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# THE ROLE OF CENTRAL BANK OF NIGERIA IN RELATION TO THE BANKING AND INSURANCE INDUSTRIES

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## INTRODUCTION

The financial services industry is on the threshold of a revolution. The advent of the Structural Adjustment Programme (SAP) in Mid-1986, with its underlying philosophy of liberalisation and deregulation, has brought about a proliferation of banks and non-bank financial institutions. Competition has intensified, there has been increased innovation and sophistication in product design and delivery. While the new changes have enhanced the opportunities for business and profits, they have also engendered challenges and problems calling for policy action. A number of banks are suffering various degrees of distress manifested in liquidity problems and insolvency. In response to these developments, banking regulation and supervision have given increased emphasis to prudential require- ments aimed at enhancing the safety and soundness of individual banks and the stability and efficiency of the financial system. Elsewhere in the financial services industry, intense competition and severe compression on operating margins have put the future of some operators in serious question even as new ones spring up in large numbers to take advantage of the new liberal business environment.

In the midst of these phenomenal changes and increasing comple- xity of the emerging structure and practices as well as policy response, many observers have become bemused, unable to effectively follow or explain the developments taking place. However, many experts have arrived on the scene to characte- rise these developments and formulate theories and speculate on the functioning of various segments of the financial service

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In the midst of these phenomenal changes and increasing complexity of the emerging structure and

practices as well as policy response, many observers have become bemused, unable to effectively follow or explain the developments taking place. However, many experts have arrived on the scene to characterise these developments and formulate theories and speculate on the functioning of various segments of the financial services industry to fill the information gaps that exist but with largely unsatisfactory results. Even many operators and market participants have failed, in spite of their often honourable intentions, to understand the roles of the regulatory/supervisory authorities, accurately judge the objectives, or respond appropriately, to their actions and signals.

In keeping with the long tradition of Central Banks the world over, we in the Bank have consistently maintained a policy of low profile in matters of publicity and have shown due restraint by not responding to every erroneous or misleading comment or report believing as we do that the business of Central Banking is too serious to be run on the media. Nevertheless, I am happy that this forum affords me a unique and appropriate opportunity to give an insider-perspective on the roles, objectives, instruments, etc. of the Central Bank in relation to banks and insurance companies.

In Nigeria, as in most countries, banking and insurance constitute the predominant segments of the financial system. The commercial and merchant banks as a group, are the main depository institutions in the market for short and medium-term credit while the insurance companies are among the largest institutional investors in the capital market. The Central Bank undertakes functions which impact on both types of institutions, especially the banks, through the application of various control and regulatory measures. The subject of this lecture dealing as it does on these relationships is, therefore, tropical and will address a number of leading issues on monetary and banking policy.

The paper is in four parts: Part I outlines the structure of the financial system and highlights the role of the Central Bank in the system. Part II discusses the role of the Central Bank in the banking industry while Part III focuses on the legal provisions governing the relationship between the insurance industry and the Central Bank, with a status report on the extent of compliance by the former with the relevant legal provisions. Part IV is a synthesis of some leading issues and conclusions emerging from Central Bank experience in the conduct of monetary and banking policy in the last three decades.

## PART I
## THE CENTRAL BANK AND THE FINANCIAL SYSTEM

The financial system may be said to perform two key functions which are vital to the process of economic growth and development. First, the system provides a convenient and efficient payments system without which specialisation in production so vital to productivity improvements and trade would be greatly impeded. The payments system has continued to advance in sophistication and currently ranges from instruments such as notes and coins, bank deposits, Credit Cards etc. to automatic funds transfer system as in the advanced countries. Second, the financial system pools savings from net surplus units and channels them to productive investment, a function often referred to as financial intermediation.

In the intermediation process, financial intermediaries, including insurance companies, engage principally in matching lenders and borrowers. They bring savers and borrowers together by "selling" debt instruments or securities to savers for money and lending such money to borrowers. As a result, the lender or investor receives claims on the investments which generally have stable market value and high liquidity. However, financial intermediation does not ensue from the direct lending and borrowing process but arises from the lending borrowing process which involves the generation and exchange of debt instruments or securities. The securities are then held by the intermediaries in exchange for their lending or parting with liquidity. The point of emphasis, therefore, is that financial intermediaries use their own liabilities to create additional assets, help mobilise funds, gather small sums together to reap economies of scale, and minimise the risk of investors.[2]

The financial system features a wide array of banking and non-bank financial intermediaries. The banking sub-sector of the system comprises commercial and merchant banks, development banks and the Central Bank as the apex institution. The non-bank financial institutions sub-sector includes a wide range of organisations operating as regulators, facilitators and investors.[3] The list includes insurance companies, the Securities and Exchange Commission, the Stock Exchange, Stockbrokers, Pen- sion and Provident Funds, invest- ment and finance

companies. In terms of market share, insurance companies and the Nigerian Provident Fund predominate this list of institutions in the capital market.

The functions of the Central Bank in the financial system include the issue of currency, the maintenance of external reserves to safeguard the value of the currency (the Naira) and the promotion of monetary stability and a sound financial system. In addition, the Central Bank is a banker to the banks and government, and has over the years assumed the important non-traditional functions of supporting the country's economic development efforts. The Central Bank, therefore, has a vital role to play in every facet of the financial system and indeed the national economy.

The institutions and markets in the financial system constitute channels or conduits for the transmission of monetary policy measures to the real sector of the economy. The activities of the various intermediaries are, therefore, important in influencing the outcome of actions taken by the monetary authorities. The monitoring of institutions in the financial system by the Central Bank is, therefore, necessary for the effective conduct of monetary policy. Aside from issues of monetary management, the safety, soundness, and stability of the financial system as well as the responsiveness of the financial system to the needs of the economy are also of primary interest to the Central Bank.

## PART II

## THE CENTRAL BANK OF NIGERIA AND THE BANKING INDUSTRY

The role of Central Bank of Nigeria (CBN) in the banking industry is largely anchored on two important legislations: the Central Bank of Nigeria Act 1958 (as amended) and the Banking Decree 1969 (as amended) Under the Act, the Central Bank of Nigeria is empowered to act as banker to the banks and to perform the role of "lender of last resort" to them. This function of the Central Bank of Nigeria is of crucial importance in situations of crisis arising from sharp contractions in liquidity. In such situations the Bank could, in exercise of its powers, prevent a run on a few banks from degenerating into a run on the industry as a whole. In the face of such threat, the Central Bank is empowered to supply liquidity to the banks and thereby arrest the disruptive effects of the run on bank credit, money supply and ultimately the level of economic activity.

From the point of view of the banks, this function of the Central Bank of Nigeria is highly desirable as it could be the only means of surviving a crunch. It would prevent a liquidity drain which could lead to insolvency and possible collapse, an outcome which is not unlikely if banks were compelled by such situations to undertake panic sales of their assets to meet cash demands.

The second major role of the Central Bank of Nigeria in the operation of the banking industry arises from the conduct of monetary policy. In this area, the Central Bank of Nigeria has wide powers and possesses an array of instruments which may be employed for regulating the volume of bank credit and/or influencing the cost of such credit. The Bank could issue directives which are binding on the banks or engage in moral suasion and it could act directly on banks' cash or liquid assets or seek to influence the level of bank reserves through trading in securities in the money market.

Over the years, however, the main instrument of control has been credit ceilings. Adjustments to cash and liquidity ratios have also been frequently employed. Since 1990, the Bank has found it necessary to supplement the credit ceilings with issues of stabilisation securities. The rationale for these various forms of control of bank credit lies in the fact that banks create secondary deposits and, therefore, money by the extension of credit. In order to regulate the level of money and its growth, therefore, the CBN must be able to influence the level and cost of bank credit in some way.

A third important function is prudential regulation and supervision. The objectives of banking regulation broadly are to ensure safe and sound banking practices by individual banks to secure depositor protection and the stability and efficiency of the banking system. Prudential banking regulation is accomplished through prescriptions on capital, liquidity, provisioning for non-performing assets, restrictions on banking business, and licensing requirements while prudential supervision is carried out through off-site surveillance and on-site examination in accordance with CBN guidelines. The scope of monitoring by the bank is very wide, including the extent of adequacy of a bank's capital, the standards as well as the level of provisions for non-performing assets, the quality and performance of management, staff development, standards of

book-keeping and the effectiveness of internal control arrangements. Also included is compliance of banks with policy directives and provisions of relevant legislation. In most cases, the Bank is empowered to employ sanctions to compel compliance.

Aspects of the regulatory mechanism have been strengthened or reformed in recent years to cope with the developments in the industry. Such developments include the rapid expansion in the number of institutions and increased risk of bank failure and the growing level of problem loans and also ailing institutions.

## PART III

## THE CENTRAL BANK OF NIGERIA AND THE INSURANCE INDUSTRY

In the preceding sections, an attempt was made to delineate the role of Central Bank in the financial system in general and in relation to banks in particular. This part of the paper seeks to articulate the Central Bank's existing legal relationship with the insurance industry, indicating the extent of compliance with legislations by the industry for the overall health of the financial system.

The current legal instruments guiding the operations of insurance and re-insurance business in Nigeria are the Insurance Act of 1976, and the Nigerian Re-insurance Corporation Act of 1977. Among the major provisions of the Insurance Act of 1976 are minimum paid-up share capital requirement of ₦300,000 for non-life business and ₦500,000 for life business. For companies engaged in the combined life and non-life business the minimum paid-up capital requirement was fixed at ₦800,000. In the case of re-insurance business, the 1977 Act provides for minimum paid up capital requirements of ₦5 and ₦3 million for life and non-life business, respectively. Before an applicant commences insurance business, the Act provides that the paid-up capital must be deposited with the Central Bank of Nigeria.

The 1976 Act also stipulates the pattern of investment holdings by insurance companies. According to the Act, a minimum of 25 per cent of the total assets of the insurance companies should be held in government and semi-government securities. Non-life insurance companies should invest not less than 10 per cent of their total assets in real estate while the minimum proportion for life insurance companies was fixed at 25 per cent.

However, in recognition of the financial intermediation role of insurance companies by government, the lending operations of the companies were brought under the control of the CBN with effect from April, 1978. From then, all insurance companies were required to render monthly returns of their operations to the Bank within 30 days from the end of each month. Recently, the frequency of rendering these returns was reduced to quarterly to enhance the level of compliance.

### Compliance With The 1976 Act

As indicated in Part I of this paper, the insurance companies as mobilisers of funds (savings) and mediators of such funds for portfolio investments have a great potential for influencing the effectiveness or otherwise of CBN monetary policy. Thus, concern has been expressed that unless the sector complies meaningfully with the provisions of the Act the overall success of monetary policy could be compromised. Available data indicate that the insurance sub-sector has not complied fully with the provisions of the Act. For instance, while insurance companies as a whole have generally complied with the requirement that a minimum of 25 per cent of their assets be held in government and quasi-government securities, many life companies have failed to comply with the require- ment. Moreover, the legal stipulation that a minimum of 10 per cent of assets of non-life insurers be held in real property, was not met by this class of Insurers. The life insurance companies also failed to keep to the statutory requirement that a minimum of 25 per cent of their assets be held in real estate.

An obvious implication of non-compliance with the investments provision of the Act is the debt management problems created, as the CBN is compelled to take-up unduly large proportion of government securities. This ultimately aggravates the incidence of undue monetary expansion, inflation and the depreciation of the Naira exchange rate.

Another aspect of the non-compliance with the provisions of the Act has been the failure to render regular returns even when the frequency of rendering returns was reduced from monthly to quarterly. For example, only 76 and 74 insurance companies, or 72.4 and 70.5 per cent of the industry rendered returns in 1989 and 1990, respectively. The failure of some insurance companies to render adequate returns has prevented the

CBN from having a clear and comprehensive view of the impact of their financial operations on the economy.

## PART IV

## LEADING ISSUES AND CONCLUSIONS

In this final part of my lecture, I now wish to outline a number of leading issues and draw some conclusions arising from lessons of experience in the design and conduct of monetary and banking policy in Nigeria in the past three decades.

1. The basic objectives and goals of monetary and banking policy have been essentially the same, namely: domestic price and external sector stability; fostering the growth, viability and stability of the financial sector; promoting economic development at the enhancement of the standard of living. However, the priorities, strategies and means have changed from time to time depending on the economic circumstance of the country. In this connection, it may be stated that broadly speaking we have moved from regimes of laissez faire for most of the 1960's to regulation (and over regulation) in the 1970's up to the mid 80's and deregulation since 1986. In terms of the thrust of policy objective, we have alternated between phases of monetary ease (reflationary, accommodating measures) and those of monetary restraint or stringency.

2. The term "deregulation" has become a well-worn cliche whose use has tended to be confusing and misleading. It is, therefore, in urgent need of redefinition and clarification. In my view, deregu- lation does not mean the absence of regulation. Rather, it is the delibe- rate, informed process of removal or mitigation of regulations which are worthless or anachronistic and tend to foster inefficiency or competitive inequities. Properly considered, deregulation is a rationalisation of regulations. In this connection, it involves the introduction of new measures intended to enhance efficiency and stability e.g. prudential regulation. It should also be noted that there are limits to deregulation and that because, it is a most vital sector, the banking industry is about the most regulated worldwide.

3. The efficacy of monetary policy in Nigeria is constrained by a number of factors:

(i) policy dilemmas and conflicts in objectives and measures; and

(ii) problems of predictability and control which manifest in two important dimensions, namely:

(a) quantum i.e. size of effect of policy measures; and

(b) Timing dimension which is characterised by lags - recognition lag, action lag, credit market lag and output lag.

Given the problems of conflicts in policy objectives and of achieving the optimal quantum size as well as the lag structure monetary policy, how can monetary policy be administered so that it has the desired impact at the right time? Briefly, the above situation calls for prioritisation and delicate trade-off's, developing an effective tracking system and more timely and responsive measures to avoid or minimise the incidence of large, destabilising does and surprises. It also calls for both moral suasion and the proper use of discretion, sound judgement and pragmatism. Above all, it requires supportive, compatible fiscal policies and measures. For instance, a restrictive monetary policy requires a supporting policy of fiscal restraint.

How has monetary and banking policy fared in Nigeria? My assessment is that monetary policy in Nigeria has grown in sophistication and significance over the years. It has accomplished much in the areas of domestic price stability and growth and stability of the financial system. It has also been very supportive of economic develo- pment It would, however, be immodest to assert that there have been no policy errors or that better results could not have been accomplished in spite of the various constraints. Indeed, there scope for improvement and there is ample evidence that the monetary authorities have learnt from past experience and are open to constructive ideas and criticisms.

4. The elements and direction of the emerging revolution in the financial services industry may briefly be characterised as being induced by:

(i) Deregulation - phenomenal increase in the number of participants and the intensification of inter - and inter-industry competition;

(ii) Technological Advances - the application of information technology involving the integration of advances in computerisation and communications technology, providing both immediacy of transaction and efficiency in the execution of transactions; and

(iii) Innovation - financial engineering, as manifested by the vast array of financial instruments, growth in fee-generating "off-balance sheet" transactions and other new, and

perhaps, exotic products. These changes will intensify in the next few years and raise a whole lot of issues and concerns for both market participants and the regulatory/ supervisory authorities. For one thing, innovation does not eliminate risks, it merely redistributes them. For another, increased off-balance sheet exposure has increased the risks to individual banks and to the system as a whole, calling for enhanced "safety nets".

5. Some other problem areas have also been identified and may be outlined here. First, with the growth in the number and complexity of financial intermediaries and the increasing proportion of non-per forming credits in their portfolios, the threat of failure is increasing. Second, the effective conduct of monetary policy is constrained by the existence of what has been called "regulatory arbitrage", with many non- bank financial institutions operating as bona fide banks but not subject to banking regulation or supervision. These two sets of problems call for policy action to ensure the safety and soundness of the system and better management of monetary policy.

6. Another observation I wish to make relates to the responses by financial intermediaries to policy measures and "signals" by the Central Bank. In this respect, market participants appear to be engaged in a "psychological war" with the regulators, with the former devising ingenious ways to avoid, weaken or eliminate regulatory restraints on their activities. In particular, operators tend to overstate the adverse impact of demand management measures on loanable funds and interest rates. Some bankers have also taken the Central Bank to task for, on the one hand, stipulating a minimum liquidity ratio of 30% and, on the other hand, "penalising" them for maintaining higher actual liquidity ratios. To resolve this paradox, it should be explained that the 30% liquidity ratio is a prudential requirement while stabilisation securities are monetary control devices intended to counteract the destabilising effects of excess liquidity pressures on the domestic price level, exchange rate depreciation, speculative activity etc. These are analogous to the actions of a physician to increase or reduce a patient's diagnosed low or high blood pressure to a level or range consistent with good health.

7. The Central Bank is and should be regarded as a "lender of last resort". However, this is not often appreciated by banks until a request for accommodation is rejected. Moreover although the Central Bank stands ready to fulfill its role as lender of last resort, in keeping with tradition, the Bank does not want to commit itself in advance to any precise course of action. In this more responsible and prudent behaviour on the part of banks. Banks should learn that the Central Bank is not a lender of first resort, a role that appropriately belongs to the banks with buoyant liquidity and who are active inter-bank players.

8. A little digression to the insurance industry would be appropriate at this point. Here, I would crave your indulgence and forbearance as I stray from the more familiar territory of banking to the world of "exemption clauses" that are hardly legible! From my limited knowledge, it appears that the insurance industry is in need of reform consistent with the logical imperatives of the SAP. Some of the relevant issues to raise here are capital adequacy of insurance companies; investment in Government Debt Instruments; manpower problems, in particular, the acute shortage of actuarial scientists which had severely constrained life business and fostered the concentration in non-life business; lapses in meeting statutory requirements intended to enhance monetary policy measures etc. These issues have been merely raised here for further discussion and articulation in a more appropriate forum by insurance operators and their regulators.

9. I would now like to address the issue of the future direction of monetary policy. The movement is definitely towards more indirect market-based instruments of monetary control aimed at enhancing efficiency and competition. I also see increased sophistication in the conduct of monetary policy with more timely, fine-turned, measures and more confident response by the monetary authorities to situations calling for intervention.

10. Policy measures intended for the public good involve the collaborative endeavours of, and shared responsibilities by, all concerned - the regulators and the market participants. The point should be made that the Central Bank is not in competition with operators, that it has a wider macroeconomic pers- pective and serves a larger national constituency. If market operators could alter their preferences for transactions with short cash-conversion cycles and unmitigated passion for dealing in foreign exchange and other speculative activity, the public good would be better served!

11. The impression that is fast gaining ground to the effect that "Nice guys finish last" is a moral

inversion which I should hasten to counter and reverse. The slogan should be that "You Don't have to Cheat to win" [4] It should be urged that market participants should not only concerned with short-term commercial success but should also observe legality both in the letter and spirit, appropriately fulfilling their roles as agents and mediators of change and development, as good corporate citizens!

Finally, I wish to express my appreciation to the organisers of this lecture for giving me this opportunity to present this insider perspective. I must, however, point out that what I have provided here is an introductory text or, perhaps, a footnote, on this important subject. Nevertheless, I do earnestly hope that it would serve the cause of public enlightenment and bring about a better appreciation of the role of the country's premier, apex financial institution.

**APRIL 3, 1991.**

## FOOTNOTES

1. Although the facts presented in this paper are derived largely from CBN sources, I should stress that the views and conclusions expressed are mine and do not necessarily coincide with those of CBN.

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4. The sub-title of the Power of Ethical Management by Kenneth Blanchard And Norman Vincent Peale.

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