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FINANCIAL SECTOR REVIEW
(IN THREE VOLUMES)

VOLUME 2: BANKING INSTITUTIONS AND THEIR SUPERVISION

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3. STABILITY AND PERFORMANCE OF THE BANKING SYSTEM

A. BACKGROUND AND OVERVIEW

3.1. Nigeria’s banking system, consisting of 51 commercial banks, 38 merchant banks, and 1014 community banks increasingly dominate the financial sector. As of December 1997, they constituted 50% of financial sector total assets inclusive of central bank assets and 93% of non-central bank assets. Non-bank deposit taking institutions hold only 1.6% of total assets. Moreover, the banking system grew at about 26% per annum in total assets over the previous four years. While negative in real terms (-8.7%), banks grew far faster than the non-banks which grew at only 6.5% per annum.

3.2. The number of banks expanded rapidly from 41 institutions before 1986 to a high of 120 in 1994. A number of banks, especially the newer and smaller institutions which were inadequately capitalized and/or poorly managed, experienced financial difficulties leading to the liquidation of 5 banks in 1994-95 and an additional 26 banks since 1997. In addition, 7 of the remaining 89 banks are essentially closed, an additional 7 to 8 are viewed as severely distressed (i.e., negative net worth) and 3 other banks as potentially distressed (capital below 5% of risk adjusted assets). No new domestic banks have been licensed since 1991, but CBN recently licensed a foreign bank. More detailed earlier history is contained in the White Cover 1997 Banking Sector Review and is therefore not repeated here.

3.3. Nigeria’s bank branch coverage is relatively good with 2050 commercial bank branches (of which 547 are rural), an estimated 1014 community bank branches, and 278 People’s Bank branches. Together they provide about one branch per 35,000 people. In comparison, Ghana has one bank branch per 57,000 people.

3.4. Some important recent developments relevant to the banking sector include: i) the establishment of the Failed Banks Tribunals and their commencement of recoveries; ii) the abolition of all interest rate controls and sectoral credit ceilings; iii) an increase in commercial bank cash reserve requirements to 12%, combined with the elimination of merchant bank cash reserve requirements; iv) a tenfold increase in minimum paid-in capital requirements to N500 million for existing commercial and merchant banks and to N1 billion for new banks; v) significant reduction in government-controlled banks’ market share as a result of liquidations and recapitalizations; and vi) supervisory and regulatory changes (as discussed in Chapter 4).

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1 Please note that this Banking System chapter was finalized during a January 1999 mission and has already been shared with government as part of an earlier Back-to-Office Report. Consequently, most data relate to 1998 and the analysis has not been updated for subsequent events.

2 Standard Chartered Bank of UK received a license in 1999.
B. FINANCIAL CONDITION AND PERFORMANCE OF THE BANKING SYSTEM

3.5. **Reduction in Banking System Distress.** The level of bank distress has declined dramatically since 1996 as shown in Annex 2A. Highlights of this transformation include:

(a) Aggregate banking system capital as a percentage of risk adjusted assets has increased from a negative 74% in 1996 to a positive 5% in September 1998. The healthy banks (defined as having capital in excess of 5%), representing 95% of total assets, show an average 8% capital adequacy. The number of healthy banks had increased from 65 to 71 while the number of distressed banks (capital of less than 5%) has plummeted from 50 to a still high 18 in September 1998 (since dropping to 17).

(b) Banking system non-performing loans (NPLs) have also improved sharply from an average 34% of total loans outstanding in 1996 to 18% in September 1998. Much of this reduction is, of course, due to the liquidation of 26 banks since that time. Perhaps more important is the strengthening of the portfolios of healthy banks with NPLs dropping from 20% to 13% over the last two years. Despite the positive momentum, NPL levels are still uncomfortably high as they constitute 107% of capital for the healthy banks. Distressed banks have very high NPLs (72% of portfolio on average) suggesting that closure, not recapitalization, is the most economic solution for most, if not all.

(c) The Authorities were apparently successful in sending a strong message that abuse and corruption in the banks would not be tolerated. One result is that total insider lending has dropped 66% in absolute terms since 1995 and now averages a reasonable 15% of capital for healthy banks (it averages 26% for the banking system as a whole because distressed banks have negative capital).

3.6. **Improvements in Financial Condition and Performance.** Banking system financial condition and performance have improved over the past three years as shown in aggregate financial statements (based on banks’ reporting) in Annex 2B. Salient points with respect to financial condition are:

(a) Banking system assets (excluding community banks) have grown 29% per annum and deposits have grown 27% (-8.3% in real terms) over the four years ending in 1998. Inter-bank placements have almost tripled in 1998 and investments exclusive of these placements and government securities have almost doubled.

(b) Stated capital positions have substantially strengthened, with system net worth growing at 80% per annum over the past four years and reported net worth increasing from 2.6% to 9.6% of total assets as of September 1998. A reduction in CBN overdrafts from 3.3% of total assets in 1996 to 0.8% (virtually all owed by distressed banks) in

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3 The analysis in the following sections relied principally on data collected on a World Bank mission which took place in January/February 1999.
September 1998 is additional evidence of significantly lower levels of bank distress at this juncture.

(c) With respect to liquidity, net current asset positions have not changed significantly over time, with relatively liquid assets adding to 45% of total assets and 79% of short term liabilities, down somewhat from four years ago, but increasing over the past two years. Deposits are composed of 46% demand deposits, 29% savings, and 25% time deposits, with only 3.4% of deposits for time periods of six months or longer.

3.7. Of more importance, as of September 1998, liabilities due in less than 30 days exceeded assets convertible into cash in less than 30 days by N42 billion or 7.5% of liabilities (Annex 2C). However, current assets exceed liabilities for each 3 month period beyond 30 days, and the gap is eliminated at about the 180 day point. The situation is somewhat improved over the previous quarter when the gap for assets and liabilities with a tenor of less than 30 days was N56 billion or 10.6% of total liabilities. Liquidity data are not available to compare liquidity between healthy and distressed banks, but we hypothesize that healthy banks are more liquid.

(a) 1998 Gross loan deposit ratios at 82.5% have dropped somewhat since 1995. Meanwhile, net loan deposit ratios increased significantly (from 48.7% to 67.7%) largely due to the significant improvement in portfolio quality.

(b) Banking system investment in government securities, while increasing at a rate of 21% per annum over the past 9 months, has declined by N7 billion since 1994 and now represents a relatively modest 8% of total assets (compared with 28% in Ghana). As government securities held by the non-bank public have also declined, this suggests that government borrowing does little to crowd out private borrowers or to compete with banks for deposits. Although data were not available, we understand that loans to and deposits from parastatals were not large.

(c) The combined bank statements show significantly higher net worth than combined data from other sources (Annex 2D) presented to show the share of distressed banks, probably due to significant under-provisioning in some individual bank reported financial statements that has been adjusted based on onsite examinations. This annex should be interpreted with caution as it combines data from several data bases, some obtained from CBN and some from NDIC. It may be more indicative for the banking system as a whole than when broken down by size. However, it suggests possible overall under-provisioning estimated very roughly at N17 billion inclusive of possible over-provisioning in the four largest banks more than offset by considerable under-provisioning (presumably much of it in distressed banks) in some of the smaller banks. If accurate, this implies that banking system net worth, based on aggregate statements could be overstated by roughly 20%.

(d) Many banks, perhaps because the naira has been relatively stable, are taking imprudently high foreign exchange risk. On a combined basis, the system as of September 1998 had a seemingly prudent N 6.7 billion (about 16% of stated net worth) in net foreign exchange exposure. However, 36 banks representing 52% of total assets had imprudently high net foreign exchange positions in excess of 50% of net worth. Of more
concern, 17 of these banks had net positive foreign exchange positions (i.e. foreign exchange liabilities in excess of foreign exchange assets) that exceeded net worth, while, surprisingly, 10 banks had negative positions that exceeded 50% of net worth. The four largest banks, on a combined basis, had a large positive net position, while the smallest banks held a large negative position. Reasons for this unsettling situation should be investigated.

3.8. Off-site supervision maintains a more complete data base for balance sheet data than income statement data. Subsequent to the mission, the implementation of Bank Analysis System (BAS) information system has considerably enhanced income statement data availability. Unfortunately, banking system income statements available to the mission did not allow an adequate financial analysis, (e.g., administrative costs are not available). However, a few salient points with respect to banking system financial performance based on the available data are:

(a) Reported overall banking system profit for the 9 months ending Sept. 30, 1998 represents a seemingly robust 5% of total assets, 24% of gross income, and 52% return on equity\(^4\). This represents a slight improvement over 1997 performance, and significant improvements over performance in earlier years. It is probable, however, that reported profits reflect inadequate provisions for bad debt because: i) some banks do not calculate provisions quarterly and, as fiscal years vary considerably, there is no one date when all banking system income statements fully reflect provisions; ii) NDIC informed the report team that on-site inspections have found that about 90% of the time provisions are understated, sometimes substantially; and iii) incentives to report accurate provisions are inadequate because penalties are not assessed.

(b) Non-interest income for the 9 months ending Sept 30, 1998 is a somewhat high 33% of gross income and 6.9% of average total assets and it has hovered near those levels over the past four years. While non-interest income strengthens the banks, the proportion of gross income derived from direct lending activity should increase over time.

(c) Non-interest expense, although dropping over the last 3 years, appears to be a very high 49% of gross income. It has, however, steadily dropped from 12.8% of average total assets in 1997 to a still high 10.3% for the 9 months ending Sept 1998. Banking system efficiency is clearly improving slowly but no conclusions can be made with respect to administrative efficiency until a more detailed breakdown of this expense is available. Indeed, to the extent that these numbers may include provisions or taxes, non-interest expense may not be high.

(d) Net interest margin at 8.5% of average total assets for the 9 months ending September 1998 is robust. The spread of 18.8% (interest income is a robust 25% of average interest bearing assets while interest expense is only 6.2% of interest bearing liabilities) is robust, if not excessive. While spreads may be unusually high over the last few years due to political uncertainties and an urgent need to grow net worth, they imply an inadequately competitive environment despite the large number of banks.

\(^4\) It is unclear whether this is before or after tax and to what extent provisions for bad debt have been taken into account.
C. A CROSS-CUTTING ANALYSIS OF THE BANKING STRUCTURE

3.9. Based on September 1998 individual bank data, the team undertook a cross-cutting analysis to better understand the structure of Nigeria’s banking system (Annex 2E). The results of this exercise are as follows:

(a) **An analysis by size.** As there are a large number of banks, the banking system is not excessively concentrated with the four largest banks controlling 38% of total assets, 45% of total deposits, and 44% of bank branches. The next ten largest banks (all but one are commercial private banks) control an additional 23% of total assets and 21% of deposits. In terms of performance, it is interesting to note that the four largest banks, despite significantly higher NPLs (18.5% of loans vis. 8.8% for the next ten banks) report considerably higher profits as a percentage of assets. It would be useful to analyze this situation in more depth as it could suggest that the largest banks have substantial advantages in terms of cost of funds and/or earning non-interest income which they do not pass on to customers in lower interest rates and fees, while the next ten banks have significantly higher costs and/or engage in more competitive pricing.

(b) **An analysis of ownership** Government-controlled banks constitute a small and decreasing market share and the performance of these institutions is far worse than that of privately controlled banks. In December 1996 there were 20 government controlled banks and 13 additional banks with minority government ownership. Two years later, there were only ten government controlled banks, seven federally controlled and 3 state-controlled, which together have a small 4.6% share of banking system assets and 12% of the branches. An additional 12 banks with minority government ownership (excluding Afribank for which the Privatization Bureau is still holding a 30.5% share) have 7.6% of assets. On a combined basis, the government controlled banks have: i) average NPLs amounting to 48% of loan portfolios, while NPLs for the remainder of the system are 15%; ii) average net worth equal to –30.6% of total assets, vis. 6.9% for the remainder of the system; iii) reported profits of 0.9% of total assets vis. 4.0% for the non-government banks; iv) eight of the ten government banks are in distress vis. 9 of the 79 banks not so controlled; and v) foreign banks do not yet play a significant role in Nigeria. Only 2 of Nigeria’s banks, involving 4% of total assets, are controlled by foreign banks, while an additional 13 privately controlled banks, involving 23% of total assets, have some foreign ownership (see footnote 1). Fifty two of Nigeria’s banks, representing 61% of banking system assets, are 100% Nigerian privately owned.

3.10. Seventeen banks, holding a 53% market share in banking system assets and 61% of the branches, were listed on the stock exchange as of September 1998, increasing to 23 by September 1999. As a group, listed banks appear somewhat more profitable than the remaining banks, had somewhat stronger capital positions, and similar quality portfolios. Banking system access to the Nigerian capital market for long-term equity capital appears to be a significant source of ongoing strength. However, while the capital market could be relevant for the sale of some government minority share positions, it may be of more
limited use in the privatization of government controlled banks given the pervasive
distress among that group. Anecdotal evidence suggests that bank price earnings ratios
exceed those of other listed companies.

D. ANALYSIS OF DISTRESS AND COMPLIANCE WITH PAID-UP CAPITAL REQUIREMENTS

3.11. Fourteen of Nigeria’s banks (primarily based on NDIC data), involving 2% of
banking system assets, have been identified as distressed, while an additional 3 small
banks with positive net worth of less than 5% of risk adjusted assets were classified as
potentially distressed. Four additional banks which reported net worth of less than 4% of
total assets, might be additional candidates for this classification.

3.12. One previously distressed bank has raised N1.8 billion in new capital and the
Authorities anticipate that 3 other banks which are processing initial public offerings
(IPOs) will also be successful. In addition, potential investors have expressed interest in
investing new capital in 2 of the remaining distressed banks.

3.13. Fifteen banks not in compliance with the N500 million paid-up capital requirement
as of September 1998 were classified as distressed or potentially distressed banks. Of the
remaining 23 banks, 18 met minimum capital adequacy requirements, 2 were expected to
utilize IPOs that would bring them into compliance, and 2 non-distressed banks had
neither adequate capital-asset ratio or an announced plan to meet the requirement. Six of
the 23 non-complying banks, because they have paid-in capital of more than N395
million and reasonably sound net worth positions, may be able to reach the requirement
soon. On the other hand 12 banks with paid-in capital of less than half the N500
requirement may have considerably greater difficulty in achieving compliance.

3.14. We understand that 64 banks had complied with the N500 minimum paid-in capital
requirement by the initial year-end 1998 compliance date, and that most non-distressed
banks were expected to meet the requirement before the end of March, 1999. Several
others have increased paid-in capital significantly but fall short of the target.

3.15. The Authorities may face a dilemma in that the widespread non-compliance
undermines their credibility, but a decision to close an otherwise sound bank that does
not meet the paid-in capital requirement does not sound reasonable. One approach that
might be considered, following more detailed study of the individual banks involved to
ascertain appropriateness, might include: i) reclassifying all banks which still have less
than N250 million in paid-in capital, as well as all banks that have N250 to N499 million
in paid-in capital, but less than 8% capital-assets ratio, as distressed banks and subjecting
them to the policies imposed on distressed banks; ii) reaching agreed individual time-
bound schedules for all other banks to come into compliance and treating them as
distressed banks if they do not meet that schedule; and iii) imposing modest financial
penalties on any banks not now in compliance.
E. DEPOSIT INSURANCE FUNCTIONS

3.16. NDIC and the deposit insurance system have, on balance, played a positive and reasonably efficient role in supporting Nigeria’s banking system. While there were reportedly runs on several small banks some years ago, overall confidence in the banking system has been largely maintained despite the ongoing liquidation of 31 banks. However, long delays in assisting depositors in insolvent banks that are not being liquidated is a significant blemish.

3.17. NDIC has more than enough reasonably sophisticated banking supervision staff to satisfactorily cover all distressed and potentially distressed banks. Its resources, both institutional and financial, appear adequate for dealing with present levels of distress, and delays in taking required action are based to some extent on forbearing attitudes that provide banks with unduly long periods of time to restore satisfactory financial condition, and on political considerations largely outside NDIC’s control.

3.18. Deposit insurance is mandatory for all licensed banks, thus not covering community banks (which would be covered if they were permanently licensed), development banks (which do not take deposits), finance companies, or primary mortgage companies. When liquidation of a bank is initiated, and only at that point, NDIC will pay off all deposits subject to a maximum N50,000 per depositor. Refund of deposits above those levels depend on liquidation proceeds which must to some extent be shared with other claimants including NDIC. Therefore, some large depositors in banks under liquidation have not yet, and in some cases may never be repaid in full.

3.19. The report team did not analyze NDIC’s ability to honor its deposit obligations in detail but it appears subject to question. NDIC said that it has N9.8 billion available, compared to N28 billion in insured deposits in distressed banks. New annual inflows, calculated at 15/16 of 1% of each bank’s deposits per annum add to about N 3 billion a year. Liquidity support has been provided to two troubled banks.

3.20. The 1994 Failed Banks Decree established 15 tribunal courts, presided over by high court justices and reporting directly to the Attorney General. They can handle fraud cases relating to healthy banks as well as loans of failed banks.

3.21. Active efforts are being taken, utilizing some 300 staff drawn from liquidated banks, to collect on failed bank assets and to take other action relating to failed banks. As a result 892 cases had been filed as of December 1997, 338 judgements were delivered, and 37 people convicted. N3 billion was recovered through the tribunals and an additional N1.5 billion in judgement debts were in the process of collection. Also, past liquidations have resulted in a considerable flow of funds. For example, as of December 1997, proceeds from sale of N58 million in closed bank fixed assets was N122 million while N718 million (about 20%) had been collected on a beginning loan portfolio available for collection of N3682 million.
3.22. NDIC works with ten banks as payment agents and 92 payment centers for repaying depositors. As at September 1999, NDIC had paid out N3.02 billion, out of the total N5.01 billion insured in the 31 liquidated banks.

3.23. In conclusion, the deposit insurance system is working reasonably well and does not at this time represent an obstacle to taking decisive action to liquidate all of the presently distressed banks for which that action is desirable. However, as discussed in Chapter 4, we believe that the present allocation of banking supervision functions between CBN and NDIC is sub-optimal, leads to some confusion and duplication, and should be reconsidered.

F. OTHER BANKING SYSTEM ISSUES

3.24. Exit Policies and their Implementation. Nigeria has acted decisively and impressively in initiating liquidation of 26 seriously distressed banks since 1997. Moreover, the authorities have essentially closed 7 additional banks (5 of them government controlled) which are not yet being liquidated, some for a number of years. They have also identified 8 additional distressed banks that are subject to various holding actions. Moreover, the federal government has pursued a commendable policy of refusing to invest new capital in either government or privately controlled insolvent banks. Nonetheless, there are several issues associated with exit policies as follows.

(a) Methods for identifying seriously troubled banks are not optimal. A joint CBN/NDIC Executive Committee on Problem Banks does not meet often. Consequently, it was discovered that CBN and NDIC had somewhat different lists as to which banks had been identified as distressed and as potentially distressed. The definitions themselves, which are based primarily on the level of capital and liquidity are not entirely clear and it appears that an explicit CBN decision is required to declare a bank distressed, even if it meets the definition. NDIC CAMEL ratings, even when available, are not used as inputs to determining distress levels. It is the team's impression that holding and cease and desist actions are usually delayed until a bank actually has negative net worth, even in rapidly deteriorating situations.

(b) Also, while the Authorities have a number of actions available to them for dealing with distressed banks, they tend to use the more draconian measures only for banks that, in addition to being insolvent, have severe liquidity problems. Seven of the distressed banks viewed as insolvent but liquid are subjected to more lenient holding actions. CBN issues the holding actions and both CBN and NDIC are responsible for monitoring them. Potentially distressed banks, defined as those with capital-asset ratio between 2-5%, are normally subject only to being sent a warning letter and being put on a watch list.

(c) CBN has substantial legal powers and, therefore, banks that are both illiquid and insolvent are subjected to such constraints as: i) being required to impose aggressive loan recovery and cost reduction programs; ii) limiting new lending to the sum of principal and interest collections (which allows gross loans to grow); iii) prohibiting advertising for new deposits or accepting new depositors, while allowing deposits of existing depositors
to grow; iv) prohibiting new dividends; v) submitting turn around plans if the problems are viewed as structural; vi) placing CBN and/or NDIC on Boards of Directors; and vii) if approved by Nigeria’s President, replacing management. If these various actions are not complied with or fail to achieve the desired effect, CBN has the power, but at least until recently not the obligation, to turn over the control and management to NDIC.

(d) The relative responsibilities of CBN and NDIC with respect to distressed institutions appear somewhat conflicting and ambiguous and there is a need to reach agreements which clarify this respective roles and improve modalities for coordination. The 1998 amendment says that NDIC should take over responsibility for all banks with 2 to 5% capital, but it is our impression that this does not take place until CBN declares a bank to be in that category and/or passes authority to NDIC. In early March, NDIC announced that CBN will hand over responsibility for these banks, but will retain responsibility to deal decisively with terminally distressed banks rather than expecting NDIC to try to restructure them. NDIC, if it is unable to rehabilitate or merge a troubled bank, does not have the power to revoke its license or liquidate the bank. CBN can revoke the license but needs the approval of the President to do so, hence subjecting the decision to political influence.

(e) This has led, in several cases, to long and undesirable delays in taking decisive action with deeply distressed banks, especially several in which individual states have a financial and political interest. As one example, although the National Bank was closed in 1990 and has huge negative net worth, liquidation has not begun and, hence, none of its insured depositors are being paid. Seven closed banks, five of which are government controlled, have a combined N4.1 billion in deposits and negative N 7.5 billion in net worth. Continuing to leave these banking problems unaddressed undermines confidence in the banking system and the otherwise reasonably well functioning deposit insurance system. Even if there are possibilities that new investment can be found, it is unlikely that such investments will be economically sound and/or that the governance of these failed institutions could be sufficiently strengthened that they could be satisfactory. It is recommended that licenses be revoked for at least the 7 closed banks as soon as possible and requests for winding up be submitted to the court.

3.25. Other commercial bank-related issues identified include: i) a complaint that CBN has to approve any change and is very cautious, thus putting a major damper on innovation or the growth of new markets or instruments; ii) CBN requires naira down payments as collateral before opening letters of credit, thus making this routine business unnecessarily cumbersome and expensive; iii) NDIC is not allowed to ask for bank auditors’ working papers; iv) inter-bank loans cannot be counted toward Liquid Asset Requirements (LAR), unless collateralized, thus significantly inhibiting development of this market; iv) personal bankruptcy does not work because it is so hard to obtain a judgment identifying a borrower as a debtor; v) a new bankers’ tariff while an improvement, may continue to represent unnecessary interference in freedom to price; vi) banks are able to get around regulations relating to how much they can invest in a subsidiary by having each of their subsidiaries make separate investments in the same entity and not consolidating it; vii) few staff in the largest banks are computer literate; and viii) treasury bill rates, although recently increased, are still not at market-determined
levels. Thus prescribed liquidity ratios force the banks to invest in relatively low interest bearing bills and create incentives for them to minimize these investments.

3.26. **Merchant Banks.** Although 43% of Nigeria’s large banks were classified as merchant banks prior to the recent change in regulatory differences with commercial banks, commercial banks controlled 95% of the combined branches and 84% of the combined assets. While differences between the two types of banks were steadily narrowing over the years, some important differences remain. For example, commercial banks are on average 4 times as big in total assets (average size N 12.8 billion) and have significantly lower loan deposit ratios (72% vis 134% as of Sept 1998). Merchant banks have arguably proven riskier over time as half of the 26 banks closed since 1996 were merchant banks. This may be due to higher loan deposit ratios, somewhat higher cost of funds (merchant banks are not supposed to take demand deposits), potentially more volatile deposits (they are more “lumpy” and price elastic), and greater loan concentrations. Data showing that merchant banks, as a group, have significantly lower NPLs and stronger capital positions may be misleading as commercial bank data are influenced by government controlled distressed banks, all of which are commercial banks.

3.27. Merchant bank asset and liability structures were becoming more similar to those of commercial banks over time. Differences in composition of assets appear insignificant. Unfortunately, comparative data were not available on the tenor of loan portfolios. However, it is likely that merchant banks are still doing relatively more long term lending because they were required until 1996 to channel 20% of their loans and advances into medium and long-term lending and report that, while they are not subject to financial penalties, they are still under moral suasion pressures from the Authorities to do so.

3.28. It is the mission’s view that, despite their original purposes, merchant banks are actually likely to be less well positioned than the commercial banks to do significant term lending because:

- **(a)** Only 4.9% of their deposits are for six months or more, not significantly more than commercial banks 3.0%.

- **(b)** Despite having no access to the clearing house and being prohibited from taking de jure demand deposits without special CBN permission, merchant banks report that “demand deposits” constitute 29.5% of total deposits. For such deposits, they (at least those that are not owned by a commercial bank) are subjected to a serious competitive disadvantage in that they must depend on a commercial bank (which can collect business sensitive information or poach customers), to handle their check clearing.

- **(c)** Merchant Bank deposits are more lumpy (e.g., they are not allowed to take deposits of less than N 10,000) and volatile as their client base tends to be more sophisticated corporate clients and high net-worth individuals whose behavior is more price-elastic than the general market;
(d) Only 3.3% of merchant bank deposits (compared to 28.9% of commercial bank deposits), are savings deposits which often prove in practice to be among the most stable sources of funds.

(e) Merchant banks, are more highly leveraged and exposed to funding risk with average loan-deposit ratios of 134% vis. 72% for commercial banks as of September 1998. Moreover, they can lend up to 50% of net worth to one credit risk, compared to 20% for commercial banks. These factors would seem to offset any liquidity advantage they gain by being exempted from reserve requirements.

(f) Merchant banks have significantly higher interest income as a percentage of interest bearing assets (10.7% vis 7.6% for the 9 months ending September 1998 and 30.2% versus 19.5% during 1997), implying that they may be engaged in riskier lending. This may be necessitated by a higher cost of average borrowed funds (4% vis. 1.5% for the 9 months ending Sept 1998) not fully offset by comparatively stronger net non-interest income performance.
4. AN ASSESSMENT OF BANKING SUPERVISION

A. INTRODUCTION

4.1. An assessment of banking supervision in Nigeria was conducted against the Basle Core Principles of Banking Supervision. The methodology recently designed by the “Liaison Group of the Basle Committee for the Core Principles” was applied and the evaluation exercise was done jointly with the International Monetary Fund.

4.2. The assessment of the overall process of banking supervision in Nigeria is based on: i) the review of various documents (laws, regulations, guidelines, etc.); ii) discussions held in Nigeria with numerous representatives from the regulatory agencies and other relevant parties such as bankers and external auditors; and iii) review of confidential documents (including bank examination reports and letters) that the team was given access to by both CBN and NDIC. The team gained insight as to how day-to-day operations are performed and laws and regulations enforced.

4.3. Even though the team had access to comprehensive information, thanks to very cooperative Nigerian counterparts, this report is not to be viewed as the result of an audit, as commonly defined.

4.4. The assessment of compliance with the Core Principles (CPs) is not an exact science. Banking systems differ from one country to another. Furthermore, banking activities are changing rapidly around the world, and theories, policies, and best practices of supervision are swiftly evolving. Nevertheless, it is internationally acknowledged that the CPs will be viewed as minimum standards and/or best practices.

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5 A detailed evaluation of banking supervision using this methodology is available to interested readers as a separate document. This methodology is however not the final version endorsed by the Basle Committee in October 1999.
6 These are the Central bank of Nigeria (CBN), Nigerian Deposit Insurance Corporation (NDIC), National Board of Community Banks (NBCB), and the Securities and Exchange Commission (SEC).
7 An audit would require a more comprehensive review of documents and systems.
Box 4.1. Core Principles for Effective Banking Supervision

**Principle 1:** An effective system of banking supervision will have clear responsibilities and objectives for each agency involved in the supervision of banks: (1.1) Each such agency should possess operational independence and adequate resources; (1.2) A suitable legal framework for banking supervision is also necessary, including provisions relating to authorisation of banking establishments and their ongoing supervision; (1.3) A suitable legal framework for banking supervision is also necessary, including powers to address compliance with laws as well as safety and soundness concerns; (1.4) A suitable legal framework for banking supervision is also necessary, including legal protection for supervisors; (1.5) Arrangements for sharing information between supervisors and protecting the confidentiality of such information should be in place.

**Principle 2:** The permissible activities of institutions that are licensed and subject to supervision as banks must be clearly defined, and the use of the word “bank” in names should be controlled as far as possible.

**Principle 3:** The licensing authority must have the right to set criteria and reject applications for establishments that do not meet the standards set. The licensing process, at a minimum, should consist of an assessment of the banking organisation’s ownership structure, directors and senior management, its operating plan and internal controls, and its projected financial condition, including its capital base; where the proposed owner or parent organisation is a foreign bank, the prior consent of its home country supervisor should be obtained.

**Principle 4:** Banking supervisors must have the authority to review and reject any proposals to transfer significant ownership or controlling interests in existing banks to other parties.

**Principle 5:** Banking supervisors must have the authority to establish criteria for reviewing major acquisitions or investments by a bank and ensuring that corporate affiliations or structures do not expose the bank to undue risks or hinder effective supervision.

**Principle 6:** Banking supervisors must set minimum capital adequacy requirements for banks that reflect the risks that the bank undertakes, and must define the components of capital, bearing in mind its ability to absorb losses. For internationally active banks, these requirements must not be less than those established in the Basle Capital Accord.

**Principle 7:** An essential part of any supervisory system is the independent evaluation of a bank’s policies, practices and procedures related to the granting of loans and making of investments and the ongoing management of the loan and investment portfolios.

**Principle 8:** Banking supervisors must be satisfied that banks establish and adhere to adequate policies, practices and procedures for evaluating the quality of assets and the adequacy of loan loss provisions and reserves.

**Principle 9:** Banking supervisors must be satisfied that banks have management information systems that enable management to identify concentrations within the portfolio and supervisors must set prudential limits to restrict bank exposures to single borrowers or groups of related borrowers.

**Principle 10:** In order to prevent abuses arising from connected lending, banking supervisors must have in place requirements that banks lend to related companies and individuals on an arm ’s-length basis, that such extensions of credit are effectively monitored, and that other appropriate steps are taken to control or mitigate the risks.

**Principle 11:** Banking supervisors must be satisfied that banks have adequate policies and procedures for identifying, monitoring and controlling country risk and transfer risk in their international lending and investment activities, and for maintaining appropriate reserves against such risks.
**Principle 12:** Banking supervisors must be satisfied that banks have in place systems that accurately measure, monitor and adequately control market risks; supervisors should have powers to impose specific limits and/or a specific capital charge on market risk exposures, if warranted.

**Principle 13:** Banking supervisors must be satisfied that banks have in place a comprehensive risk management process (including appropriate board and senior management oversight) to identify, measure, monitor and control all other material risks and, where appropriate, to hold capital against these risks.

**Principle 14:** Banking supervisors must determine that banks have in place internal controls that are adequate for the nature and scale of their business. These should include clear arrangements for delegating authority and responsibility; separation of the functions that involve committing the bank, paying away its funds, and accounting for its assets and liabilities; reconciliation of these processes; safeguarding its assets; and appropriate independent internal or external audit and compliance functions to test adherence to these controls as well as applicable laws and regulations.

**Principle 15:** Banking supervisors must determine that banks have adequate policies, practices and procedures in place, including strict “know-your-customer” rules, that promote high ethical and professional standards in the financial sector and prevent the bank being used, intentionally or unintentionally, by criminal elements.

**Principle 16:** An effective banking supervisory system should consist of some form of both on-site and off-site supervision.

**Principle 17:** Banking supervisors must have regular contact with bank management and a thorough understanding of the institution’s operations.

**Principle 18:** Banking supervisors must have a means of collecting, reviewing and analysing prudential reports and statistical returns from banks on a solo and consolidated basis.

**Principle 19:** Banking supervisors must have a means of independent validation of supervisory information either through on-site examinations or use of external auditors.

**Principle 20:** An essential element of banking supervision is the ability of the supervisors to supervise the banking group on a consolidated basis.

**Principle 21:** Banking supervisors must be satisfied that each bank maintains adequate records drawn up in accordance with consistent accounting policies and practices that enable the supervisor to obtain a true and fair view of the financial condition of the bank and the profitability of its business, and that the bank publishes on a regular basis financial statements that fairly reflect its condition.

**Principle 22:** Banking supervisors must have at their disposal adequate supervisory measures to bring about timely corrective action when banks fail to meet prudential requirements (such as minimum capital adequacy ratios), when there are regulatory violations, or where depositors are threatened in any other way. In extreme circumstances, this should include the ability to revoke the banking license or recommend its revocation.

**Principle 23:** Banking supervisors must practise global consolidated supervision over their internationally active banking organisations, adequately monitoring and applying appropriate prudential norms to all aspects of the business conducted by these banking organisations worldwide, primarily at their foreign branches, joint ventures and subsidiaries.

**Principle 24:** A key component of consolidated supervision is establishing contact and information exchange with the various other supervisors involved, primarily host country supervisory authorities.

**Principle 25:** Banking supervisors must require the local operations of foreign banks to be conducted to the same high standards as are required of domestic institutions and must have powers to share information needed by the home country supervisors of those banks for the purpose of carrying out consolidated supervision.
B. METHODOLOGY

4.5. The assessment of compliance with each principle was made on a numeric, but qualitative basis using a seven-level rating scheme:

1 = Principles fulfilled
2 = Principles largely fulfilled and efforts to achieve fulfillment are underway
3 = Principles largely fulfilled and efforts to achieve fulfillment are not underway
4 = Principles largely unfulfilled and efforts to achieve fulfillment are underway
5 = Principles largely unfulfilled and efforts to achieve fulfillment are not underway
6 = Principles not fulfilled and efforts to achieve are underway
7 = Principles not fulfilled and efforts to achieve fulfillment are not underway

4.6. Obviously, the assessment of each principle is subjective in nature. It reflects the assessor’s judgment which may well differ among assessors, other things being equal. Therefore, the evaluation depends significantly on the experience and background of the assessor(s). As previously stated, while the Core Principles for Effective Banking Supervision have emerged over time, it is also legitimate to adjust policies to the needs of countries. Nonetheless, the detailed criteria suggested by the aforementioned “Liaison Group” should help minimize the risk of substantial variance.

4.7. While laws and regulations are critical to effective banking supervision, the environment in which supervisory authorities operate as well as the degree of capacity, competence, and integrity of local supervisors are of the utmost importance. Therefore, great emphasis has been put on both Principles 1.1 and 1.2 which deal with the foundations for the supervisory architecture. Equally important are the quality of the organization of day-to-day operations, the extent of coordination within and between agencies, the follow-up on, and enforcement of decisions, and a “quality assurance” function. In this regard, criteria set out in Principle 16 on off- and on-site surveillance were considered as essential building blocks. Lastly, the extent of the authorities’ willingness to carry-out their mandate, to the extent that one could capture it, was weighted as a critical component in assessing the degree of compliance.

C. INSTITUTIONAL FRAMEWORK FOR BANK REGULATION AND SUPERVISION

4.8. The severe crisis that crippled the Nigerian banking system for most of the 1990s has attracted the vigorous attention of the Nigerian authorities, as evidenced by the number of banks closed. Until the recent amendments to the Banks’ and Other Financial Institutions (BOFID) Decree, the legal and institutional framework governing the actions of supervisors had remained almost unchanged. As the crisis spilled over the whole

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8 The BOFID is to be viewed as the Nigerian “Banking law” and was originally promulgated in 1991, with successive amendments in 1997, 1998 and 1999.
financial system, institutional changes were implemented to strengthen the regulatory framework by granting the Central Bank of Nigeria (CBN) most of the supervisory authority and responsibility. Regulatory reforms also aimed at gradually granting more independence to supervisory authorities.

4.9. Prior to the 1998 amendment of the BOFID, the responsibility for supervision of financial institutions was split among several agencies. The CBN was charged with the supervision of both commercial and merchant banks. The National Board of Community Banks (NBCB) was responsible for the supervision of community banks in all respects with the exception of granting permanent licenses which was entrusted to the CBN. Also, the Federal Mortgage Bank of Nigeria (FMBN) had served as a regulatory body since 1989 with licensing and supervisory powers over mortgage institutions until these responsibilities were shifted to the CBN in 1998.

4.10. In the late 1980s, as the Nigerian banking system began to exhibit serious fragilities, the government felt the need to implement a mechanism that would facilitate orderly closure and resolution of problem banks, while preserving public confidence. The Nigerian Deposit Insurance Corporation (NDIC) was set up in 1989 at a time when the number of banks viewed as distressed was low (7) compared to the level reached ten years later (47 in number accounting for almost 20% of bank assets). In hindsight, this decision was judicious as the restructuring and closure of numerous banks has been one of the major challenges that Nigerian authorities have confronted since 1989.

4.11. NDIC is empowered with functions similar to those performed by the Federal Deposit Insurance Corporation (FDIC) in the USA. Thus, in addition to ensuring that depositors in each insured bank are repaid their deposits up to N50,000 under specified circumstances (see para. 4.19), NDIC plays a key role in restructuring problem banks. The Corporation is also active in supervising insured institutions jointly with the CBN (both off- and on-site).

4.12. The Financial Services Regulation Coordinating Committee (FSRCC) was established in 1994, primarily to enhance coordination among all agencies with supervisory powers including the Securities and Exchange Commission and the Insurance Commission. Currently chaired by the Governor of CBN, the Committee coordinates the activities of all regulatory agencies. Cooperation between CBN and NDIC in the area of problem banks and other issues of common interest is dealt with by two ad hoc committees. In addition to a technical committee, there is an Executive Committee that makes decisions regarding problem banks.

4.13. The fragmentation of supervision, previously among several agencies, and now between CBN and NDIC may have resulted in sub-optimal supervision. As the number of institutions mushroomed over the last decade without adequate entry procedures and monitoring, Nigerian authorities have made CBN the pivotal institution responsible for all aspects of supervision of financial institutions irrespective of their charter (community banks, finance companies, development banks, primary mortgage institutions, discount
houses and bureaux de change). Translating a broader mandate into actual enforcement of rules and procedures will require comprehensive organizational changes that are not likely to occur in the short term. Nonetheless, it is reasonable to expect tangible improvements, provided that CBN agrees with the NBCB and other regulators on a smooth transition. Another essential prerequisite would certainly consist of upgrading CBN’s information system, which cannot presently absorb the burden of over 1,000 community banks, as well as 279 finance companies and 195 primary mortgage institutions. As regards community banks, CBN is contemplating the possibility of subcontracting on-site examination, once the re-licensing phase is complete. The granting of licenses will be decided based upon on-site examinations of all applicants, which will be conducted by the end of year 2000.

4.14. The restructuring that CBN envisages is timely as the main challenge in the next years will be to insure that all financial institutions are properly supervised relying on existing resources. In this regard, it will be important to verify whether the report being prepared by private consultants hired by the CBN to review banking supervision provides recommendations as to how CBN could optimize the use of its resources and rationalize supervision. Given the larger number of institutions to be supervised, it becomes important to better customize the “supervisory process” based on risks undertaken by banks.

4.15. Notwithstanding the still ambiguous legal provisions that lay out the respective roles of CBN and NDIC in dealing with problem banks, no major legal impediment prevents both supervisors, in their respective areas, from discharging their duties. The Nigerian government has apparently been to some degree supportive of crucial measures in the face of a widespread crisis, which left no option but to close a large number of ailing institutions. Nonetheless, the independence of supervisors vis-à-vis the Nigerian Government was not legally secured until the 1999 amendment of the BOFID. Up to then, public authorities such as the President or the Ministry of Finance held extensive powers regarding “entry” and “exit” of financial institutions. Political influence may still undermine supervisors’ effectiveness, as it did in the past, even though credibility of banking supervision has been enhanced by embedding independence of CBN in the law.

4.16. The new architecture of banking supervision envisages no major change in the role assigned to NDIC, although new procedures – embedded in the central bank decree – attempt to clarify the respective roles of CBN and NDIC in the area of bank resolution. In the domain of bank supervision, NDIC will continue to act as an independent supervisory authority, conducting both off- and on-site examinations which add to or complement what CBN accomplishes. The final licensing of some community banks, which may take place in the months to come, may result in a larger number of institutions benefiting from the deposit insurance scheme.

4.17. The 1988 decree that established the NDIC was aimed at enhancing confidence in the financial sector via two mechanisms. First, by virtue of this Decree, insured banks are required to adhere to prudential standards identical to those prescribed by CBN.

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9 CBN does not have the responsibility for the supervision of insurance companies, pension plans or capital markets.
Second, NDIC was mandated to provide insurance to every licensed bank and other deposit-taking financial institutions. In fact, while registration in the Deposit Insurance Scheme is mandatory for all these institutions, in practice, only deposits at commercial and merchant banks are insured. Banks pay premiums, which are calculated on the basis of collected deposits. NDIC is also empowered to take remedial actions against banks failing to comply with sound banking practices, having obvious interest in protecting accumulated premiums. NDIC enjoys wide powers ranging from instructing banks to remedy weaknesses to ruling the termination of the status of insured institutions.

4.18. While several episodes of banking distress since 1989 challenge the actual effectiveness of existing safeguards, NDIC has fulfilled its mandate rather successfully as receiver/liquidator, and it has been able to reimburse most insured deposits. The objectives relating to providing insurance to depositors as a means of boosting confidence in the banking industry and, in turn, avoiding a run on banks has been met for the most part. Nevertheless, the current insurance system would not be totally adequate unless NDIC actually guaranteed payments to depositors in case of “imminent or actual suspension of payments by insured banks” as stated in its charter (NDIC Decree art. 5 c.). In fact, the legal trigger for actual repayment of deposits is the closure of the distressed bank and the removal of its license, which can be delayed until long after a bank is closed. Repayments of deposits are not made when it becomes certain that the ailing bank can no longer meet its obligations, but rather when the license is withdrawn. Consequently, the legal framework allows much flexibility in determining the timing of NDIC intervention as insurer/receiver. It is therefore possible for depositors to be deprived of their rights and insurance benefits for long periods of time. This legal loophole may explain why CBN did not proceed with the withdrawal of licenses and closure of several severely ailing banks. This resulted in deposits being “frozen” in the amount of the approximate size of the Fund.

D. PRUDENTIAL REGULATIONS AND BANKING SUPERVISION

Prudential Regulations

4.19. The Central Bank of Nigeria is granted powers that allow it, in theory, to efficiently supervise most types of financial institutions both off- and on-site. CBN is also legally responsible for designing regulations that it deems necessary. In addition, CBN plays an important role in bank restructuring, even though NDIC is more directly involved in the design and implementation of restructuring efforts.

4.20. The legal framework is composed of numerous documents such as decrees and guidelines. The main documents relating to regulations and other existing norms are listed below:

i) The BOFID issued in 1991 and revised in 1997, 1998 and 1999 is the main regulation that sets the regulatory and institutional framework for banks, discount houses, finance companies and specialized institutions including community banks, development banks, mortgage institutions and the People’s Bank of
Nigeria. The Decree encompasses various prudential rules that are in line with or inspired by international standards and best practices.

ii) The “Prudential Guidelines” promulgated by the Central Bank in 1990 is another important document. It exclusively focuses on loan classification and rules for establishing allowances against impaired loans and expected losses.

iii) The Statement of Accounting Standards set in 1990 by the Nigerian Accounting Standard Board was tailored to the need of banks and non-bank financial institutions to provide guidance for accounting policies and methods that should be followed by these financial institutions in the preparation of their financial statements. This initiative was taken to remedy unacceptable practices within the industry and ensure greater consistency among banks’ accounting policies.

iv) The Failed Banks and Other Financial Malpractice in Banks Decree was promulgated by the Federal Government in 1994 to expedite the collection of loans in failed institutions and to combat insider transactions and other financial malpractices.

v) The Money Laundering Decree was promulgated in 1995 to prevent the use of the banking system for the purpose of money laundering.

Box 4.2. below contains a summary of the main prudential regulations in force in Nigeria

**Box 4.2. Main Prudential Requirements**

**Licensing:** Article 2 of the BOFID states that companies cannot carry on banking business without a valid license granted by prudential authorities. As only one new license has been granted over the last ten years, the licensing activities of the Central Bank are largely restricted to: i) ensuring that banks are in compliance with the conditions of their charter; and ii) renewal of licenses.

**Minimum Paid-up Capital:** In the light of the naira exchange rate depreciation, rampant inflation and erosion of capital due to mounting losses in loan portfolios, the minimum paid-up capital for commercial and merchant banks has been increased from N50 and N40 million for Commercial and Merchant banks, respectively, to N500 million for each. Banks have had to comply with this new requirement by March 31, 1999. New banks that will be applying for a license will be subject to a higher threshold (N1 billion).

**Capital Adequacy Ratio:** In 1990, the CBN instructed that banks comply with the Basle Accord. The minimum capital ratio was raised from 7.25% to 8% of risk adjusted assets as defined by the Basle Committee.

**Loan Classification and Provisioning:** Since 1990, banks have been required to establish general and specific reserves. Each licensed bank should have at least 1% in a general provision in addition to specific provisions made on the basis of perceived risk of default. As for specific provisions, for principal repayment not yet due, provisions should be made as follows: i) for sub-standard category, (unpaid principal and/or interest remains outstanding for more than 90 days but less than 180 days), the minimum reserves requirement is 10% of the outstanding loan balance; ii) for doubtful category (unpaid principal and/or interest remains outstanding for more than 180 days but less than 360 days), the minimum reserves
Box 4.2 (contd.)

requirement is 50%; and iii) for lost category (unpaid principal and/or interest remains outstanding for 360 or more), the minimum reserves requirement is 100%.

? Loan Concentration: The single credit risk limits for commercial and merchant banks are 20% and 50% of the shareholders’ fund unimpaired by losses, respectively.

? Insider Lending: The BOFID limits the amount of unsecured loans and advances to a bank’s shareholders, directors, executives, officers and their relations to N50,000.

? Liquidity: Banks are required to have a minimum liquidity ratio of 40% in addition to cash reserve requirements of 12%.

? Information Disclosure: As stated in Article 27 of the BOFID, annual accounts of banks should be forwarded to the CBN not later than four months after the end of its fiscal year for review prior to publication. As regards the form and content of the annual accounts, financial statements should comply with the accounting standards laid out in the Statement of Accounting Standards published by the Nigerian Accounting Standard Board.

4.21. The current set of prudential rules and regulations does have shortcomings. To catch-up fully with international best practices, the prudential authority should consider enhancing rules in areas such as capital adequacy, loan concentration, related lending, exit procedures, all of which have had adverse consequences with respect to banks’ soundness in the recent past. In addition to existing norms, supervisory authorities may find it beneficial to provide banks with more detailed guidance on sensitive issues such as internal control and risk management with a view to promoting safer behavior and dissemination of best practices.

4.22. Nigerian banks are subject to capital adequacy rules inspired by international standards. All risks incurred by banks, including off-balance-sheet items, are weighted in accordance with customary percentages and the regulatory capital ratio relative to these aggregated risks has been set at 8% since 1991. As recommended by Basle, prudential authorities should consider shifting from a quantitative approach to a more risk-based approach to best reflect the peculiarities of Nigeria (e.g. the fact that banks experienced tremendous distress and might confront similar episodes in the future) and impose higher capital ratios accordingly. In the same vein, the current legal framework applies to all financial institutions regardless of their intrinsic strengths. The CBN may thus consider customizing capital requirements to the risk profile of banks, for instance based on the CAMEL rating system being developed by NDIC.

4.23. Most current exit rules were designed as early as 1989 before the banking crisis unfolded. The recent amendments to the CBN Decree aim to establish a clearer division of labor between CBN and NDIC in dealing with problem banks. In fact the new rules do not bring about major changes, i.e. they do not meet the objectives:

a) Under the present legal framework, CBN and NDIC have sufficient powers and means of actions for dealing with problem banks either through rehabilitation procedures or by triggering closure, the latter being subject to legal shortcomings. Despite the wave
of closures initiated in the recent past (thus demonstrating a genuine willingness to rid the
ing the banking industry of insolvent banks) supervisors’ decisions are still influenced by
political concerns. Although recent amendments to the decrees establishing CBN and
NDIC are aimed at clarifying their respective roles, the new framework is still not very
clear as to when CBN should ask for NDIC’s intervention. It is ambiguous whether the
decision to solicit NDIC is entirely discretionary or whether NDIC must intervene when a
bank’s capital adequacy ratio falls below 5%. The mission assumes that the above issues
are discussed by the members of the Liaison Committee established for dealing with
problem banks.

b) The 1998 amendment of the BOFID resulted in some clarification regarding the
role of each supervisory agency. At least, it has been enacted that CBN is the pivotal
supervisory entity for bank resolution. However, NDIC continues to have obvious
interest in ensuring that timely actions are taken and plays an important role in helping
distressed banks receive adequate support. For instance, NDIC may find it the least cost
solution to grant facilities to a distressed bank. Although the Decree does not set out the
conditions under which NDIC is permitted to provide such support, NDIC is entitled to
take such steps, and if and when necessary, may ask for CBN resources.

c) CBN and NDIC’s roles in dealing with problem banks overlap to a very large
extent, making it difficult to identify the contribution of each entity accurately. Although
their respective duties are set out in the current legal framework, other key elements of
their strategies and decisions are not embedded in legal documents but may depend on
circumstances. The joint Committee that deals with problem banks apparently overcome
the obstacles created by a ill-defined legal framework.

4.24. It is recognized that lax policies and procedures for granting licenses to banks (low
capital requirements) and approving their managers (inadequate procedures for assessing
managers based on “fit and proper” criteria) led to various forms of abuses in the past and
a significant number of bank failures in Nigeria. In the face of obvious mismanagement
in bad banks (including unsafe lending policies, false accounting, inaccurate reporting,
frauds, etc.), CBN took vigorous measures to dismiss dishonest staff. In the same vein,
CBN recently imposed higher minimum capital requirements, N500 million for all
commercial and merchant banks, and N1 billion for new entrants. This initiative has
triggered mergers and/or exit of non-viable banks. As regards new entry in the banking
sector, there have been few, if any, potential investors eager to apply for licenses given
the turmoil this sector has experienced since 1989. A better climate that has gradually
emerged in Nigeria resulted in investors’ willingness to acquire license, and CBN has
responded positively to an application from a large foreign bank. It is true that an
embargo on licenses was in place in the 1990s and lifted only recently, albeit in favor of
foreign banks.

Banking Supervision

4.25. The fact that two independent organizations are entrusted with almost identical
powers for supervising banks both off- and on-site is quite unusual in the context of
developing countries where an understaffed banking supervision department is more the
rule than the exception. Still, the combined CBN and NDIC staffing in the supervision area (excluding staff involved in bank restructuring and asset resolution) exceeds four hundred employees, which is high relative to the number of banks (89). Considering, however, the larger number of non-bank financial institutions to be supervised, CBN may have to hire additional staff, but certainly not all of NBCB’s 700 employees.

4.26. Fragmentation is another significant peculiarity of the Nigerian supervision system. The customary division of labor between on-site and off-site surveillance reflected in separate units in many countries, is accentuated in Nigeria due to the distinct geographical location of departments as well as by the involvement of distinct institutions. On-site departments of CBN and NDIC are logically located in Lagos where most of banking activities are performed, whereas off-site surveillance is done from Abuja. The essential cooperation between CBN and NDIC together with the need to ensure a smooth communication internally makes optimizing the resources devoted to banking supervision challenging. While overlapping is limited in the on-site area, as examinations are alternatively handled by CBN and NDIC, there is much duplication of efforts in carrying out off-site surveillance. Also, the alternate on-site assignments may have the undesirable effect of undermining continuity and institutional memory.

4.27. Off-site surveillance in both organizations so far has been conducted based on detailed monthly returns, and was not automated until recently, due to a shortage in resources to develop in-house software. As a result, collected information greatly exceeded technological capacities, making it almost impossible for supervisors to exploit all the information provided in prudential returns. This major weakness is being addressed by CBN and NDIC who launched a joint project aimed at designing software that suits the needs of both organizations. This system should provide financial analysts with meaningful and easy-to-digest information. It should also facilitate comparisons of balance sheets and income statements of financial institutions in the same peer group. In addition to facilitating the financial analysis of banks, this system will make it easier for CBN and NDIC to come up with more homogenous views on the financial condition of banks.

4.28. While the BAS is likely to result in significant improvements, both CBN and NDIC still lack adequate systems to ensure that all collected information, besides prudential returns, is captured and stored in a way that permits easy access and meaningful use. Most units within each institution have their own information system that fits specific needs, with ineffective linkages with others. Furthermore, information is processed within numerous departments without an efficient mechanism for sharing it either internally or externally. The present level of computerization is so weak that the cost of sharing information would likely outweigh the expected benefits. The current information architecture is undoubtedly the major impediment to further improvements. CBN and NDIC should consider pooling additional resources in order to expand the existing BAS into a system that would also include qualitative information (monitoring of licensing, holding actions, of on-site examinations findings, follow-up, penalties, credit bureau, etc.). In the more sophisticated banking system that is likely to emerge in Nigeria,

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10 This is the Bank Analysis System (BAS).
supervision of banks will require not only analyzing financial data but also other qualitative factors, which should be tracked rationally.

4.29. While on-site examinations are performed by CBN and NDIC in a very similar way--although minor differences in approach exist--off-site surveillance differs more significantly. The off-site department of CBN pursues several objectives which are reflected in its internal organization: i) a unit focuses on ensuring that banks comply with cash reserve, liquidity ratio and capital adequacy requirements; ii) a small unit conducts in-depth reviews of external audits, as banks cannot publish their annual financial statements without the prior consent of CBN; iii) as soon as concerns of material importance warrant that a bank be included on the “watch list”, its monitoring would be taken over by a another unit which deals exclusively with problem banks. If judged appropriate by this unit, banks may be subjected to “holding actions”, which trigger additional monthly reporting and enforcing actions agreed upon with CBN (suspension of dividends, lending constraints, etc.); and iv) a special division deals with licensing issues and changes in management. Lastly, since it has been empowered with the supervision of all financial institutions, CBN is changing its organizational chart to be able to handle a broader mandate in the years to come. At present, CBN is considering undertaking a restructuring of its activities with the assistance of a major foreign consulting firm. The Banking Supervision Department is being reviewed and one can therefore expect that its activities will be transformed, in particular in the area of data processing.

4.30. In sharp contrast to the CBN, the division of labor within the off-site department of NDIC is not structured by tasks but rather by banks. The portfolio of commercial and merchant banks is split among financial analysts who are responsible for analyzing “prudential reports”, providing detailed financial analysis on a regular basis and, where necessary, proposals for remedial actions.

4.31. The overall efficiency of off-site supervision in both institutions would greatly benefit from a more integrated information system and better communication since not all relevant analysis is presently shared. For instance, the “CAMEL” ratings\footnote{CAMEL stands for Capital, Assets, Management, Earnings, Liquidity.} attributed by NDIC based on off-site review of monthly returns are not communicated to CBN. Similarly, the analysis of external audit reports that highlights issues of great interest to both institutions are not made available to NDIC. As neither CBN nor NDIC off-site departments are responsible for following-up on on-site examinations, the extent of cooperation between departments is limited to exchanging some but not all information.
Conclusions

4.32. The Nigerian prudential framework is unique as two institutions--NDIC and CBN--are empowered to supervise banks off- and on-site. In a context like this one, a smooth and close cooperation between supervisors is essential to ensuring effective supervision and convergent decisions. In this regard, CBN and NDIC should intensify the efforts being made with a view to best leveraging their respective advantages.

4.33. Both CBN and NDIC have the necessary staffing--provided that the new organization results in more productivity--adequate skills and prudential tools to fulfill their respective mandates. Their vigorous actions in the wake of the financial crisis have enhanced public confidence in the banking sector. Political pressure may still influence supervisors’ decisions, even though CBN and NDIC enjoy autonomy in dealing with a serious banking crisis and although independence was granted to CBN in 1999. The NDIC has not been granted the same extent of autonomy as it still reports to the Ministry of Finance. A program of strengthening banking supervision in the years to come, in line with both international standards and best practices, can be implemented if supervisors take full advantage of their newly-granted independence.

4.34. In addition to existing vulnerabilities at the institutional level, the supervisory framework in Nigeria suffers two additional shortcomings: First, the current fragmentation of banking supervision is detrimental to the best use of existing resources. Well-trained supervisors and periodic on-site examinations are critical factors that may compensate for this sub-optimal organization. Second, the modernization of CBN information systems is certainly key to the improvements that supervisors must contemplate, should they seek to keep up with changes in the financial sector at large and enforce international best practices.

E. ASSESSMENT AGAINST THE TWENTY-FIVE CORE PRINCIPLES

4.35. The assessment of the Nigerian supervisory system reveals that out of 30 principles (including the five sub-principles of Principle 1), 9 are fulfilled, 11 largely fulfilled, 4 largely unfulfilled and 6 unfulfilled. Box 4.3 below shows a summary of this assessment against the Basle Core Principles.
### Box 4.3. Summary of the Assessment of Bank Supervision

<table>
<thead>
<tr>
<th>9 CPs Fulfilled</th>
<th>11 CPs Largely Fulfilled</th>
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<tbody>
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<td><strong>1. Fulfilled</strong></td>
<td><strong>3. Efforts to achieve fulfillment are underway</strong></td>
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<td>CP17: Understanding bank operations</td>
<td>CP8: Loan classification</td>
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4.36. The nine principles in this category are divided into two groups. The first group includes three principles (CP2, CP17 and CP19) which are relevant to the Nigerian context. The second group comprises six principles (CP11, CP12, CP20, CP23, CP24, CP25), which are not fundamental as Nigerian banks and/or supervisors are not dealing with the issues addressed. Comments are not provided for the latter group.

a) Principle 2 on *permissible activities of licensed institutions* is fulfilled. The current regulatory framework should enable supervisors to ensure that all institutions undertaking banking business are licensed. Moreover, the Decree stipulates that only licensed banks are allowed to use the word “bank” (including community banks, but most of these are not licensed other than on a temporary basis). However the definition of deposits should be clarified as some forms of deposits in Finance Companies are considered by CBN as an "investment", which may have implications for NDIC whose liability is limited to insured deposits.
b) Compliance with Principle 17 on regular contact with bank management and supervisors’ understanding of bank operations is also met. Mainly in the course of on-site examinations, supervisors have close contacts with the senior management of banks. As CBN and NDIC take turns to conduct these examinations, there may however be some disruption in dialogue. As regards the understanding of bank operations, supervisors seem to have a fairly good knowledge of activities performed by Nigerian banks, thereby allowing them to discharge their duties effectively and with credibility.

c) Principle 19 on independent validation of supervisory information either through on-site examinations or use of external auditors is fulfilled. Nigerian supervisors conduct frequent on-site inspections (every eighteen months on average), making it possible to verify the quality of information submitted by banks and assessing their overall financial condition. Close cooperation with external auditors also provide a means of independent validation of supervisory information.

Principles largely fulfilled

4.37. The principles largely fulfilled—eleven in number—are regrouped under two headings depending on whether actions towards compliance are underway or not:

(a) Efforts to achieve fulfillment are underway

i) Principle 1.4: a suitable legal framework for banking supervision is also necessary, including powers to address compliance with law. Both CBN and NDIC have sufficient and comprehensive legal powers to take adequate and timely action against banks facing distress. The wave of closures initiated recently demonstrates a genuine willingness to rid the banking industry of poorly performing banks. Nonetheless, actions undertaken by supervisory authorities may be still subject to some form of political pressure, even though CBN was granted legal independence in 1999.

ii) Principle 8 on loan classification. Prudential Guidelines were issued as early as 1990 with the aim of providing banks with detailed criteria to ensure proper homogenous evaluation of the quality of assets and adequate provisions. This regulation also grants supervisors enough flexibility in evaluating the classification itself based on their own judgment.

iii) Principle 15 on money laundering. The Money Laundering Decree of 1995 gives CBN powers to address financial crimes. The Money Laundering Surveillance Unit of CBN took several concrete initiatives in order to combat money laundering and criminal activities related to banking operations (seminars, workshops, book publication, sensitization of general public, etc.). This Unit works very closely with the Special Adviser to the President on drugs and other financial crimes.

iv) Principle 16 on off- and on-site supervision. The fact that two independent organizations are entrusted with almost identical powers for supervising banks both off- and on-site is quite unusual in the context of developing countries where an understaffed
banking supervision department is more the rule than the exception. The overall staffing of CBN and NDIC altogether in the supervision area (excluding staff involved in bank restructuring and asset resolution) exceeds 400 employees, which is high relative to the number of banks (89) but may not suffice to supervise all institutions (community banks, finance companies, primary mortgage institutions), other things being equal.

4.38. Off-site surveillance by CBN and NDIC is done without effective information technology systems, so the current system does not allow for tracking both quantitative and qualitative information. The analysis focus on compliance issues such as compliance with regulations on capital and liquidity and to a lesser degree on other risks. The two supervisors recently pooled resources with a view to designing a common computerized tool for assessing banks’ prudential returns (Bank Analysis System, BAS). In addition to facilitating the financial assessment of banks, this tool will help supervisors best monitor trends and developments in the banking sector as a whole. More importantly supervisors of both institutions are more likely to come up with convergent views on the financial condition of banks if they use the same system.

4.39. Lastly, as pivotal supervisor for all financial institutions, CBN is now facing the challenge of restructuring its internal organization in order to be able to effectively supervise all of them off-and on-site.

**(b) Efforts to achieve fulfillment are not underway**

i) Principle 1.6 on information sharing. The current system for cooperation and information sharing among supervisors is achieved only through the Financial Services Regulation Committee. In addition, CBN and NDIC set up two committees for dealing with issues of common interest, including problem banks.

ii) Principle 4 on transfer of ownership. Under the current regulatory framework, CBN is able to monitor any significant change in ownership as banks should solicit its approval prior to initiating any shift in ownership that would result in a transfer of control. The legislation, however, does not contain a clear definition of what “significant ownership” means.

iii) Principle 5 on acquisitions and investments. CBN has the authority to establish criteria for reviewing major acquisitions or investments by banks. Although Nigerian banks are not authorized to acquire shares in companies without the consent of CBN, they are not expected to ask for CBN permission prior to embarking on new activities that were not reviewed and/or approved when the license was granted.

iv) Principle 7 on loan policies. Neither CBN nor NDIC have established guidelines that it regards as essential to ensuring sound lending and investment policies. The issuance of guidelines has not yet been scheduled. Nonetheless, even though there is no explicit requirement in this area, both supervisory agencies look at this critical aspect in the course of on-site inspections.
v) Principle 13 on **liquidity and other material risks.** On-site examiners devote sufficient attention to the monitoring of bank liquidity, and review the nature and extent of involvement of both the senior management and Board in taking major decisions.

vi) Principle 14 on **internal control.** As reflected in on-site reports, investigations on internal control vary markedly and focus on accounting issues mostly. Neither on-site reports nor analysis undertaken off site by either CBN or NDIC sufficiently identify the business lines of banks and related risks. Rather, supervisors focus on the analysis of the financial condition of banks and compliance with regulatory ratios (capital, liquidity, etc.). The current legislation does not emphasize the critical role the Board of Directors should play in safeguarding assets and ensuring adequate internal control. As regards senior management of banks, CBN has the power to dismiss any director guilty of misconduct in relation to its duties\(^\text{12}\). CBN also has the legal authority to restrict activities of banks when deemed necessary, which apparently includes the case where the management is not able to run activities in a sound and safe manner.

vii) Principle 21 on **accounting and disclosure.** Detailed accounting norms on key aspects of banking, inspired by International Accounting Standards (IAS), have been designed by all interested parties (CBN, Ministry of Finance, external auditors, NDIC, etc.). In addition, there are mechanisms for evaluating the banks’ prudential returns. As a result, supervisors are likely to have a fairly good understanding of the true condition of banks. Nevertheless, one cannot expect that market discipline will operate in a very effective way since banks are not required to disclose the information that would permit the public to form a fair judgment. The fact that CBN must approve financial accounts prior to publication may pose a risk to CBN’s credibility.

**Principles largely unfulfilled**

4.40. The principles largely unfulfilled - four in number - are regrouped under two headings depending on whether actions towards compliance are underway or not.

\((a)\) **Efforts to achieve fulfillment are underway**

i) Principle 1.2 on **independence/resources.** This principle is largely unfulfilled even though CBN was granted legal autonomy in 1999. Given the pattern of political pressure, it may take some time before the CBN can act as a fully independent supervisor. Relative to the size of the banking industry, the staffing of all supervisory agencies seems largely sufficient to undertake both off and on-site supervision. Maintaining the quality of supervision in the years to come will not be possible if supervisors do not devote resources to upgrading IT systems. Even with a larger number of financial institutions to supervise, adequate investment in automation should suffice to allow CBN to carry out wider duties with only a limited number of employees from NBCB\(^\text{13}\).

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\(^{12}\) See Article 44 of the BOFID.

\(^{13}\) NBCB’s staff strength is currently around 700
ii) Principle 6 on capital requirement. While the current framework is almost in line with international standards, local prudential authorities should adopt a more prudent approach due to the fragility of the Nigerian banking system and to keep with the norms on capital that the Basle Committee is contemplating. The present framework does not prescribe that CBN may customize capital requirements to the risk profile of banks. In addition, although all financial institutions are expected to be in compliance with capital adequacy rules, not all institutions submit information necessary to monitor capital ratios (e.g. community banks).

(b) Efforts to achieve fulfillment are not underway

i) Principle 9 on Management information. The current regulation on loan concentration restricts the definition of “large exposure” to those exceeding specified thresholds (20% or 50% of capital for commercial and merchant banks respectively), and gives no definition of “related companies”. There is no solid ground for setting separate lending ceilings for merchant and commercial banks as the difference in activities blur over time. Contrary to the current rule, one could argue that merchant banks should not be allowed to hold higher single exposures relative to their capital as their activities used to be less diversified and riskier than those of commercial banks. The initiative taken by CBN to systematically collect information on loans in the amount of N1 million and above through the credit bureau is a critical step toward tracking the largest exposures and identifying excessive indebtedness. The aim of leveraging the credit bureau database would require that: i) CBN and NDIC incorporate it in the supervisory process; and ii) NDIC and CBN adopt identical onsite procedures to ensure the best quality of data.

ii) Principle 10 on connected lending. Insider abuse has been widely recognized as one of the major causes that triggered significant distress in the Nigerian banking industry. Indeed, regulatory safeguards were not sufficient to discourage unsound lending practices, nor were penalties stiff enough to avert activities detrimental to banks’ soundness. One can legitimately wonder whether adequate systems were present to help supervisors detect and force banks to correct such anomalies or whether supervisors were prevented from taking action. To be in compliance with the objective of this core principle, CBN should consider adopting more stringent limitations and penalties that would be applied to banks and management involved in unsafe insider and/or related lending.

Principles not fulfilled

4.41. The six principles unfulfilled are regrouped under two headings depending on whether actions towards compliance are underway or not.

(a) Efforts to achieve fulfillment are underway

i) Principle 1.1 on clear supervisory responsibilities. This principle relates to the need to assign clear responsibilities and objectives to supervisors. In the aftermath of the recent banking crisis, the institutional framework has been amended to empower CBN
with broader responsibilities and independence. Hence, CBN has become the leading institution supervising all deposit-taking institutions as well as non-bank institutions such as mortgage companies, *bureaux de change*, etc. Nonetheless, CBN will not be able to carry out these extended responsibilities until some legal amendments are passed and procedures are put in place. It is obvious that absorbing the burden of supervising an increased number of financial institutions will take some time.

ii) Principle 1.3. on *legal framework and provisions relating to “the authorization of banking establishments and their ongoing supervision”* is not fulfilled. Due to political pressure, there has been significant interference that arguably altered the supervisor’s ability to enforce prudential actions in a timely fashion.

iii) Principle 3 on *licensing of banks*. In the 1980s, Nigerian authorities granted licenses liberally with a view to fostering activity and competition in the banking industry. In fact, lax licensing procedures together with significant political interference resulted in poor performance of newly licensed banks and later to failure of many of them. Until recently, no new license has been granted as Nigerian authorities gave high priority to restoring confidence in this important sector of the economy. Consequently, the licensing activities of CBN over the last seven years have been restricted to withdrawing licenses and ensuring that banks are in compliance with the conditions of their charter. However the embargo on new licenses is presently lifted and new licenses are likely to be given in the years to come as the Nigerian banking sector becomes more attractive to investors, even though new entrants will be subject to a N1 billion minimum capital as opposed to N500 million for existing banks. In the context of the legal framework that prevailed before 1998, community banks were granted provisional licenses and were supposed to be formally licensed after operating for two years. To date, no formal license has been issued by the CBN. Under the new decree, all community banks should be either licensed by CBN or put out of business. Those granted licenses would have access to deposit insurance.

iii) Principle 18 on *Prudential reporting*. Supervisors demand a very comprehensive set of prudential returns on a monthly basis but presently lack the technical capacity to process this data effectively. The main rationale for requesting monthly reports is to fine-tune monetary policy, banking supervision being a secondary concern. Hence CBN may consider alleviating the burden of monthly reports, thus limiting the scope of data banks must submit. Information relevant to banking supervision *per se* would be received on a quarterly basis. It is worth noting that not all banks, especially those with large branch systems, can provide accurate information due to inadequate IT systems. As regards the accounting framework, the Nigerian standards are inspired by IAS.
(b) Efforts to achieve fulfillment are not underway

i) Principle 1.5. on Legal protection granted to supervisors. Presently, the legal framework provides adequate protection to CBN. CBN staff, are only protected, provided they have acted in good faith. Even though staff of other agencies do not enjoy the same extent of protection, there is no case of supervisors being sued by banks for matters related to supervision.

ii) Principle 22 on Corrective Action. According to the present legal framework, CBN and NDIC have sufficient and comprehensive powers for taking action towards problem banks either through rehabilitation procedures or closure. Despite the wave of closures initiated in the recent past, demonstrating a genuine willingness to rid the banking industry of inefficient banks, supervisors’ actions have been influenced by government policy. Given the track record, the closure of banks is a very sensitive issue where supervisors may still confront considerable political pressure.

4.42. The recent amendments to CBN and NDIC Decrees mainly deal with penalties and procedures for tackling problem banks, with the aim of clarifying their respective roles. Despite these changes, the current framework remains unclear as to when CBN should solicit NDIC’s intervention. It is not clear whether NDIC intervention is entirely discretionary or whether NDIC must intervene when a bank’s capital adequacy ratio falls below 5%. As NDIC has primary responsibility in assuming deposit liabilities of failing institutions and acting as receiver/liquidator of banks, it has a strong interest in ensuring that timely actions are undertaken. It also plays an important role in helping distressed banks receive adequate support. For instance, NDIC may find it beneficial to grant facilities to a distressed bank. Although the Decree does not set out the conditions under which NDIC is permitted to provide such support, NDIC has taken such steps whenever it is considered to be the least cost solution. For this purpose the NDIC can borrow money from the CBN.

4.43. All in all, the roles of CBN and NDIC in dealing with problem banks overlap to a very large extent, making it difficult to capture the respective roles of each entity. Tracking their input is also a legal issue since key elements of supervisors’ strategies and decisions are not embedded in legal documents (e.g., there are no legal provisions explicitly dealing with liquidity support).
5. DEVELOPMENT FINANCE INSTITUTIONS (DFIs)

A. OVERVIEW

5.1. This report reviews Nigeria’s primary DFIs including Nigerian Industrial Development Bank (NIDB), the Nigerian Bank for Commerce and Industry (NBCI), Nigerian Export-Import Bank (NEXIM), National Economic and Reconstruction Fund (NERFUND), the Urban Development Bank (UDB), and the National Education Bank (NEB). An analysis of the Nigerian Agricultural and Cooperative Bank (NACB) was conducted on a parallel basis by a Rural Finance team. The rural finance mission has also reviewed an Agriculture Credit Guarantee Scheme (ACGS) and People’s Bank in a separate report. People’s Bank, while primarily a commercial bank also does developmental and small scale lending as do a number of Nigeria’s 1000 community banks which are analyzed in Chapter 6. In addition, there are a number of regional and state-owned DFIs that have not been studied.

5.2. Nigeria has traditionally used its DFIs as an important tool for providing specialized credit to priority areas on a targeted, and often subsidized, basis. Separate highly specialized institutions were created for each of six major sub-sectors including medium/large scale industry, small scale enterprise, exporting/importing, urban, education and agriculture. Two DFIs (NEXIM and NERFUND) function essentially as apex institutions which onlend funds to other institutions which in turn lend to final borrowers. While Nigerian DFIs’ objectives continue to be important, their ability to achieve them has been severely impaired over the years. With no significant exception, they cannot have meaningful economic impact unless large amounts of additional funds are provided from public sector sources and there are major improvements in how to efficiently allocate these funds. None are well positioned at this juncture to mobilize funds from multilateral or commercial sources. Moreover, the DFIs have been increasingly marginalized as the private commercial banking system has evolved into the major financing source for the real sectors.

5.3. A summary financial overview of the development banking sub-sector based largely on 1998 audited and unaudited data (Annex 4A) presents a relatively dismal financial picture. It shows that on a combined basis, NIDB, NBCI, NEXIM, NERFUND (1997), UDB, NEB (1997) and NACB have:

i) 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.

ii) accumulated losses in year-end balance sheets of N10.2 billion (44.5% of assets).

iii) negative net worth of N5.8 billion (25.2% of assets).

iv) a gross loan portfolio adding to N17.0 billion. For the four DFIs for which data were available, 78% of the loan portfolio was non-performing.
v) 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.

vi) virtually no 1998 disbursements by four of the seven DFIs, and a net decrease of N2 billion for the seven DFIs as a group.

vii) combined total assets declined almost 17.8% in nominal terms in the most recent reporting year.

5.4. 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 relatively 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 banks from entering the long-term finance arena.

5.5. Most development banks are increasingly illiquid and, if they are to continue, government will have to invest new funds on a regular basis to meet administrative costs and pay off existing debt, even if they make no new loans. The worst performing DFIs, i.e., those for which new investment tends to be least justified because of their low development impact, have the most urgent need for new cash. Paradoxically, such DFIs have been the primary recipients of new capital and liquid resources from Government in the past two years.

5.6. Four DFIs, NIDB, NBCI, NEXIM, and NERFUND operate in industrial and commercial sub-sectors for which a robust commercial banking system, given proper incentives and access to more long-term funds, could conceivably become the most important engine of growth. Moreover, these four institutions as a group have significant overlaps in clients, administrative structures, and modus operandi.

5.7. The NACB, while performing an important function somewhat more successfully than some of its counterparts as it continues to make significant disbursements in the rural and agricultural area (with emphasis on small-scale lending) where commercial banks in Africa often do not play an active role, is deeply troubled. It would need major restructuring before it could again play a meaningful role. The Urban Development Bank and Education Bank, although relatively newer and smaller, are floundering to the extent that they cannot engage in meaningful new lending and radical solutions should be actively envisaged.

5.8. 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) noncommercial governance that gives higher priority to developmental than commercial objectives; ii) politicization of lending associated with 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.

5.9. Of particular relevance to the DFI sub-sector, the mission has identified unavailability of long-term credit for creditworthy productive entities as a significant obstacle to Nigeria’s economic development (see Chapter 10 for details) and, despite a strengthening commercial banking system and macro-economy, this remains one of the most serious continuing flaws in the financial system. Commercial and merchant banks, albeit reasonably healthy at this juncture, are for the most part unwilling to provide much longer term credit and their ability to raise long term debt funds is severely limited. Indeed, commercial banks are even less willing than in many other African countries to provide long-term finance (96% of their lending is for less than one year) in response to Nigeria’s historically high levels of political, economic and policy instability. The more specialized traditional sources for longer term credit, e.g., these DFIs, the Primary Mortgage Institutions, finance companies, and the supply side pensions and insurance companies are all troubled and cannot be expected to play a meaningful long-term credit role in the near future, if at all.

5.10. On the positive side, the CBN has recently taken over responsibility for supervising and regulating these institutions 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.

5.11. A larger number of DFIs are operating in Nigeria than in countries in which DFIs have been particularly successful such as Korea, Brazil, Thailand, India and Sri Lanka. There are a number of DFIs around the world that continue to operate on a successful basis. Successful DFIs elsewhere tend to be: i) diversified well beyond their original focus, thus reducing risk through a broader focus and evolving as the markets in which they operate evolve; ii) more commercial than developmental in their primary objectives; iii) properly capitalized and funded often with the support of government; iv) predominantly privately owned and controlled; and v) staffed with high quality, well paid employees.

5.12. This report analyzes six DFIs in some depth and has looked at various alternatives for dealing with them as follows.
B. NIGERIAN INDUSTRIAL DEVELOPMENT BANK

5.13. **Background.** Nigerian Industrial Development Bank (NIDB), the second largest development bank, was established in 1964 as a private limited company for the primary purpose of providing long term debt and equity financing to medium/large scale projects in industry and agriculture. It has N1 billion in paid-in capital and is owned 59.54% by the Ministry of Finance (MOF), 40.36% by CBN, and 0.1% by 42 Nigerian citizens and associations. NIDB works under the oversight of the Ministry of Industry. As of January 1997, responsibility for its supervision, as well as that of all development banks, was transferred to the CBN. And like all other DFIs, it has functioned without a formal Board of Directors since 1992.

5.14. NIDB operated successfully over much of its 35 year history. It has reported a profit each year, although reported profits in several recent years would have been losses if international accounting standards had been adhered to. Until about 1982, NIDB operated under an umbrella of substantial government support in the form of foreign currency loans, annual government concessionary loans, and access to professional advice and support from international multilateral institutions. Over that time, it developed a culture of operational efficiency and reasonably effective policies and procedures relating to credit appraisal, decision-making and collections.

5.15. As of December 1998, it had mobilized $540 million from multilateral and regional agencies and invested N5.9 billion, of which 3% was in equity, in 987 projects involving N20.3 billion and generating an estimated 320,000 jobs. Although it lends in a number of subsectors, textiles and petroleum/chemicals together utilized 50% of total NIDB investment. While NIDB was predominantly involved with medium/large scale industry, much of it foreign controlled in its earlier years, it has also developed a significant small scale enterprise financing business and was the largest user of NERFUND and the World Bank’s second SME line of credit.

5.16. Despite NIDB’s auspicious beginning, it has fallen on hard-times. While a larger number of NIDB’s loans have been fully repaid, 55% of the present borrowers (77) in its December 1998 portfolio were losing money or being liquidated. Other major causes of its problems included a huge burden caused by foreign exchange risk on borrowed funds (on both NIDB and its borrowers), difficult business conditions, unpredictable or harmful Government policies (e.g., prohibitions on international borrowing), and a poor credit disciplinary environment.

5.17. Consequently, NIDB has largely ceased new lending activity and is focusing almost entirely on collecting old loans. NIDB has made no new approvals or disbursements during the past two years despite employing N3.17 billion in paid-in capital and loans from CBN or largely guaranteed by government, 436 staff in 6 regional offices, and incurring about N366 million (almost 17% of net loans available for collection) in administrative costs. On the positive side, and unlike most other DFIs, it has so far been able to meet all its debt service commitments (with the exception of one European Investment Bank line which is in dispute) without any additional financial
support from government or CBN. This may be a primary reason why there has been no response to date to its requests for additional capital.

5.18. NIDB’s financial statements superficially imply a satisfactory financial condition as they show positive net worth of 25% of assets, good liquidity (cash and liquid assets are 41% of total assets), a small reported 1998 profit of N14 million or 0.3% of total assets and small positive cumulative retained earnings. However, the 1998 income statements include an increase of N27 million in accrued income despite a very poorly performing portfolio and N22 million increase in unrealized foreign exchange losses.

5.19. Stated December 1998 net worth of N1.4 billion does not reflect N647 million in unrealized foreign exchange losses which NIDB hopes government will eventually take responsibility for. Moreover, cumulative provisions, amounting to only 18.1% of gross loans, appear far short of what should be appropriate under normal loan provisioning practices given both total arrears (principal and interest) and nonperforming loans (NPLs) adding to 55% of its December 1997 gross portfolio of N2.5 billion. If all NPLs eventually become bad (and there are always strong tendencies in that direction), NIDB is exposed to an additional N1.1 billion in potential provisions and interest suspension expense.

5.20. The development banks have now been placed under CBN supervision and, if CBN imposes accounting and provisioning policies on development banks more in line with those for Nigeria’s commercial banks (which the team recommends that they do), all of NIDB’s net worth could be eliminated.

5.21. On the positive side, while the manufacturing sector remains weak, there is potentially strong future demand for NIDB’s primary product, long-term loans, as macroeconomic uncertainty has sharply diminished yet there are virtually no other significant sources of long term debt finance at this juncture other than commercial bank overdrafts which are “converted” for that purpose. Moreover, NIDB has implemented an innovative diversification strategy which includes developing a letter of credit business and establishing affiliated companies in leasing, consulting, and stock brokerage. Finally, NIDB, despite losing a number of its better staff, probably still retains more project lending/supervision skills and more effective credit-related procedures than the other DFIs.

5.22. However, NIDB is facing daunting challenges at this juncture and it is being increasingly marginalized. These challenges include: i) a steady exodus of better quality staff; ii) virtually no new lendable resources; iii) huge exposure to foreign exchange risk as it has borrowed heavily in foreign exchange and onlent in domestic currency; iv) inadequate gross interest rate spreads administratively limited to 4% for much of its lending, resulting in substantial negative spreads after adjusting for suspended interest on bad loans; v) still close to reasonable administrative costs that will inevitably escalate out of control given present trends, reaching 51% of gross income and 8.2% of average total assets in 1998 as administrative costs increase (up marginally in 1998), while total assets steadily drop (down 2.4%); vi) a slowly more tarnished reputation as its financial and collection problems grow; and vii) an inadequate commercial culture and governance
issues given its owners’ relative noncommercial objectives and the lack of a Board of Directors with strong commercial expertise.

5.23. **What to Do?** NIDB and NACB are Nigeria’s most important development banks. While its financial condition, skills and culture have eroded substantially in recent years, NIDB 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. However, even with substantial recapitalization, in the mission’s view, it is unlikely that NIDB can be turned around without fundamental and far reaching restructuring.

5.24. Actions that should be considered as part of NIDB’s fundamental restructuring include:

i) An attractive package of existing equity investments could be placed in a unit trust and sold off through an Initial Public Offer (IPO) or private placement to raise cash for future lending. It’s equity investment portfolio has a market value of roughly N420 million, well in excess of its book (cost) value of N164 million. It holds 36 investments with a cost of N80 million in profitable companies and its dividend return on portfolio (N49 million in 1997) is substantial. NIDB could book a profit and raise long-term liquid local currency resources suitable for new lending.

ii) NIDB might aggressively seek opportunities to increase noninterest income (which added to a modest 4.1% of total assets in 1998) in an effort to diversify beyond long-term lending. Developing a merchant banking/financial consulting business would appear to fit well with NIDB’s skills. In addition to creating fee-based income, this might allow NIDB to more extensively revolve its existing portfolios through future unit trusts or selling off performing loan portfolios to create cash for new lending. NIDB is already considering several other diversification initiatives including establishing a venture capital fund and a credit rating agency.

iii) NIDB might further diversify its traditional lending focus by limiting all future long-term foreign currency lending to *de facto* exporters who can hedge the risk and increasing the percentage of its total lending done in local currency. It should also aggressively expand emphasis on small scale enterprise lending given: i) the high priority government places on this arena; and ii) NIDB’s comparative advantage in terms of regional offices and past SME lending experience.

iv) NIDB should not accept NERFUND or other funds if they place interest rate ceilings on NIDB’s onlending terms or spreads. Such ceilings are likely to damage NIDB’s ability to conduct SME lending on a sustainable basis because: i) higher spreads are needed to break even given the high cost of bad debt; and ii) subsidized interest rates create greater diversion of funds from intended purposes and increase risk of non-repayment.

v) NIDB’s balance sheet should be restructured with the objective of making it a creditworthy recipient of funds from nongovernmental sources that expect to be repaid. The audit of its 1999 balance sheet can be conducted based fully on international accounting principles and CBN requirements relating to provisions and suspension of
interest. As suggested above, without recapitalization, NIDB’s balance sheet might show little or even negative net worth. Government could accomplish significant recapitalization of NIDB, effective retroactively to December 31, 1999 without immediate incremental cash expenditure by assuming responsibility for NIDB’s remaining debt (about N1.025 billion which it has already guaranteed) due to the European Investment Bank (EIB) and the African Development Bank (ADB). The reduction in interest expense and need for future provisions and suspended interest associated with the balance sheet restructuring should restore NIDB to profitability assuming its future lending is sustainable.

vi) NIDB should aggressively cut costs with the objective of reducing overhead expense to less than 5% of total assets. If assets are again growing, this might be achieved through reducing non-essential (mostly support) staff, reducing the number of sector departments, reducing costs associated with poorly performing subsidiaries, more efficient use of vehicles and more efficient training program design. However, NIDB should probably not reduce the number of branch offices without careful study if they are going to expand SME lending.

vii) NIDB’s restructured balance sheet and income statement could then be used as a foundation for implementing a strategy to commercialize its culture to further enhance its creditworthiness with international as well as domestic sources of funds. Its culture could be commercialized by: i) shifting oversight responsibility from the Ministry of Industry to the Ministry of Finance which is likely to place higher priority on financial performance and sustainability vis. real sector objectives; ii) appointing a Board of Directors that consists predominantly of highly skilled private sector individuals with reputations for integrity; and, most importantly, iii) seeking a private strategic investor or investors who will take a majority ownership position and assume primary responsibility for NIDB’s management.

viii) NIDB’s liquidity, and any new capital it may receive, should be invested primarily in its lending and equity investment activities rather than in real estate. If it chooses to build an Abuja headquarters, it might consider a sale and leaseback on its NIDB Lagos building as the funding source.

ix) NIDB, with its strengthened balance sheet and commercial governance, can then aggressively seek debt capital in foreign exchange from multilateral sources and in domestic currency (possibly through issuing debentures) from such sources as NSITF, the larger insurance companies, and developmental agencies that may be operating as apex lenders. It might also consider seeking permission to sell medium-term certificates of deposit in the wholesale market but such permission should be granted only after all the above restructuring has been implemented.
C. NIGERIAN BANK FOR COMMERCE AND INDUSTRY

5.25. **Background** The Nigerian Bank for Commerce and Industry (NBCI) was established in 1973 as a statutory corporation under its own decree for the primary purpose of providing long term investment debt and investment financing to small and medium scale enterprises (SMEs). It has N200 million in paid-in capital and is owned 60% by the Ministry of Finance and 40% by CBN. The shareholders have approved an increase in authorized capital to N 1 billion and have put up an additional N 273 million deposit toward subscribing additional shares. NBCI works under Ministry of Industry oversight and is now supervised by CBN. It has functioned without a Board of Directors since 1992.

5.26. As of April 1999, NBCI had disbursed N1.5 billion in support of 704 projects. The bulk of their support has been in the form of 5 to 7 year loans with about 10% in the form of short-term working capital. In its early years, it made some equity investments, e.g., in a cement plant. The bank played a dynamic role in supporting SMEs until falling on hard times beginning in 1988. It secured the first SME lines of credit from the World Bank and ADB and played a pioneering role in obtaining Nigerian access to the international capital markets, raising 20 million pounds sterling from Morgan Grenfell. Additional funding was raised from NERFUND and Elgap.

5.27. NBCI’s lending terms and conditions, in addition to providing longer maturities, have been somewhat lower than commercial terms. Their naira SME term loans were at the average prime rate charged by the four largest banks, i.e., about 21% at the time of the mission. Most foreign exchange loans were at 14.5%, while NBCI is charging about 30% for working capital loans. Entrepreneurs are expected to put up 30% of project cost in equity and NBCI does feasibility analyses on individual projects before approving them.

5.28. Unfortunately, despite its promising start and its designated role as the primary financier of SMEs in Nigeria, NBCI subsequently became so dysfunctional that it was able to finance only one subproject under the second World Bank SME line of credit. As of Dec. 1995, 92.7% of their loans were in default. Other reasons for its poor performance included: i) losses on deposits in commercial banks that were liquidated; ii) foreign exchange losses, especially on an ADB line of credit; and iii) losses on a deal involving 20 mini-flour mills. NBCI’s public image has been damaged by past lending practices and results.

5.29. A restructuring committee, in a 1995 report, concluded that NBCI was still relevant given the high priority attached to its SME client base and recommended radical restructuring. In response, NBCI has aggressively downsized, reducing the number of offices from 21 to 6 (4 zonal offices as well as Abuja and Lagos), the number of employees from 700 to 183 (77 of whom are categorized as senior), and the number of departments from 14 to 10. Other recommendations including conversion into a limited liability company, signing a performance contract with government entities and a generous recapitalization were not implemented.
5.30. Despite the aggressive restructuring, NBCI’s performance remains dismal. As of December 1998, its portfolio consisted of N1245 million in principal lent to 430 projects, 98% of which was overdue with 74% overdue by more than 24 months. Unpaid interest totals N 1333 million or over 100% of principal outstanding. NBCI has actively utilized about 80% of its senior staff in debt collection but has been able to collect only N32 million, i.e., only 1.2% of the amounts overdue during the 9 months ending September 30, 1999. As some collections pertain to new amounts coming due, it is probable that it would cost more to continue to collect against the existing portfolio than can be collected. Indeed, annual administrative cost of N130 million now being incurred (which accomplishes little beyond collection efforts on the existing portfolio) amounts to 720% of the total amount estimated to be collectable. There has been virtually no new lending for 3 years although a trickle of disbursements has continued to finish previously committed projects.

5.31. NBCI appears to be using the new capital inflows it has received to finance administrative cost, repaying loans and capital expenditures, rather than in implementing its objective of providing financing to SMEs. Its year-to-date loss for the six months ending June 30, 1999 was N78 million of which about N68 million represented cash. N9 million was invested in fixed assets, including N1.3 million in a new headquarters building in Abuja and NBCI hopes to make additional substantial fixed asset investments in a badly needed computer system as well as the new headquarters. Meanwhile, NBCI’s owners have invested N1.56 billion to date, including an additional N 167 million in 1999, and frequent infusions of new cash will be required to keep it alive even if it is not engaged in new lending.

5.32. NBCI faces major challenges including: i) huge exposure to foreign exchange risk given past heavy borrowings in foreign exchange onlent in domestic currency terms; ii) lack of identified viable lending base and demonstrated ability to lend successfully; iii) heavy reliance on Government subsidies and inability to generate own resources; and iv) an insufficiently commercial culture. Indeed, NBCI’s future prospects appear bleak.

5.33. **Financial Condition and Performance** NBCI’s financial statements, unlike NIDB’s have been prepared largely in line with CBN accounting and provisioning policy guidelines. As shown in Annex 4C, NBCI’s financial condition, despite the new inflow of N273 million for paid-in capital is highly insolvent with negative net worth of N3.925 billion or 367% of total assets. Although over 90% of NBCI’s assets, i.e., N900 million, is in liquid assets, its net working capital is essentially zero as it is offset by bank overdrafts and unpaid interest. It has periodically run a debit balance in its CBN current account. From a financial perspective, NBCI has ceased to be a lending institution as loans, net of provisions, amount to only 1.5% of total assets. Assuming future losses could be eliminated, it would require an additional N4 billion to provide NBCI with a reasonable capital position. Of this, roughly N2.4 billion appears to represent amounts due to government or guaranteed to government and is, hence, nonincremental.

5.34. During the 1992-99 period for which data were available, NBCI has lost about N3.3 billion with losses in every year except 1997. The N78 million loss for the six months ending June 30, 1999 represented about 15% of total assets. Despite the massive
administrative downsizing, NBCI still suffers from excessive administrative cost, with non-interest expense for 1998 adding to 11% of average assets and 95% of gross income. Non-interest income at 1.4% of assets is considerably lower than for the other larger development banks and does little to offset the high administrative cost burden. Although NBCI’s debt is relatively low cost at 5.8%, its spread is also low because of the relatively poor quality of its earning assets. NBCI is likely to continue to incur cash losses on an ongoing basis, before servicing debt principal, unless it is provided with substantial cash resources which it can invest in safe deposits.

5.35. What to do? NBCI’s objective of providing long term finance for SME development remains unquestionably relevant as it remains a high government priority. However, there is inadequate evidence on which to base an assumption that NBCI, even if massively recapitalized, can be effectively relevant to this objective as it faces serious obstacles. It has not demonstrated an ability to lend money on a viable basis, the lending skills it did have are being eroded by a lack of activity and departure of some of its better staff over the years, and its client base appears to have developed a culture of non-repayment. It has not succeeded in developing a commercially oriented culture and morale is not high. The cutback in its branch structure has eliminated any comparative advantage it once had in being located closer to borrowers. Among developmentally oriented institutions, only NACB and People’s Bank (which are now being merged) now have such a structure and even NIDB has as much regional geographical representation as does NBCI.

5.36. Three alternative strategies for dealing with NBCI are as follows:

i) NBCI can be given access to substantial new resources through massive recapitalization in the form of government assumption of most of its debt and an infusion of at least N1.5 billion in cash resources. If NBCI drops plans to build a new headquarters, invests some 60% of the new funds in safe deposits, and makes new SME loans with the remainder on a very cautious basis, while it would become a marginal player, it could conceivably be sustainable. However, the amount of new SME lending it could do would probably continue to be limited to this funding plus possible borrowing from NERFUND as it appears doubtful that NBCI could regain a sufficiently sound foundation to attract significant new debt capital from multilateral or commercial sources. Its administrative structure would largely duplicate that of NACB and NIDB and any new capital might dilute government ability to provide support to these other developmental institutions.

ii) NBCI could be liquidated. If liquidation were to be implemented immediately, such that shareholders advance no incremental funds and amount of additional administrative cost, this might be the lowest incremental cost solution. Assets could probably be sold for close to 100% of book value as 90% represent cash and bank deposits. Meanwhile, fixed assets, much of which represents real estate in Lagos and Abuja, can probably be sold for more than its book value. While its remaining net loan portfolio of N18 million would probably not be collectible, this represents only 1.5% of net assets and its collection value net of collection cost may already be negative. Most of the debt that remains to be serviced represents little incremental cost as government will have to take responsibility for servicing or writing it off in any event.
iii) NBCI could be partially merged with NIDB which in turn would be asked to place considerably more emphasis on SME lending. NIDB is already a much more substantial player than NBCI in SME lending, has at least as suitable a geographical administrative support structure for onlending, and has better developed credit and administrative support procedures. NBCI’s liquid assets and fixed assets could be sold to or transferred to NIDB at book value in the form of capital thus reducing the size of the future NIDB recapitalization burden on shareholders. Zonal offices should be closed and the largely uncollectable loan portfolio could be turned over to professional debt collectors in return for a portion of the proceeds. Government would take responsibility for most of NBCI’s debts including amounts due ADB, World Bank and NERFUND. NIDB could take over employment contracts for those selective few it wanted to hire while the remaining NBCI staff would either be terminated or spun off into a consulting organization oriented toward providing non-financial technical services to SMEs.

D. NIGERIAN EXPORT-IMPORT BANK

5.37. Background Nigerian Export-Import Bank (NEXIM) was established as a limited liability company under a 1991 decree for the purpose of: i) providing export credit guarantees and insurance; ii) export promotion; and iii) providing export financing to support exporters. NEXIM has paid-up capital of N500 million and is 50% owned by FGN and 50% owned by FGN. FGN has put up an additional N125 million deposit to purchase additional shares. The Ministry of Commerce has oversight responsibilities and CBN now has supervisory responsibility. NEXIM, like other DFIs, has no Board of Directors at this juncture.

5.38. NEXIM’s primary activities since its inception have involved export financing as a second tier institution, i.e., borrowing money from the African Development Bank and CBN and onlending funds to banks which in turn lend to exporters whose applications are approved by NEXIM.

5.39. Initially, the primary lending involved the use of a $5 million ADB line of credit, which was fully utilized in 1992, to make “export stimulation loans”, i.e., five year foreign currency loans to exporters through approved commercial banks. NEXIM borrowed the money at 7.64%, onlent the funds at 10.5% interest in foreign exchange to banks who were allowed to onlend at up to 14.5%. Actually, much of the line of credit was lent by CBN prior to the establishment of NEXIM with the portfolio turned over to NEXIM at its inception. Most of these loans were made to banks that were eventually liquidated and NEXIM was not able to collect the loans or service the corresponding debt to ADB.

5.40. Consequently, as of December 1997, NEXIM had N2.0 billion in export stimulation loans on its books, 99.7% of which were non-performing, and offset by a N4.1 billion loan from ADB in foreign exchange. NEXIM was saddled with large interest expense and foreign exchange losses (due to devaluation), offset by virtually no interest income and Government was forced to make the payments on NEXIM’s behalf as the bank was unable to service this loan. In 1998, NEXIM’s financial statements show that FGN transferred both the loan portfolio and the ADB liability to its own account, thus
retroactively increasing NEXIM’s December 1997 net worth from negative N 3.26 billion to a positive N0.38 billion, i.e., a de facto recapitalization of N 3.64 million. However, CBN inspectors did not find evidence that these transfers had been legally approved and finalized.

5.41. While NEXIM no longer has foreign exchange funding available for lending, it has recently resumed naira lending utilizing N 450 million received from Government as a deposit toward new paid-in capital, after several years in which no loans were made due to lack of funds. These bans are typically made to commercial banks at 17% interest for up to 120 days which can be onlent at up to 21% to exporters preapproved by NEXIM, with the commercial bank taking full credit risk.

5.42. All of the new lending has been under NEXIM’s export credit rediscounting and refinancing facility (RRF) which involves lending eligible commercial and merchant banks local currency 100% refinancing for pre and post-shipment exports with the objective of increasing the tenor of bank export lending. Funds are available on a substantially subsidized basis (presently 21% vis. a prime rate hovering at about 26%) for all exports other than oil, including primary, processed and semi-processed products. Funding is made available for up to a maximum 120 days for pre-shipment finance, 90 days for post shipment, and 180 days on a combined basis. Both the banks and exporters must be pre-approved by NEXIM.

5.43. NEXIM also has two other lending facilities that are presently inactive. One is a foreign input facility, designed to provide medium and long term foreign exchange through commercial banks to exporters for financing the importation of raw materials, packaging materials, capital requirements and spare parts. A stocking facility is meant to provide exporters with short term finance for the purchase of local production inputs. Also, NEXIM management is presently considering providing medium-term loans directly to exporters.

5.44. NEXIM’s past lending has been unsuccessful from both a financial and real sector point of view. From a financial perspective, even after Government took over responsibility for over N2 billion in non-performing loans and participating banks take full credit risk on the individual borrowers, 98% of its remaining portfolio was non-performing. In 1998, NPLs dropped to 92.3% of total loans, largely due to N48 million in new disbursements which may or may not become non-performing over time.

5.45. In the past, given that most sound banks have adequate funding to support their short term export lending at a cost of funds considerably below the levels charged by NEXIM (presently 17% to the banks), it appears that virtually all banks which did borrow either had serious liquidity problems or, as money is fungible, often used the money for some other purpose. NEXIM is presently lending to 8 banks and has pending applications from two others. Unfortunately, it is always likely to face this “adverse selection” risk, although several of its present borrowers are sound merchant banks whose lending capacity (because of large recent increases in new capital) substantially exceeds their deposit base and for whom NEXIM funds appear more attractive than does borrowing in the interbank market.
5.46. It is difficult to ascertain whether or not NEXIM financing is, in fact, producing incremental exports and what the value-added impact of the exports it finances are. Commercial banks view export financing for creditworthy clients as low risk lending and, as the banking system usually has significant liquidity, there is intensive competition for such business from banks who do not access NEXIM funds. Therefore, if NEXIM does, in fact, support incremental exports it is likely to be from borrowers who are viewed as marginally creditworthy. Also, while NEXIM states that it gives preference to value added exports, information on value-added is not collected in the credit applications. A rough analysis of NEXIM's N14.4 billion in RRF lending over the 1991-98 time period suggests that, excluding cocoa-related lending (some of which involves processed goods), only 5.4% was used for processed and semi-processed goods. The NEXIM loans may be making some of these exports more price competitive (a NEXIM objective) because of the subsidized interest rates. However, NEXIM officials report that it is difficult to verify the validity of applications and that the subsidized interest rates attract a number of fraudulent applications from borrowers who do not intend to use the money to finance exports.

5.47. NEXIM is considerably smaller administratively than other DFIs with a total of 3 offices and 75 staff, of whom 39 are higher level staff. Noninterest expense, adding to 8.8% of average total assets and 23.4% of gross income, is very high for a second tier institution.

5.48. Financial Condition and Performance As shown in Annex 4D, NEXIM’s financial condition, which had been highly insolvent, per its statements, has improved dramatically due to the N4.0 billion in de facto recapitalization it claims to have received in 1998-99. As of December 1998, the bank had N2.5 billion in assets and claimed an adequate N502 million, or 19.8% of total assets, in net worth.

5.49. Also, the bank had a strong liquidity position with cash and short term investments of about N 2.3 billion (90% of total assets) and a tiny 5% of assets invested in loans and long term investments. The bank’s only debt is a N1.225 billion loan at 8% interest from CBN which behaves like quasi-equity because NEXIM does not service it. If it has in fact been recapitalized, NEXIM, at this juncture has some borrowing capacity given its strong balance sheet, sufficient funding to significantly expand lending, and flexibility as to how it chooses to lend.

5.50. Financial performance, while historically disappointing, also improved dramatically in 1998, assuming that responsibility for the ADB loan has been transferred to Government. Interest margin is a high 10.7% of assets due to high interest income on treasury bills, offset by low interest expense (because of the CBN facility) of 5.6% of assets. Non-interest income at 5.2% of average assets is reasonable and to a significant extent offsets the non-interest expense of 8.8% of assets. Bad debt provisions expense for bad debt were insignificant as almost all loans were already fully provisioned or are new. Following losses in earlier years, NEXIM, due to its recapitalization, reported a satisfactory 1998 pre-tax profit adding to 4.7% of assets.

5.51. As evidenced by its past dismal lending record, NEXIM has not yet established its ability to lend profitably. Assuming NEXIM wishes to lend in support of its stated
objectives, it cannot remain profitable unless its new lending is profitable. It is the mission’s view, that NEXIM’s new lending can only be profitable if it takes advantage of the new opportunity provided by its recapitalization to fundamentally change its lending products and procedures.

5.52. **What to do?** NEXIM may have already been massively restructured financially. However, in addition it is asking CBN to convert N 450 million of its present debt to paid-in capital, thus matching the deposit already paid in by government for this purpose. It is also asking that interest on the remaining debt be reduced from 8% to 2 or 3%. The interest rate on the CBN borrowing is already subsidized and there is little justification to subsidizing it further. Indeed, NEXIM as well as other commercial organizations should, where they have the ability, honor obligations by paying the interest as due. Also, NEXIM does not need additional capital. New capital would be justified, in the mission’s view only if NEXIM develops a new lending strategy and makes major improvements in every aspect of the credit administration process.

5.53. NEXIM’s present lending strategy is seriously flawed because: i) efforts to subsidize the cost of money to the final borrower reduces commercial bank lending margins (making the program unattractive to most of the better banks), and encouraging both rent seeking behavior and fraudulent diversion of funds; ii) short term credit for creditworthy exporters is readily available and banks are not going to use NEXIM funding for marginally creditworthy borrowers because cost of funds is high, margins, are low and they have to take 100% credit risk; iii) weak banks will be more interested in NEXIM funds than strong banks are; and iv) the cost and time delays associated with NEXIM approval of individual sub-loans is not justified because its review does not increase export value added and/or can not with high confidence ensure that the funds are not used fraudulently.

5.54. NEXIM’s present funding base is very long term while Nigeria’s creditworthy exporters have difficulty in borrowing long-term funds because commercial and merchant banks are reluctant to make loans of three years or more. If NEXIM would make their funds available through the banking system only for medium and long term loans at non-subsidized rates that give commercial banks margins that they determine for themselves, the prospects for helping *bona fide* exporters incrementally would increase significantly. It is recommended that NEXIM terminate its short term lending facilities and make only medium and long term funding available to banks while leaving the banks free to charge the final borrower whatever interest rate they wish.

5.55. NEXIM is considering the possibility of lending directly to clients without using banks as an intermediary. Experience elsewhere shows that simultaneously lending to banks and to customers who are clients of banks creates a serious conflict of interest and would have negative impact on any future lending programs through banks. It is strongly recommended that NEXIM lend either to commercial banks or directly to clients, but not to both groups simultaneously.

5.56. NEXIM has no experience in direct lending and lacks credit appraisal, processing and collection skills. Moreover, it is not well positioned in terms of branch offices or numbers or types of staff to conduct direct retail business. This type of lending is
potentially very high risk and, even if the loans can be collected, the administrative and transactions costs are high. A continuation of the present policy, a function parallel to that of NERFUND, of lending only to commercial banking institutions (possibly including NIDB if it is restructured) appears to be a more advisable strategy. However, as the function is so parallel, it creates unnecessary duplication of costs and a less integrated more fragmented apex interface with the banks.

E. NATIONAL ECONOMIC AND RECONSTRUCTION FUND

5.57. Background. The National Economic Reconstruction Fund (NERFUND) was established in 1989 as an apex agency to promote small and medium scale enterprise through providing credit. It is owned by the Ministry of Finance (with a 67% share) and the CBN. Its CEO reports to the Minister of Finance and the CBN recently took over responsibility for its supervision.

5.58. It has borrowed money from the ADB ($ 140 million) and lent both foreign exchange and local currency funds (from its N 323 million capital) to participating commercial and development banks for on-lending to enterprises. Loans are for 5 to 10 years inclusive of a grace period. ADB funds were lent with foreign exchange risk at 10.5% (giving NERFUND a 1% mark-up) to the intermediating bank which in turn could lend at 14.5% to the final borrower. Naira loans are lent at 15.5% to the intermediary and passed on to final borrowers at 19.5%.

5.59. NERFUND reviews and approves individual loan applications but finds it difficult to ensure that its funds are used as intended, e.g., that they are not refinancing previous loans and, hence, liquefying banks. It estimates that 85% of its past approvals were for start-up operations. It expects participating banks to provide augmenting working capital loans. NERFUND has defined the target group as enterprises with less than N 36 million in fixed assets but plans to increase the limit to N120 million because of devaluation of the naira. NERFUND reports that some 148,000 new jobs have been created. NERFUND does not take credit risk on the final borrower and has no data on final borrower repayment performance.

5.60. During the last ten years, NERFUND has made 190 commitments and disbursed about N 7.8 billion (US $160 million equivalent) for 260 projects, an average of over US $600,000 per project. Almost 90% of disbursements have been in foreign exchange. However, foreign exchange resources have been fully used and new disbursements are limited primarily to collections. NERFUND approved virtually no new loans in 1998, but has made new disbursements of N41 million during 1999. It reports that new applications from banks have thinned considerably.

5.61. Financial Condition and Performance Summary financial statements are shown in Annex 4E. As of December 1997, the most recent year available, NERFUND reported total assets of N8.9 billion (US$ 108 million). Net worth added to N739 million, or 8.3% of total assets. It had virtually no net working capital with near cash assets of about N1
billion approximately equal to debt due within one year. Loans, which dropped sharply in 1997, represented 85% of total assets.

5.62. Income statement data is sketchy. NERFUND has shown a profit in every year, with 1997 net profit of N 142 million representing 1.3% of average total assets. The fund is administratively relatively small with 85 employees and offices only in Abuja and Lagos. While NERFUND has disbursed on only 0.3 projects per staff member per year it nonetheless appears relatively efficient administratively with total 1997 expenses inclusive of interest expense adding to only 5.4% of average assets and 80.3% of gross revenue. Administrative costs at less than 1% of average total assets compare very favorably with NEXIM’s 8.8% costs for implementing essentially the same function.

5.63. NERFUND’s collections have been relatively good as it has the power to debit participating bank’s accounts with CBN on a quarterly basis. However, about N1.5 billion, or 20% of its end-1997 loan balances had been made to banks under liquidation proceedings and is likely to be uncollectable. It appears that NERFUND has not made bad debt provisions or suspended interest in respect of these loans in accord with central bank provisioning requirements. If it were to do so, it would probably report negative net worth and losses in 1997. Management has indicated that it plans to provide N274 million in bad debt provisions in their 1998 accounts, equal to about 60% of their year-end 1997 net worth. In recognition of its need for new capital, NERFUND is requesting N1.5 billion in new capital in 2000.

5.64. While NERFUND’s own collections are reasonably good, repayment default by final borrowers is probably high, given that most disbursements have been foreign exchange denominated and many of the final borrowers are not exporters and, hence, can not hedge foreign exchange risk (naira/dollar exchange rates have risen from N7.4 to the dollar to N95 over the last 10 years). It is not surprising that demand for NERFUND funding has dropped as most participating banks have probably experienced substantial losses on relending its funds.

5.65. Primary obstacles to successful NERFUND operations include:

i) Foreign exchange denominated funding, which represents most of NERFUND’s money, is largely unsuited for small and medium enterprise lending. On the other hand, given its $600,000 average loan size, NERFUND does not seem to have concentrated primarily on small scale lending in the past.

ii) If it is not recapitalized, NERFUND’s new lending will continue to sharply diminish as repayment requirements on the ADB line of credit will take an increasingly large portion of new amounts that NERFUND collects. NERFUND currently has little working capital.

iii) Demand for NERFUND funds has dropped because: i) banks have experienced losses on their previous onlending of NERFUND funds and find foreign exchange denominated funds unattractive; ii) long term loans to medium and small scale enterprise are always high risk; and iii) NERFUND limits the margins of participating banks to 4%.
iv) NERFUND has not done adequate credit analysis on participating banks, resulting in a substantial high bad debt cost despite its huge advantage in collection mechanisms, which may make the operation unsustainable. NERFUND appears to face the same “adverse selection risk” that NEXIM does in that weaker banks are more likely than stronger banks to find this funding source attractive.

v) It is probably not feasible that NERFUND review the quality of individual subprojects given their small size and large number. Efforts to do so would require upgraded staff skills and would incur high administrative costs.

5.66. What to do? Government places high priority on NERFUND’s stated objective of supporting small and medium scale industry and an unquestionable need exists for additional longer term credit to this subsector. Three alternative strategies for dealing with NERFUND are as follows:

i) NERFUND could continue to operate as it has in the past. This would require recapitalization and access to new borrowing. Under this strategy, only domestic currency lending should be undertaken. Government may wish to take foreign exchange risk on foreign exchange lines of credit in return for an appropriate fee. Participating banks should be carefully analyzed from a credit perspective to limit NERFUND’s credit risk and bad debt expense. While commercial banks should represent the primary channels for NERFUND credit, a recapitalized NIDB would also represent one suitable participant. Banks should be free to adjust maturities to fit individual borrower requirements and to charge any interest rate they wish on onlent funds. Ceilings should be placed on maximum loan size to ensure that most NERFUND financing goes to small scale borrowers in line with national priorities.

ii) NERFUND, as its apex functions are parallel, could merge with NEXIM to cut combined administrative cost and reduce skilled staff requirements given the high degree of parallelism in their apex lending functions. It would also reduce total new capital requirements and oversight burdens imposed on the central bank and government. Under this scenario, it would probably be preferable that NEXIM be merged into NERFUND, rather than vice versa, given NERFUND’s much larger financial size, better performance record, and enhanced legal powers in the collection of its loans from banks.

iii) NERFUND could be liquidated as there appears to be little need for more than one apex. However, given the high priority government places on providing credit support for small and medium scale industry and NEXIM’s high degree of specialization, a new apex institution would probably need to be found to perform this function. It is unclear whether any new institution would be more efficient than NERFUND.
F. URBAN DEVELOPMENT BANK

5.67. Background. The Urban Development Bank (UDB) was established as a limited liability company under a 1992 decree with a mandate to foster the rapid development of urban infrastructure (especially urban markets, water supply, solid waste disposal, roads and recreation facilities) through the provision of banking and finance services. It was designed to be a vehicle for mobilizing funds from multilateral institutions. It has been provided with N623 million in paid-up capital and is owned by the FGN (20%) as well as various state (20%) and local (40%) governments, the Nigeria Labor Congress (10%) and individual Nigerians (10%).

5.68. While UDB was initially exempted from the Banks and Other Financial Institutions Decree of 1991, it, together with all other development banks, was placed under CBN regulatory and supervisory authority in January 1997. The Federal Ministry of Works and Housing also provides oversight. Like other DFIs, UDB has been operating without a Board of Directors for some years.

5.69. UDB is staffed to provide extensive technical expertise to legal communities in designing, providing financing and assisting in the implementation of projects with offices in Abuja and Lagos, two additional liaison offices, and a staff of 165. Its 70 higher level staff have widely varying professional skills in such areas as finance, accounting, banking, architecture, and engineering.

5.70. UDB has de facto become the only source of financing for its projects and, since it has been unsuccessful in mobilizing borrowings from external sources, has only its own rapidly diminishing paid-in capital to draw upon. Its prospects for raising loans from international sources will steadily deteriorate as capital continues to erode with each passing year.

5.71. Its stated policy is to provide communities with 5 to 10 year loans at interest rates 2 to 4% below commercial bank loan levels. As a response to serious problems in collecting on its first several loans, UDB has come up with a process whereby it can deduct amounts due from communities for debt service directly from FGN statutory payments from the budget to the communities, thus dramatically reducing the risk of bad debt. UDB prefers not to use this power unless necessary because it can create friction with its clients. In one early operation, UDB suffered financial losses during an innovative effort to assist Kano with a municipal bond offering.

5.72. Financial Condition and Performance. As shown in Annex 4E, UDB is experiencing increasingly serious financial problems. It has lost money every year since it began operations, including a N84 million loss (23% of remaining capital) in 1998. Despite the fact that UDB’s accrued income of N148 million (15 months of gross income) gives evidence of serious collection problems, UDB has taken no provisions for bad debt in recent years. This suggests that losses may be higher and net worth lower than the accounts suggest. Although steadily eroded over the years, UDB, per its financial statements, still has a strong capital position (net worth adding to 94% of assets) because it has no debt and almost no lending assets.
5.73. UDB has engaged in virtually no new operations since 1995. Consequently, its investments and gross loans add to only 10% of total assets as of December 1998, interest income added to only 3.7% of average assets, and, because of its inability to borrow, UDB incurred no interest expense. Opportunities to conduct new operations appear to be rapidly diminishing as UDB now has significant liquidity problems with liquid assets having dropped 77% during 1998 to a level of only N 28 million or 7% of assets.

5.74. UDB necessarily requires a large technical staff to prepare its projects so overhead cost is an extremely serious problem. 1998 total administrative cost of N 185 million added to an extremely high 43% of average total assets, 51% of ending net worth, and 179% of gross income.

5.75. The one financial bright spot, noninterest income adding to 20.4% of average assets, is likely to disappear in 1999. UDB had been able to provide significant consulting services to the Petroleum Trust Fund in 1998 and earlier, as they had money for projects similar to those UDB was established to implement but lacked the appropriate in-house staff skills. PTF has been disbanded so this source of fee income has disappeared.

5.76. This implies that, without new operations, UDB’s loss for 1999 could add to N 150 million or more, i.e. possibly more than 40% of net worth. Without any change in present trends, UDB is likely to use up all of its liquidity during 1999 and virtually all of its capital before the end of 2000. As its ability to borrow from international financial institutions appears to be rapidly diminishing it may well be able to continue in business only if it receives new capital or grants from government.

5.77. **Obstacles to successful UDB operations.** Prospects that UDB can develop a satisfactory level of successful operations, after almost 7 years of relative inability to do so, appear increasingly dim. Obstacles to doing so include:

i) division of most metropolitan areas into a number of separate local governments, making the logistics associated with urban projects that necessarily involve more than one legal jurisdiction (i.e., virtually any project that does not operate solely out of one physical location) very difficult;

ii) inability of many local governments to mobilize significant tax revenues due to cadastral inadequacies, etc.

iii) extremely high administrative costs relative to likely levels of operation. While these costs can be cut somewhat, UDB would always need to maintain a high cost staff if it is to continue with its present *modus operandi*.

iv) inability to finance new lending due to increasing inability to borrow and increasingly severe liquidity problems.

v) a potential conflict of interest making tough credit decisions difficult in situations in which turning down an applicant simultaneously deprives UDB of technical business
opportunities it desperately needs to keep its staff busy and to achieve its developmental objectives.

5.78. On the positive side, UDB appears to have four comparative advantages, i.e.,

i) access to significant urban development technical skills.

ii) access to means to collect loans from local governments directly from the budget allocations, thus reducing bad debt risk much below that of other lenders to these entities. With this exception, UDB has no comparative advantages as a supplier of loan capital.

iii) having a more commercial (albeit not necessarily adequate) perspective than other urban development entities which are more closely associated with government.

iv) Nigeria’s urban areas continue to require the inputs that UDB was formed to provide.

5.79. What to do?. It appears unlikely that UDB’s proposed *modus operandi* is viable given the unsatisfactory performance to date, troubling trends, and severe obstacles to its operating effectively. Moreover, UDB will probably become insolvent within the next two years if nothing is done to change the status quo. Therefore, the status quo is not an attractive option.

5.80. Five alternative strategies for dealing with UDB are as follows:

i) UDB could be given access to substantial additional resources through new capital and/or access to deposits. Once it has a stronger capital and liquidity base, it could again aggressively look for new international debt capital sources. However, in the mission’s view, it appears likely, given the formidable obstacles to UDB’s success (it was unable to do significant lending even when it had adequate funding for this purpose), that without major changes in its modus operandi, UDB would eventually lose any additional capital or any deposits it was able to mobilize. The more funds it mobilizes, the more it is likely to lose. While Government may wish to devote additional funding in the future to support UDB and its objectives, the mission strongly recommends maintaining a hard budget constraint on its expenditures and losses by giving it no access to deposits.

ii) UDB could be liquidated. This may be the best alternative from a financial perspective but may be politically difficult as nongovernment shareholders are likely to object. Moreover, UDB has mobilized valuable technical skills to meet an important developmental need for which demand has not diminished.

iii) UDB could be merged into another financial institution, thus creating greater economies of scale and reducing the combined need for capital. This alternative does not appear feasible because there are few synergies with the business strategies of other institutions as they lend to entirely different borrowers. Moreover, the high administrative costs, most of which are not fungible for other purposes because of specialization requirements, would create a serious financial burden.
iv) UDB could continue to operate as a bank and be privatized. This alternative may not be feasible as most private investors have little experience with municipal lending and UDB’s future profitability appears uncertain if not dismal.

v) UDB could be converted into a consulting organization and nonbank by essentially removing its lending function. It could operate thereafter by selling its services and seeking grants from the recurrent budget to finance shortfalls. Its consulting services could then include assisting its clients to obtain financing for its projects from sources such as NIDB and commercial banks, utilizing its power to make claims on the statutory budget funds made available to the borrowers, to make agreements that ensure the lender will be repaid. UDB could cut its administrative costs significantly by eliminating staff whose primary duties relate to the banking or administrative functions made redundant by this downsized scope. As a substrategy, consideration might be given to selling this downsized consulting organization to its employees rather than continuing to provide an administrative grant to keep it afloat.

G. NIGERIAN EDUCATION BANK

5.81. Background. The Nigerian Education Bank (NEB) was established as a 100% FGN-owned limited liability company under a 1993 decree. It has relatively wide financial powers, including the right to mobilize deposits, and was formed for the purposes of providing bans for various educational purposes such as publishing and to students to finance higher education, as well as other activities to promote higher education. It never received planned paid-in capital of N400 million but has received N83 million in various grants. These grants represented assets and liabilities, including a poor quality loan portfolio which were rolled-over from an unsuccessful Nigerian Student Loans Board which the NEB replaced. NEB was also given access to an interest free N232 million revolving loan fund to be used for on-lending to students.

5.82. NEB is under the oversight of the Minister of Education and, since January 1997, is subject to CBN supervision. It has never had a Board of Directors. It has 261 staff deployed in 21 regional offices. The mission was told that most of these staff, which were inherited from the Student Loans Board, are essentially civil servants with few responsibilities. Only 6 staff were described as having professional skills in banking or human resources.

5.83. In its 7 years in operation, NEB has never made a loan. Reasons given for this result are: i) presently allowed maximum loan per student is N1000 per year, an amount too inconsequential to justify; and ii) a management-prepared draft loan policy and proposal to raise the maximum loan to N10,000 per year per student have never been approved because there is no Board of Directors to approve it. NEB has not raised deposits or borrowed additional funds for similar reasons.

5.84. Financial Condition and Performance. As shown in Annex 4F, despite losses in every year of operation, NEB remains soundly capitalized. De facto equity remains at N346 million or 98% of total assets if the revolving fund (which is interest free and has no repayment terms) is treated as quasi-equity.
5.85. NEB’s financial performance, despite its strong capital base, is unsatisfactory. It has lost money in every year of operation despite receiving annual grant income (a cumulative N62 million) from the Government budget every year. Cumulative losses before these subventions had reached about N150 million by December 1997. In 1997, NEB losses before subventions amounted to 12% of average assets and 13% of net worth. As there are few potential sources of revenue, if no changes are made, losses are likely to slowly increase in future years.

5.86. The revolving fund was invested primarily in fixed deposits on which large losses have been incurred because the banks involved were liquidated. Collections on the inherited loan portfolio have been negligible and 98% of that portfolio is non-performing. Gross income (excluding FGN subventions) is a minuscule 0.7% of average total assets, as interest income is tiny and non-interest income is negligible. Despite no significant operational activity, administrative costs are a high 12.8% of average assets and 1760% of gross income. Even without lending, liquid assets had dwindled to only N10 million by December 1997 because of large expenditures on building an office complex and a staff housing estate (fixed assets constitute 93% of total assets) as well as the losses.

5.87. **Obstacles to Successful Operations**

NEB appears to have little comparative advantage. Bottom line, it is de facto a real estate holding company without educationally relevant operations. While student access to financing for higher education remains an important objective in Nigeria, NEB faces serious obstacles in efforts to work toward this objective as:

i) NEB has no lending experience and does not have relevant staff skills. It has weak leadership, lacks commercial discipline, and does not have access to cheap money or liquid resources to support future operations. Despite a seemingly strong balance sheet, it has little ability to borrow other than possibly through obtaining a mortgage on its office complex under construction.

ii) There is no evidence that student loan programs from what is essentially a central government agency can be an economically viable activity in Nigeria as administrative costs would necessarily be high and ability to collect debt repayment as due would be doubtful. On the other hand, availability of student loans remains an important objective and there is no other source for such loans in Nigeria.

5.88. **What to Do?**

The mission understands that a proposal is being discussed to merge NEB with the Education Tax Fund which controls a large fund (reportedly in excess of N 10 billion) for education purposes and is supported by large new inflows from a 2½% corporate education tax. While such a merger should be considered as it may represent a politically feasible way to eliminate NEB, a careful analysis should be undertaken to ensure that on balance it would add value as well as potentially large administrative cost to Education Tax Fund operations. Our initial examination of the NEB balance sheet and operations suggests that, with the exception of its large real estate holdings that might be converted into cash and possible administrative locations that might be useful, it might add little value. The feasibility of providing financing for student loans through the commercial banking system might be explored to replace that NEB function.
5.89 Alternatively, NEB might be liquidated and its staff terminated or shifted to more productive employment. Its substantial real estate investments might be sold to provide cash either to support these terminations or to raise liquid resources that could be directly invested in supporting education.

H. PROPOSED ACTION PROGRAM AND STRATEGY FOR DFIS

5.90. Nigeria has already made a very substantial N 43.5 billion investment in its DFIs and large incremental investment is required to keep them operating. DFIs, with the exception of an apex institution such as NERFUND which can ensure repayment of most loans to other financial institutions through debiting their accounts at CBN should, for practical purposes, have minimum net worth equal to at least 15% of total assets. Increasing net worth to this level could be accomplished in several DFIs by Government assumption of already guaranteed debt and write-off of already existing Government or CBN loans to the institutions. However, it is the mission’s view that several DFIs would not be viable and/or could not continue to mobilize and onlend funds on a sustainable basis even if they were recapitalized in this fashion. Liquid resources would be required to finance operating cash losses.

5.91. No DFIs should be re-capitalized unless they are fundamentally restructured, can ensure commercially oriented governance, and provide clear evidence that the all significant causes of previous poor financial and operating performance have been effectively addressed. For several individual DFIs, this would be extremely difficult. It is even more difficult to achieve this simultaneously for a number of different institutions as limited skills, financial resources, and the attention of senior decision-makers would be fragmented and diluted.

5.92. Strategically, it is recommended that Nigeria concentrate its financial resources and skills on restructuring a small number of DFIs which have the best potential for success. Consideration should be given to choosing three DFIs and focusing attention and funding on fundamentally restructuring them (through steps such as those listed below for NIDB), to make them sufficiently creditworthy that they can attract debt capital from nongovernmental and commercial sources. These three DFIs should also diversify their activities and lending to additional sub-sectors so they are able to fill gaps created by the inability of other DFIs to conduct significant lending activity as well as reduce the high risks created by present narrow specialization. In addition, attention needs to be devoted to improving the environment in which they operate, e.g., insulating them from political interference by ensuring autonomy, privatizing ownership where feasible, and improvements in the credit disciplinary environment to enhance ability to collect overdue loans.

5.93. Among steps that could be taken to strengthen the selected DFIs are: 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 they are run by highly competent commercially sophisticated CEOs; iii) formulating and implementing comprehensive reforms and revising operational policies
and practices; iv) preparing a solid financial foundation through conducting audits of 1999 financial statements in accord with international principles and then converting sufficient existing government guaranteed or supplied debt to equity to achieve reasonable gearing; v) taking additional steps as appropriate to each individual DFI to ensure more independent and more commercially oriented governance; vi) designing and implementing strategies for raising debt capital from non-governmental sources; and vii) eliminating subsidized interest rates to final borrowers.

5.94. It is recommended that Government strengthen NIDB and NACB and focus its retail developmental lending strategy around these two institutions as well as the commercial banking system. NIDB could expand its product mix to place increased emphasis on SME and export lending and to do some municipal financing loans as does the Development Bank of Southern Africa. NACB, should broaden its rural lending customer base and eliminate most of its larger scale lending in order to concentrate its resources in the small scale arena where it has a comparative advantage and better repayment experience. An apex DFI will be needed to provide support and augment sources of financing primarily to provide funding through commercial banks, but also to provide limited support to these retail organizations.

5.95. At the wholesale level, consideration might be given to creating one strong well managed apex to create a clear focal point by merging NERFUND and NEXIM to provide long-term funds through the commercial banking system for various developmental needs. If funds are on-lent only to financial institutions that are strong and creditworthy and no retail lending is done, the combined institution can depend on NERFUND’s present ability to debit accounts at CBN to collect on its loans. The combined apex can reduce the amount of time and attention devoted to subproject approval if the cost of funds is not subsidized such that there are significant incentives for diversion to other purposes. This would eliminate some of the need for real sector skills at the apex level, allow for a significant reduction in staffing and combined administrative cost, possibly resulting in administrative costs of below 1% of total assets, and make merger a more attractive alternative than it otherwise would be. Alternatively, NEXIM’s banking functions could be merged into NERFUND, while it continues as a non-bank export promotion agency.

5.96. Other poorly performing DFIs, i.e., NBCI, UDB and NEB, could then be eliminated through liquidation or partial merger with those that remain, thus reducing financial requirements to re-capitalize and meet operating cash deficits and concentrating scarce staff and financial resources in institutions that are sufficiently strong financially and sufficiently well managed that they can attract the debt capital necessary to grow lending substantially and make a significant developmental impact.

5.97. Selected NBCI assets and staff could be merged into NIDB (see para 5.36, alternative 3) which in turn should expand its SME lending programs. In addition, with the support of NERFUND, Nigeria should design an SME lending strategy that involves substantial commercial banking system participation. UDB could be transformed into a technical consulting company, possibly privatized, with its lending and banking functions assumed by NIDB (see para. 5.80, alternative 5). Selected NEB assets can be merged
into the Education Tax Fund and/or it can be liquidated as discussed in paras. 5.88 and 5.89.

5.98. Successful implementation of a strategy along the lines presented above should enable Nigeria to create a more focused, streamlined, administratively cheaper, operationally effective DFI framework consisting of a few strong institutions which might provide and catalyze significantly greater flows of badly needed long term funds for the development of large and small scale entities in Nigeria’s industrial, commercial, agricultural and municipal sectors. However, given the past poor performance, the challenge is huge and it is likely that the commercial banking system, if an integral part of the strategy, will develop into a more important source of SME financing than DFIs.
6. COMMUNITY BANKS AND RURAL COMMERCIAL BANKING

I. COMMUNITY BANKS

A. OVERVIEW

6.1. Community Banks (CBs) are an important component of the Nigerian financial system. Established in December 1990, the number of community banks grew rapidly from 104 in 1991 to 1368 in 1995, when the issuance of provisional licenses by the National Board for Community Banks (NBCB) was suspended. The stated objectives of the CBs include the promotion of rural development, the promotion of an effective and integrated national financial system that responds to the needs at the grassroots community level, the inculcation of disciplined banking habits among the low-income population, especially in rural areas, and the fostering of a spirit of community ownership and use of economic assets on a sustainable basis.  

6.2. Each Community Bank is privately owned by at least 50 shareholders including a Community Development Association, regarded as the primary sponsor and shareholder, other trade associations, groups and organizations, and individuals. Community Development Associations are traditional apex organizations for planning and sponsoring development activities within the community. Each CB has been assigned a “catchment area”, a geographically delimited market in which no other CBs may operate.

6.3. About one thousand unit banks serve probably one million deposit customers, and between 100 thousand and 200 thousand loan clients. Their presence improves Nigeria’s overall bank density from 43.6 thousand to 30.9 thousand inhabitants per bank branch. About one third of the CBs are located in urban areas. In rural areas, the improvement in coverage attributable to community banks can be estimated to go from 88.8 thousand to 46.4 thousand inhabitants per bank branch.

6.4. The CBs’ broad outreach in number of clients does not translate into a significant share of financial sector aggregates, as they account for only about 0.6% of total financial assets, and 1% of the total deposit liabilities of deposit money banks. Their loan portfolio is dominated by commerce (40%), agriculture (38%), and manufacturing (12%), a distribution that reflects the predominantly short-term nature of their lending.

6.5. The CBs’ culture and governance is essentially private, in contrast with that of People’s Bank branches, which are owned and operated by government. Nevertheless,

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15 For comparison, this is about 5 times the loan outreach of NACB.
16 Available data do not allow a breakdown of total assets between urban and rural areas. It is likely, however, that the share of urban business in CBs’ total assets exceeds the share of urban branches in the total number of CBs.
17 Estimates count NACB branches (64), not the total “outlets” reported by NACB (379).
the fact of being aggressively promoted by government in their inception, and being supervised by a government parastatal (NBCB) gives many CBs a “governmental image” which hurts loan recovery and makes the inculcation of “disciplined banking habits” a difficult objective to fulfill.

6.6. The NBCB was created in 1992 to supervise the individual CBs, but this responsibility was subsequently transferred to the CBN in 1997. The NBCB provides subordinate loans to augment initial capital, sanctions the appointment of managers by the individual CBs, and provides training. Although the CBN has ultimate responsibility for supervision, the NBCB continues performing an off-site supervisory role, compiling CBs’ returns and reporting these to the CBN. Likewise, NBCB inspectors still carry out on-site supervision, albeit limited by a shrinking operating budget. These on-site inspections are often performed jointly with CBN and NDIC inspectors.

6.7. Community Banks are for the most part subject to the same regulations as commercial banks (with lower paid-in capital requirements). Yet no CBs have been formally licensed by the CBN, and none therefore is covered by deposit insurance, or have access to the clearing house. These two shortcomings affect the ability of CBs to compete for deposits, and increase the transaction costs of community banking by forcing the CBs to use the clearing services of commercial banks. A critical review of the standards applicable to CBs is suggested in this report.

6.8. While collectively important, most community banks are individually weak, under-capitalized, too small and of limited outreach. Of the 1368 banks created, 354 have been closed. NBCB estimates that roughly 200 CBs are currently profitable and eligible for final licensing, and at most an additional 300 may have the potential to reach that level. The review carried out below, however, suggests that the CBs may have a significant role to play in the strengthening of Nigeria’s rural financial system, provided some degree of consolidation and a number of structural reforms take place.

B. PERFORMANCE

6.9. Performance analysis of CBs is complicated by three main factors: i) the number of CBs reporting varies from one quarter to another; ii) the same bank may not report systematically every quarter; iii) the quality of the data reported is suspect since CBs are not all regularly inspected; and iv) it is not clear whether reported data reflects inspection findings. A critical limitation for performance analysis is that portfolio quality is not regularly reported and inspected, hence loan repayment performance cannot be assessed, and inadequacies in loan provisioning cannot be detected.

6.10. Aggregate financial data for reporting banks (Annex 3A) show relatively sound capital structures with net worth ranging between 18.7% and 21.7% of total assets for the average bank in the period 1994-1998. Loan to deposit ratios increased from 39.4% in 1994 to 55% in 1997 and 51% in 1998. Aggregate total assets, loans and advances, total deposits and capital and reserves (shareholders’ funds) all declined in real terms between 1994 and 1997, and partially recovered in 1998 to approximately 1996 levels. During the entire period, however, the number of reporting banks decreased from 902 (92% of existing banks) in 1994 to 491 (36% of existing) in 1997, and 569 (56%) in 1998. When
the average per reporting bank is used, all main balance sheet items fall in real terms between 1994 and 1996, but a substantial recovery is observed in 1997, the year with the lowest number of reporting banks, and a subsequent increase occurs in 1998 (see Annex 3A). This pattern may be reflecting the closing of failing banks in late 1997, which made 1997 and 1998 figures represent the relatively better performing banks.

6.11. Even by using averages per reporting banks, a trend analysis is misleading given that the number and identity of reporting banks varies each year. To overcome this problem, a consistent data set was obtained from NBCB including only banks that systematically reported each end-of-year for the period 1996-1998\(^{18}\). Only 262 banks met this condition. Among these, three groups were defined by asset size to obtain further insights when analyzing performance and trends. The following analysis presents findings for the entire group of 262 banks, and for each of the top 30, middle 30 and smallest 30 banks by asset size.\(^{19}\) Given the particular significance of end-of-year reporting, one can speculate that these 262 banks are probably a better performing group than the rest of the banks, thus making the analysis below represent an upper-bound estimate of the performance of the entire CB community.

**Growth**

6.12. Moderate to modest growth characterizes the behavior of total assets of community banks in the three-year period 1996-1998 (see Annex 3B). Total assets grew in real terms by 7.3% in 1997 and by 21.4% in 1998, a pace comparable to that of commercial banks in the same period (17% per year).\(^{20}\) Important differences by scale are observed among CBs. While the large banks grew 13.1% and 45.2% in real terms in 1997 and 1998, the smallest banks lost 3.3% of their assets in 1997 and lost a further 6.4% in 1998. Total assets for the middle group remained practically the same in real terms during the three-year period.

6.13. Loans and advances increased for the average of all banks in real terms by 13.7% in 1997 and slightly over 10% in 1998, again with diverse behavior across scale categories (Annex 3C). Most strikingly, the smallest banks show a 12.3% decrease in loans and advances in 1998 with respect to 1997. The levels of total assets and loans and advances during the three-year period reveal a loan-to-asset ratio rather stable around 30% for all banks with not only different ratios across bank sizes but also different trend over time. The largest banks show lower and declining loan-to-asset ratios as compared to the middle scale and smallest banks, which show an upward trend for this ratio (see Figure 6.1 and Annex 3D).

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\(^{18}\) December 31\(^{st}\) is the end of fiscal year for CBs

\(^{19}\) The largest 30 CBs in the group had total assets in 1998 from N 273 million (a large CB in Lagos, the next bank in size had N 95.4 million in assets) to N 22 million; the middle 30 had total assets between N7.6 million and N 5.7 million; the smallest 30 had total assets below N 2.1 million, down to N 0.5 million.

\(^{20}\) In contrast, NACB lost, in real terms, 16% of its assets in 1997 and lost a further 29% in 1998.
6.14. The observed trend in the loan-to-asset ratio seems consistent with the mission’s observation in the field that CBs appear to be using non-loan investments and commercial ventures as a means of increasing revenues. This practice, dealt with in further detail below, allows CBs to circumvent existing regulations and increases the overall risk exposure of individual banks. A look at the behavior of other assets, however, indicates that the item increasing in the last three years has been cash and short-term funds. Overall, this item increased from 35% to 43% of total assets, with the largest banks showing an increase from 51% to 55%, and the smallest banks going from 20% to 28% of total assets. Other investments and fixed assets appear, on average, falling from 31% to 27% of total assets. These represent the largest share of total assets among the smallest banks, although their incidence declined from 51% to 35% of total assets between 1996 and 1998. The data do not allow a deeper insight into these patterns, but there seems to be a clear indication of large-scale banks moving away from lending, into making short-term placements. Smaller banks, meanwhile, struggle to reduce the share of fixed assets in their portfolios, while trying to remain liquid enough vis a vis their deposit base.

6.15. Total deposits grew steadily in real terms in the group of CBs with systematic reporting for 1996-1998, increasing by 17% in 1997 and almost 20% in 1998 (Annex 3E). For the largest banks, the average growth rate was about 37% each year; while the middle-scale banks showed a rather modest increase, 2.7% and 12.3% in 1997 and 1998, respectively. Total deposits in the smallest banks jumped 73% in 1998 with respect to 1997, when they had only increased 1.6% over the 1996 level. The average loan-to-deposit ratio for all 262 CBs decreased from 50% to 45% between 1996 and 1998 (Annex 3F). As of the end of 1998, both the large-scale banks and the small-scale banks showed loan/deposit ratios of about 33%, while the ratio for the middle-scale banks remained close to 60%. It must be noted that these results, using a consistent data set, are
in contrast with those obtained using the aggregate NBCB reports (see above) which suggested an increasing trend in the loan/deposit ratio.

6.16. The observed patterns in asset composition and total deposits suggest that the smallest banks may be facing a serious liquidity problem. On average, cash and short term funds in 1998 were only 26% of total deposits for the small-scale banks, while the same ratio was 83% for the largest banks and 42% for the middle-scale CBs, just about the required reserve ratio (40% of deposits).

C. PROFITABILITY AND OPERATIONAL EFFICIENCY

6.17. No rigorous analysis of CBs’ viability could be performed given the information available. A major limitation, as indicated above, is the lack of loan-recovery and loan-loss provisions data. Still, with this important caveat, some useful insights were obtained analyzing the data set of regularly reporting banks. Gross earnings ratios and overhead costs ratios over total assets are reported in Annex 3G. The same ratios with respect to loans and advances are shown in Annex 3H. Overhead costs include interest expense and administration costs (although these components are not reported separately). Hence, the difference between gross earnings and overhead is an unadjusted measure of net profits before taxes and provisions.

6.18. The findings indicate strikingly limited profits with sharp differences across scale categories. These differences in profitability are primarily explained by significantly different overhead costs ratios. Overhead costs as a percentage of total assets are 3 times as high among small-scale banks as they are for the largest banks (Figure 6.2). Overhead costs as a proportion of loans and advances among the smallest banks are about twice as high as those of the largest banks (Figure 6.3). The effect on net profits over total assets is shown in Figure 6.4. For the largest banks, the ratio of net profits (before taxes) to total assets fluctuated between 3.6% and 4.7%, while the smallest banks show losses in all three years, from (-7.9%) in 1996 to (-1.7%) in 1998. Overall, the observed differences across bank-size categories suggest the presence of important scale economies among CBs, a factor that needs to be taken into account when considering the future of the sector.
Figure 6.2: Community Banks: Overhead Costs-Asset Ratio

Overhead Costs/Total Assets

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Community Banks, by scale, 96-98

Figure 6.3: Community Banks: Overhead Costs-Loans Ratio

Overhead Costs/Loans

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</tr>
<tr>
<td>Smallest 30</td>
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</table>

Community Banks, by scale
6.19. The overall situation, as portrayed in Figure 6.4, appears to improve for all categories of CBs between 1996 and 1998. A comparison with international performance standards for micro-finance institutions (MFIs) is complicated by the much different asset composition and the fact that CBs are deposit-taking institutions (thus the need to maintain liquid reserves). While CBs’ overhead costs over total assets, 11.4% in 1998, would compare favorably with the operating expenses ratio of all MFIs (worldwide) reporting to the *Microbanking Bulletin*, 37.8%, the earnings generated by those assets are clearly insufficient. The (unadjusted) operational self-sufficiency of CBs would still compare favorably, excepting the smallest CBs, with those of all MFIs and especially African MFIs, as Table 6.1 below shows. Operational self-sufficiency measures the institution’s ability to cover operating expenses with its operating (interest and non-interest) revenues.

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Table 6.1: Community Banks, by scale, 96-98

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<thead>
<tr>
<th></th>
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</thead>
<tbody>
<tr>
<td>ALL (N=262)</td>
<td>-10.0%</td>
<td>-8.0%</td>
<td>-6.0%</td>
</tr>
<tr>
<td>Largest 30</td>
<td>-4.0%</td>
<td>-4.0%</td>
<td>-4.0%</td>
</tr>
<tr>
<td>Middle 30</td>
<td>-2.0%</td>
<td>-2.0%</td>
<td>-2.0%</td>
</tr>
<tr>
<td>Smallest 30</td>
<td>0.0%</td>
<td>2.0%</td>
<td>4.0%</td>
</tr>
</tbody>
</table>

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Table 6.1: MFIs: Comparative Operational Self-Sufficiency

| Group                        | Operational Self-Sufficiency, %
<table>
<thead>
<tr>
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</thead>
<tbody>
<tr>
<td>All MFIs(^b)</td>
<td>101.8</td>
</tr>
<tr>
<td>Fully-sustainable MFIs(^b)</td>
<td>133.3</td>
</tr>
<tr>
<td>African MFIs(^b)</td>
<td>62.2</td>
</tr>
<tr>
<td>Nigerian Community Banks</td>
<td></td>
</tr>
<tr>
<td>All (N=262)</td>
<td>127.2</td>
</tr>
<tr>
<td>Largest 30</td>
<td>148.2</td>
</tr>
<tr>
<td>Middle 30</td>
<td>110.1</td>
</tr>
<tr>
<td>Smallest 30</td>
<td>93.2</td>
</tr>
</tbody>
</table>

\(^a\) Ratio of operating revenues over operating expenses.
\(^b\) Microbanking Bulletin, July 1999.

6.20. The CBs’ operational self-sufficiency ratios above ought to be taken with caution since no adjustment for loan losses have been made. Yet, when comparing these unadjusted ratios with similarly unadjusted ratios for NACB, 63%, and PBN, 44%, the community banks, despite the serious problems many are facing, appear much more sustainable than other rural finance institutions in Nigeria.\(^22\)

**Capitalization**

6.21. The averages of both paid-up capital (Annex 3I) and capital and reserves (shareholders’ funds, Annex 3J) for the group of 262 banks in 1998 are fairly close to those indicated in Annex 3A using NBCB aggregate reports. Their growth in real terms, however, is totally different from the sustained 23% per year the aggregate figures suggest.\(^23\) On average, paid-up capital increased 8.5% per year and shareholders’ funds grew 13.1% per year between 1996 and 1998. Moreover, the differences across scale categories are substantial. Average capital and reserves of the smallest banks fell almost 20% in 1997 and dropped a further 13.5% in 1998. The largest banks show a steady annual increase in capital and reserves of 24.4% while the middle-scale banks seem to have recovered in 1998 from a sharp loss in 1997 (Annex 3J).

6.22. About 25% of all reporting banks in March 1999 (138 out of 548) had met the minimum N3 million capital. Approximately the same proportion in the group of regularly reporting banks had paid-up capital above N3 million, and about 31% had shareholders’ funds above that amount. In this same group, another 11% had a N1 million deficit with respect to the minimum required. With all the dangers of

\(^22\) Ratios for NACB and PBN calculated from figure reported in Draft Yellow Cover Report No. 19973-UNI, December 1999. The same ratio can be estimated at 136% for Nigeria’s commercial banks.

\(^23\) The reader is reminded that Annex 3A uses aggregate figures as reported by NBCB, representing all banks reporting at end the end of each year, while our analysis is based on the 262 banks systematically reporting each year from 1996 to 1998.
extrapolation, one may submit that between 230 and 250 CBs have met or could soon meet the minimum capital requirement established by CBN.

6.23. In summary, community bank performance overall has been rather modest. The smallest banks have been struggling during the last three years, unable to maintain the real value of their asset portfolio and further reducing their capital, while their overhead costs continue to increase relative to their total assets. Middle-scale banks and especially the largest banks on the other hand, have shown moderate growth and gradually-improving profitability and capitalization.

6.24. It must be taken into consideration that CBs, in contrast to DFIs, do not receive regular government subsidies. Given the relatively short-term of both their assets and liabilities, it would be difficult for a CB to sustain loan losses for too long without reaching illiquidity and insolvency. The fact that about 25% of CBs’ licenses were withdrawn by the CBN in late 1997, when CBs had at most 6 years in operation, is probably a reflection of this relative institutional fragility.

6.25. It is impossible to determine whether the observed differences in performance across bank scale categories are due to an ill-designed initial allocation of market areas, which could have been the consequence of local political pressures. It seems likely that the markets around the CBs evolved in such a way that some of them could effectively grow and prosper whereas others were faced with difficult clienteles in areas economically depressed. Quality of CB management may also have played a significant role in determining the observed outcomes, making banks initially of small scale perform well and grow, while other banks became small because they performed badly. At this point in time, however, the analysis detects substantial differences in performance and outlook across bank sizes. Upper middle-scale and relatively large CBs show good potential to evolve into self-sustainable financial intermediaries provided that the constraints and challenges discussed below are properly addressed.

**D. CONSTRAINTS AND CHALLENGES**

6.26. It is useful to categorize the observed constraints and challenges faced by CBs into those that could be considered exogenous to the individual CBs, and those factors that could be addressed through internal decisions. Among the former, interest-rate ceilings determined by NBCB, and clearing house charges by commercial banks, unavoidable given the nature of the CB charter, are discussed below. The level and adequacy of supervision, an important external factor, will be discussed in the section dealing with NBCB. Internal (endogenous) factors such as ownership and governance, staff turnover and Management Information Systems (MIS) are briefly addressed before discussing the challenge of effectively capitalizing on what could be called “economies of association.”

6.27. **Interest-rate ceilings.** Interest rates charged by CBs need NBCB approval, and NBCB in turn advocates “reasonable rates”. As a consequence, CBs operate with a cap of 21% on lending rates, while commercial banks operate in the 24% to 26% range. Given the relatively high overhead costs, this ceiling acts as an incentive to reduce lending in favor of non-loan placements. Aside from short-term placements in commercial banks, CBs carry out profit-sharing investments and commercial ventures
which tend to exceed by far what would be their authorized maximum loan amount (10% of capital and reserves). These investments, on the other hand, appear to be a main vehicle to circumvent insider-lending restrictions, as the partners in these joint ventures are frequently CB board members (Box 6.1).

**Box 6.1. Profit-sharing investments and commercial ventures as regulation avoidance**

Practically all of the 9 CBs visited by the mission were active in profit-sharing investments and commercial ventures. The former would typically finance a provider in a local purchase order (LPO) issued by a local or regional governmental agency. The profit-sharing (or revenue sharing in a couple of cases) was negotiated with the supplier but would fall in the neighborhood of a 60/40 or 70/30 arrangement with payments on the LPO domiciled at the CB to ensure collection. Other profit-sharing investments would indeed be disguised loans that exceed the maximum exposure to a single client, in some cases a CB Board member.

Commercial ventures such as transportation services (motorcycle taxis and mini-buses), and wholesale and retail merchandise business on the CB premises financed with CB funds were observed in some of the CBs. Moreover, perusal of audited annual accounts of a few CBs show high incidence of “trade investments” (unspecified in the audit notes), and investments in cement ventures and cocoa ventures under the general asset category of investments.

Both practices allow the circumvention of existing regulations on maximum exposure to a single client (10% of capital and reserves) and insider lending. In addition, they constitute a significant risk exposure overlooked in regular inspections. Investments and commercial ventures (on and off-balance sheet) appear to be known but tolerated by NBCB inspectors, on the basis that they represent a major source of revenue.

6.28. **Clearing house charges.** Since CBs are not licensed by CBN, they do not have access to the clearing house and must use commercial banks as correspondents for check clearing. This practice increases the operating costs of CBs, allegedly by substantial amounts. CBs visited by the mission indicated 20% of overhead, or 2-3% of deposits as estimates for the incidence of COT charges. Using COT charges for a sample of banks in the Kaduna zone (as of September 1999), their incidence was estimated at 4% of total deposits.24 This limitation of CBs is one of the key arguments put forth for NBCB and the CBs to create an apex commercial bank that serves as clearing house and holds CBs’ cash reserves, among other functions.

6.29. **Ownership and governance.** The field visits suggest that CBs are highly heterogeneous with respect to both ownership and governance, albeit within the limits established by their original charter. The number of total shareholders vary from the minimum required of 50 to several hundred. Directors’ involvement in regular management affairs also varies from total separation to fairly hands-on intervention in

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24 The typical COT charge is N5 per N1000, which some CBs are able to negotiate down to 2 or 3 naira per thousand depending on how competitive the commercial banking presence is in the area, as well as the size of the COT volumes the CB regularly handles.
management decisions. The latter situation lends itself to incidences of insider lending and portfolio concentration in related businesses.

6.30. **Staff skills and staff turnover.** Staff skills in the CBs visited seemed adequate for the services provided and the technical resources available. Management and clerical staff, however, appear to be under-paid relative to local branches of commercial banks (when present) by a factor of almost 2 to 1 at the manager’s level. This creates a rather high staff turnover. The recent reductions in NBCB staff training programs seem to compound the staffing problems, to the extent that staffing decisions tend to favor local candidates. Nevertheless, one could speculate that the closing of more than 300 CBs in 1998 might have created a pool of managers and officers from which other community banks could select and recruit new staff.

6.31. **Management Information Systems (MIS).** Judging by the field visits, the potential for improvement in this area is enormous. Modern equipment is practically non-existent and many operations are handled manually. The returns to modest investments in equipment and software could be extremely high in terms of the CBs’ ability to efficiently process large numbers of transactions.

6.32. **Economies of association.** Perhaps the most important observation with respect to the CBs as a system is that they do not really constitute a network, i.e., a collection of nodes with links between them. They are better characterized as a collection of isolated entities that share some common characteristics but make no gain from that commonality of features and interests.\(^{25}\) Comparable unit-type financial institutions such as credit unions in many countries tend to have a second-tier organization, a federation, where a central liquidity facility (among other common services) helps spread risks across the network, especially when there are urban and rural units in the network with counter-balancing seasonal liquidity fluctuations. Reserves can also be pooled at the federation level and a stabilization fund could play the role of deposit insurance.\(^{26}\) In the specific situation CBs face with respect to check clearing, a federation could auction the clearing house services among commercial banks on behalf of all or sub-sets of member CBs to minimize COT charges.

E. **THE NATIONAL BOARD FOR COMMUNITY BANKS (NBCB)**

6.33. The NBCB was created by the federal government to “promote, develop, monitor and supervise” the community banking system. The NBCB is a government agency, funded through the fiscal budget and staffed with government employees. Its 559 total staff (1998) are organized into three major departments, under the authority of the Office of the Secretary and CEO. The Department of Finance is responsible for finance and general administration of the Board. The Operations Department, the largest of all is responsible for CB appraisals, promotions, training, research, planning and statistics.

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\(^{25}\) The National Association of Community Banks (NACOB) initiated and promoted by the NBCB, seems to exist in the NBCB annual report but was never mentioned in numerous meetings with NBCB or in the visits to individual CBs.

\(^{26}\) Is was unclear to the mission whether CBN granting of final license to CBs would automatically give them access to deposit insurance.
This department carries out the promotion and development (essentially training) functions of the Board. Finally, the Department of Banking Inspection is responsible for on-site and off-site inspection of CBs. This department collects and appraises the statements of accounts submitted by the CBs and carries out field inspections. About 100 inspectors comprise the staff of this department.

6.34. No systematic reporting exist of the performance of NBCB itself in the fulfillment of its functions, with the partial exception of inspection.27 Hence, the analysis below is limited to what the 1998 Annual Report indicates for previous years.

6.35. One of the main NBCB instruments for promotion of CBs, the matching loans to augment CB working capital, has only been used with 313 of all banks created since 1990, for a total of N110 million, of which N48million has been repaid. Most of these loans were granted before 1996, and NBCB does not have at present the resources to continue this line of support. This means of promotion appears extremely limited compared, for example, to the 1998 level of deposit balances in CBs, N3.8 billion. The NBCB claims to have trained 5,000 rural bankers, and sponsored Certificate courses in community banking at universities and polytechnics that have graduated 1,000 students.

6.36. Off-site supervision is subject to the willingness of CBs to submit monthly reports and annual reports. The NBCB continues to implement this form of supervision as a conduit between the CBs and the CBN. Compliance with monthly reports, as has been commented earlier, is less than 60% of existing CBs (569 in the last quarter of 1998). Submission of annual financial statements, also mandatory for all CBs, is even more scarce. Only 160 banks submitted statements in 1998. Efforts to improve compliance with required reporting through circulars and fines have not been successful, as there were no effective way for the NBCB to enforce any penalties. Field inspections were reduced to 182 in 1998, from a total of 265 in 1997. Field staff complained of the lack of resources to maintain a regular calendar of visits to CBs under their responsibility.

6.37. Drastic reductions in government budgetary allocations to NBCB since 1996 have practically halted most promotion and training activities, and further reduced NBCB’s ability to effectively supervise the CBs. In practice, operating funds appear to be barely sufficient to pay salaries, leaving any other operating expenses associated with training and inspections for the most part unfunded.

6.38. The full transfer of the supervisory responsibility to the CBN means that NBCB is left with functions that exist on paper but are not indeed carried out. Board inspectors continue to work primarily as team members in CBN/NDIC inspections. The impression from the field was that Board inspectors are experienced and capable. Their transfer to CBN as employees or contractors would probably be warranted.

6.39. At this juncture, given the state of CBs documented in this report, it appears that the original functions and mission of the NBCB have been rendered obsolete. With the supervision function gone to the CBN, promotion and development as originally

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27 No NBCB Annual Reports exist between 1994 and 1998. The number of inspections is usually included in the quarterly reports, which are available for most of that period.
conceived do not match the current need for consolidation and effective integration of community banks.

F. CONCLUSIONS AND RECOMMENDATIONS

6.40. Community Banks are an important component of the Nigerian financial system of Nigeria. They have extensive outreach and carry out about two thirds of their activity in rural areas, significantly enhancing the availability of banking services. They are private entities, albeit with some degree of government image derived from government promotion and supervision through NBCB, a government agency. They provide a broad range of banking services, loans, deposits and payments, with limitations derived from the nature of their charter, and constraints imposed by government through the NBCB.

6.41. Community banks, despite many poorly performing individual banks have performed relatively well as a group compared with non-bank financial intermediaries in Nigeria, clearly much better than NACB and PBN. Several rough indicators of CB performance are comparable to those reported for institutions of comparable mission and clientele elsewhere in the world. Mid-size and especially large-scale CBs have performed particularly well, while the smaller banks are suffering from persistent operational losses, asset erosion and de-capitalization.

6.42. **Consolidation and capitalization.** Quasi-equity financing (e.g. debenture-based) could be invested in better performing banks to increase their capital to at least the required minimum of N3 million, conditional upon meeting revised standards that reinforce their lending role. The CBN could set these standards with appropriate technical assistance, and play the role of quasi-equity investor. The current stock-taking initiative of the CBN for the entire CB system would be a logical starting point to assess individual banks and establish the selection criteria and procedures. Without the benefit of that census, and from the findings of this report, one could estimate that this consolidation and capitalization effort may imply scaling-up 200 to 250 banks, including mergers and acquisitions, to arrive at a total population of about 350 to 400 fully licensed community banks, merging in, acquiring or closing the remainder 600 banks.

6.43. The consolidation effort would require a re-definition or outright elimination of market (“catchment”) areas, and in practice would improve CBs’ ability to face commercial bank competition in their current markets. It would also require granting the CBs the same autonomy commercial banks enjoy to operate and especially to price their financial products on a market basis. No attempts should be made to use the CBs as conduits of government directed credit programs involving interest-rate subsidies.

6.44. The capitalization of selected CBs would also require finding the financial resources to do so. It may also require fiscal resources to clean up and restructure portfolios as a once-and-for-all measure. The magnitude of fiscal outlays, however, may be foreseen as a fraction, probably one-fifth or one-fourth of what it may cost to revitalize government rural credit institutions (NACB and PBN). The expected pay-off of this fiscal expenditure in terms of increased sustainable outreach would on the other hand be much higher for CBs than for NACB and PBN combined.
6.45. A new apex for community banks. The private nature of CBs is being reinforced by the transfer of supervision responsibilities to the CBN. Developmental and promotion services for CBs would therefore be much more logically placed and better performed in a second-tier institution established in line with the interests of the CBs instead of those of the government. The initial promotional role played by the NBCB has been rendered obsolete by the evolution and performance of the CBs, which now require consolidation, capitalization and modernization. The Board should probably be closed, NBCB inspectors could be transferred to CBN, while other staff could be absorbed in other development institutions.

6.46. A new apex institution established by the CBs themselves would take over technical assistance, training and promotion services. It could also develop a central liquidity facility where individual CBs can hold deposits and from where they can borrow. This function would help diversify risks and smooth liquidity fluctuations over the entire system. The apex could also establish a central reserve function, as a basis for a stabilization fund that serves as deposit insurance. Whether the apex should have a commercial bank status, or a CBN involvement is a matter for further study. The commercial bank charter may be preferable since it would resolve the clearing house problem of most CBs, although there may be communications and technological impediments to this solution that would need to be addressed. Even in the absence of a commercial bank charter, the apex could negotiate on behalf of all or specific sub-sets of CBs, depending on geographic location, the terms of clearing-house services provided to CBs by commercial banks.

6.47. While ownership of such an apex is obviously a matter that needs further discussion and active involvement of CBs, one could foresee a majority interest held by the CBs, and participation of private financial groups (especially if the apex is to have a bank charter). Participation in ownership or perhaps presence on the board without ownership by an international institution may also be studied as a possibility.

6.48. Regulatory standards and supervision capacity. At present, the CBN is applying to CBs essentially the same licensing and regulatory standards (excepting minimum capital requirements) it applies to commercial banks. This matter may need further analysis, given the nature of CB ownership. The difficulties in meeting minimum capital standards are an indication of the difficulties that can be anticipated to raise additional capital in the face of a solvency problem. Capital adequacy ratios may therefore need to be higher for community banks than they are for commercial banks. This would not need to be the case if shareholding of CBs were opened to non-community investors (e.g., a commercial bank or other corporate body), but such an opening would probably undermine the community-based nature that distinguishes CBs. Interest rates ceilings on community bank lending should be removed.

6.49. Even with the consolidation recommended here, CBN would be faced with the huge task of expanding its supervision function to about 6 or 7 times the number of institutions it currently oversees. The current staff of NBCB inspectors represents a pool of experienced resources that should be utilized to augment supervision of community

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28 See note 25 regarding access to deposit insurance by newly licensed CBs.
banks. For example, a delegated supervision mechanism could establish certified (private) inspection agencies, initially staffed with former NBCB inspectors, to act on behalf of the supervisory authority.

II. COMMERCIAL BANK RURAL BRANCHES

6.50. Commercial banks account for about one-third of all rural bank outlets in Nigeria, second only to the Community Bank network in rural presence. The four largest commercial banks taken together have 325 rural branches, or 58% of the country’s rural commercial bank branches. A majority of these rural branches, 70 to 80% by different estimates, were opened in the 1980s under a CBN mandate which required commercial banks to establish branches in remote localities, without a feasibility study, and following unclear criteria as to what determined the specific branch location. Foremost among these ambiguities is the definition of what is considered “rural”, still an unclear matter for the mission after inquiries with the commercial banks and the CBN. A combination of regional and local lobbying, inter-regional balance, and the apparent target of one-third of total commercial bank branches seem to have led to the current rural branch network.

6.51. While one of the stated criteria to mandate the opening of commercial bank rural branches was remoteness and absence of banking services, the emergence in the 1990s of the Community Banks and later on of the People’s Bank have created some degree of competition in rural communities. It is however unclear to what extent there are still rural localities where the only provider of banking services is the commercial bank branch. Even in the localities where there is overlapping with Community Banks and People’s Bank, commercial banks are the only providers of check-clearing services and serve as depository institutions for other financial entities.

6.52. The main services rural branches of commercial banks provide are: i) deposits from the general public; ii) payments and transfers, notably civil servants salaries; and iii) correspondent bank services for Community Banks and People’s Bank. While officials of commercial banks at the regional and central level indicated that fee income (COT) for correspondent bank services was not a major entry in their income statements, at the individual branch level COT income is likely to account for an important share of total revenues. Clearing (COT) charges, N5 per N1000, constitute a major reason Community Banks advocate to have their own “commercial bank” or at least a check-clearing facility.

6.53. Loans, even when generated in the rural branch market area, are typically handled and accounted for at the corresponding regional branch or the state “senior” branch, except for small personal loans and small farming and trading loans. Hence, rural branch activity reports would normally not include a significant local loan portfolio. The main sources of revenue for these rural branches are fee income for correspondent bank services and payments and transfers. In addition, at least the large banks do practice

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29 The share of commercial banks in total rural branches increases to 38%, and that of community banks to 44% if only the true branches of NACB (67) are counted towards the total, as opposed to the 379 “total outlets” reported by NACB.
internal transfer pricing, thus creating an accounting revenue for the rural branches, by
definition surplus units given the way in which loans are managed.\textsuperscript{30}

6.54. Commercial banks have adjusted the scale and level of activity of their rural branches to the markets they serve to ensure branch viability, in some cases only being able to minimize their losses given the CBN prohibition to close branches. Hence, whereas the number of rural branches represents 26\% of the total number of commercial bank branches, the number of staff in those rural branches accounts for only about 6\% of the total staff. Hours of operation in small rural branches are also reduced as compared with larger branches in the same state, e.g., eliminating Saturday morning service, or opening only on market days (once or twice a week). It is therefore safe to assume that operating the rural branch network represents less than 6\% of the total operating costs of commercial banks.

6.55. The contribution by rural branches to commercial banks’ revenues could not be ascertained. Interviews with commercial banks at headquarters and at the regional and rural branch levels indicate that a number of small rural branches (15\% to 25\% of the total by some estimates) may be “non-performing” by headquarters’ standards.\textsuperscript{31} This means carrying very little business and especially collecting limited amounts of savings. This subjective evaluation could not be documented with branch-level financial statements, but it helps provide a general dimension to the effect of CBN restrictions on branch closings. One could place the “tax” represented by this restriction between 0.9\% and 1.5\% of commercial banks’ operating costs.\textsuperscript{32}

6.56. In summary, rural branches of commercial banks perform valuable services in the communities they serve and do have a significant public utility function. In particular, they provide payments and deposit services that other financial intermediaries (such as DFIs) cannot offer or may offer (as the Community Banks) with lesser appeal to potential clients. As a consequence, commercial banks tend to maintain these rural branches, sometimes on a reduced-services basis, but still providing fee income. Moreover, given transfer-pricing practices, even with no active lending in these branches many are able to show profits.

6.57. CBN restrictions on branch closings, in spite of their relatively low estimated “tax” effect, should however be revised and limited to localities where no other form of financial intermediation exists. Even for these localities, as studies elsewhere have shown, it is possible that potential clients would rather travel to another locality with a larger branch and more comprehensive services than use the local outlet. A careful review of market coverage by commercial banks, community banks and other financial

\textsuperscript{30} Surplus transfers to headquarters are “remunerated” at a 10\% rate. Detailed branch-level income statements were not made available by either the commercial banks interviewed or the CBN. Figures and rates reported here were obtained in direct interviews and should be considered general orders of magnitude.

\textsuperscript{31} Interviews were carried out at the headquarters of the four largest banks in Lagos, the regional office of First Bank in Kaduna and in two rural branches of the same bank in Lokoja.

\textsuperscript{32} Estimates using the rate of non-performing branches times the share of rural branches on operating costs. The actual “tax” will depend also on the magnitude of the losses, not documented in this study.
intermediaries operating in rural areas should help guide CBN policy making on this matter.