



# **BANKS IN NIGERIA AND NATIONAL ECONOMIC DEVELOPMENT: A CRITICAL REVIEW**

Sanusi Lamido Sanusi, CON  
Governor  
Central Bank of Nigeria

Being a Keynote Address at the Seminar on “Becoming An Economic Driver While Applying Banking Regulations”, organized by the Canadian High Commission in Joint Collaboration with the Chartered Institute of Bankers of Nigeria (CIBN) and the Royal Bank of Canada (RBC) on March 7, 2011

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## **Protocol**

1. I am very delighted to be invited to present a key-note address at this important forum. I wish to commend the organizers, the Canadian High Commission, the Chartered Institute of Bankers of Nigeria and the Royal Bank of Canada for gathering top policy makers and operators in the banking and finance industry here today for this all important seminar which is focusing on the banking sector in Nigeria. The theme of this seminar "Transformational Banking for Economic Development" is indeed topical, and couldn't have come at a better time, considering that the banking sector in Nigeria is passing through a critical and decisive path in reforms to reposition it to effectively impact on other sectors of the economy, especially the real sector.
  
2. Economic development is about enhancing the productive capacity of an economy by using available resources to reduce risks, remove impediments which otherwise could lower costs and hinder investment. The banking system plays the important role of promoting economic growth and development through the process of financial intermediation. Many economists have acknowledged that the financial system, with banks as its major component, provide linkages for the different sectors of the economy and encourage high level of specialization, expertise, economies of scale and a conducive environment for the implementation of various economic policies of

government intended to achieve non-inflationary growth, exchange rate stability, balance of payments equilibrium and high levels of employment.

3. The role of finance in economic development is widely acknowledged in the literature. In particular, Schumpeter (1911) put the role of financial intermediation at the center of economic development. He argued that financial intermediation through the banking system played a pivotal role in economic development by affecting the allocation of savings, thereby improving productivity, technical change and the rate of economic growth. He believed that efficient allocation of savings through identification and funding of entrepreneurs with the best chances of successfully implementing innovative products and production processes are tools to achieve this objective.

4. The endogenous growth literature also supports the argument that financial development has a positive impact on growth. Well functioning financial systems are able to mobilize household savings, allocate resources efficiently, diversify risk, and enhance the flow of liquidity, reduce information asymmetry and transaction cost and provide an alternative to raising funds through individual savings and retained earnings. These functions suggest that financial development has a positive impact on growth.

5. Ladies and Gentlemen, for many of you here, I may be stating the obvious, by highlighting the central role that banks play in the development of every economy by mobilizing resources for productive investments and being the conduit for the implementation of monetary policy. Yet, I have given this the emphasis it requires. Due to the critical nature of these roles, and the fact that the ability of banks to effectively impact on economic development hinges largely on their soundness and efficiency, governments across the world

continue to take variety of measures to safeguard the banking sector through reforms. Such reforms often focus on increased risk management procedures and enhanced corporate governance in order to strengthen and reposition the banking industry to enable it contribute effectively to the development of the real sector through its intermediation process. In addition, such reforms may involve a comprehensive process of substantially improving the regulatory and surveillance framework; fostering healthy competition in banking operations, ensuring an efficient framework for monetary management, expansion of savings mobilization base, enforcement of capital adequacy, and the promotion of investment and growth through market-based interest rates. The need for reforms on an on-going basis has become more imperative with the increasing sophistication of the global financial products. The recent experience from the global financial crisis has further underscored the imperatives for countries to embark on banking reforms on a regular basis.

6. Ladies and Gentlemen, the process of reforming a financial sector usually involves the movement from an initial situation of controlled interest rates, poorly developed money and securities market and under-developed banking system, towards a situation of flexible interest rates, an expanded role for market forces in resource allocation, increased autonomy for the central bank and a deepening of the money and capital markets. It would indeed be difficult to define the components of 'good' banking sector reform in absolute terms. Generally speaking, good reforms would engender clear market entry and exit conditions; ensure the ability of banks to function according to market principles without state intervention in their decision-making; guarantee central bank independence and establish independent banking oversight. This means that reform in the domestic financial system will comprise of three key policy actions. The first is removal of price restrictions; that is, the removal of ceilings on deposit interest rates and restrictions on lending interest rates. The second component is

removal of quantity restrictions; that is, the removal of direct credit allocation mechanisms, relaxation of reserve requirements, and removal of restrictions on foreign currency deposits. The third policy action consists of removal of entry barriers in the financial system. In countries with a heavy government presence in the financial sector, reform would usually involve privatization of public financial institutions and relaxation of restrictions on the creation of private financial institutions. Liberalization would also include opening up of the financial system to foreign players. All these actions aim at promoting strong competition in the financial system, which improves the efficiency of intermediation through the dismantling of monopolies in the financial system.

7. Thus, a well repositioned bank is therefore expected to perform its role more efficiently and contribute to the development and growth of the economy. Banking sector reform leads to improved financial services which lead to cost reduction by the industrial concerns. More people will have access to funds from the banking system and this will increase aggregate demand for goods and services. Increased aggregate demand will impact positively on output and employment generation thereby reducing poverty – the ultimate goal of economic management.

8. In the final analysis, bank reforms aim at ensuring financial deepening which implies the ability of financial institutions to effectively mobilize savings for investment purposes. The growth of domestic savings provides the real structure for the creation of diversified financial claims. It also presupposes active participation of financial institutions in financial markets, which in turn entail the supply of quality (financial) instruments and financial services.

9. Ladies and gentlemen, I do not wish to bore you with a chronicle of distress and reforms that have taken place in Nigeria since the 1950s. I have

done so in many fora. Suffices it to say that many crises had happened and many reforms had been initiated and implemented in the banking sector. At the inception of the reforms in 2004, the thrust of policy was to grow the banks and position them to play pivotal roles in driving development in other sectors of the economy, as well as induce improvements in their own operational efficiency. As a result, banks were consolidated through mergers and acquisitions, raising the capital base from N2 billion to a minimum of N25 billion, which reduced the number of banks to 25 from 89 in 2005 and later to 24. Beyond the need to recapitalize the banks, the reforms focused on ensuring minimal reliance on public sector for funds, but rather relying on the private sector. The adoption of risk focused and rule-based regulatory framework; adoption of zero tolerance in regulatory framework in data/information, rendition/reporting and infractions; strict enforcement of corporate governance principles in banking; expeditious process for rendition of returns by banks and other financial institutions through e-FASS; revision and updating of relevant laws for effective corporate governance; and ensuring greater transparency and accountability in the implementation of banking laws and regulation.

10. The implications were that the resources base of such banks was weak and volatile, rendering their operations highly vulnerable to swings in government revenue, arising from the uncertainties of the international oil market. It was also observed that many banks appeared to have abandoned their essential intermediation role of mobilizing savings and inculcating banking habits at the household and micro enterprise levels. The apathy of banks towards small savers, particularly at the grass root level, had not only compounded the problems of low domestic savings and high bank lending rates in the country, it 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.

11. Another aspect of the reforms which is seldom mentioned relate to the changes in policy approach at the CBN. Beginning from December 2006, the Bank introduced a low interest rate based framework and made the monetary policy rate the operating target. The new framework has enabled the bank to be more proactive in countering inflationary pressures. Also, in the use of the framework, upper and lower limits to the monetary policy rate were set, coinciding with the rate for the standing lending facility and standing deposit facility, respectively. The corridor regime has helped to check wide fluctuations in the interbank rates and also engendered orderly development of the money market segment.

12. There are, no doubt, some positive outcomes of the reforms. First, banks by their size were enabled to undertake funding of large ticket projects, especially in infrastructure, and oil and gas sectors, through the new window in the enlarged single obligor limits. The larger size of banks also engendered improved customer confidence. The number of bank branches has increased from 3,247 in 2003 to over 5,837 in 2010 and employment in the sector rose from 50,586 in 2005 to 71,876 in 2010. Also, the capital market received a boost as several banks recorded successes in their initial public offers (IPOs). The consolidation exercise also impacted on the payment system positively as the fewer number of banks made it easier to deploy the new automated clearing systems and also reduced the length of time spent on the clearing floor. Concerning supervision, the relative ease of having to oversee 24 banks as against 89 deserves mention.

13. In spite of these positive developments, a new set of problems emerged and threatened the financial system from 2008, coinciding with the global financial crisis. The surge in capital put pressure on the availability of human

capacity in the sector and coupled with poor corporate governance and risk management frameworks this led to our recent experience with margin loans and other high risk investments. Consequently, when the capital market bubble burst, the balance sheet of banks became eroded to the extent that some of them remained for some time on ‘life support’ from the CBN. Inter-bank rates spiked as banks tried to borrow at any rate in order to remain afloat, the size of non-performing loans significantly increased, customer panic re-emerged and several instances of unethical conduct among the managements of banks were revealed. In addition, the critical question “Are our banks playing the pivotal role of driving development” could not be answered in the affirmative. It was this scenario that set the stage for the most recent set of reforms.

14. The reforms could be broadly divided into two. The first part of the reform focused on ensuring that the nine banks, which the CBN/NDIC special examination revealed were in a dire state, were rescued. Some of the actions included the reduction of cash and liquidity ratios, expanded discount window operations, which enabled the banks to borrow for up to 360 days from the CBN. It also admitted non-traditional instruments, like commercial papers, promissory notes and bankers' acceptances in the discount window. Interbank lending was also guaranteed to encourage banks to lend among themselves. The sum of N620 billion was injected into eight banks as a direct rescue package, while corporate governance was enhanced with the appointment of new management teams. Over all, we can now say that the system has been restored to the path of stability.

15. The second aspect of the reforms is couched in terms of medium to long term objectives. Under this, financial sector stability is emphasized alongside the need to position the banks to provide funding for the development of the real sector of the economy. The four cardinal pillars of the reform are: enhancing the

quality of banks, establishing financial stability, enabling healthy financial sector evolution, and ensuring that the financial sector contributes to the real economy, which is very critical to the type of growth that translates to improved welfare.

16. Enhancing the quality of banks entails the initiation by the CBN of a five part programme to enhance the operations and quality of banks in Nigeria. This programme consists of the following: industry remedial programmes to fix the key causes of the crisis; risk-based supervision; reforming the regulatory framework; enhanced customer protection; and internal transformation of the CBN. Issues such as effective corporate governance, data quality, and financial crime have seen increased attention. More so, consumer confidence is also being tackled in the reform programme as complaint desks have been opened to ensure that financial services are delivered to customers as transparently and fairly as possible.

17. Establishing financial stability entails conscious actions by the CBN, and other regulatory agencies to stem wide fluctuations in the key macroeconomic indicators. The high points of this pillar include, strengthening the Financial Stability Committee within the CBN, establishment of macro-prudential rules, development of directional economic policy and counter-cyclical fiscal policies by the government and further development of capital markets as alternative to bank funding. It is hoped that the new macro-prudential rules would leverage on the following:

- Limiting capital market lending to a set proportion of bank's balance sheet;
- Prohibiting banks from using depositors' funds for proprietary trading, private equity or venture capital investment; and

- Adjusting capital adequacy and forward looking capital requirements driven by stress tests by the CBN.

18. Enabling healthy financial sector evolution entails the CBN reviewing the basic one-size-fits-all model of banking. This has made possible the emergence of international, national, regional, mono-line and specialized banks such as non-interest banks, etc, with different capital requirements commensurate to the depth of their operations.

19. The fourth pillar of the reform has direct bearing on the development of the real sector as it seeks to position the banking system to contribute to the growth and development of the various sectors of the economy. The spirit of this pillar is anchored on the fact that real economic growth must be supported by actual rise in physical goods and services. This segment of the reform has sought to break from the classical orthodoxy of leaving the allocation of financial resources to the market forces. Rather, the reform has identified priority sectors and developed tailored interventions to support and promote growth in these sectors. Some of the key interventions in the real sector under this reform pillar include: the N200 Billion Commercial Agricultural Credit Scheme (CACS); the N300 Billion Power and Aviation Intervention Fund; the N200 Billion Restructuring/Refinancing to the Manufacturing Sector/SME; the N200 Billion Small and Medium Scale Enterprises Guarantee Scheme (SMECGS).

20. The CACS was established by the CBN in collaboration with the Federal Ministry of Agriculture. It is being funded through the issuance of FGN Bond worth N200 billion, by the Debt Management Office (DMO) in two tranches. The first tranche of N100 billion had been raised and passed on to participating banks for on-lending to farmers. Loans made under this scheme are at single digit interest rate subject to a maximum of 9.0 per cent, while the CBN bears the

interest subsidy at maturity. The scheme was initially to promote commercial agricultural enterprises but was later expanded to accommodate small scale farmers through the on-lending scheme of the state governments. The sum of N96.81 billion has been disbursed to 104 projects through 11 banks and 18 State governments including the Federal Capital Territory, as at end of December 2010.

21. Under the Power and Aviation Intervention Fund, the CBN made available the sum of N300 billion to stimulate credit to the domestic power sector and the troubled airline industry. The amount was part of the initial N500 billion intervention fund sourced to catalyze financing of the real sector of the Nigerian economy. The main objective of the initiative was to help finance badly needed power projects and to allow banks to refinance loans to the heavily-indebted airline industry. The programme operates in such a way that borrowers will be able to access the fund at an interest rate of 7 percent payable on a quarterly basis including all charges in order to refinance existing loans and leases and provide working capital for the two sectors. The fund is managed by the Bank of Industry (BOI) while the Africa Finance Corporation (AFC) serves as the technical adviser to the fund.

22. As part of efforts towards unlocking the credit market and to ensure that credit flows to the real sector of the economy, the CBN made available N200 billion for re-financing/re-structuring of banks' existing loan portfolios to the manufacturing sector and SMEs. The main objective of the fund is to fast-track the development of the manufacturing sector by improving access to credit by manufacturers as well as improving the financial position of the DMBs. The types of facilities under the fund include long term loans for acquisition of plant and machinery, refinancing of existing loans, resuscitation of ailing industries, working capital and refinancing of existing leases. The loan amount for a single obligor is

a maximum of N1 billion in respect of re-financing/re-structuring with an interest rate of 7 per cent payable on quarterly basis. All commercial banks and Development Finance Institutions (excluding BOI) had all been enlisted to participate in the scheme. As at the end of December 2010, N199.6 billion had been disbursed to 539 beneficiaries across twelve different sectors of the economy.

23. The N200 billion Small and Medium Scale Enterprises guarantee Scheme established by the CBN in 2010 aims at promoting access to credit by SMEs in Nigeria. The scheme provides guarantees on loans by banks to the sector in order to absorb some of the risk elements that inhibit banks from lending to the real sector. The activities covered under the scheme include manufacturing and agricultural value chains; SMEs, processing, packaging and distribution of primary products. The maximum amount that can be guaranteed is N100 million and is in the form of working capital, term loan for refurbishment, equipment upgrade, expansion and overdraft. The guarantee covers 80 per cent of the amount borrowed and is valid up to the maturity date of the loan, with maximum tenor of 5 years.

24. A new financing framework for agriculture, the Nigerian Incentive-Based Risk Sharing System for Agricultural lending (NIRSAL) is being introduced. This model of financing agriculture is different in many ways from the current model which has not yielded the desired impact of making adequate credit available in the sector. NIRSAL is a demand driven credit facility rather than the current supply driven funding. It would adopt a value chain approach to lending and banks would be free to choose which part of the chain they would be interested in lending. It would build the capacity of banks to engage and deliver loans by providing technical assistance, reduce counterpart risks facing banks through innovative crop insurance products, reward performance in

agricultural lending and would be managed with performance based incentives. NIRSAI would pool the current resources in CBN's agricultural financing schemes and other investor funds and transfer these into the different components of the programme. In other words, our existing agricultural financing and insurance scheme would be assessed, modified and integrated into NIRSAI.

25. All of our development initiatives at the CBN have been underpinned by a new engagement with the Banking industry through the Bankers' Committee by adopting a more collaborative approach for financial services led national economic development and transformation. The Bankers' Committee has identified 3 key sectors: Power, Transportation and Agriculture, as most critical to development of the real economy, as well as the change that will drive other sectors and contribute to economic development of Nigeria. We work by identifying initiatives in each of the focus sectors that the financial system will support, determine requirements for success including funding and engage in advocacy to effect government policy changes. The Bankers' Committee also supports industry-wide capacity-building and work on the development of regulation and legislation to support lending to these three key sectors.

26. Available data shows that the macroeconomic environment has improved considerably. Inflation rate has moderated at a low double digit while the prime lending rate has gone down significantly. The exchange rate has been relatively stable. All these have impacted on the growth of the real economy.

27. From the recent experience it is discovered that the preponderance of toxic assets in bank portfolios have largely contributed to liquidity challenge facing some banks. However, the operation of AMCON has started to

strengthen the balance sheets of the deposit money banks. It is important that the banking system should learn to strictly comply with the BASLE requirements in their operations in order to safeguard their stability. Therefore, bank managers must be guided by professionalism and good corporate governance principles in their day to day activities so that our banks can remain safe, sound and competitive in the global market.

28. Maintaining a safe and sound banking sector is essential, given the key role that banks play in facilitating economic growth and financing developmental projects, particularly key infrastructure, agriculture and industry. Most emerging market economies have been known to use the domestic financial institutions to execute real sector big ticket projects and financial institutions in Nigeria should not be an exception if we hope to achieve our developmental objectives. Therefore, for our banks to be globally competitive, the current reforms in the banking will be sustained and strengthened.

29. Finally, ladies and gentlemen, some schools of thought have questioned the rationale for any central bank to pursue the so called multiple objectives. Let me emphasize the fact that in a developing economy such as ours in need of strong growth, typically a central bank's objectives should include developmental role in addition to its core mandate of ensuring price stability. Indeed, during the global financial crisis, most central banks subordinated the price stability objective to achieving financial stability and initiating growth.

30. Despite the unusual monetary policy environment, the CBN has recently pursued the objectives of financial stability and initiating growth, but with a critical eye on price developments. The point here is that a focus on price stability is not inconsistent with financial stability and economic growth

objectives as you cannot have economic growth without price stability. Thus, it is our expectation that effective implementation of the recent initiatives would help to promote Small and Medium Enterprises, bring the necessary improvements to the power sector, increase agriculture output, create employment and reduce poverty as well as put Nigeria on the path to meeting the targets of the Millennium Development Goals (MDGs).

**I thank you for your attention.**