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## Bank Failures in Nigeria: Causes, Effects and Solutions

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### **Abstract:**

*Banking system in any economy performs very important roles in economic growth and development. However, banking system in Nigeria has not been performing these roles satisfactorily due to crises situations experienced in that industry. It is for this reason this paper investigates 'Bank failures in Nigeria: causes, effects and solutions. In order to achieve the objective of the study, qualitative descriptive research method was adopted in this study. The analysis is based on the causes, effects and solutions proffer to banking distress in Nigeria. The paper concluded that banking crisis is a global problem but the rate at which it happened in developing countries such as Nigeria is very disturbing. The paper therefore recommends that government and monetary authorities should put policies in place to reduce the incidence of bank failures. Government should not wait until banking public discovers that a bank is in distress before they swing into action. Bank management should tighten their internal control mechanisms and put in place good corporate governance for survival and excellence.*

**Keywords:** Bank failure, Bank distress, Bank crisis, Fraud, Internal control and Corporate governance

### **1. Introduction**

A sound banking system enables money to perform its functions efficiently, vastly facilitating the exchange of goods and services and enabling the country to make the most efficient use of its human and materials resources.

The deregulation of the financial system embarked upon from 1986 allowed the influx of banks into the banking industry. As a result of payment of attractive interest rates on deposit, approval of loans without sufficient collateral and credit appraisal, banks began to sustain losses. The rising volume of non-performing loans reduced the amount of credit that banks were able to extend to new clients. A situation where non-performing loans exceeded 10% of some banks' loan portfolio, thereby result in banking crisis in Nigeria.

According to Kama(2010), 'banking crisis 'refers to a situation of major disruption in a country's banking sector which may not just be minor downturns or disturbances. Banking crisis occurs when the capital of the banking sector has been depleted due to loan losses, resulting in a negative net worth of the banking sector. This implies that the system is insolvent and therefore the value of its realizable assets is less than the total value of its liabilities.

A banking distress can also occur from illiquidity point of view. According to Ebhodaghe (1997), a bank is illiquid when it can no longer meet its liabilities as they mature for payment, which is a breach of the contractual obligations. Alashi(2002) stated that a bank is said to be in severe crisis when it shows most or all of the following:

- Gross under-capitalization in relation to the level and character of business;
- High level of non-performing loans to total loans;
- Illiquidity as reflected in a bank's inability to meet customers' cash withdrawals and / or a persistent overdrawn of position with the central bank and
- Weak management as reflected by the poor asset quality, insider abuse, inadequate internal controls, fraud, including unethical and unprofessional conduct, squabbles, and a high staff turnover, among others.
- Adekanye (2010) stated that a crisis is a situation in which a significant number of financial institutions have liabilities in excess of the market value of their assets leading to runs, other portfolio shift, the collapses of some financial firms and government intervention. It is a major collapse of the financial system entailing the inability to provide payment or allocate credit. It is precipitated by the desperate actions of bank customers to obtain cash based on the fear that payments will not be available because the bank is suspected to have problems. Such action squeezes the reserves in the banking system.
- There has always been debate about the major causes of bank crisis. While bankers usually blame the crisis on external factors such as inappropriate government policies; supervisors attribute bank crisis to poor management and depositors invariably blame it on inadequate supervision and weak management.

Under the failed bank (Recovery of Debt and Financial Malpractice in Banks) Act 18 of 1994 as amended, the Act defined 'failed bank' as a bank or other financial institution whose licence has been revoked or which has been declared closed, placed under receivership or otherwise taken over by the Central Bank of Nigeria or the Nigeria Deposit Insurance Corporation. Oboh (2005) stated that banking malpractice and insider abuse which came in different forms have in no small way contributed to bank failure in Nigeria. These malpractices are usually perpetrated by outsiders, staff, and even

some top management staff. They include fraud and forgeries of different kinds which types are never exhaustible as new methods and devices are invented on a daily basis.

It is for the reasons discussed above that this paper investigates bank failure in Nigeria: causes, effects and solutions.

## 2. Causes of Bank Failures in Nigeria

Possible causes of bank failures in Nigeria are discussed below:

- Absence of regulation and control: The pre- CBN bank failures in Nigeria were attributed to absence of regulation and control. The period 1952 to 1958 saw the first round of bank failures in Nigeria. By the year 1954, out of about twenty-five (25) indigenous banks established, only four(4) of them survived the 1952 Banking Ordinance. It was with the establishment of Central Bank of Nigeria in 1958, that banking business came under the regulation and control of the CBN (Osuka & Mpamugoh, 2007). Adekanye (2010) stated that free- for- all banking experienced in Nigeria between 1952 to 1958 resulted in bank failures and losses to depositors of affected banks.
- Macroeconomics instability: Macroeconomics environment plays a crucial role in the survival of banking system of any country. Macroeconomic instability has negative effect on the performance of the banking system. If an economy is experiencing sluggish growth or recession, it poses serious challenges to all economic agents, thereby making business opportunities to shrink. In such a situation, bankers take actions which will affect the health of the banking system adversely. The introduction of Structural Adjustment Programme (SAP) in 1986 and the fixing of interest rate and later deregulation in 1987, all these have negative effect on macroeconomic environment in Nigeria thereby having adverse effect on the performance of the banking sector which in the long run, accountable for crisis in the banking sector. Generally, it is easier to achieve a sound banking system under a stable macroeconomic environment than an unstable one. On the other hand, an unsound banking system could trigger macroeconomic instability, hence, the symbolic relationship between the banking system and macroeconomic environment (Sanusi, 2003).
- Weak management: Poor management is one of the principal factors that could precipitate banking crisis. Recruitment and placement of fit and proper persons in the management of a bank as well as the integrity and transparency of its management will definitely impact positively on the performance of a bank. A bank with poor quality staff and management and engages in non-publication and non- disclosure of accounts and other performance indices can lead to poor performance and eventual demise of a bank (Kama, 2010).
- Deregulation of the economy: With the introduction of Structural Adjustment Programme (SAP) in 1986, and subsequent deregulation of the economy in 1987 in the form of deregulation of interest rate and licensing of new banks which brought into the banking industry untrained and unqualified personnel. Many of the bank staff were running the banks as ordinary business, forgetting that there are technicalities involved in managing banks. This led to banking crisis and finally, the withdrawal of their licences as witnessed in 1998 when licence of 25 banks were revoked by Central Bank of Nigeria.
- Capital inadequacy: It is necessary to measure capital adequacy to determine whether a bank's capital is adequate to cushion possible losses resulting from loan losses or disappointing interest margin (Adekanye, 2010). Sound capital management in banking requires maintenance of adequate base of equity funds supplemented by long term debt. It is the policy of banks generally to maintain sound capital growth by balancing earnings allocation between dividend pay-out and profit retention in order to enhance future assets and earnings and by issuing new equity whenever the need arises. The most unfortunate feature of the banking system in Nigeria before 2005 was undercapitalization. Most of the banks that were established were with inadequate capital. With the increase in banks' paid up capital from ₦1 billion (old bank) and ₦2 billion (new bank) to ₦25 billion in 2005, banks were still granting credit facilities over and above their paid-up capital. Most of these loans which were non- performing eroded the capital base of many banks thereby making them insolvent.
- Bad lending: Credit management lies at the heart of banking. Credit became the business of banking and the primary basis on which a bank's quality and performance are judged. Credit management was the most important cause of bank failure in Nigeria. The high volume of non- performing loans and bad debts resulting from poor credit management has left many banks in Nigeria in financial difficulties as many loans granted were not properly appraised while many loans were unsecured making it difficult for the banks to recover the facility. In some cases, loans were granted to fictitious clients, board members of the bank and relatives. This situation gives rise to loan default and irredeemable assets resulting in bank failure.
- Fraud: Fraud has been defined as 'Deceit or trickery deliberately practised in order to gain some advantages dishonestly' (Olufidipe, 1994). Fraud has been identified to be the major collapse of many banks in Nigeria. The fraud has been made possible for the perpetrator as a result of poor internal control. Internal control is the measure put in place by management of the bank to ensure that operations of the bank are carried out in an orderly and efficient manner, safeguard the assets and secure the accuracy and reliability of the bank's records. Unfortunately, many of the controls are not put in place. In the case of credit facility granted by a bank, a bank credit policy manual should be put in place to guide Credit Officer in respect of the procedures to be followed in granting facilities. It was reported that many of these failed banks have no detailed credit policy to guide their Credit Officers. Most of the banks lacked internal controls, this resulted in fraud and unauthorised lending thereby making them to end up in crisis situation.
- Illiquidity: According to Ball (2000), the results from past studies suggested that bank failure is essentially a function of liquidity, market and credit risk, which can all be influenced by individual bank characteristics and the

macroeconomic environment. Liquidity is a measure of the ability of a bank to meet its obligations as they fall due (Nwude, 2005). Liquidity is not synonymous with profitability. A bank could be very profitable while its liquidity position could be poor if the lives of the assets and liabilities are not properly managed. Poor earnings quality of a bank could lead to liquidity problem for a bank. Bello (2006) noted that poor earnings quality leads to bank failure. Between the period 2002 and 2003, the banking industry in Nigeria recorded only a marginal growth in the quantum of earnings from core banking activities (lending) which increase by merely one percent.

- High cost of fund: As a result of banks inability to meet their customers request for cash withdrawal, they offer interest rate on deposits which is higher than the lending rate to borrowers. This practice by which banks obtain funds at the rate higher than lending rate resulted in loss to the bank thereby contributing to high rate of bank failures in Nigeria.

Inability to generate profit: The primary objective of any business /bank is to make profit which is the difference between the cost of deposits and other costs and income from credit advances and other investments (Oluitan, 2004). Bank lending leads to creation of wealth/profit. One cardinal aim in extending credit is to generate income. For this reason, the banker should not extend credit if a problem of performance is anticipated or if it becomes evident that a bad and doubtful account will arise. A great deal of restraint and discipline is required when extending bank credit because the experience of international banks during 1980s has shown that loan growth is not synonymous with higher profits. Credit is the life wire of any bank as financial intermediaries. But majority of Nigeria banks could not make profit as a result of high percentage of non- performing loans or bad loans which led to the crisis of those banks as in the case of National Bank of Nigeria, African Continental Bank and Bank of the North all in liquidation.

### 3. Effects of Bank Failures in Nigeria

Bank failures had serious implications for the financial system and by extension, the economy. The following are some of the consequences of bank failures.

Loss of savings / deposits: Bank failure leads to loss of savings and deposits made with banks by customers of the failed banks. In the event of bank failure in Nigeria, customers deposits are insured up to ₦50,000 by the Nigerian Deposit Insurance Corporation in 1988. In 2006, the limit was increased to ₦200,000 per depositor in the universal banks and ₦100,000 per depositor in microfinance and primary mortgage institutions. The coverage has further been increased to ₦500,000 for universal banks and ₦200,000 for microfinance and primary mortgage institutions (NDIC,2010). A depositor with more than ₦500,000 in universal banks and more than ₦200,000 in microfinance and primary mortgage institutions will have to wait till when assets of the banks are realised. This may take years and money may not be fully repaid by the NDIC.

Loss of public confidence in the financial system: Bank distress / failure makes banking public (customers, depositors and other stakeholders) to lose confidence in the banking and financial system. This will create negative banking habit as bank distress paralyses the development of a good banking culture. It becomes difficult to convince people to patronize banks as people will prefer to keep money at homes instead of banks.

Increased unemployment and loss of jobs: The employees of distress banks also suffer as their appointment with the bank ends with the collapse of the bank. The problem here is that there are no jobs in the labour market. The loss of jobs leads to economic crisis. This ugly situation would lead to frustration. The frustrated man may turn to some criminal activities to survive.

Banks will no longer perform function of credit creation: The distressed banks can no longer create credit. Ebhodaghe (1997) observed the trend of net domestic credit to the economy and then compared it with the trend of key economic parameters such as the rate of growth of real gross domestic product (GDP), the rate of manufacturing capacity utilization and per capital income in Nigeria and compared with variables with the level of distress in the system. In the analysis, Ebhodaghe (1997) confirmed the assertion that developments, which disrupt the operations of banks as financial intermediaries will adversely affect total quantity of bank credit.

Increase in cost of intermediation: Ebhodaghe (1997) argued that bank distress increases the bank cost of intermediation, as banks need to pay higher returns to attract and retain deposits. Many banks at the height of the tension offer interest rates on deposits higher than the prevailing market rates to boost their deposits and lure customers and this further complicated the situation.

Threat to the development of an efficient payment mechanism: Banks are known for providing a safe, economic and convenient payment mechanism world- wide. Banks are central to an efficient and effective payment system in any country, with bank distress, the payment would be perilous and at great risk between the real sector and the financial sectors. Also, international settlement would be adversely affected. The international perception of the banking system would be that of suspicion as it will be feared that their funds could be locked up or lost in the banking system of a country experiencing banking distress.

Enforcement of monetary policies by the government will be difficult: Government through Central Bank implements monetary policies by directing banks direction to follow especially during inflationary period. During inflationary period, Central Bank will use monetary policies to reduce money in circulation in order to stabilize prices of goods and services. When there is banking crisis, this will be very difficult for government to achieve as money will be outside the banking system as a result of loss of confidence in the banking system by the banking populace.

Adverse balance of payment: The balance of payment of any country or economy going through bank distress would be unfavourable and will always be in deficit, this will result in the loss of national productivity and output. A

banking crisis may lead to a fall in output through a sharp contraction in the stock of money due to decline in credit supply to productive sectors

**Reduction in government revenue:** Employees of banks pay their Personal Income Tax to Internal Revenue to the appropriate state governments under Pay as You Earn (PAYE) system. When the employees of distressed banks are laid off, the state governments lose the revenue derivable from such employees. The same situation applies to the National Union of Banks, Insurance and other Financial Institutions Employees whose numerical strength and dues receivable would be reduced due to bank failures.

**Financial costs to government:** Bank failures are usually followed by government bailouts. Fiscal cost of banking crisis includes cost of restructuring the banking system, considering the payments to depositors, bank recapitalization bonds, and asset management schemes. The fiscal gross direct costs are measured as outlays of the government and Central Bank in terms of bond issuance and disbursements of liquidity support, pay-out of guarantees on deposits, cost of recapitalization, and purchase of non-performing loans e.g. Asset Management Company. The public money that is needed to recapitalize insolvent banks puts pressure on the budget deficit to increase.

#### 4. Solutions to Bank Distress in Nigeria

Banking sector is the nerve centre of any economy, in the event of distress of banks, the following solutions are suggested:

**Recapitalization:** Bank recapitalization is simply the act of supplying long-term funds to a bank to place the bank on a good stead financial-wise to carry out the business of banking properly. While bank recapitalization is the act of beefing up the long-term ownership capital of a bank to the level required by the monetary authorities. The amount of capital funds a bank needs should be related to the risks it assumes (Nwude, 2005). It has been discussed many times that before recapitalization exercise of 2005, that Nigerian banks were under-capitalized i.e. old banks ₦1 billion and new banks ₦2 billion. It is therefore envisaged that if re-capitalized, the banks would supply core capital to be used for businesses. Banks would have enough funds to free-up from liabilities and acquire more income yielding assets which will boost the profitability levels. With the resultant opportunities to invest in bigger projects, the profitability of banks would continue to grow as long as the internal rate of return (IRR) is greater than the cost of funds.

**Maintaining adequate level of liquidity:** Liquidity is a measure of the ability of a bank to meet its obligations as they fall due. The liquidity of a bank should be measured both in short and long run in order to establish its ability to redeem its obligations promptly. Many of the Nigerian banks were in distress because of under-capitalization and over-trading which resulted in low liquidity. It was reported that many distress banks in Nigeria were unable to meet the liquidity ratio stipulated by Central Bank of Nigeria. Regulatory authorities should ensure that all banks maintain to liquidity ratio to make the banks have smooth-free operations.

**Adherence to lending limits:** Central Bank sets a limit for lending to individual debtors or group of inter-related debtors. This limit is expressed as a percentage of the banks' own funds. It is otherwise called legal lending limit or *single obligor* limit. As banks capital provides a cushion against risk, the maximum lending limit of a bank is thus statutorily tied to its own funds. Regulatory authorities should ensure this rule is adhered to by banks. This is because most bank failure could be traced to huge percentage of bank loans to a single customer. In the event that the business in which the customer invested in collapses; the bank will be adversely affected resulting in distress.

**Establishment of special courts for debt recovery:** There is need for legislation to facilitate the recovery of debts in the failed banks by establishing a special court with constitutional powers to try bank loan defaulters and staff members of banks who were involved in fraudulent practices that led to failure of those banks as it was done during the regime of General Sanni Abacha when Recovery of Debt and Financial Malpractice in Bank Act 18 of 1994 was enacted. With the establishment of special court, it will eliminate time consuming adjournments / injunctions usually encountered in normal courts which may extend period of trial for years and at the end of it, the culprit will be discharged and acquitted.

**Sanctions against banks who failed to meet CBN standards:** Central Bank of Nigeria should ensure banks in Nigeria meet the standards set for them in terms of capital adequacy, limitation of lending limits (*single obligor limit*), weighted risk /asset ratio and liquidity reserve ratio. These standards are set to protect the banks and bank depositors. Any bank that fails to meet any of these requirements, should be sanctioned by Central Bank of Nigeria to serve as deterrent to others.

**Control of cost of funds:** It was observed that many banks when in liquidity problem, in order to attract deposits to meet depositor's cash withdrawal request, offer interest rates on deposits that are higher than their lending rates. Such a bank will be operating at a loss. Central Bank should stipulate that deposit rates of any bank should be lower than the lending rates. The practice by which banks obtain funds at the rate lower than the return at which the funds are to be invested is called financial leverage. This process is expected to increase the percentage return on equity.

**Sound management team:** One of the major factors that have contributed to the distress in some financial institutions is poor management. Poor management is reflected in poor asset quality, insider abuse, inadequate internal controls, fraud, including unethical and unprofessional conduct. It is the responsibility of the directors to select competent management teams and effectively supervise them. Directors are also required to fire incompetent management teams. The safety and soundness of any bank largely depend on a strong and effective management team.

**Liquidation option:** This is the last option adopted by Central Bank / Nigerian Deposit Insurance Corporation aside from bail out. This is when a bank licence is revoked by CBN/NDIC. Immediately a bank license is revoked, the NDIC proceeds with the necessary liquidation process by closing the branches and head office of the liquidated bank. In the absence of court case challenging the liquidation, payment of liquidation dividend to the bank customers will commence.

The NDIC guarantees payment of deposits up to maximum of ₦500,000 to a depositor in universal banks/deposit money banks and ₦200,000 to a depositor in microfinance and primary mortgage institutions that are insured with NDIC. Depositors with credit balances in excess of ₦500,000 for deposit money banks and ₦200,000 in microfinance and primary mortgage institutions are paid liquidation dividend based on the available funds realised from the assets of the closed banks.

## 5. Conclusion and Recommendations

This paper x-rayed causes effects and solutions to bank failures in Nigeria. While crisis in the banking sector is a general phenomenon, the rate at which it occurred in the developing countries especially Nigeria is very worrisome. The study therefore recommends the following:

That government and monetary authorities need to put policies and ensure the enforcement of all the policies to be put in place so that banks failure is reduced to the barest minimum if it cannot be eliminated in Nigeria.

CBN / NDIC should not wait until the banking public discovers that a bank is distressed before they swing into action.

Rating bodies should desist from rating banks using profitability indices as this has made many banks to employ window dressing and dubious means in paddling up accounts. Rather, rating bodies should use standards set by CBN like capital adequacy ratio, liquidity ratio, performing loans to total loans ratio etc in rating banks. This will make bank management to be more efficient.

Banks in Nigeria should apply effective risk management tactics in their operations and ensure effective investment of depositor's funds in their loan granting approach.

Finally, bank management should tighten their internal control mechanisms and put in place good corporate governance for survival and excellence.

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