

# FINANCIAL DEREGULATION AND THE EFFECTIVENESS OF BANK SUPERVISION IN NIGERIA

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## 1. Introduction

The Nigerian Deposit Insurance Corporation (NDIC) conducted a survey of Nigerian banks in 1989 with a view to determining their soundness and continued viability. The picture that emerged awoke serious concerns among policy-makers and the general public alike. The survey (see NDIC, 1989) revealed that the banking industry had many firms operating below solvency levels with negative shareholders' funds amounting to N763 million. It was also discovered that a total of twenty-three banks did not meet the statutory paid-up capital of N20 million for commercial banks and N12 million for Merchant Banks<sup>1</sup>. The system was also burdened with extensive classified assets amounting to N9.4 billion. This represented 40.8% of total assets and 280% of shareholders' funds. Many institutions were also experiencing serious management problems evidenced by large-scale frauds insider abuse and weak internal control systems. In 1989, sixty-eight banks reported fraud incidents with losses totalling N 104.9 million (NDIC, op. cit. p. 29).

This situation has raised serious doubts about the effectiveness of the existing regulatory and supervisory framework in fostering a sound and safe banking industry.

The uneasiness stems from the recognition that the ongoing financial deregulation has changed the industry unrecognisably. Banking has diversified considerably, investment options have been broadened and liability management is now prevalent. Further, regulations have been relaxed in a number of ways. Banks can now hold stocks in non-financial companies, buy and sell foreign exchange freely, and engage in equipment leasing. Entry barriers into the industry have also been softened with the number of banks today standing at 124, compared to only 40 in 1986 when deregulation commenced.

The aim of this paper therefore is to look at bank supervision in Nigeria within the framework of a deregulated financial system. Our central contention is that deregulation brings a potential increase in the level of risk assumed by individual institutions. This will undoubtedly expand the problems of bank supervision to challenging proportions, with heavier demands placed on the resources available for the maintenance of a safe financial system. We therefore examine ways in which bank supervision can be reshaped to ensure its continued relevance with the present dispensation.

The outline of the paper is as follows: Section 2 reviews the theoretical premises for

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<sup>1</sup> In May, 1991 capital for commercial banks was raised to N 50 m and Merchant Banks, N 40 m.

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bank regulation and supervision.

In Section 3, we describe the existing supervisory framework in Nigeria, focusing particularly on the powers and functions of the various regulatory agencies. Section 4 discusses the challenges to bank supervision within the context of financial liberalisation while Section 5 offers appropriate policy responses. In Section 6, we provide concluding remarks.

## **2. Why Banks are Regulated**

In general, banks are similar to other business organisations. However, they possess certain features which make them unique enough to attract regulatory attention. First, banks are the only financial institutions legally permitted to accept Demand Deposits (DD) which are bank accounts transferable from one economic unit to another. Since DDs could then be used for transaction purposes, banks occupy a central position in an economy's payments system. This is very crucial indeed considering the role of money as a medium of exchange and means of payment. Second, banks serve as depositories for the savings of different economic units. Firms and individuals alike hold their savings in the form of bank accounts (e.g. savings Deposits and Time Deposits), which makes them bank creditors. Third, banks significantly determine the allocation of credit as they constitute a major source of loanable funds to business firms, households and the government. Hence, bank credit is important in the finance of investment, consumption and government expenditure. Fourth, banks have the ability to "create" money. Due to their DD liabilities, they can expand the money supply by opening new accounts for loan customers. This capacity to expand the money supply has serious implications for the formulation and implementation of monetary policy and by extension, for the stability of the overall economy.

From above, it is clear that the regulatory and supervisory attention focused on banks is far from misplaced. "They represent channels through which national monetary and credit policies are implemented and their welfare significantly affects the nation's level of employment and income" (Duffey, 1983 p. 4). The authorities therefore monitors them closely given their importance to the health of the economy. Regulation of banks have consequently been wide and varied, covering their portfolio decisions, the prices they can charge and the prices they can pay (Mayer, 1967). Restrictions are also placed on who can open banks and what product can be offered. Specifically, bank regulation

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and supervision have five major goals<sup>2</sup>.

(I) *Protection of depositors*: As we noted earlier, banks act as depositories for the savings of the public. The fortunes of depositors therefore becomes inexorably linked to that of their banks and they have to find ways of guaranteeing the safety of their deposits. Investigating the factors which determine deposit safety is however too complex for individual depositors and the relevant information may not even be available to members of the public. The government then comes in to alleviate this "depositor ignorance" by evaluating the condition of banks and enforcing necessary safety procedures (Mayer, op. cit. p. 132). This is achieved through measures such as providing deposit insurance, prescribing capital adequacy standards and monitoring credit quality.

(II) *Monetary stability*: Since banks play a central role in the payments mechanism, they represent channels, through which monetary and credit policies are implemented. It is therefore the objective of bank regulation to control those aspects of banks' deposit activities which affect monetary policy especially by specifying those that can offer deposit accounts and the types/levels of reserves that must be held against these accounts. This is necessary because the welfare of banks is closely tied to that of the whole economy. Problems which develop in the banking industry usually spread rapidly because of their lending and investment linkages (Duffey, op. cit.). For instance, a bank run or panic is usually accompanied by a sharp contraction of the money supply which causes a downturn in economic activity with increased unemployment and business failures (Friedman and Schwartz, 1963). As argued by Corrigan (1991), banks are regulated because of "systemic risk" which refers to the danger that problems in financial institutions can quickly be transmitted to other institutions, thereby inflicting damage on them and the economy at large. Similarly, Eisenbeis (1987) contended that the externalities associated with cumulative bank failures provide the rationale for public intervention.

Banking regulations are therefore instituted "to provide a stable framework for individuals and business to conduct monetary transactions and to prevent fluctuations in business activity" (Spong, 1985 p. 7).

(III) *Efficient and competitive financial system*: Regulations also arise from the need to maintain sufficient competition in the banking industry. Competition breeds efficiency since a competitive environment forces banks to operate efficiently. Bank regulation

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<sup>2</sup> The rest of this section relies in part on Spong (1985) pp. 5-26.

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thus focus on entry into the industry and on the level of concentration of resources.

(IV) *Consumer protection*: Regulations aim at protecting borrowers from abusive practices by making them more aware of the cost and commitments of loan contracts. This is often pursued through "disclosure acts", requiring lenders to provide borrowers with meaningful information on credit terms.

(V) *Economic development*: A notable objective of regulations especially in developing countries is to ensure the flow of credit into so-called "high-priority sectors". Banks, being profit-oriented entities have little incentive to extend credit to high-risk but socially desirable ventures such as agriculture and small-scale industries. Consequently, selective credit controls are imposed on the argument that "the financial intermediation process does not by itself ensure the socially optimum use of resources" (Coats and Khatkhate, 1980 p. 25).

### 3. Bank Regulatory Agencies in Nigeria

In Nigeria, there are four principal agencies charged with the responsibility of bank regulation and supervision. These are the Central Bank of Nigeria (CBN), The Federal Ministry of Finance and Economic Development, The Nigerian Deposit Insurance Corporation (NDIC) and the Securities and Exchange Commission (SEC).

(I) *The Central Bank of Nigeria (CBN)*: The CBN is the primary body responsible for the regulation and supervision of banks. Under the Central Bank Act of 1968, the CBN is empowered to supervise the operations of all banks in the country. Its Bank Examination Department scrutinizes periodic bank returns and undertakes regular examinations of the books of the banks to ensure conformity with statutory regulations. The CBN has the power to fine any bank which contravenes statutory regulations and in extreme cases, it has the authority to remove erring bank officers. The CBN is also the principal bank chartering agency though the Federal Ministry of Finance and Economic Development has the final word in the issuance of bank licences. It is the CBN however which receives applications for licences, processes them and makes recommendations to the Ministry. The conduct of monetary policy through the use of weapons such as reserve requirements, discount rate changes and credit controls is also a major function of the CBN. This falls under its mandate of ensuring monetary stability in the economy.

(II) *The Federal Ministry of Finance and Economic Development*:

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This is the ultimate body approving the issuance of bank licences. The Ministry however acts on the recommendation of the CBN. It has some regulatory powers which are occasionally exercised after due consultations with the CBN. These are usually in form of policies aimed at maintaining monetary stability. For instance, in May 1989, the Ministry directed all government parastatals and agencies to transfer their deposits from commercial banks to the central bank in an attempt to reduce the inflationary monetary overhang in the economy.

(III) *The Nigerian Deposit Insurance Corporation (NDIC)*: The NDIC was established by Decree No. 28 of 1988. Its primary function is to insure deposits in all depository institutions. The insurance is funded from annual assessments with each bank required to pay 15/16 of one *per cent* of its total deposits at the end of the preceding year. Each depositor is covered up to a maximum of N 50,000.

As an independent agency, the NDIC has supervisory powers in order to maintain the safety and soundness of the insured banks. The examiners of the NDIC are authorised not only to audit a bank's condition and verify that it complies with prudential regulations, but also to counsel banks regarding ways in which management could reduce the risk of failure (see Alawode, (forthcoming)). The NDIC has the power to restrict the activities of erring banks and to advise the closure of any bank deemed to be insolvent. In the extreme, the insured status of a bank could be terminated after giving due notice to depositors.

(IV) *The Securities and Exchange Commission (SEC)*: In-as-much as some banks are listed in the stock market, they fall under the regulatory auspices of the SEC. This relationship will become more important as other banks get quoted under the ongoing privatisation exercise. The SEC was established by Decree No. 71 of 1979 and has the responsibility of registering securities so as to determine the adequacy and validity of information provided about offered securities (Alile and Anao, 1986). The SEC therefore determines the amount and time at which securities are to be offered for sale and it maintains surveillance over the securities' market to ensure orderly, fair and equitable dealings.

#### **4. Deregulation and the Challenges to Bank Supervision**

The challenges to bank supervision have multiplied with the initiation of financial deregulation in 1986. We have witnessed an increase in the number of banks from 40

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in 1986 to 124 by June, 1991. This was as a result of the authorities' less conservative attitude to the issuing of bank licences. However, the proliferation of banks has not been matched by an equivalent increase in the supply of skilled personnel (see Oballum, 1991). There is now a scarcity of qualified and experienced professionals with many new banks forced to employ individuals who do not possess the requisite managerial experience. These banks are likely to run into problems since the management of bank risks requires sound judgment and good organisational skills especially in the increasingly competitive environment. The lack of experienced staff could easily lead to poor internal controls, frauds and bad loan procedures, putting the affected institutions in jeopardy (Snoek, 1989).

Also, deregulation has given banks expanded powers in the range of assets and liabilities they can acquire. Investment options have been broadened and liability management is now widely practised. Banks have become active in insurance-brokerage, sale and purchase of foreign exchange, equipment-leasing and stock-holding in non-financial firms. Although such new powers could foster greater efficiency and flexibility (Greenspan, 1988 p. 7), they lead banks into hitherto unfamiliar terrains which expose them to a variety of new risks. Considering the shortage of skilled personnel, such a development raises serious anxieties about the ability of banks to reasonably manage such new risks.

The introduction of deposit insurance is ironically another source of worry. Though deposit insurance is expected to promote depositor confidence and prevent bank runs, it has the potential to significantly alter the attitude of banks toward risks (Kuprianov and Dotsey 1990). The subsidy provided by deposit insurance contains a "moral hazard" whereby banks assume higher risks knowing well that depositors no longer have the incentive to monitor them. The moral hazard is worsened if the authorities show reluctance in liquidating insolvent institutions.

The expansion of the financial system has increased the number of non-bank financial intermediaries (NFIs). Though information on the operations of these institutions is undesirably sketchy, it is evident that they are rapidly attaining prominence. This is a welcome development in the spirit of institution-building but the fact that NFIs are not regulated leaves much to be desired. They have no capital-adequacy standards, their accounts are not regularly audited and they render no statistical returns on their operations. Many of them engage in non-financial activities such as clearing and forwarding, thereby assuming more risk than prudence suggests. With deregulation, NFIs are forging closer ties with other financial institutions; the danger therefore exists that trouble

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in this part of the financial industry could eventually inflict damage on other institutions in a classic manifestation of contagious distress.

The multiplication of banks will definitely impose extra demands on the available regulatory and supervisory resources. A chronic problem of bank supervision in Nigeria is the lack of qualified and experienced staff. This problem will become more acute as the number of institutions to be monitored increases.

The expansion of financial institutions also fosters increased competition which may ultimately threaten the soundness of many banks since a more competitive and deregulated environment increases operating risks. As the struggle to out-do rivals mount, unsound practices tend to develop (see Larrain, 1989). In particular, credit standards may fall as banks compete for loan customers.

There has been an upsurge of liability management in the banking industry following deregulation. Money market instruments such as Certificates of Deposit (CD) are now actively traded in the race to mobilise deposits. This may lead banks to maintain less liquid asset structures on the confidence that these instruments could be utilized when needed to activate idle money balances (Thomas, 1979 p. 384). Banks could therefore have difficulty in meeting unforeseen cash needs which may set off a run by depositors. Moreover, since CDs and other instruments encourage the transfer of funds from one bank to another, the fortunes or misfortunes of different institutions become closely linked. A default by one bank triggers a direct "pyramid effect" whereby local weaknesses inflict damage on the entire financial system<sup>3</sup>. This problem becomes magnified in a developing country like Nigeria where the opportunities for prompt portfolio adjustments are slim, considering the narrow nature of the financial market.

Finally, the historical performance of the supervisory authorities is nothing to cheer about. Banks have often flouted statutory regulations with impunity. In 1989, it was revealed that a total of 27 banks did not meet the prescribed minimum capital standards. Also, over the years, banks have failed to observe statutory targets set for the allocation of loans and advances to the various sectors of the economy, usually exceeding the ceiling for "less-preferred" sectors and falling short of targets set for "high-priority" sectors. (Nwankwo, 1990). With the foregoing in mind, the urgency for reshaping supervisory capabilities and regulations in line with the ongoing deregulation becomes clear.

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<sup>3</sup> For a discussion of the Pyramid effect, see Evans, R. W. and Makepeace G. (1979, pp. 97-98); Ikhide, S. and Alawode, A. (Forthcoming).

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It is our opinion that further delays may prove costly.

### 5. Policy Recommendations

Streamlining bank supervisory procedures should take careful note of the identified problems. First, the CBN and associated regulatory authorities should pay particular attention to strengthening banks' management. This could be pursued through training programmes designed to intimate bank personnel with up-to-date techniques of banking. Training in credit analysis, risk evaluation, loan documentation and financial control should be stressed and the Training school of the CBN would be of immense value in this regard.

While the authorities worry about the quality of bank management, the banks themselves should recognise that staff training and development is a *sine qua non* for their success. They should therefore intensify their efforts in the training and development of the requisite manpower. They should take advantage of institutions such as the Financial Institutions Training Centre (FITC) and the Centre for Management Development (CMD), both in Lagos. The Nigerian Institute of Management (MIM) at Enugu could also be of assistance.

In the extreme, the authorities should not hesitate to remove any weak bank management. It is their duty to replace incompetent management before the affected bank runs into serious trouble. The concern for the quality of bank management stems from the recognition that "the primary line of defence against banking insolvency and financial system distress is the quality and character of management within the banks themselves" (Polizatto, 1990).

Second, the authorities need to modify their supervisory procedures to maintain their relevance in a deregulated environment. CBN Annual Reports indicate that on-site inspections are few, and only focus on ensuring bank compliance with statutory prescriptions such as sectoral credit guidelines. This should be carried further to include thorough financial analyses, meant to reveal the strengths and weaknesses of individual banks (Snoek, op. cit.). In particular, such exercises should aim at determining the accuracy of bank reports plus an assessment of their assets and management control systems. In assessing the quality of assets, loans should take primary attention because they constitute the principal component of bank assets. As such, formal loan policies within each bank should be analysed and the extent of policy adherence determined.

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The CBN currently has a practice of concentrating on new banks to make an early appraisal of their strengths and weaknesses. This is to enable the CBN assist them overcome "teething problems". We feel this should continue given the fierce competition such new banks have to face from inception.

Improvement of supervisory procedures will achieve nothing unless regulatory authorities possess adequate enforcement powers. They must be able to impose appropriate sanctions whenever prudential regulations are violated. Not only should they levy fines and issue formal warnings, they must also possess the power to remove bank management if necessary. It is only then that the whole regulatory apparatus will have the desired potency.

The new portfolio powers acquired by banks should also be closely monitored. These activities take banks into new spheres and bring them into contact with unfamiliar risks. Banks should be made to render accurate and timely returns on such new activities as equipment leasing, stockholding and insurance brokerage. These returns should be properly scrutinised to reveal problem areas for early attention.

Some aspects of bank regulation also require reform. In the prevailing atmosphere of deregulation, policies such as credit ceilings, interest controls and sectoral credit guidelines are costly anomalies. Credit ceilings restrict access to needed funds to carry out productive investments while interest rate controls discourage savings (McKinnon, 1973; Shaw, 1973; IMF, 1983). Though interest rates were deregulated in 1987, controls were reimposed in January, 1991 on the argument that high costs of investment were slowing down economic recovery. It is our opinion that such restrictions be dismantled.

We noted earlier the increasing importance of NFIs in the economy. It is important that they be subjected to regulatory and supervisory attention. Licensing should be properly monitored and minimum capital standards prescribed. More importantly, they should be required to make statutory returns which will assist the authorities in determining the state of individual NFIs at any point in time.

It is cheering to note that prudential guidelines for banks have been officially issued. It covers making provisions for loan lossess and also imposes a uniform accounting standard on banks. This makes it easier to appraise and evaluate the financial condition of different banks. This task was previously complicated since bank supervisors had to analyse reports from different banks using different accounting and reporting systems.

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Also, higher capital standards are now required of banks. Commercial banks are now required to have a minimum capital base of N 50 million, up from N 20 million. Also, Merchant banks are now expected to have a minimum of N 40 million, compared to the previous N 12 million. The increased capital standards ought to provide banks with a stronger fortification against losses. However, it is the duty of the regulatory agencies to ensure compliance.

Evidence cited earlier showed that many banks violated minimum capital requirements. Such situations should be prevented if these revisions are to have the desired relevance.

The regulatory and supervisory reforms suggested would be of no effect unless the authorities awake to their responsibilities. Regular consultations and exchange of information should take place among the different regulatory agencies. Their goals should be pursued with objectivity and consistency. Most importantly, the regulatory authorities should be immune to political interference, so that they can adequately pursue their principal goal of ensuring soundness and safety within the financial system.

## 6. Conclusions

This paper has examined the implications of deregulation for the safety and soundness of the financial industry. The central contention was that deregulation poses new challenges to bank supervision which may prove over-whelming unless appropriate changes are made. In particular, we noted that giving banks expanded powers, softening entry barriers and the growth of non-bank intermediaries may pose threats to the safety of the system, placing heavier demands on the supervisory authorities.

As such, appropriate regulatory and procedural changes are suggested with a view to reshaping the supervisory framework. This is done on the conviction that unsound bank practices will develop if the regulatory environment does not keep pace with the deregulation of the financial system.

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### **Abstract**

*In 1986, Nigeria adopted a medium-term Structural Adjustment Programme (SAP). A major plank of this package was financial deregulation which involved the softening of entry barriers into the banking industry and the granting of expanded powers to banks in their acquisition of assets and liabilities.*

*The attendant euphoria soon died as it was revealed in 1989 that the financial condition of many banks had deteriorated. Bad debts, managerial problems and large scale frauds were rampant.*

*The main objective of this paper is to examine the implications of financial deregulation for the effectiveness of bank supervision in Nigeria. This is done on the recognition that deregulation not only poses potential threats to the health of the financial system, but also places heavier demands on the supervisory authorities.*

*Consequently, our central contention is that urgent steps need to be taken to reshape the existing bank supervisory framework, so as to ensure its relevance and effectiveness within a liberalised financial system.*



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## LE LIBERALISME FINANCIER ET LE DEFIL DE LA SUPERVISION BANCAIRE AU NIGERIA

### RESUME

*En 1986, le gouvernement Nigérian adopte un programme d'ajustement structurel à moyen terme. Le désengagement de l'état vis à vis de la production et du secteur financier forme la pierre angulaire de ce programme.*

*L'euphorie qui suivit le lancement du programme au Nigéria n'a pas beaucoup duré. On découvre bientôt de la part des banques des mauvaises dettes, des problèmes de gestion et une rampante corruption.*

*L'objectif de cet article est d'examiner les effets du libéralisme financier sur la supervision des banques par les autorités monétaires. Nous reconnaissons qu'un libéralisme total pose d'autres problèmes, notamment la supervision devient plus difficile en face de la relaxation des lois bancaires jusqu'alors restrictives.*

*Nous proposons, en conclusion, une révision et une réorientation urgente de la supervision bancaire pour qu'elle puisse répondre d'une manière plus adéquate aux nouvelles exigences d'un secteur financier libéralisé.*

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## Summary

Rural women have been one of the most consistently neglected groups in development planning and programming, and, paradoxically, one of the groups with the greatest unrealized potential. Direct access to credit, accompanied by savings, can become a catalyst for change that brings benefits to rural women, as well as to their families and communities. The book will address this issue as follows:

— In the introductory chapter, the reasons for direct, lending to rural women in developing countries are highlighted and women's creditworthiness is reviewed.

— A review of women's informal practices of borrowing and saving, their advantages and disadvantages is given in Chapter 2.

— This is followed by an overview of women's limited use of formal financial markets for borrowing and savings, and existing constraints on the supply of credit to women in Chapter 3.

— Chapter 4 discusses women's demand for credit, its assessment and promotion, with reference to both institutional credit and to savings.

— Chapter 5 provides an overview of institutional strategies for providing financial services to rural women, either separately or together with men, with extensive case illustrations; the variety of operational linkages that are being tried between credit and savings.

— The role, development and functioning of grassroots credit and savings groups, and the factors that determine its effectiveness in practice are discussed in Chapter 6.

— The concluding chapter summarizes what we have learned about the planning of appropriate financial services for women and the related policy implications.

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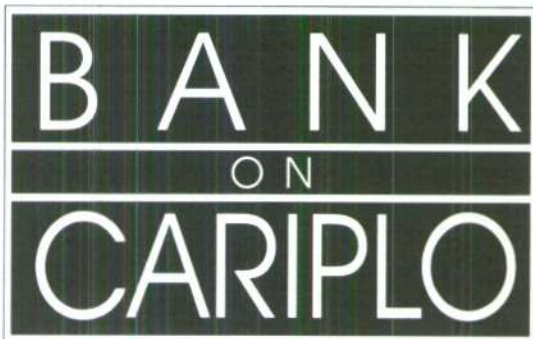
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