taking financial institutions as well as instituting a strong regulatory/supervisory apparatus has been emphasized in the chapter in order to ensure the effectiveness of the DIS.

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## ABOUT THE AUTHOR



A graduate of Economics from University of Ibadan, (Nigeria's Premier University), Mr. Ganiyu Adewale Ogunleye had a 25-year central banking career, 18 of which were in banking supervision. He served as Director of Bank Supervision of the Central Bank of Nigeria for 7 years where his responsibilities covered policy formulation, prudential regulation, bank resolution and inter-relationship with other safety-net participants. He became the Managing Director/CEO of the Nigeria Deposit Insurance Corporation in 1999 and served the Corporation in that capacity up to November, 2009 after completing 2 terms of 5 years each.

Over the years, he had served on numerous Boards or Committees constituted to resolve financial sector issues in Nigeria. Some of the Committees included:

- Designing framework for resolution of liquidity crisis in the banking system
- Preparation of Statement of Accounting Standard for Banks
- Developing framework for the establishment of Financial Services Regulation Coordinating Committee
- Chairman of Interim Boards of eight troubled banks pending resolution of their financial distress
- Member of Presidential Committee on Bank Consolidation
- Member of the Steering Committee of Financial System Strategy (FSS 2020) Committee

At the international level, he had served as the Chairman of Committee of Bank Supervisors in West and Central Africa. He was elected to the Executive Council of the International Association of Deposit Insurers (IADI) in 2002 and had served as Chair of the Africa Regional Committee from 2002 up to 2008. He was a member of both Training and Conference Committee as well as Membership and Communications Committee of the Association. In recognition of his contributions to financial system stability in Nigeria, he was awarded national honour in the category of Officer of the Order of the Federal Republic (OFR) in 2002. He was also conferred with fellowship of both the Chartered Institute of Bankers of Nigeria (CIBN) and Business Recovery and Insolvency Practitioners Association of Nigeria (BRIPAN).