BANKING SECTOR CRISIS AND RESOLUTION OPTIONS IN NIGERIA

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1.0 Introduction

Economic development is contingent on productive investment and the financing of such productive activities can be obtained through two channels: via capital markets or banks. In modern economies, these two channels are complementary. But the role of banks is clearly central. Banks are key players in the financing of economies and when their own financial position prevents them from performing this function, economic growth is compromised. As McKinnon and Shaw (1973) observed in their seminal work on the key roles of banks as propellants of growth and development in developing economies, a feeble banking system is repressive, distortionary and dis-connects the intermediation process, thereby, precipitating macroeconomic instability. This requires that policy makers, as Nnanna (2005) opines, must articulate robust policies that will deepen the financial system to enable banks to play their roles most efficiently.

Banks play a prominent role in the credit intermediation process in most countries, providing funding to firms beyond the cash flow provided by their normal operations. Banks also typically serve as custodian of a significant portion of household saving. Banks play a key role in channeling credit to firms--particularly those firms that are not able to acquire funding from capital markets or other sources--and also hold substantial consumer deposits. Specifically, banks perform a maturity transformation function. The banking sector is the agent for financial intermediation, enhances financial intermediation by mobilizing savings (deposits) and channeling them into productive investment in the real sector of the economy (lending). In other words, it performs the function of resource allocation from surplus units to deficit units; increase the allocative efficiency of resources; facilitate risk sharing spreads/ reduces risk faced by economic agents and thereby reducing costs; facilitates generation of wealth in the economy; promotes productivity and economic growth, thereby contributing to poverty alleviation. It also facilitates the exchange of goods and services through the provision of effective and efficient systems of payments, and expands and diversifies opportunities through innovations.

A banking system that is in crisis cannot therefore, carry out its intermediation role effectively as new lending comes to a halt, which is known as a credit crunch. Two mechanisms can act: low capital adequacy ratios of banks and shortfall of liquidity. In the first instance, prudential rules set out the risks that banks can take in relation to their capital requirements. During economic and financial downturns, losses may appear that reduce banks' capital; this effect may be amplified by the accounting rules that require certain assets to be marked to market. In parallel, the risks, often measured on the basis of the credit agencies' ratings that are regularly downgraded during crises, increase and result in higher capital requirements. The shortfall of liquidity results when markets no longer function correctly. Hence, when banks are not sure that they can obtain financing, they stop lending. These two "channels" could combine and be mutually reinforcing, particularly in the case of build-up of non-performing loans in some institutions that sheds doubt on their solvency. This may lead to bank failures with the associated multiple effects. The whole system then seizes up, and the financing of the economy is jeopardised.

The objective of this paper is to x-ray banking sector crisis and its resolution options in Nigeria. The causes and impacts of banking crisis as well as the way forward for such crisis will also be examined.

The paper has been divided into six main sections. Following this introduction, Section 2 gives the conceptual/jurisdictional experience of banking crisis. Section 3 gives an overview of the structure of the Nigerian banking sector, the causes of banking crisis and its impacts on the economy, while Section 4 highlights the various banking sector resolution options and the Nigerian experience in banking sector crisis resolution. Section 5 highlights the way forward, while Section 6 concludes the paper.

2.0 Conceptual Issues/Country Experience of Banking Crisis

2.1 Conceptual and Definitional Considerations

The term "banking crisis" refers to a situation of major disruptions in a country's banking sector which may not just be minor downturns or disturbances. Banking crisis occurs when the capital of the banking sector has been depleted due to loan losses, resulting in a negative net worth of the banking sector. This implies that the system is insolvent and therefore the value of its realizable assets is less than the total value of its liabilities. A banking crisis can also occur from liquidity point of view. According to Ebhodaghe (1997), a bank is illiquid when it can no longer meet its liabilities as they mature for payment, which is a breach of the contractual obligations. Thus, banking crisis could be insolvent but liquid; illiquid but solvent; and illiquid and insolvent. According to Alashi (2002), a bank is said to be in severe crisis when a bank shows most or all of the following:

- Gross under-capitalization in relation to the level and character of business;
- high level of non-performing loans to total loans;
- Illiquidity as reflected in a bank's inability to meet customers' cash withdrawals and/or a persistent overdrawn of position with the Central Bank;
- Low earnings resulting in huge operational losses; and
- Weak management as reflected by the poor asset quality, insider abuse, inadequate internal controls, fraud, including unethical and unprofessional conduct, squabbles, and a high staff turnover, among others.

The crisis could become systemic if a sizeable number of banks in the economy are involved, resulting in runs on banks as depositors lose confidence in the system and attempt to avoid capital losses. In this case, the country is said to be experiencing a banking crisis. More specifically, banking sector systemic crisis occurs when a fairly reasonable proportion of banks in the system are unable to meet their obligations to their customers, owners and the economy as a result of weakness in their financial, operational and managerial conditions which have rendered them either illiquid and/ or insolvent. It can equally be described as those situations where the solvency and/or illiquidity of many or most banks have suffered shocks that have shaken public confidence. Examples include the banking crises in Iceland in 2008, Mexico in 1994, East Asian countries after 1997, in transition economies in the 1990s and many other developed economies in the recent financial crisis. In a systemic crisis, corporate and financial sectors experience a large number of defaults and difficulties repaying contracts on time. As a result, non-performing loans increase sharply. This situation is often accompanied by depressed asset prices (such as equity and real estate prices) on the heels of run-ups before the crisis, sharp increases in real interest rates, and a slowdown or reversal in capital flows. The CBN and NDIC (2002) joint study recognized a systemic banking crisis as when at least two of the following situations are present:

- The banks that are critically distressed control 20 per cent of total asset in the industry;
- 15 per cent of total deposits are threatened; and
- 35 per cent of the banking system's total loans are not performing.

2.2 Jurisdictional Experience of Banking Crisis

A wave of banking crises has afflicted many countries of the world in the last two or three decades. Banking crises have been protracted and systemic in such countries as Argentina, Chile and Uruguay; in Bolivia, Brazil, Ecuador, Peru and Venezuela, among others. In the USA, the banking crisis of the 1930s had devastating effects on the economy as the American tax payers had to part with about $160 billion to resolve the resulting savings and loans debacle. Some countries in Europe, Japan and some of the Asian Tigers as well as many other developing countries have tasted the 'bitter pill' of banking crisis.

A review by Lingren, Gracia and Saal (1996) revealed that, out of the 186 current member countries of the International Monetary Fund (IMF), 73.5 per cent or 133 have experienced significant banking sector problems at some stages or the other since 1980. Two general classes of problems were identified: crisis (41 instances) and “significant” problems (108 instances). The classification referred to cases where there were runs on banks or other substantial portfolio shifts, collapse of financial firms, or massive government intervention, as crisis. Extensive unsoundness but short of “crisis” status was termed “significant”. Evidently, several countries experienced repeated problems of either or both types. Where the problems in banks did not have a significant impact on either the functioning of the banking sector, or the macro-economy as a whole, as was the case in seven of the countries analyzed, distress was categorized as neither “crisis” nor “significant”. The extent or severity of distress was measured by the size of assets or deposits, or the number of banks involved in distress, vis-à-vis the industry.

The recent financial crisis that started in 2007 has equally degenerated into banking crisis in many developed economies. The crisis which began as an aftermath of the US sub-prime mortgage led to the fall of many financial institutions in the US including, Indy-Mac Bank; Freddie Mac; Fanny Mae; and UK's fifth largest mortgage lender, Northern Rock. It also led to the insolvency of America's largest securities firms, Merrill Lynch and Lehman Brothers as well as the bankruptcy and eventual collapse of the third largest mortgage lender in the US which caused the collapse of government-backed mortgage. With the crash of structured-products and mortgage market, consumer loans and mortgage market distress led to counter-party risk. The financial contagion that resonated world-wide due to the inter-linkages of the world financial system, led to the tumbling of stocks of all major trading markets across Europe, Asia and other emerging economies. As the financial panic developed, there was a “flight to quality as investors sought safety in US treasury bonds, and currencies such as the US Dollar and the Yen.” Equity prices crashed in most Exchanges such that the global stock market gains of previous years were wiped out. Some stock exchanges were closed for days in order to avoid a big plunge. As at end-December 2008, an estimated $14.0 trillion share values were wiped off world-wide as many stock markets around the globe suffered their worst 12 months of trading.

The seriousness of the economic crisis led various governments to initiate unprecedented financial bail-outs coupled with subsequent proposals of massive fiscal stimuli to reverse the trend and bring the world economies out of the doldrums. The policies adopted varied from interest rates cuts, bail-out packages, nationalization of financial institutions, swaps arrangements, coordinated rates cuts among central banks, etc. In the United States for instance, as at December 24, 2008, the Federal Reserve had used its independent authority to spend US$1.2 trillion beyond the $700 billion Troubled Asset Relief Program, (TARP) authorized by Congress from the federal budget on the purchase of various financial assets and extended emergency loans to banks, credit card companies, as well as general businesses. Temporary swaps of treasury bills for mortgage-backed securities and ban on short selling of 799 financial stocks in September 2008 were also adopted. Others included the sale of Bear Stearns, bailouts of American International Group (AIG), Fannie Mae and Fredie Mac, and Citigroup. In addition, investment banks in the US, converted to bank holding companies, a status subject to more regulation, but with readier access to government capital.

In the Euro zone, the European Central Bank (ECB) injected about US$84.0 billion into the economy to ease liquidity problem. It engaged in coordinated rate cuts with six major central banks (the Federal Reserves, Bank of England, Bank of Japan, RBA, Bank of China, and Swiss National Bank). It also used swap lines from the Fed to support its US dollar operations. Other measures in the European Union (EU) were the agreement to increase minimum bank deposit guarantee from 20,000 to 50,000 Euro. In individual EU member countries, initiatives included the German parliament approval of 500 billion Euro (US$675bn) financial rescue package, while the French government injected 10.5bn Euro (US$14bn; GBP8.2.bn) into the country's six largest banks. In the United Kingdom, the government directly nationalized parts of the banking system through purchases of equity stakes in certain banks and a GBP300 billion rescue packages was released to banks prompt lending by early 2009. Banks were also subjected to recapitalization. Indonesia in a move adopted by several countries reduced its overnight repo rate, by two percentage points to 10.25 percent. The government introduced safety net regulations that allowed the government and the central bank to quickly address financial sector weakness. It revised the year's budget to reduce financing needs, pledged to respect the free movement of capital and also set up a task force to manage the crisis. In addition, insurance on bank deposits was revised from US$10,000.00 to US$20,000.00.

In Nigeria, to avoid being drawn deep into the crisis, the government and regulatory authorities took some proactive measures. These included:

- Presidential Steering Committee on Economic Crisis
- Presidential Advisory team on capital market to deliberate on measures to reverse the declining trend in Nigerian Capital market
- Reduction of fees by SEC, NSE and all capital market operators by 50 per cent
- Daily price movements harmonized to 5 per cent either way in October 2008
- Guidelines on market makers released by SEC
- NSE reviewed trading rules and regulations
- NSE de-listed 19 moribund companies
- Share buy-back limited to 15 per cent
- Strict enforcement of NSE listing requirements
- Review of budget to cut financing requirements
- Fiscal stimulus through drawdown from oil savings to augment monthly revenue to three tiers of government to mitigate the adverse effect of substantially lower current revenue receipts
- Cut in foreign exchange financed expenditure e.g. overseas trips by government officials

- The CBN, in line with global experiences, substantially eased monetary policy to mitigate the negative effects of the financial crisis on liquidity in the banking system through a combination of measures:
- Monetary policy rate (MPR) reduced gradually from 10.25 percent to the current 8.0 percent
- Cash reserve requirement (CRR) reduced gradually from 4.0 percent to current 1.0 percent
- Liquidity ratio reduced gradually from 40 .0 percent to current 25.0 percent

3.0 Overview of the Nigerian Banking Sector and Banking Sector Crisis in Nigeria

3.1 Overview of the Structure of the Nigerian Banking Sector

The Nigerian financial services industry comprises: banking, insurance, capital markets, pension fund and other financial institutions. The regulators in the sector include the CBN, the Nigerian Deposit Insurance Corporation (NDIC), the Securities and Exchange Commission (SEC), the National Insurance Commission (NAICOM), and the National Pension Commission (PENCOM).

As at the end of March 2010, the operators in the industry included 24 deposit money banks (DMBs), 5 discount houses (DHs), 941 microfinance banks (MFBs), 107 finance companies (FCs), 101 primary mortgage institutions (PMIs), 5 development finance institutions (DFIs), 1,621 bureaux-de-change (BDCs), 1 Stock Exchange, 1 Commodity Exchange and 73 insurance companies, about 690 stock brokers, 13 pension fund administrators and 5 pension fund custodians.

The banking sector in Nigeria comprises the DMBs with 5,565 branches spread over the country and the DHs.

3.2 Causes of Banking Sector Crisis

Banks are generally in the business of borrowing short and lending long. In doing so, they provide an essential service (create credit) that allows the real economy to grow and expand. This credit creation service, however, poses an inherent fragility in the banking system. For instance, if depositors are gripped by a collective movement of distrust and decide to withdraw their deposits at the same time, banks would be unable to satisfy these withdrawals as their assets are illiquid thereby leading to liquidity problem. In normal times, when people have confidence in the banks, these crises do not occur. But confidence can quickly evaporate, for example, when one or more banks experience a solvency problem due to non-performing loans. Bank runs are then possible. A liquidity crisis erupts that can also bring down sound banks. The latter become innocent bystanders that are hit in the same way as the insolvent banks by the collective movement of distrust. Sound banks that are hit by deposit withdrawals have to sell assets to confront these withdrawals. The ensuing fire sales lead to declines in asset prices, reducing the value of banks' assets. This in turn erodes the equity base of the banks and leads to a solvency problem. The cycle can start again: the solvency problem of these banks ignites a new liquidity crisis and so on.

All banking crises are different even if they share a number of common characteristics. Generally speaking, they follow a period of significant credit expansion and a sharp rise in stock market and/or property prices in a largely self-sustained mechanism. With the increase in value of assets that may be used as collateral for loans is used to secure new loans, even if the intrinsic economic justification of the new loans is not uncertain. Any external shock that calls into question the value of these assets reveals the poor quality of these loans and the crisis erupts. Losses reduce the banks' capital and the most exposed banks become insolvent. While doubts persist over the extent and the distribution of the losses, the markets become totally illiquid.

Apart from the above scenario, one major cause of banking crisis is macroeconomic instability. Goldstein and Tunrner (1986) noted that macroeconomic volatility can cause banks to be vulnerable if it alters the relationship between the values of bank assets and liabilities. A study by Brownbridge (1998) revealed that periods of high inflation occurred in all the four countries covered in the study. He noted that a high inflation rate was largely responsible for the volatility of business profits because of its unpredictability, coupled with a high degree of variability in the rate of increase of the prices of particular goods and services which constituted the overall price index. This observation underscores factors of adverse selection and poor incentives for borrowers to take risks and inevitably, accounts for the high probability of loan default. In addition, a high inflation rate makes loan appraisals very difficult for banks, especially as the viability of potential borrowers depends on unpredictable developments in inflation, exchange and interest rates.

A dramatic increase in uncertainty in the banking sector, due largely to the failure of a prominent bank or non-financial institution, a recession, political instability, rumors of instability in the sector or a stock market crash, makes it difficult for lenders to separate good from bad risks. The rise in uncertainty therefore is capable of making information in the banking sector even more asymmetric and may worsen the adverse selection problem and these will make lenders unwilling to lend thereby precipitating to a decline in lending, investment and aggregate economic activity. A typical example is that of Northern Rocks. A news flash by the British Broadcasting Corporation indicating that the bank had approached the Bank of England for a facility under the last resort created a run on the bank that eventually led to the failure of that bank.

Poor risk management procedures, ignorance and non-compliance with rules, laws and regulations, technical incompetence, violation of regulations, policies, procedures guidelines, unhealthy competition and weak internal controls and operational procedures lead to banking crisis. Banks that have proper risk management and internal controls as well as a well focused strategic objective are likely to operate normally even in the face of turbulent situation.

Weak corporate governance, particularly insider abuse and contravention of supervisory regulatory provisions and overbearing directors' interest in loans and advances or any credit facilities are major causes of banking crisis, especially in a developing country like Nigeria. A study conducted by the Research Department of the Bank revealed that in one of the then distressed banks in Nigeria, four of the erstwhile bank's directors abused their privileges and breached their fiduciary duties by engaging in several activities to the detriment of the bank's depositors and other stakeholders. Specifically, they obtained insider loans that constituted about 520 per cent of the bank's total risk assets or about 50.5 per cent of the total loans and advances when the bank was liquidated in 1998.
Overtrading, assets mismatch and excessive risk taking indicating high loan to deposits ratio are significant causes of banking crisis. If a bank's core deposits are short-tenored and it engages in unbridled lending, particularly long-term lending, the tendency for the bank to go into insolvency is there. This is a case of assets mismatch. Overtrading could imply that a bank is giving out loans without taking into consideration of the amount it would be used in settling its daily and future commitments.

Ownership structure of a bank has a direct bearing to its survival. The overbearing influence of a particular director on the board and management of a bank could result in frequent boardroom crisis and the breakdown of internal controls precipitating to banking crisis and may eventually lead to the failure of the bank.

The role of management in the effective performance of a bank is critical. Poor management is one of the principal factors that could precipitate banking crisis. Board squabbles; ineffective board oversight functions; poor leadership and administrative ability; as well as fraudulent and self-serving practices among board members, management and staff have been attributed as one of the causes of bank failures. Besides, recruitment and placement of fit and proper persons in the management of a bank as well as the integrity and transparency of its management will definitely impact positively on the performance of a bank. On the other hand, a bank with poor quality staff and management and engages in non-publication and non-disclosure of accounts and other performance indices can lead to poor performance and eventual demise of a bank.

Moreover, banks are susceptible to the risk of contagion, owing to their financial inter-relationships through lending and borrowing from each other, holding of deposit balances with each other and through the payments/clearing system. Banking crisis could erupt from bank(s) having exposures with other local banks or its foreign affiliate and correspondent bank(s). Though banks generally need to work in tandem with other local and foreign banks for their smooth functioning, the exposure that such dependence imposes should be limited and secured. This is because the impact of the poor performance of one or more of the banks in the system arising from bank-related distress may negatively affect the operations and activities of other sound banks in the system, leading to systemic problem.

On the foreign front, the excessive dependence of one bank on a foreign bank for its operations poses a significant to the survival of the bank in particular and sector in general. For instance, at the advent of the consolidation exercise in the Nigerian banking sector, many Nigerian banks had correspondent relationships with foreign banks. But when the global financial crisis set in, many of the credits earlier granted to the domestic banks were recalled and most of the local banks recorded some losses as some of the foreign banks were affected negatively.

Gross under-capitalization constitutes another source of banking crisis. Banking sector soundness and its susceptibility to shocks largely depend on the adequacy of its capitalization. Provisioning for bad loans and other unforeseen losses are absorbed by robust capital, while poor capitalization would lead to the folding up of a bank should the risk of default crystalises.

Financial reforms actually would lead to a more competitive market, but at the same time may lead to an increase in the failure rates of banks and other financial firms. Under stiff competition, banks will normally respond to higher competition and a shrinking customer base by charging lower rates on loans. With increasing competition in the deposit market, banks' funding costs may rise because they have to pay higher rates to attract deposits from competitors. As revenues decrease and costs rise, lending margins shrink as monopoly rents are competed away. Poorly performing institutions will see their economic capital eroded, and they could face the prospect of closure by banking regulators.

3.3 Impact of Banking Sector Crisis on the Economy

As alluded to earlier, a healthy banking system generally contributes to strong economic growth, while banking crisis can present a substantial drag on the real economy as it reduces the amount of financial intermediation undertaken and consequently a decline in investment and aggregate economic activity in the economy. By the nature of their business, banks tend to be highly leveraged and incur a mismatch in the maturity of assets and liabilities, which make them susceptible to deposit runs. Banks' intermediation function entails that they link most sectors of the economy. Hence, on one hand, banking sector difficulties have an effect outside the banking sector, and on the other, shocks to any one sector are reflected in bank performance and can be transmitted through the banking system throughout the economy. For instance, the fall in the price of oil has affected the banks indirectly. Banking crises intensify slowdown in economic activities, prevent loanable funds from being allocated to their most productive uses, reduce the availability and increase the cost of funds to small and medium-size businesses and seriously constrain the conduct of monetary policy, among others. In developing economies, like Nigeria, banks are the major participants in the financial systems. They operate the payments system, provide liquidity to fledging securities markets and are major purchasers of government securities. Given the major role of banks in these economies, it is easy to conclude that the collapse of the banking system causes serious negative externalities for the rest of the economy. These externalities take various forms.

Bank failures are usually followed by government bailouts. Fiscal costs of banking crises include costs of restructuring the banking system, considering the payments to depositors, bank recapitalization bonds, and asset management schemes. The fiscal gross direct costs are measured as outlays of the government and central bank in terms of bond issuance and disbursements for liquidity support, payout of guarantees on deposits, costs of recapitalization, and purchase of non-performing loans. Net costs to the public sector are estimated as the deduction from gross costs of recoveries from the sale of assets and equity stakes and repayment of debt by recapitalized entities (Hoelscher and Quintyn, IMF 2003). The public money that is needed to recapitalize insolvent banks puts pressure on the budget deficit to increase.

In addition, poorly enforced banking crisis resolution may engender moral hazard on the part of bank borrowers and bank managers. The fiscal burden created through banking crises and any fiscal bail-out of the financial system reduces the resources available for government programs that are of greater intrinsic social value, and can give rise to all sorts of economic, political and social problems when the time arrives to face the costs. The bailout, of course, intensifies the moral hazard problem in the future, due to the fact that future depositors have less incentive to monitor the activity of banks thereby discouraging saving in the domestic banking system, especially where depositors had incurred losses from the failure of banks.

Financial sector crisis has often been

associated with reductions in output and other macroeconomic disturbances, as evidenced by the recent global financial crisis. A banking crisis may lead to a fall in output through a sharp contraction in the stock of money (monetary channel), through the decline in credit supply (credit channel) and also by the "idling" of resources that result from bankruptcies, judiciary procedures and seizure of collateral. Furthermore, a breakdown in the payments system would imply severe costs.

A banking crisis also influences the conduct of monetary policy. The monetary authorities need to supply the banking system with liquidity during a period of crisis. Banks cannot service their loans and need funds to pay their creditors (depositors). They look at the central bank, as the lender of last resort, to provide them with the needed funds. But, central banks must also be concerned about conducting a monetary policy that provides price stability and promotes growth making the situation a difficult one for the conduct of effective monetary policy.

Banking crises pose devastating effects to many of the weakest sectors in the economy that are "credit intensive:" such as housing, agriculture, and small and medium size enterprises. These sectors constitute the highest employer of labour in the economy and so any adverse effect on them will have a multiplier effect on the economy as a whole, particularly in the area of employment. Moreover, the banking system, particularly in a developing economy like Nigeria, the banking sector is the greatest employer of labour aside agricultural sector. A crisis in the sector would translate to more joblessness in the economy.

Furthermore, during a banking crisis, the quality of available information worsens, and that intensifies the adverse selection problem and given that several firms experience a decrease in their creditworthiness, due to their inability to pay back their loans, there is a high chance that funds will be directed to inefficient firms because these are the ones that are willing to pay the higher interest rates. As a consequence, the quality of investment is likely to suffer after a banking crisis has occurred.

Also, a banking crisis normally leads to erosion of public confidence in the sector and hence a decline in banking habit. In a country like Nigeria where much effort had been directed to propagate banking habit in the banking public, an erosion of confidence in the banking sector could be a critical one for the nation as it would create distortions in the economy.

Banking crises in emerging economies may have significant negative spillover effects on industrial economies and vice versa. The reason is that the importance of emerging economies in the world economy and in international financial markets has grown in recent years. Most developing economies import a lot from the developed world. At the event of financial crisis in the emerging economies, there is bound to be weak demand for imported goods hence a production slowdown. The current financial crisis is a typical case where produced goods in the developed countries are being auctioned at buy 2 and get one free.

In the Nigerian context, the effects of the Global financial crisis include lower demand for Nigeria's exports, particularly crude oil, whose price has been on the decline since the crisis. Oil constitutes 25 per cent of our GDP; 99 per cent of exports; and 80 per cent of government revenue. At least 40 per cent of Nigeria's trade is with the US. There is the likelihood of lower commodity prices, for non-oil exports. In addition, there are more job losses, especially in the capital market, while inflationary pressure has resurfaced with the attendant reduced confidence in business environment. All these have resulted in government revenue contraction; de-accumulation of foreign reserves; pressures on exchange rate; limited foreign trade finances for banks as credit lines dry-up for some banks; divestment by foreign investors in the Nigerian capital market with the attendant tightness and possible feedback effects on the balance sheet of banks; and counter-party risks vis-à-vis external reserves, however, the CBN has taken measure to safeguard the reserves.

Long run costs of banking crisis include low savings rates, very limited long term financial relationships, reliance on external financing, high interest rate spreads, dollarization and a heavy public sector debt burden. Under these conditions of "short-termism" and low intermediation, deposit withdrawals translate quickly into credit contractions, which may further worsen the situation as firms are starved of working capital and investment is constrained. Furthermore, the country becomes more dependent on inflows of foreign capital to finance investment or government. Hence, the probability and expected severity of a banking crisis increase, which reinforces the tendency towards low domestic savings.

Once a system has experienced a banking crisis, several mechanisms may perpetuate vulnerability. A crisis may not only have reputational effects, but also forces banks to charge high interest spreads to rebuild capital and reserves, or to pay for emergency lending from the central bank and deposit insurance payouts. If there has been a bail-out with public funds, fiscal sustainability may be threatened, and therefore savers and investors will be discouraged by the prospect that a debt crisis will spill over in to the banking system, or be resolved through a new round of hyperinflation or deposit conversion.

4.0 Banking Sector Crisis Resolution Options and the Nigerian Experience

4.1 Banking Sector Crisis Resolution Options

The policy options available in a banking crisis are sensitive to the type and size of shock affecting the financial system, in particular, whether failures are thought systemic. If the situation is non-systemic, the focus of the resolution is on the individual failed bank's balance sheet. In this case the failed bank will either be merged with a healthy bank or liquidated. In a systemic situation, however, the immediate aim of the authorities is usually to restore financial stability of the system as a whole, restore public confidence and avoid bank runs. Here guarantees are likely to be given to liability holders at the failed bank(s), and perhaps to the financial system as a whole to avoid or reduce panic. So the aim is first to stabilise the liabilities of the banking system, before restructuring the assets of the failing banks.

There is a range of options for resolving insolvent banks. At one extreme, a bank can be kept open through an injection of capital. At the other extreme, a bank can be closed with its assets sold and depositors and possibly other creditors paid off. Between these extremes, a bank's licence may be removed but with the bank sold off to another bank, in full or part, to preserve the bank's activities. The extent of involvement of the authorities may also vary. It may be limited to encouraging or organising private sector support, or extended to official financial support, in the limit through government takeover. When a bank is financially distressed there should be a preference, first, to encourage a private sector solution. If an unassisted private sector solution cannot be found, a decision would next be made about whether to liquidate the bank or provide some form of government assistance. In exceptional circumstances, if there were a systemic threat, governments might consider a takeover or guarantee to a failed bank, as an interim measure.

These options are reviewed below in turn.

4.1.1 Unassisted Resolution Options

Bank status unchanged

When a bank supervisor discovers that a bank is at, or close to, the point of insolvency, the first response is to see whether the bank can be rehabilitated without government assistance. There are often several steps here. The bank can be instructed to curtail lending, either in a specific line of business or across the board. A request (demand) for additional capital from existing shareholders or other interested parties is often issued; management changes can be required; and operational changes are almost always undertaken.

Bank status changed private sector merger

If a capital infusion from existing shareholders or other interested parties is not available, an unassisted merger with another healthy financial institution is usually the next course of action. For an unassisted merger to occur, the extent of losses must be transparent to the prospective acquirer. Therefore, supervisors should examine the troubled bank to determine the size of losses to ensure that the acquiring institution has sufficient capital to absorb potential losses in the failing institution.

4.1.2 Liquidation Option

If an unassisted private sector merger is not possible, a decision is often made to liquidate the bank. In liquidation, the bank is declared insolvent, closed, and depositors paid off. The restructuring authority then liquidates all assets. In most cases uninsured depositors and other creditors are only covered if sufficient funds are available after liquidation. Liquidation exerts a strong financial discipline on the various stakeholders. But when liquidation occurs, it may affect other banks through direct exposures or changes in financial market prices. In addition, reimbursing depositor and creditor claims, from the sale of the failed bank's assets, can be a long and disruptive process that locks up people's wealth for months or even years and has knock-on effects throughout the economy.

4.1.3 Assisted Resolutions

If some form of government intervention is considered, various forms are available:

Bank status unchanged

Lender of last resort (LOLR)

Central banks usually only provide emergency liquidity assistance in potentially systemic situations and only for a limited period. Liquidity support to individual institutions can buy time to assess the underlying solvency position and to assess alternative resolution strategies. Although LOLR is intended for illiquid but fundamentally solvent banks, in practice it may be difficult, in the time available, to distinguish between a liquidity and a solvency problem. Mechanisms should be put in place to ensure that such lending is time-limited and conditional, and that the central bank protects itself from incurring losses, in particular through taking collateral.

Open bank assistance

This occurs when the government provides financial assistance to a distressed bank without taking the bank over or eliminating the current stockholders' position entirely. The assistance can be in the form of the provision of capital or through purchasing non-performing assets from the bank. This allows the operations of the bank to continue uninterrupted. However, there are potential weaknesses with open bank resolutions. Most important, if the bank's management is left in place, and the existing shareholders' investment protected, this will seriously increase moral hazard. Making government support conditional can reduce this problem, for example, through replacing management, eliminating or downgrading existing shareholders' interests, or mandating an infusion of private sector capital. Open bank assistance has often required repeated capital injections before problems have been solved, resulting in large fiscal costs of resolution.

Bank status changed

Assisted Merger or Acquisition

Resolution of a bank failure often involves an assisted merger or acquisition. The transaction can be completed with another bank or, if permitted by law, another type of institution. A merger provides business continuity for both borrowers and depositors. It can be structured in many different ways, depending on the size and complexity of the distressed bank, the funding constraints of the resolution authority, and the amount of time until failure. Banks can also be split up, with the deposits, branches and assets sold off separately.

Assisted mergers are sometimes accomplished using Purchase and Assumption model (P&A). In an assisted P&A, the acquirer purchases the assets and assumes the liabilities, in whole or part, of the failed bank, with the resolution authority compensating for the difference. Here, existing shareholders lose all of their investments. Uninsured creditors, too, may lose part of their investment if the P&A is only partial.

Bridge Banks

This is a form of temporary government ownership. A number of industrialised countries with systemic crises, such as Finland and Sweden, have assumed temporary ownership of troubled large banks, to permit restructuring and subsequent sale to a private institution. Bridge banks offer a holding period so that a final resolution strategy can be effected. While the government can maintain the business operation of the bank, the set time period forces the resolution authority to focus on cleaning up the bank's balance sheet in preparation for selling it.

Outright Government Ownership

This has typically occurred when a very large bank fails. The government authorities take over the bank by nationalising it, usually eliminating the stockholders' interest but protecting depositors and other creditors. One problem with outright nationalisation, however, is that government managers do not have the same incentives as private bank managers. In market economies, private sector banks are essential for efficiently allocating credit. Evidence suggests that countries with higher shares of state-owned banks tend, on average, to have a higher share of non-performing loans and higher operating costs (Goldstein and Turner (1996)).

4.2 The Nigerian Experience

Two broad types of resolution options have been adopted in Nigeria so far by the regulatory/supervisory authorities:

Outright liquidation (deposit pay-out) and the Purchase and Assumption (P&A) options (assisted mergers and acquisitions). Other resolution options adopted in Nigeria will also be discussed.

Outright Liquidation (deposit pay-out):

Under this option, the entire assets and liabilities of the affected bank are placed under the control of the liquidator (NDIC) who would arrange to physically close the bank. NDIC then verifies the assets and liabilities of the bank and exercises control over all its moveable assets. Under Nigeria's deposit insurance scheme, each customer's account is insured up to a maximum N200.0 (two hundred thousand naira). In 1998, 26 banks with 347 branches spread over 32 states and Abuja were closed down and faced liquidation under the NDIC. Some of them were Financial Merchant Bank (FMB), Kapital Merchant Bank (KMB), Alpha Merchant Bank (AMB), United Commercial Bank (UCB), Republic Bank (RBL), CCB, PBN, Mercantile Bank etc

Purchase and Assumption (P&A) Model

The basic characteristics of this option is the purchase of the whole or part (cherry-picking) of the assets of a failed bank by a healthy (assuming) bank and the assumption of the deposit liabilities of the failed bank by the same bank. The P&A 0ption has featured prominently in the history of bank failure resolution in Nigeria. Following the conclusion of the bank consolidation exercise at end-December 2005, 13 banks that failed to make it were handed over to the NDIC for liquidation. The P&A model has since been adopted by the Corporation for their liquidation. As at end-December 2009, 11 out of the 13 affected banks had been assumed by some healthy banks. These include Allstate, Hallmark (Eco bank); trade, Metropolitan, City Express, African Express, Gulf, Liberty (UBA); Lead, Assurance (Afribank); and Eagle (Zenith). The cases of Triumph and Fortune International banks are still pending in the court.

Other bank resolution options adopted in Nigeria included:

CBN Bail-out Using Guarantees

This option was applied by the CBN during the late 1990s for some of the ailing banks. For instance, at the inauguration of one of the affected bank's new board and management, the CBN gave a commitment that it was fully behind the bank and would honour all cheques drawn on it. Further guarantees were given to other healthy banks, which enabled those banks to provide life-boat facilities to the affected banks. Unfortunately, this option did not stop the run on these banks.

CBN/NDIC Controlled Restructuring (Open bank assistance)

This option implies taking over the board and management of a bank by the CBN and NDIC in order to restructure the bank and run it profitably. The hope is that the cream of professionals selected jointly by the CBN and NDIC would be able to turn the bank around within a short period of time and return the bank to the owners. This was variously used by the Bank in the late 1990s and recently when about eight (8) banks had problems. In most cases, this option worked out as some of the affected banks were resuscitated, while in other cases the resuscitation efforts proved abortive. In most of the failed cases, the banks had forwarded falsified financial reports to the regulatory authorities to cover up its fraudulent practices which were already beyond redemption.

4.3 The current Banking Sector Crisis Resolution/Pre-emptive Actions by the Regulatory Authorities

The global financial crisis strained the progress made in the sector. The industry experience in the face of the global meltdown is, however, consistent with global trends. Specifically, a section of the banking industry was badly affected and liquidity problem was precipitated following its significant exposure to the capital market in form of margin trading loans. Again, in the wake of the high oil prices, a section of the industry was badly exposed to the oil and gas sector. These excessive exposures resulted in the weaknesses (liquidity problems) exhibited by some of the banks towards the end of 2008.

A joint special examination (CBN/NDIC) of 10 out of the 24 banks as at May 31, 2009 revealed that some of the banks exhibited the following symptoms:

- Substantial non-performing loan;
- Poor corporate governance weaknesses in governance and management;
- Weaknesses in capital adequacy; and
- illiquidity problem

It was against this background that the CBN moved decisively to strengthen the industry, protect depositors and creditors, and restore public confidence and safeguard the integrity of the Nigerian banking industry.

In this regard, it replaced the chief executives/executive directors of the banks identified as the source of instability in the industry and injected the sum of N620.0 billion in to the banks in an effort to prevent a systemic banking crisis. The injection of this fund (Tier II capital) into these banks is considered sufficient to resolve and stabilize them to enable them to continue normal business operations. Arrangements have been made to recover non-performing loans from the banks' debtors while guaranteeing all foreign credits and correspondent banking commitments of the five banks.

Other Recent Policy Actions to Strengthen the Reform Process

The CBN commenced the creation of Asset Management Corporation. The draft Bill for the establishment of Assets Management Corporation of Nigeria (AMCON) has already been passed into law by the National Assembly. The AMCON as a resolution vehicle is expected to soak the toxic assets of the CBN-intervened banks and provide liquidity to them as well as assist in their capitalization.

Furthermore, the Bank in collaboration with the fiscal authorities is improving the macroeconomic environment so as to achieve robust monetary and financial policies in particular and, the overall macroeconomic objectives of the government, in general. In this regard, the Bank is collaborating with the Federal Government to raise N500.00 billion for power/infrastructure development. This is expected to provide favorable environment that would encourage operators in the industry. In addition, N200.00 billion has recently been provided wholly by the CBN for SMEs financing.

It is also collaborating with the Securities and Exchange Commission (SEC) and the Nigerian Stock Exchange (NSE) to reduce the cost of transactions, particularly bond issues so as to diversify funding sources away from banks as well as attract more foreign portfolio investors into the sector.

Efforts are also being intensified towards strengthening regulatory and supervisory framework and enhancing monitoring of the operations of the Deposit Money Banks (DMBs) to ensure that they remain safe, sound and healthy. In addition, these efforts will also ensure the maintenance of public confidence through the enforcement of appropriate disclosures and reinvigorating the policy of zero tolerance on all unprofessional and unethical banking practice, and greater emphasis on enforcement of Code of Corporate Governance. Standby teams of target examiners are being deployed to any bank at any time to ensure timely regulatory actions, if necessary.

To further engender public confidence in the banking system and enhance customer protection, the CBN established the Consumer and Financial Protection Division to provide a platform through which consumers can seek redress. In the first three months of its operation, about 600 consumer complaints were received by the Division which was a manifestation of the absence of an effective resolution mechanism in banks. The CBN has also issued a directive to banks to establish Customer Help Desks at their head offices and branches. In addition, the CBN has commenced a comprehensive review of the Guide to Bank Charges with a view to making the charges realistic and consumer friendly. Furthermore, the Consumer and Financial Protection Division is expected to commence a programme of consumer education and enlightenment and is also collaborating with the Consumer Protection Council on the review of the Consumer Protection Council Act No. 66 of 1992 to regulators to enforce discipline in the market.

The CBN has taken steps to integrate the banking system into the global best practices in financial reporting and disclosure through the adoption of the International Financial Reporting Standards (IFRS) in the Nigerian Banking Sector by end 2010. This is expected to enhance market discipline, and reduce uncertainties which limit the risk of unwarranted contagion. The CBN is also, closely collaborating with other stakeholders like the Nigerian Accounting Standard Board (NASB), Federal Ministry of Finance (FMF), NDIC, SEC, and NAICOM; PENCOM, Federal Inland Revenue Service (FIRS), and Institute of Chartered Accountant of Nigeria (ICAN), among others, towards ensuring a seamless adoption of IFRS in the Nigerian banking sector by 2012. These efforts are being pursued under the aegis of the Roadmap Committee of Stakeholders on the Adoption of IFRS in Nigeria inaugurated by the NASB and facilitated by the World Bank.

The universal banking (UB) model adopted in 2001, allowed banks to diversify into non-bank financial businesses. Following the consolidation programme, banks became awash with capital, which was deployed in multiplicity of financial services. In effect, the laudable objectives of the UB Model were abused by operators with banks operating as financial supermarkets to the detriment of core banking practices. To address the observed challenges, the CBN is reviewing the UB Model with a view to directing banks to focus on core banking business. Under the new model, banks would not be allowed to invest in non-bank subsidiaries, while banks with such investments would be required to either divest or spin-off the businesses to holding companies that will be licensed by the CBN as other financial institutions. The three classes of deposit money banks being proposed are: International banks, National banks, and Regional banks.

Other measures included: the strengthening of institutional coordination through the Financial Service Regulation Coordinating Committee (FSRCC), adoption of common accounting year end for all banks, aimed at improving data integrity and comparability; conducting own-risk assessments and relying less on classifications by rating agencies; limiting the tenor of Chief Executives of Banks to 10 years;; sound and timely regulation and supervision of the financial sector; stringent demand for transparency in the financial sector; and transparency in structured credit instruments to be improved upon for easy assessment of associated risk.

The Alpha Project Initiatives of the CBN

The Central Bank of Nigeria has articulated a blue print for reforming the Nigerian financial system in general and the banking sector in particular in the next ten years. The blue print is built on 4 pillars of enhancing the quality of banks, establishing financial stability, enabling healthy financial sector evolution and ensuring that financial sector contributes to the real economy. The details are as follows:

- **Enhancing the quality of banks**

The CBN would initiate a five-part programme to enhance the operations and quality of banks in Nigeria, which would consist of industry remedial programmes to fix the key causes of the crisis, implementation of risk based supervision, reforms to regulations and regulatory framework, enhanced provision for consumer protection and internal transformation of the CBN which has commenced.

- **Establishing Financial Stability**

This would centre on strengthening the Financial Stability Committee within the CBN and establishing a hybrid monetary policy and macro-prudential rules. It would also include the development of directional economic policy and counter-cyclical fiscal policies by the government and further development of capital market as alternative to bank funding. Some of the potential levers for the new macro-prudential rules may include limiting capital market lending to a proportion of a bank's balance sheet, prohibiting banks from using depositors' funds for proprietary trading, private equity or venture capital investment, adjusting capital adequacy and forward looking capital requirement driven by stress tests by the CBN.

- **Enabling healthy Financial Sector Evolution**

The CBN would review the basic one-size-fits-all model of banking in addition to reviewing the universal banking model mandates which would make it possible to have international, national, regional, monoline and specialized banks such as Islamic banks, etc, with different capital requirements, commensurate to the depth of their activities.

- **Ensuring the Financial Sector Contributes to the Real Economy**

This would entail leveraging on the CBN Governor's role as Adviser to the President on Economic Matters to ensure that the financial sector contributes to the real economy. The CBN would take the lead in measuring more accurately the relationship between the real economy and financial sector, as well as cooperating with state governments to run pilot programmes in directing the financial sector's contribution to social and economic development within the states.

Furthermore, the CBN intends to be announcing an advance calendar of its operations for each week so that market expectations are formed in a manner that is conducive to the realization of the objectives of policy. The Bank also proposes to have in place firm consultation procedures with bank executives, prior to and after the policy meetings as a condition for bringing about a more open and transparent monetary policy. The CBN is putting in place a code of conduct for regulators to ensure that regulatory and supervisory staff in the financial services sector live up to the high expectation, thereby reducing various types of risks in both their domestic and international operations.

5.0 The Way Forward

Maintaining a safe and sound banking sector is essential, given the key role that banks play in promoting the health of a country's overall economy. Most countries do this by some form of banking supervision, generally accepting that the added protection to the banking system in the form of supervision is worth the costs of the regulatory burden. One of the ways that bank supervisors can help promote a healthy banking system is to focus banks on the development of improved risk-management techniques.

Indeed, identifying, assessing, and promoting sound risk-management practices have become central elements of good supervisory practice. Bankers should therefore ensure that their risk-management practices include a focus on less likely outcomes, not just the most common ones, and that the bank is being adequately compensated (provisioning) for the risk it is bearing. The use of exercises such as stress tests and scenario analyses can help bankers identify certain points of vulnerability that may arise during potential downturns.

To arrest banking crisis, there is need to strengthen banks' capital requirements in order to ensure their solvency. This is achieved via the purchasing by public authorities of securities issued by banks or by taking stakes, where necessary, in troubled banks. Banks will thus be able to continue developing their lending activities, by increases in their capital, even if adverse market conditions prevent them from raising funds on financial markets.

Another type of action consists in ensuring the proper provision of liquidity to banks by the monetary authorities so that they can continue to finance the economy in the short- and long-term. Central banks have regularly adjusted their operational frameworks in order to provide the banking systems with all the liquidity that they need: The discount window operations was recently extended in order to give renewed impetus to the money market beyond the very short-term segment. The money market transaction thus was considerably strengthened. The range of eligible counterparties was extended to enable the maximum diffusion of liquidity in the system; the scope of eligible collateral for refinancing was enlarged to provide more flexible access and make larger quantities available; in the system the refinancing potential of counterparties was thus almost doubled; the refinancing procedures were also radically modified: quantities are no longer limited and are agreed at a fixed rate (instead of a system of variable rates via auctions).

It has been noted that better risk management and stronger financial buffers alone cannot prevent higher-risk activity taking banks from causing systemic crisis. Banks' quest for maximum profit and shareholders' value leads to pressure on the bank management to take excessive risks and should be discouraged through setting of limits of risk-taking. The global financial crisis has demonstrated that banks' excessive risk taking can be catastrophic and that there is no built-in safeguard to constrain such risk taking. It is therefore imperative that regulatory authorities should set percentage-of-capital limits on banks' high-risk activities. The adoption of such limits is the only tangible way to reduce the threat to the financial system.

One of the key board responsibilities is to design compensation programs that reward long-term performance and promote sound risk management. The recent financial crisis revealed that bank compensation practices encouraged excessive risk taking and rewarded short-term profits at the expense of long-term viability. To address this deficiency, regulatory authorities in collaboration with boards of directors of banks should establish and adopt prudent standards for bank compensation programs that require a significant portion of bonuses to be paid in shares that vest over time; link bonuses to performance targets and adherence to prudential principles; and permit bonuses only if supervisors consider a bank's capital ratios sufficient..

Moreover, pursuing sound macroeconomic policies is another way for policymakers to help prevent banking and financial crises. For instance, it is beneficial to have sound and sustainable monetary and fiscal policy to provide a stable operating environment for entrepreneurs and financial institutions and markets. Many past crises were precipitated either by an external shock affecting an already vulnerable financial sector or by market participants targeting vulnerabilities in certain markets or in certain institutions or governments. Experience has shown that if a condition or policy looks unsustainable, it is most likely that market forces will eventually bring it to an end.

A major cause of distress in most Nigerian banks has been attributed to poor corporate management. In most cases, members of management are often self-serving and indulging in criminally irresponsible behaviour in the administration of their banks. This suggests the need for an appropriate mechanism to be put in place to ensure that erring directors are prosecuted on accelerated basis.

Furthermore, having an open and transparent financial system and economy, accompanied by reliable and accurate accounting standards would generally benefit a country and its market participants. A core principle of economics is that markets are more competitive, and therefore more efficient, when accurate information is available to both consumers and suppliers. Information is thus critical to the effective functioning of financial markets: Timely and accurate financial information about markets, market participants, and governments is important for all actors to be able to make informed decisions. This is of course true during normal times, but perhaps more so during a crisis when market participants and governments are sometimes trying to determine where problems lie and how severe they might be. Lack of information can present additional problems during a crisis, and incorrect or incomplete information provided by firms, governments, and other institutions can severely undermine their credibility, worsening the problem. Transparency will assist banks to make informed decisions; rescue them from the illusion of high performance; help to build both customer and investor confidence; provides opportunity for re-strategizing; provides a competitive advantage, clear understanding of the risks and challenges facing the bank.

There is need for a forward-looking supervisory regime which would ensure appropriate and sustained capacity building initiatives. Also, bank supervisors should keep abreast of state-of-the art practices and procedures in order to discharge their functions efficiently, effectively and creditably.

6.0 Concluding Remarks

We have tried to explain the concepts involved in banking crisis and jurisdictional experience in financial crisis. The causes and the impact of banking crises on other sector of the economy were also x-rayed. Some policy options for a healthy banking system, including sound macroeconomic policy, sound risk management system and high levels of transparency and disclosure, among others, were recommended.

As a final thought, there is no uniform effects neither is there any single remedy to each crisis, but each brings its own surprises and risks. Clearly, we should not assume that past remedies will fully solve the current and next set of problems or address all future crises. The key is to take lessons from the past and tailor them appropriately to address future situations of potential crisis.

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