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POST-CONSOLIDATION CHALLENGES

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Overview

Industry consolidation usually takes either of two possible routes. The first route is that where there is an industry shakeout that is driven by the market. The disruption to activities is often manageable and a self-adjustment process follows to bring stability to the industry thereafter. The second route is that where a fundamental change or major policy shift triggers the industry consolidation, as in Nigerian banking at present. The disruptions and challenges of the latter are more significant, and require more efforts to handle than what would be sufficient for the former.

One of the general effects of consolidation is reduction in the number of players, moving the industry more toward an oligopolistic market. The expectation of collusion in an oligopolistic market and its tendency to water down competition might be upturned by the nature of the industry and evolving circumstances, which are capable of raising the stake of competition. As such, fewer players might not necessarily reduce the force of competition in the industry after consolidation.

Starting from the premise of "why consolidate the Nigerian banking industry", arguably, the most fundamental reason has been reiterated several times as the growing distress in the industry and a real threat of imminent bank failure. If the distress is of manageable proportion and thus could be curtailed, there probably would have been no need for the present radical policy shift. The fear was however, that the situation could snowball into systemic distress, and eventually slow down a domestic economy that was just trying to gather the momentum for growth.

There have been debates and arguments about the details and appropriateness of the strategy adopted by the Central Bank of Nigeria (CBN) in this banking system consolidation exercise. The disagreements notwithstanding, there is a consensus that change of a fundamental nature was necessary to redirect the banking system towards its traditional role of providing effective intermediation and financing economic growth.

The huge complexity of a consolidation programme of the kind embarked upon by the CBN demands caution, constant reappraisal of strategies and actions, and full attention to the identified and emerging challenges.

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This paper is structured into three parts, dealing with the benefits of a properly conceived and effectively implemented consolidation programme, which has several components. Beyond the benefits, the paper also examines the challenges that the banking industry stakeholders (especially the Central Bank of Nigeria) will face when the "dust settles". The final part offers some advice on what the CBN and other stakeholders should do in order to handle effectively the challenges identified.

The Benefits of Consolidation

The benefits of bank consolidation have been listed severally, particularly with reference to Nigerian banking. Some of these are obvious and quite rational, while some others are spurious and require much agonizing over to convince skeptics. The obvious ones are discussed in this paper as follows.

The process should cause to evolve banks that are better capitalized and bigger because the new minimum capital of ₦25 billion is a growth inducer. The average ratio of banks' equity to total liabilities in Nigeria during 1991 to 2004 was 5.86%, which translates into a multiplier of 17.06 and an average business volume of ₦426.6 billion (or balance sheet footing) for any bank in compliance with the new minimum capital. In a global survey of the ratio of banks' equity to total liabilities, banks were found to fall in the range 4.4% to 5.5%, implying multipliers of between 18.18 and 22.73. If these are set against the new minimum capital requirement in Nigeria, the banks should grow to balance sheet size of between ₦454.5 billion and ₦568.25 billion.

Strong capital is a basic indication of solvency, and it will take a while along with careless risk taking for any of the newly capitalized banks to walk its way into insolvency. From experience, bank customers have tended to shift their deposits from smaller to big (or mega) banks in the thinking that they are safer, a phenomenon that is generally referred to "the flight to safety" and quite pervasive whenever there are concerns about the state of health of the banking system.

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

The consolidation exercise should provide a vehicle for taking out the weak banks in the system in an orderly manner. This has always been a major challenge to banking systems, especially the evolving ones like Nigeria's. There is still some concern though that some weak banks might end up having no "suitors" and thus require further attention (beyond the merger and acquisition option) from the regulatory authorities. Such banks might, at the end of the day, be "forced into a marriage of

convenience" and supported through an Asset Management regime that discounts their deficient risk assets as well as some new capital injection.

Another benefit of the on-going consolidation exercise is the expansion of the shareholding base of Nigerian banks, thus eliminating the phenomenon of "family banks" and the tendency for poor corporate governance arising from such ownership pattern. Again, the argument could go in two directions. First is that ownership spread is not equivalent to ownership diffusion. The former refers to the number and possibly the geographical spread of shareholders, which the quest for the high minimum capital has made most banks pursue. The latter concerns the extent of individual holding and control of the emerging institutions from the exercise. Fact is that there is hardly any business that has no historical root in a family or group of families, while the influence of families (either in shareholding or control over activities/ decisions) remains pervasive globally.

Secondly, family control through ownership does not necessarily lead to compromise of standards and poor corporate governance. Precluding these is largely a matter of the nature and firmness of internal control measures as well as their enforcement. Integrity plays a vital role in this as much as the values of the organization do. Where individual organizations define clearly what they stand for and the public good plays a prominent role in that, the tendency is for good corporate governance to be the norm. The real challenge is not the ownership structure, but the adequacy of internal controls, their enforcement and close monitoring by the supervisory/regulatory authorities. This requires the Central Bank to define and set the minimum standards in this respect, and ensure that operators are encouraged actively to implement them.

Vender Vennet (1997) found that domestic mergers improved profitability and operational efficiency, but cross-border acquisitions were a surer source of cost efficiency. The Nigerian banking experience puts this to test, as big banks had to learn from the smaller and leaner banks in the areas of operational efficiency and profitability. The growth patterns of some of the newer generation banks has proved, so far, that mergers are not a sufficient condition for growth – a vision, a strategy and solid commitment to both are the key.

Beyond the obvious benefits listed in the preceding seven paragraphs, there are complementary benefits as well. These include:

1. Stricter industry regulation and supervision through new rules, capacity building and deployment of information communication technology (ICT) by the Central Bank and the other banking system regulatory/supervisory agencies. These have been demonstrated by not only the Central Bank, but by the Securities and Exchange Commission, the Nigerian Stock Exchange, Federal Inland Revenue Service, etc.
2. Industry cleansing, which results from stricter and more professional supervision and regulation. In this vein, a self-regulatory body like the Chartered Institute of Bankers of Nigeria has joined forces with the Central Bank and the other agencies listed

above. This development reinforces good corporate governance and promises better health of the banking system in future.

The Challenges of Consolidation

The challenges identified in this paper cut across the banking system, relating to the Central Bank, other regulatory agencies, operating banks, their shareholders, bank employees and other stakeholders in the banking industry.

It is an established fact that the fastest route to improving efficiency in any industry is to foster competition among the operators. This is evident in two important growth sectors of the Nigerian economy — aviation and telecommunications over the last one decade. A major challenge of bank consolidation is how to foster competition with fewer, mega banks. Certainly, fewer cannot be more competitive. There is however, the other side to the argument, which considers the number and spread of bank branches. The fewer banks are likely to be pressured to expand further, seeking business opportunities through aggressive branching to hitherto unexplored territories. There is ample evidence that this is the direction that the emerging banks in Nigeria are likely to follow, going by the indications in their capital raising information memorandum. International evidence on bank consolidation also confirms this, except that it is more in the context of cross-border acquisitions. See Hughes, Lang, Mester and Moon (1998).

One of the supposed benefits of consolidation (bigger banks) is indeed an efficiency challenge. The argument has been that bigger banks might not necessarily be fitter or more efficient, since they have no incentive to improve efficiency within the limited competitive field. Observers of Nigerian banking have noted that the big banks (perhaps because of the increase in the number of customers) have slipped back to their erstwhile habits before the advent of the new generation banks. Available empirical evidence from Hughes et. al. (1998) supports improved efficiency (measured by expected profits, riskiness of profit, profit efficiency, market value, market-value efficiencies and the risk of insolvency) where mergers involved institutions whose operations cut across state and geographical boundaries. This evidence can however, not be stretched to all bank mergers and acquisitions, especially the Nigerian situation where big banks have been found less efficient in terms of returns on investments (assets and equity) and other key financial ratios relative to smaller and leaner banks.

The large capital requirement that comes with the on-going bank consolidation in Nigeria poses a challenge of generating commensurate return. If Nigerian banks want to maintain any semblance of their five-year average return on equity (about 43.92% during 1998 to 2002), a figure averaging between ₦11 billion and ₦19.8 billion would become the new profit targets! This might not be a big deal for the big banks that have been operating within this threshold. But for the new big banks, it could signpost the "race of death", which the Central Bank must gear up to monitor and find strategies to check.

Another major challenge of bank consolidation is capacity building for risk management, for both the regulators and operators.

Both constituencies of the banking system need to enhance their risk management skills and indeed acquire new ones, covering the three planks of risk recognition, evaluation and monitoring. In addition, operators will have to take more seriously the important issue of risk acceptance/rejection, which is often the point at which bankers fall into or escape the trap of greed. The end of risk management for operators is risk mitigation, which emphasizes the protection of the bank's assets and by extension, depositors' funds and capital. The Central Bank should also begin to take more interest in the decision making process (especially compliance with laid down procedures) of banks when major risky transactions are involved.

It is imperative for the Central Bank to work out a framework for dispute and conflict resolution in the on-going bank consolidation in Nigeria. The fact that the mergers and acquisitions in process now are not all voluntary (if any), the policy has put together strange bedfellows in their desperation to meet the requirements of minimum capital and the merger condition. Early evidence of this is found in some banks that initially signed memorandum of understanding and have had to back out and embark subsequently on regrouping with others. Also, it is not unlikely that certain key individuals would in the consolidation process take some strategic positions that might not be acceptable to other stakeholders after the process completion. The Central Bank should anticipate such occurrences and begin now to set out the modalities for resolving consolidation-related disputes and conflicts.

One other important challenge is in the gaps that exist in the legal framework for banking in Nigeria, including the Central Bank of Nigeria Act and the Banks and Other Financial Institutions Act in the main. Provisions that enhance the autonomy of the apex bank and minimize restrictions on the emerging mega banks are most desirable in the post-consolidation era. Any issue that can readily be misconstrued, misinterpreted, misrepresented and carry any amount of ambiguity should be reviewed, and either restructured, restated or expunged altogether from the Acts. A period of major change like this offers an opportunity to deal with all such inhibiting provisions and debilitating matters.

There has been the argument that small and medium scale enterprises (SME's) will suffer neglect in lending by the emerging mega banks. Available evidence in the work of Jayaratne and Wolken (1998) suggest that bank consolidation will have little effect on credit availability to small firms. Other findings by Cole and Walraven (1998) suggest that consolidation in the banking industry may have enhanced rather than restricted the availability of credit to small businesses, although they did not rule out changes in the credit terms. These studies relied on data from the banking system of the United States of America, and thus could not be directly extrapolated to Nigerian banking. This is more so that the pattern and origin of bank mergers and acquisitions in the US were not exactly the same as what is happening in Nigeria at the moment. There is as well, the thinking that the antecedents of Nigerian banks with lending to SME's is not inspiring and

might be carried over into the post consolidation era.

Consequently, some school of thought foresee the need to strengthen, streamline and restructure non-bank financial institutions in order to take care of SMEs that are likely to be neglected by mega banks. This is largely to do with the internal structure, capabilities, resources and activities of the Other Financial Institutions Department of the Central Bank. For instance, how can community banks be strengthened for micro credits? What are the possibilities of resuscitating finance companies and tailoring their activities more towards SME's? What chances exist for reviving primary mortgage institutions and focusing their operations on SME's? Can a linkage be established between the bureau-de-change and the other segments of the sector as well as SME's? What can be done to make development finance institutions more virile and highly supportive of SME's? The posers raised here are not about capitalization only; they are meant to set the apex bank thinking about a cocktail of incentives that will make these non-banks show genuine interest and commitment to funding of SME's.

One potential area of challenge to the bank regulatory authorities and indeed all the stakeholders of Nigerian banking is the fresh wave of fierce competition that accompanies bank consolidation and its capacity to trigger another round of unethical practices and poor corporate governance. Available global evidence points to size as a non-issue in corporate governance – most big organizations, whether bank or non-bank have, at one time or the other, violated the basic tenets of good corporate governance. See Berenson (2003). The two ways this can go are:

1. Employ unethical strategies to beat competition, in the bid to meet profit targets. This entails strategies for getting and keeping business, as well as negative application of deep smarts in public sector dealings.
2. With all the mega banks listed on the Stock Exchange, performance pressures might result in income inflation, notwithstanding the tax implications. This is one of the major problems with large business organizations all across US and Europe that fell foul of business ethics.

An important challenge of bank consolidation comes under the nomenclature of financial infrastructure, dealing with the capital market, insurance sub-sector and new financial instruments. Only very few analysts would have given the Nigerian capital market any thought of the volume of fresh capital raised from it in the last one year, June 2004 to June 2005. The pleasant surprise notwithstanding, there are efforts still required to deepen the market and expand its scope. In most of the advanced financial systems, the pressure that the money market bears in Nigeria is usually offset by the virility of the capital market. Indeed, in corporate finance, the world capital market is generally found to be doing not less than 150% of the aggregate credit in the banking system.

The insurance sub-sector of the financial system is an important plank of the financial system. The commencement of universal banking in Nigeria has not caused to evolve bancassurance, as it exists in other banking jurisdictions. The banks have restricted themselves to insurance

agency, although essentially because of regulatory restriction. Perhaps, with the on-going bank consolidation, Nigerian banks will pay more attention to building a strong linkage between banking and insurance. Some of the banks have recently (in the last one year) floated insurance subsidiaries, which are prelude to the emergence of bank holding companies that will house the entire gamut of financial services companies.

The introduction of new financial instruments is basically the responsibility of operators, in their response to market dictates. The pattern in Nigerian banking over the past few decades has been for banks to copy one another, especially when the product of any particular bank appears to be thriving. Until the banks are challenged to look beyond the usual and possibly offered incentives for introducing new instruments, there might not be tangible results in this area. The incentive could take the form of a certain percentage drawback on verified research expenditure for successful cases, or the institution of an award for banks that excel in product innovation.

What to do

It should be obvious from the challenges discussed in the preceding section what the Central Bank of Nigeria and other banking stakeholders should do, if there is common desire for success of the on-going consolidation and they are all equally committed to that.

Policy responses to market developments and research findings should be robust, dynamic and proactive. Well-researched and evidence-based policies would be difficult to fault, and also would be an easier sell to stakeholders. As such, getting stakeholder cooperation and support at implementation would be easier. The gaps needing to be filled thereafter would also be minimal.

The experience to date on the bank consolidation shows clearly that there is need for rapid capacity building at the Central Bank of Nigeria. The key question is “what do the management and staff of the apex bank need to know?” Information is power as much as knowledge (routed in analytical skills) is key. The knowledge and skill acquisition procedure at the bank needs to be overhauled. The argument remains that a regulator/ supervisor cannot effectively manage what s/he does not understand.

It is important to ensure the success of the information communication technology (ICT) component of Project EAGLES of the apex bank. In particular, the Central Bank should seek compatibility of banking software across the industry as well as with the apex bank itself. Ultimately, there should evolve seamless interface between the apex and operating banks.

The Central Bank should engage more in dialogue with operators and key stakeholders. There has been some improvement in this area between the commencement of the consolidation exercise in July 2004 and now. But, there is room still for improvement. The diversity of views and opinions provides a rich base from which a widely acceptable policy could evolve and cooperative agreement reached. In this vein, the CBN should be more receptive to constructive criticism of

its policies and actions. Such could be useful in re-examining positions and gaining respect/ cooperation of all stakeholders.

When all the above have been done sufficiently, there still remains the problems created for the banking system by fiscal imprudence by governments at all tiers in Nigeria. The macro-economic consequences of this have the tendency to stymie the gains of the on-going bank consolidation, and in fact be turned around as the (adverse) aftermath of consolidation! The CBN should therefore, move promptly and decisively, using anticipatory monetary policy changes/ shifts to checkmate fiscal imprudence that might derail the macro-economic agenda of the Federal Government. The global practice is that whenever the economic agenda of a government derails, the blame is always laid at the door of the apex bank.

Conclusion

No doubt, bank consolidation brings some benefits to all the stakeholders of the banking system. Some of the obvious ones were discussed and represent the low hanging fruits of the programme. Even at that, they must not be taken for granted, as efforts are needed to stay the course.

Post consolidation, there are daunting challenges to the Central Bank, operators, investors and other stakeholders of the Nigerian banking system. These, as presented in this paper, all point the direction in which the stakeholders should go. While specific advices were offered the Central Bank, the advices to operators and investors are to be inferred. For example, if profit expectations remain indexed to historical levels, there could be trouble very soon for the institutions that engage in unethical practices and pranks in order to maintain the status quo. Also, high profit expectations by investors (which for now, seem unrealistic) would result in dashed hopes. Stakeholders should brace up to face the realities of low return on equity at post consolidation in Nigerian banking.

In all, the greatest challenge of post bank consolidation is that facing the Central Bank of Nigeria. Specific advices were given on how the bank may proceed and reap the rewards of the bold initiative, in spite of the inadequacies at the beginning of the exercise. The greatest asset that the apex bank needs now and going forward is flexibility, and a strong will to review situations as they unfold and respond appropriately. The bank will surely need to maintain rapport with operators especially – they are the ones that actually implement policies, in their day-to-day interactions with their customers and other economic agents.

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