

# **REGULATORY CHALLENGES IN A CONSOLIDATED NIGERIAN BANKING SYSTEM –NDIC PERSPECTIVE\***

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## **1.0 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 number of banks and other deposit-taking financial institutions with a simultaneous increase in size and concentration of the remaining 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 consolidation and the implications for the economy, and the banking system and other agents like NDIC.

The resolve 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 for all universal banks to N25 billion in July, 2004. No doubt, the development had in turn prompted a regulatory-induced restructuring in the form of consolidation through Mergers and Acquisitions (M & A). Consolidation of banking institutions aims, among others, at strengthening the

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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 failing, both because of systemic concerns and because of 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.

## **2.0 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 with 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, 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 weaknesses 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.

### **3.0 CONSOLIDATION OF THE NIGERIAN BANKING INDUSTRY**

In general terms, consolidation of banking firms involves either a combination of existing banks, growth among 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. 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 system.

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.

#### **4.0 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 depositors, particularly the small ones, in the event of a bank failure. Bank deposit insurance schemes developed out of the need 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 in a DIS, coverage is usually limited. Also, while deposit insurance premium is paid by the insured institutions, depositors are the direct beneficiaries of the scheme.

The practice 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 operations in March 1989. The scheme was introduced to provide a further layer of protection to depositors and complement the role of 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 an additional framework to serve as a 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 bid 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 bank failures in Nigeria and the lessons of other countries with bank deposit insurance schemes.

The scheme therefore, envisions increasing the competitive efficiency of the banking system as well as reducing the 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 been quite prominent, partly because of the large size of Nigeria and partly because of the enormity of the challenges faced by the Nigerian scheme at 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 responsibilities to guarantee payment to depositors of insured institutions, monitor the health of insured institutions through supervision and serve as 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.

## **5.0 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.

### **5.1 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 in 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 N25 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 deposit insurer. It is hoped that such share acquisitions 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 rationalization process. Common reasons for possible escalation of the risk profile of the merged 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.

## **5.2 Post-Consolidation Challenges**

### **a. Possibility of Bank Failure**

Some banks that could neither be merged nor acquired, (either because of their 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 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 N50,000.00 to N200,000 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 enthronelement 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, the Regulatory Authorities would therefore, continue to encourage the enthronement of 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 banks and investing public that consolidation may create. With consolidation, it is important that the accounting as well as disclosure requirements of emerging 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 of the on-going banking reform programme is an establishment of the 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 the 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.

## **6.0 SUMMARY AND 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 regulatory 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.

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