

Institute of Advanced Legal Studies
School of Advanced Study
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Olubunmi Opeyemi Balogun

A review of the Central Bank's role as prudential
regulator in Nigeria: an analysis of the case for a
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LLM 2010-2011
**International Corporate Governance, Financial Regulation and
Economic Law (ICGFREL)**

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ABSTRACT

In the aftermath of the subprime crisis that rocked the world in 2007, there has been a marked effort to review the oversight of financial markets and specifically financial institutions globally. The crisis which saw the demise of long standing institutions such as Lehman Brothers underscored the importance of the regulation of global financial markets. Central Banks worldwide have been apportioned some of the blame in the episode for falling asleep at the wheel, investigations and inquiries into the crisis exposed the fact that many Central Bankers were not in tangent with the developments in the financial markets and in some cases did not have a clear handle and understanding of the many instruments that were introduced into the markets. Consequently, many governments have made radical changes to their Central Banking operations in a bid to ensure better oversight of their economies. The main discourse over Central Banking has been the separation or alignment of the two main activities of the banks – microeconomic and macroeconomic regulation. There is no clear cut consensus from studies into these variants that one option supersedes the other. Thus it can be argued that there are other variables in specific economies that should come in to play in arriving at this decision. Whatever approach may be adopted, it is a very important role that sets the tone for economic development in any country. Like its counterparts worldwide, the Central Bank of Nigeria also contemplated making changes to its operational structure.

This work will review the role of the Central Bank of Nigeria in prudential regulation and recommend an approach that would work for a developing country in Sub-Saharan Africa considering the political and economic climates in these regions.

INTRODUCTION

Prudential regulation is an important part of the key activities of any economy involving the supervision of financial institutions. They are important players in the financial markets and should have their activities under surveillance to ensure that there is stability in the financial system and deposits taken from the public are safe and secure. The occurrence of the sub-prime crisis in late 2007 showed the importance of this role by Central Bankers and also the enormous influence that financial institutions wield within the global economy. The effect of the meltdown during that period still reverberates globally with many economies struggling to recover from the attendant downturn that occurred.

In every region there is a lot of rhetoric on the structure of Central Banking and where prudential regulation should be placed in that structure. This study highlights the fact that there is no model that fits all situations. There are pros and cons to whichever method is adopted by regulatory authorities and it is also dependent on other factors such as the level of development and sophistication in the economy being considered. The main focus will be on the prudential regulation activities of the Central Bank of Nigeria and will attempt a review of the effectiveness of the adopted structure. As with many structural policies that emanate from developed countries, it has been widely acknowledged that these policies require adaption to work in developing countries.

Overall, this paper will seek to recommend appropriate structures that can be applicable in developing/third world countries.

The first chapter will review the current literature on separation of the dual roles of Central Banks – Monetary Policy and Prudential Regulation. As highlighted above there is no consensus on which option is superior. Chapter Two of this study is an in-depth analysis of the banking supervision structure in Nigeria and will also give an overview of Nigeria financial markets for a holistic perspective.

The third chapter will review the impact of the global financial crisis on Nigeria's banking sector and the central bank's response to the crisis. It will also outline the peculiar factors that affect the performance of the bank in the Nigerian environment. Particular attention will be paid to the recent bank failures in the after math of the subprime crisis. The main issues that caused the collapse of these institutions will be critically examined to determine if the failures could have been avoided if there was a specialist agency set apart to supervise banking activities in the country.

The final Chapter concludes the finding of the study and recommends lasting reform for the operational independence of the Central Bank in the supervision of banks and the infrastructure that needs to be in place for the Bank to live up to expectation in a complex environment like Nigeria. Key issues to be discussed here will be the corruption pervasive in the country as a whole and capacity building in the Central Bank at large.

Chapter 1

The Organisational Structure of Central Banks

1.1 The Role of Central Banks

Central banks perform two main functions namely macroeconomic and microeconomic regulation. These activities are very closely inter-related because the achievement of monetary and price stability rests on maintaining micro-level financial stability in the payments and banking system (Goodhart, 2000)¹. However in the last decade there has been more and more separation of these two functions by policy makers. Examples where this has occurred include the United Kingdom where the Financial Services Authority (FSA) was established in June 1998 to supervise Financial Institutions. Following this move by the United Kingdom, we had more and more European countries follow the same trend (Masciandaro, Quintyn, 2009)². Between the years 1998-2008, many countries also made changes to their supervisory structure (Masciandaro, Quintyn, 2009)³. It is noteworthy that in studies conducted countries with a developed financial system did not have central bank exclusivity over banking supervision but rather this was the case in less developed countries with little or no

¹ Goodhart, “The Organisational Structure of Banking Supervision” (2000), Financial Stability Institute Occasional papers No 1

² Masciandro, Quintyn, “Reforming Financial Supervision and the role of Central Banks: A review of global trends, causes and effects (1998 – 2008)” (2009), Centre for Economic Policy Research Policy Insight No 30

³ Ibid 3

international bank presence (Blei, 2001)⁴. The reason for these changes are the more complex nature of financial markets and the seeming blur between the various kind of financial institutions operating in the markets however in light of the rude awakening in 2007-2008 with the global crisis, there are attempts worldwide by policy makers to revisit their regulatory structure.

It has been established that the two roles of the Central Bank are interlinked and thus one would rationally expect that the roles would be kept in a single entity however the policy reforms of the decade 1998 -2008 proved otherwise and we shall examine the argument for and against separation of the banking supervision mandate of the Central Bank.

1.2 Arguments for the Separation of Banking Supervision

Despite the interconnectedness of both roles of the Central Bank, many policy makers went ahead to separate both functions with the most notable being the United Kingdom.

The following were the rationale for splitting the functions -

1.2.1 – Conflict of Interest

The conflict of interest argument is hinged on the possibility that supervisory concern about the fragility of the banking system might influence the central bank to allow a more

⁴ Ibid 1

accommodating monetary policy regime to ensure for price stability (ECB, 2001)⁵. It is reasoned that with sole discretion of monetising financial distress, a central bank can even fuel a systemic risk because bailing out the financial system can ultimately derail monetary policy and aggravate financial instability⁶.

Expanding on the conflict of interest argument, Goodhart and Schoemaker ⁷(1995) further argued that the cyclical effects of both regulatory and monetary policy tend to conflict. They opined that monetary policy tend to be counter-cyclical whilst regulation is pro-cyclical stating further that it is harder to increase capital during a recession when bank costs are high and profits are very low. Studies by Heller (1991)⁸ have shown that inflation rates are higher in economies where the central bank partakes in regulation of banks. This is also corroborated in studies by Di Giorgio and Di Noia (1999)⁹ which revealed that in countries where the central bank is the sole supervisor, inflation rates are twice as high as in other economies.

⁵ European Central Bank, “The role of Central Bank in Prudential Supervision” (2001) www.ecb.int/pub/pdf/other/prudentialsupcbrole_en.pdf

⁶ Jacome, “Central Bank Involvement in Banking Crisis in Latin America” (2008) IMF working Paper series WP 08/135

⁷ Goodhart, Schoemaker, “Should the Functions of Monetary Policy and Banking Supervision Be Separated?” (1995), *Oxford Economic Papers*, 47, 539–60.

⁸ Heller, “Prudential Supervision and Monetary Policy”, (1991) in J. Frenkel and M. Goldstein, eds, *Essays in Honor of Jacques Pollack*. Washington, DC: IMF, 269-281

⁹ Di Giorgio, Di Noia, ‘Should Banking Supervision and Monetary Policy Tasks be given to Different Agencies?’ (1999) *International Finance* 2:3, 361-378

1.2.1 – Excessive Power

One of the reasons against the supervision of banks by the central bank is excessive power in the hands of select individuals whose accountability may be weak (Llewellyn, 2006)¹⁰. If a central bank has the sole discretion to set interest rates in addition to supervisory powers for the banking sector it is considered risky to allow the concentration of such powers in the hands of unelected officials (Masciandaro, 2006)¹¹. One of the consequences of above is a moral hazard issue which sends a wrong signal to the public that the safety net implicit guarantee by the central banks is available to every type of deposit institution (Herring, Carmassi, 2008)¹².

1.2.3 - Reputation Risks

A clamour for separation is rooted in the fact that the risk of reputational losses increases when a central bank has sole responsibility for banking supervision. This is occasioned by the fact that supervision entails a higher visibility of failures than flagships (Goodhart,

¹⁰ Llewellyn, “Institutional Structure of Financial Regulation and Supervision: The Basic Issues” (2006), Paper presented at World Bank Seminar – *Aligning Supervisory Structures with Country Needs*

¹¹ Masciandaro, “E Pluribus Unum? Authorities Design in Financial Supervision: Trends and Determinants” (2006) *Open Economies Review*, Vol. 17, No. 1 , 73-102

¹² Herring, Carmassi, “The Structure of Cross-Sector financial Supervision” (2008), *Financial Markets, Institutions and Instruments*, Vol. 17, No. 1, 51-76

2000)¹³. This further cause's complicity where in order to stem reputational losses the bank may accommodate bail out pressures using liquidity tools (Masciandaro et al, 2010)¹⁴. Because reputation and credibility are crucial for effectiveness of monetary policy, central banks are better off veering away from banking supervision.

1.2.4 – The Changing Structure of the Financial System

Hitherto, banking was limited to financial intermediation by commercial banks and with the onset of other non-bank financial institutions there were clear cut demarcation between the activities of the various institutions (Goodhart, 2000)¹⁵. The regulation of these activities would be mainly protecting consumer interest and welfare which were issues that were of little significance to the central bank (Blei, 2005)¹⁶. These previously determinable distinctions are now blurred with the advent of universal banking and the sophistication in financial instruments (Borio, Filosa, 1994)¹⁷. Many policy makers made changes in the regulatory structure to accommodate the changing landscape of the market.

¹³ Ibid 2

¹⁴ Masciandaro, Pellegrina, Pansini, "Governments, Central Banks and Banking Supervision Reforms: Does Independence Matter?" (2010) *Paolo Baffi Centre Research Paper* No. 2010-74

¹⁵ Ibid 2

¹⁶ Ibid 1

¹⁷ Borio, Filosa, "The Changing Borders of Banking: Trends and Implications" (1994) *BIS Economic Paper*, No. 43

1.3 – Arguments for Unifying Banking Supervision

1.3.1 – Information Related Synergies

Because prudential regulation is closely related to macro-economic policy, it has been argued widely that both operations should reside in a unified agency. Data from the banking sector is a critical input into the formation of macroeconomic policy thus there is a consensus that central banks ought to have direct involvement in this key variable for proper interpretation (Bernanke, 2007)¹⁸. Splitting the functions into two will be costly as there will be duplication of effort in collecting the information (Llewellyn, 2006)¹⁹. He stated further that central banks require information about the liquidity and solvency of banks when considering its lender of last resort role. Other arguments are that it is more difficult to coordinate between institutions than it is to coordinate between departments and institutions have an aversion for sharing information (Blei, 2005)²⁰.

1.3.2 – The Systemic Risk Argument

Central Banks have a mandate for systemic risk which is a function of the prudential regulation of banks and the risk for the financial market as a whole thus it is more

¹⁸ Bernanke, “Central Banking and Banking Supervision in the US” (2007) Speech delivered at Allied Social Sciences Association Meeting, Chicago

¹⁹ Ibid 11

²⁰ Ibid 1

practical for banking supervision to be undertaken by the central bank (ECB, 2001)²¹. The central banks focus on systemic stability allows them better perspective of the likelihood and potential impact of macro-shocks in both domestic and international markets whereas a separate agency focuses on issues bordering on investor protection (ECB, 2001)²².

1.3.3. – Independence of Central Banks

Central Banks are more likely to be independent from political and other external interference in carrying out banking supervision function. They are also more likely to be immune from regulatory capture by the supervised institutions which is largely predominant in developing countries (Davis, Obasi, 2009)²³.

1.3.4 – Skilled Staff

Proponents of the unified regulatory system have argued that central banks have the ability to hire more qualified staff (Quintyn, Taylor 2007)²⁴. Due to its status and prestige, it is able to attract more qualified staff into the institution than an agency that is

²¹ Ibid 6

²² Ibid 6

²³ Davis, Obasi, “The Effectiveness of Banking Supervision” (2007) *Brunel University Economic and Finance Working Paper Series*, Working Paper 09-27

²⁴ Quintyn, Taylor, “Building Supervisory Structures in Sub-Saharan Africa – An Analytical Framework” (2007) *IMF Working Paper* WP 07/18

the offshoot of the central bank. This is all the more valid when regulators have to compete with the market to attract qualified personnel as supervisors.

1.4 – Further Determinants of Banking Supervision Structure

Apart from the clear cut pros and cons of either separation and unification of regulatory roles, there are other variables that have come about in the discourse of this topic which are discussed below.

1.4.1 – Emerging/Developing Country

Goodhart (2000)²⁵ postulated in his paper that the arguments enumerated above will be secondary in the case of emerging countries and developing economies. Firstly, this is because the banking in developing countries is not as complex and sophisticated as obtained in developed countries. It is mainly restricted to core commercial banking thus the blurring of the boundaries between financial intermediaries and complexity of markets that give rise to structural changes in regulation are absent. Goodhart (2000)²⁶ also advanced the second reason as the tendency to focus more on systemic risk than prudential regulation and consumer interest because developing nations are more prone to systemic disturbances. Lastly the issue of personnel quality and status of the central bank in an emerging country is a key variable because they play important roles as specialist experts in international financial dealings and the perception of other central

²⁵ Ibid 2

²⁶ Ibid 2

bankers is vital in maintaining confidence in the country's economy. The above explanations sheds more light on the unified approach of most developing countries, if there are any changes at all many are responding just like their counterparts worldwide on strengthening the structure of their regulation.

1.4.2 – Corporate Governance

Corporate governance as it relates to regulatory and supervisory organisation is a key consideration in organising the regulatory framework of any economy as a sound governance structure will enhance the reputation, credibility and effectiveness of an agency (Llewellyn, 2006)²⁷. It is also pertinent that an agency is able to demonstrate its independence, integrity, transparency and accountability.

1.4.3 – Regulatory Capture

The literature of supervisory architecture has also been viewed from the political economy prism – this is the relationship between politics, government and bank supervision (Davis, Obasi, 2009)²⁸ with all policymakers regarded as politicians. Two approaches have been identified in this arena called the public interest view and the

²⁷ Ibid 11

²⁸ Ibid 24

private interest view (Barth et al, 2004)²⁹. The public interest view is where banks are directly regulated by government in every aspect from ownership to types of lending. This is evident in powerful supervisory agencies that have the power to completely oversee and discipline banks. The reverse is the case with private interest view where regulation is light and banks are allowed a free reign in their operations such that they can “capture” regulations and subvert the system to work in their interests (Barth et al, 2004)³⁰.

The foregoing shows that there is no optimal regulatory structure but it would be dependent on the variables that are prevalent in the economy in question. Above all the political economy variable is a very important and crucial one that sets the tone for the direction that policy makers tow especially in a developing economy.

²⁹ Barth, Caprio, Levine, “Bank Regulation and Supervision: What works best?” (2004) *Journal of Financial Intermediation*, Vol.13, No.2 , 205-248

³⁰ Ibid 30

Chapter 2

Central Bank of Nigeria's Financial Regulatory Structure

2.1 – Banking Regulation and Supervisory Agencies

2.1.1 – The Central Bank of Nigeria (CBN)

The CBN was established by the Central Bank Act 1958 (as amended) and commenced operation in July 1959. In 1969, the Banking Decree was also enacted giving full authority regarding banking business in the country. The mandate of CBN was as follows

- i. Issuance of legal tender
- ii. Maintain the external reserves of the country
- iii. Promote monetary stability and a sound financial environment
- iv. Lender of last resort
- v. Financial Adviser to the Government

In 1991, the Banking Act of 1959 and the Banking Decree of 1969 were repealed and replaced with the Banks and other Financial Institutions (BOFI) Decrees 24 and 25 to strengthen CBN's position in its oversight of enacting monetary policy, banking

regulation and supervision of all financial institutions in the country. The new decree brought non-bank financial intermediaries under the supervision of CBN.

CBN lost its limited autonomy in 1997 with the enactment of the CBN Amendment Decree No.3 and BOFI (Amended) Decree No. 4. With the enactments of these laws, the CBN was effectively brought back under the control of the Ministry of Finance with regards to bank supervision and regulation. Under this regime the CBN played a relatively ineffective role in bank supervision and lacked any powers to carry out its duties judiciously.

In 1998, the 1997 Decrees were repealed by the CBN Amendment Decree No. 37 and Bank and other Financial Institutions Decree No. 38 of 1998. These new decrees restored some measure of autonomy to the CBN. Specifically, they empowered the CBN to review or revoke banking licenses. In 1999 a further amendment to the BOFI decree was made - Bank and other Financial Institutions Decree No. 40 of 1999 allowing CBN to remove the officers of any financial institution and apply the rules applicable to failed banks to other non-bank financial institutions. A major change was the enactment of the CBN Act 2007 which repealed the CBN Act of 1991 and all its amendments. The consequence of the Act was that CBN became a fully autonomous body as regulator and its remit was enlarged to include serving as economic advisor to the Federal Government.

In 1994, the CBN in a bid to ensure that there was some form of coordination in the activities of all the regulatory agencies for effective oversight of the financial sector established the Financial Services Regulation Coordinating Committee (FSRCC). It is noteworthy that the committee was only accorded legal status by the amendment to the CBN Act 1991 in 1998 and was formally inaugurated in 1999. The following institutions were members of the committee –

- i. Central Bank of Nigeria (Chairman)
- ii. Corporate Affairs Commission
- iii. Securities and Exchange Commission
- iv. Ministry of Finance
- v. Nigeria Insurance Commission

2.1.2 – The Nigerian Deposit Insurance Corporation (NDIC)

NDIC was established by the promulgation of Decree No.22 of 1988 due to the identified need to safeguard depositor's funds. With the liberalisation policy on the back of the Structural Adjustment Programme of the government in 1986, there was a proliferation of banks in Nigeria. The number of banks in Nigeria increased from 40 to

120 between the periods 1986 – 1992 such that the banking landscape became mired in problems. These problems include the follow (NDIC)³¹

- i. Sharp practices due to increased competition in the industry
- ii. Unscrupulous individuals became promoters of financial institutions
- iii. Inadequate Skilled Manpower

In 2006, the decree was repealed and replaced with the NDIC Act No. 16 of 2006 with the following public policy objectives³²

- i. Protect small uninformed investors and less financially sophisticated depositors by providing an orderly means of compensation in the event of failure of financial institutions
- ii. Contribute to the financial system by making incidence of bank runs less likely
- iii. Enhancing public confidence and systemic stability by providing a framework for the resolution and orderly exit mechanisms for failing and failed institutions

³¹ <http://ndic.org.ng/history--rationale--for-establishing-ndic-2.html>

³² Nigeria Deposit Insurance Corporation ANNUAL REPORT 2009 - http://ndic.org.ng/files/NDIC_2009_ANNUAL_REPORT.pdf accessed 19/6/2011

2.1.3 Securities and Exchange Commission (SEC)

Another key institution in the financial landscape in Nigeria is the Securities and Exchange Commission responsible for the oversight of Nigeria's capital market. SEC was promulgated under the SEC Decree number 71 of 1979 to replace the Capital Issues Commission. Prior to promulgation of SEC, the capital market regulation was carried out under the supervision of the CBN. The SEC Decree no 71 was repealed by the SEC Decree number 29 of 1998 and two further amendments were made in 1999 and 2007. SEC is currently governed by the Investment and Securities Act Number 29 of 2007.

SEC is a member of the FSRCC and rightly so because of the importance of the capital market as a strong pillar for economic development in any country. The Nigerian capital market has a long run as one of the most profitable stock exchanges in the world and was the toast of many international investors but this trend reversed after the global financial crisis. Investigations into the slump of the capital market could be attributed partly to bank regulation failure which will be discussed later in this paper.

2.2 – The Banking Supervision Structure

Until 1965, the CBN operated a “scrutiny section” whose primary responsibility was the off-site supervision of banks with the Ministry of Finance taking charge of the on-site examination functions through the Banking Examination Department (BED). The

banking supervision function was transferred fully to CBN in 1966 with the BED transferred and merged with the hitherto scrutiny section. The status quo held till 1977 when the BED was renamed Banking Supervision Department (BSD) with four additional divisions created – Central Supervision, Field Examination, Financial Sector Development Division and Foreign Exchange inspectorate Division.

In 1986, the Federal Government embarked on a liberalisation of the banking sector with the adoption of the Structural Adjustment Programme. As highlighted earlier the number of banks surged dramatically from 40 in 1986 to 120 in 1992 with a number of unscrupulous practices introduced into the sector. This led to the establishment of the NDIC as depositors' funds insurer and also to complement activities of CBN with on-site and off-site supervision. Accordingly, the BSD was now split into BED and BSD and assigned on-site and off-site responsibilities. The Central Bank continued to operate this method until the outbreak of the subprime crisis which led to major reforms in the banking supervision mandate of the bank.

As banking regulator in Nigeria, a developing country, CBN plays an important role in the development of the economy. Banks which are under its purview are a major factor in the stimulating of economic activity in their role as financial intermediaries. In light of the recent global financial crisis we will in particular assess the effectiveness of prudential regulation by looking at banking reforms attempts and attendant bank failures in Nigeria to date and reasons that can be attributed to the situation.

2.3 – Evolution of Banking Sector in Nigeria

Prior to the establishment of the CBN, there was a proliferation of indigenous banks to 25³³ between the years 1947-1952 however by 1954 21 of these banks had collapsed. This first financial crisis was mainly due to undercapitalisation, weak management, absence of corporate governance structures, overtrading and poor asset management³⁴

After independence in 1960, the Nigerian financial landscape was mainly dominated by foreign and government owned banks. The few indigenous banks that were established did not fare well as highlighted above. With the establishment of the CBN in 1959, there was a phase of regulatory control over the activities of banks in the country. This also marked the beginning of the development of the money and financial sector in the economy. Between 1959 and 1960, there were 8 additional bank licences granted to banks and this brought the number of banks in Nigeria to 12 by 1960 with a further increase to 17 by 1962³⁵. Policy changes at this time to strengthen these institutions were the use of the policy of directed credit, control of the interest rate and a significant

³³ Ogunleye, G.A, “NDICS Deposit Insurance Scheme in Nigeria – Problems and Prospects”, (2002), Paper presented at Annual Conference of International Association of Deposit Insurers.

³⁴ Aruwa, S., “Market-Induced Consolidation in Post Consolidation Banking Era”, (2008), Academy Journal Of Defence Studies, Nigeria Defence Academy, Vol 15
http://nsukonline.academia.edu/nsukedungacademiaedu/Papers/154355/MARKET-INDUCED_CONSOLIDATION_IN_POST_CONSOLIDATION_BANKING_ERA

³⁵ Soyibo, Adekanye, “Financial System Regulation, Deregulation and Savings Mobilisation in Nigeria” (1990), Paper presented at the African Economic Research Council Workshop Ivory Coast
<http://idl-bnc.idrc.ca/dspace/bitstream/10625/10078/1/95967.pdf>

increase in the paid up capital required for the establishment of new banks. The paid up capital as set up by CBN in 1958 was N400,000³⁶. In the following years there was a huge growth in the number of banks, and by 1978 – the number of banks has increased to 45 with paid up capital requirement of N1,500,000 by the Central Bank.³⁷

Between 1979 and 1987, a further 9 banks were licensed bringing the total number of banks to 54 with a paid up requirement of N2,000,000 for Merchant Banks. Most of the banks that were licensed during this period were local private investors who entered a space that was hitherto dominated by foreign and government owned banks. One of the major aims was to correct deficiencies in the financial intermediation as the attention of these banks was focused on the corporate sector to the detriment of the growing domestic private sector. The other reasons were the relative ease to obtain a banking license due to the minimal entry requirements and the opportunity to profit on a scale not seen in other sectors of the economy³⁸.

2.3.1 – Banking Sector Reforms in Nigeria

Before the 1980's, bank supervision and prudential regulation was not accorded much importance in many developing countries because they had financial regimes that were

³⁶ Somoye, R.O, "The Performances of Commercial-Banks in Post-Consolidation Period in Nigeria – An Empirical Review" (2008), *European Journal of Economics, Finance and Administrative Sciences*, Issue 14

³⁷ Ibid 36

³⁸ Brownbridge, M, "The Causes of Financial Distress in Local Banks in Africa and Implications for Prudential Policy", (1998), UNCTAD Discussion Paper No 132

essential controlled by the government for economic, social and political objectives.³⁹ With the financial crisis that started in the 1980's, many low developing countries embarked on reforms of their financial sectors mainly in response to conditionality's attached to loans from multilateral agencies like the World Bank⁴⁰. Nigeria was no exception in this vanguard and the mid-1980s saw a major step in ensuring a sound banking sector to protect against any systemic risk and ensure that the path to economic stability was sustained.

The start of radical financial sector reform was a vital portion of the Structural Adjustment Programme which was introduced in 1986; this programme was adopted by Nigeria upon rejection of an International Monetary Fund loan due to the conditionality's that were attached. The reform agenda in the financial sector was three pronged- deregulation of interest rates, exchange rates and entry/exit into the banking business⁴¹. The objective of these reforms was essentially to ensure that the banking sector was in a position to play its role of intermediation and thereby constitute a viable engine in economic development.

³⁹ Brownbridge, Kirkpatrick, "Financial regulation In Developing Countries" (2000), The Journal of Development Studies, Vol 37, 1

⁴⁰ Ibid 39

⁴¹ Iganiga, B, "Evaluation of the Nigerian Financial Sector Reforms using Behavioural Models", (2010) Journal of Economics, Vol 1, 2
<http://www.krepublishers.com/02-Journals/JE/JE-01-0-000-10-Web/JE-01-2-000-10-PDF/JE-01-2-065-10-048-Iganiga-B-O/JE-01-2-065-10-048-Iganiga-B-O-Tt.pdf>

Following this initiative, a major policy advent by the CBN was the introduction of prudential guidelines in 1990. The guidelines were created for the following reasons⁴²:

1. Ensure a more prudent approach in their credit portfolio classification, provision for non-performing loans, credit portfolio disclosure and interest accrual on non-performing assets
2. Ensure uniformity of their approach in 1 above and ensure reliability of published accounting information and operation.

With the liberalisation of the economy, the number of banks by 1991 has grown to 119 from 40 in 1986 with paid up capital base of N20,000,000 and N12,000,000 for commercial and merchants banks respectively. Credit ceilings limits were removed from banks that were determined to meet certain criteria – cash reserve, Liquidity ratio, prudential guidelines, statutory minimum paid up capital, capital adequacy ratio and sound management⁴³. Eighty banks in number qualified to have their credit limits removed after meeting stipulated criteria by CBN.

The rapid proliferation of banks had its pros and cons for the economy and the banking system at large. A major advantage was that the new banks were targeting local and private businesses that the foreign and government banks tended to ignore. The attention of these banks was skewed to the private sector and multinationals who were key clients

⁴² *ibid* 41

⁴³ *ibid* 36

for many banks at the time⁴⁴. Genuine investors were able to take advantage of this gap by lending to small and medium scale enterprises and in some cases offered better services than the established banks.

Because of the relative low barrier to entry in terms of paid up capital, many unworthy investors were also able to get their hand on bank licences. It is interesting to note that the applications did not have rigorous requirements in terms of expertise and neither did it state any grounds for declining banking applications⁴⁵. One of the many incentives to a lot of investors was the foreign exchange market in Nigeria which has been liberalised in the financial sector reform. In fact, many banks that were established at this time were simply for the sole aim of getting a foreign exchange allocation from the central Bank of Nigeria and selling it at a premium on the “black” market. This was an extremely lucrative business and for many banks, it was a primary source of their profitability. Also many bank promoters had the sole aim of funding their own businesses via the banks. There were very many indiscriminate lending practices in a number of these banks and because of the really high leverage employed by these institutions, the owners did not have much to lose in terms of eroded capital. It is noteworthy that very many of the bank directors in the proliferation wave were retired military officers who had hitherto ruled Nigeria in the 1970’s. It has been widely acknowledge that many of them leveraged on their contacts in government to ensure that they got regular foreign exchange allocations

⁴⁴ Ibid 38

⁴⁵ Ibid 38

and influenced government ministries and agencies to deposit large funds with them making for non-reliance on depositors funds for quite a number of banks.

In 1991 and 1997, CBN made two further increases to the minimum paid up capital of banks culminating in N500,000,000. During these years the second wave of bank failures was witnessed in Nigeria. By 1991, cracks were already evident in the balance sheets of many banks, one of the measures that CBN had taken as part of the financial sector reform was the instruction to all government ministries and agencies to recall their funds deposited with banks and return same to CBN. As highlighted above, this was a major source of funding for many banks and straightway brought about considerable stress on these banks' balance sheets. Indeed during this period, there was an embargo on the licensing of new banks and by 2003, there were only 89 banks left with others technically insolvent and liquidated. Capital requirement of banks was also increased to N2bn in 2003.

Interestingly, the factors that were responsible for the failure of the banks in the second wave were no radically different from the reasons responsible for the failure of the indigenous banks prior to the establishment of CBN. These factors will be considered in depth in the next chapter. However the status quo continued until the banking consolidation exercise of 2005 which was a significant milestone in banking reforms in Nigeria.

2.3.2 – Banking consolidation in Nigeria

In 2004, the CBN embarked on a major reform programme by increasing the paid up capital of banks from N2bn to N25bn and banks were encouraged to embark on a merger and acquisition programme to meet up with the requirement. At this time only 62 banks were classified as sound/satisfactory with the rest classified as marginal/unsound⁴⁶. There was a lot of criticism at the time that this radical reform was ill-timed in light of the economic challenges facing the country. The aims of the policy reform as outlined by CBN were as follows⁴⁷ -

- i. Ensure minimal reliance on public sector funds
- ii. Adoption of risk-focused and rule-based regulatory framework
- iii. Adoption of zero-tolerance in regulatory framework and data/information rendition/reporting
- iv. Stricter enforcement of corporate governance principles for banking and revision of relevant laws for effective corporate governance
- v. Expeditious process for rendition of returns by banks and other financial institutions through electronic Financial Analysis and Surveillance system (E-FASS)

⁴⁶ Ibid 34

⁴⁷Sanusi, L, “Global Financial Meltdown and the Reforms in the Nigerian Banking Sector” (2010), Convocation Lecture Abubakar Tafawa Balewa University
http://www.cenbank.org/OUT/SPEECHES/2010/GOV_ATBU%20CONVOCATION%20LECTURE.PDF

- vi. Ensuring greater transparency and accountability in the implementation of banking laws and regulation
- vii. The establishment of an asset management company as an important element of distress resolution.

By the end of the deadline given to the banks, 89 banks had whittled down to 25 banks approved and 13 liquidated banks. This development was regarded as positive for the banking sector as the institutions now had adequate capital to withstand shocks in the system but also to enable them operate in the global market space. On the other hand many opined that there were fundamental problems to be addressed and that simply merging the banks would not ensure a stable banking sector. Prior to this time most Nigerian banks has a capital base that was less than \$10m, to put this in context the largest bank in Nigeria has a capital base of \$240m compared with \$526m for the smallest bank in Malaysia⁴⁸.

The emergence of 25 strong banks was widely celebrated by the CBN and the populace at large as it was a milestone achievement and streamlined the banking sector to a manageable number of players. The banks continued to post bumper profits and in fact many posted record profitability after the merger exercise. This was all good until the

⁴⁸ Soludo C. , Consolidating the Nigerian Banking Industry to meet the development of challenges of the 21st Century” (2004), Address by Governor of the Central Bank of Nigeria at Bankers Committee meeting July 2004 <http://www.cenbank.org/OUT/SPEECHES/2004/GOVADD-6JUL.PDF>

onset of the global crisis which threw up a can of worms in the sector that was beyond imaginable belief.

Chapter Three

Nigerian Banking Sector and the Global Financial Crisis

3.1 - The Effect on the Banking Sector

The Subprime crisis that engulfed the world in 2007 reverberated in all economies. Developing economies like Nigeria's did not feel the first wave of the crisis as the financial sector is not fully integrated with the global markets; it was the second wave that hit Nigeria and exposed the sordid on goings in the financial sector. The first hit for the Nigerian economy was the reduction in oil revenue for government as this was a major source of income for the country. Government has to resort to dipping into the excess crude oil account and domestic borrowing to meet its obligations with the attendant effect of a devaluation of the currency. Foreign direct investment and foreign trade finance lines for banks were significantly reduced but the greatest impact was in the capital market⁴⁹. Nigeria's capital market the darling of foreign investors saw a huge withdrawal of these funds when the crisis kicked in, the Nigeria Stock Exchange all share index which gained a record 74.73% in 2007 has slumped by 45.8% as at close of 2008⁵⁰.

⁴⁹ Ibid

⁵⁰ Oteh, A, "From Crisis to a World Class Market" (2010)
<http://www.sec.gov.ng/files/speech%20-%20from%20crisis%20to%20a%20world%20class%20market.pdf>

These twin effects – the reduction in global oil prices and the slump in the Nigerian stock exchange threatened to pull down the entire banking sector. Between 2004 and 2008, there was an upswing in oil prices culminating in huge foreign exchange inflow and attendant increase in economic growth. Consequently, there was huge liquidity in the system and the excess was channelled to the stock market explaining its impressive performance. Also banks used this as an opportunity to bolster their capital base. By the end of 2008, banking stocks made up 60% of the market capitalisation.

In a bid to utilise the significant capital and liquidity at their disposal, banks set about creating risk assets where they had no expertise especially margin lending and oil and gas financing. By end of December 2008, the banks total exposure to the oil and gas industry had accumulated to N750bn, representing 10% of industry assets and over 27% of shareholders' funds whilst exposure to the stock market was N1.6 trillion⁵¹.

In the words of the current CBN Governor “when the global financial crisis set in mid-2008 the domestic financial system was already engulfed by several interdependent factors that led to the re-emergence of an extremely fragile financial system to pre-consolidation era. Indeed, the Nigerian banking sector was thrown into severe crisis as many banks became distressed⁵².”

⁵¹ Ibid 47

⁵² Ibid 47

The CBN took various initiatives to contain the distress but the banking system remained fragile and was virtually at the point of collapse. One of the measures taken by the CBN was the expansion of its discount window to 360 days to allow banks restructure their margin loans. Similar measures included progressive reduction of cash reserve ratio from 4.0% to 1.0% and liquidity ratio from 40.0% to 25.0% to further ease the liquidity crunch. Despite these far-reaching measures, nine banks remained perpetual borrowers at the discount window and posed a risk to the collapse of the financial system.

With a view to solving the problem, a special joint audit of all banks was embarked upon by the CBN and NDIC to assess the true financial condition of the banks; the result of this audit exhumed the rot that had hitherto plagued the banking system in Nigeria and resulted in the removal of 8 bank managing directors.

3.1.1 – The CBN/NDIC Special Bank Audit

As highlighted above, with the threat of imminent collapse of the financial sector, the CBN/NDIC commenced a special investigation into the books of the 25 banks that also included a diagnostic audit carried out through independent consultants. The results of the tests showed that 9 banks were technically insolvent on account of capital, liquidity

and corporate governance problems revealing illegal activities that had been taking place in a few of the affected banks⁵³.

Five of these banks were in grave danger and constituted a systemic risk to the sector at large such that the CBN had to guarantee all inter-bank loans to these banks to prop up the market. Available results from the tests showed that the five banks had aggregate non performing loan portfolios of 40.8% and accounted for a significant proportion of total bank exposure to the stock market and oil and gas sector. Furthermore the banks accounted for 39.93% of total sector loans, 29.99% of deposits and 31.47% of total assets as at the 31st May 2009⁵⁴.

On the basis of the report of the special audit and invoking the powers of the CBN governor as contained in Sections 33 and 35 of the Banks and other Financial Institutions Act 1991, the Managing Director and the Executive Directors of the following banks were removed –

1. Afribank Plc
2. Intercontinental Bank Plc
3. Union Bank of Nigeria Plc

⁵³ Sanusi L., “Press Address by the Governor of Central Bank of Nigeria on Developments in the Banking System in Nigeria” (2009)
<http://www.cenbank.org/OUT/SPEECHES/2009/GOVADD-14-8-09.PDF>

⁵⁴ Ibid 53

4. Oceanic Bank International Plc
5. Finbank Plc

The CBN also went further to inject N400bn into the banks in the form of Tier 2 capital to be repaid from the proceeds of future capitalisation of the banks. The funds would be divested as soon as new investors took over the banks. In addition to the above, the CBN broke the traditional banker-customer relationship by publishing the names of all the bad debtors of these banks in the daily newspapers and collaborated with the law enforcement and anti-corruption agencies to recover the loans.

3.2 – Cause of Bank failures in Nigeria

The sacking of Managing Directors and Executive Directors in the five banks was an event that was long overdue in Nigeria. The report of the special audit into the activity of banks did not reveal anything radically different from the earliest failures in the market in the pre-independence days and late 1980's. In the following section we will look at the specific problems highlighted in the banks from these prisms – Institutional, Economic and Political Factors⁵⁵

⁵⁵ Ogunleye G, "The Causes of Bank Failure and Persistent distress in the banking Industry, (2010), Perspectives on the Nigerian Financial Safety-Net, Chapter 4
<http://ndic.org.ng/files/Perspectives%20%20On%20the%20Nigerian%20Financial%20Safety-net%20NDIC%202.pdf>

3.2.1 – Institutional Factors

i. Weak Corporate Governance/Insider Loans

At the heart of every bank failure in Nigeria is the discovery that there are weak corporate governance measures in the banks. Many banking licences in Nigeria had been given to people who were highly connected to the government so there was difficulty in ensuring that corporate governance standards were adhered to. It was a known fact that decisions were given social and political considerations rather than implementing decisions that were in the best interest of the institution⁵⁶. In addition many private investors saw the banks as a personal business with children and family members who were not qualified in any way occupying key positions in the bank⁵⁷. With the proliferation in the 1980's, most of Nigeria's elite families had key stake holdings with the public perception that this was their bank. The consequence of this quantum leap in the number of banks was the lack of skilled personnel in the industry. A number of bankers rose rapidly through the ranks by moving jobs frequently giving rise to many

⁵⁶ Ibid 55

⁵⁷ Olufon G., "Problem of Boardroom Imbroglia Afflicting the banking industry in Nigeria – The leadership role of Board Chairman in Bank Management" (1992), Published Chartered Institute of Bankers Nigeria

inexperienced senior managers in the sector. The current CBN Governor did acknowledge that this was the principal factor contributing to the financial crisis⁵⁸.

Examples of the extent of the criminality exhibited by bank management included the establishment of Special Purpose Vehicles to lend money to themselves for stock price manipulation and purchase of real estate all over the world⁵⁹. One of the troubled banks borrowed money to buy jets only to have them registered in the CEO's sons name – he was the Chief Operating Officer of the bank! In another bank, the management set up 100 fake companies for the sake of perpetuating fraud. Suffice to say, CBN did have corporate governance codes in place but these were not enforced in any way⁶⁰.

Below table indicates the level of insider loans in some failed banks in the second banking crisis of the late 1980's⁶¹. It is instructive to note that many of the directors of these banks had taken these loans with no intention of paying back. The banks usually manipulated their books to clear out these loans.

⁵⁸ Sanusi L., "The Nigerian Banking Industry: What went wrong and the way forward" (2010), Convocation Lecture, Bayero University
http://www.cenbank.org/OUT/SPEECHES/2010/THE%20NIGERIAN%20BANKING%20INDUSTRY%20WHAT%20WENT%20WRONG%20AND%20THE%20WAY%20FORWARD_FINAL_260210.PDF

⁵⁹ Ibid 57

⁶⁰ Code of Corporate Governance Post Consolidation – Central Bank of Nigeria (2006)
<http://www.cenbank.org/out/Publications/bsd/2006/corp.Govpost%20con.pdf>

⁶¹ Ibid 55

Table 3.1 – Insider Loans at Some Failed Banks

Bank	No. of Directors Involved	Amount as at Closure (N)	% of Total Risk Assets
Alpha Merchant Bank Plc	11	1,314,418,700.43	33%
United Commercial Bank Ltd	5	741,755,808.86	30%
Financial Merchant Bank Ltd	1	383,061,096	100%
Highland Bank of Nigeria plc	12	33,197,157.58	38%
Commercial Trust Bank Ltd	1	247,749,719.10	38%
ABC Merchant Bank Ltd	8	272,981,634.00	49%
Royal Merchant Bank Ltd	7	646,940,182.23	69%
North-South Bank of Nigeria Ltd	13	240,668,637.62	32%
Abacus Merchant Bank Ltd	14	568,888,254.11	47%
Credite Bank Nigeria Ltd	6	379,634,611.47	76%
Prime Merchant Bank Ltd	1	539,292,310	64%
Amicable Bank of Nig Ltd	7	149,854,896.00	56%
Century Merchant Bank Ltd	5	272,072,261.00	32%
Group Merchant Bank Ltd	13	595,836,077.20	80%
Commerce Bank plc	4	1,294,851,665.64	52%
Pinnacle Commercial Bank Ltd	10	298,766,751.76	20%
Republic Bank Ltd	1	161,375,466.00	38%

Source: NDIC

ii. Inadequate Risk Asset Management

Many banks did not have credit policies in place to guide them in the creation of risk assets and even when they were in place, they were not strictly adhered to by the banks.

Loans were given out without due consideration to the ability of the customer to repay,

many loans were given out as order from above in the case of many institutions to friends and associates of the directors and owners of the business⁶². In addition many loans were given out with highly overvalued assets as collateral and in some cases no collateral at all gambling with depositors funds⁶³. There was also a large asset and liability mismatch in the balance sheet of many banks, a lot had hitherto relied on public sector funding for liability generation and when these funds were recalled from banks threw many into serious problems.

Expectedly, this put a lot of strain on the capital of banks and is clearly reflected in CBN's response by regularly increasing the capital limit at every banking policy reform.

iii. Inadequate Disclosure

It is widely acknowledge amongst banking operators in Nigeria that only very few banks report accurate data to CBN in their monthly returns. Therefore with inaccurate data it would be extremely difficult for the CBN to understand what is truly going on in the banking sector. It is also unnerving to note that some of the banks that have failed in the wake of subprime also had positive ratings from reputable credit agencies such as Fitch. The banks were also able to sway the banking public with selective disclosure of certain aspects of their balance sheets highlighting their ever-increasing billion naira albeit non-

⁶² Okpara G, "A Synthesis of the Critical Factors Affecting Performance of the Nigerian Banking System" (2009), *Journal of Economics, Finance and Administrative Sciences*, Vol. 17

⁶³ *Ibid* 55

existent profits. This sent out the wrong message to the investing populace with many unwary investors drawn to the banking stocks in the capital market

3.2.2 Economic Factors

Nigeria is a mono income country relying mainly on oil revenue for economic growth. In every cycle of bank failure, oil price volatility has always been a trigger in straining the system due to inadequate policy response.

During the banking failures in the late 1980's the collapse of oil prices was the main trigger that brought about low economic growth and high level of inflation making it difficult for existing borrowers to service their loans. To address these concerns, the Structural Adjustment Programme was embarked upon in 1986 with measures including liberalisation of bank licensing and deregulation of interest and exchange rates⁶⁴. Whilst liberalising interest rates put pressure on borrowers, banks profited massively from the exchange rate deregulation by simply purchasing foreign exchange from CBN and selling same at the parallel/black market. At this time, CBN also decided to withdraw public sector funds from banks thereby exacerbating the problem thus it was no surprise that within a decade over 20 banks had collapsed.

The third wave of the banking crisis had its roots in the oil price increase between 2004 and 2008. Government spending was in tandem with the increase in oil prices with the excess liquidity finding its way into the banking system. Banking assets increased four

⁶⁴ Ibid 55

times between these years with foray into margin loans and the oil and gas business. A lot of margin loans by the banks were actually proprietary trading activities disguised as loans. Consequently the Nigeria Stock Exchange index increased fivefold at its peak in 2007 whilst banking stocks increased nine fold. The stock exchange attracted massive foreign investment for the best performance in the world; it was thus no surprise the dire crash that occurred once fortunes reversed at the onset of subprime. Regulatory authorities did not take adequate measures to ensure the massive liquidity did not flow into the banking market but rather embarked on a consolidation exercise which worsened the situation – after the consolidation banking assets grew by 76% annually⁶⁵.

3.2.3 – Political Factors

Political instability in Nigeria also has its place in the discourse of banking failures. The tension between military and democratic rule took its toll on the banking sector in the late 1980's to early 1990's with the panicking populace withdrawing massively from the banks.

The licensing of banks in Nigeria was also a very political process. Many banks today count amongst the majority shareholders Nigeria's social elite and retired military officers. Of equal importance is the political will to fight the menace in the banking industry, the CBN sometimes is handicapped because a lot of the bank failure culprits are the untouchables of society. In fact the first significant step to bring bank defaulters to

⁶⁵ Ibid 55

book was the promulgation of the Failed Banks and Financial Malpractices Act of 1994 and the setting up of a failed bank tribunal. Prior to this, many borrowers saw bank loans as their “share of the national cake”. The tribunal had 139 cases filed by the CBN with 44 judgements delivered and 144 people convicted⁶⁶. Suffice to say there were only very few “big fish” apprehended as those convicted were usually the managers in the bank taking instructions from above, many cases were transferred to the state courts with the closure of the tribunal culminating in a drastic slowdown in delivering judgement. In my opinion, it is fair to rationalise the problems in the banking sector as an expression of the endemic corruption the country.

3.3 – Central Bank of Nigeria’s Role in Banking Crisis

The aim in this part of the paper is to review the role of CBN as banking supervisor and regulator from the same three prisms used to highlight the banks failures. Evidently CBN also carries some of the blame in the debacle that has occurred in the banking crisis especially the third wave in the wake of the global financial crisis. It would be apt to say that CBN fell asleep at the wheel in its function as banking supervisor and regulator.

⁶⁶ Ibid 55

3.3.1 – Institutional Factors

CBN was unable to unearth the practices going on at the banks not just because of an inadequate number of personnel but also skilled personnel. With the liberalisation of the banking sector and the enormous jump in number of banks in the late 1980's, CBN was simply unable to cope as banking supervisor. As a result of this, many banks went through the accounting year without an on-site examination by banking supervisors and when this even happened the examination cycle which ought to have been yearly was conducted at intervals of two to three years⁶⁷. The implication of this trend was that problems were always detected very late.

Another significant issue was the fact that CBN banking examiners lacked the required expertise to detect fraudulent practices at the banks. The proliferation of banking institutions in Nigeria brought with it an information technology era thereby making it easy for data to be manipulated to facilitate window dressing of their balance sheets. The submission of monthly returns by banks to CBN was also plagued by inaccurate data inhibiting any quality trend analysis in many banks. It is however pertinent to mention that until the release of Statement of Accounting Standards No. 10 in 1990, there was no uniform reporting standard making it easy for inadequate disclosure by banks⁶⁸.

⁶⁷ Ibid 55

⁶⁸ Ibid 55

CBN put in place an electronic rendition system (Financial Analysis and Surveillance System) to address this trend as part of the banking reform agenda in 2004⁶⁹. However the effect of this new application is not apparent as this problem of false data was still an issue in the banking crisis of 2008. Data from the banking sector is a key component of macroeconomic policies of any country thus reliance on this data did not augur well for the enactment of any meaningful policies. The emphasis on credit risks by the regulatory authorities also made them miss problems in the banks. It is only recently in line with international standards that the risk-based approach has been adopted by CBN banking supervisors.

One of the problems with CBN as admitted by the Governor is the poor structure of the banking supervision department which has hindered effective monitoring and enforcement of regulation⁷⁰. There were no specific individuals allocated to cover various aspects of the supervisory role, the on-site and off-site supervisory teams worked unilaterally as they were not even based in the same location. A major lapse that also came to light was that there were no exhaustive pre and post consolidation exercises even after the bank consolidation reform agenda was announced in 2004.

Another regulatory lapse was the lack of co-ordination between Financial Sector regulators, the CBN and SEC were unable to detect the sharp practices that many banks had adopted to invest in the stock market. Both institutions never exchanged any banking examination reports to enhance their oversight function considering the key importance

⁶⁹ Ibid 48

⁷⁰ Ibid 58

of the banking sector and capital market as engines of economic growth. On the part of the CBN, there was no comprehensive legal and regulatory framework to ensure that there was a clear mandate for banks to follow in margin lending activity. The FSRCC made up of representatives of the CBN, SEC, Nigeria Insurance Commission, Ministry of Finance and Corporate Affairs Commission did not meet in the two years before the subprime crisis induced failure⁷¹⁷².

3.3.2 – Economic Factors

A major failing of the CBN was inadequate macroeconomic policies to stem the tide of the economic downslide in the country. As already highlighted above, oil is a major revenue stream for Nigeria with the country very vulnerable to the volatility in global oil prices. It is instructive that there was no structure in place by the CBN to ensure that this was adequately managed in tandem with the banking sector. The aggressive lending being undertaken by banks and the financial bubble they created at the stock exchange was seen as indication of a growing and vibrant economy. It was not apparent to the regulators that the growth in these sectors without a commensurate increase in the activity of the real sector indicated that there was a problem at hand. Credit was not extended to vital sectors in the economy, unemployment remained high and many manufacturers were operating well below capacity. Infrastructure development was at its lowest ebb in the

⁷¹ Sanusi, L, “Global Financial Crisis Impact in Nigeria, Nigerian Financial Reforms and the Roles of Multilateral Development banks and IMF” (2010), Submission to the House Financial Services Committee of the US congress Hearing on the Global Financial Crisis
<http://financialservices.house.gov/Media/file/hearings/111/Sanusi111610.pdf>

⁷² Ibid 58

country with poor transportation, electricity and inadequate housing for citizens. The human development indices of the United Nations rated Nigeria poorly; the only good news from Nigeria at the time was reporting of record profit levels by banks and accolades on having the most profitable stock exchange.

Interestingly, many Nigerian banks and their Managing Directors received numerous international awards on the growth in the sector and innovation in banking thus giving a false assurance that things could be no better.

3.3.3 - Political Factors

The position of CBN Governor is a political appointment by the President; the nomination is forwarded to the legislators for screening and confirmation. It is noteworthy that due to Nigeria's multi-ethnicity, political appointments are made on what is called a zoning basis – shared out amongst the various ethnic zones to ensure a fair representation in government. This methodology is not in the best interest of the country as candidates with consummate expertise are many times over looked for political expediency. This arrangement makes it difficult for a CBN Governor to function effectively and be truly independent. Many of the promoters of banks in Nigeria are well connected politically with a number the major contributors to the campaigns of various members of the political class. Many banks have also been identified as accomplices in money laundering activities by the political class. Banking licences were awarded based on political connections and also led to regulatory forbearance in many instances.

Professor Charles Soludo from East Nigeria was the CBN Governor between 2004 and 2009, prior to this appointment he was the Chief Economic Adviser to Former President Olusegun Obasanjo (2001-2009) himself a southerner. Professor Soludo an accomplished economist of international repute⁷³ was at the helm of affairs when the subprime crisis hit and he regularly assured the populace that the banks were able to absorb the shock from the global crisis as the country was not integrated to the global financial markets⁷⁴. However, the difficulties in the banks were already apparent at this time and it is puzzling why the CBN Governor did not take far reaching measures to stem the decline in the system. The only tenable reason is regulatory forbearance with the expedient option to continue to fund these illiquid banks via the CBN expanded discount window.

As soon as his predecessor Mallam Lamido Sanusi was appointed, he came in and took far reaching measures culminating in the removal of five Managing Directors of banks something that was hitherto inconceivable given the clout of the individuals involved. Mallam Sanusi was appointed by late President Umaru Yar'Adua, both of them Northerners. The discourse in society was that Mallam Sanusi was on an agenda to take over the banks from southerners and easterners because the northerners did not have considerable stake in the banking sector⁷⁵.

⁷³ Central Bank of Nigeria, Former Governors Profile
<http://www.cenbank.org/AboutCBN/RetiredExecutive.asp?Name=Prof%2E+Chukwuma+C%2E+Soludo%2C+CFR>

⁷⁴ Soludo C, "Global Financial and Economic Crisis: How Vulnerable is Nigeria?" (2009) , Presentation to the House Committee on Banking at National Assembly Abuja

⁷⁵ <http://allafrica.com/stories/200909071117.html>

These are the kind of issues that regulators have to deal with in the political landscape and I would say that the country is lucky to have found someone who is fearless and ready to confront the system and tow the right path. He took the unusual step of publishing the names of all the bad debtors of banks in the national dailies and of course, it was no surprise that the majority on the list were the top echelon of society – politicians, their cronies and the elite. Many banks due to their political inclinations were obliged to give out loans to politicians and their cronies. Also with the government being the biggest spender, such favours were rewarded with government patronage for cash collection services or deposit placements by government agencies. Below is a direct quote from current governor Mallam Lamido Sanusi⁷⁶ -

“The sad story in all of this is we now have evidence that junior officers in the CBN did document their concerns to CBN top management at that time, but no action was taken. We also have evidence that the NDIC documented its concerns but its efforts to get the CBN leadership to act quickly were rebuffed.”

Legal action was jointly taken by the CBN and Economic and Financial Crime Commission (EFCC) against erring bank directors and their accomplices. The following table shows the charges against them and the amount they have fleeced off the banks by virtue of the position of trust that they held.

⁷⁶ Ibid 58

Table 3.2 – CBN/EFCC Charges against Bank Managing Directors

Name	Amount	Case Status
Mrs Cecilia Ibru – Oceanic Bank	N160.2bn	Plea Bargain – sentenced for 18 months on 8/10/10 and also forfeited assets worth N191.0bn
Dr. B. Ebong – Union Bank	N187.1bn	On Bail
Mr Okey Nwosu – FinBank	N95.1bn	On Bail
Mr Francis Atuche – Bank PHB	N80.0bn	On Bail, Assets frozen
Dr E. Akingbola – Intercontinental Bank	N27.0 bn	On Bail, Assets frozen

Source – EFCC Website⁷⁷

As highlighted in above table the only trial that has been concluded is that of Mrs Cecilia Ibru who entered into a plea bargain with the authorities, the other cases have been going in and out of court. This is another problem that regulators face in carrying out their duties. The judicial process in Nigeria is excruciatingly slow and constant adjournments occasioned by delay tactics of defence lawyers sometimes make the plea bargain option very attractive.

⁷⁷ Economic and Financial Crime Commission, High Profile Cases
http://www.efccnigeria.org/index.php?option=com_docman&task=doc_view&gid=15&Itemid=82

3.4 – The Banking Sector Post Consolidation

The 2004 reform agenda by CBN was certainly a step in the right direction but there were a few lapses in the implementation of the initiatives. The main focus under the initiative was the recapitalisation of the banks from N2bn to N25bn in the space of 18 months which has been considered to be a rather short grace period⁷⁸. Furthermore, this decision was taken unilaterally by the CBN without reaching out to other operators to seek their input into the new paradigm being introduced in the banking sector. In developing countries such as Malaysia there were consultations with the market operators before embarking on mergers and acquisitions. This action by the CBN is typical of many policy upheavals in Nigeria; a global trend is copied without ensuring that the fundamentals to ensure that it produces desired results are in place. A school of thought opines that the consolidation exercise was ill timed given the economic condition and prevailing high inflation rate⁷⁹. An example of this is the licensing of micro finance banks to drive the growth of small and medium scale enterprises in the country, however less than five years after their introduction, many of them have already run into liquidity problems with licences revoked by the CBN⁸⁰.

⁷⁸ Ogunleye G, “The Causes of Bank Failure and Persistent distress in the banking Industry, (2010), Perspectives on the Nigerian Financial Safety-Net, Foreword
<http://ndic.org.ng/files/Perspectives%20%20On%20the%20Nigerian%20Financial%20Safety-net%20NDIC%202.pdf>

⁷⁹ Ibid 34

⁸⁰ Abayomi A, “Troubled MFB’s Risk Closure in 2011” (2011)
<http://www.microfinancenigeria.com/latest-news/troubled-mfbs-risks-closure-in-2011/>

Malaysia, a developing country like Nigeria was successful in its consolidation exercise because in addition to policy input by the operators in the sector the macroeconomic fundamentals were strong. The country had an inflation rate of 3.5% at the end of 1996 whilst Thailand and Indonesia had 4.9% and 7.9% respectively. Another key measure that was put in place by the Malaysian Government was limiting the bank's exposure to the capital market and the real estate subsector. When it comes to bank consolidation, there are two views in the discourse, the first viewpoint is that it is well able to enhance banks overall returns via cost efficiency and revenue gains⁸¹. The second opinion is that it could encourage banks appetite for risk taking via the use of off-balance sheet operations and increased leverage⁸².

In Nigeria, the consolidation exercise did increase risk taking with aggressive asset generation in the oil and gas industry and the stock market. This is in contrast to the Malaysian experience where regulators ensured that the excess liquidity was not put into sectors that could eventually harm the economy thus underscoring the importance of robust policy formation to avoid unintended consequences.

The Nigerian banking system has witnessed a trend of boom and bust cycles. It seems to be the growth cycles occur once there are policies that enhance business opportunities in the banking sector and the bust eventually catches up due to mismanagement in the

⁸¹ Calomiris, Karceski, "Is the Bank Merger Wave of the 1990's: Lessons from Nine Case Studies" (1997) National Bureau of Economic Research
<http://www.nber.org/chapters/c8650.pdf>

⁸² Mishkin F, "Financial Consolidation: Dangers and Opportunities" (1998) National Bureau of Economic Research Working Paper Series 6655

sector. The present phase of reform embarked upon presents a viable opportunity for thorough overhaul of the financial sector by ensuring that the fundamental issues are dealt with regarding macroeconomic stability and the banking sector.

In the aftermath of the subprime crisis, the CBN has now embarked on a long term reform programme targeted around 4 pillars⁸³

- i. Enhancing the quality of banks
- ii. Establishing financial stability
- iii. Enabling Financial Sector Evolution
- iv. Ensuring the financial sector contributes to the real economy

This approach deviates from the initially reform agenda in 2004 because it addresses the fundamental issues that afflict the banking sector in Nigeria. Reform in the industry will be unsustainable if these critical issues are not addressed.

3.4.1 – CBN Four Pillar Reform Agenda

Listed below is a breakdown of the specifics areas that will be addressed under each of the pillars of the new banking reform agenda⁸⁴:

⁸³ Ibid 58

⁸⁴ Ibid 58

i. Enhancing the quality of Banks

- a. Industry remedial programmes to fix the cause of the crisis – risk management, data quality, governance and financial crime
- b. CBN has established an international risk management specialist function and is in the process of transitioning to risk-based supervision
- c. The FSRCC will lead a programme to fundamentally reform the financial services regulatory framework. The initial focus will be on harmonising and raising to world-class standards the supervision processes, technology and people within the various financial regulators
- d. CBN will take on the role of consumer protector in the banking sector, setting standards of customer service for the industry and ensuring that customers are treated fairly in their dealings with the industry.
- e. CBN will also enhance corporate governance internally to ensure that it is not dependent on leadership of the governor. The organisational structure within CBN is also been streamlined for effective supervision and regulation of the industry.

ii. Establishing Financial Stability

- a. The Financial Stability Committee will be strengthened within the CBN with a primary focus on systemic stability and will be supported by a

strong technical working group. Also CBN will work closely with the Ministry of Finance to ensure consistency in monetary and fiscal policies

- b. Establishment of a hybrid monetary policy and macro-prudential rules. Under consideration is some form of oil priced linked provisioning regime in light of Nigeria's unique economic situation
- c. Development of directional economic policy to improve basic infrastructure, diversify the economy, increase the investment absorption capacity of priority sectors and support measures that enable sustainable economic growth.
- d. Further development of the capital market as an alternative to bank funding. This will ensure that long term funding is available for priority sectors in the economy.

iii. Enabling healthy financial sector evolution

- a. CBN will play an important role in facilitating establishment of complementary banking infrastructure such as credit bureaus and registrars. The creation of a credit bureau will help stem the menace of bad loans in the sector.
- b. Creation of the Asset Management Corporation to solve the non performing loan problems in banks and facilitate further consolidation in the market.

c. CBN will review the current universal banking model and has released paid up share capital guidelines for specialist banks as follows –

- i. Regional - N10 billion
- ii. National - N25 billion
- iii. International - N50 billion

iv. Ensuring the Financial sector contributes to the real economy

- a. Leverage the CBN Governors role as advisor to the President on economic matters to ensure that the financial sector contributes to the economy
- b. The following funds have been created to ensure infrastructure development and sustainable financing for the real sector.

- i. N500bn Critical Infrastructure Fund
- ii. N200bn Refinancing SME/Manufacturing Fund
- iii. N300bn Long Term Funding of Power and Aviation

The above as compared to the 2004 reform agenda is a more holistic approach to addressing the fundamental issues that plague the Nigerian banking sector however the CBN will need to work closely with all other agencies to ensure that the long term plan can be followed through. It is desirable to have laudable initiatives but the right policy

implementation is important, it will mark a turnaround in the sector if the political will to carry out this reform agenda is endorsed.

Chapter Four

Conclusion and Recommendation

4.1 – Financial Sector and Economic Growth

Nigeria's economic growth has not been commensurate with the potential that is available to her. The growth has been stunted due to fundamental weaknesses like mono-product economy and very poor infrastructure. The school of thought that reforming the banking sector without fixing the fundamental issues especially macro-economic stability is flawed, for Nigeria to harness its potential there should be reforms in all key sectors simultaneously. The latest reform agenda by CBN is a laudable plan that can deliver the required transformation if the implementation is right and the political will to make it happen is available.

The growth and transformation of Nigeria's economy hinges on the appropriate management of the volatility and distortions that is experienced by the over-reliance on oil and rejuvenating the non-oil real economy to stimulate employment. Agriculture is an area that is a potential revenue generator for the government and should be encouraged to grow. It is only in addressing these macroeconomic variables alongside banking reforms that lasting change can occur in the banking sector.

4.2 - Regulatory Agencies Reform

A critical part of the reform agenda is the role of the regulatory agencies. The CBN on its own cannot deliver on the wide remit of the agenda thus all regulatory agencies need to work together to deliver the much required development to the economy. This is a laudable initiative and it is an opportunity to tackle what has long been identified as issues plaguing the nation. One of the key issues for the regulatory agencies themselves is getting skilled and experienced personnel from the banking sector to improve effectiveness of their roles. A key lapse that has come through is the lack of collaboration between the agencies. For instance, during the entire crisis the FSC and FSRCC never had regular meetings to get a holistic picture of the state of the economy.

The regulatory agencies have started on internal reorganisations to meet the challenges and ensure better oversight of the sector. CBN as highlighted earlier has already started on a massive reorganisation of its departments for effective discharge of its duties. It has also strengthened its workforce with the employment of highly qualified citizens from the pool of talented Nigerians in developed countries.

Similar reorganisation is also ongoing in SEC, the Director General Ms Arunma Oteh was also appointed by late President Musa Yar'Adua. Since her appointment she has sacked the long standing Director-General of the Nigerian Stock Exchange (NSE) for alleged financial malpractices. In addition many securities firms and stock brokers were

named as bad debtors in the name and shame tactic of the CBN and are currently undergoing investigation by SEC.

To facilitate the reforms going on in the sector, a critical piece is the legal landscape of the nation. Judicial reform is vital in helping the agencies fulfil their mandates. In the case of the sacked managing directors in 2009 just one case has been concluded via a plea bargain. The other cases are being adjourned at every opportunity with defence lawyers having perfected the method to prolong the cases unnecessarily.

A viable option is to re-introduce special courts to deal with these issues. This was an initiative that worked well with the establishment of the failed banks tribunal after the second banking crisis. This will ensure quick determination of charges against financial market operators and will serve as a deterrent in the market. This is an initiative that should be given urgent consideration because two vital financial market agencies in the market are opportune to have erudite professionals who possess the political will to enforce compliance with the rules no matter whose ox is gored. However these appointments are for a term of five years and it is probable that the individuals will be replaced at the expiration of their tenures in line with zoning method for political appointments in Nigeria. In my opinion, I believe that it is time for the country to ensure that vital agencies that require technical skills are not subjected to political manoeuvring but employ a methodology where the mantle falls on the most qualified persons available.

4.2.1 – Separate Supervisory Agency?

A review of the banking sector indicates that the major problem is not the lack of a separate agency but rather economic, institutional and political factors as highlighted in the previous chapter. The problems stem from regulatory failure by the CBN - directly via negligence of duty and indirectly due to inappropriate macro-economic policies. Having established this fact, even with both mandates under CBN supervision, there was an inability to pursue their responsibilities effectively. Arguments for separation of supervisory duties suggest that there would be conflict of interest, excessive powers and reputation risks. In the peculiar Nigerian scenario, these issues do not impact regulation as expected because the financial market is not as developed and robust in developing countries. The macroeconomic fundamentals that affect the industry should rather be seen as policy lapses rather than conflict of interest. In terms of excessive power, CBN is actually a weak institution from a political economy perspective. Because the appointment of the governor is a political one, there has been a lot of restraint by CBN governors in enforcing some of the rules.

Regulatory capture also occurred with the CBN due to political pressure as many of the promoters of Nigerian banks are well connected to the ruling class. We thus had a situation where rather than enforce regulation banks were given liquidity support because of their relationship to the government. The only change that has occurred in Nigeria is the appointment of the current Governor who fearlessly took measures that were alien to the culture hitherto witnessed within the Nigerian public service

environment. Another perspective to independence of CBN is the role and motives of the individual. The forthrightness and the boldness of the CBN governor have been attributed to the fact that he is a prince of a prominent ruling Northern family and therefore has the clout to tread where his predecessors did not dare. To buttress this point, it was the CBN governor in a speech last year that alerted Nigerians to the fact that their legislators were earning the equivalent of about \$1.5m annually! This indeed caused a furore in the populace as it was rather ironic that legislators in one of the world's poorest countries were receiving almost quadruple the \$400,000 annual pay of the President of the United States of America. The Governor was invited to the legislative chambers and admonished by legislators to retract this statement and in a live broadcast he stood by his statement and declared he was ready to be relieved of his position.

It is noteworthy that Prof. Charles Soludo his immediate predecessor went into mainstream politics immediately after his tenure running for election as a state Governor in Nigeria. The stance of many was he had questions to answer having given the false impression that all was well with the banking sector whilst insinuations abound on the source of the funds he expended on the lavish campaign trail for his political aspirations.

A key solution to the above problem will be a mechanism to ensure that the political interference is reduced to a bare minimum in the sector. One way this can be done is enforcing corporate governance codes in the banks and finding ways to ensure that financial institutions have diversified holdings. CBN recently put out a circular directing any Managing Director who had been in office for more than 10 years to stand down

from the position and 3 managing directors had to leave office. This is one of the ways that CBN can implement effective supervision in the banks even though it remains to be argued if they are over stepping their boundaries. Having said this, Nigeria is a peculiar environment with its attendant issues and unusual policies that address this peculiarity should be adopted if required. An unconventional method adopted by CBN is the publication of debtors of the banks that had their managing directors removed in the national newspapers.

Without doubt the CBN fits the criteria for a unified agency to allow for information synergies and a better approach for systemic risk which the ongoing reform will address if there is adequate implementation. It will however require the buy in of many governmental agencies such as the Ministries of Finance, Trade and Investment and Infrastructure. In a highly politicised government such as Nigeria's rather than cooperate with this laudable programme of CBN, some ministers may see it as an encroachment of their remit and thus not work in the best interest of the country.

4.3 Conclusion

Nigeria is a country with great potential and to achieve this potential a vibrant financial sector is required to drive economic growth and development. Two main areas that would drive this are the banking sector and the capital market, the current reform exercise presents an opportunity to tackle fundamental flaws in the system and reposition the economy for greater heights.

It would be of immense benefit if the current reform embarked upon by the CBN is actually incorporated as a national agenda. The initiative is a long term one and it would only deliver if it is implemented as currently articulated. There is a possibility that if a new governor is appointed in 2014, the reform may not be followed upon and as often witnessed in Nigeria, the new governor may want to be seen as initiating something new thereby not giving the reform agenda the priority it requires. Governmental agencies will also need to work with the CBN in actualising the proper disbursement of the huge resources allotted to the developmental funds created by the CBN on infrastructure, manufacturing, power and aviation. Ideally one would have expected that these initiatives would come from the governmental agencies in charge of these areas.

Undoubtedly, the extent of the reform required to sanitise the banking industry in Nigeria calls for a unified approach to the CBN mandate. The peculiar nature of the environment requires a holistic approach to tackle the fundamental and inter-related issues and necessitates that several agencies work in a cohesive manner in the interest of the country.

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