



PAN AFRICAN CAPITAL GROUP, LLC

Research Note
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Is the Nigerian Financial Sector Set to Reform?

Actions by the Central Bank of Nigeria (CBN) to tackle deep-rooted problems within the financial sector, including insider lending and speculative practices that flourished in the past due to weak disclosure, inadequate transparency, and lax regulatory supervision are a positive and long-overdue response. In order to address these issues, the new CBN Governor Sanusi Lamido Sanusi has begun a reform process to implement a regulatory environment that will strengthen risk management policies and collateral obligations while curtailing insider lending, margin lending, and money laundering. The first step the CBN took was an audit that found five banks to be basically insolvent, and took them under receivership with new executive and board leadership. This is an important first step for the CBN, but it remains to be seen if there will be sufficient political will to carry through with the new Governor's reform agenda, and how far the CBN will be able to proceed in a country that is in many ways still defined by vested interests. The depth and impact of the reforms could also have far-reaching, if unforeseen, effects on the expansion of Nigerian banks across Africa, as well as foreign bank entry into the Nigerian market. The beginning of these reforms is encouraging because there is now the possibility of meaningful reform in a historically opaque market, but at the same time they create more questions about the future than can be currently answered.

There is now an impetus for reform in the Nigerian financial sector because even though the NSE has been relatively stable over the last 9 months, certain giants in the banking sector

have had to rely on a steady diet of cheap, short-term funding from the Central Bank of Nigeria's Expanded Discount Window (EDW) to stay afloat. It became apparent that some of these banks were almost completely dependant on the CBN, and the intended short-term use of the EDW funds had essentially been funding these balance sheets. Governor Sanusi decided that the concentration of this borrowing among five banks in the sector was enough to warrant swift action.

In late 2008, Nigerian President Umaru Yar'Adua decided not to renew the nomination of Central Bank Governor Professor Chukwuma Soludo. Governor Soludo has been credited with expanding the capacity of the Nigerian banking sector and increasing the credit available to grow the economy. At the same time there were fears that the effects of the recent financial crisis on Nigeria were being prolonged by the CBN allowing faltering banks cheap credit and insufficient regulatory oversight of their loan portfolios and business practices. Perhaps in response to this, President Yar'Adua nominated Sanusi Lamido Sanusi, Group Managing Director of First Bank of Nigeria and a risk management expert who committed himself to a stronger regulatory regime and a more active interest by the CBN in the business practices of the Nigerian banking sector. Governor Sanusi took office on June 4th, 2009 and it did not take long for him to begin instituting a strong set of policy reforms which could reinvigorate the Nigerian financial sector and the economy as a whole.

Swift Action by the CBN

By August, the CBN's Director of Banking Supervision had completed a special audit of five major banks in Nigeria, Afribank, Intercontinental Bank, Union Bank, Oceanic Bank, and FinBank. The CBN focused on these five initially because they were the recipients of the majority of the funds from the EDW, were significantly raising their savings rates to attract funds, and had allowed their portfolios to deteriorate on the back of unsecured capital market and oil sector loans. Based on the results of the audit, the CBN injected a combined \$2.6 billion in Tier II subordinated debt, with a maturity of seven years, and replaced the executive management and some board of directors at each of the five failing banks. The five banks had a combined loan portfolio of \$18.7 billion (40% of the market) when the CBN took them over, 41% of which was non-performing. The CBN's issues with these banks were money laundering, uncollateralized loans to insiders and related parties that held conflicts of interests, and a significant amount of margin lending that inflated the bank's market capitalizations and share prices before the credit crunch struck.

Four of the replaced managing directors and a handful of executives and directors have been detained and are being investigated by the Economic Financial Crimes Committee, while one of the MDs has fled the country and is believed to be hiding in London. It suddenly appears as if the heavyweights of the Nigerian economy have lost their untouchable aura, especially as the CBN has now published a full listing of the

most significant non-performing loans owed to the five banks in receivership. The list includes a good amount of the major corporations and individuals that dominate the landscape. Some have argued that this is a political purge ahead of Presidential and State elections, but every action by the CBN and EFCC has so far appeared to be in line with the best practices of the rule of law, a significant step forward for Nigeria.

The CBN also completed an audit of five additional Nigerian banks which were found to be in good standing, and is set to release its complete findings on the remaining fourteen banks in the sector by the end of September. There is the possibility that some of these fourteen banks may be placed in receivership in order to avoid failure, but the weak banks that were the most important (the five banks above account for 30% of deposits and 40% of loans in the sector) to the Nigerian economy have been stabilized.

These steps have shown that Governor Sanusi is committed to his announced intentions to strengthen the regulatory power of the CBN. As the former MD of First Bank (one of the other five banks audited but given a clean bill of health), he is very aware of the institutional policy weaknesses in the sector and has set out to correct them without deterring growth. Bringing a stronger regulatory hand to bear will actually serve to increase confidence in a recovering banking sector and stabilize Nigerian financial markets. International investors should be encouraged by his steps and may look to return to a stabilizing stock market, and large institutional investors may even look to take large if not controlling stakes

in some of the rescued banks. With the exception of commercial bank IBTC, a subsidiary of Stanbic resulting from a merger, no Nigerian banks have more than 5% foreign direct ownership, this could quickly change based on the recent comments by the Governor and the potential attractiveness of the market to major international banks. In a sign of increased international confidence in the sector, IBTC recently announced plans to expand its branch network by 20% bringing the total to eighty-two in every Nigerian State.

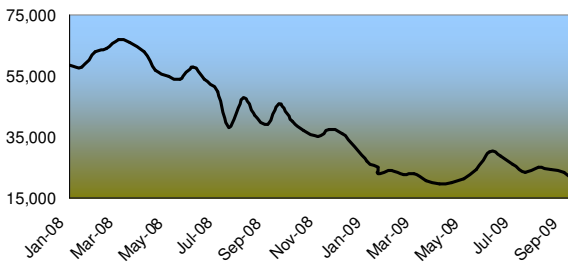
Policy Shifts

The new CBN administration has been very careful to do nothing to discredit the previous administration of the CBN, but at the same time he has taken strong steps which have brought to light institutional weaknesses in the banking sector that are arguably the direct responsibility of CBN policy over the past three to five years. This includes ignoring the various practices of the banking sector such as ill-advised risk management strategies, non-collateralized loans to well-connected corporations and individuals which are now non-performing, margin lending to brokerages and individuals, and allowing money-laundering to persist even while Nigeria's banks were expanding regionally and globally. The CBN has now committed itself to living up to international norms and best practices in order to solidify the Nigerian economy and the Nigerian financial sector as an African economic champion.

The first policy overhaul stems from Governor Sanusi's recognition that the

banking sector was too focused on making speculative, and in the end empty, profits from the stock markets and oil sector while not giving enough attention to the broader economic activities that will build Nigeria for the long-term. Even though banks should always focus on making profits, their risk management practices did not stop them from being overly exposed to just two sectors that were based on international commodity prices and investors in control of very liquid capital. The banking sector and the Nigerian economy has paid the price for this, but the risk management skills of the current Governor will result in CBN policy that will curtail undue exposure to any single sector and encourage diversification in loan portfolios and money market strategies. The Nigerian stock market

Nigerian Stock Exchange ASI

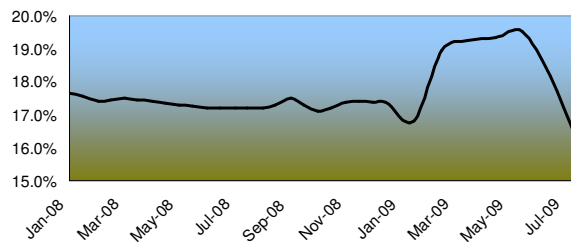


appears to have leveled out at realistic levels, and it is reasonable to assume that it will start to rise at justifiable rates in the near future.

The second major policy shift will be a greater amount of oversight on how loans are authorized and stricter collateral obligations for security against default. Governor Sanusi has been previously quoted as being extremely aggressive in regards to non-performing loans when he was in charge of risk management at the United Bank of Africa (another bank that

has been audited but found to be in good standing). The threat to bank balance sheets and respective capital-adequacy-ratios from the large ratio of NPLs forced prime lending rates to skyrocket, and they ended up averaging 19% through the second quarter of 2009. The stabilization and regulatory measures taken by the CBN allowed banks to lower the prime rate to its current levels around a more reasonable 16%. In a related turn the

Prime Lending Rate



depository rates have stabilized as banks no longer have to compete with the five troubled banks that had started offering exorbitant depository rates to attract funds to shore up their balance sheets.

The EFCC is now investigating how bank executives and directors were authorizing loans that were not properly collateralized, and in particular, how many of these loans were being disbursed to parties with business and social connections to the same executives and directors. These actions essentially defrauded shareholders in the banks as the loans were arguably never intended to be repaid. In many cases the loans were not being used for the stated purposes, which is technically a breach of credit contract and automatically results in default, yet the executives continued to extend credit to these parties. If the persons in charge were aware and complicit in these actions, a significant amount of jail time could be the result.

This sends a message to executives, directors, investors and depositors that the CBN is now fully engaged in protecting the rights of the shareholders, the customers, and the stability of the Nigerian financial sector.

Similarly, margin lending, or the practice of lending for speculating on the stock market was rampant among the five banks. This practice is not unusual in the international money markets, but the amount of the five banks portfolios dedicated to these loans was nearly 12%, and accounted for 46%* of the bank's capital, a staggeringly high number for retail or commercial banks entrusted with securing depositor's funds. Many of these loans were also directed at investing into the shares of the very bank from which it originated, creating a spiraling upward, and then free-fall effect, of market capitalization in lockstep with loan performance.

The third major policy shift under the new Governor is a more direct approach to bank practices that allowed illicit money laundering. Controls and regulations on the flow of funds within and between banks will be a central focus of the CBN over the next year. This is essential to curtailing the ability of both private and public sector actors to utilize illicit funds that have been ill-earned through a variety of means. It is not necessary to dive very deep into this issue except to state that Nigeria can no longer allow for black market and corrupt practices to flourish, often with the assistance of a loosely controlled financial sector.

Conclusion

If the Nigerian government, and the CBN led by Governor Sanusi can carry through on their actions and policy initiatives to date, there is a lot of hope that Nigeria will fulfill its role of African heavyweight not just in terms of size and economic force, but also in terms of leading the continent into the next economic age through transparency and diversification. The next twelve months are critical in determining the strength and depth of this reform agenda. If the reforms are mired in political in-fighting, the Nigerian financial sector may end up worse than it was when the reforms began, but if they are successful and find traction, Nigeria will take its place as a continental power in both finance and influence.

* At the time of writing Oceanic Bank's website and financial information were not available.

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Most recently, PACG, alongside partners Databank (Ghana) and Trust Bank Limited (The Gambia), acquired majority control of International Bank (Liberia) Limited, Liberia's oldest commercial bank and the preeminent business-focused financial institution.

PACG and its affiliates maintain a nexus of offices throughout West Africa and have strategic alliances in East Africa, North Africa and the United Kingdom.

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