Charles Chukwuma Soludo: Consolidating the Nigerian banking industry to meet the development challenges of the 21st century

Address by Mr Charles Chukwuma Soludo, Governor of the Central Bank of Nigeria, at the Special Meeting of the Bankers' Committee, Abuja, 6 July 2004.

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Introduction

I am delighted, as part of this first meeting of the Bankers Committee under my chairmanship, to share some thoughts with you on a major policy shift regarding the banking industry. Given the potential implications of the policy shift for the ownership and operations of the banking industry, we thought it was important to have this special meeting (with Chairpersons of Boards of Banks also in attendance). As you are aware, I assumed duties as the Governor of the Central Bank barely one month ago and we are still working out the fine details of the New Agenda for Repositioning the CBN and the Financial System for the 21st Century. Our goal is to consolidate and build upon the achievements of the sector especially in the last 10 years and to take the system to greater heights. Let me use this opportunity to invite all of you to send us any proposals or ideas that you might have in respect of how best the CBN can continue to serve the financial system and the Nigerian economy better in the years ahead. I will share the strategic agenda with you and the generality of Nigerians in due course, especially in respect of the agenda for ensuring exchange rate and price stability, managing interest rate for stability and development, macroeconomic coordination, vigorous pursuit of the developmental roles of the Central Bank, improvement of the payments system, financial sector diversification and regulatory reforms, and strategies for integrating Nigeria's financial system into the African regional and global financial system. For today, I concentrate on the theme of banking sector consolidation.

Before I proceed, let me once more pay tribute to the Committee for its many achievements over the years. In particular, I wish to once more commend my predecessor, Chief (Dr.) J. Sanusi for the sterling achievements over the past five years. I also commend your contributions to our national economy - both in your individual capacities and in the context of your banks. I look forward to the continued cooperation of the Committee. As time goes on, we may need to reappraise the frequency of the meetings of the Committee. May be, beginning 2005 we could restrict the general meetings to say, three times a year (that is, every four months) while the sub-committees could meet more frequently. I would appreciate your thoughts on these suggestions.

Let me return to the theme of my speech - consolidation and strengthening of banks! Strengthening and consolidating the banking system will constitute the first phase of the reforms designed to ensure a diversified, strong and reliable banking sector which will ensure the safety of depositors money, play active developmental roles in the Nigerian economy, and be competent and competitive players in the African regional and global financial system. The goal of the reforms is to help you become stronger players, and in a manner that will ensure longevity and hence higher returns to your shareholders over time and greater impacts on the Nigerian economy. We strongly believe that the ultimate beneficiaries of this policy shift would be the Nigerian economy - the ordinary men and women who can put their deposits in the banks and have a restful sleep; the entrepreneurial Nigerians who can now have stronger financial system to finance their businesses; and Nigerian economy which will benefit from internationally connected and competitive banks that would also mobilize international capital for Nigerian development. This measure is about the Nigerian people. It is about meeting their NEEDS. It is about positioning Nigeria and Nigerians to become competitive players in the 21st century. The second phase will address the issues of diversification, including programmes to encourage the emergence of regional and unit/specialized banks.

Case for mergers and acquisitions as instrument for banking soundness

Before I go further, let me share some thoughts on why mergers and acquisitions should be taken seriously as an instrument for enhancing banking efficiency, size, and developmental roles.

All over the world and given the internationalization of finance, size has become an important ingredient for success in the globalizing world. In the world of finance, no country can afford to operate in isolation. The last few years have witnessed the creation of the world's banking group through mergers and acquisitions. The trend has been influenced by factors such as prospects of cost-savings due to economies of scale as well as more efficient allocation of resources; enhanced efficiency in resource allocation; and risk reduction arising from improved management.

Mergers and acquisitions especially in the banking industry is now a global phenomenon. In the United States of America, there had been over 7,000 cases of bank mergers since 1980, while the same trend occurred in the United Kingdom and other European countries. Specifically, in the period 1997-1998, 203 bank mergers and acquisitions took place in the Euro area. Cross-country mergers are also taking hold. In 1998 a merger in France resulted in a new bank with a capital base of US$ 688 billion, while the merger of two banks in Germany in the same year created the second largest bank in Germany with a capital base of US$ 541 billion. In many emerging markets, including Argentina, Brazil and Korea, consolidation has also become prominent, as banks strive to become more competitive and resilient to shocks as well as reposition their operations to cope with the challenges of the increasingly globalized banking systems. In Korea, for example, the system was left with *only 8 commercial banks* with about 4,500 branches after consolidation.

As I stand before you today, I can visualize the Nigerian and world economy in the year 2025 and 2050. What I see is a world economy with no more than 10-20 mega-banks all over the world. I see national and cross-national mergers and acquisitions taking place in massive scales. It will not be a world for marginal or fringe players. Countries that fail to proactively position themselves today will wake up then to continue to complain of marginalization. I can see Asia consolidating. I see consolidation in Europe, America, and South America. Consolidation is taking place in South Africa such that one bank in South Africa - Amalgamated Banks of South Africa (ABSA) has asset base larger than all of Nigerian commercial banks put together. Malaysia has recently gone through its first round of consolidation whereby about 80 banks shrunk to about 12 within one year. In Malaysia, banks were required to raise their capital base from about $70 million to $526 million in one year. In Singapore (with about three million people), banks have now consolidated to about six and further moving down to three - with the second largest bank having a capital base of about US$ 67 billion.

Where is Nigeria - Africa's most populous country and potentially its largest economy? In Nigeria, we have 89 banks with many banks having capital base of less than US$ 10 million, and about 3,300 branches. Compare this to 8 banks in South Korea with about 4,500 branches or the one bank in South Africa with larger assets than all our 89 banks. The truth is that the Nigerian banking system remains very marginal relative to its potentials and in comparison to other countries - even in Africa. We have a duty to be proactive, and to strategically position Nigerian banks to be active players and not spectators in the emerging world. The inability of the Nigerian banking system to voluntarily embark on consolidation in line with the global trend has necessitated the need to consider the adoption of appropriate legal and supervisory frameworks as well as a comprehensive incentive package to facilitate mergers and acquisition in the industry as a crisis resolution option and to promote the soundness, stability and enhanced efficiency of the system.

Context: where are we coming from and where are we now?

The Nigerian banking system has undergone remarkable changes over the years, in terms of the number of institutions, ownership structure, as well as depth and breadth of operations. These changes have been influenced largely by challenges posed by deregulation of the financial sector, globalization of operations, technological innovations and adoption of supervisory and prudential requirements that conform to international standards.

As at end-June, 2004, there were 89 deposit money banks operating in the country, comprising institutions of various sizes and degrees of soundness. Structurally, the sector is highly concentrated, as the ten largest banks account for about 50 percent of the industry's total assets/liabilities. Most banks in Nigeria have a capitalization of less than $10 million. Even the largest bank in Nigeria has a capital base of about US$ 240 million compared to US$ 526 million for the smallest bank in Malaysia. The small size of most of our banks, each with expensive headquarters, separate investment in software and hardware, heavy fixed costs and operating expenses, and with bunching of branches in few commercial centres - lead to very high average cost for the industry. This in turn has implications for the cost of intermediation, the spread between deposit and lending rates, and puts undue pressures on banks to engage in sharp practices as means of survival. I am sure many of you would agree with me that some of our banks are not engaged in strict banking business in terms of savings intermediation - they are traders - trading in foreign exchange, in government treasury bills, and sometimes in direct importation of goods through phony companies. This is not healthy for the economy.

Think about this caricature of what could happen under this system. A group of people get a banking license, use their connections to garner some billions of Naira in deposits from one or two parastatals, and use the deposits to trade in Government treasury bills, foreign exchange and open letters of credit for importers. Such a bank can declare billions of Naira in profit. It sounds like a fiction but this describes the situation with many banks in the system. With many of such banks, depositors with balances of less than N50,000 or N100,000 are not welcome. Today, we have more than N400 billion as currency outside of the banking system. There are many reasons for this, including the large informal economy, but obviously a key reason is the perverse incentive to look mostly to high net-worth agents for deposits - government agencies, blue chip companies and rich individuals. Again, this is neither sustainable nor healthy for the economy.

The latest assessment shows that while the overall health of the Nigerian banking system could be described as generally satisfactory, the state of some banks is less cheering. Specifically, as at end-March, 2004, the CBN's ratings of all the banks, classified 62 as sound/satisfactory, 14 as marginal and 11 as unsound, while 2 of the banks did not render any returns during the period. The weaknesses of some of the ailing banks are manifested by their overdrawn positions with the CBN, high incidence of nonperforming loans, capital deficiencies, weak management and poor corporate governance. These shortcomings have, in recent years, led to the revocation of the licenses of two banks and the suspension of three others from clearing house activities, prior to the commencement of the new settlement system.

A further analysis of the returns of the marginal and unsound banks reveals that they account for 19.2 percent of total assets of the banking system, 17.2 percent of total deposit liabilities while the industry non performing assets account for 19.5 percent. Although these ratios, except that for deposits, were below the trigger points for declaring the system as distressed, they are nevertheless of major supervisory concern.

The fundamental problems of the banks, particularly those classified as unsound, have been identified to include: persistent illiquidity, poor assets quality and unprofitable operations.

For clarity, we can summarize the major problems of many Nigerian banks as follows:

(a) weak corporate governance, evidenced by high turnover in the Board and management staff, inaccurate reporting and non-compliance with regulatory requirements, falling ethics and de-marketing of other banks in the industry;

(b) late or non-publication of annual accounts that obviates the impact of market discipline in ensuring banking soundness;

(c) gross insider abuses, resulting in huge non-performing insider related credits;

(d) insolvency, as evidenced by negative capital adequacy ratios and shareholders' funds that had been completely eroded by operating losses;

(e) weak capital base, even for those banks that have met the minimum capital requirement, which currently stands at N1.0 billion or US$ 7.53 million for existing banks and N2.0 billion or US$ 15.06 million for new banks, and compared with the RM 2.0 billion or US$ 526.4 million in Malaysia.

(f) Over-dependency on public sector deposits, and neglect of small and medium class savers.

One of the recent developments in the banking system, which is of great concern to the monetary authorities is the significant dependence of many Nigerian banks on government deposits, with the three tiers of government and parastatals accounting for over 20 percent of total deposit liabilities of deposit money banks. Although the distribution among banks is not uniform, there are some banks whose dependency ratios are in excess of 50 percent. The implications are that the resource base of such banks is weak and volatile, rendering their operations highly vulnerable to swings in government revenue, arising from the uncertainties of the international oil market.

In recent times, many banks appear to have abandoned their essential intermediation role of mobilizing savings and inculcating banking habit at the household and micro enterprise levels. The apathy of banks towards small savers, particularly at the grass-root level, has not only compounded the problems of low domestic savings and high bank lending rates in the country, it has also reduced access to relatively cheap and stable funds that could provide a reliable source of credit to the productive sectors at affordable rates of interest. The current structure of the banking system has promoted tendencies towards a rather sticky behaviour of deposit rates, particularly at the retail level, such that, while banks' lending rates remain high and positive in real terms, most deposit rates, especially those on savings, are low and negative. In addition, savings mobilization at the grass-root level has been discouraged by the unrealistic requirements, by many banks, for opening accounts with them.

The summary from the foregoing is that the Nigerian banking system faces enormous challenges which if not addressed urgently could snowball into a crisis in the near future. We don't have to wait for the crisis to explode before we act.

Our vision of a sound and reliable banking structure for the 21st century

The Nigerian banking system today is fragile and marginal. Our vision is a banking system that is part of the global change, and which is strong, competitive and reliable. It is a banking system which depositors can trust, and investors can rely upon. Evolving such a banking system is a collective responsibility of all agents in the Nigerian economy. Everyone has a role to play.

On the part of banks, the challenges are enormous. We recognize that banks and their owners are primarily in business to make profit, and we are conscious of the need not to jeopardize this key driving motivation for innovation and entrepreneurship. However, we all know that banking system occupies a unique position in every economy and that is why it often attracts more than a casual regulatory attention. Our industry in the 21st century must have a moral face and live up to some modicum of social responsibility. Capitalism must have a social face and a human soul to be sustainable. This is the lesson of world history. It is in this context that we view with serious concern the spate of frauds, ethical misconduct, falsification of returns by the banks to the Central Bank, unprofessional use of female staff in some banks in the name of 'marketing', etc. Collectively we can stop these misconducts and give the system a new face.

Banks are also expected to imbibe best-practice corporate governance, improve on self-regulation, enhance the capital base, institute IT-driven culture, and seek to be competitive in today's globalizing world. Diversification of the productive base of the economy remains a fundamental challenge of economic management, and banks will increasingly be challenged to become more innovative in their intermediation function, and especially to increase financing to the productive sectors.

The regulatory authorities, on their part, would further streamline the regulatory framework and strengthen the supervisory capacity to ensure a sound and efficient system. It is not enough to have a vision, we must act now. Accordingly, let me share with you some of the preliminary thoughts on the major elements of the reforms by the CBN in this first phase of the banking sector reforms. We welcome your comments and suggestions before we finalize them. Some of the key elements might include:

(i) Requirement that the minimum capitalization for banks should be N25 billion with full compliance before end-December 2005 (that is, 18 months notice rather than 12 months normally given in many countries).

- Only the banks that meet the requirement can hold public sector deposits, and participate in the DAS auction by end 2005.
- Publish the names of banks that qualify by 31 December 2005.

(ii) Phased withdrawal of public sector funds from banks, starting in July 2004.

(iii) Consolidation of banking institutions through mergers and acquisitions.

(iv) Adoption of a risk focused, and rule-based regulatory framework. We will always pre-announce the rules of the game and stick to them. Arbitrariness will be reduced to the barest minimum. More often, operators who run foul of the rules plead for 'political solution'. Those who petition for 'political solutions' to otherwise strictly economic and financial problems should understand the damages that such arbitrariness can do to the system, and the wrong signals and moral hazard that it creates. Once we start with one 'political solution', there is no end to it and the system would suffer. In the interest of preserving the integrity of the system, transparency and probity, we will insist on the rules and regulatory framework, in the interest of Nigeria and Nigerians.

(v) Adoption of zero tolerance in the regulatory framework; especially in the area of data/information rendition/reporting. All returns by banks must now be signed by the MDs of the banks. The so-called ‘re-engineering’ or manipulation of accounts especially in hiding of information under ‘other assets/liabilities’ and off-balance sheets will henceforth attract serious sanctions.

(vi) The automation process for rendition of returns by banks and other financial institutions through the electronic Financial Analysis and Surveillance System (e-FASS) will be completed expeditiously.

(vii) Establishment of a hotline, confidential internet address (Governor@cenbank.org) for all Nigerians wishing to share any confidential information with the Governor of the Central Bank on the operations of any bank or the financial system. Only the Governor has access to this address.

(viii) Strict enforcement of the contingency planning framework for systemic banking distress;

(ix) Work towards the establishment of an Assets Management Company as an important element of distress resolution;

(x) Promotion of the enforcement of dormant laws, especially those relating to the issuance of dud cheques, and the law relating to the vicarious liabilities of the Board members of banks in cases of failings by the bank. A situation where a bank collapses due to negligence and mismanagement and the bank directors move about in their limousines while the poor depositors languish in pains is unjust and unfair. There is a law which makes the Directors and management liable, and we will henceforth enforce them.

(xi) Revision and updating of relevant laws, and drafting of new ones relating to the effective operations of the banking system.

(xii) Closer collaboration with the Economic and Financial Crimes Commission (EFCC) in the establishment of the Financial Intelligence Unit (FIU), and the enforcement of the anti-money laundering and other economic crime measures. Greater transparency and accountability will be the hallmark of the system.

(xiii) Rehabilitation and effective management of the Mint to meet the security printing needs of Nigeria, including the banking system which constitutes over 90 percent of the Mint’s business. In due course, you will not need to print your cheques abroad.

The other reforms will be included in the Banking Sector and Monetary Policy Reform Agenda which we are working on. I will be glad to receive your reactions and suggestions for the refinements and implementation of the above agenda.

The Central Bank will collaborate with other institutions - the NDIC, SEC, NSE, the fiscal authorities, National Assembly and the Bankers committee to work out the structure of incentives and legal/regulatory frameworks to facilitate the rapid consolidation of the system. We would set up a Technical Committee, including international and national consultants to provide free consultancy services to banks intending to merge or that are involved in acquisitions. The gamut of incentives and guidelines would be out within one month. We welcome your suggestions on the way forward. Banks that merge and meet the minimum capital base by March 2005 will be rewarded.

I am aware of the fact that this measure may not be very popular with some owners and managers of banks. I understand our cultural environment, and the mindset whereby many people prefer to own “100 percent of barely nothing” by way of family businesses rather than “1 percent of something”. For many also, it will be a very difficult challenge to deal with the possibility that they are not ‘chairmen’, ‘Directors’, or MDs of banks especially as these have become important status symbols. Even the threat of losing ‘control’ can be an issue with many people. I only hope that these personal considerations can be submerged in the interest of the national economy and the banking industry. In a few years time, we will all realize that the Nigerian economy and bank shareholders are better for it.

Conclusion

In conclusion, let me reiterate that the sole objective of these changes is to move the Nigerian economy forward, and to proactively position the banking system to become sound and reliable catalysts of development. Realizing this objective is a daunting task and would require all hands to be on deck. The CBN will remain focused in reducing the risk of systemic banking crisis, and promoting general economic and financial sector development. We shall continue to enlist the co-operation and partnership of the Bankers' Committee in accomplishing this objective. I look forward to a cordial working relationship with all of you and I thank you for your kind attention.