

**THE IMPACT OF REGULATORY SANCTIONS ON BANKS FOR
NON- COMPLIANCE WITH FOREIGN EXCHANGE GUIDELINES:
A CASE STUDY OF 25 BANKS**

BY

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FOREWORD

Following the deregulation of the foreign exchange market in 1986, serious distortions and misalignment in the exchange rate emerged

resulting in widespread malpractices and other rent-seeking activities by the market operators. This necessitated a close monitoring of the operations of the authorized dealers.

Nevertheless, several routine and target examinations by the Central Bank of Nigeria (CBN), have revealed the prevalence of sharp practices amongst the authorized dealers. This development had at several occasions left the CBN with no option than to invoke the provisions of the relevant laws on the perpetrators of such acts. Accordingly, in March 2002, the foreign exchange dealership licenses of 25 banks were suspended by the CBN. This singular action barred them from trading in foreign exchange for a period of twelve months. The regulatory measure was not popular in the industry because of the implications of the sanctions on the bottom-line of the affected banks. However, most Nigerians reacted positively and commended the monetary authorities for their determination to restore ethics and professionalism in the market.

This study was specifically commissioned by the management of the CBN, to assess the immediate and prospective impact of the regulatory measures on the affected banks. The study was a follow-up to an earlier one by a joint team of the CBN/NDIC.

We hope that the findings reported in this study will persuade market operators to always play by the rules, as well as encourage the monetary authorities to enforce the policy of zero tolerance in regulatory compliance.

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Director of Research

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The task of the study was lightened by the involvement of the staff of Banking Supervision, Trade and Exchange and the selected banks. We also acknowledge the contributions of Messrs Batari Musa (Deputy Director), W. D. Gotring (S\Manager) and Olu Vincent (Manager) of the Trade and Exchange Department as well as Messrs I. R. Yusuf (S\Bank Examiner), M. A. Raji and S. A. Barde (Bank Examiners) of the Banking Supervision Department at the survey stage of the study. We also express our indebtedness to all the Heads of Division in the Research Department, particularly, Mr. C.M. Anyanwu and Dr. A. Englama, for their respective and valuable contributions. We particularly, appreciate the diligence of the Project Secretary Mr. U. S. Udoette in painstakingly typing the manuscripts. Secretarial assistance was also provided by Mrs O. O. Ikotun, while Mr. P. O. Agbede assisted with office logistics.

Executive Summary

1.0 Introduction:

As part of the efforts to sanitize the foreign exchange market and instill market discipline, the Central Bank of Nigeria (CBN),

among other punitive measures, suspended the foreign exchange dealership licence of twenty five banks for one year in 2002. Expectedly, there were reactions from both within and outside the banking community. In order to ascertain the effect of the measures adopted by the CBN, a joint study team consisting of CBN and NDIC conducted a preliminary assessment while the sanctions were still on.

Bearing in mind the lag effect in policy transmission, it therefore became imperative for a follow-up on the earlier study in order to evaluate the full effects of the sanctions. The need to fill this knowledge gap is the basis for this study.

2.0 Objective of study:

The objective of the study is to assess the primary and secondary impact of the suspension of foreign exchange trading on the affected banks and to highlight the various strategies adopted by the banks to mitigate the impact of the sanctions.

3.0 Study methodology:

The study depended on both primary and secondary sources of data. To generate the primary data, a field survey was conducted through the use of in-depth interview. The secondary data were sourced from statutory returns of the banks to the CBN and the annual financial statements of the affected banks.

4.0 Major findings:

The major findings of this study are summarized below.

- The share of the income of sanctioned banks' derivable from foreign exchange transactions to their gross earnings was on the average 31.1 per cent. Therefore, in the absence of measures taken to cushion the effects of the sanctions, the banks were vulnerable to the regulatory action.
- Analysis of the major key performance indicators of the banks did not reveal the cost of the impact, partly due to aggregation bias and partly because of the alternative investment windows exploited by the banks, particularly investment in NTBs.
- The total deposit liabilities of the banks analysed on quarterly basis showed a decline of 8.8 per cent only in the first quarter during the sanction period. This reflected the initial panic that trailed the sanctions and the subsequent flight to safety by customers.
- Panic withdrawal of accounts by customers because of foreign exchange induced sanctions reflects the poor knowledge of the workings of the banking industry in Nigeria, as the customers misconstrued the sanctions for distress condition in the affected banks.
- The fact that the banks were able to record profits, soon after the initial shock revealed how quickly they recovered. It is also indicative that banking industry in Nigeria is very profitable and that the operators can make decent income without resorting to malpractices.
- The phenomenal increase in the holdings of NTBs by the affected banks when they were out of the foreign exchange

market, and the declining trend immediately upon their return, confirms the substitutability of domestic assets for foreign assets under a positive interest rate regime.

- Total loans and advances of the affected banks grew significantly by 54.6 per cent from the pre-sanction period, reflecting increased tempo of core banking activities. However, this quantum jump was not sustained in the period after the sanctions were lifted as growth slowed to 29.5 per cent, indicating that banks' foreign exchange transactions have replaced financial intermediation as the core function of banks in Nigeria.

5.0 Recommendations:

- Under the current setting of the foreign exchange market where market discipline is lacking, the need to efficiently manage the country's scarce foreign exchange resources makes it imperative that the Bank continue with the present Rules-Based-System. When the rules are broken, sanctions must be swiftly invoked. However, it would be in the long-term interest of all stake-holders for the CBN to pursue more vigorously the campaign for Self-Regulation. To this end, the CBN should institute an annual award based on self regulation to be made at the Annual Monetary Policy Conference. The relevant supervisory departments should work out the details of the criteria which would be used as basis for selecting winners. Such an award particularly, when given wide publicity, would serve as a major incentive for banks to stay clean in view of the

enormous potential benefits in terms savings on advertisements, confidence building, among others.

- The parallel market premium remains a major incentive for malpractices in the foreign exchange market, particularly, round tripping of funds. Therefore, the exchange rate in the official segment of the market should be managed to reflect market fundamentals with a view to narrowing the parallel market premium.
- The introduction of a Wholesale DAS should be considered revisited as it is capable of wiping out the arbitrage. With funds sold directly to authorized dealers, the incentive to round-trip and create distortion would be very minimal, thereby, allowing the rates at the official and parallel segments to converge.
- The CBN should evolve objective criteria for licensing authorized dealers. In other words, not every licensed bank should be made an authorized dealer.

6.0 Concluding Remarks:

The suspension of the foreign exchange dealership licences of the banks involved in malpractices in 2002 served to convey the resolve of the CBN to deal with such unethical conduct. To some extent, it has also served to re-focus them away from undue dependence on the foreign exchange market. It is hoped that the on-going reforms in the industry, particularly, the increase in capital base and phased withdrawal of public funds would reposition the banks to face the challenges of core banking with salutary effects on the stability of the foreign exchange market.

THE IMPACT OF REGULATORY SANCTIONS ON BANKS FOR NON- COMPLIANCE WITH FOREIGN EXCHANGE GUIDELINES: A CASE STUDY OF 25 BANKS¹

1.0 Introduction

1.1 Background

¹ *Research Assistance for this study was provided by the able team of Assistant Economists in the External Sector Division, Research Department including: B. S. Omotosho, T. S. Ogunleye, A. T. Inuwa, M. U. Wambai (Mrs), V. E. Eleam and U. S. Udoette.*

The liberalization of Nigeria's foreign exchange market in 1986 brought about a phenomenal increase in the number of market participants as all licensed banks became authorized dealers in foreign exchange. It also created enormous regulatory and supervisory challenges to the Central Bank of Nigeria (CBN). Before the deregulation of the banking industry and the foreign exchange market, 40 banks were licensed as authorized dealers in the foreign exchange market. However, by 1991, the number has risen to 115. This quantum jump in market participants was not matched with equal supervisory capacity of the monetary authority. This development encouraged widespread malpractices in the foreign exchange market. Typically, the foreign exchange market was characterized by foreign exchange round-tripping, abuse of nostro accounts and arbitraging.

In recognition of the supervisory challenge for a market with numerous operators and the need to instill market discipline, the CBN formulated a set of guidelines and regulations to govern the conduct of transactions in the foreign exchange market. However, some authorized dealers, in an attempt to exploit the existing arbitrage premium resorted to sharp practices in order to contravene the guidelines. In 2002, the routine examination of the foreign exchange transactions in banks revealed cases of wide-scale malpractices. In the circumstance, the CBN had no choice than to invoke the provisions of the relevant laws on the identified culprits. Accordingly, the foreign exchange dealership licenses of 25 banks were suspended for twelve months beginning from March 2002.

Consequently, the banks were barred from trading in the foreign exchange market for that period.

Mindful of the implications of its regulatory action on the affected banks, the CBN constituted a joint study team consisting of CBN/NDIC in 2002, while the sanctions were still in force, to assess the immediate effects of its action. The preliminary findings of the study team revealed that the sanctioned banks were likely to suffer some financial loss as a result of the sanction. This study did not cover the post sanction period and thus was limited in scope. It should also be noted that in presenting the data on bank statutory returns and other sensitive information required for the study, codes were randomly assigned to individual bank in order to maintain confidentiality and nondisclosure.

1.3 Objectives of the Study

The objectives of this study are to assess the full impact of the sanction on the banks after the lifting of the sanction. The study will also highlight the various strategies adopted by the banks to mitigate the impact of the sanction; as well as elicit suggestions towards sanitizing and enhancing the operational efficiency of the market.

1.4 Limitations

There were some constraints in carrying out the study. First, given the sensitive nature of foreign exchange transactions, there was the likelihood of partial-disclosure of information and misclassification of

entries by banks. To minimize this problem, primary and secondary data sources were examined for internal consistency.

Secondly, the difficulty of isolating the effects of the sanctions per se on banks' performance. This is because aggregate profitability of a bank depends on the totality of banking operations.

1.5 Layout of the Study

The paper is organized into five sections including this introductory section. Section 2 presents the conceptual issues, literature review and the legal framework for foreign exchange management in Nigeria, while Section 3 discusses the survey methodology and analytical technique. Analysis of data and presentation of result are presented in Section 4. Section 5 contains summary of the findings, policy recommendations and concluding remarks.

2.0 Conceptual Issues, Literature Review and Legal Framework

2.1.1 Foreign Exchange Market in Nigeria

Nigeria's foreign exchange market is very broad on the demand-side, but very shallow on the supply side. Currently, the market consists of 89 deposit money banks and the CBN, which is also the major market maker. Unlike other jurisdictions, all licensed banks in Nigeria are also authorized dealers in foreign exchange. The market is demand driven and it is characterized by rent-seekers and non-adherence to regulations. Between 2000-2003, a total sum of US\$53.9 billion was sold in the foreign exchange market of which

65% was supplied by the CBN. The end-period exchange rates in the official and parallel market are tabulated below as follows:

Foreign Exchange Supplied to Banks from 2000-2003
(US\$'billion)

	2000	2001	2002	2003
CBN	7.9	9.6	7.8	9.6
Other Sources*	2.3	3.6	5.3	7.8
Parallel Market Rate	121.43	134.41	138.00	149.86
End-period Exchange Rate	106.71	113.01	126.88	137.22
Premium	13.79	18.93	8.76	9.21

Note

*Include non-oil export proceeds, ordinary domiciliary account, external account, purchases from oil companies, Capital importation, Home remittance and other over other over the counter purchases.

Source: CBN Cash flow statement

2.1.2 Exchange Rate Misalignment

A misalignment is the deviation of the nominal exchange rate from its equilibrium value. According to Dornbush (1982), misalignment is determined by changes in economic fundamentals and the expected rate of a change in the exchange rate. The consequences of exchange rate misalignment are well documented in the literature. It fosters the development of black currency markets; facilitates the rapid depletions of the stock of foreign exchange reserves; discourages savings, investments, and business planning; as well as encourages the growth of speculative activities, Itsede (2003). The distortion which results from the misalignment of the exchange rate is particularly serious under a dual-structured foreign exchange market. The premium between market segments creates incentive for

arbitrage activities in the market. Thus, market operators tend to exploit the differentials for profits.

2.1.3 Foreign Exchange Malpractices

Foreign exchange malpractices include among others: over invoicing of imports, under invoicing of exports, round tripping, falsification of documents, trading in “free funds”, duty evasion, and laundering of foreign currencies. Malpractices do impact negatively on the stability of the foreign exchange market, and result in multiple exchange rate practice. The identified causes of these malpractices are numerous, they include; the existence of sustained wide arbitrage premium between the official and unofficial exchange rates, lack of professionalism and ethics.

2.2 Review of Literature

Advanced economies with well developed financial markets and independent central banks generally allow market forces to determine their exchange rates. The problems of multiple exchange rates and arbitrage premium are generally eliminated when the exchange rate is allowed to reflect the economic fundamentals. While it is ideal to have an efficient foreign exchange market, information asymmetry sometimes make the markets excessively volatile or drive exchange rate away from values consistent with their underlying macroeconomic fundamentals. With imperfections in the financial markets, government interventions may become imperative. Taylor (1982) recounts a number of methods which countries use in intervening indirectly in the foreign exchange markets, whenever misalignment is induced by speculative forces. The motivation for

intervention has been widely researched and discussed. Monetary authorities with floating exchange rates most often employ intervention to resist short run trends in exchange rates. In an influential paper, Montgomery et al (1998) noted that central banks have varied goals for their interventions. These may be to influence trend movements in exchange rates, to calm disorderly markets and to readjust its foreign exchange reserves holdings. However, the effectiveness of intervention differs and will often depend on its timing and scale, and on the exchange rate level at which intervention occurs.

The literature further indicates that government intervention in exchange rate management has been quite extensive especially in third world economies. Although each central bank has its own particular set of practices, in most cases it takes place in the dealer market. Humpage (2003) focused on the information revelation process that occurs during intervention and observed that central banks rarely provide traders with information regarding their specific goals for particular intervention. This lack of information in turn makes it difficult to assess the “success” of individual intervention. Generally, the magnitude and persistence of intervention’s influence is dependent on the interaction of central bank’s goals as well as market perception of those goals. Naranjo and Nimalendran (1998) hypothesized that interventions create significant adverse selection problems. They find evidence that dealers increase exchange rate spreads during the intervention and suggested that in doing so they

protect themselves against the greater information asymmetry around intervention.

2.3 Legal and Regulatory Framework For Foreign Exchange Management

The CBN, authorized dealers and other participants in the foreign exchange market operate within a legal framework as provided in the relevant laws. These laws and regulations provide the basis for the monetary authority to regulate and supervise banks and their customers in the foreign exchange market. Prior to the deregulation era, the major foreign exchange law was the Exchange Control Act 1962, which empowered the CBN to approve payments that were not within the authority of the authorized dealers. It also made the CBN responsible for the day to day administration of the exchange control regulations. It was jettisoned because of its failure to address the contemporary international trade and payments needs of Nigeria. It also encouraged corruption and misallocation of resources. The Exchange Control (Anti-Sabotage) Decree, 1977 was later promulgated. The Decree imposed heavy financial penalties as well as imprisonment on foreign exchange offenders. It became an offence to sell or buy foreign currency in Nigeria unless the person had been duly appointed an Authorised Dealer by the Federal Commissioner for Finance. To counterfeit or falsify any document for purposes of obtaining foreign exchange was an offence punishable under the Decree.

Following the deregulation of the financial sector in 1986, the Exchange Control Decree of 1977 was abrogated and replaced with

the Second-Tier Foreign Exchange Market (SFEM) Act of 1986. The Act liberalized access to foreign exchange subject to, inter alia, “satisfactory documentary evidence of a valid, due or outstanding obligation in respect of a commercial or service transaction or of a capital transaction....” However, owing to continued abuses in the foreign exchange market, the government introduced the Foreign Exchange (Monitoring and Miscellaneous Provision) Decree 17, 1995. Under this decree, those offences that attract penalty were broadly highlighted. They include intention to defraud, mutilate, forge, alter or deface any currency, Traveler’s Cheques or other instruments of exchange in the market.

In addition to these major laws and in reaction to the increasing incidences of malpractices in the foreign exchange market, the CBN had from time to time released a number of regulations and guidelines to guide the market. The following which are by no means exhaustive constitute foreign exchange infractions under the guidelines, which therefore attract sanctions:

- (i) Round-tripping of officially sourced foreign exchange attracts the following sanctions: suspension of the authorized dealers for six months with “full effect”; refund of the Naira equivalent of the gains, refer the offence to the sub-committee on ethics of the Bankers’ Committee for notification and subsequently to the police for prosecution; and revocation of the authorized dealership license on second occurrence of breach.

- (ii) Failure to fund account on due date with Naira value of foreign exchange funds bought also attracts suspension from the foreign exchange market for 10 working days and delivery of such funds shall be aborted.
- (iii) Failure to return unutilized foreign exchange also attracts the following sanctions: interest at FED fund rates is to be charged until funds are credited; bank's request for foreign exchange would not be entertained until delivery of contract of sale, and banks shall be entitled to interest on funds bought from CBN until such is delivered.
- (iv) Non-observance of prescribed spread attracts sanctions. The difference as calculated by the CBN shall be refunded to the customer(s), and the bank shall be made to pay the amount so calculated to the CBN.
- (v) Default in the rendition of data, for instance late rendition of data attracts a fine of ~~N~~4,500.00 (Four thousand five hundred naira only) daily, till the returns are rendered. If not rendered by the 10th of the following month, in the case of monthly returns, or Tuesday of the following week, in the case of weekly returns, it shall be regarded as non-rendition. In this case, a fine of ~~N~~100,000.00 (One hundred thousand Naira only) shall apply in addition to ~~N~~20,000.00 (Twenty thousand Naira only) daily thereafter, until returns are submitted. For rendition of false data, the bank's dealership license shall be withheld for six months with "full effect".
- (vi) Banks using foreign exchange for ineligible transactions shall be issued a warning letter, those companies involved

in the illicit act shall be blacklisted and made to refund the foreign exchange sold to them, which will be duly credited.

- (vii) Where bank exceeds the approved Open Position Limit (OPL) three times within the OPL period, such bank shall have their limits reduced by 50 per cent for 3 (three) months.

3.0 Survey Methodology and Analytical Techniques

3.1 Research Design

The study employed both quantitative and descriptive research methodology to investigate the movement in selected Deposit Money Banks (DMBs) balance sheets to assess the impact of the sanctions on the affected banks' operations. A trend analysis of the financial aggregate of the sanctioned banks as a group was carried out.

Given the sensitive nature of the information on foreign exchange transactions and banks operations generally, a field survey using a structured questionnaire and an in-depth interview was designed to generate a wide range of information on issues bordering on their operations. A set of structured questionnaire was administered to each of the selected banks' Chief Executive officers and an in-depth interview session held with the foreign exchange desk officers.

The survey covered the entire target population of twenty five sanctioned banks. A purposive sample of ten other non-sanctioned banks whose inputs were required to facilitate comparative analysis was also included in the field survey. A total of 35 banks were

covered in the exercise. This number represented 39.3 per cent of banks in the Nigerian banking industry.

The team visited the Corporate Headquarters of the thirty five selected banks, thirty four of which are located in Lagos. Thirty five questionnaires were distributed, while thirty three completed ones were retrieved, indicating a response rate of 94.3 per cent.

Table 3.1

Distribution and Retrieval of Structured Questionnaire

	Distribution	Retrieval
Sanctioned Banks	25	23
Non-Sanctioned Banks	10	10
Total	35	33

Source: CBN Field Survey 2004

Table 3.2

Total Number of Banks Personnel Interviewed

Sanctioned Banks	64
Non-Sanctioned Banks	40
Total	104

Source: CBN Field Survey 2004

3.2 Sources of Data

The primary data was generated from the questionnaire as well as other information from the in-depth interview sessions. Other sources of secondary data employed in the analysis were the monthly returns of Deposit Money Banks (DMBs) to the CBN, the audited Annual

Reports and Statement of Accounts of the banks for the period 2001-2003, and the average monthly earnings per share of quoted banks obtained from the Securities and Exchange Commission (SEC). The monthly returns were consolidated into a quarterly time series spanning the period: one year before the sanctions, during the period of the sanctions and a year after the sanctions.

3.3 Technique of Analysis

The study employed a descriptive analysis of the movement in bank's financial statements. The key financial aggregates include: gross income, profit before tax (PBT) and earnings per share (EPS) as measures of profitability; deposit liabilities and bank credit. Other variables included measures of portfolio diversification such as Nigerian treasury bills (NTB) holdings. The value, volume and the growth rates of these variables were considered within the period before the sanctions, during the sanction and after sanction.

4.0 Data Analysis and Presentation of Result

4.1 Data Analysis

The study sought to determine the proportion of income attributed to foreign exchange transactions of the sanctioned banks to their aggregate income with a view to establishing their vulnerability to the sanctions. An analysis of the survey returns showed that on the average, the 25 affected banks as a group earned 31.1 per cent of their gross income from foreign exchange and related transactions before the sanctions. However, it was much higher on individual basis as the share of some banks was as high as 44.0 per cent.

Thus, in order to assess the full effects of the sanctions, a trend analysis of the relevant performance indicators were undertaken over the three distinct periods; pre, during and post sanction. The variables considered include; gross income, profit before tax, earnings per share, deposit liabilities, aggregate credit, and treasury bills holdings.

4.1.1 Gross Income

The gross earnings of 21 out of the 25 sanctioned banks for which data were available stood at ₦74.04 billion prior to the sanctions, it rose by 17.9 per cent to ₦87.29 billion during the sanction period. After the sanction period, gross earnings continued in its upward trend to peak at ₦100.69 billion, representing an increase of 15.4 per cent. The development suggested that banks refocused their activities during the period of sanction. In spite of the positive performance of the sanctioned banks as a group during the sanction, five of the affected banks recorded negative growth rates of 77.0, 19.9, 12.5, 11.8, and 0.8 per cent (Table 1 & figure 1).

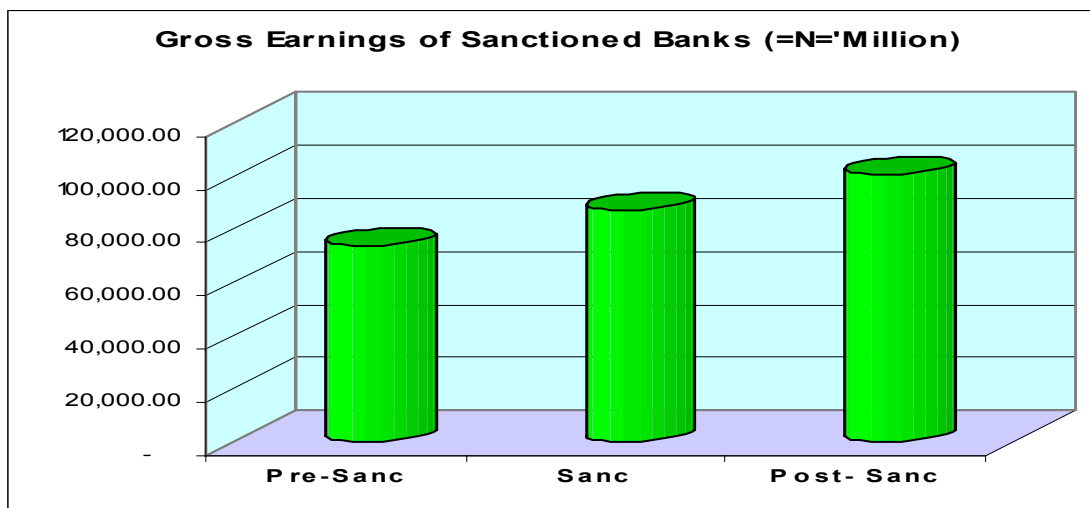


Figure 1

4.1.2 Profitability

[a] Profit Before Tax

The operations of the sanctioned banks generated an average profit before tax of ₦8.6 billion before the sanction. However, this dropped by 18.8 per cent to ₦7.0 billion during the sanction and increased by 38.8 per cent to ₦9.7 billion after the sanction period. The impact of the sanctions was pronounced during the first quarter of the sanction, as the profit before tax of the sanctioned banks as a group, averaged an all-time low of ₦5.9 billion, representing a decline of 28.4 per cent from the level just before the sanctions. After this initial shock, the average profit before tax rose progressively in the period after the sanction. With the exception of five banks, all other sanctioned banks recorded significant decline in average profit before tax during the sanction period. This was further corroborated by the outcome of the structured questionnaire, as most of the banks confirmed the modest effects of the sanctions on their respective turnover. Except for four banks, growth in banks' profit during the post sanction period improved significantly (Table 2 & figure 2).

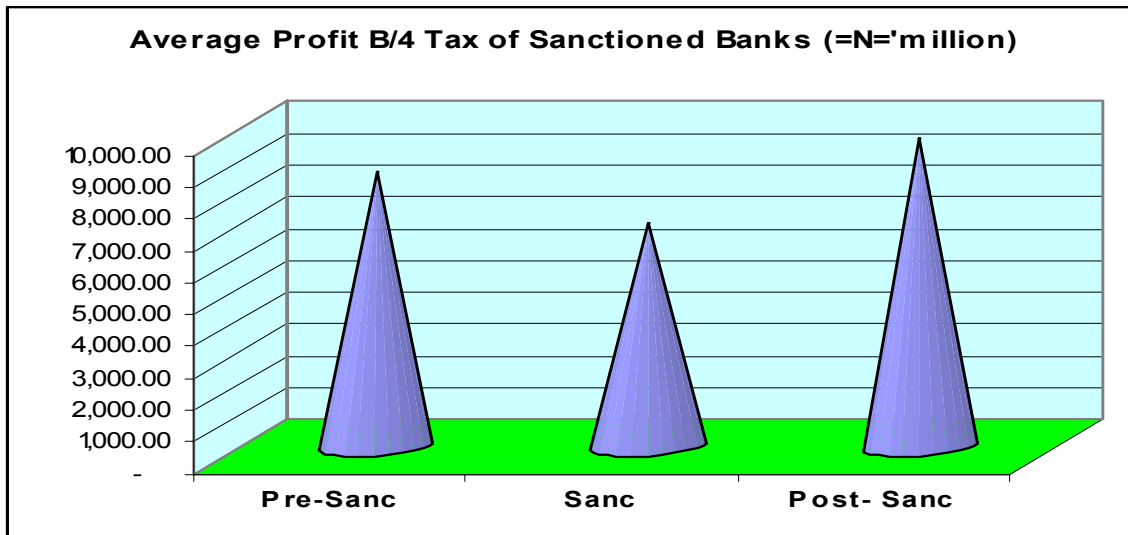


Figure 2

[b] Earnings per Share (EPS)

The average EPS of the sanctioned banks as a group fell from 55 kobo in the pre-sanction period to 33 kobo during the sanctions, indicating a decline of 40.0 per cent. However, after the sanctions were lifted, their average EPS rose marginally by 6.1 per cent to 35 kobo. A breakdown of the movements of the average EPS of individual banks between the pre and during sanction period showed a mixed performance as twelve or 54.6 per cent of the 22 sanctioned banks for which data were available, recorded similar pattern as the group. However, the average EPS of nine or 40.9 per cent actually increased while that of one bank or 4.5 per cent remained unchanged. Also, the trend during the sanction and post sanction period showed that the average EPS of eight banks or 42.1 per cent out of the 19 banks for which data were available increased, while that of eleven banks or 57.9 per cent fell (Table 3 & figure 3).

Earnings per share of sanctioned banks

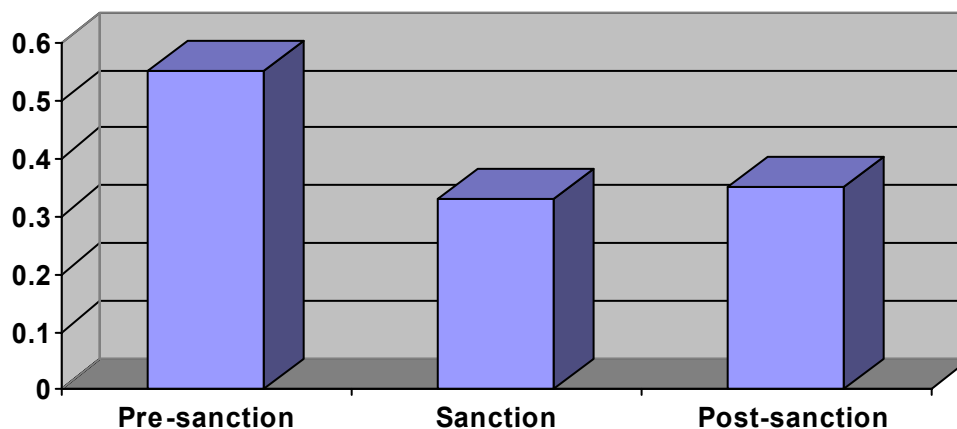


Figure 3

	Pre-sanction	Sanction	Post-sanction
EPS of sanctioned banks (N)	0.55	0.33	0.35
EPS of Non-sanctioned (N)	1.27	1.43	1.57

The average EPS of the non-sanctioned banks was much higher than those of the sanctioned banks in all the three periods considered. This comparison revealed that the sanctioned banks sustained some financial losses as a result of the sanctions.

4.1.3 Deposit Liabilities

The imposition of sanctions could affect the deposit liabilities as bank customers might initially misconstrue the sanction for distress which could trigger a run on the affected banks. The study analyzed this phenomenon. Total deposit liabilities of the sanctioned banks, which stood at ₦271.32 billion prior to the sanctions, fell by 8.8 per cent to ₦247.52 billion in the first quarter of the sanction period. This development was attributed to the uncertainty which pervaded the banking industry immediately the sanctions were imposed. However, after this initial shock, total deposit liabilities began to rise. For

instance, it rose from ~~N~~260.12 billion at end June 2002 to ~~N~~346.19 billion in March 2003 when the sanctions were lifted, and ~~N~~429.13 billion at the end of March 2004. The rising trend in the level of total deposit liabilities was attributed among other things to aggressive deposit mobilization strategy employed by the banks to shore up their deposit base (Table 4 & figure 4).

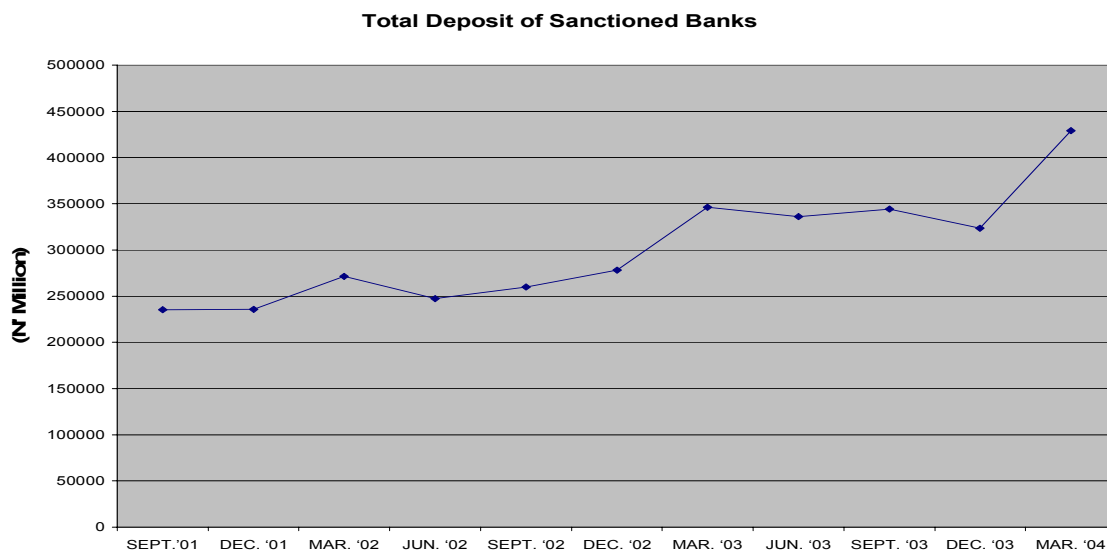


Figure 4

The investigation on customer behaviour to the sanction showed that 16 out of the 25 sanctioned banks or 65% of the respondents actually confirmed that some of their customers transferred their accounts to the non sanctioned banks, 7 banks or 28% noted that the sanction did not influence their customer behaviour while 2 banks or 8% did not respond. This is consistent with the movement in total deposit liabilities of the sanctioned banks as a group which declined from ~~N~~271.32 billion to ~~N~~247.52 billion in the quarter preceding the sanctions and the first quarter after the sanctions.

A further analysis showed that some banks were more affected than others. Earlier study by the CBN/NDIC (2002), also confirmed that the deposits of about 45.3 per cent of the sampled banks were seriously affected, while 30.2 per cent had their deposits unaffected by the sanction. However, 24.5 per cent experienced increased deposits during the period. This standpoint was also corroborated by the current survey result.

4.1.4 Banks' Credit

Aggregate credit of the sanctioned banks outstanding at ₦194.3 billion in March, 2002 before the sanctions, grew by 23.1 and 63.1 per cent to ₦239.1 and ₦316.8 billion during the sanction and post-sanction periods, respectively. This trend is consistent with the rational expectation that sanctioned banks would shift resources to other activities after being barred from the foreign exchange market. Further analysis showed that total credits of three or 12.5 per cent of the twenty four banks for which data was available, fell in the post sanction period indicating that these bank have not fully recovered from the effects of the sanctions (Table 5 & figure 5).

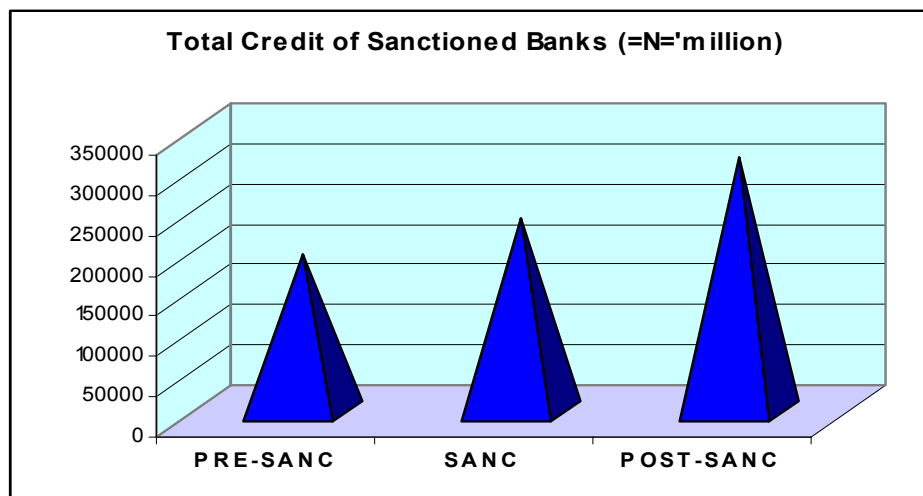


Figure 5

4.1.5 Holdings of Treasury Bills

Aggregate investment in Nigeria Treasury Bills (NTBs) by the sanctioned banks which was ₦40,300.24 million in March, 2002, when the sanctions were imposed, rose steadily to ₦78,585.47 million in December 2002, representing an increase of 95.0 per cent. It reached a peak of ₦98,913.49 million at the end of the first quarter of 2003, which marked the end of the sanctions. Thereafter, it maintained a downward movement for the rest of the year. This confirms that investment in Federal Government short term debt instruments mainly, the NTBs, presented a viable alternative to trading in the foreign exchange market. In other words, after banks were barred from the foreign exchange market, they adjusted their portfolio by increasing their investment in the NTBs, especially, when interest rate remained

Positive in real terms (Table 6 & 7 and figure 6).

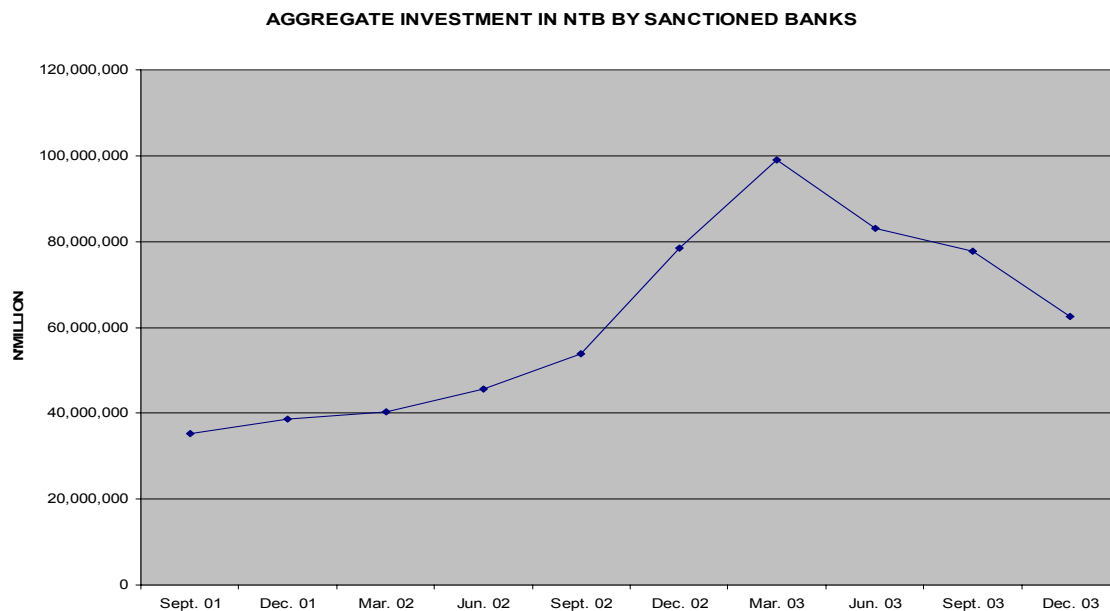


Figure 6

4.2 Strategies Adopted by Banks to Mitigate the Effects of Sanctions

The survey returns indicated that sanctioned banks in a bid to mitigate the effects of the sanctions on their operations, adopted a combination of strategies. These included the development of new products such as E-banking, supported by aggressive marketing strategy; cost reduction measures such as rightsizing, downward salary reviews, embargo on branch expansion, assignment of overly high performance targets and customers enlightenment. Twenty banks (80%) adopted aggressive marketing strategies, five banks (20%) adopted rightsizing measures, four banks (16%) employed the use of customers' fora to explain that the sanction did not in any way connote distress, while eight banks (32%) adopted downward review of salary and other cost-saving measures. Further analysis revealed that 60.0 per cent of the sanctioned banks recorded success in the new products while 40.0 per cent did not do well. One salutary effect of the sanction was that some of the affected banks were able to reinvent themselves through their choice and handling of the strategies they adopted and actually came out stronger.

4.3 Banks' Perception of CBN Foreign Exchange Policies

As a feedback mechanism, the study sought to ascertain the perception of banks on the sanction in particular, and other foreign exchange policies in general. On the efficacy of the use of sanction, 90.9% of the sampled banks indicated that sanction was a proper

instrument for deterrence to foreign exchange infractions, while the remaining 9.1% indicated otherwise. The general consensus was that the duration of the sanction was too long. Eighteen (18) banks or 54.4 per cent were of the view that one year suspension was too long and inimical to their performance and advocated that perpetrators of the infractions should be prosecuted for criminal offences. They also advocated for suspension period of not more than six (6) months period.

On the efficacy of the Dutch Auction System as a tool for foreign exchange management, it was adjudged generally satisfactory. Most of the respondents (69.9%) felt that the Bank's current strategy of regulation, supervision and monitoring should continue. Others (27.3%) advocated for periodic CBN intervention in the foreign exchange market, while a few of the banks were of the opinion that the CBN should be a market facilitator like the stock exchange. About 60.6 per cent of respondents favoured the complete deregulation of the foreign exchange market, while 33.3 per cent did not, with 6.1 per cent not responding (Table 8).

5.0 Summary of Findings, Policy Recommendations and Concluding Remarks

5.1 Summary of Findings

The major findings of this study are summarized below.

- The share of the income of sanctioned banks' derivable from foreign exchange transactions to their gross earnings was on

the average 31.1 per cent. Therefore, in the absence of measures taken to cushion the effects of the sanctions, the banks were vulnerable to the regulatory action.

- Analysis of the major key performance indicators of the banks did not reveal the cost of the impact, partly due to aggregation bias and partly because of the alternative investment windows exploited by the banks, particularly investment in NTBs.
- The total deposit liabilities of the banks analysed on quarterly basis showed a decline of 8.8 per cent only in the first quarter during the sanction period. This reflected the initial panic that trailed the sanctions and the subsequent flight to safety by customers.
- Panic withdrawal of accounts by customers because of foreign exchange induced sanctions reflects the poor knowledge of the workings of the banking industry in Nigeria, as the customers misconstrued the sanctions for distress condition in the affected banks.
- The fact that the banks were able to record profits so soon after the initial shock revealed how quickly they recovered. It is also indicative that banking industry in Nigeria is very profitable and that the operators can make decent income without resorting to malpractices.
- The phenomenal increase in the holdings of NTBs by the affected banks when they were out of the foreign exchange market, and the declining trend immediately upon their return,

confirms the substitutability of domestic assets for foreign assets under a positive interest rate regime.

- Total loans and advances of the sanctioned banks grew significantly by 54.6 per cent from the pre-sanction period, reflecting increased tempo of core banking activities. However, this quantum jump was not sustained in the period after the sanctions were lifted as growth slowed to 29.5 per cent, indicating that banks' foreign exchange transactions have replaced financial intermediation as the core function of banks in Nigeria.

5.2 Policy Recommendations

- Under the current setting of the foreign exchange market where market discipline is lacking, the need to efficiently manage the country's scarce foreign exchange resources makes it imperative that we continue with the present Rules-Based-System. When the rules are broken, sanctions must be swiftly invoked. However, it would be in the long-term interest of all stake-holders for the CBN to pursue more vigorously the campaign for Self-Regulation. To this end, the CBN should institute an annual award based on self regulation to be made at the Annual Monetary Policy Conference. The relevant supervisory departments should work out the details of the criteria which would be used as basis for selecting winners. Such an award particularly, when given wide publicity, would serve as a major incentive for banks to stay clean in view of the enormous potential benefits in terms savings on advertisements, confidence building, among others.

- The parallel market premium remains a major incentive for perpetrating malpractices in the foreign exchange market, particularly, round tripping of funds. Therefore, the exchange rate in the official segment of the market should always be managed to reflect market fundamentals with a view to narrowing the parallel market premium to a limit of not more than 3.0 per cent.
- The re-introduction of a Wholesale DAS should be revisited as it is capable of wiping out the arbitrage. With funds sold directly to authorized dealers, the incentive to round-trip and create distortion would be very minimal, thereby, allowing the rates at the official and parallel segments to converge.
- The CBN should evolve objective criteria for licensing authorized dealers. In other words, not every licensed bank should be made an authorized dealer.

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Table 1

Gross Earnings of Sanctioned Banks (=N=million)						
S/N	Bank Code	2001	2002	2003	Growth Rate (Pre/Sanc)	Growth Rate (Sanc/Post)
1	Bank A	4,286.49	4,634.37	3,756.20	8.12	-18.95
2	Bank B	NA	NA	NA	NA	NA
3	Bank C	NA	NA	NA	NA	NA
4	Bank D	NA	NA	NA	NA	NA
5	Bank E	6,202.18	7,460.88	7,250.46	20.29	-2.82
6	Bank F	2,849.56	2,494.26	2,830.64	-12.47	13.49
7	Bank G	2,759.62	3,952.73	5,245.68	43.23	32.71
8	Bank H	2,817.90	4,833.68	5,524.60	71.53	14.29
9	Bank I	2,505.34	3,307.42	3,307.42 *	32.01	-
10	Bank J	4,119.30	3,631.70	3,631.7 *	-11.84	-
11	Bank K	4,669.30	7,182.40	7,405.90	53.82	3.11
12	Bank L	429.70	879.80	517.90	104.75	-41.13
13	Bank M	10,578.76	11,582.03	13,090.80	9.48	13.03
14	Bank N	7,437.50	5,956.80	5,036.70	-19.91	-15.45
15	Bank O	1,591.88	1,912.48	1,267.82	20.14	-33.71
16	Bank P	1,300.00	2,750.00	2,536.00	111.54	-7.78
17	Bank Q	NA	NA	NA	NA	NA
18	Bank R	5,942.42	9,205.73	9,438.89	54.92	2.53
19	Bank S	8,315.71	10,646.92	15,112.94	28.03	41.95
20	Bank T	1,922.00	3,130.00	3,637.00	62.85	16.20
21	Bank U	3,579.97	3,550.88	5,037.00	-0.81	41.85
22	Bank V	8,980.66	8,980.67	14,540.40	0.00	61.91
23	Bank W	2,280.00	2,970.00	2,988.00	30.26	0.61
24	Bank X	1,834.60	421.13	631.70	-77.04	50.00
25	Bank Y	453.50	1,758.51	3,012.30	287.77	71.30
		74,035.34	87,288.06	100,687.11	17.9	15.4

**The Bank Codes assigned do not reflect in any way a particular order (Alphabetical/order in list or otherwise)

* As in the Previous Period level (Estimate)

Source: Banks' Annual Reports & Account

Table 2
PROFIT BEFORE TAX OF SANCTIONED BANKS(=N=MILLION)

S/N	Bank Code	PRE -SANCTION Period Average	JUN. '02	SEPT. '02	DEC. '02	MAR. '03	SANCTION Period Average	POST SANCTION Period Average	Growth Rate (PRE SANC/ SANC)	Growth Rate ((SANC/ POST-SANC)
1	Bank A	214.7	101.0	192.0	243.0	316.0	213.0	178.8	-0.8	-16.1
2	Bank B	568.3	185.0	253.0	247.0	247.0	233.0	396.3	-59.0	70.1
3	Bank C	142.0	127.0	103.0	152.0	185.0	141.8	216.3	-0.2	52.6
4	Bank D	12.3	13.0	11.0	80.0	34.0	34.5	59.5	179.7	72.5
5	Bank E	334.0	213.0	134.0	254.0	334.0	233.8	467.5	-30.0	100.0
6	Bank F	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A
7	Bank G	186.0	85.0	94.0	77.0	101.0	89.3	114.8	-52.0	28.6
8	Bank H	432.3	128.0	136.0	251.0	387.0	225.5	504.8	-47.8	123.8
9	Bank I	117.3	104.0	196.0	167.0	159.0	156.5	156.5	33.4	0.0
10	Bank J	439.3	227.0	231.0	288.0	357.0	275.8	643.0	-37.2	133.2
11	Bank K	333.7	258.0	184.0	435.0	202.0	269.8	291.3	-19.2	8.0
12	Bank L	18.7	4.0	7.0	14.0	44.0	17.3	39.5	-7.6	129.0
13	Bank M	460.0	733.0	1365.0	812.0	958.0	967.0	1419.5	110.2	46.8
14	Bank N	827.7	571.0	444.0	545.0	819.0	594.8	747.0	-28.1	25.6
15	Bank O	119.3	90.0	57.0	75.0	18.0	60.0	68.3	-49.7	13.8
16	Bank P	223.7	139.0	139.0	144.0	155.0	144.3	142.0	-35.5	-1.6
17	Bank Q	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A
18	Bank R	1511.0	319.0	640.0	1036.0	1665.0	915.0	574.3	-39.4	-37.2
19	Bank S	879.0	745.0	560.0	771.0	941.0	754.3	1339.3	-14.2	77.6
20	Bank T	288.0	179.0	167.0	146.0	175.0	166.8	238.8	-42.1	43.2
21	Bank U	456.3	493.0	304.0	409.0	126.0	333.0	391.8	-27.0	17.6
22	Bank V	580.7	1062.0	459.0	491.0	481.0	623.3	899.5	7.3	44.3
23	Bank W	163.7	55.0	76.0	74.0	286.0	122.8	245.8	-25.0	100.2
24	Bank X	178.7	41.0	80.0	25.0	28.0	43.5	31.8	-75.7	-27.0
25	Bank Y	142.3	23.0	181.0	664.0	694.0	390.5	499.5	174.4	27.9
		8629.0	5895.0	6013.0	7400.0	8712.0	7005.0	9665.3	-18.8	38.0
**The Bank Codes assigned do not reflect in any way a particular order (Alphabetical/order in list or otherwise)										

Source: Quarterly Returns to CBN

Table 3

EARNINGS PER SHARE (N/SHARE)				
		Pre-sanction	Sanction	Post-sanction
S/N	Bank Code	2001	2002	2003
1	Bank A	0.84	0.18	0.19
2	Bank B	0.76	0.33	0.21
3	Bank C	0.07	0.37	0.03
4	Bank D	-1.08	-0.25	NA
5	Bank E	0.58	0.54	0.17
6	Bank F	0.81	0.26	0.14
7	Bank G	0.60	0.93	0.21
8	Bank H	0.35	0.07	0.13
9	Bank I	0.03	0.21	0.19
10	Bank J	1.20	0.12	NA
11	Bank K	0.74	0.81	0.50
12	Bank L	0.04	-0.42	NA
13	Bank M	0.48	0.59	0.63
14	Bank N	2.34	1.37	0.31
15	Bank O	0.15	0.42	2.28
16	Bank P	0.19	0.19	0.06
17	Bank Q	NA	0.46	0.27
18	Bank R	1.64	1.49	0.32
19	Bank S	0.41	0.65	0.71
20	Bank T	0.29	0.27	0.16
21	Bank U	0.31	0.51	0.05
22	Bank V	1.87	0.86	NA
23	Bank W	NA	0.21	0.16
24	Bank X	-0.44	-1.84	NA
25	Bank Y	NA	-0.11	NA
		0.55	0.33	0.35

****The Bank Codes assigned do not reflect in any way a particular order (Alphabetical/order in list or otherwise)**

Source: Banks' Annual Reports and Accounts
Securities & Exchange Commission

Table 4

TOTAL DEPOSITS IN SANCTIONED BANKS (=N='MILLION)

S/N	Bank Code	PRE SANCTION PERIOD	SANCTION PERIOD			POST SANCTION PERIOD
		March '02	June '02	September '02	March '03	Mar-04
1	Bank A	3,809	2,316	2,426	4,102	5,104
2	Bank B	18,737	15,038	14,698	21,974	22,835
3	Bank C	3,111	3,519	4,003	6,197	8,722
4	Bank D	649	702	814	219	1,133
5	Bank E	22,678	8,065	9,420	20,798	23,660
6	Bank F	4,354	7,126	3,833	8,042	13,669
7	Bank G	6,642	9,522	10,685	7,212	10,487
8	Bank H	7,386	8,375	8,496	9,387	13,321
9	Bank I	9,019	9,016	10,944	14,290	16,834
10	Bank J	10,343	9,594	10,719	11,306	14,540
11	Bank K	18,220	14,860	17,831	25,860	32,256
12	Bank L	480	506	533	1,468	1,283
13	Bank M	25,905	35,171	37,108	35,441	61,209
14	Bank N	28,211	30,086	26,409	34,658	38,752
15	Bank O	3,885	2,807	2,363	2,626	2,814
16	Bank P	3,061	2,776	2,946	3,513	4,861
17	Bank Q	-	-	-	-	-
18	Bank R	24,190	20,078	22,048	30,648	32,559
19	Bank S	14,965	14,630	20,023	35,382	54,915
20	Bank T	6,321	5,613	7,044	10,334	12,007
21	Bank U	10,216	10,012	12,045	13,473	9,177
22	Bank V	35,852	26,096	22,935	31,402	29,950
23	Bank W	4,976	3,798	4,344	9,377	10,452
24	Bank X	2,207	1,950	1,984	2,440	2,537
25	Bank Y	6,101	5,860	6,465	6,045	6,054
		271,318	247,516	260,116	346,194	429,131

****The Bank Codes assigned do not reflect in any way a particular order (Alphabetical/order in list or otherwise)**

Source: Quarterly Returns to CBN

Table 5

TOTAL CREDIT OF SANCTIONED BANKS (=N= 'MILLION)												
S/N	Bank Code	PRE SANCTION PERIOD			SANCTION PERIOD				POST SANCTION PERIOD			
		SEPT.'01	DEC. '01	MAR. '02	JUN. '02	SEPT. '02	DEC. '02	MAR. '03	JUN. '03	SEPT. '03	DEC. '03	MAR. '04
1	Bank A	7,663	8,582	7,752	8,377	8,899	9,419	8,281	8,614	9,518	10,179	12,045
2	Bank B	14,023	12,807	14,021	11,650	11,179	12,358	13,951	12,285	12,467	11,519	11,371
3	Bank C	2,362	2,851	2,886	3,573	4,091	3,916	3,597	3,447	4,293	4,891	4,866
4	Bank D	1,131	1,689	1,317	1,358	1,500	1,489	1,708	1,656	1,516	2,008	2,451
5	Bank E	9,153	10,499	15,029	13,124	13,648	10,562	13,769	12,901	11,576	9,624	18,684
6	Bank F	4,294	3,300	3,722	4,825	3,893	3,653	5,475	8,124	7,154	8,814	9,804
7	Bank G	9,623	7,901	7,309	8,451	10,708	10,153	11,047	11,885	12,740	11,771	11,927
8	Bank H	7,917	6,732	6,208	8,114	7,179	7,589	8,356	7,618	8,206	8,372	9,179
9	Bank I	4,425	3,995	5,101	5,411	5,962	6,133	8,898	9,505	11,060	9,080	10,512
10	Bank J	5,872	7,342	7,558	7,638	7,170	7,651	7,770	8,969	10,382	11,930	13,803
11	Bank K	12,736	11,559	13,412	15,605	15,375	15,787	20,117	19,207	20,786	24,118	31,853
12	Bank L	2,117	1,674	1,698	1,649	1,803	1,911	2,276	2,269	2,433	2,380	2,517
13	Bank M	19,470	13,001	11,306	20,140	18,091	13,761	16,027	27,133	25,359	21,669	28,699
14	Bank N	18,181	19,638	24,581	21,258	19,773	23,410	22,914	23,648	26,521	29,425	30,824
15	Bank O	4,383	3,154	4,214	3,340	3,274	3,284	3,649	2,678	2,750	2,636	3,898
16	Bank P	3,070	2,732	3,435	3,707	3,506	3,547	4,495	5,378	5,726	6,844	6,827
17	Bank Q	-	-	-	-	-	-	-	-	-	-	-
18	Bank R	13,869	13,950	13,899	14,202	15,175	16,775	15,525	17,247	19,557	17,227	16,833
19	Bank S	9,677	13,952	10,158	10,649	12,999	19,263	27,209	23,582	29,701	24,948	35,533
20	Bank T	4,676	5,964	6,863	6,947	6,536	8,867	9,963	10,534	8,583	9,572	10,939
21	Bank U	5,304	4,517	6,040	7,158	6,436	6,658	6,793	8,012	7,553	8,966	10,168
22	Bank V	7,800	14,831	12,241	14,669	13,115	13,879	8,804	13,278	17,046	25,929	14,016
23	Bank W	6,468	6,396	6,403	6,110	6,103	4,844	7,809	5,965	7,520	7,787	9,376
24	Bank X	3,121	6,989	6,638	6,184	6,131	6,072	6,239	6,422	6,068	5,943	6,001
25	Bank Y	3,545	2,349	2,526	3,002	3,865	4,421	4,421	4,224	3,937	4,371	4,652
		180,880	186,404	194,317	207,141	206,411	215,402	239,093	254,581	272,452	280,003	316,778

**The Bank Codes assigned do not reflect in any way a particular order (Alphabetical/order in list or otherwise)

Source: Quarterly Returns to CBN

Table 6

Nigeria Treasury Bills Holdings (Sanctioned Banks)

S/N	Bank Code	Pre-Sanction	Sanction		Post Sanction
		March '02	December '02	March '03	December '03
1	Bank A	174,227.00	75,226.00	2,022,226.00	97,226.00
2	Bank B	3,398,488.00	5,749,178.00	6,640,508.00	5,237,767.00
3	Bank C	475,000.00	702,779.00	2,141,215.00	547,224.00
4	Bank D	580,000.00	284,557.00	297,023.00	21,500.00
5	Bank E	1,180,568.00	1,141,680.00	2,141,679.00	1,141,680.00
6	Bank F	250,482.00	2,585,482.00	1,973,482.00	488,219.00
7	Bank G	1,079,510.00	2,823,583.00	2,020,998.00	1,204,965.00
8	Bank H	870,000.00	727,000.00	1,841,535.00	91,000.00
9	Bank I	993,392.00	2,189,371.00	2,097,806.00	388,893.00
10	Bank J	921,800.00	2,255,397.00	3,266,000.00	1,951,750.00
11	Bank K	1,649,910.00	1,669,910.00	8,009,910.00	5,269,910.00
12	Bank L	0	50,000.00	308,500.00	410,066.00
13	Bank M	4,835,847.00	13,066,955.00	8,485,847.00	12,069,227.00
14	Bank N	6,601,488.00	11,031,391.00	10,616,156.00	6,753,166.00
15	Bank O	75,000.00	4,308.00	0	4,308.00
16	Bank P	613,778.00	937,626.00	887,778.00	533,747.00
17	Bank Q	N/A	N/A	N/A	N/A
18	Bank R	7,153,034.00	9,906,783.00	14,296,883.00	5,894,441.00
19	Bank S	1,250,098.00	11,808,081.00	10,051,098.00	10,329,959.00
20	Bank T	1,457,152.00	4,299,668.00	6,856,259.00	3,193,712.00
21	Bank U	2,884,319.00	3,630,295.00	3,724,728.00	1,670,370.00
22	Bank V	2,632,937.00	2,350,862.00	7,489,624.00	2,490,359.00
23	Bank W	740,432.00	910,056.00	3,107,449.00	1,738,000.00
24	Bank X	0	257,500.00	259,000.00	539,500.00
25	Bank Y	482,783.00	127,783.00	377,783.00	377,783.00
		40,300,245	78,585,471	98,913,487	62,444,772

****The Bank Codes assigned do not reflect in any way a particular order (Alphabetical/order in list or otherwise)**
Source: Quarterly Returns to CBN

Table 7

INFLATION AND NTB RATES			
	INFLATION RATE	NTB RATE	% Growth Rate in NTB Holdings
Sept. 01	18.4	19.5	9.13
Dec. 01	18.9	20.5	4.48
Mar. 02	18.8	22.4	12.98
Jun. 02	16.4	20.7	18.33
Sept. 02	14.8	16.5	45.85
Dec. 02	12.9	13.8	25.87
Mar. 03	10.5	15.2	-16.13
Jun. 03	10.1	15.9	-6.17
Sept. 03	10.7	14.5	-19.77
Dec. 03	13.8	14.5	85.43

Source: CBN Annual Reports and Statement of Accounts