

Government Bailout of Financially Distressed Banks in Nigeria: A Justifiable Strategy?

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Abstract

This paper attempts to analyze the rationale behind government bailout of cash distressed financial institutions in the 2009 financial crisis. This enquiry is important from the standpoint of the reasons that have been discovered to be the core of the national financial distress. Irresponsible corporate governance, outright fraud and excessive risk taking with moral hazards were the major culprits behind the meltdown. The research is a qualitative study which is based on secondary data gleaned from journal articles and books on the subject matter from the virtual and physical libraries. In the United State of America and Japan, government bailout of the banking system seems to be justified as the crisis emanated from error in their policy thrust. The paper concludes that in view of the high degree of financial shenanigan involved in the Nigeria's case, government intervention (bailout strategy) would not have been justified but for the consideration of the generality of small savers, depositors and the general impact on the economy. Certain regulatory policy prescriptions were proffered to avoid future occurrence.

Key Words: government bailout, distressed bank, Central Bank of Nigeria, strategy, Nigeria.

1. Introduction

The Central Bank of Nigeria (CBN) injected N620 billion into the troubled banks in 2009 as a form of a bailout due to non-performing and unsecured loans of the banks which led to tight credit in the economy (Sanusi, 2010). Also, a similar event happened in the United States and the country was the first to package a bailout for its financial sector at the onset of the global financial crisis in 2008. A whopping sum of \$750 billion was injected into the financial sector to ease credit situation (Scott, 2009).

According to Levitin, (2011), bail-outs are an inevitable feature of modern economies in which the interconnectedness of firms means that the entire economy bears the risk of an individual firm's failure. In Nigeria, the economy faltered and the banking system experienced a crisis in 2009, supposedly triggered by global events. The stock market collapsed by 70 percent in 2008-2009 and many Nigerian banks had to be rescued in order to stabilize the system and return confidence to the markets and investors. The CBN rescued the banking sector from illiquidity and replaced the leadership at 8 banks (Sanusi, 2010).

The government of the United States of America, after the dot.com bust of 2000 and concerned about deflation and the Japanese stagnation of the 1990s, abruptly lowered its target rate from 6.5 percent to under 2 percent and then kept it at 1 percent until July 2004. The inflation rate over this period was around 2 percent; hence the real rate of interest was negative.

Government-sponsored enterprises, (GSEs) would insure residential mortgages that met their standards, for a fee. They would also buy the loans and put them into a pool, which could then be sold to private investors, thereby providing funds for additional purchases from banks and mortgage originators. The GSEs led the way for the development of a securitization market for conventional mortgages. The goal for the government was to push homeownership rates ever higher which incidentally involved pushing credit standards ever lower (Scott, 2009).

The process reached its zenith with the creation and promotion of substandard loans, that is, loan with poor credit scores. Conventional down payment requirements of 20 percent dropped to as low as 3.5 percent for the GSEs and to zero for some private originators because significant down payments were viewed as barriers for low income families. Interest only loans involved no amortization of principal for a period of ten or fifteen years. No documents loans became common place. Both borrowers and lenders were expecting house price appreciation to create some equity and enable a sale or refinance of the property when the resets crystallize. The graph of the accelerating house price appreciation eventually took a nose dive toward the end of 2006. House values quickly fell below the amount of the mortgage debt with no significant down payment and the bubble busted. Apparently, the financial crisis in the USA was originated by unmonitored government policy on home expansion which the market operatives took advantage of.

The financial crisis in Japanese banking industry emanated from heavy dependence on revenue from lending with lack of profitability from their lending operations due to low interest margin and many of its customers are insolvent. Other factors are the large size of their banking industry, inability to offer new high-margin financial services, as they are unable to compete with money-losing government lenders (Kashyap, 2002). In Nigeria the case is different. The bubble was absolute financial shenanigan in the Nigerian banking system, most of which were routed through the stockbrokers and absolute fraud. It was never a response to government policy or misallocation arising from policy prescriptions. As a result of the fact that shareholders are generally diversified, they have far greater willingness to tolerate risk, and to pressure management for increased leverage. Probably, the pressure on banks to deliver high returns to their shareholders after the rapid expansion in their capital base post-consolidation contributed to some of the highly risky behaviour that led to the insolvency of some of the banks. How justifiable then should tax payers money be applied to rescue individuals who wantonly defrauded their organizations? The purpose of this paper is therefore to assess the justification or rationale for government intervention in the Nigerian banking industry meltdown through the bailout strategy.

2. Literature Review

Financial distress is defined as a situation in which “an institution’s existence will be endangered (...) without support measures” (Deutsche Bundesbank, 2007:75). Support measures are either through restructuring mergers or capital injections. When the concept of going concern is threatened, the ultimate risk faced by a bank becomes too high, then the options left with the regulators are either a bankruptcy or a bail-out (Faff, Parwada and Tan, (2010).

Many economies maintain deposit insurance schemes to protect depositors against losses when a bank fails to meet its debt obligations. Consequently, selected banks may receive capital from regulatory authorities or government when in distress in the form of bailout (Dam and Koetter, 2011). Financial safety nets for individual banks aim to reduce the social costs of bank failures due to systemic risks (Puri, Rocholl and Steffen, 2011) or bank competition (Gropp, Hakenes and Schnabel, 2011) and promote financial stability (Demirguc-Kunt and Detragiache, 2002). Deposit insurance can help prevent bank runs and mitigate the potential spillover effects of bankruptcies (Diamon and Dybvig, 1983).

Considerable resources were expended by governments worldwide on maintaining the economic viability of financial institutions to stage off the effects of the financial crisis of 2007 and 2009 (Faff, Parwada and Tan, 2010). There is a large body of research examining the effectiveness of financial rescue packages in addressing the risk of contagion. The majority of the research concentrates on credit markets, asking the question from the perspective of banks and their corporate lending clients (Slovin, Sushka and Polonchek, 1993; Giannetti and Simonov, 2010). Counterparty risk is probably one of the most dreaded potential consequences of the financial crisis. Thus, financial economists, regulators and the investing and taxpaying public are vitally interested in whether the bailouts reduced counterparty risks and avoid massive asset fire sales.

2.1. Systemic Risk

Systemic risk, the possibility that an individual firm's failure will result in broad damages to the economy as a whole is the crux of financial crisis. The first financial firm to fail sets off a cascade of successive failures (Dam and Koetter, 2011). While systemic risk is about individual firm's failure having broader economic consequences, what makes such consequences systemic or not is ultimately a valuation driven by social norms and political culture. The fact that non-financial firms can generate systemic risk just like financial firms is apparent from an examination of the mechanism by which micro-economic failure escalates into a macroeconomic problem. There are three systemic risk transmission mechanisms through which this happen: counterparty contagion, information contagion and common shocks (Letin, 2011).

Counterparty Contagion

Counterparty contagion or the domino effect, occurs when the failure of one firm leads directly to the failure of other firms that are its counterparties because the counterparties relied on payment or future business from the initialed failed firm (Humphery, 1986). This might be distinguished into obligor contagion when it is due to a payment that is not made and as supplier contagion when the contagion is due to loss of future business. The extent of counterparty contagion chains is very much determined by leverage, liquidity, diversified or replaceable sourcing. Consequently, counterparty contagion is a particular concern in highly leveraged industries like finance where even small losses can leave a firm insolvent. Helwege (2009) argued that the prerequisite for a bank run is not a bank's actual inability to repay its obligations in a timely fashion but only a perception that the bank might not be able to repay in time.

Informational Contagion

Information contagion occurs when the failure of one firm results in market confidence eroding in similar firms which then fail when they are no longer able to obtain financing or conduct transactions on viable terms. Runs can occur in not only when their funds ebb, but also when customers pull their future business from a firm because of concerns generated due to problems at a competitor. For instance, a major airline accident could hurt business for other airlines (Roubini, 2008).

Common Shock

The terrorist attacks of September 11, 2001, were a common shock to the entire air transportation industry in United States of America. First airspace was closed for several days, demand for air travel decreased and increase fuel prices subsequent to invasion of Iraq. Systemic risk can be transmitted in several distinct but often intertwined ways, all of which apply to both financial and nonfinancial firms. Although nonfinancial firms are less likely to be as heavily leveraged as financial firms, they are often more vulnerable to supplier contagion because their suppliers cannot be resourced as easily as finance suppliers can be (Lang and Stulz, 1992).

2.2. Systemic Risk in Nigeria Banking Sector

In view of the information available from CBN, it is no longer acceptable to say that the crisis in the banking sector of the Nigeria economy was a transmission of the global economic meltdown because from the public address of the CBN Governor, all the factors responsible for the failure of the sector were home-grown.

It was envisaged that rapid financial assets growth would drive economic growth. While many developing countries have followed the path of financialisation, Nigeria's experience was far too rapid to benefit the real economy. The absorptive capacity of the economy lagged behind the excess liquidity generated from bank consolidation, oil revenues and foreign investments inflows. This gave rise to significant flows to non-priority sectors and to the capital markets, mostly in the form of margin loans and proprietary trading camouflaged as loans (Sanusi, 2010).

Consequently, market capitalisation of the NSE increased by 5.3 times between 2004 and its peak in 2007, and the market capitalisation of bank stocks increased by 9 times during the same period. This set the stage for a financial asset bubble particularly in bank stocks (Sanusi, 2010). These events did not arouse any suspicion from the regulators. As credit levels rose and stock prices inflated, the CBN failed to halt the vicious circle neither did it foresee the consequences. The CBN failed to highlight or communicate the problem to fiscal authorities and the market in general.

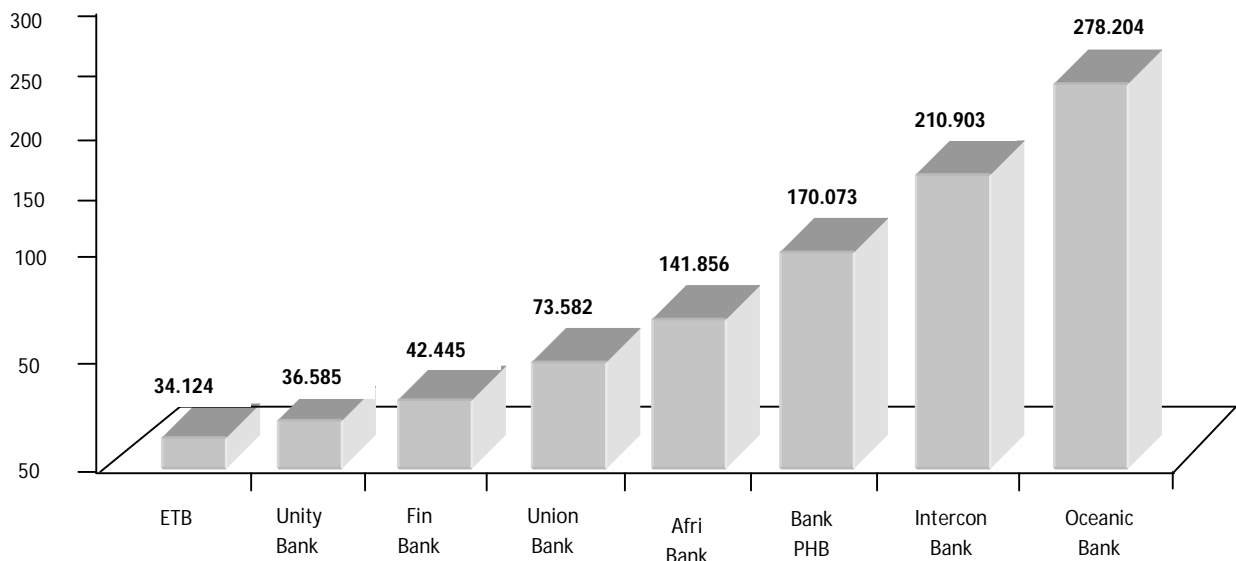
Consolidation created mega banks but failed to institute best practice corporate governance in most of the banks. Since consolidation, some of the banks engaged in unethical and potentially fraudulent business practices and the scope and depth of these activities have been documented in recent CBN examinations. Governance malpractice within banks, unchecked at consolidation, became a way of life in large parts of the sector, enriching a few at the expense of many depositors and investors.

Corporate governance in many banks failed because boards disregarded these practices for reasons including being misled by executive management, involving themselves in obtaining un-secured loans at the expense of depositors and not having the required skills to enforce good governance on bank management. The board committees were also often vain or inactive. In addition, the audit process at all banks appeared not to have taken cognizance of the rapid deterioration of the economy and hence of the need for aggressive provisioning against risk assets. This permitted the robust profit declaration at the expense of the health of the banks (CBN Report, 2010). The details of the extent of insider abuse in several of the banks were mind boggling. The CEOs set up Special Purpose Vehicles to lend money to themselves for stock price manipulation or estate acquisition all over the world. One bank borrowed money and acquired private jets which were later registered in the name of the CEO’s son. In another bank the management set up 100 fake companies for the purpose of perpetrating fraud (Sanusi, 2010). A lot of the capital supposedly raised by these so called “mega banks” was fake capital financed from depositors’ funds. Thirty percent of the share capital of Intercontinental bank was purchased with customer deposits. Afribank used depositors’ funds to purchase eighty percent of its IPO. It paid N25 per share when the shares were trading at N11 on the NSE and these shares later collapsed to under N3. The CEO of Oceanic bank controlled over 35 percent of the bank through SPVs, borrowing customer deposits. The collapse of the capital market wiped out these customer deposits amounting to hundreds of billions of naira (CBN Report, 2010).

3. Research Methodology and Methods

This study being historical and explanatory utilized secondary sources of information to describe the research phenomena. Secondary data are data collected by individual(s) other than the investigator and for purposes other than the current needs of the researcher (Harris, 2001). This process is economical because it saves time and cost that would otherwise be spent collecting data (Zikmund, 2003). Furthermore, secondary data generally have a pre-established degree of validity and reliability which need not be re-examined by the researcher who is re-using such data (Bishop, 2007). Data collected from these sources enabled the researcher in comprehending the details of the research problem from historical perspective. The bibliographical references and internet provide a complete list of the series of sources upon which the study was based. The table below reveals the gap between the 25 billion naira equity share capital and the magnitude of non-performing loan balances.

Non-Performing Loans of Troubled Banks in Nigeria as at May 31, 2009 (N'bn)



Source: CBN, (2010)

The Central Bank had a process of capital verification at the beginning of consolidation to avoid bubble capital. For some inexplicable reason, this process was stopped. Subsequent investigation revealed that in many cases consolidation was a sham, the banks never raised the capital they claimed they did. The Governor of the CBN, in his brief to the Senate on the global financial meltdown on October 21, 2008 was quite confident that the increase in equity share capital of the banks achieved through the consolidation exercise will be more than sufficient to stand the banks in good stead. Little did he know that the exercise has been jeopardized with internal fraud (Soludo, 2008).

4. Discussion

As the quickest and the simplest way for a financial institution to increase its profitability is to increase its leverage, a continuing anxiety will exist between regulators and systemically significant financial institutions over the issues of risk and leverage. Heightened systemic risk involves costs that are externalized by the company and fall on society. Unrestrained shareholder pursuit of wealth maximization can lead to externalities (Coffee, 2010). When a distressed financial institution dumps assets on a thin market in order to raise capital, it depresses asset values and hence reduces the market value of other financial institutions. If its bankruptcy causes other failures or necessitates public bailouts of other firms, it imposes costs on society. The level of risk that is privately optimal for the shareholders of a financial institution may not be socially optimal (Schwarcz, 2008).

Even if regulations are implemented decisively and administered prudently, economic shocks are rarely predictable and they arrive with a suddenness that often outpaces the capacity of bureaucracies to respond in a relevant fashion (Anabtawi and Schwarcz, 2010). The reason stems from three interrelated factors: (1) inherent bank frailty; (2) a regulatory sine curve under which a period of thorough regulatory inspection following a market crash is followed by increasing respite of the rules that typically capture the regulator (at least to some degree) by the industry; and (3) cognitive limitations on the ability of both private gatekeepers and public regulators to perceive new risks accurately (before it is demonstrably too late). This claim that systemic failures will recur may sound overly aggressive and unproven, but it is simply a distillation of what financial historians have repeatedly reported. From the classic work of Kindleberger (1975) to more recent work by Reinhart and Rogoff, (2009) whose aptly named book, “THIS TIME IS DIFFERENT: Eight Centuries of Financial Folly,” expresses the essential point, the same theme recurs: human beings have bounded rationality and will predictably be blindsided by a new crisis.

Banks (and similar financial institutions) are subject to a fundamental mismatch between the short-term character of their liabilities and the longer term character of their assets (Posner, 2009). Depositors expect and receive high liquidity, while obligors expect to repay their loans over a multi-year period. In good times, banks profit from this “maturity transformation,” realizing the spread between the lower rate paid depositors and the higher rate charged borrowers. But, in bad times, banks have been characteristically subject to “runs” when depositor confidence is shaken (Diamond and Dybvig, 1983; Calomiris and Mason, 2003). To maintain investor confidence and avert runs, bank regulators engage in “safety and soundness” regulation that is designed to convince depositors that their bank can handle sudden increases in the rate of depositor withdrawal.

When the market suspects that a financial institution is subject to a risk of insolvency, short-term creditors may stage their own bank “run” by refusing to renew short-term credit lines or greatly increasing the interest rate. This functional equivalent to a “run” by depositors appears to have happened not only at Bear Stearns and Lehman, but across the banking system in 2008 (Gorton, 2009). If we recognize both that some regulatory failures are inevitable and that the interconnections among financial firms may lock the financial industry into a downward spiral if any major firm fails, a failsafe option should be designed in advance.

Bebchuk, Cohen and Spamann (2010) focus on the perverse influence of executive compensation. They argue not only that executive pay packages extremely focused on short-term results, but that because senior executive compensation packages were closely tied to highly levered bets on the value of the banks’ assets, senior executives shared in any shareholder gains, but were insulated from shareholder losses. Hence, they could focus on the upside and ignore the downside of any risky strategy. The result, they argue, is a classic moral hazard problem. To corroborate their claim, Bebchuk *et. al.* (2010) have collected data showing that senior managers appeared to have profited substantially even when shareholders lost virtually everything.

Examining the failures of Bear Stearns and Lehman, they find that the top-five executive's teams at each firm cashed out extraordinary amounts of performance-based compensation during the 2000-2008 periods. If managers win when shareholders lose, this evidence would seem to confirm Bebchuk's moral hazard analysis. As liquidity crises are a recurring (and perhaps unavoidable) experience in the field of banking, restrictions that deny banking regulators the capacity to stave off such a crisis by advancing funds to a troubled firm may frustrate an opportunity to preserve the assets as opposed to dissipating their value through liquidation or foreclosure. Because of a variety of factors – the inherent fragility of financial institutions, the interconnections among them and the closely correlated risks that they face, and finally the political economy of financial regulation – it is unfortunately predictable that serious problems capable of generating a systemic crisis will not be detected in advance or will elicit only an inadequate response such as the experience in the financial sector in Nigeria economy. Therefore there must be contingent plans to forestall its occurrence or make its impact less harmful on the taxpayer (Diamond and Dybvig, 1983).

5. Conclusion and Recommendation

The goal for CBN policy must be to make the financial system more resilient to localized economic shocks in order that a crisis at one financial firm does not generate a cascading series of failures by interconnected financial institutions. To create such a buffer that prevents the failure of one significant firm from carrying its interconnected cohorts down with it, creative policy prescriptions must be initiated, implemented and meticulously monitored because whatever ails the financial system ails the economy. The CBN has taken some regulatory steps post crisis such as the creation of Asset Management Corporation (AMCON) to resolve the non-performing loan problem in the banks, the specification of tenor for banks' chief executive officers and their external auditors. Yet there are myriads of other regulatory initiatives that must be designed and implemented to avoid the repeat of the banking crisis in Nigeria.

In addition, the CBN should embark on a systematic review of regulations and guidelines around the key contributors to the recent financial crisis; for instance, corporate governance, margin loan, the fraudulent use of special purpose vehicles, data quality, enforcement, and risk management. Monetary policy should be shaped by systemic risk trends and consistent with the expanded goals for asset price stability.

An enhanced annual performance measurement process for boards and individual directors should be introduced. Such measures should include updated corporate governance statements and mandatory board committees and their quantifiable responsibility.

The goal of price stability should be supplemented by a robust macro-prudential regulatory framework which monitors and acts on signs of systemic risk through a dedicated unit as warning signs are easily missed without a dedicated unit to monitor and act upon such signs. CBN policy prescriptions should emphasize a healthy romance between the banking sector and the real sector of the economy, namely: power, transport infrastructure and agriculture. A reasonable percentage of the bank loans should mandatorily be channeled to these sectors with enduring impact on macro-economic productivity.

The Nigerian financial market has for too long been very compact and restrictive. In the capital market subsector, beside equity share and FGN bond, corporate bonds have not been very popular. Therefore, infrastructure for a corporate bond market, more accessible equity market which supports deeper venture capital for new businesses and sustainable private equity environment should be encouraged. Nigerian financial sector is matured for the introduction of derivatives market. Greater diversity and flexibility should be introduced in bank mandates with varying capital requirements. It should be possible to have international, national, regional, mono-line and specialized banks. In view of their interconnectedness, bank should carry out proper due diligence on each other for exposure decisions even for repos.

Other strategies for curtailing unbridled speculative behaviour of the banks will include setting a limit to capital market lending to a set proportion of a bank's equity capital, outright outlaw of using depositors' funds for proprietary trading, private equity or venture capital investments and creation of special purpose vehicles.

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