NIGERIA BANKS FAILURES: EFFECTS ON THE NATION'S ECONOMY, 1959-1999

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Abstract

The banking industry is the heart of any nation's financial system, and the genesis dates back to 1892. From a handful of banks in the early sixties, the Nigerian economy has witnessed an astronomical growth in the number and variety of banks, because banks remain the undisputed pivot around which major activities in the economy revolves. There exists a direct relationship between growth and development of banks and growth and development in the national economy. In a bid to give a semblance of national spread, many banks opened new branches in unviable areas leading to large overhead costs, low earnings and huge operational losses. Also, lack of internal financial or administrative control unit and fraud led to bank failures. As a result, threat of contagion across banks and the potential for high macro-economic costs resulting from bank distress led government to adopt a safety net.

INTRODUCTION

The two decades preceding the country's independence were, therefore a period of tremendous growth and development in this crucial sector of our national economy. This rapid transformation of the financial structure has been both qualitative and quantitative. The period from 1986 to the present, (1998) has witnessed even more dramatic institutional growth, with the banking system recording unprecedented increase both in the number of banks and in the range of institutions. These include the establishment of a purely 'consumer' bank - the Peoples' Bank of Nigeria, the concept of the community bank and. more recently, mortgage finance Institutions, and discount houses. Hence bank policy orientation, leadership, ownership and management have become truly Nigerian and also in terms of growth and development.

The banking system may be conceived as a network of monetary financial institutions which act together as a repository for the community's wealth; the interbank financial markets (foreign exchange and money markets) which provide a web of debt instruments, and the framework of laws and regulations which control the flow of money and credit in time and space. In this chapter we shall examine the evolution of the Nigerian banking industry, evidence of banks failure, factors responsible for bank failures in Nigeria and the effect of bank's failure on the economy and society in general.

HISTORY OF THE NIGERIAN BANKING

Nigeria, the largest country in Africa in terms of population (about 120 million people in 1991)[1]. Also she has the largest financial system in terms of the number of financial institutions, the range of services provided and the level of sophistication of customer requirements. On the eve of independence in 1960, the financial system was underdeveloped and most of the complex ramifications which were integral to it today were not there. The Central Bank of Nigeria (CBN) began operation on July 1. 1959[2], a year before independence, and until that date, there was little significant regulation of the banking industry. At the time, too, fiscal policy was rudimentary. Most of the banks were foreign-owned and foreign-managed, and their orientation was essentially foreign. Rural banking was unheard of as most of the foreign banks had their branches located either at the local towns or at urban centres.[3]

Before the advent of colonial rule in Nigeria, the traditional barter system was widely practised, although a multiplicity of indigenous currencies (e.g. cowries and manilla) and foreign currencies circulated side by side within Nigeria.[4] Towards the end of the 19th century, British silver coins were imported into the West African colonies to monetize the economies. Indeed, it was the need, among other factors, for the importation and distribution of these silver coins that led to the establishment of the African Banking Corporation (ABC) in January 1891, following an agreement between the Crown Agents and the management of the African Banking Corporation which at the time had a branch in South Africa. The bank began operation in Lagos in that year, but as a result of the trade recession which hit Lagos in 1892, the bank was taken over in March 1893 and ran by Elder Dempster and Company (a shipping firm) as a private bank

The second bank to be set up in Nigeria, the Anglo-African Bank (later renamed Bank of Nigeria) was established in 1899 by the Paiges Trading Firm in Eastern Nigeria.[5] The bank was in competition with BBWA until it was absorbed by the latter in 1912. Consequently, at the time the West African Currency Board (WACB) was formed in 1912, the BBWA became its sole agent for distributing currency within the West African sub-region and the Lagos colony.

Furthermore, another purely expatriate bank, the Colonial Bank, based in the West Indies, opened for business in Lagos in 1916. [6]It was taken over in 1925 by Barclays Bank. Barclays Bank later amalgamated with the Anglo-Egyptian Bank and the National Bank of South Africa to form the new Barclays Bank (Dominion, Colonial and Overseas (DCO)) now known as Union Bank of Nigeria Plc.[7] As it were the economy was to experience between the closing years of the 19th century and a better part of the 1920s a monopoly of the two foreign banks.

It is believed that it was in an effort to counter the apparent discrimination by the two existing expatriate banks to extension of credit facilities to Nigerians that strenuous efforts were made by many Nigerians to set up banks in the country in the first half of the 20thcentury. Thus, the first indigenous bank to be established in the country, the Nigerian Industrial and Commercial Bank, formed in 1929 went into liquidation in 1930, with total deposit liability of about £13. 000 sterling.[8] This bank was founded by a Gold Coastian resident in Nigeria, Tete Ansah. Among the reasons for the liquidation was that the bank's records were not properly maintained and this made it impossible to ascertain the total assets and liabilities of the bank accurately at the time of liquidation.[9] The second indigenous bank founded by Mr. Ansah in 1931 was the Nigerian Mercantile Bank. In 1936, the bank folded up. These two banks failed as a result of alleged incompetent management accounting, ineptitude and the unsound policies and practices of their officers.[10]It is, however, possible that hard colonial environment and policies contributed to their failure, too.

The National Bank of Nigeria Limited which was set up in 1933 by a group of Nigerian businessmen was the first indigenous bank to be successfully established. The second successful indigenous bank, the African Continental Bank started as a private company known as Tinubu Properties Limited in 1937 by Nnamdi Azikiwe. It changed its name to Tinubu Bank Limited in January 1947, and subsequently, adopted the name, African Continental Bank Limited, later in the year.[11]

It has been claimed that when the Paton Commission of Inquiry was inaugurated in 1948, only six banks were in existence in Nigeria - three indigenous and three expatriates. Paton's report led to the promulgation of the first banking law in Nigeria, the Banking Ordinance of 1952. The 1952 Banking Ordinance represented a watershed between the eras of experimental and extreme banking on the one hand and on the other hand that in which a modern and regulated financial system started to emerge. It may be pertinent to note that while the 1952 Banking Ordinance prevented under-capitalization in banks it was incapable of developing the banking system or preventing the worst mal-practices and abuses in banking.

Another important development during the free-banking era was the establishment in 1957 of the Nigeria Building Society which was co-financed by the colonial (now Commonwealth Development Corporation) and the Federal and Regional Governments in Nigeria. This institution was restructured into the Federal Mortgage Bank of Nigeria by a decree in July 1977.[12]

The post-civil war period in Nigeria (1970 onward) witnessed a number of economic policies including attempts to indigenize the economy by the military government at the time. The indigenization Era (1970-1985) was characterized by the following programmes and activities, economic reconstruction and development, government incursion into the banking scene, indigenization and rural banking.

To tackle the lingering inadequacies of the banking sector, substantial changes were introduced in the industry in the decades of the 1970s. Among these changes were the deregulation of the financial activities, especially interest rate determination, credit

administration, treasury securities, trading and monetary management. Other measures were the review and update of banking laws. Introduction of prudential guidelines, and the relaxation in the rules for the licensing of banks. The effect of these measures was a considerable rise in the number of commercial and merchant banks to 66 and 54 respectively by 1991 before their reduction to 64 and 51, respectively, by 1995, following the liquidation of five banks.[13]
The five liquidated banks were:

i	Reliance Merchant Bank	1992
ii	Financial Merchant Bank	1994
iii	Capital Merchant Bank	-1994
iv	United Commercial Bank	-1994
v	Alpha Merchant Bank	-1994

There also emerged innovative banking institutions in the 1970s, 1980s and 1990s which included the Peoples' Bank of Nigeria, Community Banks; the Nigeria Export-Import Bank (NEXIM) and more specialized development banks as well as new supervisors such as the Nigeria Deposit Insurance Corporation (NDIC) for deposit insurance and the Federal Mortgage Bank of Nigeria. On its part, the NDIC added the supervision of the mortgage institutions to its existing functions. Although, the reforms since 1990 have brought significant improvement in the provision of financial services, through improved competition and financial resource allocation, the period had accommodated distress in the banking system which also encouraged deterioration and failure in banking activities.[14]

EVIDENCE OF BANKS FAILURE IN NIGERIA

If we take bank failure to mean inability of banks to meet their obligations, it is clear that Nigerian banks have not been able to meet fully their obligations since the inception of modem banking in Nigeria in 1891. Some of the branches of these obligations included inaccessibility of many Nigerians to banking services as well as delays and inefficiency in rendering such services. To a large degree, this situation has encouraged many Nigerians to patronize the informal financial sector.

The early 1990s might have witnessed a considerable reduction in the ownership interests in the banking institutions by government, resulting in a significant drop in the number of banks to 60, with less than 30 of them active players.[15] Prior to 1992, the minimum paid-up; capital requirement for banks in Nigeria was N12 million for the merchant banks and N20 million for the commerci~~a~~l banks. A review that year moved the requirements to N40 million and N50 million respectively. This level lasted till 1997 when a uniform N500 million minimum capital requirement was introduced in the system. Indeed the late 1990s was an era of guided deregulation, with an embargo placed on the entry of new banks into the industry.

Despite the increase in the capitalization requirement to N500 million, it was still inadequate to protect the banks from the vagaries of the market**.** In fact, it has been pointed out that one of the major causes of distress in the industry was gross under-capitalization which never compared well to their level of operation and services. The banks were also allegedly saddled with a high level of classified loans, advances and insider abuses. It was not unusual for banks to grant unsecured loans to political appointees, members of the board and managements of the banks, their friends and even staff and their relations.[16]

It was perhaps in a bid to laud their image or give a semblance of rational spread that many banks opened new branches in unviable areas leading to large overhead costs, low earnings and huge operational losses. That was not all, most of the banks did not have an internal financial or administrative control unit and where they had, it was porous and powerless.[17] Again, most banks were plagued by fraud inevitably, all these combined to result in the inability of the banks to honour their contractual agreements, principally in terms of customers' cash withdrawals.[18]

FACTORS RESPONSIBLE FOR BANK FAILURES IN NIGERIA

This section attempts to identify those factors which are relevant in explaining the various forms of bank failure experienced in Nigeria, although part of this has been highlighted previously. Experience gained through the monitoring of banks since 1979 shows two levels of causes of bank failure, from bank balance sheet management to the economy. The first level of causes (or the fundamental causes) is what went wrong with bank portfolio management while the second level relates to factors within and outside the banks, which encouraged poor portfolio management. Overall, it has been observed that the performance of banks, on aggregate, deteriorated over the years as shown below:[19]

i. Capital adequacy, measured by the average ratio of classified assets to shareholders' fund, deteriorated over the years though marginal improvement became noticeable since 1995.
ii. Asset quality, as reflected in the ratio of classified assets to total loans and advances deteriorated progressively for many banks from 1990-1995.
iii. Liquidity of banks, measured by the liquidity ratio, which fluctuated around the policy minimum between 1990 and 1992 showed some improvement since 1995. Relying on the desirable level of loan/deposit ratio of about 70 percent, many banks over-lent their resources most of the time.
iv. The earnings indicators of the banks showed mixed and varying performance among the banks.
v. Bank management, measured by their inability, to check capital inadequacy, poor asset quality, poor earning capacity and distress has been rated ineffective.[20]

If we accept the fact that all the banks faced the same external influences from the economy, it would be appropriate to conclude that the test of individual banks lies in the way they managed their portfolios under the existing circumstances. While poor portfolio management was the fundamental cause of bank distress and failure, the factors, which inhibited the effectiveness of portfolio management constituted the second level of causes. For analytical convenience, the factors which encouraged poor portfolio management could be grouped into three, *namely*, internal constraints, regulatory constraints and environmental constraints.

a. Internal Problems

A review of the operations of the banks from 1978 shows that the root cause of poor portfolio management was the bank operators (insiders') lack of integrity which comprised order and accountability and opened the way for bad and doubtful debts as reflected in the rising ratio of classified assets to total loans and advances which reached a climax in 1994 before some improvement in 1995 when accountability was taken seriously through law enforcement. For example, reported frauds and forgeries in commercial banks increased from N98.2 million in 1989 to N265.2 million in 1994when accountability was neglected much, and dropped sharply to N1, 006.3 million in 1995 when me tribunals under the Failed Bank (Recovery of Debts) and Financial Malpractices Decree forced bankers and their customers to account for their use of banks' resources.[21]

Also, in 1998, some banks lost over half a billion naira to a fraud involving two companies owned by a set of Lebanese resident in Nigeria. Available information shows that those banks declared distressed had manifested greed-related characteristics among shareholders, board members, management and **s**taff through one or combined factors such as the following:[22]

Ownership tussles; ii. Boardroom squabbles; iii. Large scale fraud; and iv. fraudulent management

b. Regulatory Constraints

Despite the salutary effects of regulatory changes between 1990 and1995, which tended to strengthen the banking sector generally, some of the measures proved burdensome and counterproductive to the system. First, the transfer of public sector deposits from banks to the Central Bank of Nigeria (CBN) in 1990 proved too sudden, especially for weak banks with prudential lapses. The viability of such banks was seriously impaired because they were unable to get alternative deposits in the meantime. Secondly, there was easy and excessive licensing of banks which injected much competition into the system while, at the same time, the victims of me ensuing competition were not allowed to leave the system ever, when they were no longer showing concerns.[23] This regulatory stance constituted serious constraint in sanitizing the system.

The third regulatory problem for the banks was the mandatory financing of fiscal deficits by the CBN, which reached a climax in

1993. This fuelled the economy with excessive liquidity, which had to be mopped up through the banks in the form of mandatory holding of stabilization securities from 1990, with adverse effects on individual banks. Fourthly, the policy which sustained new banks with regular allocation of foreign exchange which was abused often, deprived the banks, from their inception, the incentives to imbibe sound banking principles which could ensure viability.[24] Fifthly, indiscipline was encouraged by weak banking laws, which faded to provide adequate penalty for operators' abuses. For example, until 1995, there was no effective way of making bankers and their customers, shareholders and regulators account for their role in providing, promotion and utilizing services.

c. Environmental Constraints

Until the mid-1990s, the economy was beset with sluggish growth output and rapidly rising inflation for most of the period and fast depreciating exchange rate until 1995. Economic downturn deprived the banking sector of its vibrancy as economic activities, which were expected to stimulate banking sector, declined. High inflation and **depreciating** exchange rate eroded the purchasing power of bank. This encouraged withdrawal from banks m order to meet essential needs thereby reducing deposit liabilities, which constituted the main source of banks loan-able fund. The pervading economic downturn and instability encouraged short term views of business, at the expense of long-term planning, thus, impairing the viability of the banks. Like micro-economic instability, political crises, especially between 1993 and 1904 created general uncertainty and made banking activities difficult.[25]

EFFECT OF BANKS' FAILURE ON THE ECONOMY

In the early 1980s, the Nigerian banking sector started to a decline. This was apparently due to the downturn in the country's economy. With the inability to moderate boom-time consumption habits in line with the realities of the depressed economy, the financial condition of individuals, companies and government at all levels worsened, making them unable to honour their contractual obligations on loan repayment to banks. This consequently impaired the portfolio quality of the banks. The economic downturn combined with factors such as mismanagement illiquidity and undercapitalization to adversely affect the fortunes of many banks.[26]

The adverse effects of bank distress on the economy of any country is not a respecter of the level of development.[27] Whether a country is industrialized, developed and big or poor, under-developed and small, bank failures, if not well managed portend doom and; collapse for the economy. The devastating effects of bank failures on the only super-power in the world today - USA - and the threat it posed to the economy on the first industrialized country, Britain, are well documented in the literature.[28]

The governments, regulators, members of the public end bank operators have always resented bank failures due to various reasons. Governments are particularly concerned in view of the social, political and economic implications of bank distress. The externalities, associated with distress make it distasteful and of serious macro-economic implications, unlike what obtain when a non-banking institution fails.

According to Glaessner and Mas, perceived threat of contagion across banks and the potential for high macro-economic costs resulting from bank distress have often led government to adopt a safety net to prevent these outcomes.[29] This implies that, when a bank becomes distressed, apart from the economy, there may be a spillover of the problems to other banks, unlike what obtains when a brewery company is insolvent, its demise does not affect other breweries instead they benefit by having more customers.

A major factor that impacted negatively on the banking sector in the mid-1980s was the lack of experienced and adequate personnel to cope with the burgeoning industry. With the number of banks ballooning to 120, and with the few experienced hands moving to the highest paid jobs, opportunities were created for inexperienced staff and even misfits to be appointed or promoted into sensitive positions in the banking industry. This led to diminished professionalism, which relegated honesty and integrity to the background, elevating materialism and inordinate ambition.[30]

Economically, the intermediating role of banks and their relevance both in the transmission of monetary policies and in the payment system underscore their importance as well as the problem that bank failure of the prevailing dimension in our economy could precipitate. Arising from their intermediation, bank**s** generate financial resources to further the course of economic growth in the form of increased employment of otherwise idle resources and this in turn leads to increased output. Therefore, an industry-wide insolvency of banks, such as the one being experienced in Nigeria, should be expected to retard the economy's *rate* of capital *formation,* reduce *its level* of employment and *output and ultimately* the pace of economic growth.[31]

For most developing countries that are undergoing one form of economic reform or the other, IMF working paper, says that the existence of a well-functioning banking system will determine the success of their privatization effort. The absence of ready sources of financing serves as a barrier to entry and delays industrial restructuring and domestic competition.

Furthermore, a well-functioning banking system also encourages a wide variety of services, which include financial advisory services, foreign exchange dealings and domestic as well as international payments complement the deposit-taking and loan-granting services of banks. If banks perform these functions efficiently, then they would contribute significantly to real economic development in a country.[32]

The theoretical insights about the relationship between banking development and economic growth have generated several empirically observed patterns of the finance/growth linkage.[33] These patterns offer some lessons f or **a** developing country such as Nigeria, which badly needs some way of digging itself out of a deep economic crisis. At the broadest level of generalization, empirical studies have established strong positive correlation between real growth of output investment bank assets and money supply.[34]The forgoing serves to indicate the place of banks in economic growth and development. The emphasis here is that a well-functioning banking system will promote rapid economic development while a banking system that is characterized by massive failures would retard growth and development in the real sector of the economy.[35]

Be that as it may, trust and confidence have always been regarded as the cornerstone of banking. It is because of trust and confidence, which members of the public repose in banks, that they keep their valuables and deposits with the banks. Thus the banks occupy a unique position, which compel them to seriously safeguard the depositors on which their own existence also depends.

CONCLUSION

This work traced the history of the growth and development of the banking system in Nigeria from pre-colonial era to the present. It also discussed various factors which were responsible for bank failures, as well as the effects on the economy. From the foregoing, it is therefore not surprising that loss of confidence in banks is usually accompanied by a catalogue of consequences which could affect foundation of the social, economic and political stability of the country.

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