NIGERIA
FINANCIAL SECTOR REVIEW
(IN THREE VOLUMES)

VOLUME 1: OVERVIEW AND MACRO-FINANCIAL ENVIRONMENT

MAY 2000

Financial Sector Unit
Economic Management and Social Policy Department
Africa Region

Document of the World Bank
CURRENCY EQUIVALENTS

Currency Unit = Naira (N)
US$1.00 = N105.0 (as at May 11, 2000)
N1 = 100 Kobo
<table>
<thead>
<tr>
<th>Abbreviation</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>ACGS</td>
<td>Agriculture Credit Guarantee Scheme</td>
</tr>
<tr>
<td>ADB</td>
<td>African Development Bank</td>
</tr>
<tr>
<td>AFEM</td>
<td>Autonomous Foreign Exchange Market</td>
</tr>
<tr>
<td>ATS</td>
<td>Automated Trading System</td>
</tr>
<tr>
<td>BAS</td>
<td>Banks Analysis System</td>
</tr>
<tr>
<td>BOFID</td>
<td>Banks and Other Financial Institutions Decree</td>
</tr>
<tr>
<td>CAR</td>
<td>Capital Adequacy Ratio</td>
</tr>
<tr>
<td>CBN</td>
<td>Central Bank of Nigeria</td>
</tr>
<tr>
<td>CPI</td>
<td>Consumer Price Index</td>
</tr>
<tr>
<td>CSCS</td>
<td>Central Settlement and Clearing System</td>
</tr>
<tr>
<td>DFIs</td>
<td>Development Finance Institutions</td>
</tr>
<tr>
<td>ECOVAS</td>
<td>Economic Commission for West African States</td>
</tr>
<tr>
<td>EIB</td>
<td>European Investment Bank</td>
</tr>
<tr>
<td>EU</td>
<td>European Union</td>
</tr>
<tr>
<td>FGN</td>
<td>Federal Government of Nigeria</td>
</tr>
<tr>
<td>FHA</td>
<td>Federal Housing Authority</td>
</tr>
<tr>
<td>FMBN</td>
<td>Federal Mortgage Bank of Nigeria</td>
</tr>
<tr>
<td>FMFL</td>
<td>Federal Mortgage Finance Limited</td>
</tr>
<tr>
<td>FMWH</td>
<td>Federal Ministry of Works and Housing</td>
</tr>
<tr>
<td>FSRCC</td>
<td>Financial Sector Regulation Coordinating Committee</td>
</tr>
<tr>
<td>IAS</td>
<td>International Accounting Standards</td>
</tr>
<tr>
<td>IFEM</td>
<td>Inter-Bank Foreign Exchange Market</td>
</tr>
<tr>
<td>IPO</td>
<td>Initial Public Offering</td>
</tr>
<tr>
<td>MIS</td>
<td>Management Information System</td>
</tr>
<tr>
<td>MOF</td>
<td>Ministry of Finance</td>
</tr>
<tr>
<td>MRR</td>
<td>Minimum Rediscount Rate</td>
</tr>
<tr>
<td>NACB</td>
<td>Nigerian Agricultural and Cooperative Bank</td>
</tr>
<tr>
<td>NAICOM</td>
<td>National Insurance Commission</td>
</tr>
<tr>
<td>NBCB</td>
<td>National Board for Community Banks</td>
</tr>
<tr>
<td>NBCI</td>
<td>Nigerian Bank for Commerce and Industry</td>
</tr>
<tr>
<td>NBFi</td>
<td>Non-Bank Financial Institutions</td>
</tr>
<tr>
<td>NDIC</td>
<td>Nigerian Deposit Insurance Corporation</td>
</tr>
<tr>
<td>NEB</td>
<td>Nigerian Education Bank</td>
</tr>
<tr>
<td>NERFUND</td>
<td>National Economic Reconstruction Fund</td>
</tr>
<tr>
<td>NEXIM</td>
<td>Nigerian Export-Import Bank</td>
</tr>
<tr>
<td>NHF</td>
<td>National Housing Fund</td>
</tr>
<tr>
<td>NIDB</td>
<td>Nigerian Industrial Development Bank</td>
</tr>
<tr>
<td>NSE</td>
<td>Nigerian Stock Exchange</td>
</tr>
<tr>
<td>NSITF</td>
<td>Nigerian Social Insurance Trust Fund</td>
</tr>
<tr>
<td>OMO</td>
<td>Open Market Operations</td>
</tr>
<tr>
<td>PBN</td>
<td>Peoples Bank of Nigeria</td>
</tr>
<tr>
<td>PLAMs</td>
<td>Price-Level-Adjustable Mortgages</td>
</tr>
<tr>
<td>PMI</td>
<td>Primary Mortgage Institutions</td>
</tr>
<tr>
<td>SEC</td>
<td>Securities and Exchange Commission</td>
</tr>
<tr>
<td>SME</td>
<td>Small and Medium-Scale Enterprises</td>
</tr>
<tr>
<td>SMF</td>
<td>Secondary Mortgage Facility</td>
</tr>
<tr>
<td>SRO</td>
<td>Self-Regulating Organization</td>
</tr>
<tr>
<td>SSM</td>
<td>Second-Tier Securities Market</td>
</tr>
<tr>
<td>STBs</td>
<td>Special Treasury Bills</td>
</tr>
<tr>
<td>UDB</td>
<td>Urban Development Bank</td>
</tr>
<tr>
<td>VAT</td>
<td>Value Added Tax</td>
</tr>
</tbody>
</table>
# TABLE OF CONTENTS

PREFACE........................................................................................................................................................................5

EXECUTIVE SUMMARY ..................................................................................................................................................6

1. OVERVIEW OF THE FINANCIAL SYSTEM ...........................................................................................................21
   A. INTRODUCTION.................................................................................................................................................21
   B. REGULATORY AND SUPERVISORY INSTITUTIONS ..........................................................................................22
   C. THE BANKING SYSTEM ................................................................................................................................23
   D. NON-BANK FINANCIAL INSTITUTIONS (NBFIS) ..............................................................................................24
   E. FINANCIAL MARKETS... .....................................................................................................................................25

2. MACRO-FINANCIAL ENVIRONMENT ...................................................................................................................26
   A. MACROECONOMIC OVERVIEW ............................................................................................................................26
   B. FINANCING GOVERNMENT DEFICITS .................................................................................................................27
   C. MONETARY AND CREDIT DEVELOPMENTS.........................................................................................................28
   D. STRUCTURE OF INTEREST RATES ........................................................................................................................28
   E. SAVINGS AND INVESTMENT .................................................................................................................................29
   F. FINANCIAL SECTOR POLICIES ............................................................................................................................29
   G. FINANCIAL DEEPENING .....................................................................................................................................33
   H. MONETARY POLICY AND THE FINANCIAL SYSTEM .........................................................................................34
LIST OF FIGURES

Figure 1.1.  Distribution of Financial System Assets (excl. central bank), (%), 1998 ......................21
Figure 2.1.  Saving-Investment Gap, 1993-98 (% of GDP) .................................................................30
Figure 2.2.  Financial Depth (M2/GDP) (%), 1993-98 .......................................................................34

LIST OF BOXES

Box 2.1.  Implicit Taxation of the Nigerian Banking System ...............................................................32
PREFACE

This report is a comprehensive review of the Nigerian financial system, covering the following areas: i) macro-financial environment; ii) safety and soundness of the banking system; iii) banking supervision; iv) development finance institutions; v) community banks and commercial banks’ rural operations; vi) insurance and pensions; vii) housing finance; viii) money and capital markets; and ix) term finance and leasing. The chapter on the banking system was originally part of a White Cover Report released in July 1999. That report was based on data and other information collected during a January 1999 mission. Other chapters were based on findings of a second Financial Sector mission in October 1999.

The review had two major objectives:

?? To assess the safety and soundness of the financial system, especially the banks which were believed to be in near crisis.

?? To evaluate the major constraints facing the financial system and its ability to support economic development and to formulate actions and policies to address these constraints.


This report was prepared under the oversight of Gerard Byam (Sector Manager, AFTPF) and Yaw Ansu (Country Director, Nigeria). Contributors to the report were: Abayomi Alawode (Economist/Task Manager, AFTPF), Paul Murgatroyd (Lead Specialist, AFTPF), Salomon Samen (Senior Economist, AFTM3), Don McIsaac (Lead Specialist, FSD), Carlos Cuevas (Principal Financial Specialist, FSD), Alain Laurin (Principal Financial Specialist, FSD), Fatouma Ibrahima Wane (Financial Analyst, FSD), Loic Chiquier (Senior Financial Officer, FSD) and Miguel Navarro-Martín (Financial Sector Specialist, EASFS). Greg Nzekwu (Economist, AFMNG) provided support from the Nigeria Country Office and Georgette Johnson provided secretarial assistance. Khalid Siraj (Consultant), Patrick Honohan (DECRG) and Anil Chandramani (IFC) served as Peer Reviewers for the report.

This report has benefited from the excellent cooperation of officials of the Central Bank of Nigeria (CBN), Nigeria Deposit Insurance Corporation (NDIC), the Ministry of Finance (MOF), National Insurance Commission (NAICOM), Nigerian Social Insurance Trust Fund, (NSITF), National Board for Community Banks (NBCB), Securities and Exchange Commission (SEC), Nigerian Stock Exchange (NSE), as well as numerous individuals at various bank and non-bank financial institutions in both Lagos and Abuja.
EXECUTIVE SUMMARY

Overview

1. The Nigerian financial system is one of the largest in sub-Saharan Africa, consisting of a fairly diverse array of banking and non-bank financial institutions, including 89 commercial and merchant banks, over 1000 rural-oriented community banks, the Peoples’ Bank, 7 development finance institutions (DFIs), 229 licensed finance companies, about 195 primary mortgage institutions, over 100 insurance companies, 5 discount houses, various pension schemes and over 100 bureaux de change. There are also embryonic money and capital markets. However, the apparent diversified nature of the system is deceptive as commercial banks overwhelmingly dominate the financial sector (accounting for 93% of non-central bank assets) and traditional bank deposits represent the major forms of financial savings.

2. Overall, the financial system is not effectively supporting real sector development and is currently not in a position to fulfill its potential as a propeller of economic growth and development. The formal financial system is relatively shallow, with an M2/GDP ratio of 13% in 1998 and a relatively low level of credit to the private sector at 9.5% of GDP. Although the banking system has largely recovered from the recent crisis, the performance of non-bank financial institutions has been generally disappointing. A parallel World Bank review of financing for Rural Micro and Small-Scale Enterprises has also found that the absence of efficiently operating rural financial markets in Nigeria has become a serious constraint on sustainable rural development. In sum, both the formal and informal financial sectors in Nigeria are not currently in a position to effectively support a strong expansion of the real sector and maximize their contribution to economic growth and development.

3. The Financial Sector and Poverty Alleviation. The malfunctioning of various components of the Nigerian financial system impedes poverty alleviation in many ways, including inter alia:

?? A chaotic housing finance industry means that many Nigerians cannot afford decent housing and end up living in urban slums.

?? Small and Medium Scale Enterprises (SMEs), which have substantial potential for employment generation, currently lack reliable access to long term (and often short-term) credit and other financial services due to the underdevelopment of leasing, the disappointing performance of community banks and the crippled state of DFIs.

?? Most of the poor live in the rural areas but the rural banking infrastructure (commercial and community banks and NACB) have not been able to make

---

1 See Financing Nigeria’s Rural Micro and Small-Scale Enterprises, Yellow Cover Report, World Bank Rural Development 2, Africa Region.
significant contributions to rural development through providing widespread access to financial services.

?? A fragmented pensions industry with limited coverage does not adequately protect most Nigerians (and their families) from falling into poverty upon the death or retirement of the primary income-earner.

4. With over 70 million Nigerians now living in poverty, sustained and equitable economic growth is key to alleviating chronic poverty. There is abundant empirical evidence on the linkages between a strong, efficient and diversified financial system and economic growth. The declared strategy of private-sector led growth can only succeed if the financial sector is in a position to provide effective support for the real sector. At this juncture, this is not the case in Nigeria. Therefore, there is an urgent need for the Nigerian authorities to address key problems identified in the following paragraphs if the Nigerian financial system is to make its maximum contribution to economic growth and development.

Main Findings and Recommendations

5. **Macro-financial environment.** Although some risks remain with regard to fiscal discipline and consistency of monetary and financial policies, there have been substantial recent improvements in the macro-financial environment. Notably, inflation dropped from 73% per annum in 1995 to 6.8% by end-1999, significantly improving the atmosphere within which financial institutions and markets operate. Monetary policy is functioning reasonably satisfactorily and financial repression has been virtually ended with real interest rates on savings moving largely to positive levels. However, more recent data indicate some deterioration in the macroeconomic environment. In 1998, real GDP growth slowed down to 2.4% due mainly to the softening of international oil prices and the external position came under pressure, with a current account deficit representing 3.5% of GDP. The fiscal balance returned a deficit amounting to 4.7% of GDP and deficits for the first five months of 1999 were 8.3% of GDP, compared to IMF program projections of 5.8%.

6. Although the macro-financial framework has generally strengthened, there is room for improvement in several areas. Hence, the following recommendations are made with respect to the macro-financial framework in Nigeria:

?? consideration should be given to stating limits on government borrowings from the CBN in absolute cash amounts or as percentages of past revenues and the CBN should firmly exercise its newly-gained autonomy and enforce the agreed limits on government borrowings.

?? the authorities should address the problem of wide spreads by focusing on the key problems underlying wide interest spreads such as high costs of sorting cash.

---

2 The chapter on the banking system was originally part of a White Cover Report released in July 1999. That report was based on data and other information collected during a January 1999 mission. Other chapters were based on findings of a second Financial Sector mission in October 1999.
inadequate financial infrastructure (e.g. poor payments system), high unremunerated reserve requirements as well as the burden on banks from loss-making rural branches.

the requirement for banks and other financial institutions to invest 10% of their loans and advances in the National Housing Fund should be abolished.

once fiscal deficits are firmly under control, there is a need to consider reducing reserve requirements or allowing them to earn interest at market rates.

7. **The Banking System.** The financial condition and soundness of the commercial banking system has strengthened significantly in the last several years. The authorities have closed 31 banks, increased minimum paid-in capital requirements ten-fold to N500 million (N1 billion for new banks) and forced the majority of the remaining banks into compliance. Evidence of banking system strengthening, largely as a consequence of these actions and improving macro-economic conditions, include: i) aggregate banking system capital increasing from negative 74% to a positive 5% of risk adjusted assets; ii) aggregate non-performing loans dropping from 34% of gross loans to 18%; iii) a drop in insider lending of 66% in absolute terms to 15% of capital for healthy banks; iv) a drop in non-interest expense from 12.8% to a still high 10.3% of average total assets; and v) clearly evident but hard to quantify improvements in banking system profitability which are reported at 5% of assets for the most recent period available.

8. The banking system is also improving structurally as: i) the four largest banks now control a relatively low combined 38% of system assets; ii) the number of government controlled banks has dropped from 20 in 1996 to 10 banks at end-1998 with a combined 4.6% of banking system assets; iii) 23 banks holding a 53% market share are listed on the stock exchange; and iv) foreign banks, which potentially catalyze innovation, play a small but increasing role controlling 2 banks with a 4% market share and holding minority investments in 13 other banks. Government’s recent decision to eliminate regulatory differences between commercial banks and merchant banks is a constructive step given the narrowing of the differences between the two types of institutions over the years, the potentially greater instability associated with the merchant bank structure and the unequal playing field they faced.

9. NDIC’s administered deposit insurance system and 15 tribunal courts established under a 1994 Failed Banks Decree are functioning sufficiently effectively to begin rebuilding confidence in the banking system. On balance, the banking system has strengthened to such an extent that it is now ready to resume a critical role as an engine for economic growth in Nigeria.

10. Nonetheless, serious problems remain. Many banks are taking imprudently high foreign exchange risk, with 36 banks, representing 52% of system assets, holding net foreign exchange positions in excess of 50% of net worth. Also, as of September 1998, 14 banks involving 2% of system assets were classified as distressed (capital of under 2% of assets). A number of these have negative net worth (predominantly government owned banks), some for a number of years. Cease and desist orders have been issued for the troubled banks and 7 banks have been *de facto* closed. Unfortunately, it has taken a
long time for depositors in these “closed” banks to be repaid because formal liquidation proceedings were not initiated. As at September 1999, however, NDIC had paid out N3.02 billion out of the total N5.01 billion insured in the 31 liquidated banks.

11. An additional 7 banks, four classified as potentially distressed, appear to remain at risk and there are still several otherwise sound banks that have not yet fully complied with the new paid-in capital requirements. It is therefore recommended that: i) licenses be revoked for all closed banks as soon as possible; ii) classification of banks as distressed be made automatically and quickly when they fall below the defined quantitative thresholds; and iii) any banks still not in compliance with minimum capital be treated as distressed banks and subjected to penalties if they are not forced out of existence.

12. **Banking Supervision.** Despite a number of weaknesses, the banking supervision framework displays a set of regulatory rules and procedures which are generally in compliance with the standards necessary for reasonably effective banking supervision. With adequate backing from the legal framework, the authorities have done a remarkably effective job in the difficult arena of dealing with troubled banks. An assessment of the supervisory framework against the 30 Basle core principles (inclusive of 5 sub-principles under the first core principle) indicates that 9 are fulfilled, 11 are largely fulfilled, 5 are largely unfulfilled and 5 are unfulfilled. Of particular importance, the regulation on loan classification and provisioning is in compliance with Basle requirements and its enforcement is scrutinized during onsite inspections. A major concern for banking supervision is the transfer of the responsibility for supervising all non-bank financial institutions to the CBN, which does not at this juncture have either the human resources or the necessary established policies and procedures to provide adequate oversight for these institutions. The overlapping roles of CBN and NDIC in conducting both off-site and on-site supervision also poses risks in terms of fragmentation, confused signals, coherence, coordination and efficiency. It is recommended that their respective roles and responsibilities be more clearly defined to reduce ambiguity and overlap and to enhance coordination.

13. Consideration should be given to implementing a widespread “housecleaning” by de-licensing non-bank financial institutions that do not meet capital requirements or are seriously deficient in reporting, and instituting a quality upgrading of those that remain by imposing strengthened requirements, e.g., increasing paid-in capital requirements. Priority might be given to first tackling those institutions that take deposits (i.e., community banks and primary mortgage institutions) to limit future depositor losses (as these deposits are uninsured). Institutions that do not have access to deposits are likely to be more resource constrained and the naira losses associated with their ongoing operations may be less open-ended.

14. Other recommendations relating to banking supervision include: i) devoting adequate resources to upgrade IT systems and automation capacity; ii) adopting higher minimum capital requirements for banks than the present 8% of risk adjusted assets; iii) leveraging the credit information system database by incorporating it into the CBN and NDIC supervisory and on-site procedures; iv) adopting more stringent limitations and penalties related to unsafe insider and related party lending; v) either licensing or closing
every community bank; and vi) passing legal amendments to remove conflicting legal clauses relating to CBN’s assumption of full responsibility for supervising PMIs and other NBFIs.

15. **Development Finance Institutions (DFIs).** Traditionally the major source of long-term debt capital for the real sector, DFIs have been increasingly marginalized and present a dismal financial picture:

- a) a combined annual loss, for the most recent fiscal year for which financial statements were available, of N2.1 billion or about 8.6% of average total assets.
- b) accumulated losses in year-end balance sheets of N 10.2 billion (44.5% of assets).
- c) negative net worth of N5.8 billion (25.2% of assets).
- d) a gross loan portfolio adding to N17 billion. For the four DFIs for which data were available, 78% of the loan portfolio was non-performing.
- e) Government investment, inclusive of external loans (assumed to be guaranteed) of roughly N33 billion with an additional N10.5 billion required if capital is to be raised to 15% of total assets.
- f) virtually no 1998 disbursements by four of the seven DFIs, and a net decrease of N2 billion for the seven DFIs as a group.
- g) combined total assets declined almost 17.8% in nominal terms in the most recent reporting year.

16. While this depicts an urgent and serious crisis for the sub-sector, from an overall national perspective the situation does not represent serious crisis because these institutions represent a small part of the financial sector (total assets are only 3% of commercial/merchant bank assets). Also, importantly, DFIs do not have access to public deposits and are, therefore, subject to a relatively hard budget constraint. As a group, these institutions will continue to lose money, but under the hypothetical assumption that no new funds are injected, rough incremental losses, exclusive of interest expense on already borrowed funds, should not exceed N1 billion a year in administrative expense (minus amounts collected) plus any losses on the limited new lending that may take place. On the other hand, if the DFIs are sufficiently recapitalized such that they continue to operate as they are, they impose a high cost on the economy in terms of wasted resources, continue to infuse the overall financial sector with an increased level of inefficiency and corruption, and discourage more efficient commercial banks from entering the long-term finance arena.

17. While each DFI has unique problems, and the relative importance of the varying causes of their problems may differ, a number of more generic causes often play a role, including: i) non-commercial governance that gives higher priority to developmental than commercial objectives; ii) politicization of lending due to government ownership; iii) lack of quality internal direction given an absence of qualified Boards of Directors; vi) a poor credit disciplinary environment in which many borrowers may not take their responsibility to repay seriously (especially when government-owned lenders are involved); vii) a lack of sub-sector diversification which further raises already high risks associated with DFIs that lend predominantly long-term in developing economies; ix) inadequate appraisal, supervision and collection skills and procedures; x) inappropriate funding vehicles (e.g., funds requiring assumption of foreign exchange risk) vis. the
targeted borrowers; xi) demoralization and loss of quality staff; xii) cumbersome administrative structures and lending patterns dictated by regional considerations; xiii) inability to compete for the best customers; xiv) use of subsidized funds which encourages diversion of funds to unintended purposes; and xv) a lack of market discipline. On the positive side, the CBN has recently taken over responsibility for supervising and regulating DFIs and this could lead, at the initial stage, to more transparent accounting policies that are largely consistent with those followed in the commercial banking system.

18. Nigeria will face a seriously constrained level of term finance for its real sectors for a considerable period of time. Therefore, while the primary strategy for mobilizing long term finance should focus on utilizing commercial banks, this funding source can be augmented by creating a much more focused, streamlined, administratively cheaper and operationally effective DFI framework. Elements in such a plan might include the following:

?? Nigeria should concentrate financial resources and skills on fundamentally restructuring 3 DFIs i.e. NERFUND, NIDB, and NACB (discussed in a separate Rural Finance Study), which have the best potential for success and/or play a role that it would be difficult for commercial banks to duplicate, while liquidating the other four DFIs (but merging NEXIM’s financial functions into NERFUND).

?? Generic steps that should be taken to strengthen all DFIs that remain in existence include: i) placing them under the Ministry of Finance (as well as CBN) rather than sector ministry oversight and appointing highly qualified, commercially oriented Boards of Directors; ii) ensuring that they are run by highly competent commercially sophisticated CEOs; iii) subjecting them to the same regulatory standards as commercial banks in most respects, including loan classification and provisioning, but with strengthened minimum capital requirements; iv) seeking private participation ownership to the extent feasible; v) designing and implementing strategies for raising debt capital from non-governmental sources; vi) formulating and implementing comprehensive reforms and revising operational policies and practices; vi) preparing a solid financial foundation through conducting audits of 1999 financial statements in accord with international principles, and vi) eliminating subsidized interest rates to final borrowers.

?? Consideration should be given to merging NEXIM’s financial functions into NERFUND to create one strong well managed apex to provide a clear focal point for providing long-term funds on a non-subsidized basis through the commercial banking system for developmental needs. This apex should lend only on a wholesale basis to creditworthy financial institutions, utilize its ability to debit accounts at CBN to collect, raise interest rates to financial institutions to reduce incentives for diversion of funds to non-targeted purposes, remove all limitations on what intermediaries can charge final borrowers, eliminate most of the subproject approval role (other than ascertaining final borrower’s business fits the line of credit objectives), and attempt to reduce administrative costs to less than 1% of total assets.
NIDB, while its financial condition, skills and culture have eroded substantially in recent years, retains a substantial reservoir of skills and resources that remain relevant to Nigeria’s medium/large scale industry and small scale enterprise long-term credit needs. It already is a much more substantial player than NBCI in SME lending, and has at least as suitable a geographical administrative support structure for onlending, better developed credit and administrative support procedures and much superior performance and capability. Therefore, NBCI could be partially merged into NIDB by transferring only elements that strengthen NIDB with NIDB in turn asked to place considerably more emphasis on SME lending. Such a partial merger might involve i) transferring NBCI liquid assets and relevant fixed assets to NIDB in the form of a capital contribution; ii) closing NBCI zonal offices and turning the loan portfolio over to professional debt collectors; and iii) transferring existing debt to Government (which already has responsibility for this debt anyway).

However, NIDB needs fundamental restructuring before any recapitalization is considered. In addition to implementing all the generic changes as listed above, NIDB should consider such restructuring steps as: i) packaging existing attractive equity investments in a unit trust to be sold to raise cash for future lending; ii) increasing noninterest income and diversification, possibly by developing a merchant banking/financial consulting business; iii) limiting all future long-term foreign currency lending to de facto exporters who can hedge foreign exchange risk; iv) cutting administrative costs to less than 5% of total assets; v) eliminating any new investment in real estate; and vi) retaining a reputable international firm to audit the 1999 financial statements in accord with international principles and CBN requirements relating to provisions and suspension of interest.

If the above restructuring is well underway, Government could strengthen NIDB’s capital position, without the infusion of new cash by assuming full responsibility for NIDB’s remaining debt (which Government already guarantees) to the European Investment Bank (EIB) and African Development Bank (ADB). Immediately, thereafter, NIDB, with its strengthened financial position and more commercially oriented governance, can aggressively seek: i) a private strategic investor or investors who would take primary responsibility for management; and ii) debt capital in foreign exchange from multilateral sources and in domestic currency through sources such as NERFUND, NSITF, and the larger insurance firms.

Community Banks and Rural Commercial Banking. While the potential contribution of the largely rural community banking system to extending the outreach of financial services is important, its performance to date has been disappointing. While collectively important, community banks are individually weak, undercapitalized, too small and of limited outreach. Of the 1368 community banks that were established, 354 have been closed, only about 200 are believed to be profitable, and most of the 380 banks that have not filed mandatory returns/reports are probably insolvent.

Using data on 262 banks which systematically rendered returns to the NBCB between 1996-98, we observed that overall performance in terms of the growth of assets, deposits and loans has been modest. The smallest banks have been struggling during the
last 3 years, unable to maintain the real value of their asset portfolio and further reducing their capital while overhead costs continue to increase relative to their total assets. Medium sized banks and particularly the large banks have however shown modest growth and gradually improving profitability and capitalization.

22. Constraints faced by community banks include: i) Board controls on their lending rates; ii) lack of access to the clearing house and the associated high costs of using commercial banks as correspondents (estimated at 20% of overhead); iii) in several community banks, close involvement of directors in regular management affairs leaves room for insider lending and portfolio concentration in associated businesses; iv) inability to exploit "economies of association" as community banks merely represent a collection of isolated entities with common characteristics but no arrangement (e.g. a second-tier organization or federation) to pool reserves and spread risks across the network; and v) virtual lack of computer equipment as most community banks handle operations manually.

23. The community bank industry is in urgent need of consolidation and recapitalization. Quasi-equity financing could be invested in better performing banks. This consolidation process should produce 300-400 fully licensed community banks, with about 600 others closed or acquired. In addition, capital standards may need to be raised for community banks relative to commercial banks and Board interest rate ceilings on community bank lending should be removed.

24. It is recommended that a second-tier institution be established for community banks to take over technical assistance, training and promotion services. It could also develop a liquidity facility for community banks to help diversify risks and smooth liquidity fluctuations over the entire system. The present NBCB board should be closed.

25. The challenges faced by the CBN in supervising a large number of community banks and other institutions could be mitigated if the current staff of NBCB inspectors could be utilized to augment supervision of community banks.

26. A number of commercial bank rural branches were opened in the 1980s under a CBN mandate which required banks to establish branches in remote, rural localities where banking services are often absent. These branches take deposits from the general public, make payments and transfers and provide correspondent bank services for community banks and the Peoples' Bank.

27. Most of these branches have a considerably scaled-down level of operations (in line with the level of economic activity in their rural locations), with reduced hours of operation, many opening for business just twice a week to coincide with market days. Although many rural branches are not viable and are "loss-centers" for the banks concerned, current CBN regulations prohibit the closure of commercial bank rural branches. These regulations should be amended to prohibit closures of these branches only in localities where no other commercial bank or successful community banks exist.
28. **Housing Finance.** The present housing finance system consists of a two tier institutional structure comprising: i) a Federal Mortgage Bank of Nigeria (FMBN) which has mobilized about N4 billion through a National Housing Fund (essentially a de facto tax on banks, insurance companies and salaries) for wholesale lending through primary mortgage institutions (PMIs); and ii) 195 PMIs of which the largest, FMFL, is government-owned. The performance of the mortgage sector to date has been disappointing as less that 20 PMIs are operationally active, formal housing investment constitutes only 1.7% of GDP, and home-ownership ratios are relatively low.

29. Over the past 6 years, the NHF has disbursed a modest N75 million (corresponding to 141 individual loans (i.e. 1 borrower per 4000 contributors) from the N4 billion mobilized. Unfortunately, most of NHF’s long term funds (administered through the FMBN) are invested short term in bank deposits and treasury bills (at a time when Nigeria has a serious shortage of long term funds for investment). Moreover, most PMI funding is short term so only 14% is invested in mortgages, while PMIs’ assets are dwindling and many, if not most, are experiencing financial distress. They are also not effectively supervised. While the primary mortgage market is moribund, the secondary mortgage market is non-existent.

30. Commercial banks offer much better long-term potential than PMIs as channels for increasing mortgage lending in Nigeria given their comparative advantage in terms of their larger size, cheaper, more stable funding through core deposits and large distribution networks. It is also feasible to develop secondary mortgage markets by encouraging sales of mortgage portfolios across banks, PMIs and insurance companies.

31. It is recommended that the housing finance structures and processes be fundamentally changed by taking the following actions over the next several years:

   a) The 1989 PMI decree should be amended to make it fully congruent with CBN’s taking regulatory and supervisory control of PMIs. PMI statutory reserves should be transferred from FMBN to CBN. CBN and FMBN should improve coordination with CBN utilizing FMBN supervisory personnel in the supervision of PMIs and should providing FMBN with copies of reports it receives from PMIs as inputs to FMBN’s NHF accreditation practices.

   b) Sound PMIs should be allowed to expand the scope of their lending somewhat and be allowed direct access to the treasury bill market. Providing such PMIs with deposit insurance coverage should be considered. On the other hand, CBN should move quickly to de-license and close all PMIs that are financially unsound and/or do not meet minimum capital requirements. It is recommended that FMFL be closed.

   c) FMBN accounts should be prepared for FY 1999 and thereafter, treating NHF as a separate entity. If FMBN is to remain essentially a second tier institution, it should sharply cut its branch structure and administrative expense (which is presently 10% of total assets inclusive of NHF), provide NHF with investment and administrative services in return for a transparent administrative fee for services, and focus attention, in accord with its mandate, on catalyzing capital market funding for the mortgage industry.
d) NHF needs to be profoundly reformed if it is to play a meaningful role in supporting housing finance. It is proposed *inter alia* that, in terms of future flows, NHF be made voluntary, interest rates paid to contributors be raised to levels slightly discounted from market rates, with interest rates charged to intermediaries at slightly below treasury bill rates, while removing all caps (or substantially raising them) on interest rates charged by intermediaries. Intermediaries should be expanded to include sound commercial and merchant banks. NHF loans should be more directly correlated to the level of a given contributor’s savings with a limit in terms of a multiplier over the accumulated savings, while collateral and refinancing underwriting review requirements are loosened, and more inflation resistant mortgage loan instruments such as price level adjustable mortgages are adopted to make mortgages more affordable.

e) Development of a secondary mortgage market to augment NHF refinancing should be encouraged through improvements in the mortgage market infrastructure, e.g., increasing mortgage origination fees, eased administrative requirements vis. administrative requirements for transfer of loans and deeds, and reducing the risk weighting of residential mortgages in accord with Basle Accord Guidelines. Once other changes are in place, a Secondary Mortgage Facility (SMF) owned by FMNB and other key institutional investors might be developed to issue market-oriented mortgage bonds to refinance primary mortgage lenders.

32. **Insurance.** The insurance industry is grossly underdeveloped, with premiums received amounting to less than 1% of GDP. The life insurance market is steadily shrinking, non-life companies face numerous problems and a number of insurance companies are distressed. There is a serious problem with unpaid premiums, especially by government agencies and parastatals. Overdue premiums currently amount to 38% of annual premiums, with some arrears dating back several years. Although life insurance companies are a major source of long-term funds in developing countries, the industry is presently investing almost entirely in short-term securities and real estate. The National Insurance Commission (NAICOM) is tackling industry issues in a proactive fashion but has been operating without a Board of Directors for more than four years and is hampered by a lack of resources to carry out its broad mandate.

33. There is an urgent need to prescribe a clear standard for minimum solvency in the industry and shift emphasis from a controls-based supervisory system to solvency monitoring, with onsite inspections focusing on identifying risks to the financial soundness of firms rather than focusing on compliance with regulations. Adequacy of capital should be monitored on a continuous basis through the collection of monthly reports from companies. In making this transition, the Insurance Commission should be made more effective by constituting its Board of Directors as soon as possible.

34. The authorities should take steps to address the problem of unpaid premiums, most of which are owed by government agencies and parastatals. In addition, investment rules should be changed to concentrate on protecting policyholders and providing a rate of return that is consistent with the safety of principal. There is a need to remove supervisory controls over the pricing of insurance products and consideration should be given to permitting foreign investors into the insurance business.
35. **Pensions.** The pension fund industry, another potentially important source of long-term funds is somewhat chaotic. Composed of the Nigerian Social Insurance Trust Fund (NSITF), a number of government-run pension funds for public employees, about 2000 Occupational (company sponsored) pension plans, and personal pension schemes, the system is fragmented. It lacks an adequate overall policy, legal and regulatory framework and there is no empowered coordinating body to supervise it. Existing programs cover only a small proportion of the labor force and there is no portability to support job mobility.

36. The **NSITF**, a mandatory, defined benefit program is facing challenges in collecting contributions due to widespread evasion. It also suffers from a mismatch between the level of contributions and benefits. Other problems faced by the NSITF include: i) high administrative costs amounting to over 60% of total contributions; ii) slow growth in investments; and iii) concentration of investment portfolio in a small number of risky assets and industries (real estate and equities) with little allocation to fixed income securities that can be matched to benefit outflow requirements. If the level of contributions is not raised soon, and administrative expenses brought under control, the financial sustainability of the program will be jeopardized.

37. **Public service pension schemes** cover all employees in the public service including the federal, state and local governments, parastatals and quasi-government organizations (e.g. CBN, the railway corporation, utility companies, universities, and the Ports Authority). To date, approximately 650,000 active members and 130,000 pensioners are registered in various public service schemes. These schemes are defined benefits programs which exhibit the following weaknesses: i) they are largely unfunded and lack periodic actuarial valuations, making it difficult to accurately determine their past and future liabilities; ii) the existence of multiple pension schemes and multiple parties involved in the management of public service pension schemes is inefficient and costly; and iii) there are additional problems with portability.

38. **Occupational pension plans**, 90% of which are defined contribution and the rest defined benefit, cover an estimated 2.5 million people. The majority of the plans are set up as provident funds where employer and employee contributions are limited to 25% of basic salary and benefits provided on a defined contribution basis.

39. **Personal pension plans** are mainly products offered by life insurance companies. They are however not common in Nigeria as widespread unemployment and low pay for many workers make pension plans and other insurance products unaffordable and/or superfluous. These plans are not regulated or supervised by NAICOM, which regulates and supervises the insurance industry.

40. A single, coherent **National Pension Strategy** is required to overcome individual weaknesses and ensure old age income security as NSITF's long term financial sustainability in question, public pension schemes largely unfunded and company-sponsored and individual schemes so diverse in nature. Such a strategy could be built
around a two tier approach in which mandatory and optional savings are included and a minimum benefit is guaranteed.

41. The first tier could be a mandatory, publicly managed, defined benefit scheme. It could be re-distributive, and provide a minimum benefit guaranteed by the government to co-insure against long spells of low investment returns, recessions and inflation. The minimum benefit could take the form of an employment-related flat benefit or a minimum pension guarantee. The parameters of a new system (contributions, benefits, eligibility requirements, etc.) should be based on a detailed financial and actuarial analysis to ensure its long term sustainability.

42. Funding for the first tier should come from limited contributions by all employers and employees and/or from the Government’s General Revenue. This will require a formal commitment from the Government to make funding available on a regular basis (from other taxes/income) and, ideally the creation of a pension fund reserve (from privatization proceeds).

43. The second tier should be a voluntary system that incorporates all current voluntary and occupational schemes. All schemes would be regulated and supervised by a central regulatory agency (e.g. a National Pension Agency) that would ensure their financial sustainability and compliance with their own rules and regulations. This agency will also be in charge of promoting voluntary and occupational plans by providing the necessary incentives and establishing the minimum criteria they should follow to be granted tax exemption (e.g. annual audits, asset segregation and governance structure, safe custody of assets, guarantees, etc.).

44. This proposal has various implications for the various pension schemes currently operating in Nigeria:

?? NSITF could become the government’s agency administering the first tier (mandatory defined benefit scheme). The current NSITF system would then have to be redefined and expanded to include public service employees and an in-depth reorganization would be required to make it more efficient and less costly. Such a reorganization might include, but not be limited to, improving/streamlining collections (particularly compliance), record keeping, information systems, investment strategies, and payments. Particular attention should also be given to the investment strategy to make benchmarks/targets consistent with the actuarial projections and maintain the long-term financial viability of the first tier. This strategy would have to be limited in scope until the provisions of the Trustee Investment Act are relaxed somewhat and other investment restrictions are lifted (e.g. investments abroad or in foreign securities) and new investment alternatives are created in the local markets. If NSITF is not chosen to administer the first tier, the government could opt to contract out the administration of this tier (but keeping its guarantee).

---

3 There is a need for extensive dialog with the authorities on the details of this proposal.
4 Re-distribution occurs when a minimum universal benefit financed with pooled contributions is on average worth more to those with lower lifetime income than those with higher lifetime income.
Public Service Employees could also participate in the first tier (mandatory defined benefit scheme). Current pension schemes could become part of the second tier (voluntary and occupational plans) but under new parameters. The basis for the computation of contributions and benefits should be equal for all and the system would desirably be funded to facilitate portability.

45. Other recommendations pertaining to the pension system include: i) the reporting and collection system for NSITF needs considerable improvement; ii) NSITF should consider extending its coverage to include the agricultural sector; and iii) early withdrawals from personal pension plans threaten the main objectives of a pension plan and should not be allowed.

46. The money market. The value of money market instruments grew by over 60% between 1994 and 1998 but the market is still overwhelmingly dominated by government treasury bills, although there has been a sharp increase in the inter-bank funds market in the last couple of years. The market is relatively illiquid (transactionally) and further development of the market has been hampered by instability in government macroeconomic and financial policies as well as inadequacies in the payments system. Although discount houses have played an important role in the implementation of OMO and in providing liquidity to cash-strapped banks, their continued survival in the present form is questionable. Their use for OMO auctions should disappear once the CBN becomes more adept at handling the logistics of conducting indirect monetary policy. As the revival of the inter-bank market reduces business volume for discount houses, there is a need to clarify what their medium to long-term role would be.

47. In order to improve the functioning of the money market and further promote its development, it is necessary to:

- Ensure macroeconomic and policy stability to reduce uncertainties and increase transactional liquidity
- Address auction failures of treasury bills by fully deregulating rates and injecting more competition by allowing the direct participation of insurance companies and other interested investors
- Increase transactional liquidity by increasing the volume of treasury bills available for trading through: i) substantially reducing CBN absorption of treasury bills; and ii) relaxing portfolio restrictions and lowering liquidity ratios which force banks and discount houses to hold excessive amounts of bills in their portfolios.
- Upgrade the payments and settlement system to facilitate the transfer of funds to Lagos where all money market activities currently take place.

48. The Capital Market. Although market capitalization increased seven-fold between 1993 and 1996, the capital market remains underdeveloped representing only 0.5% of financial sector assets, with market capitalization currently at 9% of GDP, and a still low turnover of 5.2%. There is little diversification of securities traded as over 95% of transactions is in equities, new issues are small in number and the bond market is moribund. Constraints on foreign participation have been lifted but given the high cost of
transactions and the instability of macroeconomic and financial policies, foreign investors have not entered the market in force.

49. To enable the capital market to effectively play its role in mobilizing and allocating long term funds, there is a need to:

?? Lower transaction costs to encourage trading, improve liquidity and promote share ownership

?? Stabilize government macroeconomic and financial policies to create a favorable enabling environment

?? Increase demand and supply for securities through: i) resuming and sustaining the privatization exercise; ii) conducting an awareness campaign on the benefits of listing, especially for SMEs; and iii) removing portfolio restrictions to encourage wider participation by institutional investors

?? Reinvigorate the bond market by: i) making the pricing of bonds less rigid and more competitive; and ii) resuming the issuing of competitively priced government bonds to serve as benchmark. The recent establishment of a credit rating agency (Duff and Phelps) in November 1999 should help foster confidence in the bond market.

?? Complement the newly-issued Investment and Securities Decree (ISD) by strengthening the capacity of the SEC (manpower and technology) to maintain effective surveillance and enforcement.

50. **Term Finance.** There is a chronic shortage of term finance in Nigeria as over 96% of bank loans have maturities of 12 months or less. Other potential source of long term debt capital—development finance institutions, insurance companies, pension funds and the capital market—are currently not in a position to fulfil their potentials in this regard. On the demand side, there is a lack of “bankable” projects due to the distressed state of the real sector. Slow GDP growth in recent years, falling sales and profits, and the collapse of basic infrastructure in the country have substantially increased credit risks associated with lending to the real sector. Private enterprises are also not motivated to undertake new investment in plant and equipment.

51. In order to encourage the availability of long term debt capital, it is necessary to: i) create a stable macroeconomic and policy environment; ii) revitalize the life insurance industry and reform the pension system both of which have stable, long-term liabilities and are therefore natural sources of long term finance; iii) strengthen selected DFIs, PMIs and finance companies (while liquidating those that are insolvent and/or non-viable), to complement the activities of a banking sector that is growing in strength; iv) strengthen the speed, transparency and integrity of contract enforcement mechanisms; and v) take steps to support the recovery of the real sector, particularly through the enhancement of basic infrastructure.
52. **Leasing.** Leasing, which can effectively address the shortage of medium to long-term finance (particularly for SMEs), remains underdeveloped, accounting for only 1% of total domestic investment in 1997. The further growth of leasing is hampered by: i) the lack of a coherent body of law to govern leasing transactions; ii) problems with contract enforcement and difficulties in repossessing leased equipment from defaulting lessees; iii) lack of domestic long term funds to finance leasing; iv) rising costs of equipment; and v) general lack of awareness and the poor skills base in the industry.

53. The further development of the leasing industry would require:

- The promulgation of a Leasing Law, which will indicate the rights, duties and obligations of participants and facilitate the adjudication of cases involving breaches of contract.

- Increasing the number of skilled professionals especially in cash-flow-based credit analysis, asset-liability matching, supervision of clients as well as equipment insurance procedures.

- Educating SMEs and the general public on the potential benefits of leasing, through workshops, seminars and other enlightenment mechanisms.

- Diversifying the sources of leasing finance by tapping insurance firms and pension funds, exploring opportunities for raising equity or bond financing and seeking foreign direct investment, particularly from the International Finance Corporation (IFC).
1. OVERVIEW OF THE FINANCIAL SYSTEM

A. INTRODUCTION

1.1. The Nigerian financial system is one of the largest and most diversified in sub-Saharan Africa. In recent years, the system has undergone significant changes in terms of the policy environment, number of institutions, ownership structure, depth and breadth of markets, as well as in the regulatory framework.

Figure 1.1. Distribution of Financial System Assets (excl. central bank), (%), 1998

1.2. However, in spite of the far-reaching reforms of the past ten years, the Nigerian financial system is not yet in a position to fulfill its potential as a propeller of economic growth and development. The financial system is relatively shallow and the apparent diversified nature of the financial system is deceptive. Although a wide variety of financial institutions and markets exist, commercial banks overwhelmingly dominate the financial sector and traditional bank deposits represent the major forms of financial saving. Non-bank financial intermediation is relatively insignificant (see Figure 1.1).
1.3. The rest of this chapter briefly describes the structure of Nigeria’s financial sector in terms of the regulatory and supervisory agencies, banking and non-bank financial institutions, as well as financial markets.

**B. REGULATORY AND SUPERVISORY INSTITUTIONS**

1.4. Nigeria’s regulatory and supervisory framework is composed of the Central Bank of Nigeria (CBN), the Ministry of Finance, the Nigerian Deposit Insurance Corporation (NDIC), the Securities and Exchange Commission (SEC), National Insurance Commission (NAICOM), and the National Board for Community Banks (NBCB). There is also a Financial Services Regulation Coordinating Committee (FSRCC), charged with coordinating the activities of these regulatory institutions.

1.5. **Central Bank of Nigeria (CBN).** Established in 1958, the CBN is the apex regulatory authority for the Nigerian financial system. It is also in charge of the formulation and implementation of monetary policy. CBN’s main responsibilities include: i) promoting monetary stability and a sound financial system; ii) acting as banker and financial advisor to the Government; and iii) acting as banker and lender of last resort to commercial and merchant banks. CBN’s regulatory and supervisory responsibilities were enlarged and strengthened in 1997 through the Banks and Other Financial Institutions Decree (BOFID), which extended CBN authority beyond the banks to include finance companies, all development banks, the Federal Mortgage Bank of Nigeria, community banks, and primary mortgage institutions (PMIs). In 1999, the CBN was granted legal autonomy in the exercise of its regulatory and monetary policy functions.

1.6. **The Ministry of Finance (MOF).** The MOF cooperates with the CBN on monetary matters. Since 1997, the MOF has chaired the Financial Services Regulation Coordinating Committee (FSRCC).

1.7. **Nigeria Deposit Insurance Corporation (NDIC).** The NDIC, patterned after the USA FDIC, complements the regulatory and supervisory functions of the CBN. NDIC was established in 1988 to provide deposit insurance in order to boost confidence in the banking system. Licensed banks are mandated to pay 15/16 of 1 percent of their total deposit liabilities annually as deposit insurance premium to the NDIC. Depositor claims are insured to a maximum of N50,000 in case of bank failure. Following the recent distress in the banking sector, NDIC was given wide powers over the resolution of insolvent banks.

1.8. **Securities and Exchange Commission (SEC).** Established in 1979, the SEC is the regulatory authority for the capital market. SEC’s major objective is the promotion of an orderly and active capital market to ensure adequate protection of the investing public. The SEC maintains proper standards of conduct and professionalism in the securities business, and surveillance over the market to enhance efficiency. Further to the 1990 Companies and Allied Matters Decree, the SEC was empowered to approve and regulate mergers and acquisitions and authorize the establishment of unit trusts. In addition, the...
Investment and Securities Decree of 1999 has invested the SEC with the additional responsibility of directly promoting and developing the capital market in Nigeria.

1.9. National Insurance Commission (NAICOM). Established in 1997, NAICOM is charged with the regulation and supervision of the insurance industry. Its purview includes: i) establishment of standards for the conduct of insurance business; ii) ensuring that insurance companies maintain adequate capitalization and reserves; iii) ensuring good management of insurance companies; and iv) protection of insurance policy holders.

1.10. National Board for Community Banks (NBCB). The National Board for Community Banks (NBCB) provides support functions for establishing and operating community banks. Until recently, it was also responsible for regulating, and supervising a large number of community banks. The NBCB provides provisional licenses to community banks, while final licenses are to be granted by the CBN, which since 1997 has taken responsibility for community bank supervision.

1.11. The Financial Services Regulation Coordination Committee (FSRCC). The FSRCC was established to coordinate the supervision of all financial institutions. It is chaired by the Governor of the CBN with the following members: i) Director General, Securities and Exchange Commission; ii) Commissioner for Insurance; iii) Registrar-General, Corporate Affairs Commission; and iv) a representative of the Ministry of Finance not below the rank of Director.

C. THE BANKING SYSTEM

1.12. Commercial and Merchant Banks. Financial intermediation is carried out in Nigeria primarily through 89 commercial and merchant banks. These institutions are deposit-taking institutions offering loans (mostly short term) and providing other services. Commercial banks clearly dominate the banking system, accounting for nearly 80% of total (non-CBN) financial assets in 1998. Merchant banks are designed more as wholesale banks but are increasingly emulating commercial banks in the way they operate. They cater for the needs of corporate and institutional customers, and are encouraged to provide medium and long term financing.

1.13. Community Banks. Community banks are rural-oriented financial institutions owned and managed by a community or a group of communities to provide financial services to that community. Each bank has a Community Development Association as its primary sponsor and shareholder and to date, over 1000 community banks have been issued with provisional licenses. Although the CBN is expected to issue formal licenses, to date, no community bank has been granted a formal license.

1.14. Peoples Bank. The Peoples Bank is a target-group oriented credit institution, set up to provide loans to the poor without collateral securities. Borrowers are sometimes organized in groups of 7-10, each group recommending its members and ensuring that members pay back loans.
1.15. Non-bank financial institutions (NBFIs) are essentially non-deposit taking financial institutions that mobilize savings and facilitate the financing of different activities. In Nigeria, NBFIs include: i) development finance institutions (DFIs); ii) finance companies; iii) the mortgage finance industry; iv) the insurance industry; v) pension funds; and vi) discount houses and bureaux de change.

1.16. Although they have the potential to mobilize and allocate significant long-term financial resources, NBFIs still make up only a very small part of the Nigerian financial system with about 6% of financial assets in 1998 (Figure 1.1).

1.17. Development Finance Institutions (DFIs). Nigeria has six DFIs created for each of six major sub-sectors: i) the Nigerian Industrial Development Bank (NIDB), for medium and large scale industries; ii) the Nigerian Bank for Commerce and Industry (NBCI) for small scale enterprises; iii) Nigerian Agricultural and Cooperative Bank (NACB) covering agriculture; iv) Nigerian Export-Import Bank (NEXIM) to promote exporting and importing; v) Urban Development Bank (UDB) to promote the development of urban infrastructure; vi) Nigerian Education Bank (NEB) and vii) Nigerian Economic Reconstruction Fund (NERFUND) for financing small and medium-scale enterprises. NEXIM and NERFUND function essentially as apex institutions, onlending funds to other institutions which then lend to final borrowers.

1.18. Finance companies. Nigeria’s 229 licensed finance companies, following crisis and some scandals in the early 1990’s, have been marginalized, accounting for only 0.6% of total financial assets. Only 88 finance companies are presently submitting required reports to CBN and most of the others are believed to be insolvent.

1.19. Mortgage finance industry. This is comprised of the Federal Mortgage Bank of Nigeria (FMBN), and about 195 Primary Mortgage Institutions (PMIs), of which the Federal Mortgage Finance Limited (FMFL) is government-owned and the largest. The banking system and the insurance industry are taxed to provide funding for mortgages through the National Housing Fund (NHF).

1.20. Insurance industry. Until the recent closure of 19 companies, the insurance industry consisted of 143 insurance companies of which 56 sell life insurance. Within the NBFI group, insurance companies are the most important, growing at a rate of 15% per annum during 1993-97, and accounting for 1.7% of total financial assets in 1997.

1.21. Pension funds. Nigeria’s pension system is composed of a mandatory Nigerian Social Insurance Trust Fund (NSITF), several Public Service Pension Schemes, various Occupational Pension plans sponsored by private companies, as well as Personal pension plans.

1.22. Discount houses and bureaux de change. Five discount houses, largely through buying and selling government debt instruments, have played a valuable role in
supplying liquidity to the banking system and promoting money market development. However, while, their financial performance has been satisfactory, a rapidly growing inter-bank market raises questions with respect to their ongoing role in the financial system. Bureaux de change are authorized dealers in the spot market for foreign exchange and exist mainly to facilitate access to foreign exchange for small users. Since 1997, bureaux de change have been under the direct supervision of the CBN.

E. FINANCIAL MARKETS

1.23. Money market. The Nigerian money market is comprised of the inter-bank funds market as well as the market for instruments such as treasury bills, treasury certificates, certificates of deposit, bankers’ acceptances, commercial papers and short-dated eligible development stocks.

1.24. Capital market. The Nigerian capital market is one of the oldest in sub-Saharan Africa, and key players on the market include the Securities and Exchange Commission as the regulatory body, the Nigerian Stock Exchange (NSE), issuing houses (mainly merchant banks), over 150 stock brokers, 14 unit trusts as well as company registrars. Although stock market valuation grew by over 300% over 1993-1997, the stock market is still very small relative to the whole financial system, with only 0.5% of financial assets in 1997.
2. MACRO-FINANCIAL ENVIRONMENT

A. MACROECONOMIC OVERVIEW

2.1. Between 1993 and 1995, the Nigerian economy experienced serious macroeconomic instability, a situation which posed significant risks to financial institutions and markets. The annual inflation rate stood at 57.2% in 1993, rising to a peak of 73% by end-1995. Fiscal deficits amounted to 15% of GDP in 1993, and international reserves were at very low levels, averaging 1 month of imports over 1993-95. However, the macroeconomic environment began a remarkable turn-around from 1995 onwards, becoming far more conducive to financial sector development:

- After growing at an average of 2% over 1993-95, real GDP picked up slightly and recorded increases of 3.4% and 3.8% in 1996 and 1997 respectively.
- The most outstanding improvement in macroeconomic performance was in the area of domestic prices. Inflation, as measured by the consumer price index (CPI), plunged from a peak of 73% per annum in 1995 to 8.5% by 1997.
- The elimination of chronic double-digit inflation owed much to a sharp narrowing of the overall fiscal deficit (excluding grants) from the equivalent of 15% of GDP in 1993 to 7.7% in 1994. The fiscal accounts actually moved into a modest positive balance in 1995 and remained positive through 1997.
- On the external front, the current account balance swung from a deficit representing 9.4% of GDP in 1995 to a surplus amounting to 8.5% of GDP in 1996 and 1.2% of GDP in 1997 (Annex 1A).
- External reserves jumped from only 1.5 months of imports in 1993 to over 7 months of imports in 1997. With the introduction of the Autonomous Foreign Exchange Market (AFEM) in 1995, the naira exchange rate stabilized at around N81 to the dollar, contributing to the reduction in inflation.

2.2. However, more recent data have revealed some deterioration in the macroeconomic environment. Real GDP growth slowed down to 2.4% in 1998 and due mainly to the softening of international oil prices, the external position came under renewed pressure, with a current account deficit representing 3.5% of GDP in 1998. In sharp contrast to the modest surplus of 1997, the fiscal balance returned a deficit amounting to 4.7% of GDP in 1998 as falling international oil prices plus the substantial outlays associated with the program of transition to democracy put pressures on government finances. Fiscal deficits for the first five months of 1999 were 8.3% of GDP, far higher than the 5.8% IMF

---

5 See Annex 1A for data on selected macroeconomic indicators
6 Deficits however plunged to 7.7% of GDP the following year.
program projection for the whole year. Nonetheless, inflation remains subdued with the consumer price index increasing by 10% in 1998 and falling to 6.8% by end-1999. International reserves shrank significantly between January and May 1999, with gross foreign exchange reserves declining by $2.1 billion dollars\(^7\). There was a build up of reserves thereafter and by end-1999, reserves stood at $5 billion, equivalent to 6 months of imports. The first half of 1999 also witnessed two devaluations of the naira, from N86 to N90 per dollar in March and then to N95 per dollar in early May. The naira has depreciated further with the introduction of the Inter-Bank Foreign Exchange Market (IFEM) in October 1999, and currently trades at over N100 per dollar.

### B. FINANCING GOVERNMENT DEFICITS

2.3. From Annex 1B, it is seen that in recent years, fiscal deficits in Nigeria have been financed principally from domestic sources, especially from the central bank. A breakdown of domestic government debt by holders reveals that the central bank holds an inordinately high proportion of domestic government debt, averaging more than 70% over 1993-1997 and accounting for 81% as at end-1998. Commercial and merchant banks are the next major holders with 10% of total debt as at December 1998. The impact of deficit financing on the banking system is marginal as banking system holdings of government debt on average represent only 8% of total bank assets and have decreased as a percentage of total banking credit from 60.4% of total credit in 1994 to 12.4% in 1997, indicating a considerable reduction in crowding-out as banks reduce their holdings of government securities. The proportion of government debt held by the non-bank public jumped from 12.4% to 20% between 1993 and 1994 but fell back to 9% as of December 1998. Disaggregated data on non-bank public holdings are not available, making more detailed analysis difficult.

2.4. The CBN’s large purchases of government debt is a major source of concern as it directly augments the monetary base and is equivalent to printing money\(^8\). Although inflation is currently under control, there is a danger of a re-emergence of inflationary pressures if the central bank continues to be a major source of fiscal accommodation. There is therefore a need for the central bank to exercise its newly-gained autonomy and enforce the agreed limits on government borrowings which currently stand at 12.5% of expected revenue. However, consideration should be given to reviewing how the lending limits are defined. The current lending limit, expressed as a percentage of expected revenue, is too loose as it allows the government to be over-optimistic in its revenue projections. Limits couched in absolute cash amounts or as percentages of past revenues are more binding. However, regardless of how the lending limits are defined, the important task is to ensure that such limits are respected and enforced.

---

\(^7\) IMF estimates.

\(^8\) In 1998, government securities accounted for almost 50% of CBN assets.
C. MONETARY AND CREDIT DEVELOPMENTS

2.5. The substantial reduction in the size of fiscal deficits between 1995 and 1997 had a significant impact on the growth of monetary aggregates. This is reflected in the growth of broad money (M2) which dropped from an annual rate of 54% in 1993 to 16.8% in 1997\(^9\) (see Annex 1C). The growth of narrow money (M1) similarly dropped from 57% in 1993 to 10.6% in 1997. This sharp slowdown in monetary growth was largely influenced by a substantial slowdown in the growth of bank credit to the government. Recent data however show that M2 grew by 24% in 1998 compared to 16.8% in 1997, mainly due to an acceleration in bank credit to the federal government. In the first half of 1999, M2 grew by 35.5% while M1 increased by 38.7%, far in excess of their respective growth targets of 10% and 4%.

2.6. Credit to the government grew at an average of 40% per annum over 1993-95 but contracted by 62% and 33% in 1996 and 1997 respectively (see Annex 1C). Credit to government has correspondingly fallen as a proportion of total credit from 74% in 1993 (27.2% of GDP) to 20.1% in 1997 (2.1% of GDP). However, available figures as at end-1998 indicated a 48% expansion in bank credit to the government.

2.7. From the peak of 73% attained in 1994, the growth of credit to the private sector slowed steadily to 23.3% in 1996, only to increase to 39.3% in 1997. Provisional figures for 1998 show a modest 11% expansion in private sector credit. As a proportion of total credit, private sector credit has increased from 26% in 1993 to 80% as at end-1997, due mainly to the combination of a reduction in credit to the government and an increase in demand for credit to fund foreign exchange purchases. However, as a share of GDP, credit to the private sector has fallen from 12.5% of GDP in 1994 to 9.5% of GDP as at end-1997. This has been a direct result of the distressed state of the real sector in Nigeria.

D. STRUCTURE OF INTEREST RATES

2.8. Nominal interest rates in Nigeria have shown a downward trend over the past five years (Annex 1D). From 16.7% in 1993, rates on savings deposits declined consistently to stand at 5.2% by December 1998. Rates on time deposits have shown a similar trend, with the 12-month time deposit rate falling from 24% in 1993 to 10.8% in December 1998. A similar downward pattern is indicated by the prime lending rate which declined from 36.1% in 1993 to 18.3% by December 1998\(^10\). Real rates have however improved significantly, due to substantial reductions in the inflation rate. Between 1993 and 1997, all deposits and lending rates were substantially negative in real terms, sometimes by as much as -60%. Such levels of negative real yields constituted a major disincentive to financial savings. However, by December 1998, only savings deposits carried a negative real yield (-3.3%), which in itself is a major achievement considering that only two years earlier, the real yield on savings deposits was -63%.

---

\(^9\) M2 in Nigeria is composed of currency outside banks, demand deposits, plus time, savings and foreign currency deposits of commercial and merchant banks, excluding takings from discount houses.

\(^10\) Lending rates have fluctuated widely thereafter, reaching 35% in November 1999.
2.9. There is a wide spread between the prime lending and savings deposit rates in Nigeria. This spread amounted to 13.1 percentage points in December 1998, down from 19.4 percentage points in 1993. However, wide spreads are not uncommon in Africa, reflecting the high costs of doing business in many countries in the region. Comparative recent spreads are 13.9% for Zimbabwe, 12.2% in Zambia, and 13.5% in Kenya. In contrast, South Africa has a low spread of 4.6%.

2.10. Wide spreads discourage saving and borrowing, with adverse effects on growth and development. High spreads in Nigeria reflect a host of factors that artificially increase the cost of providing banking services including: (i) reserve requirements earning zero or below-market yields; (ii) costs of transporting and sorting huge amounts of low-denomination currency; (iii) inadequate physical and financial infrastructure, such as poor telecommunication facilities and frequent power failures as well as the poor payments system; (iv) loss-making rural branches that banks are not allowed to close; and (v) non-performing assets and associated provisions. As long as banks continue to incur these unnecessary costs, spreads are bound to remain wide.

E. SAVINGS AND INVESTMENT

2.11. Gross domestic savings in Nigeria are low, averaging 21% of GDP over 1993-98 (see Annex 1A). Savings increased sharply from 18.2% of GDP in 1995 to 33.5% in 1996, as a result of a jump in public savings but fell back to 11.8% of GDP in 1998. Although low and declining, domestic savings in Nigeria were large enough to meet investment needs until 1998 when domestic savings dipped below investment requirements (Figure 2.1). In 1998, comparative saving-GDP ratios were 13.2% in Ghana, 13.4% in Kenya, and 19.6% in Zimbabwe. Historically, the Nigerian government has been the principal user of domestic savings.

2.12. Also, the ratio of investment to GDP has been low as well as declining. There has been a steady fall from 23.3% of GDP in 1993 to 15.3% in 1997, but rising to 20.0% in 1998. Comparative 1998 investment ratios were 22.9% for Ghana, 18.4% in Kenya and 21.2% for Zimbabwe. The unimpressive picture for domestic investment has been mainly due to a combination of political and macroeconomic instabilities which plagued Nigeria for most of the 1990s.

F. FINANCIAL SECTOR POLICIES

2.13. *Interest rates.* In 1996, the government removed all controls on interest rates in order to allow market forces to determine the level and structure of rates. Until that time, interest rate policy had been characterized by reversals and inconsistencies as the government had no recognized firm policy on interest rates and was easily swayed by pressures from various interest groups. For example, interest rates were first deregulated in 1987 at the start of the financial reform program but in 1991, the authorities imposed a ceiling of 21% for lending rates and a floor of 13.5% for deposit rates. These controls
were removed in 1992, only to reappear in January 1994 with the re-introduction of the 1992 controls. In November 1998 controls on Treasury Bill rates, which were the last set of rates still controlled, were lifted and at this juncture, the authorities appear serious about keeping interest rates deregulated. It is expected that a system of market-determined interest rates will facilitate the use of the Minimum Rediscount Rate (MRR) as a key instrument of indirect monetary policy\(^\text{11}\). In line with this expectation, the Central Bank increased the MRR in two steps in March 1999, first to 14.75\% (from 13.5\%) and thereafter to 20\%. The CBN however reduced the MRR to 18\% in November 1999 as inflation fell further into single digits. The MRR acts as a benchmark rate and is a nominal anchor for the determination of other rates. The authorities can therefore use changes in the MRR to indicate the desired direction of interest rate movements.

2.14. The wide spread between lending and deposit rates has attracted regulatory attention. Concerned that wide spreads could hamper growth by discouraging saving and investment, the CBN has recommended a benchmark spread of 7 percentage points between lending and deposit rates, to be achieved through moral suasion only. The problem of wide spreads can only be effectively addressed if the authorities focus instead

\(^{11}\) The MRR refers to what the CBN charges for lending to banks in the performance of its function as lender of last resort. It is called a rediscount rate because the CBN deducts interest at the outset of the loan rather than charge interest when the loan is due.
on eliminating the key problems underlying widening spreads such as high unremunerated reserve requirements, inadequate physical and financial infrastructure, the costs of sorting cash, as well as the burden from loss-making rural branches.

2.15. Credit policies. In 1992, the government abolished credit ceilings for banks that met CBN criteria relating to capital adequacy, asset quality, managerial competence and liquidity levels\textsuperscript{12}. These changes were phased in as part of the move towards indirect monetary control. However, prescribed sectoral allocation of credit remained in place until 1996 when the practice was abolished. Anecdotal evidence suggests however that the authorities exert moral suasion pressure on merchant banks to grant more medium to long-term loans, even though the formal requirement to do so was abolished in 1996. As at now, credit allocation is virtually market-determined except for a regulation requiring banks to invest 10\% of their loans and advances in the National Housing Fund to be on-lent for mortgage purposes\textsuperscript{13}. Although there is no evidence that banks comply with this directive (a testimony to its redundancy), it violates the spirit of liberalization underlying current financial policies. It is suggested that the authorities take steps to abolish this requirement.

2.16. Exchange rate and exchange controls. In January 1999, Nigeria’s dual exchange rate regime was abandoned as the official N22 to a dollar exchange rate was scrapped. Prior to then, the official rate co-existed with the rates on the Autonomous Foreign Exchange Market (AFEM) and was used for selected government transactions including external debt service. From then, the prevailing rate on the AFEM applied to all foreign exchange transactions. The elimination of the dual exchange rate system introduced uniformity of price in foreign exchange transactions and eliminated the arbitrage opportunities created by having an overvalued official rate side-by-side with a market-determined rate. It also introduced more transparency into government financial transactions as only the President previously had the right to determine which transactions were to be conducted at the official rate. In October 1999, a daily Inter-Bank Foreign Exchange Market (IFEM) replaced the AFEM. Under the IFEM, the CBN monopoly on the supply of foreign exchange was removed as oil exploration and producing companies were allowed to sell foreign exchange directly to banks rather than through the CBN. The CBN however remains the principal supplier of foreign exchange in the market and exerts considerable influence on the determination of the exchange rate.

\textsuperscript{12} Thus, only banks classified as “distressed” were subject to controls and not allowed to grant new credit.

\textsuperscript{13} See Chapter 7 for details on the National Housing Fund.
Box 2.1.  Implicit Taxation of the Nigerian Banking System

There is an implicit tax on the banking system arising principally from the imposition of restrictions on bank portfolios by the government. Here, we consider the implicit tax on commercial and merchant banks arising from the combination of a non-interest bearing cash reserve requirement with a statutory liquidity requirement. In Nigeria, commercial banks are required to keep 12% of total deposit liabilities as cash reserves (merchant banks are exempted from cash reserve requirements). In addition, all banks are required to hold a minimum 40% of their liabilities in the form of eligible liquid assets, 10% of which must be in government securities. Although the statutory liquidity requirement allows the holding of interest-bearing assets, a significant proportion is in the form of government securities which still carry below-market rates.

To compute a rough estimate of the implicit tax imposed through reserve requirements, we assume that bank reserves could be priced at the prime lending rate in a free market. The tax on reserves is then calculated as the difference between the prime lending rate and the rate actually paid on reserves (cash plus secondary reserves), multiplied by the amount of reserves (including excess reserves). For simplicity, we assume that the interest-bearing portion of reserve requirements earn interest at the prevailing treasury bill rate.

It is shown in Annex 1E that the implicit tax on the banking system averaged 1.3% of total assets over 1993-97. However, there has been a decline in the tax over time, falling from 1.6% of assets in 1993 to 0.8% in 1997, due mainly to the phasing out of stabilization securities (see below).

Annex 1E also gives an indication of the degree to which the government relies on the banking system for revenue. The implicit tax on the banking system averaged 7.3% of non-oil government revenue over 1993-97. In naira terms, this amounted to an annual average of N5 billion over 1993-97, representing 1.2% of total bank assets. However, total implicit tax has steadily declined from 14.6% of non-oil revenue in 1993 to only 3.1% in 1997. This trend has been mainly driven by the fall in the implicit tax arising from stabilization securities, which fell from 51.5% of total implicit tax in 1993 to only 15% of total tax in 1997. As a proportion of non-oil revenue, tax due to stabilization securities fell from 7.5% in 1993 to a mere 0.5% by end-1997. Phasing out stabilization securities has therefore contributed significantly to reducing the implicit tax on banks arising from reserve requirements.

2.17. Entry into the banking industry. The 1991 moratorium on the licensing of new domestic banks remains in force. However, as the clean-up of the banking system nears completion, selected foreign banks are being allowed into the system. The entry of foreign banks will be beneficial to the system in terms of competition, innovation and transfer of skills but it is important that the authorities take cognizance of the regulatory and supervisory implications of licensing foreign banks.

2.18. Reserve requirements. In Nigeria, banks are subject to a combination of cash reserve and statutory liquidity requirements. From May, 1999, commercial banks were required to keep 12% (increased from 10%) of total deposit liabilities, certificates of deposit, promissory notes and other deposit items as non-interest bearing cash reserves.

---

15 Standard Chartered Bank of UK received a license in 1999.
In addition, all banks (both commercial and merchant), are required to hold a minimum 40% of their liabilities in the form of eligible, liquid earning assets, 10% of which must be in government securities. Cash reserve and liquidity requirements generally serve as a ready source of revenue for the government as government securities are reserve-eligible thereby turning the banking system into a captive market for deficit financing (see Box 2.1). They impose hidden costs on banks and artificially increase the cost of doing business. They also contribute to wide interest rate spreads which hamper the mobilization of deposits and discourage borrowing by creditworthy customers. There is thus the need to reduce reserve requirements or make them earn interest at market rates\textsuperscript{16}.

G. **FINANCIAL DEEPPENING**

2.19. Available data reveal that the Nigerian financial system is surprisingly shallow. In 1998, the ratio of broad money (M\textsubscript{2}) to GDP stood at 13% (Annex 1F). The relatively low financial depth is quite surprising given the size of both the Nigerian economy and the financial sector. Although the banking sector dominates the financial system, the ratio of bank deposits to GDP is also small, averaging roughly 13% between 1993-97. In 1997, bank deposits represented 66% of M\textsubscript{2} which is relatively low compared to other African countries\textsuperscript{17}. The lack of depth of the financial sector becomes stark when compared to other African countries. In 1998 for instance, Kenya’s M2/GDP ratio stood at 42%, South Africa’s was 61% and Zimbabwe’s was 23% (see Annex 1F). Nigeria’s relatively low level of financial intermediation constitutes an impediment to economic growth as it severely limits the contribution of the financial sector to the mobilization and allocation of resources for productive activity.

2.20. The recorded low depth of the financial system seems to be a direct consequence of several factors:

**Historically negative real interest rates.** The absence of positive yields on financial assets has been a major factor hampering the growth of financial intermediation. Over the 1993-96 period, real returns on deposits averaged negative 41\% for savings deposits and negative 38\% for both 3- and 12-month time deposits. Over this period, the average annual growth rate of broad money (29\%) was much lower than the average growth rate of nominal GDP (45.6\%). In 1996, as the inflation rate fell sharply, real returns on time deposits turned slightly positive; however, real returns on savings deposits are still negative.

**Bank distress.** The recent distress in the banking system had a strong negative impact on public confidence in the financial system. As Annex 1F clearly shows, financial depth halved between 1994 and 1995, as the M2-GDP ratio plunged from almost 30\% of GDP in 1994 to 16\% in 1995 (see also Figure 2.2). The ratio of bank deposits to GDP also lost 7 percentage points over this period, which coincided with the peak of the banking crisis (see Annex 1G).

\textsuperscript{16} This should however be seriously considered only when fiscal deficits have been significantly reduced.

\textsuperscript{17} In 1997, bank deposits accounted for over 80\% of M2 in Kenya, Zambia, and Zimbabwe.
Deficient payments system. The payments system in Nigeria is plagued by several inadequacies creating high transaction costs in the use of financial services. Banking system intermediation is relatively low, with 32% of M2 held in domestic currency outside the banking system, compared for example, with 5% in South Africa, 14% in Zimbabwe and 16% in Kenya. Bankers speculate that less than 10% of the value of financial transactions is conducted with checks, and a large portion are conducted in cash. In addition, checks take 4 days to clear locally and 12 days from upcountry and there are problems with fraudulent checks.

Figure 2.2. Financial Depth (M2/GDP) (%), 1993-98

H. MONETARY POLICY AND THE FINANCIAL SYSTEM

2.21. The transition to market-based techniques of monetary control began in June 1993 when the CBN adopted Open Market Operations (OMO) as the primary indirect monetary instrument. Before then, the CBN relied on a battery of direct controls for liquidity management. The principal types of direct control included ceilings on domestic credit expansion, ceilings on interest rates, selective credit policies, a fixed exchange rate, as well as cash and liquidity ratios. Supplementary reserve requirements were also imposed in the form of mandatory purchase of stabilization securities by banks as well as the demand for special deposits from banks.
2.22. OMO aims to control the monetary base by focusing on bank reserves, which is a variable that the CBN can easily control using the instruments at its disposal. Targeting bank reserves is expected to keep the monetary base and ultimately, the broad money supply at desired non-inflationary levels. To do this, the CBN computes the optimal demand for total bank reserves followed by an estimation of the total supply of bank reserves. The difference between the demand and supply of bank reserves then becomes the OMO target. If there is an excess supply of reserves, OMO will seek to mop up the excess reserves and if there is a shortage, the aim of monetary policy will be to inject reserves.

2.23. OMO is conducted using Treasury Bills as the sole intervention security and is implemented exclusively through licensed discount houses which constitute the secondary market for these securities. Auctions of securities take place once a week with written notices sent to all banks two days before the auction. The banks then submit open bids comprising the discount rate and the volume of subscription to the discount houses who in turn make bids to the CBN. The total bids received are collated and arranged in descending order of prices. In theory, the CBN then accepts the highest bid price (lowest discount rate) for sales and the lowest prices offered (highest discount offer) for purchases. Until recently, there was anecdotal evidence that the CBN placed formal limitations on cut-off yields at the auctions and “high” bidders often failed to get allocations. This suggests that the CBN systematically eliminated outliers in arriving at the final rates. However, in late March 1999, the CBN raised the rates on treasury bills to an all-time high of 18%, indicating a greater willingness to make treasury bills competitive.

2.23 The bidding process ends when discount houses allot treasury bills to dealers whose bids have been accepted. Treasury bill holders who are pressed for funds can discount them at any time with any licensed discount house, thus assuring the necessary liquidity for these securities. In 1996, the CBN commenced repurchase transactions (Repos) with discount houses, involving the purchase or sale of government securities with an obligation to reverse the transaction on an agreed date. This move has served to further enhance OMO flexibility.

2.24. Due to the infancy of market-based monetary control in Nigeria, OMO is supplemented with direct controls in the form of cash and liquidity ratios. Prior to January 1999, all banks were also subject to the use of stabilization securities, which were mandatory, non-negotiable instruments of CBN which banks were compelled to buy from time to time. The use of this instrument, which imposed significant costs on the banks, was discontinued in 1998. However, in April 1999, the authorities introduced Special Treasury Bills (STBs), which all banks submitting bids for foreign exchange were compelled to buy. The declared aim of STBs was to mop up the excess liquidity generated by the abolition of the retail banking functions of the CBN, which released over N100 billion into the system. The introduction of these mandatory government securities however created more uncertainties in the system and evoked major doubts
about the declared commitment of the authorities to a market-based framework for monetary control\textsuperscript{18}.

\textsuperscript{18} In January 2000, the CBN released the last tranche of funds held in STBs to commercial and merchant banks.