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Risk-based regulation: the future of Nigerian banking industry

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Abstract

Purpose – This paper aims to argue that the Nigerian banking industry needs to adopt a risk-based regulation as a future regulatory model in the industry. The frequent distress and failures in the industry have shown that reliance on recapitalisation and on credit rating information by the supervisors and investors to determine the health of the financial institutions is less than satisfactory. This is more so when agency ratings suffer accountability deficits.

Design/methodology/approach – This paper posits that while the regulation of the credit ratings is necessary for institutional accountability, it is never a substitute for oversight functions and due diligence exercise for both the supervisors and investors in the industry. This exploratory research paper is structured to cover the origin of banking regulation in Nigeria, the recapitalised efforts by the regulators, the problem with the agency ratings and why the future of Nigerian banking regulation should be risk-based.

Findings – This research paper posits that while reliance on recapitalisation strategy and agency rating publications is relevant in banks, the future of Nigerian banking regulation should be risk-based.

Originality/value – The Nigerian banking industry should develop effective risk-management structures in line with the international regulatory framework.

Keywords Nigeria, Emerging economy, Investors, Risk management, Banking industry, Regulators, Recapitalisation, Rating agencies

Paper type Research paper

Introduction

The paper posits that the future of Nigerian banking regulation lies in a risk-based framework in line with global best practices and the international regulatory structure in banks. Given the frequent distress and failures in the banking sub-sector, the reliance solely on recapitalisation strategy and information from rating agencies (which is currently the case) by the supervisors and investors to determine the health of these institutions is less than satisfactory. This is more so when the rating institutions are embroiled in accountability issues. Generally, banking has always been and will continue to be the pivot around which every economy in the world revolves. This prime of place of banking is owed, essentially, to its fundamental macro-economic significance, which results, primarily, from the financial intermediation or wealth-creation role of the banking sector in a nation[1]. Banks are key players in any country's financial sector, given that they occupy a delicate position in economic equation of any country such that their (good or bad) performance invariably affects the economy of any country. Studies

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have shown that the banking sub-sector, which actually started in Nigeria in 1892 (Nwankwo, 1990, p. 21; Oliyide, 2013, p. 2), has been largely volatile with spates of failures experienced in most parts of the 1990s, and in the early and mid-2000s. This evidence points to the fact that the method often used to strengthen banks in Nigeria and save them from financial distress is capital regulation. In the recent times, the Central Bank of Nigeria (CBN) and investors equally rely on agency ratings[2] in taking regulatory actions and investment decisions. It is argued that these regulatory strategies (though necessary) have not been able to protect the banks from distress and failures. This is why this paper canvasses for a paradigmatic shift in regulatory actions and strategies by regulators and operators to a risk-based approach that has some nexus with identified sectorial problems.

This exploratory research paper which is not based on empirical analysis explores the regulatory structure of Nigerian banking. The paper is divided into four parts. The first part will trace the evolution of the banking regulation in Nigeria. The second part will consider the previous efforts to recapitalise the banks as a regulatory strategy in the industry. The third part will examine the basis for frequent reliance on agency ratings after the financial crisis, given that these institutions are embroiled in credibility issues. This will be followed by the analysis of the poor risk-management structure as the major cause of the bank failures in Nigeria and how adopting a risk-based framework as a regulatory model can improve the banking landscape in the nation's sub-sector. The fourth part will be the conclusion and the suggested ways forward in improving the industry.

Banking regulation

Generally, the word "regulation" refers to the act of monitoring, supervision or control, often, by virtue of the setting of rules and guidelines, which must be followed by the monitor, regulator or supervisors (Nwankwo, 1990, p. 26; Oliyide, 2013, p. 7). The act of regulation, naturally, presupposes the existence of a regulator or regulatory agency whose activity may include the setting of the rules and guidelines but must, certainly, include ensuring compliance with the rules and regulations that are in place. In the context of banking regulation in Nigeria, "regulation" means the monitoring, supervision or control of banking business in the country. (Nwankwo, 1990, p. 7). By law, the CBN must ensure compliance with these rules and guidelines, the objective being to prevent systemic failures in Nigerian banking, and ensure public confidence, so that banking may engender the desired economic development and growth in the country. Thus, as the apex regulator of banking, the CBN is, under the law, empowered to promote monetary stability and a sound financial system[3]. In the nation's sub-sector, the scope of banking regulation is wide enough to encompass all statutory provisions that have a direct or indirect bearing on the control or supervision of banking. These include the Credit and other Guidelines and Monetary Circulars issued by the CBN, Rules and Regulations issued by self-regulatory agencies such as the Bankers' Committee Rules of Professional Ethics for Bankers, amongst others. Nevertheless, by far, the most statutory instrument for regulating banking in Nigeria is through the Bank and Other Financial and Institutional Act (BOFIA)[4].

Evolution of regulation in Nigerian banking

Banking regulation commenced in 1952, with the enactment, in that year, of the Banking Ordinance[5]. Nevertheless, contemporary banking in Nigeria had begun in 1892, with the establishment of the first commercial bank in the country popularly known as "the African Banking Corporation". The banking establishment was later metamorphosed into the modern-day "First Bank of Nigeria Plc[6]". The period between 1892, when contemporary banking commenced, and 1952, when banking regulation started, has been described as the "era of unregulated banking in Nigeria" (Nwankwo, 1990, p. 40; Uzor, 2006, p. 32). This period is so described because there was no form of statutory regulation of banking, whatsoever, in the country at the time. As such, banking business was transacted at "whims and caprices" of the promoters of such business and was carried on as the promoters deemed fit. After the World War II, British rule over Nigeria weakened with the passage of the 1946 Constitution that gave a majority of the seats in the National Assembly (MPs) to native Nigerians. The Nigerian Government began to regulate banking with the passage of the Banking Ordinance of 1952.

Before the commencement of banking regulation in 1952, particularly, because banking business was entirely an "all comer affair", there was a perennial collapse of banks. For instance, a motivation for passage of the Banking Ordinance of 1952 was the failure of 21 of 25 Nigerian banks in the period from 1947 to 1952. This massive collapse of indigenous banks, unimaginably, brutalised the confidence of the public in the banking sector so seriously as to portend inevitable calamity for the country economy (Uzor, 2006, p. 31). The enactment of the Banking Ordinance of 1952 was in tandem with the recommendation of G.D Paton's Commission of Inquiry into banking business which was saddled with the responsibility of making recommendations to the government about the desirability and extent of banking regulation in the sub-sector (Nwankwo, 1990, p. 60). The creation of the Central Bank of Nigeria Banking Ordinance of 1958 further strengthened the bank regulatory structure. The CBN began full operations on July 1, 1959. The 1960s and 1970s saw more financial institutions being created and a greater role of the government in regulating and owning banks in the country. The Indigenous Enterprises Promotion Decrees of 1972 and 1977 set a policy of government ownership of significant portions of the economy. On that basis, the government took ownership of 60 per cent of the equity in expatriate banks operating in the country, including First Bank, Union Bank and United Bank of Africa (Uche, 2004, p. 69). Until 1979, banks wholly owned by the federal and state governments dominated the industry. After 1979, privately owned banks began to emerge, but the federal government dominated ownership in banking until the introduction of the Structural Adjustment Program in the mid-1980s (Uche, 2004, p. 70).

Similarly, in 1986, the government as a condition of an agreement to borrow from the International Monetary Fund came up with a Structural Adjustment Program that generally required economic liberalisation and decreased government regulation and ownership in much of the economy. Bank licensing requirements were substantially eased, resulting in a large increase in the number of banks operating in the industry. From 1985 to 1992, the number of banks increased from 40 to 120 banks, the highest number to that point in time. During this period, in 1988, the Nigeria Deposit Insurance Corporation (NDIC)[7] was created to offer deposit insurance to depositors in failed banks. In 1991, the Bank and Other Financial Institutional Decree (now Act) was enacted, which brought the supervision and regulation of all financial institutions, not just banks, under the CBN. Prior to this, supervision of non-banks was shared between CBN and the Ministry of Finance (Uche, 2004, p. 67; Ogowewo and Uche, 2006, p. 161).

Distress in Nigerian banking

Bank failure and bank distress have been inextricably interlinked in the literature. Bank failure or distress could be loosely defined as the inability of a bank to meet up with its financial obligation to its customers. In technical terms, banks are defined as financially distressed when they are technically insolvent and/or illiquid (Ogowewo and Uche, 2006, p. 165). In the financial terms, to be insolvent means that business is both unable to meet its current obligations and settle its outstanding debts. The author posits that insolvency and financial distress/failure are two different things. This is mainly because distress or failure occurs when insolvency is officially recognised and the organisation is closed or measures are put in place for consolidation or mergers. In Nigeria, the problem of bank distress has been observed as far back as 1930s. From 1930 to 1958, over 21 bank failures were recorded in the industry. The banking failures during that era might have been induced by the domination of foreign banks in terms of the exclusive patronage by British firms. Distress in Nigerian banks was also recorded in the 1990s and in the early parts of the 2000s (Brownbridge, 2002, p. 176). The number of distress banks grew from 15 in 1991 to about 55 in 1994 and 60 banks were known to be distressed in 1995 and by 1997, the number of problem banks had reduced to 47. As at the year-end 2000, that number reduced significantly to 1, then 15 in 2001, before dropping again to 10, shortly before the 2004 banking consolidations.

Causes of bank failures

Many reasons could lead to bank distress or failures. In the case of the Nigerian banking, major reasons identified as the causes of the distress and failures are cases relating to insider abuses, fraud and embezzlement[8]. The increasing incidence of these problems is symptomatic of poor management and its attendant poor internal control. Given the poor risk-management structures in the nation's banking sub-sector, insider abuses such as unsecured loans are easily and fraudulently granted by members of the board and management to themselves, and loans with high probability of default are deliberately made to their friends and relatives by relaxing the credit standard. A result of the reasons stated above is that most, if not all, of the banks that failed in Nigeria failed largely due to non-performing loans. Arrears affecting more than half of the loan portfolios were typical of the failed banks (Uzor, 2006, p. 32; Ezeoha, 2007, p. 7; Ezeoha and Ogamba, 2010, p. 15).

Recapitalisation of banks in Nigeria

Given the sectorial deficits above, one of the strategies often utilised to regulate, strengthen and safeguard banks from distress is capital regulation by the CBN. A cursory look at the history of banking in Nigeria reveals that the CBN has found reasons to shore up the capital base of banks a number of times in the recent past[9]. The current reform effort by the CBN follows a significant initiative earlier begun by the former Governor of the CBN Professor Charles Soludo in 2004. When Professor Soludo took office as the Governor of the CBN in 2004, he announced a new policy to increase the minimum paid up capital of banks to N25 billion naira (equivalent to USD173 million) from N2 billion naira (USD14 million), which had been the minimum capital for establishing the business of banking in Nigeria. Banks in the sub-sector were required to obtain this capital by the end of December 2005, roughly 18 months from the policy announcement (Ezeoha, 2007, p. 173).

The clear purpose of the policy guidelines was to consolidate the existing banks into fewer, larger and financial stronger banks. Arguably, it would be recalled that before 2004, the banking industry consisted of 89 banks that were fragmented into relatively small, weakly capitalised, with most banks having paid in a capital of $10 million or less. The best capitalised bank then had a capital of USD240 million, but it was far less than satisfactory when compared with other developing countries. For instance, in Malaysia, the least capitalised bank had a capital of USD526 million at the time. In the Nigerian banking, the smaller banks were family-owned and privately held. Nevertheless, the industry was heavily concentrated, with the ten largest banks controlling 50 per cent of the assets and deposits in the industry. The result of this new, much larger capital requirement was the consolidation of banks into larger entities (Ezeoha, 2007, p. 172). During this 18-month period, there were a number of mergers and acquisitions among Nigerian banks to meet this new capital requirement. In the end, the 89 banks that existed in 2004 decreased to 25 (now 18) larger, better capitalised banks. While capital regulation strategy was well-intentioned and a step in the right direction, it could not reduce the problem of distress in the industry, given that the fundamental cause of bank distress and failure in Nigeria is the massive credit losses as a result of non-performing loans and poor risk management structures (Uche, 2004, p. 67; Ezeoha, 2007, p. 171). In what follows, agency ratings will be discussed as another regulatory strategy in the industry.

Gatekeeper enrolment – credit rating agencies

This regulatory strategy is characterised by various patterns of enrolment, in which different organisations – transnational or national, public or private – have differential regulatory capacities and can enhance that capacity by enrolling others to perform some functions[10]. One strategy which appears to be successful in the context of regulatory approach is to enrol gatekeepers. "Gatekeepers" are those who are not directly the subject of regulation, but who have a strategic position over those who are. The benefits of using gatekeepers in a regulatory framework are that regulators can leverage off the control that such actors have over the regulatees, and that the gatekeeper actors themselves have no particular incentives not to comply with the regulatory requirements, as they would not benefit directly from non-compliance. However, the incentive structures of gatekeepers may not always be so neutral. For instance, auditors who sign off false accounts do not benefit from the increase in the share prices, but may benefit from continued business with the firm[11]. In part, these failings arose from the lawyers and accountants (Coffee, 2006, p. 23; Carsten, 2009, p. 317).

In the banking and financial markets globally, the main substantial failures arose from the credit rating agencies (CRAs). The experience of enrolling CRAs illustrated that although gatekeeper regulation is a potentially useful regulatory strategy, in practice, whether the framework is successful depends on the motivation, regulatory capacity and, most importantly, the broader market context, culture and incentives of those being relied upon to act as gatekeepers. CRAs normally rate creditworthiness of corporations and have a long history due to their growth owing to the combination of the markets and regulatory factors. Although they are dominated by an oligarchy of three agencies (such as Fitch, Moody and Standard and Poors), but through the structure of global capital regulation, their ratings have assumed a privileged status which creates incentives for issuers to acquire ratings. That notwithstanding, their role in the financial crisis is now well-known in both legal and economic literature (Carsten, 2009, p. 318). The banks which were creating asset-backed securities products and products based on them paid ratings agencies to rate the securitised products to improve their marketability to investors. Although, rating agencies might not have directly benefitted from whether the rating they gave was high or low, but, perhaps, they did benefit from the revenue stream that came from giving ratings; revenue streams that were directly linked to the level of rating they gave. To secure businesses, these agencies rated products without really understanding what they were rating and caring even less, and often with the involvement of the bank structuring the products (Staphenie and Gabriel, 2009, p. 532; Carsten, 2009, p. 320).

Regulators enrolled not only ratings agencies but also the models and standards that they used to devise their ratings. In significant areas of regulation, and notably with respect to capital requirements, credit ratings are hardwired into the regulatory regime. In Basel II regime, external ratings can be used to determine the risk exposures and debt profile of banks. The Central Banks have also relied on credit ratings to determine what may be their sovereign debt positions and what could be accepted as a collateral[12]. Similarly, one of the global rating agencies (Fitch) rated Nigerian banks recently as “BB” (negative) – meaning that the country’s economic outlook appears to be in a stable condition barring all difficulties[13]. Although, in theory, this might sound encouraging to the Nigerian Government as an emerging market, but the practical dimension of the rating raises the question as to what extent such rating of economic fundamental impacts on the country’s economic climate or on the standard of living of the Nigerian citizens, as fundamental inaccuracies in external rating of securitised products could be injected straight into regulatory operation? In reality, regulators should not be too complacent simply because of good rating from the agency; after all they paid to be rated, which arguably put the objectivity of the agency in doubt. It equally questions the credibility of their accountability process (Staphenie and Gabriel, 2009, p. 532; Carsten, 2009, p. 368).

Enrolment can confer benefits, extending regulatory capacity, however, as the role of credit ratings in the recent financial crisis has demonstrated, it creates significant dependencies and vulnerabilities to banks because of frequent reliance on the agencies. It can also create opportunities for manipulation (gaming) of the regulatory rules: for example, banks guaranteed the liabilities of their special purpose vehicles, which gained high credit rating to reduce their capital requirements. The role of CRAs as gatekeepers is being significantly re-evaluated, as these institutions arguably suffer from accountability deficits. This is why the agency rating is being regulated in the developed world[14]. While CRAs are now to be regulated within the EU, regulators and Central Banks in many developed world are now withdrawing their sole reliance on them for regulatory purposes. The paper posits that while enrolling the rating agencies as “gatekeepers” might appear to be relevant as one of the contemporary banking regulatory strategies, Nigerian Central Bank and other emerging world should, in the future, view agency ratings with caution and their information should be re-examined before incorporating it in their regulatory action in keeping with current global trends in financial regulations. Similarly, to demonstrate that some lessons have been learnt from the recent global financial crisis, it is further argued that both the regulators and investors should not place undue reliance on credit ratings without performing their own primary due diligence functions in the industry. This suggestion applies to both the developed and emerging economies. Furthermore, the regulatory action in Nigeria should emphasise more on how to improve on risk management structure which is still at the formative stage in the industry and seems to be the solution in reducing the banking distress and failures (Fadun, 2013, p. 1).

Risk management in Nigeria

The section will discuss the risk management structure and why the future of the Nigerian banking regulation lies in the risk-based strategic framework. Any discussion of risk management in banking must start with the understanding that banks exist for the purpose of taking risk, and the objective of supervision is not to completely eliminate risk-taking. Rather, the aim of supervision is to assist in the management of risk. Arguably, one should not lose sight of the fact that banks' willingness and ability to take risk, in turn, have allowed them to contribute substantially to economic growth by funding households and businesses. Nonetheless, this economic function, particularly when conducted with a relatively small capital base and using mainly funds that have been borrowed short-term, partly led to periodic rounds of bank failures (Fadun, 2013, p. 3). Such a history has often led to proposals for a dramatic overhaul of the business of banking. This development in the industry, however, did not change the risk-taking function of banking, nor the need for risk management. Even in the modern banking, with professional management largely divorced from the owners, the desire of management to have the institution survive is still a major impetus to risk management (Ferguson, 2003].

Risk management is the identification, assessment and prioritisation of risks followed by the coordinated and economical application of resources to minimise, monitor and control the probability and/or impact of unfortunate events. It introduces the idea that the likelihood of an event happening can be reduced, or its consequences minimised. Risk is an essential part of business because firms cannot operate without taking risk. Risk is associated with uncertainty, as the event may or may not occur, and a decision to do nothing explicitly avoids the opportunities that exist and leaves the threat unmanaged. Risk is also a pervasive part of organisational strategy, with profound implications for the success or failure of any business undertaking[15]. Risk is particularly relevant to the industry, given that banks perform three main functions – financial intermediation, asset transformation and money creation. These roles are fraught with obvious risks. Traditionally, risk has been viewed as negative consequences and unfavourable events. The consideration of risk from the negative perspective is restrictive and arguably appears to be misleading for two major reasons. First, uncertainty may manifest in either negative (threat) or positive (opportunity) form or both. Second, the way a risk is perceived influences the manner in which it is handled. Managing risks from a negative perspective may result in complete omission of potential opportunities. However, viewpoints on risk differ, as the risk definition depends on and is affected by the risk observer. Moreover, risk sometimes entails some economic benefits, as firms may derive considerable gains by taking risk. Business grows greater through risk-taking and the greater the risk, the higher the potential returns. Risk is integral to opportunities and threats which may adversely affect an action or outcome. Similarly, getting rid of risk undermines the source of value creation, which truncates potential opportunities. Therefore, banking must strike a trade-off between the threat and opportunities posed by risk-taking (Hindson, 2011, p. 23).

Crises in the Nigerian banking industry have shown that not only do banks often take excessive risks but they also differ across banks, and some managers are more prudent and would be able to contain the risks than the others. As a way to stem the tide, the CBN on July 6, 2004, introduced measures to make the entire banking system a safe, sound and stable environment that could sustain and inspire public confidence in the sector. Professor Soludo argued that the aim was to set up a structure that could create a strong base relative to the kind of economy that would operate where banks become channels to do proper intermediation[16]. Similarly, as a follow-up to this exercise, the CBN came up with further agenda to stabilise the base of the banks. Arguably, the essence of the reform policy was to consolidate the banking institutions through mergers and acquisitions. While initially the policy appeared to have raised some dusts and heated debates among different strata of the Nigerian society, it is to be seen that at the end of the exercise, 25 of the 89 commercial banks operating in the country emerged consolidated through re-capitalisation to the tune of N25 billion naira (equivalent to USA$173 million). More than 50 per cent of the new banks came to their present position through mergers and acquisitions[17].

It is pertinent to stress that since the emergence of consolidated 25 (now 18) commercial banks in Nigeria, the industry players and other stakeholders have been confronted with how best to manage the post-consolidation challenges that squarely face the industry and, by extension, the nation's economy. This is the compelling reason operators and regulators of the banking system in Nigeria are further challenged to take more seriously the important issue of risk management, which is arguably often the point at which bankers fall into or easily escape the trap of greed. The end of risk management for operators is risk mitigation, which emphasises the protection of the bank's assets and, by extension, depositors' funds and capital (Fadun, 2013, p. 8).

Risk management practices

As pointed out previously, the banking business by its nature is a high-risk environment. It is risky in the sense that it is one of the businesses where the proportion of borrowed funds is far higher than the owners' equity. A high level of financial leverage is usually associated with high risk. This can easily be seen in a situation where adverse rumours, whether founded or unfounded, could trigger financial panic and, by extension, a run on a bank. Few banks are able to withstand a persistent run, even in the presence of a good lender of last resort. For instance, as depositors take out their funds, the bank suffers and in the absence of a good liquidity support, the bank is forced eventually to close its business. Thus, the risks faced by banks are endogenous, which is associated with the nature of banking business itself, while others are exogenous to the banking system (Fadun, 2013, p. 5).

Although there has been noticeable improvement in risk management practices in few Nigerian banks following the intervention of the CBN[18] to avert massive bank failures in 2009-2010 and the subsequent reform measures being proposed currently, risk management practice in the nation's financial services industry is still at the rudimentary stage and is facing a number of challenges. Chief among these challenges is the acute dearth of knowledgeable and skilled risk professionals. Most of the available risk experts appear to be concentrated in certain banks, yet even in these institutions, those with risk experience may not be fully involved in the major strategic decisions. This situation is further exacerbated by the poor knowledge of risk management by the members of the board of many banks, as revealed by the result of the diagnostic study commissioned by the CBN in the wake of the banking sector crisis in 2009. In the hindsight, it was apparent that the senior management and many directors did not clearly appreciate the nexus between their banks' business strategies and risk appetite and the implications for risk management within the organisation. Some factors may have accounted for this less than satisfactory state of affairs in the industry. First, the absence of the formal training institutions offering risk management courses and industry-recognised risk management practitioners with formal qualifications and technical depth to foster the development of professional talent in the different areas of risk management such as credit, operational, liquidity and market risks is an issue. Second, the absence of a holistic, well-structured and well-co-ordinated framework to support capacity development in these banks, particularly in the area of risk management and corporate governance for members of the board and management, is a challenge (Fadun, 2013, p. 4).

Furthermore, evidence from the liquidated banks clearly showed that inability to collect loans and advances extended to customers and directors or companies related to directors/managers and their associates were a major cause of the distress of liquidated banks. In a collaborative study by the CBN and NDIC, operators of financial institutions confirmed that bad loans and advances contributed most to the banking distress[19]. In their assessment of factors responsible for the distress, the operators ranked excessive risk-taking such as bad loans (un-serviced loans) and advances first with contribution of 60 per cent (Owojori *et al.*, 2011, p. 28). This development provokes a pertinent question in the research which is: What lesson (s) can be learned from the experiences of the liquidated banks in this regard? To answer this question, one needs to examine the administration of loans and advances which contributed partly to the crisis coupled with possible mitigation that could have been applied. In Nigeria, banks are expected to have credit policies which should guide them in credit administration. For example, the Act[20] forbids a bank from granting any advance, loan or credit facility to any person, unless it is authorised in accordance with the extant rules and regulations of banks. This section also directs a bank to obtain adequate securities for advances, loans or credit facilities. In addition, the Act[21] prohibits a manager or any officer of a bank from having personal interests in any advance, loan or credit facility, and if they do, such should be declared.

In practice, evidence has shown that most of the liquidated banks' officers flouted these provisions with impunity and many of them currently in operation do not obey these provisions. Failed banks granted loans without collateral, and loan disbursements in many instances were known to have been effected even before conditions precedent to draw down were met. These banks were (and some are still) reckless in disbursing facilities before loan applications and/or acceptance letters were received. This paper wonders how these customers could be made to repay the facilities if the simple but important contract documents that are in tandem with the extant laws were not executed at the onset of the credit relationships. Similarly, the Act[22] further seeks to limit the credit exposure of banks to single obligor limit as a means of avoiding undue credit concentration, which has the potential to mitigate credit risk[23]. However, practice in the industry showed that most of these failed banks flagrantly violated 20 per cent of shareholders' funds unimpaired by losses limit. Although the CBN guidelines for banking have raised the limit to 35 per cent recently, some banks are known to have been exceeding the limit without seeking approval from the CBN, as required by the law (Owojori *et al.*, 2011, p. 25). It is argued that such practices hardly reflect and indicate that the affected banks in particular and the industry at large have learned any worthy lessons in this regard from the experiences of the failed banks. This is because by wantonly exceeding the limit without approval, such banks have consciously (unconsciously) laid foundations for distress, in addition to being labelled as non-compliant[24].

Furthermore, directors of banks are also not allowed to have outstanding unsecure loans, advances or unsecure credit facilities in their names and/or in the name of associated companies without prior approval in writing of the banks' apex regulator. Similarly, the Code[25] of conduct for directors of licensed banks issued by the CBN and endorsed by every bank director warns that a director shall be disqualified if any of his loans in a bank is classified lost by the Bank Examiners of the Regulatory Authorities[26]'. The provision of the Act and those of the Codes of conduct are intended to keep directors and managers above board in their banks' credit administration[27].

The Chartered Institute of Bankers in Nigeria (CIBN) enjoins directors and managers to be the leading example in this important aspect of banking operations. Nevertheless, evidence is to the contrary and suggests otherwise, given that most of the loans in these banks are insider-related and are easily extended to directors and managers in contravention of the laws[28]. These loans remained un-serviced and piled up for years and most times are written off by the supposedly debtors (board members and senior officers), and necessary actions or punitive measures are not taken by the appropriate authorities against these defaulting bank directors and managers.

In practice, to the extent that these loans were not performing, it would have been surprising for these banks to survive. Given the importance of credit allocation in a bank and the potential risks associated with credit, few of these banks have what appeared to be credit committees with the board having the highest level, but short of the banks' single obligors limit[29]. Consequently, in many of these banks, the board credit committees had been presided over by the board chairmen, until the CBN put a stop to it recently. That notwithstanding, it is argued that such an arrangement amounted to the board chairmen reporting to themselves, which is bad for practice and, to a great extent, it effectively compromised the independent appraisal that the committees would have given the board (Akinpelu, 2011, p. 32). In spite of the major reason of speed of credit approval adduced to justify the practice, it could not have been in the best overall interest of the banks that had the practice. It is suggested that senior management oversight of leading function, involving regular and periodic loan review, done independently of the lending officers, is a good credit risk management. Such credit periodic review can actually or potentially reveal weaknesses inherent in outstanding facilities and could allow for quick intervention or remedial measures to prevent loan or, at worse, minimise such losses[30]. Although many of these banks purport to have credit review committees, in a real sense, it is merely a sham and symbolic, as nothing concrete arguably is known to have been done to enforce the committees' recommendations. As a matter of fact, rather than make provisions for loan losses as prescribed by the committees, these banks are known to have abandoned such recommendations in favour of year-end profits.

It is the argument of the paper that to further strengthen the good risk management practices in banks in Nigeria, it is necessary that the board of directors and managers imbibe and adhere to the Code of Corporate Governance standards with respect to risk administration. The main principle of the Code with regard to risk management is that the board of directors must identify key risk areas and key performance indicators of the business enterprise and monitor these factors[31]. The board has the responsibility to first understand and fully appreciate the business risk issues and the key performance indicators affecting the ability of the institutions to achieve its purpose[32]. Furthermore, this would require that the business risks and key performance indicators should be benchmarked against industry's norms and code of practice, so that the institutional performance could be further evaluated[33]. It is important that all banks in Nigeria should set up risk management committees to provide oversight of management activities in managing credit, market, liquidity, operational, legal and other risks of the institutions. In addition, it is required that directors and senior management should be trained to enable them to understand the institution's business, nature of the risks, the consequences of risks being inadequately managed and an appreciation of the techniques of managing the risks effectively. It is a good practice that the institution's risk management be subjected to periodic review and the results should be reported to the board. In turn, the board ought to satisfy itself that the institution's material business risks are being effectively identified, quantified, monitored and controlled and that the systems in place to achieve this are operating effectively at all times[34].

Conclusion

In line with global best practices and as part of the on-going reforms of banking sector, the CBN should commence the implementation of risk-based supervision for effective risk management in banks in Nigeria[35]. Similarly, as a complementary effort to this, the nation's apex regulators should adopt Basel II/III capital accord that emphasises on risk regulation and management. The adoption and implementation of these initiatives will foster and further deepen risk management in banks as well as improve regulatory supervision and industry transparency[36]. Secondly, Committee of Governors of the CBN should institute a process of regular dialogue between the banks' leadership on the one hand, and chief risk officers (CROs), chairmen of the board risk committees and credit committees of the banks on the other. The collaborations of these committees are necessary, as their dialogues enable the regulators to provide policy guidance to bank risk managers. There should also be an evolving effort to set up a forum of CROs of banks to provide a platform to periodically discuss risk issues in the industry at large[37]. Similarly, the nation's apex regulators need to strengthen the supervision of off-shore Nigerian banks. This will require an on-going cross-border supervisory co-operation and coordination with other jurisdictions where Nigerian banks have some presence. In this regard, there is need for the creation of, and recruitment for, a specialist risk management team in the bank's Banking Supervision Department that houses the regulator's bank examiners for proper oversight functions.

Thirdly, the credit risk management bureau of the CBN that provides information on prospective borrowers should be activated to serve as a viable medium for credit risk mitigation[38]. The information from the bureau which is intended to assist lending officers in forming opinions as to the credit worthiness of potential borrowers is necessary. It is obvious that the services provided by the bureau, which in any case will benefit the bankers and operators, are to assist banks to fight the menace of "professional" borrowers who move from bank to bank securing credit facilities with no intention to repay. In the same vein, it is also necessary that the banks make use of risk quality ratings of both internal and external ratings systems to provide some information on the risk quality of bank borrowers[39]. Internal risk systems entail ranking customers in accordance with information available to the banker about the credit quality of the customers, whereas external rating usually relies on published information from credit rating agencies. Unfortunately, many banks have consciously or unconsciously refused to avail themselves of the services provided by the medium. This is why this paper posits that regulators and supervisors in the industry need to effect regulatory process that will entrench effective risk management to raise the standard and to rekindle the much needed confidence in banking for the investing public and the nation's economy.

Furthermore, the apex regulator needs to pressure the Banker's Committees to evolve an effective competency framework for the Nigerian financial services industry which is expected to contribute towards addressing identified capacity gaps. Capacity building and development in professional risk management has the potential to enable strategic partnerships and collaborations with global professional associations to leverage cutting-edge best practices in risk management[40]. On the domestic plane, similar partnership should be forged with local professionals associations, corporate learning centres, industry learning organisations and industry regulators towards capacity development to raise the standard of the industry[41]. The paper has argued that the above highlighted measures and guidelines are urgently needed to further improve the landscape in the nation's banking sub-sector. The move by the CBN to introduce a risk-based supervision and effective risk management is a welcome development and could represent a paradigmatic shift from sole reliance on capital-based regulation and information from agency ratings[42]. It is argued that this new regulatory paradigm when implemented will further boost the country's investment profile and reposition the continent's largest economy as the investment destination centre in the sub-Saharan Africa[43].

Notes

1. Financial intermediation means the process of channelling funds from the affluent in an economy called the surplus unit, to the needy within that economy, called "the deficit unit".
2. CRAs are institutions that normally rate creditworthiness of corporations and have a long history due to their growth owing to the combination of the markets and regulatory factors. Although they are dominated by an oligarchy of three agencies (such as Fitch, Moody and Standard and Poors), but through the structure of global capital regulation, their ratings have assumed a privileged status which creates incentives for issuers to acquire ratings.
3. The CBN Act was promulgated in 1991 as Decree No. 24. The enactment of this law and Banks and Other Financial Institutions Act 1991 which largely regulate the banking sub-sector of

the financial services industry was considered a landmark development, as they conferred on the CBN a measure of instrument autonomy for the effective discharge of its core mandate. But the law and its subsequent amendments could not meet the challenges leading to its amendment in 2007. For more see CBN Act No. 7 2007.

4. BOFIA 1991 provides for the powers and duties of licensed banks and the role of the CBN. See the amended BOFIA No. 4 1991. Others include CBN Act 2007 and Rules/Guidelines/Circulars for Banking Operations Issued by CBN.
5. No. 15 1952.
6. Bank of British West Africa is the predecessor to the current "First Bank of Nigeria", while Barclays is the predecessor to the current "Union Bank of Nigeria Plc".
7. The NDIC is an independent agency of the Federal Government of Nigeria. The objective of the deposit insurance system is to protect depositors and guarantee prompt and efficient settlement of insured funds in the event of failure of insured participating institutions. See NDIC Act No. 16 2006.
8. Other problems that could cause banking problems include (but not limited to) corporate governance issues, financial crimes, accumulations of poor asset quality and bad policies of the government.
9. Nigerian banks were mandated to shore up their capital as a regulatory strategy from a modest value of N10 million naira minimum paid-up capital in 1988. Nigeria commercial banks were required to maintain capital not below N50 million in 1991. Between 1991 and 2005, subsequent increases have also been made ranging from N500 million in 1997; N1billion in 2001; N2billion in 2002 (US$14 million) to N25 billion in 2005 (US$173 million).
10. Gatekeepers are professionals better placed to give expert advice to firms and regulators because of the presumed neutrality of their incentive structures, e.g. accountants, auditors, securities experts and CRAs.
11. As the corporate accounting scandals and frauds in Enron, Worldcom, Parmalat and their ilk demonstrated, those relied upon to act as gatekeepers can be less than reliable, and need not to have performed the role that regulators assume they would play.
12. The European Central Bank only accepted A-rated products; however, as the Greek crisis has demonstrated, in times of crisis this strict stance may have to be adjusted, and the ECB has had to say it will accept bonds regardless of their rating.
13. Fitch affirms Nigeria's 'BB- "Rating, Stable outlook" 17th October, 2013.
14. See EU Regulation No 1060/2009; *US Dodd-Frank Wall Street Reform and Consumer* Protection (*Dodd-Frank Act*) Pub L No. 111-203, 124 State, 1376 (2010).
15. Risk taking is an integral part of and constitutes a major feature of banking business.
16. Professor Charles Soludo was the Former Governor of Nigerian Central Bank (from 2004-2009), who believed that recapitalisation structure could create a strong base relative to the kind of economy that would operate where banks become channels to do proper intermediation.
17. More than 50 per cent of the new banks came to their present position through mergers and acquisitions.
18. The CBN as an institution is the apex regulator of the licensed banks and other financial institutions in Nigeria as enshrined in the CBN Act 2007, ss. 1, 2, 12, 17, 20, 25.

19. This diagnostic study was carried out by the major regulatory agencies in the Nigerian financial services industry to determine the financial health of the banks in Nigeria. These agencies are CBN and NDIC.
20. BOFIA, 1991, as amended, s. 18 (1) (b).
21. BOFIA, 1991, s. 18 (1) (a).
22. BOFIA, 1999, s. 20 (1) (a).
23. Single obligor limit is the maximum amount a bank is allowed to lend a single borrower or an individual in relation to the total shareholders' fund of that bank.
24. At the height of the distress in 1995, when 60 out of 115 operating banks were distressed, the ratio of the distressed banks' non-performing loans and leases to their total loans and leases was 67 per cent. The ratio deteriorated to 79 per cent in 1996; to 82 per cent in 1997 and between 2002-2004 to 23.08 per cent and the licenses of 35 of the distressed banks were revoked subsequently, available at: www.ndic.org.ng (accessed on 24 February 2014).
25. See the Code of Corporate Governance for banks and other financial institutions in Nigeria post consolidation 2006, available at: www.cenbank.org.ng/publication/corp.govpost%2006.pdf (accessed on 26 January 2014).
26. The CIBN is the umbrella professional body for bankers in Nigeria. It was incorporated in 1976 as the Nigerian Institute of Bankers and was chartered in 1990. See CIBN Act No 5 of 2007, s. 16.
27. CBN Act, 2007, ss. 12, 17.
28. BOFIA, 1991, ss. 17, 18, 20, 21; CIBN Act 2007, ss. 15, 16.
29. NDIC has recommended a downward review of the single obligor limit, which is at present pegged above 20 per cent, available at: www.ndic.org.ng (accessed on 23 February 2014).
30. Risk management framework is at the formative stage in Nigerian banking industry and many banks do not have risk structure according to CBN, available at: www.cenbank.org.ng (accessed 20 February 2014).
31. Adherence to the Code of Corporate Governance is good practice for banks in Nigeria.
32. CBN Code of Corporate Governance for Banks 2006, Principles 8.3, 8.4, 8.5.
33. CIBN Act, 2007, ss. 15, 16.
34. Risks in banks are endogenous which is associated with the nature of banking business itself, while others are exogenous to the banking system.
35. See Basel II amended capital accord on risk management, available at: www.bis.org/publ/bcbs56.pdf (accessed 20 February 2014).
36. See CBN Supervision Guidelines (2011) for improving risk management and transparency in banking, available at: www.cenbank.org.ng (accessed 23 February 2014).
37. See CBN, *Code of Corporate Governance for Banks in Nigeria 2006*, Principles 8.6 and 9.
38. The information from the bureau is intended to assist lending officers in forming opinions as to the credit worthiness of intending borrowers. But, banks fail to provide credit information to the bureau.
39. Internal risk systems entail ranking customers in accordance with information available to the banker about the credit quality of the customers, whereas external rating usually relies on published information from CRAs.

40. Such as the Global Association of Risk Professionals and Institute of Risk Management in the United Kingdom.
41. Credit Risk Management Association of Nigeria.
42. The CBN is now increasingly focused on risk-based approach and even encourages strong risk management in banks and other financial service institutions under bank's regulatory purview. The operators and regulators in the industry will now have to be proactive rather than reactive in determination, assessment and management of risks.

43 Nigeria's economy surpassed South Africa's as the largest on the continent after the West African nation overhauled its gross domestic product (GDP) data for the first time in two decades. On paper, the size of the economy expanded by more than three-quarters to an estimated 80 trillion naira ($488 billion) in 2013. While the revised figure makes Nigeria the 26th biggest economy in the world and largest in Africa, the country lags in income per capita, ranking 121 with $2,688 for each citizen. For more see *Federal Office of Statistics Report* 2013 available at: www.nigerianstat.gov.ng (accessed on July 2014).

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Further reading

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