# BANK DISTRESS AND ITS RESOLUTION OPTIONS [THE NIGERIAN EXPERIENCE]


BY

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1999

## *DECLARATION*

I hereby declare that this project was written by me and it is a record of my own research work. It has not been previously presented in any applications for a higher degree.

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## CERTIFICATION

This thesis entitled "Bank Distress And Its Resolution Options (The Nigerian Experience)", by DIANA OKWUY OKONTA, which meets the regulations governing the award of the degree of Master of Business Administration (MBA) Ahmadu Bello University and is approved for its contribution to knowledge and literary presentation.

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# DEDICATION

To My Son

**CHUKWUEMEKA ANTHONY EKEOPARA JNR.**

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# CERTIFICATION

This is to certify that the research work for this thesis and the subsequent preparation of this thesis by **Diana Okwuy Okonta (G97/BAP/7107)** were carried out under my supervision

**Alhaji Sani Abdullahi**

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# ABSTRACT

This study attempts to examine the problem of distress and the resolution options used in dealing with the problem in the Nigerian banking system.The study identified the causes of distress in the Nigerian banking industry to include Inhibiting Policy environment; capital inadequacy; management problems; ownership structure/pervasive influences among others. It also discovered that the level of distress in the Nigerian banking system kept increasing at an alarming rate despite the efforts made by government to address it. Some of the resolution measures used in dealing with the distress problem include establishment of legal frameworks (CBN decree 24 of 1991, BOFI decree 25 of 1991 and NDIC decree 22 of 1988), moral suasion,imposition of Holding Actions, financial assistance, supervisory intervention, change of management, suspension of banking license and liquidation of distressed banks.The study also found the existing distress framework to be ineffective in addressing the problems of banks because of inadequate resources for failure resolution,ineffectiveness of Holding Actions.

The study therefore concludes that the ineffectiveness of the existing distress resolution framework can be attributed to the inadequacies and lapses inherent in the existing operational framework.

The researcher recommends substantive reforms on bank distress resolution options, which should include: measures that will minimize the undesirable effects of Holding actions; the need to set aside financial resources to handle bank distress; increased supervisory capacity; distribution of failure losses during liquidation and restructuring of other sub-sectors of financial services industry.

# CHAPTER 1

## 1.0 INTRODUCTION

The Nigerian banking system, in recent times especially since the adoption of Structural Adjustment Programme (SAP) in mid 1980s, witnessed crisis of the magnitude compared to the banking failures of the early fifties. The crises could be attributed to the wide ranging reforms introduced in the nation's financial system since 1986. The aims of the reforms was to increase competitions as well as promote more efficient financial intermediation. The financial reforms included among others the licensing of new banks and non-bank financial institutions, introduction of new prudential guidelines for banks, the introduction of Open Market Operations as a tool of monetary management and the freeing of interest rates.

The above efforts to deregulate and liberalize the financial system exposed the financial institutions to increased risks in the face of inflation and balance of payments, difficulties arising from the weakening of oil the market and the depreciation of the naira. The situation was further exacerbated by political instability and policy-induced shocks. The political crises of 1993, for example, led to large -scale withdrawals of deposits from the financial system. Consequently, the initial positive impact of these reforms was off-set by the general poor state of the financial sector which was characterized by liquidity problems and even outright failure. Although the problem of bank failure is not new in Nigeria, the post - 1987 crises has been the most wide-spread and intense in the history of financial system crises in the country.

The difficulties of the financial institutions in coping with the above external forces were reinforced by their internal structural weaknesses such as inadequate capitalization, poor asset quality, bad management and insider abuses, and political interferences. The rapid expansion of the financial system following liberalization resulted in a situation where major management decisions had to be taken by relatively inexperienced staff in a number of institutions . Moreover, the access of newly licensed banks to the lucrative foreign exchange market did not allow them to cultivate appropriate banking traditions for survival. Supervisory weaknesses were conducive to loose banking practices and made it difficult to arrest an accumulation of non-performing loans at an early stage.

Financial distress manifested in a number of ways. In the Nigerian banking system, there was increasing illiquidity in several banks. This first became noticeable in the late 1988 when the CBN decided that the back-log of naira backing for foreign exchange application yet to be approved be moved from the banks to the CBN.Also, later in early 1989, as a result of Federal Government decision to transfer all public sector deposits from commercial and merchant banks as well as other financial institutions to the Central Bank, several banks became illiquid and some of them either suspended deposit withdrawals altogether or placed limits on amounts withdrawable. These created some panic in the banking system.

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## 1.1 BACKGROUND OF THE STUDY

The problem of distress in the Nigerian banking industry and the financial sector generally dates back to 1930s when the first bank failure was reported. Between 1930s and 1959 when the Central Bank of Nigeria (CBN) was established, over 21 bank failures were recorded. However, the degree of intensity and scope of the distress has never been as serious as has been observed since June, 1989, when the government directive to withdraw deposits of government and other public sector institutions from banks to the CBN exposed the weak financial condition of most financial institutions in the country. Since then, the number of distressed banks and the severity of the problem has progressively increased. For example, the number of distressed banks in the system increased from seven (7) banks in 1989 to sixty (60) banks in 1995 and later fall to forty one (41) banks in 1997 in response to the measures put in place by the regulatory authorities to address the problem of distress in the system.

While concerted efforts are being made to address this evil tide, the magnitude and depth of distress in the system kept increasing at an alarming rate. This became an issue of serious concern to the government, the regulatory authorities, the bankers as well as the general public. This is so because the banking sector is not only seen as the nerve centre of any modern economy but also as engine of growth by way of channelling funds from the surplus units to the deficit units of the economy where it is needed. The questions to ask are, why is it that despite the distress resolution options applied by the regulatory authorities, the distress level kept on increasing? Could it be that the distress resolution options applied

were not appropriate for the kind of problems faced by the distressed banks? Answers to these questions will be the central issues this study is out to investigate.

Some of the efforts made by government at addressing the problem of distress in the banking system included the imposition of holding actions, take-over of management of the distressed banks and outright liquidation. The use of liquidation as a last resort saw the liquidation of 31 terminally distressed banks between 1995 and 1998. In addition to this, the CBN in 1997 raised the capital base of the existing merchant and commercial banks from ₦40 million and ₦50 million respectively to a uniform figure of ₦500 million. Impressed by the response of banks on the policy, which as at December 1999, 95% of the banks have not only complied but some even exceeded the ₦500 million minimum, the CBN included in the year 2000 Monetary and Credit Policy Guidelines that all new entrants into the banking system must have a capital base of ₦1 billion to qualify for registration. This is to guard against re-occurrence of capitalization problem suffered by virtually all the distressed banks.

## 1.2 STATEMENT OF THE PROBLEM

The issue of distress in the Nigerian banking system has never been as serious as was witnessed in the recent past. The situation was so bad that the ratio of distressed banks to healthy ones was almost one to one. This impacted negatively not only on the efficiency of the monetary and fiscal policies in the economy.

The refusal by the regulatory/supervisory authorities to expose the identity of the affected banks further worsened the situation as people lost confidence in the entire banking system.

Attempts have been made by the regulatory/supervisory authorities to arrest the situation without any success, instead the number of distressed banks kept increasing. Given this kind of situation, one may be tempted to ask some pertinent questions such as, why is it that despite the distressed resolution options applied by the regulatory authorities, the distress level kept on increasing? Could it be that the distressed resolution options applied were not appropriate for the kind of problems faced by the distressed banks? Answers to these questions will be central issues this study is out to investigate.

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## 1.3 STUDY OBJECTIVES

The objectives of the study are:

1. To critically examine the causes of distress in the Nigerian banking industry.
2. Examine the extent and implications of distress in the Nigerian banking industry.
3. Appraise the efficacy of the distress resolution options put in place by the regulatory authorities in the country.

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## 1.4 SIGNIFICANCE OF THE STUDY

Distress in the Nigerian banking industry was never as full blown as was witnessed in recent times in the country. For example, in 1995, almost half the banks in the system were classified distressed by the regulatory authorities. The fact that the identity of the distressed banks could not be disclosed to the public instilled fear in the minds of the banking public with serious consequences on the confidence enjoyed by the banking system in the country. This impacted on the efficiency of the payment system as well as the effectiveness of monetary policies in the country. In the light of these therefore, any study that seek to investigate the causes and implications of this problem as well as carry out an appraisal of the resolution options applied and which refused to work, will be quite relevant.

## 1.5 STUDY METHODOLOGY

This study will mainly involve the use of secondary data. The data will be sourced from the publications of the Nigeria Deposit Insurance Corporation (NDIC), Central Bank of Nigeria (CBN) and other relevant agencies and institutions. Non parametric techniques such as financial ratios and charts will be used for data analysis.

## 1.6 SCOPE OF THE STUDY

Although the distress in the Nigerian banking industry affected all the participating institutions such as the mainstream banks as well as Community, Peoples and Development banks, this study will only be confined to licensed Commercial and Merchant banks.

## 1.7 STRUCTURE OF THE REPORT

The study will be organized into six chapters. Chapter one will be the introduction. In chapter two, we will examine some related conceptual issues in banking distress such as the nature, causes and implications of bank distress. In chapter three, we will share the experiences of other countries of the world in the area of distress management. Chapter four will give an overview of distress in the Nigerian banking industry. In chapter five we will appraise the current distress resolution framework that are being used in Nigeria. The report will be summarized and concluded in chapter six.

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# CHAPTER 2

## 2.0 CONCEPTUAL ISSUES IN BANK DISTRESS RESOLUTION

### 2.1 Definition Of Bank Distress

Several scholars have attempted in the past to define distress in the financial services industry generally. Benston et al (1986) for instance defined distress as a situation of complete or near-complete loss of shareholders funds. Alashi (1993) saw distress to mean a cessation of independent operation or continuance without the assistance of relevant authorities such as a deposit insurance institution. This therefore means that loss figures as presented in standard financial statements are very sufficient in assessing the degree or severity of distress of a financial institution (Alashi, 1993). Ologun (1994) on the other hand believe that distress exists in an institution that exhibits severe financial, operational and managerial weaknesses. In the views of the regulatory authorities (CBN/NDIC, 1995), distress in the banking industry occurs when a fairly reasonable proportion of banks in the system are unable to meet their obligations to their customers, as well as their owners and the economy. Such inability often results from weaknesses in their financial, operational and managerial conditions which would have rendered them either illiquid and/or insolvent. Under this situation, a sizeable proportion of existing banks would have their liabilities exceeding the market value of their assets which may lead to runs and other portfolio shifts and eventual collapse of some financial firms. The Federal Reserve Bank of San Francisco (1985) described distress as a sharp reduction in the value of financial institutions' assets resulting in apparent or real insolvency of many financial institutions accompanied by some runs and possibly the

collapse of some institutions. Distress in the banking system if left unchecked, can cause severe financial crisis, leading to runs and other portfolio shifts, collapse of several other financial firms, decrease in asset prices and decline in total output (or slowing of economic growth) and balance of payments problems, Sundarajan et al (1991).

## 2.2 Measurement of Bank Distress

Determining whether a bank is solvent is an obstacle of prompt action since financial distress may not be apparent in the first instance. Ordinarily, as long as a bank can meet all of its obligations out of income over the long run, it is considered viable. Measuring such streams of income involves calculating the net present value of expected cash flows. This provides the economic measure of solvency. However, such estimation can be very difficult to undertake and is highly subjective. On the other hand, the reliance on book-value solvency or the market value of the bank as a proxy for net present value is a very imperfect measure of economic solvency because of its arbitrary nature and the possibility that the bank can manipulate the way in which such statistics are presented, Glaessner and Mass (1995).

In assessing the health status of banks, bank supervisors often use an approximation by adjusting the book value using some predetermined rules, established and based on experience and comparative study of other economies' banking systems. Such rules include those based on capital, assets, management, liquidity and earnings. This supplements the generally accepted accounting

principles with specific guidelines for banks. Thus a bank is considered distressed when it is technically insolvent, that is, to say that it's capital adequacy ratio is below the minimum rate of 8% and it is not able to satisfy it's depositors demand for cash withdrawal.

Generally, the classification of a bank is based on a rating system (Sinkey, 1980), West (1985), Ebhodaghe (1993) and Nyong (1994). Under this system, the regulatory/supervisory authorities assess a financial institution's performance in five areas, namely, capital adequacy, asset quality, management competence, earnings strength and self-sustainability in terms of its liquidity position. Based on these parameters, appropriate financial ratios are developed for depicting the condition of the financial institution under consideration.

Using these parameters, an institution's financial condition is assessed against some standard benchmarks like minimum capital adequacy ratio, liquidity ratio, and ratio of non-performing credits to shareholders' funds, among others, to make statements about the health status of the institution. When these ratios deviate adversely from the predetermined critical level by the relevant authorities, the institution is described as exhibiting symptoms of distress. However, the use of such ratios alone may not describe the level of distress.

For instance, in Nigeria, an institution that has not met the minimum capital adequacy ratio of 8 per cent up to March 1999 and 40 per cent from April 1999 to December 1999 and back to 8 per cent from January 2000 to date with the

liquidity ratio of 40 per cent may have manifested some symptoms of distress without providing a good measure of the extent of distress.

In order to make for this shortcoming and derive an effective measure of distress through the establishment of thresholds, attempts have been made at developing a composite measure based on these CAMEL parameters that will enable supervisors determine on a uniform platform, the extent of distress in each of the banks and by extension in the financial system as a whole. Such a composite measure can then be calibrated into a rating grid with desired categorization like sound, weak, distressed, terminally distressed, etc.

This composite measure is simply a weighted average of the CAMEL parameters in which the weighted parameters sum to unity (or 100 per cent). The weights are made to reflect supervisors' opinions on what to emphasize in bank operations and to this extent, the assigned weights are usually arbitrary. But because there is some reasonable degree of agreement on the critical indicators of good and bad banking practices, this arbitrariness is within a narrow range. For example, the proportion of a bank's Total Assets that is income generating (i.e. earning assets) is universally accepted as an indicator of the bank's asset quality. But this can be complemented by an indicator of the proportion of deficient credits in the bank's credit portfolio which is a subset of the earning assets. This particular category of earning assets invariably constitutes the single largest chunk. So the measures of asset quality can be combined in a manner that would reflect this complementarity and be appropriately weighted. Once this is borne in mind, the



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arbitrariness will be narrowed down to reflect predominant peculiarities in the economy. These general considerations have informed the weighting of the CAMEL parameters. The monetary authorities in Nigeria have recently embarked on the development of a rating system for banks. This was initiated jointly by the CBN and the NDIC and a universally accepted rating system provides for classifying banks as shown below, given their composite scores.

**TABLE 2.1**

**CLASSIFICATION OF BANKS BASED ON THE PROPOSED RATING SYSTEM**

| Class | Composite Score (%) | Rating |
|---|---|---|
| A | 86 - 100 | Very Sound |
| B | 71 - 85 | Sound |
| C | 56 - 70 | Satisfactory |
| D | 41 - 55 | Marginal |
| E | 0 - 40 | Unsound |

***Source: NDIC Publications***

Table 2.1 shows the range of composite scores for each rating and if a threshold is agreed upon, it could enable the authorities determine those banks that are distressed and whether marginally or terminally. Details of the weights and the financial ratios used for assessing each CAMEL factors are shown in Table 2.2.

## TABLE 2.2

## PROPOSED FACTOR/COMPONENT WEIGHTS

| Factor | Component | Component Weight % | Total Weight % |
|---|---|---|---|
| Capital | (a) Capital to Risk Assets Ratio | 15 | |
| | (b) Adjusted Capital Ratio | 5 | |
| | (c) Capital Growth Rate | 5 | 25 |
| Asset Quality | (a) Non-performing Risk Assets to Total Risk Assets | 15 | |
| | (b) Reserve for Losses to Non-performing Risk Assets | 5 | |
| (c) Non- | (c) Performing Risk Assets to Capital and reserves | 5 | 25 |
| Management | (a) CAEL/85 | 5 | |
| | (b) Compliance with Laws and Regulations | 10 | 15 |
| Earnings | (a) Profit Before Tax to Total Assets | 5 | |
| | (b) Total Expenses to Total Income | 5 | |
| | (c) Net Interest Income to Total Earning Assets | 5 | |
| | (d) Interest Expenses to Total Earning Assets | 5 | 20 |

| | | | | |
|---|---|---|---|---|
| Liquidity | (a) | Liquidity Ratio | 10 | |
| | (b) | Net Loans and Advances to Total Deposits | 5 | 15 |
| Total | | | | 100 |

The table is self-explanatory, except for the fact that the scoring under "management" factor is based on its effects on other factors; hence, for the first parameter under this factor, " CAEL/85", the score is the sum of the weighted scores in other factors divided by 85 and represented by a weight of 5. The other parameter, "Compliance with Laws and Regulations", is given a weight of 10. The reasoning for this approach to scoring management factor is that management quality is reflected in the other factors and that other quantitative indicators of management performance would fit into one or more of the other CAMEL factors.

## 2.3 Causes of Distress

Causes of distress and distress resolution differ from country to country owing to the differences in macroeconomic conditions, the regulatory framework, the intensity of crises and the approaches used to deal with it (Balino, 1991). Inspite of that, available literature has identified a long list of potential causes of distress in a financial system to include weak management, inadequate capital base, fraudulent and corrupt practices of owners and managers, poor asset and liability management, macroeconomic instability/interference and inadequate legal

framework and structure. Others include delayed supervisory action towards insolvent institutions, economic recession and inadequacy of the regulatory framework, amongst others.

In an attempt to analyse distress in some developing countries, some researchers have identified causes of distress to include macroeconomic shocks, effects of financial reforms, changes in prudential regulations and how the authorities of the affected countries have responded to the crises. For instance, it was discovered that in the case of countries like Argentina, Chile, Malaysia, Japan, Thailand and Uruguay, the crises period were closely associated with periods of strong reductions in real output, down- turn in investment, adverse external shocks and balance of payment difficulties. While the effects of the overall macroeconomic problems on financial distress are of varying degrees, it has been established that it is difficult to separate distress in the financial services industry of a country from the severity of the recessions witnessed by the economy (IMF, 1991). This is because it is only a resilient economy that can provide the primary guarantee for stability in the financial system.

With regards to the effects of financial sector reform and distress, it is difficult to establish which one causes the other. For instance, in Argentina, Uruguay and Chile, while their financial reform programmes took place between mid- 70's and the late 70's, distress in their financial sector took place in the early 1980's. In

Spain, however, it's financial distress occurred right within the period of it's financial reform, i.e. between 1977 and 1983. In the Philippines, the distress in it's financial services industry set in immediately after the deregulation of its financial sector in 1981. The above evidence indicates that the analysis of relationships between the effects of financial reforms and distress may well be revealing the underlying macroeconomic environment of an economy. In many cases the weaknesses of problem institutions might have started well before these weaknesses were noticed by supervisory agencies as it was usual for distressed institutions to conceal relevant information about their true financial condition(Dejuan, 1987 and Long, 1988) . Nevertheless, deregulation is always accompanied by rapid growth of financial institutions such that many of them are manned by inexperienced personnel. This situation can cause /aggravate financial crises which may eventually lead to distress (Fernandez,1983). Furthermore, deregulation often changes the structure of the financial system with the emerging structure depicting concentration of power in the financial system with interlocking ownership and lending patterns. Such an environment has been described as particularly susceptible to failures. This type of situation mirrored what happened in the Chilean private sector banking system and in Spain where there were large shares of credit to related firms (Balino,1991). Deregulation may also lead institutions with vulnerable liability structures to engage in distress borrowing which consequently leads to serious liquidity problems of individual financial institutions , thereby aggravating the financial crises of the system.

Again, where the sequencing of financial reforms does not accord the required priority to the existence of an appropriate macroeconomic environment and supervisory/regulatory apparatus to match the likely developments in the system after deregulation, distress in the system may quickly occur (Banco Central de la Republic Argentina, 1980).

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## 2.4 Implications of Bank distress for an economy

The intermediating role of banks and their relevance, both in the transmission of monetary policies and in the payment system, under score their importance as well as the problem that bank distress at the prevailing dimension in our economy could precipitate . Arising from their intermediation, banks generate financial resources and put these at the disposal of deficit economic units in the form of increased employment of otherwise idle resources and this in turn leads to increased output. This therefore means that an industry - wide insolvency of banks, such as the one just experienced in Nigeria, should be expected to retard the economy's rate of capital formation, reduce its level of employment and output and the pace of economic growth.

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In the course of mobilizing financial surpluses, banks issue claims (securities) on themselves to the fund owners. Such securities become less attractive in the event of wide - spread insolvency thereby increasing the holder's risk exposure and also making them lose confidence in the banking system. This development will also

cause the bank's cost of intermediation to rise as banks will need to pay higher returns to attract and retain deposits. Other indirect costs will also go up as in the case of more frequent intervention by the regulatory authorities. With terminally distressed banks, depositor's fund is lost unless there is implicit/explicit provision for protecting depositors.

Another serious danger posed by widespread distress among banks is the threat to the development of an efficient payment mechanism. Settlement of transactions will become predominantly cash - based with its associated risks.

In Nigeria today, it is puzzling that in spite of global trend towards credit - based economies and the growth of this culture in most emerging markets, most economic transactions in our economy are carried out on a cash - and - carry basis. The cash - based nature of our economy not only chokes the development of the financial services industry by hampering efficient resource allocation and financial intermediation, but it also encourages distortion in money supply and macro- economic management.

Also, there will be financial cost to be incurred by the economy in order to resolve the distress problem. This is invariably borne by tax payers at large. The implications would even be more severe for a depressed economy that is already on the path of declining growth, Safe and Sound Banking Practices in Nigeria : Selected Essays by J.U. Ebhodaghe (1997).

# CHAPTER 3

## 3.0 EXPERIENCES OF SELECTED COUNTRIES OF THE WORLD IN THE AREA OF DISTRESS MANAGEMENT

The measures undertaken in the sample countries considered below, vary a great deal, owing to differences in legislative framework as well as macroeconomic and political environments. Nevertheless, governments in the different economies have reacted similarly to the banking crises though with different policy options. For instance, all the countries adopted emergency measures aimed at stabilizing the financial system as rapidly as possible. Secondly, all embarked on providing long-term solution to the banking distress through bank restructuring, liquidation, deposit insurance, recapitalization among others. Thirdly, all sample countries assisted borrowers one way or the other. Such assistance included financial support, technical assistance and debt-equity conversions. Finally, in all countries considered, the emergence of crises highlighted was closely linked to the weakness in legislative and regulatory frameworks and hence substantive regulatory reforms were undertaken, Sundararajam et al (1991). Below, we consider case-study of each country.

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## 3.1 United States Banking Sector

The banking crisis of the United States which spanned the 1982-90 period was caused amongst other things by decline in farm prices, decline in oil prices, collapse of real estate, increasing competition, deregulation and the international

debt crisis. A total of 1,575 problem banks or 11 percent of the 14,289 FDIC insured banks were involved in the crisis.

The policy response in the US then was to tighten overall bank supervision. A new capital adequacy guideline was adopted and emphasis was placed on timely and realistic on-site examinations of asset quality to determine capital adequacy and solvency. The FDIC restructuring technique was basically to provide assistance where cost of assistance was less than liquidation or liquidation when the reverse was the case.

Amongst other lessons learnt from the US banking crisis were the need to:

i. tighten supervision and take prompt action to limit bank failure losses
ii. have adequate capital and control risk exposure by banks
iii. recapitalize promptly or close banks that are close to insolvency.

## 3.2 United Kingdom Secondary Banking Crisis

In the United Kingdom, the banking crisis spanned between 1973-1976 and 26 "fringe banks" of which eighteen were deposit-taking institutions and 5 authorized banks were involved. The banking crisis in the UK was caused by oil shock, volatile currency markets, deterioration in balance of payments as well as the growth of fringe banks and deposit taking companies in 1960 and early 1970s which were not effectively supervised under the law. These fringe banks

borrowed heavily from the money market and financed property boom of early 1970s.

Policy response to the problem was the establishment of joint committee of Bank of England and clearing banks chaired by Deputy Governor and the restructuring was initial financial assistance followed by liquidation of insolvent banks. The total liquidity loans provided at commercial rate to distressed but solvent banks was ,1.2billion.

Lessons to be learnt from the UK Experience were:

i. Need for supervision of deposit-taking institutions and legal powers for the Central bank to do so;

ii. Quick, pragmatic, and flexible actions of the apex bank to stave off systemic failure and collapse of confidence.

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## 3.3 Colombia

The Colombian banking crisis occurred between 1982 and 1987; twenty-six banks including the largest and the second largest banks were involved. The crisis was caused, amongst other things, by overvaluation of currency, excessive external borrowing, sharp decline in growth after coffee boom, financial sector and interest rate liberalization.

The policy response was that of sharp devaluation and cutback in fiscal deficit. Deposit guarantee fund was established in 1986 and the guarantee fund was empowered to nationalize banks by purchasing 100 percent of shares. The government guarantee was proportionate to government equity share. This Fund was also given power to extend loans, buy real estate, assume domestic or foreign debt, offer guarantee, establish a deposit insurance scheme and administer viable institutions.

The key lessons learnt from the Colombian experience were:

i. Need for strong supervision to reduce loan concentration and bank fraud.

ii. Need for early warning system to alert the government to solvency problems.

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## 3.4 Chile

The Chilean experience with banking crisis spanned the period between 1975-85. Thirteen (13) banks out of 25 domestic banks were affected and the crisis was caused by collapse of major export prices, high domestic interest rates, deterioration of balance of payments and over borrowing by private sectors. Policy response in Chile was devaluation in 1982 and adoption of measures aimed at reducing interest rates. Restructuring technique adopted was that banks were given emergency loans which were converted into equity. Also, Central Bank purchased bad loans initially up to total bank capital and reserves by swap

with non-interest-bearing Central Bank bonds. Key lessons to be learnt from the Chilean experience were:

i. Drastic relief programme at high cost to Central bank kept banking system functioning and stabilized confidence.

ii. Financial liberalization without adequate banking supervision does not lead automatically to well functioning markets.

iii. Bank supervision should prevent loan concentration and interconnected lending.

iv. Wait-and-see attitude delays macroeconomic recovery problem.

## 3.5 Malaysia

The Malaysian banking crisis spanned the 1985-88 period and it affected 3 out of 35 deposit taking cooperatives. It was caused by sharp economic contraction after the collapse of export prices, interest rate liberalization undercapitalization, management, speculation in property and stocks and lax supervision.

Policy responses were: Central Bank freeze of failed deposit- taking cooperatives (DTC), merger of 12 DTCS into one licensed finance company, injection of soft loans to assist rehabilitation and refund of depositors. The restructuring technique adopted was assumption of control and investigation, for commercial banks; injection of equity with buy back option by shareholders after recovery. After control, the central bank removed old management, cut overheads and

rationalized staff as well as appointed new management seconded from other banks. In total, the central bank injected M$672 million in equity plus total government loans of M$1.3 billion.

Lessons to be learnt from the Malaysia experience were:

i. Pragmatic and flexible response to crisis

ii. Extensive powers given to Central Bank to act on ailing financial institutions, including powers to freeze assets and investigate fraud.

iii. Strong political commitment and support for bank restructuring vital to success.

## 3.6 Philippines

Banking crisis occurred in the Philippines between 1981 -1987 and a total of 182 banks including two of the largest government banks were involved. The crisis was caused by interest rate liberalization and introduction of universal banking. Heavy family ownership of banks, loan concentration and political interference in credit decisions were other factors.

Policy response to the Philippines' banking crisis was the establishment of deposit insurance fund but slow payments due to insufficient funds exacerbated declining confidence in the banking system.

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The restructuring technique adopted involved a combination of loans by the Central Bank of Philippines to ailing banks as well as liquidation of insolvent banks. At its peak, the Central bank of Phillippines loaned P19.1 billion, (equivalent to 47.3% of reserve money), in assistance to financial institutions in early 1986.

Key lessons to be learnt from the Philippines banking crisis:

i. Supervisory machinery may be in place, but execution and enforcement may not be effective because of political interference and interconnected lending.

ii. Delays in closing down ailing banks are doubly costly, in losses as well as tying down scarce supervisory staff.

iii. Slow payments of deposit insurance scheme (due to shortage of funds) worsen confidence, rather than improve it.

## 3.7 Guinea

The Guinea banking crisis spanned between 1982 and 1985 and it involved the closure of six government banks and it was caused by extensive fraud and mismanagement with lax supervision.

Policy response was a banking reform which allowed banks to have foreign

management hence three new banks with foreign participation emerged in 1985. The restructuring technique adopted was that of complete liquidation. Lessons to be learnt from the Guinea experience were:

i. Poor management, complete lack of supervision, fraud created large losses;

ii. New banks established with domestic equity control, but foreign management and equity participation proved banking can be profitable.

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# CHAPTER 4

## 4.0 Overview of Distress in the Nigerian banking Industry

## 4.1 Causes of Financial Distress in the Nigerian Banking Sector

First and foremost, there is the need to establish the causes of financial distress in Nigerian Banks as this will enhance our ability to appreciate the failure resolution options being adopted to solve the problem. As a vehicle towards achieving this, a CBN/NDIC collaborative study [1996] undertook an empirical method to verify the causes of bank distress in Nigeria. This study used the analysis of primary data obtained from a survey and the analysis of secondary data on a wide range of performance indicators such as:

- Capital Adequacy
- Assets Quality
- Management
- Earnings; and
- Liquidity

The findings of this study indicates that distress among Nigerian banks is a visible expression of a complex set of interrelated problems emanating from a number of factors amongst others:

i. **The inhibitive policy environment**:

Prior to the adoption of the Structural Adjustment programme, our banking system was highly regulated. Some of which were counter-productive and contributed to strains in the banking system.

Banks were subjected to substantial restrictions on their products and activities and these restrictions limited some banks' ability to adopt to changing market conditions. Government, in the past, used the control over the banking sector as a tool of the country's economic development strategies. Government then believed that without such intervention, the banking system might not co-operate in the development efforts because of the divergence between public and private goals. These policies manifested in the form of direct control and the establishment of interest rate ceiling as well as restrictions on entry into the banking sector.

Through the direct credit control, banks were forced to perform developmental roles for which some of them were ill-equipped and this led them to serious financial problems arising especially from mismatching of assets and liabilities. The direct credit controls also made banks to provide credit, most times at non-competitive rates to priority sectors and public enterprises which on the long run led to defaults in the repayment of such loans and advances to agricultural and small and medium scale enterprises. Banks were also forced to participate

in Rural Banking Programmes and this forced some of them to expand beyond their capabilities in addition to the non-viability of most of the branches known as loss centers.

The control of interest rates reduced the banks profitability contributed largely to their poor financial condition and this led to distress in the sector.

In a bid to sanitize the operations of banks in a deregulated environment led to the introduction of -

- Prudential Guidelines
- Statement of Accounting Standards
- The Withdrawal of public sector deposits to the CBN in 1989
- The indiscriminate use of stabilization securities by the CBN to mop up excess liquidity in the system

The adoption of these measures exposed many weak banks and threatened their very existence.

ii **Capital Inadequacy**

The major function of capital in a bank is to serve as a means of absorbing losses. It provides a cushion to withstand abnormal losses not covered by

current earnings, enabling banks to regain equilibrium and to re-establish a normal earnings pattern. At that time however, most of the banks were grossly undercapitalized. This was so because many of the banks were established with very little capital (for example most of the state government - owned banks) and there was also a huge amount of non-performing loans.

The ensuing distress led the regulatory authorities to raise the minimum equity share capital of commercial and merchant banks first from ₦20 million and ₦12 million to ₦50 million and ₦40 million respectively for Merchant and Commercial banks effective from June 20, 1992 and secondly to ₦500 million for any commercial and merchant bank effect from January 1997 and the deadline given to existing banks for compliance is 31st December 1998 or face liquidation.

The penalty for non-compliance of this policy was however not enforced on the defaulting banks in order not to create further disruption to the already troubled sector. However, by the end of 1999, the capital base of almost all the banks had exceeded the stipulated minimum of ₦500 million.

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As a result of the declining value of the Naira, the year 2000 Credit and Monetary Policy Guideline raised the capital base from ₦500 million to ₦1 billion to all new entrants into the banking sector, a pre-requisite for registration.

iii **Management Problems:**

It is known world-wide that the quality of Management and staff makes the whole difference between viable and unviable banks. It is also established that mismanagement is the bane of bank distress. A significant characteristics of mismanagement is in the negative attitude and behaviour of bank managers which is difficult to correct through external policies and measures.

Four common types of mismanagement, namely: technical mismanagement, cosmetic mismanagement, desperate mismanagement and fraud are identified to be common in banks [World Bank, 1989]. Technical mismanagement involving inadequate policies, lack of standard practices, prevalence of over-extension, poor lending, mismatching of assets and liabilities, weak and ineffective internal control systems, and poor and lack of strategic planning have been prevalent in the Nigeria banking industry.

This often leads to insider abuse as depicted in Table 3

## TABLE 3

## Extent of Insider Loans in Liquidated Banks As at 31st December, 1996

| Liquidated Bank | Total Loans [=N=m] | Loans to Insiders [=N='m] | Proportion of Insider Loans to total Loans [%] |
|---|---|---|---|
| Financial Merchant Bank | 577.5 | 363.1 | 62.9 |
| Kapital Merchant Bank | 246.8 | 140 | 56.7 |
| Alpha Merchant Bank | 2837.2 | 647.2 | 22.8 |
| United Commercial Bank | 308.5 | 219.1 | 71 |
| TOTAL | 5705.1 | 2552.9 | 44.7 |

***Source: NDIC***

Cosmetic mismanagement [usually a derivative of technical mismanagement] consist of hiding past and current losses to buy time and stay afloat, looking, hoping and waiting for miracles. This depicts the typical practice of some bank managers in Nigeria which include systematic rolling over, capitalization and accrued interest income on delinquent facilities, keeping dividends constant on spurious earnings, fictitious collateralization, et cetera, particularly before the introduction of prudential guidelines.

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Desperate mismanagement is a condition where bankers see themselves in danger to declare, among others, capital reduction, operational loss and no dividends. The main unwholesome practices in desperate management by Nigerian bankers include speculation particularly by the distressed banks which used to pay above the market interest rates for deposits and charging higher interest to borrowers.

Fraud is part of the delinquent features that turn good bank managers into bad ones. When there are too many of them, the affected bank might have lost its capital several times before it knows. The Management and staff of many banks extend loans under suspicious circumstances and wanton violation of their credit policies, thus making it extremely difficult or impossible to recover all or a substantial part of such loans. No doubt, the situation described here is reminiscent of what obtained in our banking system which has been riddled with fraudulent staff as the amount involved/lost through fraud has been on the increase in the recent past [see Table 4].

## TABLE 4

## Extent of Frauds and Forgeries In Banks

| Year | Amount involved [=N='m] | Actual/Expected Loss [=N='m] | No. of Staff Terminated/Retired Dismissed for Frauds |
|---|---|---|---|
| 1989 | 105 | 15.3 | 313 |
| 1990 | 804.2 | 55.8 | 417 |
| 1991 | 388.6 | 26.7 | 514 |
| 1992 | 411.8 | 73.1 | 436 |
| 1993 | 1419.1 | 246.4 | 516 |
| 1994 | 3399.4 | 950.7 | 737 |
| 1995 | 1011.4 | 229.1 | 625 |
| 1996 | 1600.7 | 375.3 | 552 |
| 1997 | 3777.9 | 226.54 | 566 |

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### iv. IMPACT OF DEREGULATION

The deregulation of the economy has brought about increased competition and innovation in the market place. The increase

competition and innovation has equally brought about visible traces of strains into the banking system. In a competitive environment, allocative and operational efficiency require inefficient and marginal firms be crowded out and allowed to go under. In accordance with the principle of free market, there is free entry and there must be free exist. Some banks that have previously been protected from competition do not have the management expertise to survive in an increasingly complex, volatile and competitive market which has resulted from the current banking deregulation. In a way, therefore, it is a paradox that while competition enhanced the menu of bank products available to customers, such competition has indirectly caused the insolvency and failure of some banks in Nigeria through increased cost [K.S. Adeyemi, 1993].

## v. OWNERSHIP STRUCTURE/PERVASIVE INFLUENCES

Ownership structure is one of the major variables that could be used to explain financial distress in Nigerian banks. Owners direct interventions most especially in government controlled banks, in the internal operation of the banks has contributed to distress in some of them. In private banks, the prevalence of boardroom quarrels and insider abuse are precarious cankerworms causing distress in some of them.

Besides, most of the government owned banks are often treated as political banks. Some of these banks are characterized by inept management whose tenures of office are occasionally very unstable. In most cases as the owner governments charge frequently so also do board and key management staff of the banks. One result is inconsistent policies due to the fact that what one board did, the succeeding one(for political reasons) would overturn with reckless abandon.

## 4.2 LEVEL OF BANK DISTRESS IN NIGERIA:

Signs of distress in the banking sector was first officially pointed out by the World Bank team that examined the financial sector shortly before the NDIC was established in 1988. This observation gingered the supervisory authorities into examining the safety and soundness of banks in a more rigorous manner.

New prudential standards were stipulated and implemented, and this then exposed the distress subterraneously harboured by the banks. As at December 1994 there were 55 distressed banks compared with 38 in corresponding period in 1993. The situation worsened in 1996 when the number of distressed banks peaked at 60 at the year-end, out of a total of 115 banks. Thereafter however, the number has progressively declined, reflecting the success of the concerted effort at sanitizing the sector. By


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1997, the number had declined to 43 and by March 1998, only 17 banks remained classified as distressed following the liquidation of 26 terminally distressed banks in January 1998.

Table 1 summarizes some indicators of banking system distress in Nigeria between 1995 and March 1998. In addition to the number of distressed institutions, the table shows that distressed banks' share of total bank assets stood at 13 per cent at the peak of banking distress in 1995, thereafter, the proportion declined progressively to 4.9 per cent in March 1998.

**TABLE 1**

**SOME INDICATORS OF BANKING SYSTEM DISTRESS**

| Parameters | 1995 | 1996 | 1997 | March 1998 |
|---|---|---|---|---|
| Number of Insured Banks | 115 | 115 | 115 | 89 |
| Number of distressed banks | 60 | 50 | 43 | 17 |
| Total Assets | | | | |
| [a] All Insured Banks [=N='b] | 482.6 | 591.2 | 739.3 | 662.6 |
| [b] Distressed Banks [=N='b] | 62.7 | 65.0 | 56.2 | 32.2 |
| [c] Proportion of [b] to [a] | 13.0% | 11.0% | 7.6% | 4.9% |

| | | | | |
|---|---|---|---|---|
| **Loans and Advances** | | | | |
| [a] All Insured banks | 175.9 | 213.6 | 290.4 | 288.4 |
| [=N=`billion] | 90.5 | 51.7 | 49.6 | 21.6 |
| [b] Distressed banks | 51.4% | 24.2% | 17.1% | 7.56% |
| [=N=`billion] | | | | |
| [c] Proportion of [b] to [a] | | | | |
| **Classified Loans and Advances** | | | | |
| [a] All Insured banks | 57.8 | 72.4 | 74.9 | 55.4 |
| [=N=`billion] | 44.5 | 40.8 | 39.8 | 16.2 |
| [b] Distressed banks | 76.9% | 56.4% | 53.1% | 29.2% |
| [=N=`billion] | | | | |
| [c] Proportion of [b] to [a] | | | | |
| **Deposits Mobilized** | | | | |
| [a] All Insured banks | 210.75 | 258.96 | 314.18 | 363.3 |
| [=N=`billion] | 93.53 | 40.24 | 31.23 | 16.8 |
| [b] Distressed banks | 44.4% | 15.5% | 9.9% | 4.6% |
| [=N=`billion] | | | | |
| [c] Proportion of [b] to [a] | | | | |

Source: NDIC Annual Reports

Total loans and advances of distressed banks represented 51.4 per cent of industry loans and advances in 1995; again, the proportion declined to 22.4 per cent in 1996, 17.1 percent in 1997 and 7.6 percent in March 1998. As would be expected, distressed

banks' classified loans and advances as a proportion of the industry loans and advances was quite high at about 77 per cent in 1995, decreasing thereafter to 29.2 per cent in March 1998. Finally, distressed banks' deposits represented 44.4 per cent of the industry's aggregate deposits in 1995 declining thereafter to 4.6 per cent in March 1998 , NDIC Quarterly [1995 and 1997], P.N. Umoh , [1997]

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# CHAPTER 5

## 5.0 DISTRESS RESOLUTION FRAMEWORK IN NIGERIA

### 5.1 Institutional Framework for Distress Resolution in Nigeria-Legal Issues

Over the years, and especially since 1952 when the first Banking Ordinance was promulgated in Nigeria, several statutes have been put in place to serve as legal backbones for the monetary authorities' actions in regulating the banking industry. The current ones include the Central Bank of Nigeria (CBN) Decree 24 of 1991 as amended; the Banks and Other Financial Institutions (BOFI) Decree 25 of 1991as amended; the Nigeria Deposit Insurance Corporation (NDIC) Decree 22 of 1988 as amended; the Company and Allied Matters (CAM) Decree of 1990 and lately the Failed Banks (Recovery of Debts) and Financial Malpractices in Banks Decree 18 of 1994 as amended.

Specifically, the CBN and the Nigeria Deposit Insurance Corporation (NDIC) constitute the nation's regulatory/supervisory authorities for the nation's banking sector. Their enabling Decrees, especially the BOFI Decree 25 of 1991 and the NDIC Decree 22 of 1988 as amended, both contain the major legal provisions (resolution framework) for handling failing and failed financial institutions. These provisions contain series of measures to apply depending on whether banks are in failing condition

or have been declared failed in an attempt to ensure banking confidence and financial stability in the system. Aside from the provisions in the enabling statutes, there are other administrative and funding issues. All these issues are discussed below:

### 5.1.1 Provisions Of The Banks And Other Financial Institutions Decree 25 of 1991 as amended..

The implementation of the doctrine of financial liberalization policies in the late 80s created new problems and challenges which the old statute (the 1969 Banking Decree) could not address, hence the need for its revision. The BOFI Decree undertook some revisions especially, with respect to failure resolution options for failing and failed financial institutions.

On the prevention of bank failure, Section 31 of the Decree strengthens the ability of the CBN to enforce its recommendations on a bank based on the findings from its routine examinations. Sections 33 to 38 of the BOFI Decree (1991) empower the CBN to take such measures as it may deem necessary to reverse the declining fortunes of a "failing" or "failed" bank. For example, Section 33 empowers the CBN to effect a change in bank management with the approval of the President. Sections 34 and 35 empower the CBN to assume control of a failing or failed bank or appoint a person to assume control of a bank and carry out financial and

operational restructuring consisting of appropriate changes in the policies of the bank and implementation of cost-cutting measures until the Central Bank is satisfied that the condition of the licensed bank is satisfactory.

If the condition of the bank remains unsatisfactory, Sections 36 through 38 empower the CBN (on application to the High Court) to purchase or appoint a person to purchase on its behalf, the failed bank, for nominal fee for the purpose of restructuring and subsequent sale, or revoking the bank's licence and causing its business to be wound-up, provided the actions are in the interest of the bank, its depositors, creditors and the public generally. For the purpose of winding-up a bank, the BOFI Decree specifically empowers the CBN to appoint the NDIC or any other person as the official receiver or a provisional liquidator (with appropriate powers conferred under the Companies and Allied Matters Decree 1990 as amended).

### 5.1.2 Provisions Of NDIC Decree, 1988

Sections 5, 23 through 29, and Section 34 of the NDIC Decree 1988, indicate the actions which the NDIC could take in assisting insured banks either when they are failing or when they have failed.

## 5.2 MAJOR DISTRESS RESOLUTION MEASURES ADOPTED IN NIGERIA

Resolution of failures in the Nigerian banking sector is jointly handled by the CBN and NDIC. If there is a significant deterioration in the condition of a bank, it is officially declared to be distressed and placed under close supervision. Such a bank will normally be required to submit additional returns to the CBN/NDIC, so that the implementation of the various corrective measures imposed on it can be monitored. Over the years, the CBN and the NDIC have undertaken a number of such distress management measures to handle the problems of distressed banks. The measures undertaken include the following among others;

### 5.2.1 Moral Suasion

As a first step in distress management, the CBN and the NDIC would hold regular discussions and consultations with the owners and management of the affected banks with a view to making them embrace healthy practices that would enhance their performance as well as take prompt and decisive actions to revitalize their banks. Although this approach had helped in making the owners and management of most problem banks to focus greater attention on certain areas of operational problems, not much had been achieved in addressing the fundamental problems of under-capitalization and debt recovery.

### 5.2.2 Imposition of Holding Actions

Banks that were identified to be distressed, after a special examination, were placed under close supervision and restrictions through the imposition of Holding Actions. The aims of the holding actions were to allow the troubled banks to undertake self-restructuring measures as a first line of self-salvaging action and to arrest further deterioration in their financial condition. This approach was anchored on the belief that given determined management and boards, the declining fortunes of the problem banks could be reversed. Holding actions imposed on distressed banks required them to do the following:

i. Stop further advertisement for deposits without prior consent of the CBN;

ii. Not to grant further loans and advances until the regulatory authorities are satisfied with the banks liquidity position;

iii. Take necessary steps to ensure adequate internal control measures to safeguard its books, records and assets;

iv Inject further capital funds;

v Engage in aggressive debt recovery drive;

vi Take steps to perfect all collateral securities pledged for loans and advances (and keep them in protective custody);

vii Segregate all dormant accounts within a specified time limit;

viii NOT to embark on new capital projects without clearance from the CBN;

ix To reconcile all long outstanding items within a given deadline;

x Not to dispose of any fixed assets of the bank without prior consent of the CBN; and

xi Embark upon possible rationalization of staff and branches as a measure of cost reduction.

In addition, each distressed bank on which the holding actions were imposed, was required to furnish the CBN and the NDIC within 30days of being served the holding actions, details of its strategic plan for the revitalization and effective management of the bank. Such a turn-around plan was expected to be credible and to include proposals for debt recovery, rationalization of costs and staff, injection of additional capital, training, et cetera. Also each bank on which the holding actions were imposed was expected to notify its staff of the measures and ensure that adequate steps were taken to comply with them. Officials of the CBN/NDIC monitored compliance from time to time. The effects of holding actions on the distressed status of the affected banks would normally suggest the next set of supervisory measures to adopt.

The experience of the regulatory authorities had been that the holding actions had not materially reversed the distressed status of most of the banks because the heavy accumulated losses made the recapitalization requirement to be beyond the means of the shareholders. In addition, the debt recovery efforts had not been successful because the chronic debtors were mainly insiders to the affected banks who were usually unwilling to repay their debts, or who had not provided adequately perfected collateral which could be foreclosed.

In view of the above observations and arising from the recent amendments to the NDIC decree, the following measures have been considered for adoption.

i. Change of name of Holding Action to Corrective Action. This is to address the negative connotation associated with Holding Action;

ii. Banks that are significantly under-capitalized (i.e., Capital to Risk Weighted-Assets ratio of over 2% and below 5%) would qualify for Corrective Action;

iii. The Corrective Action shall be tailor-made to address the specific problems of each affected bank; and

iv. The time from for the implementation of Corrective Action shall not be more than six (6) months. The corrective actions are not sequenced on

the basis of time frame for the implementation of each element of the Actions proposed to be taken.

### 5.2.3 Financial Assistance

NDIC in collaboration with CBN extended accommodation facilities to help ten banks out of their liquidity problems in 1989. This measure recorded some success as confidence was restored within a reasonable period of time. In recent years, the Corporation has received and appraised application for liquidity support from some banks. Though, a few of these applications were approved, it was later found that the problems of the banks transcended illiquidity to include insolvency, and hence could not be adequately resolved by the mere provision of liquidity support. The regulatory authorities, therefore, decided to directly intervene by taking over the chronically distressed banks.

### 5.2.4 Supervisory Intervention

One major distress management measure that has been adopted by the regulatory/supervisory authorities is prompt supervisory intervention. The limited success of this measure has however, suggested that regulatory/supervisory authorities must find a more effective approach to manage distress in the Nigeria banking system. The authorities have thus initiated and taken stronger supervisory actions which are discussed here.

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a. **Change of Management**

Following the protracted shareholders' crisis in Fidelity Union Merchant Bank Limited in 1992, the CBN/NDIC removed the bank's board and appointed an Interim Management Board that managed it for one year. The bank was handed over to its shareholders after resolving their differences. Similarly, an Interim Management Board was constituted for Alpha Merchant Bank Plc on receipt of protests from some shareholders that the bank was being mismanaged through careful manipulation of some board members and management staff and after confirming that the protest had merit. The presence of the CBN/NDIC in the management of the bank further revealed a lot of insider abuse and financial malpractices which eventually culminated in the revocation of the bank's licence and its liquidation.

b. **Assumption of Control and Management**

Early in 1992, the CBN took over the control and delegated the management of the distressed National Bank of Nigeria (NBN) to the NDIC pursuant to the provision of section 34 and 36 of BOFID Decree. The decision to take over the NBN was informed by a number of factors including the fact that the bank's operations had been virtually suspended and the capital deficiency had grown beyond the financial capacity of the



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shareholders. Furthermore, the regulatory authorities believed that the action would send a strong signal to the owners of other distressed banks, that they run the risk of losing their bank should they fail to take appropriate corrective actions to turn them around.

On its part, the NDIC appointed an 11-man Task Force to examine the bank's books and to evaluate its financial condition. From the report submitted by the Task Force, NDIC made far-reaching recommendations to the Federal Government for the resolution of the problems of the bank. Subsequently, an Interim Management Board (IMB) was appointed to turn round the bank.

Following the increase in the number of distressed banks and the problem of which distressed bank to select next for restructuring, a frame work that entailed simultaneous takeover of all the first general insolvent banks (global restructuring) was adopted. Following the approval of the President on May 21, 1993, the CBN in the exercise of the powers vested in it, assumed the control of the affairs of five (5) distressed State Government-owned banks and handed over their control and management to NDIC, thus bringing the number to six (6). The banks were African Continental Bank Plc, New Nigerian Bank Plc, Pan-African Bank



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Limited, Mercantile Bank Plc, Co-operative and Commerce Bank Plc. The responsibilities of the NDIC as a managing agent included superintending over the affairs of the banks as well as proposing a failure resolution option consistent with the circumstances of each bank. The Corporation, in turn, appointed an Interim Management Board (IMB) for each bank to assist it in working out appropriate restructuring plans.

After an exhaustive evaluation of the turn-around plans submitted by the IMBs, the CBN/NDIC reached a conclusion that the plans would not reverse the distressed condition of the banks without a huge amount of tax payers' money being spent. As the Federal Government was not willing to bail out any bank with tax payers' money, it at that time directed that the banks should be sold to willing and credible buyers within six (6) months after which those that were not sold should be liquidated. The CBN/NDIC then dissolved the IMBs and constituted a Transitional Supervisory Board (TSB) to midwife the sale and acquisition of the six banks.

The CBN had since acquired, through the Federal High Court, all the first six banks under its control and management at a nominal fee. The acquisition of these banks was to facilitate their sale or liquidation by the authorities.

c. **Comprehensive Supervisory Intervention**

Wile considerable efforts had been made towards addressing distress in the banking system, the supervisory measures adopted had not solved the problem. As at the time the six banks were taken over, there were fewer than twenty distressed banks in the industry under the close supervision of the CBN/NDIC. Since then, the number of distressed banks had risen to about sixty (60) as earlier indicated. It therefore, became necessary to consider a more comprehensive approach that would simultaneously address all the terminally distressed banks in the system.

Consequently, the Federal Government approved the taking over of additional seventeen (17) distressed banks for the purpose of restructuring them. All the banks were taken over by the CBN on 15th September, 1995. The boards of directors of the banks were dissolved and in their place management boards were constituted as conservators. The shareholders of the banks were given another opportunity to recapitalize their banks to the satisfaction of the CBN/NDIC within one month, failing which the management boards would package the banks for sale, merger or liquidation, depending on which option would help to restore public confidence and would be most cost effective. In addition, the management boards which were to report to the NDIC were charged with

the responsibility of, among others, implementing the Holding Actions earlier imposed on the banks, identifying the bad debtors for the purpose of debt recovery and identifying those involved in financial malpractices with a view to prosecuting them in accordance with the provisions of the Failed Banks Decree.

Following the recent amendment of the NDIC Decree No. 22 of 1988 which gave the Corporation a functional autonomous status to address bank distress through the design and administration of effective failure resolution options, the Corporation, with effect from September, 1997, reconstituted the management teams of the 25 distressed banks. Each management team was made up of at least one NDIC staff and a senior staff of the affected banks where necessary. Under the management, two Management Supervisory Boards (MSBs) were established to superintend over the affairs of the distressed banks. A Committee on Distressed Banks (CDB) was also established to take executive decisions on the distressed banks based on the report from the MSBs.

## 1. Suspension of Banking Licence

In February, 1994, the CBN suspended the licences of two commercial banks, namely - Republic Bank Limited and Broad Bank (Nigeria)

Limited, following the discovery of serious malpractices perpetrated by the Management of these banks in the inter-bank clearing system. While the suspension of Broad Bank (Nigeria) Limited was subsequently lifted, the Republic Bank Limited could not meet the conditions for the restoration of its operating licence.

### e. Liquidation of Distressed Banks

Having exhausted all possible means of resolving the distressed condition of some banks, the CBN/NDIC decided to revoke the operating licences of five (5) banks with the approval of the Head of State. The licence of Kapital Merchant Bank, Financial Merchant Bank, Alpha Merchant Bank and United Commercial Bank were revoked in 1994 and that of Republic Bank was revoked in 1995. In addition, following the grave distressed financial condition of 26 (13 commercial and 13 merchant) banks in the system, the CBN revoked their operating licences in early 1998. This latest action brought to 31 the number of banks liquidated in the system within a period of less than 4 years. The commercial banks which lost their licences were Allied Bank of Nigeria Plc; Amicable Bank of Nigeria Limited; Co-operative and Commerce Bank Plc; Credite Bank of Nigeria Limited; Commercial Trust Bank Limited; Commercial Bank Limited; Highland Bank of Nigeria Plc; Lobi Bank of Nigeria Limited; Mercantile

Bank of Nigeria Plc; North-South Bank Limited; Pan African Bank Limited; Pinnacle Commercial Bank Limited; Progress Bank of Nigeria Plc. The affected merchant banks were: Abacus Merchant Bank Limited, ABC Merchant Bank (Nigeria) Limited; Century Merchant bank Limited; Continental Merchant Bank Plc; Crown Merchant Bank Limited' Great Merchant Bank Limited; Group Merchant Bank Limited, ICON Limited (Merchant Bankers); Merchant Bank for Africa (Nigeria) Limited; Nigeria Merchant Bank Plc; Prime Merchant Bank Limited; Royal Merchant Bank Limited; and Victory Merchant Bank Limited.

Consistent with the provision of the NDIC Decree, the CBN appointed the NDIC as the liquidator of all the closed banks. The on-going liquidation of these banks has been unique as it is the first time since banking business became regulated in Nigeria that so many distressed banks have been formally liquidated at once. Secondly, the liquidation of failed banks has been consistent with the posture of deregulation which allows for free entry and free exit of banks - a major departure from the previous policy of propping up inefficient and mismanaged banks. Lastly, liquidation of technically insolvent banks promises market discipline by sending strong signals that shareholders of banks stand to lose their investments should they run their banks aground.

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It is pertinent to mention here that the entire burden of resolving distress in the Nigerian banking system falls entirely on the Corporation. For the twenty-six banks currently under liquidation, the Corporation has earmarked about ₦6 billion to pay off insured depositors out of a Deposit Insurance Fund (DIF) which at the end of 1997 stood at ₦10.3 billion.

## 5.3 APPRAISAL OF THE FAILURE RESOLUTION MEASURES IN THE NIGERIAN BANKING SECTOR

Like what obtains in other parts of the world, the Government, the Central Bank of Nigeria (CBN) and the Nigeria Deposit Insurance Corporation (NDIC) - since it commenced operation in 1989, had on various occasions come out with various policies aimed at ensuring the stability of the banking system. These, as discussed in the previous section, included the use of some failure resolution options, such as holding actions, assumption of management and control as well as outright liquidation of banks, among others. With some of these resolution options available to handle failing and failed banks, most people and even Government have assumed that banking in Nigeria is under control with dangers of failures, panics and runs abolished by careful regulation coupled with the system of deposit insurance scheme in place. This however, seems not to be the case considering recent developments in the system.



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There are some observed problems militating against the working of some of the failure resolution options currently being adopted. Some of these problems included inadequate resources for failure resolution and other operational problems. Some of these Inhibitive factors are examined below:

### 5.3.1 Inadequate Resources for Failure Resolutions

The Government had on various occasions come out with various laudable policies designed to ensure the stability of the banking sub-sector of the economy. The unfortunate thing however, is that Government over the years has neither made an explicit provision in the national budget to address distress in the financial sector in order to restore public confidence nor made a categorical directive on how to expedite action in solving the problem. Efforts to deal with distress in our banking system without an adequate provision on how to finance it can only yield little or no results.

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The application of Capital Gains Tax to failure resolution transactions constitutes another erosion of the available funds for failure resolution. At a critical stage like this, government should ensure that all funds generated from failure resolution transactions are utilized for that purpose

in view of the severe resource constraint facing the NDIC in the discharge of its statutory responsibility of redressing the problem of bank distress.

### 5.3.2 Ineffectiveness of Holding Actions

The experience of the regulators so far with the application of Holding Actions has shown that this approach has not been effective in arresting the deteriorating conditions of the banks concerned. Since 1991 when the regime was introduced, about 50 banks have been affected and only four (4) banks have been able to meet the conditions for lifting the Holding Actions. Even in the case of these four banks, it has been argued that their improved conditions could not have been a direct consequence of the imposition of the Holding Actions. Rather than improve their lot, many banks never recover from the announcement effects of the imposition of Holding Actions. Most of them have suffered from deposit run while some fraudulently-minded staff, including Management staff, on sensing that their banks could eventually fail, have perpetrated all sorts of fraud in the banks, thus leaving them irredeemably distressed.

The failure of the current regime of Holding Actions has been attributed to several factors. In the first place, the imposition of Holding Actions has so far been carried out when a bank's networth has become

substantially negative. In fact, most of the banks now under Holding Actions had long qualified for the regulatory intervention (i.e., liquidation), before Holding Actions were imposed on them.

Furthermore, the restriction on some vital operations of the banks has been a major factor impeding their recovery. The liquidity positions of the banks will continue to deteriorate so long as the restriction on deposit mobilization is in place. The bank's earning capacity and, by extension, profitability will also be weakened by the embargo placed on their lending activities and their frequent exclusion from the foreign exchange market. So long as the earning capacity of an unhealthy bank is curtailed, a substantial part of loan recoveries and/or capital injection made is expended on overheads. This in itself is a limiting factor in Management's efforts to turn the bank around.

All these problems have made the noble objective of resolving the problem of distress in the nation's banking system a painful exercise to regulatory/supervisory agencies. Meanwhile, public expectation is focussed on these agencies. The delays and the seeming inactions in dealing with distressed banks in the system have no doubt, prompted public accusations of the CBN/NDIC through the media for some time now. The implication of this

development is that there is a serious need for a positive response especially by the Government to regain the confidence of depositors, creditors and the general public in the nation's banking industry.

# CHAPTER 6

# SUMMARY, CONCLUSION AND RECOMMENDATION

## 6.1 SUMMARY

The report is concerned with the problem of distress and distress resolution options applied in addressing the problem in the Nigerian banking industry.

The Chapter two of the report considered the definition, measurement of bank distress, causes of distress and its implications for an economy. The definition of various scholars were given and to summarize the definitions given, banking distress can be said to occur when a bank or some banks in the system experience illiquidity or insolvency resulting in depositors' fear of loss of their deposits. Also systemic distress occurs when a reasonable proportion of banks in the system are unable to meet their obligations to their customers, owners and the economy. In the second part of the Chapter, measurement of distress was reviewed. In the course of the review, it was discovered that bank supervisors often use approximations by adjusting the book-value using some predetermined rules, established and based on experience and comparative study of other economies' banking system. Such rules include those based on capital, assets, management, liquidity and earnings. Based on these parameters, appropriate financial ratios are developed for depicting the conditions of the financial


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institution under consideration. This constitute the threshold through which a composite measure based on the CAMEL parameters that will enable supervisors determine on a uniform platform, the extent of distress in each of the banks and by extension in the financial system as a whole. Such a composite measure can then be calibrated into a rating grid with desired categorization like sound, weak distressed, terminally distressed, etc. The third part of the Chapter highlighted the causes of distress. It started by pointing out that causes of distress and distress resolution options differ from country to country owing to the difference in macro-economic conditions, the regulatory framework, the intensities of the crises and the approaches used to deal with it. However, available literature has identified a long list of potential causes of distress in a financial system to include, weak management, inadequate capital base, fraudulent and corrupt practices of owners and managers, poor asset and liability management, macro-economic instability/interference and inadequate legal framework and structure. Others include delayed supervisory actions towards insolvent institutions, economic recession and inadequacy of the regulatory framework, among others.

In the third Chapter, the experiences of other countries in the area of distress management was reviewed. The countries selected include the United States of America, the United Kingdom, Colombia, Chile, Malaysia, Phillippines and Guinea. In the cause of reviewing the experiences of these countries in the area

of distress management, it was found out that although there are differences in legislative framework as well as macro-economic and political environments, they all reacted to banking crises in a similar manner using different options such as emergency measures aimed at stabilizing the financial system as rapidly as possible, embarking on providing long-term solution to the banking distress through bank restructuring, liquidation, deposit insurance, recapitalization as well as assisted distress institutions with financial support, technical assistance and debt-equity conversion.

In Chapter Four, the experiences of the Nigerian banking system with distress was reviewed. In the first part of the Chapter, the causes of financial distress in the Nigerian banking sector was highlighted. The causes were found to be inhibitive policy environment, capital adequacy, management problem, impact of deregulation, ownership structure/pervasive influences. In the second part of the Chapter, the level of distress in the Nigerian banks was reviewed. It was discovered that in early part of 1990s, the level of distress in the Nigerian banking industry kept increasing at an alarming rate. For example, at the end of 1993, there were 38 banks that were adjudged distressed by the regulatory authorities. This figure rose to 55 distressed banks as at December, 1994. The situation worsened in 1996 when out of the 115 banks operating in the country, 60 banks were declared distressed. However, the figure sharply decline to 16 banks in 1998 with the liquidation of 26 distressed banks in the system.

The Chapter Five of this report considered the distress resolution framework used in addressing the scourge of distress in the Nigerian banking industry. In the first section of this Chapter, institutional framework for distress resolution in Nigeria was highlighted. The legal aspects of the framework include the provisions of the Banks and Other Financial Institutions Decree 25 of 1991 as amended, in particular, sections 31 and 33 to 38 and the provisions of the NDIC Decree 22 of 1988 as amended, especially sections 5, 23 through 29 and section 34 which indicate the actions which the NDIC could take in assisting insured banks either when they are failing or when the have failed.

In the second part of the Chapter, major distress resolution measures adopted in Nigeria were highlighted. They include moral suasion, financial assistance, supervisory intervention, change of management, assumption of control and management, comprehensive supervisory intervention, suspension of banking licence and liquidation of distressed banks. Also, the failure resolution options used in Nigeria were appraised. In the course of the appraisal, it was noted that the current failure resolution framework does not provide adequate autonomy to the regulatory/supervisory authorities in handling bank distress and failure with resultant effects of rising delay-induced costs to the regulators/supervisors, the banking industry and the economy at large. It was found out that the NDIC has no legal basis for independently resolving bank distress and failure under the current framework. It has also been observed that the present framework may

have been ineffective due to lack of clear delineation of responsibility between the CBN and NDIC in resolving issues relating to bank distress and failure. In addition, attempts at developing intervention thresholds have not yielded much results. This partly, has not only prevented timely intervention by the regulatory authorities, but it has also made definition of respective roles by the CBN and the NDIC with respect to bank distress and failure resolution very cumbersome. Also, lack of explicit budgetary provisions for resolving bank distress has been identified as a serious oversight on the part of Government, and this has constrained effective implementation of certain measures at resolving bank distress.

## 6.2 CONCLUSION

The findings of this study as shown above, revealed that various distress resolution options were used by the regulatory/supervisory authorities in trying to address the problem of distress in the Nigerian banking system without any success. The resolution framework appears to have some inadequacies associated with it. Some of the inadequacies include the lack of sufficient resources to handle failure resolutions and the ineffectiveness of holding actions to handle distress.

Based on the above, we can conclude that the ineffectiveness of the existing distress resolution framework that resulted in a continuous increase in the depth

of distress and number of distress banks in the system, can be attributed to the inadequacies/lapses inherent in the existing operational framework. This therefore, calls for a reform of the operational aspects of the existing distress resolution framework for it to be effective in addressing distress problems in the Nigerian banking system. The legal aspects of distress resolution also needs to be firmed up.

## 6.3 RECOMMENDATIONS

From all these, it can be seen that the relative ineffectiveness of the existing distress resolution options can be traced to a great extent on the inadequacies in the operational framework. This therefore, calls for substantive reforms as they affect bank distress resolution options. Accordingly, the following recommendations are being proposed:

a. **Measures to Minimize the Undesirable Effects of Holding Actions**

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i. To the extent that banks on which Holding Actions are imposed are not bidding for their own account, they should be allowed to participate in the foreign exchange transactions on behalf of their customers since foreign exchange is sold on cash and carry basis to the customers through their banks. This could minimize the loss of good business and high networth customers.

ii. Banks could be allowed to lend to "first class customers" beyond the level of preceding month's recoveries, with the prior approval of the relevant supervisory agency as long as the bank's account with the CBN is not overdrawn. In deed, banks should no longer be allowed to overdraw their accounts with the CBN.

iii. Holding Actions should be imposed before a bank's Capital Adequacy Ratio becomes negative. As much as possible, the prescriptions of the already approved framework for supervisory intervention should henceforth be implemented so that banks do not become technically insolvent before some form of Holding Actions are imposed on them.

b. **Need To Set Aside Financial Resources To Handle Bank Distress**

Since the Government is so much concerned with the need to deal with widespread bank insolvency in the system, there is the need for an explicit financial provision in the national budget to deal with defaults and distress in the nation's financial sector. Such commitments on the part of the government, will go a long way in restoring public confidence in the banking system. For instance, in Spain, government's contribution to the DIF equals the contribution by the banks in time of crises. Besides, there is, for example, a clear need to set aside money by government for the implementation of the provisions of the Failed Banks Decree. As is presently done, relying solely on the slim amount of resources at the disposal of the NDIC to implement the Decree, may make the

implementation suffer some set back. This definitely will not be in the best interest of the system. Furthermore, government should exempt failure resolution transactions from Capital Gains Tax in order to curb the erosion of the available funds for failure resolution through this levy.

c. **Increased Supervisory Capacity**

There is need for increased bank supervisory capacity especially in off-site surveillance, where emphasis should be on development of an early warning model for early identification of distress, and on-site inspection. For on-site examination, it is recommended that the cycle be limited to one year, i.e. each bank is examined once a year, except where there is a need for a special examination.

d. **Distribution of Failure Losses**

In cases of liquidation, the distribution of losses should be made transparent to all parties in order not to sabotage any restructuring efforts. Such losses should be borne in descending order as follows:

| | | | | |
|---|---|---|---|---|
| Borrowers | - | Shareholders | - | |
| Fellow Bankers | - | Other Creditors | - | |
| Employees | - | Government | - | Depositors |

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e. **Phasing of Failure Resolution Options**

The phases of the failure resolution framework should be structured as follows:

**1st Phase**

Emergency measures which should be aimed at stabilizing the financial system as rapidly as possible. This should, in the least, include making available lender-of-last-resort facilities, often to replace the loss of deposits of the affected institutions.

**2nd Phase**

Long term measures. This should aim at proper restructuring, recapitalization, liquidation and deposit insurance among others.

**3rd Phase**

Assistance to borrowers. Such assistance should include financial support, technical assistance and debt-equity conversions.

f. **Restructuring of Other Sub-Sectors of Financial Services Industry**

Finally, it should be noted that mechanisms for resolving bank failure constitute only one part of a well-coordinated strategy for the financial sector and will not succeed unless structural adjustments are made in

other government financial policies, the banking sub-sector competition as well as monetary and fiscal policies of government.

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