The Nigerian Banking Industry and Cross-Border Transactions Post Consolidation

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I. Introduction

Financial sectors around the world have witnessed a wave of restructuring and mergers, making bank consolidation a major area of interest in recent financial literature. The underlying justification for consolidation policies is the notion that it reduces the likelihood of insolvency through asset diversification (Shih, 2003). Empirical studies such as Hughes, *et al* (1999) and Saunders and Wilson (1999) also document a risk diversifying effect of bank consolidation, amongst others. Policy-promoted bank consolidation enhances the efficiency of banks in general and their resilience during financial crises. Arguably, this notion underscores the resilience of Nigerian banks as shown by Olaosebikan (2009) who found evidence of steady improvements in bank efficiency during the post-consolidation period.

In terms of performance, however, Somoye (2008) observed that consolidation has not improved the overall performance of the banking industry significantly, and has only marginally contributed to real sector growth and economic development. This raises questions about the effectiveness of consolidation as a remedy for financial instability, in the face of the on-going global financial crisis.

The Central Bank of Nigeria (CBN) commenced a policy-induced bank consolidation in 2004 by raising the capital requirement of banks from ₦2 billion to ₦25 billion. This move was aimed at ensuring the safety and soundness of the financial system. Strong banks are usually bigger and fewer than any other category of banks (Lee, 2001). The successes of countries like Brazil, Russia, India and China (BRIC countries) provide insights into the major role that sound financial systems play in stimulating economic development[1]. In

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[1] See Allen and Oura (2004) for an extensive discussion on the financial system and economic growth.

particular, these countries have achieved higher economic growth and development through the successful transformation of their financial systems. Fadzlan, *et al* (2008) showed that banks could generate efficiency gains by increasing their scale of operations through mergers. As a consequence, they can increase foreign presence and improve profitability. Similarly, the Nigerian banking sector re-capitalization policy might have improved the scope and potentials of the sector and enhanced its ability to play a greater role in the economy and beyond. For instance, banks now have greater capital to undertake bigger transactions and finance cross-border expansion.

The role of consolidation in promoting cross-border banking has not been sufficiently articulated in recent literature, given that most available studies focus on the effects of consolidation on financial stability and soundness. This paper, therefore, provides a broad examination of post-consolidation activities of Nigerian banks with respect to cross-border banking.

The remainder of this paper is structured as follows: Section 2 evaluates the pre-consolidation banking industry in Nigeria, while section 3 investigates the effects of consolidation on the banking industry. The impact of Nigerian Banks on other African economies is the subject of section 4, with section 5 discussing the emerging issues and challenges in cross-border banking. The paper offers conclusion and policy recommendations in section 6.

II. Pre-Consolidation Era

In the early 1990s, the Nigerian banking industry underwent significant changes ranging from the reform of the banking and accounting procedures in 1990 and bank privatization in 1992, to the restructuring of distressed banks in 1993 and liberalization of capital flows in 1995. Prior to the various reform exercises of the 1990s, the banking system was generally characterized by weak and fragile banks; low aggregate banking credit to the domestic economy; periodic systemic crises such as the 1989-91 financial crisis in which seven banks were distressed; and the collapse of the inter-bank market in 1993 which spread to other segments of the financial system by 1995.

The banking sector also experienced a huge increase in the number of banks specializing in foreign exchange activities and an accompanying decline in the number of banks focusing on deposits and credit services (Beck *et al*, 2005). This influx was a consequence of lax restrictions on market entry and the returns on equity earned from arbitrage transactions in foreign exchange markets (Lewis and Stein, 2002).

The banking sector also had an oligopoly structure (10 out of 89 banks accounted for over 50 per cent of total banking system assets) and most banks were relatively small and were unable to finance major transactions in the oil & gas, and telecom sub-sectors. In addition, minimum capital requirements (MCR) for banks was ₦1 billion and total capital base of banking system stood at ₦293 billion as at end-December 2004. This was equivalent to the size of the 4th big bank in South Africa. These features were further compounded by poor corporate governance.

In effect, the frontiers of the industry were restricted, given the banking/population density of 1:30,432 before the commencement of the consolidation programme. Moreover, the payment system encouraged cash-based transactions as against the development of robust electronic banking systems as is the case in other parts of the world.

In order to enhance the efficiency of the banking system, a number of regulatory bodies like the Federal Ministry of Finance (FMF), Central Bank of Nigeria (CBN), Nigeria Deposit Insurance Corporation (NDIC) and the Financial Services Coordinating Committee (FSCC) have provided regulation and policy direction for the sector. Other recent changes in the banking industry include the promulgation of the Failed Banks (Recovery of Debt) and Financial Malpractice in Banks Decree No. 18 of 1994; amendments to the Central Bank of Nigeria (CBN) Decree 24 and BOFI Decree 25 in 1997; and amendments to the Nigeria Deposit Insurance Corporation Decree 22 of 1998.

Notwithstanding these changes, the structure of the banking sector prior to consolidation stifled its performance as a result of the inherent operational and structural incapacities. These inadequacies included low capital base in most banks, implying a plethora of small banks with few branches, coupled with poor bank ratings, weak corporate governance characterized by declining ethics and non-performing insider-related credits.

Furthermore, other challenges included non-compliance with regulatory requirements, over-dependence on public sector funding and the neglect of small and medium scale enterprises (SMEs). Given these challenges, the consolidation policy of the CBN was expected to reduce the effects of these problems. For instance, it was expected to strengthen banks to the extent that they can in turn support the real sector via increased credit.

III. Consolidation and Performance of the Banking Industry

In July 2004, the Central Bank of Nigeria mandated an increase in the minimum capital requirement of all banks from ₦2 billion to ₦25 billion, representing a 1,150 per cent increase. The first phase of the reform began in July 2004 and was concluded on December 31, 2005, with the number of banks reducing from 89 to 25 at the conclusion of the exercise and later to 24 with the merger of Stanbic and IBTC in 2007. The consolidation exercise impacted in the following ways:

- The number of banks reduced to 25 initially and later to 24 and their ownership became broad-based with the exception of the foreign-owned banks. Government ownership of banks (direct and indirect) was limited to 10 per cent;
- More than 7 banks had Tier 1 capital in excess of US$1 billion by the end of 2008. 11 banks had market capitalization ranging between US$1 billion and US$5.3 billion; 16 banks were in the top 1000 in the world; 5 Nigerian banks also ranked among the top 10 African banks as at May 2009;
- With the enhanced capacity, infrastructure and expanded scope (Universal Banking License), Nigerian banks now ventured into big ticket and international transactions such as structured, syndicated, and vanilla trade finances;
- Extension of services (special products) to a largely untapped consumer base like salary earners and general consumer lending;
- Diversification of income base to cover other non-interest income channels such as fees and commissions;
- Expansion into non-bank financial services such as insurance, asset management and mortgages;
- Expansion into the rest of Africa and parts of Europe and the U.S with the goal of

becoming international/regional banks. Nigerian banks are now in 18 countries with 44 subsidiaries as shown in the graph on page 4. In 5 years, Nigerian banks have spread to 15 other African countries and established 39 more subsidiaries; and

- Investment in infrastructure, including branch networks (over 4,600 branches) and ATMs (over 7,000 ATMs).

Table 1 presents the performance of banks before and after the consolidation exercise. Key indicators like assets, deposits and number of branches have increased dramatically, with growth in these indicators ranging from 42 per cent to 507 per cent. Growth in credit to the industrial sector[2] between the pre-consolidation and post-consolidation periods is 507 per cent.

Table 1: Performance of the Banking Sector Pre- and Post-Consolidation

Parameters	Pre-Consolidation (As at Dec. 2003)	Post Consolidation (As at Dec. 2008)	Per cent Increase
Banks' Total Asset (Naira, Billion)	2767.78	14932.00	439
Number of Bank Depositors	13,649,000	34,553,000	153
Total Bank Deposits (Naira, Billions)	1,409	8,693	517
Employment in the Banking Sector	60,227	85,591	42
Credit to the Industrial Sector (Naira, billions)	619.52	3,760.84	507
Credit to the Agric Sector (Naira, billions)	62.10	114.30	84
Credit to the Telecoms Sector (Naira, billions)	293.70	1,107.38	277

Source: Central bank of Nigeria (CBN)

III.1 Post-Consolidation

Nigerian banks established some presence in the African sub-region, Europe and the U.S through the establishment of foreign branches and subsidiaries. The level of activity in the

[2] This might have contributed to the recent increase in non-oil sector's contribution to GDP.

capital market also rose following the reform programme. Market capitalization as at end of 2008 was over ₦6.5 trillion, up from ₦2 trillion in 2004 but had fallen to about ₦5.2 trillion in the wake of the on-going financial crisis. In addition, Nigerian banks have become more diversified and integrated into the global market, with flexibility in the exchange rate management helping in absorbing adverse shocks (Obadan, 2009).

The sustenance of the benefits of the reform programme was, however, threatened by a number of post-consolidation challenges such as inadequate risk management and poor corporate governance rules. A major initial challenge that evolved as a result of the consolidation exercise was the emergence of large-sized banks that experienced problems of integration, acculturation, capacity building, service delivery, and boardroom/management squabbles.

Despite these challenges, Nigerian banks proved to be able to extend their services to other geographical locations. For instance, Claessens (2006) found evidence that cross-border banking supports the development of an efficient and stable financial system which offers wide access to quality financial services at low cost. Moreover, good financial systems are more likely to have cross-border banking.

Four major factors, among many others, have contributed to increased cross-border movements of financial services to the African region, Europe and the U.S by Nigerian banks. These factors included: deregulation has led to less stringent regulatory conditions across countries and this now allows institutions to move freely across geopolitical borders[3]; the strength and competitiveness of our local financial system have enhanced growth opportunities in the industry[4]; technological advances have mitigated costs associated with servicing customers and staff across large geographic distances[5]; and globalization of non-financial economic activity has increased demand for international banking services[6]. These

[3] This is attributed to WTO's General Agreement on Trade in Services (GATS) which has eased cross-border trade in services

[4] Growth in asset, deposit base and credit have enhanced health and competitiveness of Nigerian banks

[5] For example, there has been phenomenal growth in the usage of electronic banking systems like POS terminals, ATMs etc.

[6] For instance, from 1971 to 2004, services' share of world GDP grew from 53 per cent to 68 per cent.

factors served as incentives to Nigerian banks for capital mobility. They have also contributed to the distribution of opportunities/risks across geographical boundaries in a market-determined manner.

IV. Cross-Border Banking and Impact of Banks on African Economies

The role of bank consolidation as a catalyst for cross-border banking provision by Nigerian banks is explored in this section. Increased capitalization meant that banks now had more funds to expand and increase their market share across countries. Some cross-border activities of consolidated banks in Nigeria are:

- ✓ Nigerian banks facilitate the export of financial services from Nigeria to the rest of Africa. By doing so, they promote economic integration within the region;
- ✓ The banks are enhancing the provision of a wide range of universal banking services such as investment banking, securities underwriting, insurance/brokerage services, real estate/mortgage and infrastructure finance to a wider business community in sub- Saharan Africa (SSA), United kingdom (UK) and the US inclusive;
- ✓ Nigerian banks are improving and expanding the platform for supporting economic growth in SSA through the following channels:
  - ➢ Business finance;
  - ➢ Project finance;
  - ➢ Investment finance;
  - ➢ Investment advisory;
  - ➢ Microfinance; and
  - ➢ Consumer finance
- ✓ Nigerian banks also transfer banking skills, technology and experience to other SSA countries. The introduction of a number of new products/technologies to regional economies, including Short Message Service (SMS) banking, mobile banking, internet banking, e-payment solutions, Automated Teller Machines (ATM) underscores this effort. In addition, they create employment opportunities for nationals of host countries, thus, helping SSA countries achieve the macroeconomic objective of low level of unemployment and high output[7];

[7] Modern growth theory suggests that technological progress (and its transfer) are major determinants of growth and employment

- ✓ Their presence in SSA increases competition and promotes best practices in the financial services industry. Improvements in payment systems have also enhanced the development of Pan-African payment products;
- ✓ Nigerian banks deploy huge capital to support subsidiaries that in turn render improved services in a competitive and efficient manner than was hitherto experienced;
- ✓ They have also developed aggressive business practices arising from competition and this has led to the evolution of more sophisticated marketing strategies to gain competitive advantage; and
- ✓ It is also important to note that cross-border banking has shifted the regulatory frontiers of the apex bank. This has led to capacity building to meet the needs of developing regional convergence and unified supervision.

A recent report by the United Nations Environment Programme (UNEP) Finance Initiative 2009 Global Roundtable states that *through the products and services Nigerian financial institutions provide, they are today uniquely placed to influence the direction and pace of SSA's economic development – and by default its long-term sustainability.* Nigerian banks facilitate the export of investments from Nigeria and promote economic integration within the region. Nigerian banks have widened the scope of financial innovation through provision of a wide range of universal banking services such as investment banking, securities underwriting, insurance/brokerage services and real estate/ mortgage and infrastructure finance. As a result, they are able to reach out to a wider business community in SSA.

IV.1 Nigerian Banks vs International and Regional Players

It is important to examine the Nigerian banking system within the context of international and regional financial systems. Consequently, a comparative analysis of Nigerian banks and international banking institutions is presented below

Figure 1: Comparative Performance Analysis

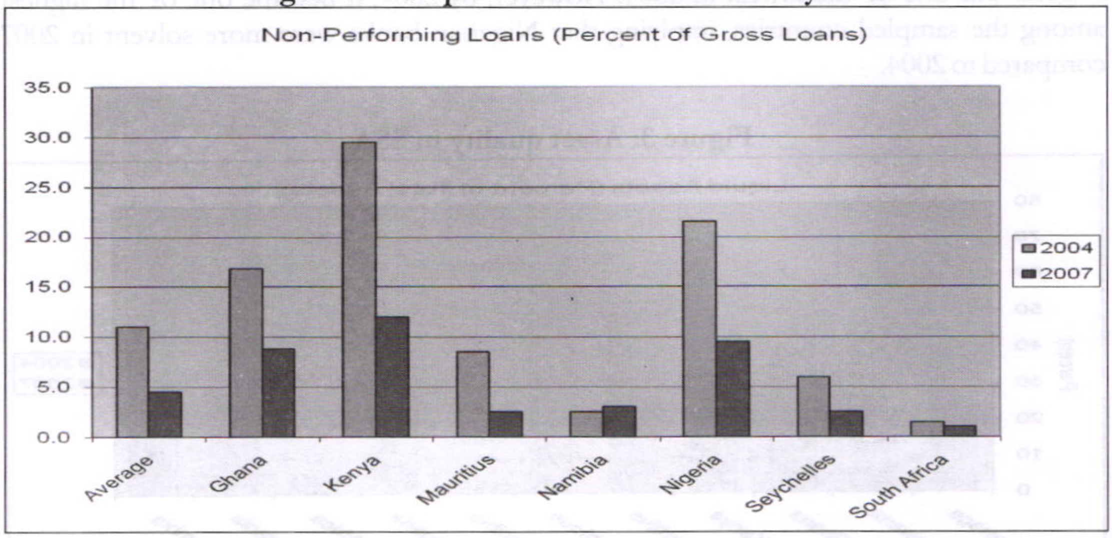
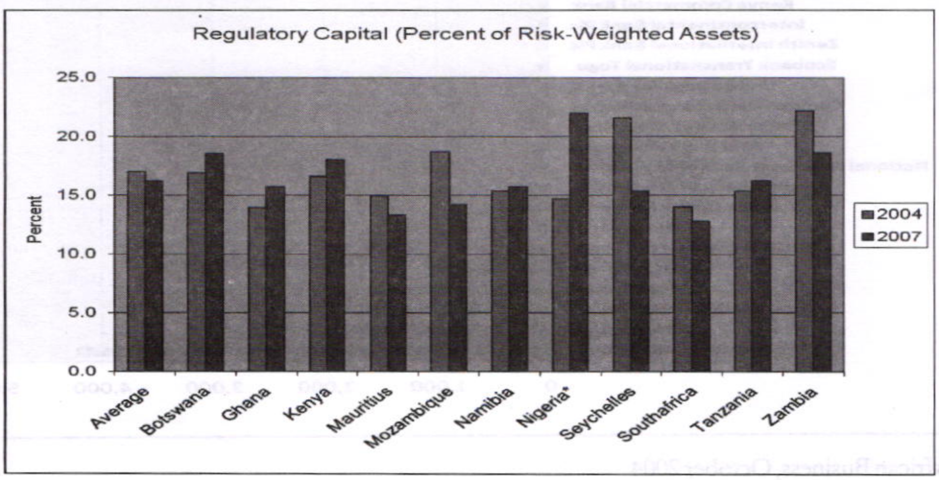


Figure 1 above presents the ratio of non-performing loans to gross loans. The figure for Nigeria was as high as 22 per cent in 2004 but by 2007, it had declined to less than 10 per cent. Comparatively, this is still higher than the average across selected countries. It is shown that Nigeria has the second highest ratio of non-performing loans to total loans after Kenya. This suggests that there is the need to adopt a risk management framework[8] that captures and reflects the underlying situations in the financial system.

Figure 2: Regulatory capital in SSA



[8] For instance, Access Bank is implementing the Basel II Capital Accord as a risk management standard.

Figure 2 above presents regulatory capital as a percentage of risk-weighted assets for banks. Nigeria was one of the lowest in 2004. However, by 2007, it became one of the highest among the sampled countries, implying that Nigerian banks were more solvent in 2007 compared to 2004.

Figure 3: Asset quality in SSA

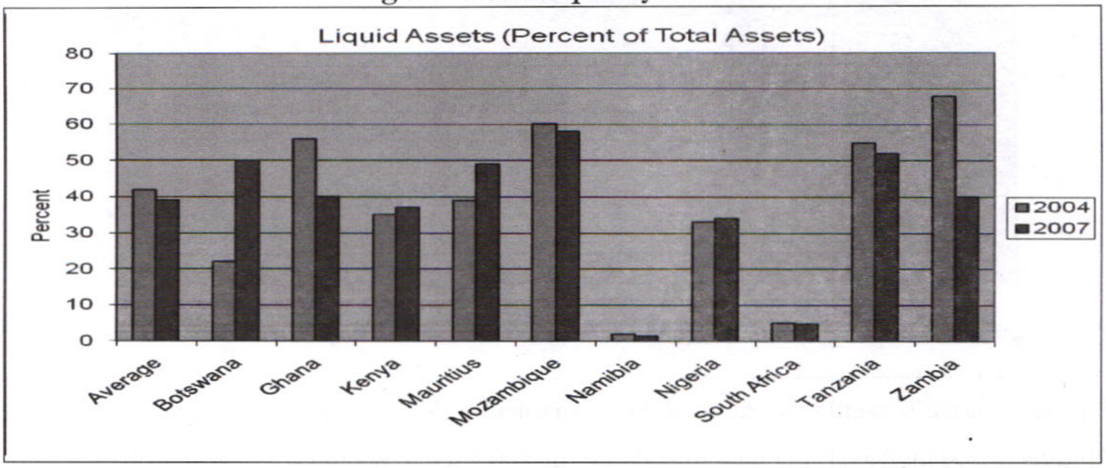
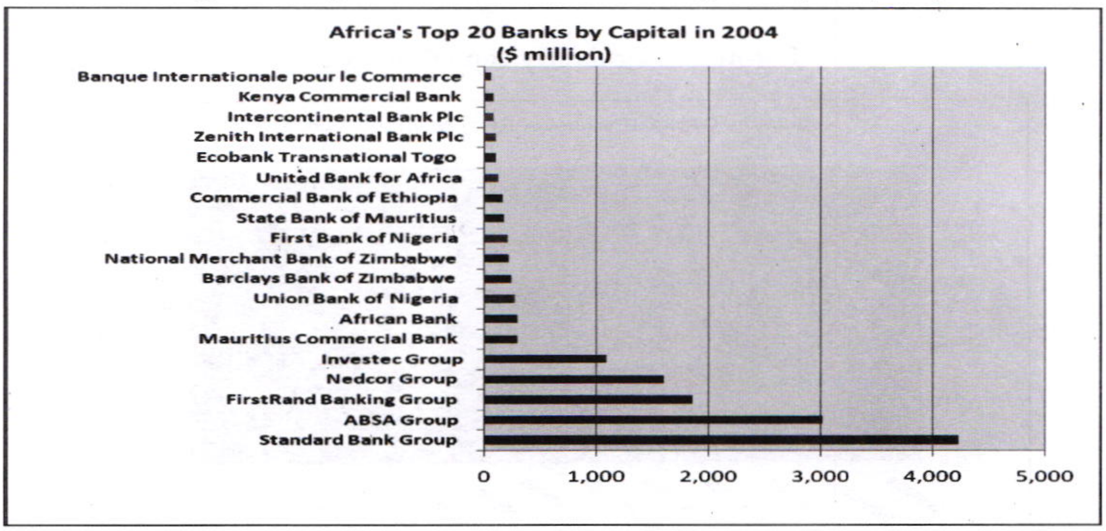


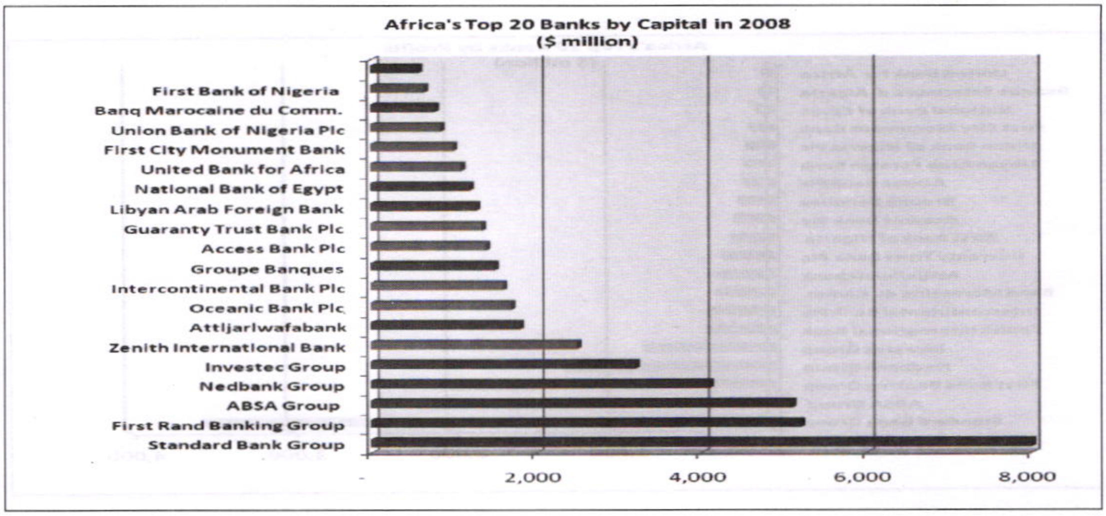
Figure 3 above is a graphical presentation of the liquid asset as ratio of total assets. Asset quality in Nigeria improved marginally from 33.0 per cent in 2004 to 35.0 per cent by 2007 which is lower than the average for other countries during the period.

Figure 4: Top Banks in Africa According to Capital (2004)



Source: African Business, October 2004

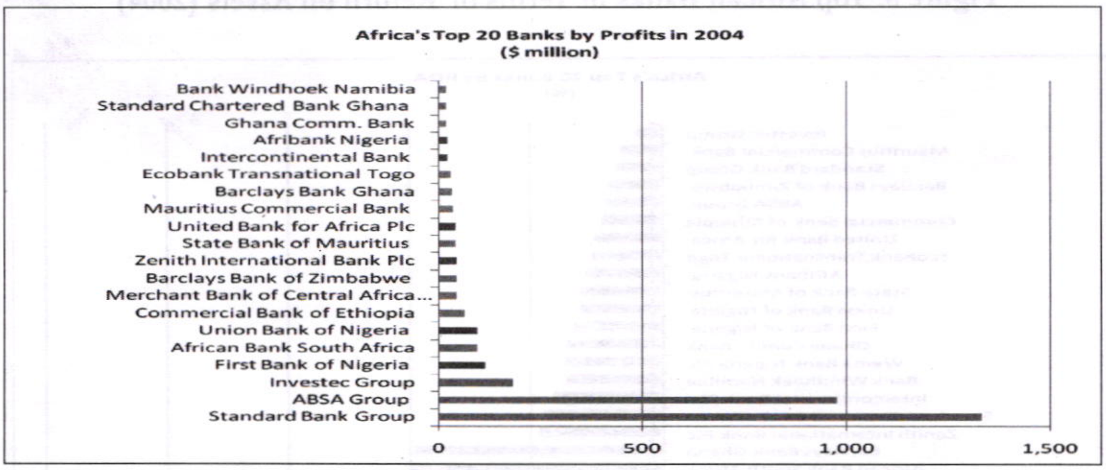
Figure 5: Top Banks in Africa According to Capital (2008)



Source: African Banker, October 2008

Nine (9) banks in Nigeria rank among the top 20 in terms of capital compared to 5 in 2004 as shown in Figure 5 above. Arguably, consolidation in the banking industry in Nigeria resulted in the emergence of big and stronger banks.

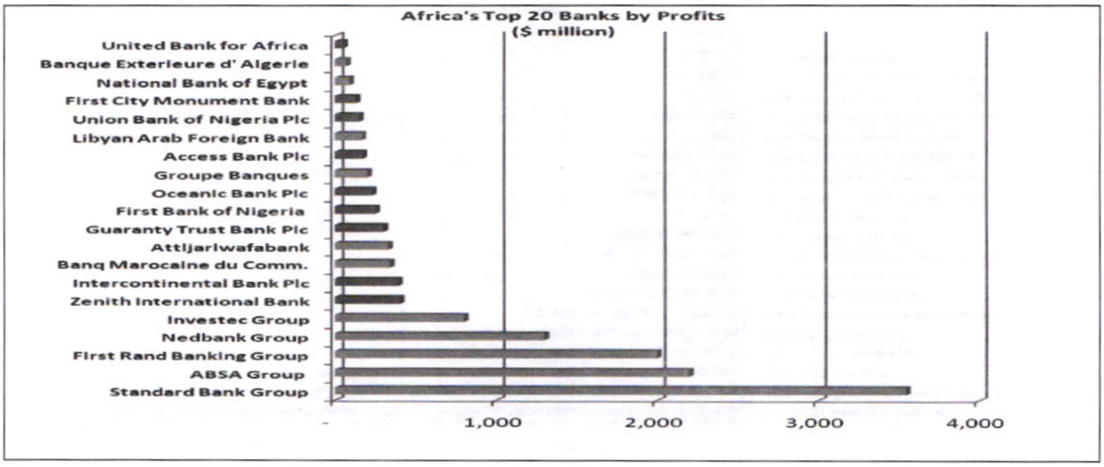
Figure 6: Top 20 African Banks by Profits (2004)



Source: African Banker, October 2008

[9] Ratings as at October 2008.

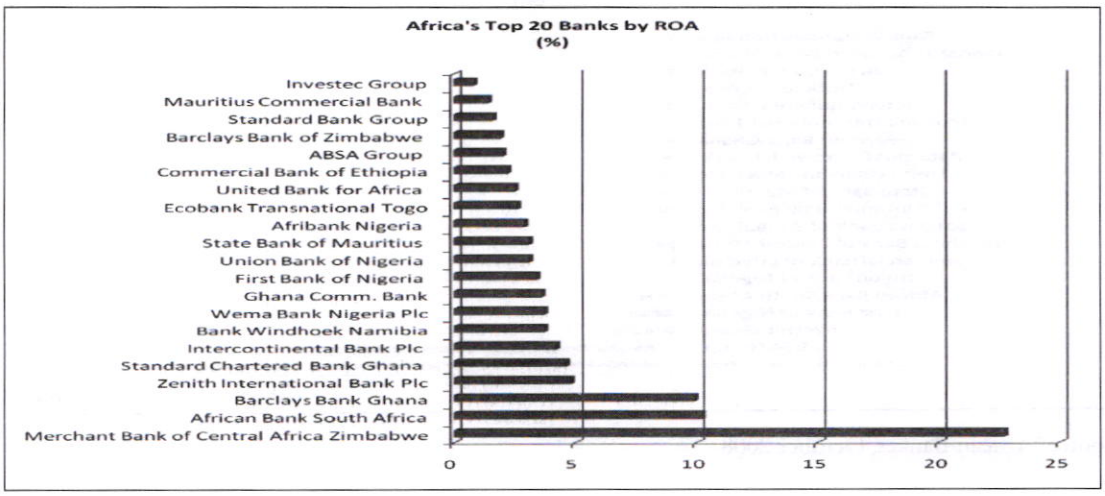
Figure 7: Top 20 African Banks By Profits (2008)



Source: African Banker, October 2008

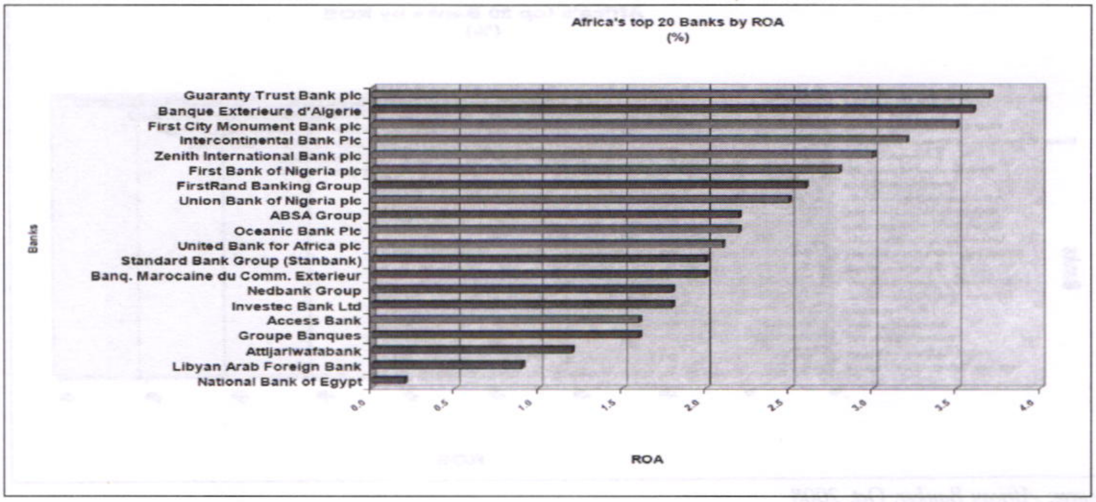
Nigerian banks continued to rank among the top 20 banks in terms of profitability compared to 5 in 2004 before the consolidation policy. This underscores the impact of consolidation on the banking sector as Nine (9) Nigerian banks are now ranked among the top 20 in Africa.

Figure 8: Top African Banks in Terms of Return on Assets (2004)



Source: African Banker, October 2008

Figure 9: Top African Banks in Terms of Return on Assets (2008)



Source: African Banker, Oct. 2008

Four (4) Nigerian banks occupy the top five (5) positions based on return on assets (ROA) while a total of nine (9) banks are in the top twenty (20) compared to none in the top 5 and 6 of the top 20 in 2004

Figure 10: Top African Banks by Return on Equity (2004)

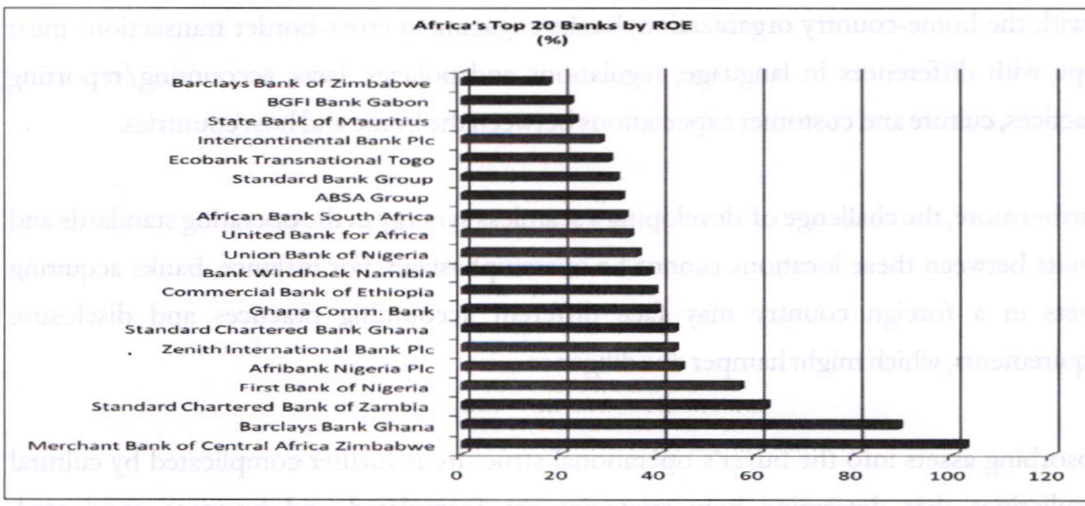
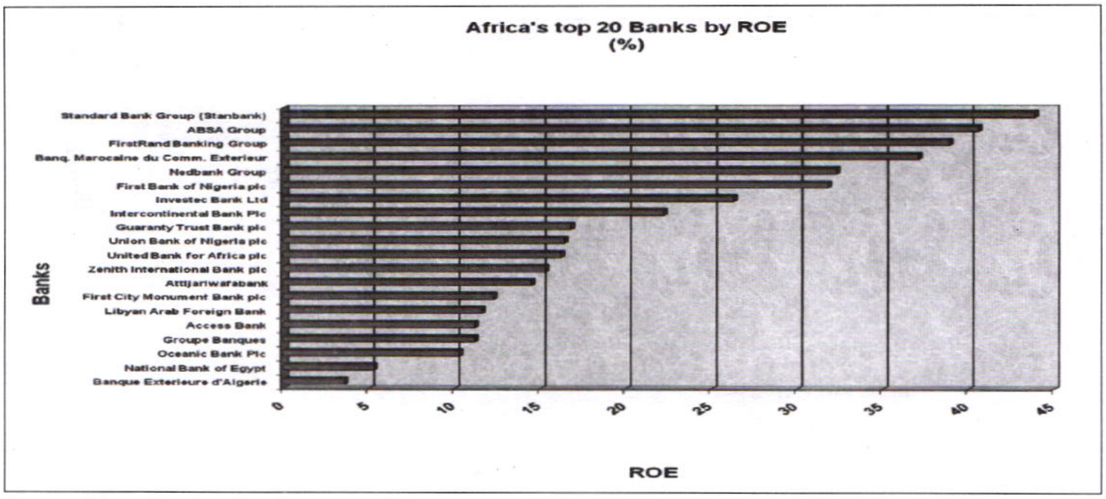


Figure 11: Top African Banks by Return on Equity (2008)



Source: African Banker, Oct. 2008

On the basis of return on equity (ROE), three (3) Nigerian banks are in the top ten (10) and nine (9) are in the top twenty in Africa. Nigerian banks are indeed emerging as a force to be reckoned with in Africa and beyond.

V. Emerging Issues and Challenges

Operating a financial institution in a foreign country raises a number of performance challenges. In addition to the usual difficulties of acquiring a foreign institution and merging it with the home-country organization, banks engaging in cross-border transactions must cope with differences in language, regulations and policies, laws, accounting/reporting practices, culture and customer expectations between the home and host countries.

Furthermore, the challenge of developing a seamless synergy in the operating standards and results between these locations cannot be overemphasized. For instance, banks acquiring assets in a foreign country may face different accounting practices and disclosure requirements, which might hamper due diligence.

Absorbing assets into the buyer's operational structure is further complicated by cultural peculiarities that determine how strategies are formulated and business conducted. Acquisition of foreign entities may also encounter differences in legal systems such as protection of property rights, a factor that adds uncertainty to future transactions.

V.1 Effects of Cross-Border Bank Transactions on Bank Risk and Value

Amihud, et al (2002) argues that, on average, cross-border bank transactions do not change the risk of acquiring banks in any significant way. This finding has important regulatory policy implications in that the effect of overseas transactions is highly bank dependent or idiosyncratic. In particular, there are no general or average increases or decreases in either systematic or total risk. In other words, the risk decreasing effects of cross-border bank transactions are offset by risk increasing effects, and the nature of the merging partners' operation adjusts in a way that leaves the acquirer's risk unchanged. Thus, there is largely no incentive for regulators to restrict banks cross-border expansions[10].

V.2 Challenges facing the Regulators

Consolidation in the Nigerian banking system promoted the emergence of bigger banks which engaged in cross-border and cross-sector activities that precipitated the need for improved supervision in order to monitor the risks associated with such activities. Increasing integration of financial markets as well as difficulty of measuring and controlling domestic monetary aggregates is also a major challenge to regulatory institutions.

In effect, the CBN, in conjunction with the Nigerian Deposit Insurance Corporation (NDIC), commenced the move towards addressing such supervisory concerns by developing a Consolidated Supervision Framework (CSF) for banks in Nigeria. The proposed framework was expected to achieve the following supervisory objectives:

- Ensuring that no banking activity goes on without supervision, irrespective of location, thus eliminating regulatory arbitrage;
- Eliminating double leverage/gearing in the computation of capital adequacy of conglomerates;
- Ensuring that all the risks incurred by a banking group are evaluated and controlled in line with global best practices;
- Enabling the CBN to quickly detect emerging problems for prompt corrective measures; and

[10] It is expected that international capital movements are guided by adequate information on risks and benefits.

- Assisting supervisors to gauge the effect(s) of potential adverse events on banking organizations and on the financial system in a timely manner.

A substantial amount of literature have cited weaknesses in the enforcement of regulation as a major challenge for regulators, thus emphasized the need to adopt this as a priority concern for reform programmes[11]. Similarly, the Group of 20 countries (G-20, 2009) in response to the financial crisis of 2008 also highlighted the importance of the enforcement of financial regulations for financial stability as follows:

"Achieving the objectives of the regulatory framework requires not only sound regulation but also effective enforcement. No matter how sound the rules are for regulating the conduct of market participants, if the system of enforcement is ineffective – or is perceived to be ineffective – the ability of the system to achieve the desired outcome is undermined. It is thus essential that participants are appropriately monitored, that offenders are vigorously prosecuted and that adequate penalties are imposed when rules are broken. A regulatory framework with strong monitoring, prosecution, and application of penalties provides the incentives for firms to follow the rules. This, in the end, adds to the framework's credibility and enhances investor confidence in the financial system".

In that report, the G-20 recommended that effective enforcement should be a priority for all financial regulators. The G-20, thus, recognized that addressing gaps or enhancing regulations must be accompanied by a commitment to effectively enforce those regulations. In financial markets, the implementation of effective and credible enforcement programs has proven to be a challenge for regulators around the world[12].

The 2008 financial scandal involving a Ponzi scheme run by Bernard Madoff, a prominent U.S. financier underscores the difficulty in achieving such a goal, even for regulators that have made enforcement a priority. The scheme, which is estimated to have generated US$50 billion, went undetected by U.S. authorities for more than two decades. This episode has had a negative impact on the U.S. Security and Exchange Commission's (SEC) reputation as well as that of other regulators in the industry.

[11] This assertion is justified within the context of asymmetric information and uncertainties.

[12] Information asymmetry represents the underlying factor leading to financial market failures as with other markets.

The inability to prevent and detect such an enormous fraud illustrates why enforcement is difficult to achieve despite the fact that the damage inflicted illustrates the importance of enforcement. Non-compliance with regulatory requirements can have serious systemic implications for the credibility of the system. Globalization in the face of weak regulatory institutions and governance increases uncertainties and vulnerabilities and likely lead to more devastating future financial crises.

V.3 Cooperation with Foreign Regulators

Consolidation of the banking industry in Nigeria has contributed to breaking down the borders that hitherto existed. Banks now transcend local borders to engage in international transactions in many jurisdictions. As a result, the ability of the CBN to share information with counterparts in foreign jurisdictions and obtain information from foreign regulatory counterparts has become an integral part of successful enforcement.

Although a significant amount of cooperation takes place on an informal basis operationally, it is important that there are clearer rules under which such exchange of information will take place. For example, IOSCO[13] has created a unique agreement, the Multilateral Memorandum for Information Sharing (MMOU), which sets out the best practices and standard for information sharing.

The agreement was developed in 2002 and sets out standards and protocol for sharing of information between members. This includes the type of information that regulators should be able to obtain, the procedures to request such information, the authorized use of information obtained under the MMOU, and the principles of confidentiality that should guide the requests. It is suggested that central banks around the world should set up similar institutions to facilitate information exchange and transfer. Financial globalization is bound to deepen and intensify cross-border regulation and supervision is expected to respond to such developments in an adequate manner.

[13] The International Organization of Securities Commissions (IOSCO) sets the Global standard regulation of securities. IOSCO Principles are used in the IMF/World Bank Financial Sector Assessment program to evaluate the strengths and weaknesses of a country's regulatory system.

VI. Conclusion and Recommendation

VI.1 Conclusion

Nigerian banks continue to play a leading role in sub-Saharan Africa in the face of the current global financial crisis. However, the spiraling effect of a depressed world economy and high level of investors risk aversion would pose growth risks to Nigerian banks. The fall in oil export receipts has led to a fall in disposable income and aggregate demand.

Lower consumer and business confidence together with the increased cost and shortened tenor of foreign trade-related credit have also put pressure on the foreign exchange market and caused liquidity problems. In order to sustain the achievements of the consolidation programme, bank regulators will require robust tools and skills to cope with the increasing supervisory challenges arising from the rapid development of the financial sector. The major challenge for regulators (CBN, NDIC, and SEC, etc) is, therefore, the strengthening of banks to withstand the effects of the on-going financial crisis without hampering their international competitiveness and growth in sub-Saharan Africa and beyond.

VI.2 Recommendations

We offer the following recommendations as inputs to policy designs relating to cross-border banking in Nigeria.

- The CBN should accelerate and intensify moves towards risk-based and consolidated supervision, as well as enhance arrangements to migrate from the current fragmented sub-sectoral supervision to an all-inclusive financial sector regulation.
- Development of information sharing mechanism with foreign regulators for joint supervision of financial institutions and strengthening of institutional coordination through the Financial Sector Regulatory Coordinating Committee (FSRCC);
- Introduction of a supervisory framework which incorporates robust enforcement strategies; it is not the law but its implementation and enforcement that counts. The CBN's recent intervention signals a change in banking supervision geared towards risk management and new disclosure standards; and
- Enforcement is a resource-intensive exercise. Investigations are time-consuming, requiring long hours of requesting, collecting, and analyzing data. A fully effective

enforcement program also requires skilled legal counsel to build and prosecute a successful legal case when there are infractions. Therefore, investigators should have a variety of skills in order to be effective (including analytical skills and knowledge of the industry and markets). In addition, prosecutors are expected to have a full set of legal and litigation skills and an effective framework to ensure compliance.

Given the foregoing, we conclude that Nigeria's objective of becoming the financial hub of Africa via cross-border banking is on course. Cross-border capital movements provide benefits for banks and the economy as a whole. These movements provide increased opportunities to banks (e.g. increased customer base; deposit mobilization; credit creation etc), while the economy attains an optimal level of capital in relation to the rest of the world[14]. There is the need for strengthened regulation to ensure that cross-border transactions are adequately managed to prevent cross-border contagion in financial markets.

[14] Following the assumption that factor mobility yields optimal allocation of resources, cross-border financial transactions will eventually lead to efficient use of factor inputs (capital in this case).

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