09-46236403
09-4623618

BSD/DIR/GEN/CIR/04/015

April 30, 2010

CIRCULAR TO ALL BANKS

THE NEED FOR BANKS TO DEVELOP AND IMPLEMENT A RISK-BASED PRICING MODEL

The Monetary Policy Committee, at its special meeting of April 15, 2010, reviewed developments in the economy during the first quarter of 2010 and noted with concern the persisting high lending rates. It attributed the resultant wide spread between lending and deposit rates to inefficiency in cost management and unrealistic profit expectations and targets on the part of the shareholders of banks.

The Committee believes that promoting transparency in the pricing and setting of rates by Deposit Money Banks (DMBs) could help to drive down lending rates. In this regard, DMBs are required to develop all inclusive risk-based interest rate pricing models and forward same to the CBN. DMBs are expected to quote lending rates as fixed spread over the Monetary Policy Rate (MPR) or any reference rate as may be determined by the CBN. They are required to render monthly returns on, and regularly publish (on a website, newspapers, and other periodic reports), a statement showing the relationship between the MPR and their prime and maximum lending rates.

The articulation of the pricing model in this mode and its disclosure to the general public is intended to serve two purposes. First, by providing visibility on relative efficiency of financial institutions, banks will be encouraged to seek profitability by driving down costs and charging competitive rates rather than charging excessive rates of interest. Second, by explicitly stating prime and maximum lending rates as a fixed spread over MPR, the policy rate becomes an effective tool for driving lending rates up or down as policy stance dictates.
Banks are advised to be guided by the following parameters, in addition to the risk premium, in determining their prime lending rates. Each of the cost element or component as described below should be separately computed and disclosed as part of the information to be made public.

1. Direct cost of fund

Direct interest cost of funds should be interest expense related to the monthly average volume of deposits and other funds reported to the CBN on a monthly basis.

2. Indirect cost/overhead

All indirect cost/overhead incurred by the bank should be included in the determination of the prime lending rate. The overheads to be separately disclosed include staff cost, bonuses, executive compensation, loan loss provision, administrative cost, etc. Overhead cost for the month should be expressed as a percentage of the average volume of funds and annualized.

3. Statutory cost

Statutory cost to be included in the computation of the prime lending rate should include the following:

a. **NDIC Premium**.

The amount payable as deposit insurance premium in each month should be expressed as percentage of the average volume of deposits for the month and annualized.

b. **Cash Reserve Requirement (CRR)**.

Banks are expected to adjust the prime lending rate by taking into account the opportunity cost of deposits that were sterilized as CRR.

4. Opportunity Cost of holding liquid assets in excess of the minimum requirement

Without prejudice to the maintenance of strong liquidity position, banks are encouraged to balance the desire for liquidity and profitability. The opportunity cost here will take into account the bank's average yield on earning assets other than liquid assets vis a vis the average yield on liquid assets.

5. Cost of holding non-earning assets

This is the cost of holding assets that do not generate any income. Banks are advised to reduce their holding of non earning assets to the minimum.

6. Target return on equity

The rate of return expected by the shareholders of banks should also be factored in the computation of the prime lending rate of banks. The expectation however, should be guided by economic fundamentals and long term sustainability of the institutions.

FLAT FEES

To ensure standardization of charges across the industry and align Nigerian banking practice to international standards, the Bankers Committee issued the Guide to Bank Charges in 2004. Banks were required to ensure compliance with the provisions of the Guide, however, in recent times, the CBN has observed the proliferation of flat lending fees charged by banks in violation of the Guide, which has led to many complaints by members of the public. To arrest this situation, banks are henceforth required to note that aggregate flat lending fees shall not be more than 200 basis points of the facility amount. The details of all fees shall be communicated to and agreed with the borrower and disclosed by the bank.

The returns as highlighted above shall, with effect from April 2010, be rendered on the 5th day following the reporting month. In addition, soft copies should be sent to the following email addresses, while hard copies forwarded to the Director, Banking Supervision Department.

1. uabdulqadir@cenbank.org
2. oogbe@cenbank.org

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