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BANKING SECTOR REFORMS AND BANK CONSOLIDATION IN NIGERIA: CHALLENGES AND PROSPECTS.

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This paper evaluates the challenges and prospect associated with the recent banking sector reforms and consolidation in Nigeria. It is hoped that it would serve as a useful guide to the stake holders and other relevant regulatory agencies charged with the task of achieving credible reforms in the Nigerian banking industry. The issue discussed relates to the structure of the Nigerian banking system, conceptual issues, the rationale and objectives, challenges and prospects of banking reforms in Nigeria. This paper concluded that the current reform was a provocative response to the preponderance of weak banks characterized by persistent illiquidity, insolvency, under capitalization, high level of non performing loans and weak corporate governance. Thus the paper suggested that as we continue to struggle with the challenges of the reforms, there is the need for all stakeholders to partner with the Central Bank of Nigeria (CBN) to ensure that the institutions are safe, stronger and globally competitive to play developmental roles in the economy and re-inforce the confidence of all stakeholders in the industry.

INTRODUCTION

Banking sector reform and consolidation has been an on going economic phenomenon. Reforms are predicated upon the need for reorientation and repositioning of an existing status quo in order to attain an effective and efficient state. Banking reforms involve several elements that are unique to each country based on historical, economic and institutional imperatives. According to Gyargy (2001), in Hungary, the reforms in the banking sector predicated against the backdrop of banking crisis due to high under capitalization of state owned banks; weakness in the regulatory and supervisory frame work; weak management practices and the tolerance of deficiencies in the corporate governance behaviour of banks.

Similarly under capitalization, poor management, hostile and unfair competition were some of the reasons for collapse of a number of banks in

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Nigeria in early 50s. The period was described as unregulated banking activities. As a result of the problems, Mr. G.O Patron was commissioned to enquire generally into the business of banking in Nigeria and recommendations were made to the Government on the form and extent of control to be introduced. This led to the formulation of Banking ordinance of 1952, which was the first attempt to reform the banking business in Nigeria. A provision in that ordinance prescribed as part of condition for entry into commercial banking a minimum paid up capital of £25,000 for bank incorporated in Nigeria and £200,000 for banks incorporated outside Nigeria. Since then, various increases have been made in the minimum capital requirement, the most recent being the minimum paid up capital of N25 billion in the current reform in the Nigerian banking system.

According to Odufu (2005) subsequent efforts at strengthening the regulatory framework resulted in the enactment of the following banking legislations:-

- The Central Bank of Nigeria Act of 1958;
- The Banks Act of 1969;
- Nigeria Deposit Insurance Corporation Act of 1988;
- The CBN Act of 1991, which amended and repealed the Act of 1958;
- Banks and other financial institution Act of 1991, which also amended and repealed the Banking Act of 1969.

The foregoing shows that reforms have been on-going in the Nigeria banking sector. The form it takes depends on the challenges posed or causative factors. The current reforms are part of the national economic reform; even though other developments such as systemic crisis, deregulation globalization and technological innovation served as a great impetus to the current reforms in the Nigerian banking sector.

Consolidation is reduction in the number of banks and other deposit-taking institutions with a simultaneous increase in size and concentration of the consolidated entities in the sector. From the works of Berger et al, (1999). De Nicolo et al (2003) and IMF (2001), consolidation is mostly motivated by technological innovations, deregulation of financial services, enhancing intermediation and increased emphasis on shareholder value and international competition. A link between consolidation and financial sector stability and growth is explained by two different views. According to Berger (2000), he is of the opinion that increased size could potentially increase bank returns through revenue and cost efficiency gain. This may also lead to reduction in industry risks through the elimination of weak banks and create better diversification opportunities. On the other hand, DE Nicolo et al (2003) argued that consolidation could increase bank's propensity toward risk taking through increases in leverage and off-balance sheet operations. In

addition, scale economies are not unlimited as larger entities and usually more complex and costly to manage.

The consolidation of the banking system in Nigeria is one of the notable features of the recent reform programmes. Interestingly, banking system consolidation is not a new phenomenon in Nigeria. For instance in 1995 Union Bank of Nigeria Plc acquired 75% in citi in Trust Merchant Bank now Union Merchant Bank, Guaranty trust Bank acquiring Magnum Trust Bank and Intercontinental Bank acquiring of 70% equity in the then Meridien Equity Bank of Nigeria in 1996. Also the acquisition of Nigerian-Arab Bank and stanbic Merchant Bank by National Insurance Corporation of Nigeria and SBIC Africa Holdings Limited respectively. In 2003, Standard Trust Bank acquired 51% share in Continental Trust Bank. However these banks that were acquired continued to operate as independent entities with the new owner having controlling share (Bello, 2005).

STRUCTURE OF THE NIGERIAN BANK SYSTEM

According to Bello (2003), the structure of Nigerian banking system were fragmented in terms of the number and size of institutions, ownership pattern, profitability and competitiveness. Added to this, was the oligopolistic nature of the industry where very few banks dominate the scene in terms of assets base, profitability and deposit structure, with others being followers and competing for a narrow segment of the market. The banking industry then consists of mainly two types of services; retail and wholesale. Retail banking is focused towards small groups or individuals while the wholesale banking caters for larger organization and other financial institutions.

Globalization, and advance in information technology has eliminated national boundaries around the world and Nigeria being an economy not in isolation is part and parcel of the trend that has characterized today's world economies. Nigeria is repositioning herself through implementing a number of reforms under the national Economic Empowerment and Development Strategy (NEEDS). One of such reforms is the banking sector consolidation, which is aimed at fostering development of domestic financial institution toward, sustainable development and at the sometime competes on a wider regional and international basis. This can not be achieved with the past structure of the banking system in Nigeria, where ownership is mainly family owned, coupled with the low level of capitalization, which made it difficult for banks to compete favourably with the best international banks in area such as size, technology, expertise, range of quality of service, facilitate international transaction and achieve higher return on their investment. Therefore, the present consolidation becomes imperative to change the structure of the Nigerian banking system.

CONCEPTUAL ISSUES IN BANKING SECTOR REFORMS AND BANK CONSOLIDATION

Banking sector reform and its sub-component, bank consolidation, has resulted from deliberate policy response to correct perceived or impending banking sector crises and subsequent failures. A banking crisis can be triggered by the preponderance of weak banks characterized by persistent illiquidity, insolvency, under capitalization, high level of non-performing loans and weak corporate governance among other, as observed in the Nigeria case (Uchendu 2005). Added to this, highly open economies, especially, those with weak financial infrastructure can be very vulnerable to banking crises emanating from other jurisdictions through the contagion effect. A combination of many of these weak elements could jeopardize the health of the system.

In view of the above, Ajayi (2005) is of the opinion that the facet of banking reforms aimed at ensuring a healthy ambience encompasses reforming the regulatory and supervisory framework, the safety net arrangements, crisis resolution mechanisms, shareholding structure, and structure of the banking industry and enthronement of good governance.

Reform of the regulatory and supervisory frame work is aimed at aligning the institutional framework governing the regulatory and supervision of financial institutions to the needs of a growing and complex financial system. It involves issues of regulating independence, risk-focused and rule-based supervision while safety arrangements in reforms embrace the traditional lender of last resort role, deposit insurance arrangement which cater for both 'normal' and financial crisis situations and prudential regulation and supervision. Reforms relating to corporate governance evolve in order to provide a well established governance structure and oversight process. This is essential in order to engender proper evaluation, understanding and mitigation of risk as well as permit banks to strengthen the stability of their operations and instill accountability. In this regard, risk throughout the institution will be properly managed and improvements will be reflected in a stronger balance sheet.

Similarly, Deccan (2004) opined that reforms in the banking industry are aimed at addressing issues such as governance, risk management and operational inefficiencies, the whirl pool of the reforms is around firming up capitalization. Capitalization is an important component of reforms in the banking industry, owing to the fact that a bank with a strong capital base has the ability to absolve losses arising from non-performing liabilities (NPL). Attaining capitalization requirements is achieved through consolidation, convergence as well as the capital market. Thus, banking reforms are primarily driven by the need to achieve the objectives of consolidation, competition and convergence in the financial architecture. Consolidation and

convergence are achieved through mergers and acquisition. A merger is the combination of two or more separate forms into a single firm. The firm that results from the process could take any of the following identities; acquirer, target or new identity. Acquisition on the other hand, takes place where a company takes over the controlling shareholding interest of another company. Usually, at the end of the process, there exist two separate entities or companies. The target company becomes either a division or subsidiary of the acquiring company.

Studies carried out by Akhavein, et al (1997) and Berger (1998) viewed the concept of consolidation through bank mergers as not just about adjusting inputs to affect costs; but also involves adjusting output (product) mixes to enhance revenues. Bank mergers tend to be associated with improvement in overall performance, partly, because banks achieved high valued output mixes through a shift toward higher yielding loan away from securities. These studies revealed also that merged banks tend to experience a lowering of their cost of borrowed funds without needing to increase capital ratios. The lower cost of funds is consistent with a decline in the overall risk of the combined bank, compared with that of the merger partners taken separately. This may imply that a merger can result in a reduction in some dimensions of risk. This then affords the post-merger bank more latitude to shift to a higher return, though perhaps higher risk output mix, the sources of diversification could be differences in the range of services or the portfolio mixes.

THE RATIONALE AND OBJECTIVES OF BANKING REFORMS AND BANK CONSOLIDATION IN NIGERIA

The rationale of banking reforms and consolidation in Nigeria is seen from the failure of the banking system to attain major objectives of ensuring price stability and facilitate rapid economic development. These are as a result of some deficiencies in the system. From the studies carried out by Odudu (2005), these deficiencies include;-

- Low Capital Base;- the average capital base of Nigerian banks is \$10 million, which is very low compared to that of banks in other developing countries like Malaysia where the capital base of the smallest bank is \$526 million. Similarly, the aggregate capitalization of the Nigeria banking system stood at N311 billion (\$24 million) which is grossly too low in relation to the size of the Nigerian economy and in relation to the capital base of \$688 billion for a single banking group in France and \$541 billion for a bank in Germany.

- A large number of small banks with relatively few branches: the 89 banks in Nigeria as at the end of May 2005 have a total of 3,382 branches whereas the eight bank in South Korea has about 4,5000

branches.

The dominance of a few banks: the top 10 banks control about 50.8% of the aggregate assets; 51.7% of total deposit liabilities and 45% of the aggregate credit.

Poor rating of a number of Banks: Though the banking system in Nigeria is on the average, rated satisfactory, a detailed analysis of the condition of individual banks as at December 2004 showed that no bank was rated very sound, only 10 were adjudged sound, with 51 satisfactory, 16 marginal and 10 unsound.

Weak corporate Governance;- evidence has shown that inaccurate reporting and non compliance with regulatory requirements, declining ethics and gross insider abuse has resulted in huge non-performing insider related credits

Insolvency;- this evidenced by negative capital adequacy ratios of some banks and completely eroded shareholders funds caused by operating losses.

Over-dependence on public sector deposits and foreign exchange trading and neglect of small and medium scale private sector savers. It is glaring that the performance of the Nigerian banking system plays a marginal role in the development of real sector. Therefore not in a position to meet the nation's ideal of a strong, competitive and reliable banking system, which depositors can trust, rely upon and which the nation can depend upon to facilitate its economic growth and development. It is imperative therefore for urgent and fundamental restructuring and refocusing.

The objective of the banking sector reforms as announced by the Governor of CBN on July 6, 2004 are as follows;-

- Requirement that the minimum capitalization for banks should be N25 billion with full compliance before end December, 2005
- Phased withdrawal of public sector funds from banks, starting in July 2004.
- Consolidation of banking institutions through mergers and acquisitions
- Adoption of a risk focused and rule-based regulatory frame work,
- Adoption of new tolerance in the regulatory frame work, especially in the area of data/information rendition/reporting. All returns by banks must now be signed by the managing Director of banks.
- The automation process for rendition of returns by banks and other financial institutions through the electronic financial analysis and surveillance system (e.FASS)
- Establishment of a hotline, confidential internet address (Governor@cenbank.org) for all Nigerians wishing to share any

confidential information with the Governor of CBN on the operations of any bank or the financial system. Only the Governor has access to this address.

- Strict enforcement of the contingency planning framework for systemic banking distress
- The establishment of an Asset management company as an important element of distress resolution.
- Promotion of the enforcement of dormant laws, especially those relating to the various liability of Board of banks in cases of failings by banks.
- Revision and updating of relevant laws and drafting of new ones relating to effective operations of the banking system.
- Closer collaboration with the Economic and Financial Crimes Commission (EFCC) in the establishment of the financial intelligence unit (FIU) and the enforcement of the anti-money laundering and other economic crime measures.
- Rehabilitation and effective management of the mint to meet the security printing needs of Nigeria.

CHALLENGES OF THE REFORM AND CONSOLIDATION PROCESS

The challenges in ensuring the realization of the objectives of the banking system reforms are enormous. Some of these challenges as observed by Odufu (2005) include:-

- Lack of country experience and technical knowledge on large scale consolidation manifesting partly in paucity of experienced staff on subject of mergers and acquisition on both the regulators and operators sides.
- Enormous cost of consolidation which widely discouraged the bank.
- Dominant government ownership in some banks and its implication for good corporate governance in emergent banks.
- The problem posed by delinquent asset and non-performing loans of banks, which might distort the balance sheet of emergent banks if not well handled. The situation was worsened by the prevalence of falsified records/account that were kept by banks.
- The possibility of inflow of laundered funds into the system. Supervisory capacity as a result of the plethora of capital verification exercises arising from mass recapitalization by banks.
- Supervision and regulation of mega banks;
- Possible litigations on mergers as acquisition;
- Operational challenge arising from ICT systems and cultural

integration as a result of mergers as acquisition.

PROSPECT OF THE REFORM AND CONSOLIDATION PROCESS

The Mega banks that evolve through consolidation would have stronger base for big risks and therefore better able to finance key growth sector of the Nigeria economy. The pattern in the past had been that financing for mega and high-risk projects in Nigeria came from external sources, with Nigeria banks either at the periphery or not featuring at all. The income and experience fallout of such projects have invariably gone to the foreign financiers with the current banking system consolidation, the Nigerian bank will be able to finance large ticket transactions and thus create opportunity for capacity building in Nigeria.

Furthermore, from the work of Bello (2005) the following prospect are to be derived from the current banking system consolidation in Nigeria. These include;

- The initial public offering by banks through the capital market. This likely to increase the level of financial deepening as evidenced in the upsurge in the volume and value of trading in the stock market.
- The current reforms in the banking industry has been able to attract more foreign investment inflows, especially in the area of portfolio investment, this development if sustained will boost the level of economic activity especially towards non oil sector.
- As the level of financial intermediation increases, interest rate is likely to fall and increase lending to the real sector that will generate employment and booster growth.
- The consolidation of banks is likely to attract a significant level of foreign banks entrance into Nigeria which will become a feature in the industry over time. This will bring about more confidence by the international community of the banking sector in Nigeria thereby attracting more foreign investment into the country. This invariably will have positive impact on the balance of payment.

CONCLUSION

It was evidenced that the current banking sector reform in Nigeria was a provocative response to the preponderance of weak banks characterized by persistent illiquidity, insolvency, under capitalization, high level of non performing loans and weak corporate governance.

It was in the light of the above that the current banking system reform programme was introduced.

There is no doubt, bank consolidation brings prospect and challenges to all the stakeholders of the banking system. Some of the obvious ones were discussed. As we continue to struggle with the challenges of the banking sector reforms, there is the need for all stakeholders to partner with the

Central Bank of Nigeria to ensure a smooth and effective implementation.

Notwithstanding the pains and strains the policy has imposed on banks, studies have shown that countries that have pursued similar programme realized sound corporate governance and effective risk management systems in the banks. These would ensure that the institutions are safe, stronger and globally competitive to play developmental roles in the economy and reinforce the confidence of all stakeholders in the industry.

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Uchendu, O.A (2005) "Banking Sector Reforms and Bank Consolidation: The Malaysia Experience" in Banking Sector Reforms and Bank consolidation in Nigeria (Publication of Central Bank of Nigeria) Vol 29. No. 2

INTRODUCTION (2007) Bank consolidation is a process of merging two or more banks into a single entity. This process is aimed at improving the efficiency and profitability of the banking system. The Nigerian banking system is characterized by a large number of banks, many of which are small and weak. This has led to a fragmented and inefficient banking system. Bank consolidation is seen as a way to address these issues and create a more competitive and stable banking system. The process of bank consolidation involves the merging of assets, liabilities, and operations of two or more banks. This can be done in a number of ways, including the formation of a new bank, the acquisition of one bank by another, or the merger of two banks into a single entity. The process of bank consolidation is a complex one, involving a number of legal, financial, and operational issues. It is important to ensure that the process is carried out in a transparent and accountable manner, and that the interests of all stakeholders are protected. Bank consolidation is a key component of the banking sector reforms in Nigeria, and it is expected to play a significant role in the development of the banking system in the future.