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Global Financial Meltdown and the Reforms in the Nigerian Banking Sector

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1. Protocol

Distinguish Ladies and Gentlemen, let me begin by thanking the organizers for honouring me with this invitation. First of all, I must thank the Vice-Chancellor, the Senate and Council of the Abubakar Tafawa Balewa University (ATBU) for this wonderful privilege and for inviting me to give this lecture titled "***Global Financial Meltdown and Reforms in the Nigerian Banking Secto***r". I am aware that the highly regarded ATBU Public Lecture Series focuses on developments on topical issues in our nation. Therefore, my invitation to this highly regarded event in the ancient city of Bauchi, and the hometown of our great Prime Minister, late Alhaji Abubakar Tafawa Balewa, is greatly appreciated.

As the International Monetary Fund, IMF observed, the extent and severity of the crisis that began with the bursting of the housing bubble in the United States in August 2007 reflects the confluence of myriad of factors some of which are familiar from previous crises, while others are new. As in previous times of financial turmoil, the pre-crisis period was characterized by (i) surging asset prices that proved unsustainable; (ii) a prolonged credit expansion leading to accumulation of debt; (iii) the emergence of new types of synthetic financial instruments; and (iv) regulatory failure. This time around the rapid expansion of securitization (not itself a new phenomenon), which changed incentives for lenders and lowered credit standards caused the crisis. Systems became fragile because balance sheets became increasingly complex (further complicated by increased use of off-balance-sheet instruments). Financial market players were highly leveraged and relied on wholesale funding and external risk assessments. Cross-border spillovers intensified after the crisis started because financial institutions and markets across borders were closely linked and risks highly correlated.

No doubt, the world is inextricably linked by globalization. Thus, the economic and financial crisis, which started in the United States, destabilized markets and economies (developed, developing and underdeveloped) around the globe and, has continued to dominate discussions on the global economy. These days one would hardly watch the television or browse through national and international newspapers, magazines and journals without stumbling upon headline news of how political leaders are scrambling for strategies to mitigate the impact of the financial crisis on the domestic and global economy.

As rightly pointed out in several quarters, the global financial crisis has been a major constraint to growth in most countries, a situation that has been aggravated by banking system crisis. The theme

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of this lecture is, therefore, very pertinent as it provides opportunity for the academia, researchers and policy makers to explore alternative policy and practical steps that can be taken to stem the tide of recession, especially in developing countries like Nigeria.

Carl Menger in his 1871 seminal work on economic principles opined that "All things are subject to the law of cause and effect". It is imperative to argue here that, there is no exception to this great principle in the light of the origin and cause(s) of the global financial crisis and its consequences. As a corollary, we live today, in an era in which economic liberalism and small governments is so much propagated, and in which, it is generally expected that self regulation of markets is the best way of promoting competition, productivity, efficiency and growth. An unarguable guide for lovers of freedom and adventure is the fact that '*freedom has responsibility'*. While the freedom to innovate has led to the rapid development of the financial market in major industrialized countries and emerging markets, it has become clear that there is an inherent danger in the manner the markets were developing without proper supervision and moderation. Innovation has worked in the financial markets and has contributed significantly to the process made possible by *laissez faire*. However, the same innovation that *deepened* the financial markets also accentuated predatory, unsecured and irresponsible lending behavior among financial institutions thus, exacerbating the global meltdown.

The focus of this lecture is on the Nigerian experience. I believe that my audience at this lecture today will share some perspectives on the subject, drawing from their individual experiences. The critical challenge that Nigeria faces today as a nation is how to create some irreducible minimum standards of financial system stability that will promote strong financial institutions and the emergence of budding banking system, and hence ensure sustained growth and development in Nigeria and indeed in the rest of Africa.

The lecture is intended to stimulate discussions, and enable policy makers to come up with ways of identifying specific institutional arrangements and practical mechanisms that would expand financial services to economic agents in Nigeria. The focus is on developing, over time, an efficient and sustainable banking sector for economic activities to thrive. The vision is for a system that integrates the domestic, foreign, short and long term sources, where banks can exploit each others' comparative advantages in cost-effective financial services delivery.

2. Global Financial Meltdown: Nature and Origin

Let me start with a discussion of the nature and origin of the global financial meltdown or crisis. The term *financial meltdown* defines moments when financial networks and markets suddenly become markedly unstable or strained to the point where it may collapse. It features sudden change in expectations, speculative bubbles, falling prices and frequent bankruptcies. The literature is replete with 'what constitute a crisis or financial meltdown, but as related to the issues in discourse Eichengreen and Portes (1987) have defined crisis 'as a sharp change in asset prices that leads to distress among financial markets participants.' As Eichengreen (2004) noted, it is not very 'clear where to draw the line between sharp and moderate price changes or how to distinguish severe financial distress from financial pressure.' Commentaries on the origin of the crisis noted myriadcauses including excessive and corrupt practices of 'sub prime mortgage lending' (that led to high mortgage default and delinquency rates in the United States), massive funding of the "war on terrorism" and the erroneous belief that "free market" principle is perfect, fair and efficient (The New York Times, November 20, 2008). It is to be noted that because it was global, its consequences affected national, regional and global markets and economies.

The financial instability and panics caused in part by the sub-prime mortgage lending difficulties and consequent failure of the investment banking industry in the United States, notably Lehman Brothers, Merrill Lynch, Morgan Stanley and JP Morgan-Chase, as well as government-backed Mortgage giants Fannie Mae and Freddie Mac are widely recognized to be at the root of the current global financial meltdown. Most commentators agree that the origin of the sub-prime crises is due to a constellation of factors notably:

i. Low real interest rates in the US which was maintained for a long-time prior to the crises thereby encouraging accommodating monetary policy;

ii. Extreme confidence about the continued rise in housing prices and low volatility in the US housing market. Between 1996 and 2005, US housing prices nationwide went up about 90 per cent. They went up 60 per cent between 2000 and 2005, and in the 30 year run-up to the crisis, rarely did housing prices fall.

iii. A shift in mortgage lending toward the less creditworthy, marginal borrowers, or sub-prime borrowers who do not qualify for prime mortgage. Also, in the sub-prime market, more than half of the loans were made by independent mortgage brokers who were not supervised at the federal level, unlike banks and thrift institutions.

iv. Incentive problems associated with the securitization model for the mortgage loans into mortgage backed securities. There were also incentive problems for the so-called "independent" credit rating agencies, who were equally heavily involved in developing the structured product they rated.

The sub-prime crises actually broke out in 2007; however its effect was not dramatic then due to write-down of losses by the affected investment banks thereby eroding their capital. The realized losses dramatically increased when the contagion spread to other counterparties such as insurance companies, hedge funds, finance companies, and mutual and pension funds that invested heavily in the structured products. The contagion became globalized because the investors were not only US companies. European banks, and emerging market institutions, in particular, bought just about as many as US banks, which led to contagion around the globe.

Perhaps, a brief synopsis of the stages of the global financial meltdown would suffice in explaining the origin of the global meltdown within an appropriate context. Historically, there have been four major crises. These are The Great Depression, the crash of 1987, the crisis of the 1990s and the 1987 Asian Financial Crisis. There was also the *dot com* crisis which was a fall out of the crises of the 1990s. In August 2007, there were reported cases of liquidity constraints as financial institutions faced difficulties raising funds in the United States so much so that, by March 2008, there was an unprecedented credit contraction or credit crunch as financial institutions tightened credit in the US. During this time, there were wide spread cases of defaults in many markets which by July 2008 had spread to other economies. By the last quarter of 2008, the US and European countries officially declared that they were in economic recession. Consequently, the magnitude of distortions to national economies became unprecedented in what was later referred to as the worst economic crisis in human history.

Thus, from 2002 to early 2007, the decline in volatility in the global economy and financial markets was reflected in lower measures of market risk, which encouraged firms to increase their risk-taking. However, in September 2008, the economic downturn particularly in the United States and a number of industrialized economies signaled the beginning of a recession triggered by the credit crunch that resulted from the crisis.

In Nigeria, like in many developing countries particularly in Africa, the initial impact of the crisis (the first round effect) was not felt because Nigeria was not a major player in the global economy.

The banking system was less integrated with the global financial market, and the sound macroeconomic policies adopted by the country also helped to cushion the effect of the crisis. In addition, the banking system operated with simple financial products but had strong capitalization as a result of the recapitalization exercise of 2005. However, as the recession in advanced countries deepened, Nigeria became affected with consequences for the economy as a whole and the financial sector in particular.

3 Impact of the Global Financial Meltdown on Nigeria

3.1 Impact on the Nigerian Economy

It is by now very clear that Nigeria was not insulated from the crisis, especially the second round effect. The crisis which manifested itself globally in the form of liquidity and credit crunch, breakdown of confidence in the banking system, de-leveraging and banks inability to improve capital adequacy, weak consumer demand, and fall in global output, affected Nigeria through both the financial and real (trade, remittances and aid) channels. The undiversified nature of the Nigerian economy and the high dependence on exports of crude oil as well as foreign capital inflows compounded the impact of the external shock arising from the crisis. In specific terms, Nigeria experienced low demand for its oil export due to recession in the economies of her major trading partners. The Nigeria's Bonny Light Crude Oil Spot Price FOB which was $95.16 per barrel in January 2008 rose to $146.15 in July 2008 before declining to $76.24 per barrel by October 17 2008. Thus, within four months, it had lost 50% of its peak price. This, coupled with the collapse in the international price of oil, led to severe decline in foreign exchange receipts and consequently, government revenue contraction. The low accretion to foreign exchange reserves and demand pressure in the foreign exchange market led to volatility and substantial depreciation of the naira exchange rate. Government resorted to Excess Crude Account drawdown and domestic borrowing to finance its activities. Within the period, there was substantial decline in foreign capital inflows (foreign direct investment (FDIs); portfolio investment, and remittances from Nigerians in Diaspora) just as foreign trade finance reduced significantly for some banks while for others credit lines literally dried-up. It is perhaps in the capital market that the greatest impact was felt. The prolonged downturn in the capital market induced by significant divestment by foreign investors and compounded by lingering liquidity tightness, waning public confidence, and panic selling by domestic investors lead to significant losses by investors. The stock market which remained bullish between December 2005 and March 2008, suddenly became bearish in April 2008 and has remained nearly so since then with only marginal recovery. At the height of the bull-run in early March 11, 2008, equity market capitalization hit ₦12.64 trillion while the Nigerian Stock Exchange All Share Index (ASI) which rose by 37.8 per cent in 2006 and 1.01 per cent in 2005 gained a record 74.73 per cent in 2007. Between 31st December 2007 and the peak of the bull-run in early March 2008, the market gained 14.45 per cent. By year end 2008, the NSE All Share Index which gained 74.73 per cent the previous year, had declined by 45.8 per cent while equity market capitalization declined by 32.4 per cent from ₦10.3 trillion at year- end 2008 to ₦6.96 trillion at the close of 2008. Thus, between 2007 and 2008 the ASI declined by 42.5 per cent compared to 33.8 per cent decline between 2008 and 2009. The corresponding figures for market capitalization were 27.5 and 28.3 per cent, respectively. The capital market downturn also had negative impact on the banks balance sheet through increased provisioning for bad debts and lower profitability.

In spite of the debilitating impact of the crisis, Nigeria's growth trajectory was not significantly impaired. The real Gross domestic Product (GDP) growth rate which averaged 6.29 per cent between 2004 and 2007 declined marginally to 5.99 per cent in 2008 rising thereafter to 6.9 per cent in 2009. This is often attributed to the impressive performance of the non-oil sector, particularly, agriculture and the continuous implementation of sound macroeconomic policies. The external reserves was, however, still able to support at least 15 months of imports.

3.2 Impact on the Banking Sector

Recall that in 2004, the Central Bank of Nigeria (CBN) embarked on banking sector reform (Bank Consolidation) which sought, among other things, to strengthen the banking system and improve the operational efficiency of the Nigerian banks. At that time, the Nigerian banks were generally weak and inefficient. CBN surveillance report as at end-March 2004 indicated that 62 banks out of 89 were classified as sound/ satisfactory and 14 as marginal. The number of unsound banks had risen from 9 as at end-December 2003 to 11 in May 2004. There was serious over-dependence on public sector funds and CBN credits as well as income from foreign exchange trading on the part of the banks. Besides being grossly undercapitalized, the banking industry was characterized by several weaknesses including poor corporate governance, poor asset quality, inaccurate reporting and non-compliance with regulatory requirements, falling ethics and de-marketing of other banks in the industry, gross insider abuses resulting in huge non-performing insider related credits, oligopolistic structure with 10 of the 89 banks controlling more than 50 per cent of the industry assets and liabilities, lack of capacity to support the real sector of the economy, and lack of competition by banks in savings mobilization to boost the level of deposits. The situation was such that weak banks were paying higher interest rates in a bid to attract more deposits. As at end-May 2004 banks indebtedness to the CBN was about ₦71.36 billion. The bank consolidation exercise was meant to address these weakness through recapitalization of banks with minimum paid-up capital of ₦25 billion: ensuring minimal reliance on public sector for funds; adoption of risk focused and rule-based regulatory framework; adoption of zero tolerance in regulatory framework in data/information rendition/reporting and infractions; stricter enforcement of corporate governance principles for banking; expeditious process for rendition of returns by banks and other financial institutions through e-FASS[3]; revision and updating of relevant laws for effective corporate governance; ensuring greater transparency and accountability in the implementation of banking laws and regulation; and the establishment of an asset management company as an important element of distress resolution.

There is no doubt that the consolidation exercise had some positive impacts on the banking sector. The banking system was transformed from 89 banks to 25 through regulatory merger and acquisition and latter to 24 through market-induced merger and acquisition. Bank branches grew from 2,900 in 2005 to almost 5,500 in mid-2009. Besides deepening of the capital market, the banks were positioned to actively participate in a wider range of activities, including financing of infrastructure and the oil sector.

However, while the consolidation exercise lasted, certain developments in the economy and within the banking system itself put the banking sector at serious risk. Between 2004 and 2008, Nigeria enjoyed unprecedented increase in oil price which resulted in huge inflow of foreign exchange and robust economic growth. This, coupled with appreciable level of foreign direct investment inflows, resulted in huge liquidity in the economy which the real sector of the economy could not absorb. The excess liquidity found its way into the stock market as shown in the unprecedented rally in the stock prices on the Nigerian Stock Exchange between 2006 and March 2008. The excess liquidity also allowed banks to raise capital. Fresh capital raised between 2006 and first quarter of 2008 amounted to ₦1,603 billion. The increase in capital supported banks' balance sheet growth with banking sector assets as percentage of GDP increasing rapidly to 60 per cent from about 30 per cent in 2004. With significant capital and greater liquidity, banks were increasingly under pressure to create risk asset amidst limited product innovation and diversification. This, coupled with poor risk management practices, ultimately led to a concentration of assets in certain areas, in particular margin lending and oil trading/marketing. As at end-December 2008, banks' total exposure to the

[3] Electronic Financial Analysis and Surveillance System, used to render report by commercial banks to the CBN

oil industry stood at over ₦754.0 billion, representing over 10.0 per cent of the banking sector total and over 27.0 per cent of the shareholders' funds.

Thus, in mid-2008 when the global financial and economic crisis set in, the domestic financial system was already engulfed by several interdependent factors that led to the re-emergence of an extremely fragile financial system similar to pre-consolidation era. These factors included macroeconomic instability caused by large and sudden capital inflows, major failures in corporate governance at banks, lack of investor and consumer sophistication, inadequate disclosure and transparency about financial position of banks, critical gaps in regulatory framework and regulations, uneven supervision and enforcement, unstructured governance and management processes at the CBN/weaknesses within the CBN, and weaknesses in the business environment.

It is clear, therefore, that when the global crisis eventually hit Nigeria, the banking sector was ill-equipped to weather the storm in spite of recapitalization. As we are all aware, the financial crisis had an adverse effect on both the oil and gas sector and the capital market where the Nigerian banks were exposed to the tune of ₦1.6 trillion as at December 2008. The result was a sharp deterioration in the quality of banks' assets which immediately led to concerns over banks' liquidity. Indeed, the Nigerian banking sector was thrown into severe crisis as many of the banks became distressed.

3.3 Remedial Measures to Mitigate the Impact on the Banking Sector

The initial diagnosis of the distress in the banking system amplified by the global financial crisis as a liquidity problem led to the introduction of several measures by the CBN between 2008 and 2009. These measures included, among others, the reduction in the Monetary Policy Rate (MPR), cash reserve ratio (CRR) and liquidity Ratio (LR). The MPR was gradually reduced from 10.25 per cent to 6 per cent to its present level between September 18, 2008 and July 7, 2009 and subsequently raised to 6.25 per cent on September 21, 2010. Similarly, the CRR was reduced from 4.0 per cent to 2.0 per cent and further to 1.0 per cent while the LR was progressively reduced from 40 per cent to 25 per cent. The CBN also issued directive to banks to restructure their margin loans up to 2009, and expanded its discount window to allow additional instruments as well as allow banks to borrow up to 360 days (currently suspended) in addition to stoppage of liquidity mopping-up. Greater emphasis was placed on enforcement of the CBN Code of Corporate Governance to promote transparency and accountability in banks as well as the review of contingency plan for systemic distress in banks.

These measures did not fully resolve the problems as the system remained fragile. It was discovered that nine banks were the main users of the Expanded Discount Window (EDW) over a nine-month period ending June 2009. Accordingly, when the CBN eventually closed the EDW in July 2009, and in its place, guaranteed interbank placements, it was observed that these nine banks were the main net-takers under the guarantee arrangement. At this point it was clear that the issue was far beyond the liquidity problem and if drastic actions were not taken, the financial system could collapse.

4 Current Banking Sector Reforms

4.1 Diagnosis and Initial Stabilization Steps

Given the precarious state of the Nigerian banks, the CBN in June 2009, took a three pronged approach to assess the financial condition of the 24 banks. The first was the special examination exercise jointly conducted by the CBN and the Nigerian Deposit Insurance Corporation (NDIC). This exercise highlighted inadequacies in capital asset ratios and liquidity ratios as well as weaknesses in corporate governance and risk management practices in 9 banks. These banks were found to be in a grave situation as a result of capital, liquidity and corporate governance concerns. They failed to meet the minimum 10 per cent capital adequacy ratio and 25 per cent minimum LR. Apart from accumulating high non-performing loans (NPL), these banks were seriously exposed to the oil and gas sector as well as the capital markets. Poor risk management practices in the form of absence of necessary controls measures were prevalent as the board and management of the banks had failed to observe established controls. The remaining 14 banks were found to be in a sound financial state and did not require the CBN to take any action.

The second approach was to carry out diagnostic audit through independent consultants. The report of the audit exercise revealed greater magnitude of weak financial condition of the nine banks. All of them were “technically” insolvent with significant negative asset value. It also exposed several illegal activities that had been taking place in five of the affected banks.

It was against this background that the CBN moved decisively to strengthen the industry, protect depositors and creditors, restore public confidence and safeguard the integrity of the Nigerian banking industry. The initial measures/ initiative taken by the CBN in conjunction with NDIC and the Federal Ministry of Finance (MOF) included injection of ₦620 billion into the nine banks; the replacement of the chief executive /executive directors of eight of the nine banks with competent managers with experience and integrity; reaffirmation of the guarantee of the local interbank market to ensure continued liquidity for all banks; and guaranteeing of foreign creditors and correspondent banks’ credit lines to restore confidence and maintain important correspondent banking relationships.

When the new management of the banks took office, it became necessary to also carry out further detailed and independent assessment of the financial conditions of the banks. Thus, the third approach was to carry out management account audit of the affected banks by their new management. The outcome was very much in line with that of the audit report. Consequently, the management took numerous actions under the CBN guidance to ensure that the banks operated effectively with particular emphasis on improving transparency and operations. To improve operations, the new management took steps to: (i) improve reporting infrastructure, internal governance and risk management procedures; (ii) increase transparency and disclosure; (iii) ensure effective and continuous communication with all stakeholders; (iv) ensure weekly reporting between the MDs and the CBN on financial performance, loan recoveries, and; (v) immediate report of any material developments to the CBN. Measures taken to improve operations included continued focus on loan recovery to improve NPL ratios; reducing cost to income ratio; avoiding unnecessary costs; focus on de-risking and de-leveraging the balance sheet and liquidity management.

There is no doubt that these initiatives enabled the nine banks to continue normal business operations and prevented a total collapse of the banking sector.

4.2 Long Term Reforms Measures

The focus of the CBN is first of all to ensure that there is financial sector stability and, secondly, that the financial system assists in growing the real sector of the economy. It is important to note that any economy that cannot create jobs on a continuous basis, reduce poverty, and guarantee its citizens functional and qualitative education as well as world class infrastructural facilities is not only unsustainable but would remain globally uncompetitive.

Attainment of this fit goes beyond short term palliative measures. It requires a strategic medium to long term measures. This explains why the focus of the recent CBN reforms is in the following four areas (pillars) namely: enhancing the quality of banks, establishment of financial stability, enabling healthy financial sector evolution, and ensuring that the financial sector contributes to the real economy. A brief discussion of each of these pillars is very critical to an understanding of where we are going.

4.2.1 Enhancing the quality of banks

This consists of a five part programme to enhance the operations and quality of banks in Nigeria. These are industry remedial programmes to fix the key causes of the crisis, implementation of risk-based supervision (RBS), reforms to regulations and regulatory framework, enhanced provisions for consumer protection, and internal transformation of the CBN.

The industry remedial programmes include a set of initiatives to fix the key causes of the crisis, namely, data quality, enforcement, governance, risk management and financial crime. These initiatives are structured in such a manner that the banks do most of the work to entrench new behaviours in the industry, with the CBN playing a cross-industry management role. The focus is to ensure that governance best practices are embedded in the industry including the CBN as well as ensuring that risk-based supervision (RBS) principles, methodology and processes are established across the CBN and NDIC. Under the RBS, the intention is to establish a programme management structure within the CBN to ensure that there is a high level of communication with the industry, implementation quality is measured and examiners acquire the necessary skills. A monitoring mechanism to measure the programme's impact and ensure a high level of responsiveness to issues raised by the industry will also be established.

The regulation and regulatory framework reform programme involves systematic review of regulations and guidelines around the key causes of the crisis by industry regulators; harmonization and raising to world-class standards of the supervision processes, technology and people within the various financial regulators; and establishment of a centre of competence for International Financial Reporting Standard (IFRS) and N-GAAP+ implementation.

In the area of consumer protection, the aim is to ensure that consumers receive appropriate protection with the CBN acting as the consumer's advocate, setting standards of customer service for the industry and ensuring that customers are treated fairly in all their dealings with the industry. Already, there is a Consumer Protection Unit in the newly created Financial Policy and Regulation Department of the Bank. This Unit will work with supervisors to ensure that appropriate rules and regulations are enforced by the banks.

Under the reform, the CBN will be transformed to ensure good corporate governance, stronger information management system, people development, and enhanced disclosure to levels expected in major investor countries such as the United States, the United Kingdom, South Africa, China and India.

4.2.2 Establishing Financial Stability

The main thrust of this pillar is for the CBN to provide leadership in some areas and championing some causes. The key features of this pillar centre around strengthening the Financial Stability Committee (FSC) within the CBN, establishment of macro-prudential rules, development of directional economic policy and counter-cyclical fiscal policies by the government and further development of capital markets as alternative to bank funding. The creation of a new macro-prudential framework designed to ensure that monetary policy is not only shaped by systemic risk trends but also consistent with the expanded goals for product and asset stability is a major component of this pillar. This will be complemented by the establishment of the FSC which will work together with the Monetary Policy Committee in achieving these objectives. It is the intention of the CBN to champion the development of the capital market through the improvement of its depth and accessibility as an alternative to bank funding as well as encourage implementation of directional economic policy, particularly counter-cyclical fiscal policies, that will reduce oil-related volatility in the system. It is time to make better use of our oil endowment by harnessing it for strategic investment and also ensure that lending and investment get to the real economy, especially the priority sectors, instead of being used to inflate financial asset bubbles.

4.2.3 Enabling Healthy Financial Sector Evolution

The focus here is on ensuring the emergence of a competitive banking industry structure; provision of the required infrastructure for financial system such as the credit bureau and registrars; improvement in the cost structure for banks through cost control and business process outsourcing; reliable and secure payments system; reduction of the informal sector and greater financial inclusion. Foreign bank participation would be encouraged in order to improve and strengthen the financial system provided such entry does not affect the development of the local banking sector. Market-based merger and acquisitions activities that would create stronger banks would be supported while other banks that would drive regional economic development will be licensed. In the area of infrastructure provision, three private credit bureaux (XDS Solutions, CRC Limited and CR Services Limited) have been licensed while the CBN would work with the Securities and Exchange Commission (SEC) towards the creation of an acceptable number of Registrars for all securities in the country. Central to the reform is the need to check the excessive costs in the banking system which is attributable, in the main, to infrastructure cost, high salaries/emoluments for executives and poor operational efficiencies. It is the intention of the CBN to encourage the development of electronic channels to drive down industry cost structure while working with the banks to improve on the quality of service delivery in order to improve customer confidence.

Nigeria presently has a large informal sector which has been estimated by the World Bank to constitute about 57.9 per cent of Nigeria's Gross National Product (GNP). This is higher than what obtains in Brazil, Ghana, Turkey, Malaysia and South Africa. Developing a financial system that will take care of this large segment of the economy is of utmost necessity. Thus, enhanced financial inclusion strategy would result in more accurate measurement of economic outputs, increase in tax base and tax revenue, more effective policy development and more efficient use of financial infrastructure. All these will in turn improve policy efficiency and help in poverty reduction.

Central to healthy financial sector evolution is the establishment of the Asset Management Corporation of Nigeria (AMCON) as part of a broad banking sector crisis resolution strategy. The AMCON Act 2010 was signed into law on July 19, 2010. When operational, AMCON would serve as a vehicle to free the banks from the weight of their non-performing assets and accelerate the process of financial revitalization of the banking sector. Besides, the CBN is currently reviewing the basic one-size-fits-all model of banking that has emerged since consolidation. In addition to reviewing the universal banking model, we consider it appropriate to introduce greater diversity in bank mandates. In the near-term, it should be possible to have international, national, regional, mono-line and specialised banks such as Islamic banks in the country. Already the guidelines for specialized institution have been fixed as follows: non-interest bank (regional), ₦5 billion, noninterest bank (National), ₦10 billion, and primary mortgage institutions, ₦5 billion. The commercial banks have also been restructured into regional, national, and international banks with paid-up share capital of ₦10 billion, ₦25 billion, and ₦50 billion, respectively.

4.2.4 Ensuring the Financial Sector Contributes to the Real Economy

The last and final pillar of the reform blue print is ensuring that the financial sector contributes to the real economy. Rapid financialisation in Nigeria did not benefit the real economy as much as had been anticipated. Development financial institutions set up for specific purposes such as housing finance, trade finance and urban development have not fulfilled their mandates. Many successful emerging markets have witnessed proactive government actions to ensure that the financial sector contribute to the real economy. Nigeria can learn from countries with successful track records in creating financial accommodation for economic growth through initiatives such as development finance, foreign direct investment, venture capital and public-private partnerships. In this regard, the CBN through the reforms shall (i) evaluate on continuous basis, the effectiveness of existing development finance institutions and initiatives in agriculture, manufacturing, and import-export credits, (ii) take a public lead in encouraging the examination of critical issues for economic development, such as the impact of infrastructure e.g. power, port and railway, (iii) lead further studies on potentials of venture capital and private-public partnership initiatives in Nigeria, and (iv) cooperate with State governments in running pilot programmes that are aimed at directing the financial sector's contribution to the State's socio-economic development.

So far, the CBN has taken concrete measures to finance the real sector of the economy. Some of these measures include:

(i) **₦500 Billion Critical Infrastructure Fund**: The Infrastructure Intervention Fund was introduced in April 2010 by the CBN to provide long-term support to finance critical infrastructure projects. The Fund is a 15-year debenture investment in the Bank of Industry (BOI) for on-lending to all eligible deposit money banks (DMBs) and Development Finance Institutions (DFIs) at 1%. These DMBs and DFIs will in turn lend to promoters of the projects at a maximum of 7.0%;

a. **₦ 200 Billion Refinancing/Restructuring of SME/Manufacturing Fund**: Out of the ₦500 billion Critical Infrastructure Fund approved, ₦200 billion was set aside for refinancing/ restructuring of SME/Manufacturing Fund in April 2010 to enable banks refinance and restructure their existing loan portfolio to SMEs and manufacturing. The 15-year facility has a 3-year moratorium with loan amounts ranging from ₦5 million (minimum) to ₦1 billion (maximum) to single obligor at an interest rate of 7.0 per cent annually repayable quarterly. On July 28, 2010, the ₦130 billion programme for refinancing and restructuring of loans to SMEs and manufacturing sector was launched. Already, 317 beneficiaries have been screened for the disbursement of the money.

b. **₦ 300 billion for long term funding of Power and Aviation.** The balance of ₦300 billion was also approved to provide long term funding to Power (₦250 billion) and Aviation Industry (₦50 billion).

4.3 The Journey so Far

In the last seventeen months, the implementation of the various aspects of the reforms has been vigorously pursued. Far reaching measures and initiatives have been put in place. New prudential guidelines were issued in May 2010. The AMCON Act has been signed into law and the Board inaugurated. These and several other measures have positively impacted on the banking sector. In spite of several challenges, it is gratifying to note that no single bank in Nigeria has collapsed and no depositor has lost his/her money as a result of the banking sector crisis. The banking system has been stabilized and the nine most affected banks have continued normal operation while modalities for injecting fresh capital into them either by shareholders or through acquisition and merger arrangements are being finalized.

To a large extent the reforms have succeeded in returning macroeconomic and financial system stability. Overall output in 2010 is expected to be higher than in 2009. Projections by the National Bureau of Statistics, showed that real GDP in 2010 will grow by 7.85 per cent compared to 6.66 per cent in 2009. The growth rate appears robust but there is need to ensure it translates into job creation and poverty reduction.

Between 2009 and 2010, the volatility in inflation has moderated significantly. Headline inflation declined steadily from 15.1 per cent in end-2008 to 10.4 per cent in September, 2009, rising thereafter to 15.6 per cent in February, 2010. Since then, it has maintained a downward trend to 13.4 per cent in October, 2010. Food inflation rose from 18 per cent at end-2008 to 20 per cent in February, 2009 before declining to 14.1 per cent in October, 2010. It is only non-food (core) inflation that has increased to 13.2 per cent in October, 2010, having declined from 10.4 per cent in end-December 2008 to 7.4 per cent in September, 2009.

Inter-bank rate and other key money market rates have moderated significantly compared to the pre-reform period. Weighted average inter–bank call rate and other key money market rates fell to below the end-December 2008 level by end-August 2009 after the sharp increase between January and July 2009. As at 28 July 2010, the inter–bank rate had fallen to 1.12 per cent while the Open Buy-Back (OBB) rate stood at 1.10 per cent. In response to the increase in MPR of September 21, 2010, both the Inter-bank call rate and OBB have trended upward averaging 10.56 and 8.23 per cent, respectively by November 15, 2010. In spite of the fluctuation in money market rates, the lending rates have remained consistently high. The prime lending rate stood at between 18 and 19 per cent while the maximum lending rate hovered between 22.56 and 23.91 per cent over March 2009 and May 2010. The average prime lending rate remained at 16.66 per cent in both October and September 2010, declining from 16.89 per cent in August 2010. The average maximum lending rate, however, declined to 21.85 per cent in October 2010 from 22.20 per cent in September 2010 and 22.31 per cent in August 2010. The weighted average savings rate equally declined marginally to 1.48 per cent in October, 2010 from 1.49 per cent in September, 2010 and 1.41 per cent in August, 2010 while the consolidated deposit rate increased to 2.31 per cent in October 2010, up from 2.07 per cent in September and 2.27 per cent in August 2010. The spread between the average maximum lending rate and the consolidated deposit rate, however, narrowed to 19.54 per cent in October, 2010 from 20.14 per cent in September 2010, and 20.04 per cent in August 2010.

The exchange rate has stabilized. The high exchange rate volatility noticed before July 2009 has disappeared. For a long time now the exchange rate has remained at between ₦148/₦152 per US$ compared with up to ₦180 per US$ between March and May 2009.

The confidence in the financial system is gradually being restored. External exposure to Nigerian banks has improved considerably. EXIM Bank exposure to Nigerian banks increased from US$403 million to US$1 billion. European Investment Bank has increased its exposure to Nigerian banks by an additional US$150 million. The International Finance Corporation (IFC) has also increased its exposure to Nigerian banks. Recently, it has announced its intention to inject US$300 million credit into two Nigerian banks. This consists of US$200 million long-term funding to GTbank and US$100 million convertible sub-debt and senior loans to First Bank.

The capital market has also witnessed some stability. The sharp drop in both market capitalization and the NSE ASI noticed between February 2008 and April 2009 has been reversed. As at July 28, 2010 market capitalization (MC) stood at ₦6.33 trillion while ASI was 25,889.98. By November 15, 2010, the ASI had declined marginally to 25,301.34 while MC increased to ₦8.08 trillion. Gross inflows of FDI are expected to improve in 2010 as first quarter 2010 inflows stood at ₦84.78 billion compared to fourth quarter 2009 inflow of ₦102.42 billion. Inflows are toward share equities, banking, telecommunication, manufacturing and oil and gas sectors.

Monetary and credit aggregates have, however, underperformed consistently falling below their long term trends. The decline in broad money (M2) growth witnessed up to July 2009 was reversed and except in January and May 2010, the growth rate has been positive. M2 grew by 4.25 per cent in October 2010 which when annualized represented a growth of 5.10 per cent. Net credit to the economy grew substantially since June 2009 although it has moderated since January 2010. In October 2010, aggregate credit grew by 19.69 per cent which annualizes to 23.63 per cent. Credit to the private sector which grew since July 2009, and declined between January and August, 2010. Since then, it has been rising. By October 2010, credit to private sector, core private sector, and government grew by 3.86, 3.07 and 64.02 per cent, respectively, on annualized basis. It should, however, be noted that the decline in monetary aggregates is not peculiar to Nigeria as other countries faced similar outcomes due to the global financial crisis.

The good news is that the banking system has resumed lending. New credit to the economy increased from ₦ 145,459 million in April 2010 to ₦173, 807 million in May 2010, ₦ 345,998 million in June, 2010 representing increases of 19.49 per cent and 99.1 per cent respectively. It however, declined to ₦322, 275 million in October, 2010, representing decline of 6.85 per cent. Credit by non-intervened banks rose from ₦127,270 in April 2010 to ₦145,885 million in May 2010, and ₦218,904 million in October 2010, representing increases of 14.63 per cent and 50.1 per cent, respectively. Similarly, the intervened banks credit increased from ₦18,189 million to ₦27,922 million and ₦43,371million, also representing 53.51 per cent and 55.33 per cent, respectively. The bulk of the credit went to Oil and Gas, Manufacturing, and Transportation and Storage. Furthermore, the stress test conducted recently on the twenty four banks has shown that the financial soundness of the banks (both intervened and non-intervened) has improved significantly compared to the crisis period.

It is also gratifying to note that of the ₦500 billion approved for power and aviation sectors as well as for the refinancing/restructuring of manufacturer's portfolios with the DMBs, about ₦199 billion had been paid to the Bank of Industry (BOI) for disbursement towards the refinancing/restructuring of manufacturers' exposures to the DMBs. Also, of the other liquidity injections approved by the CBN, ₦80.701 billion had already been disbursed under the Commercial Agricultural Credit Scheme, while ₦368.84 million had been paid by the Bank as its 6.0 per cent interest rebate obligation on 35 large scale agricultural projects under the Agricultural Credit Support Scheme.

5 Reform Challenges

In spite of the achievements so far, a number of challenges have remained. Indeed, economic growth has been robust, but a major challenge is how to sustain and translate this into new employment opportunities. The link between the major growth drivers, particularly agriculture and manufacturing, continue to be weak. Hence, the manufacturing sector remains an insignificant contributor to growth. There is, therefore, urgent need to address all binding constraints to growth. As you all are aware, inadequate or absence of basic economic and social infrastructure remains a major binding constraint on Nigeria's growth and development. There is therefore, an urgent need to fast-track the proposed reforms in some key sectors of the economy, notably power and oil/gas sectors, to attract the much-needed investment and reduce the huge import bills on refined petroleum products. There is absolutely no reason why our refineries should not be functional. There is also the need to deepen the deregulation process in the electricity and transport sector to attract private investment. The allocation of responsibility for infrastructure development among different levels of government need to be reviewed. Resumption of credit to key productive sectors of the economy is key because of the obvious medium-to-long term implications for the real economy. This requires adequate regulatory interventions to develop all sectors of the credit market from microfinance to larger corporations.

While acceleration of credit market reform such as dispute resolution mechanism, credit bureau regulation, and leasing laws are very critical, adequate attention must also be given to development of public-private partnership framework, legal framework for rental markets, etc. A major challenge also lies in reducing the high lending interest rate in the face of low money market rates.

Growing banking system liquidity is still desirable and, hence, the need to quickly bring the banking system reforms to closure. There is urgent need to inject fresh funds into the banks affected by regulatory actions in addition to the removal of the "toxic assets". This is where AMCON is very critical.

A major challenge remains how to strike an appropriate balance between monetary, fiscal and other policies. There is s a limit to what monetary policy can do to deliver economic growth. Other complementary policies must be in place. Banking sector reforms is a necessary but not a sufficient condition for economic growth and development. Complementary reforms in other areas of the economy, particularly in agriculture (in addition to energy sector mentioned above) to curb high import bills on food (rice) and reduce demand pressure in the foreign exchange market, are absolutely necessary.

Equally important is the rising government expenditure and borrowings with the possible crowding-out effects on the private sector. This brings to the fore the need to eliminate unnecessary subsidies that add to government expenditure and debt.

6 Conclusion

Distinguished audience let me reiterate the fact that a sound, efficient and stable financial system is very critical to the development of an economy. The global financial crisis and the post-consolidation weakness in the Nigerian financial system, occasioned by illegal and criminal activities in some of the Nigerian Banks have given rise to a fragile financial system which the CBN has tried to fix in the last seventeen months. The result so far has been quite encouraging. We shall remain focused and committed to this cause. Our goal is to bequeath to this country a stable financial system that will oil the wheels of economic development on a sustainable basis. We count on your support for this noble cause.

Thank you for listening.

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