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Cross - Border Transactions of Deposit Money Banks and the Issue of Monetary Control

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I. Introduction

There are different forms of cross-border transactions and they include cross-border capital flows, globalization of financial institutions and globalization of financial markets. Caruana (2007) described the degree to which capital is moving across borders as a revolution. He gave the estimated global cross-border capital flows to be US$9 trillion in 2005 compared with the estimated US$2.25 trillion in 1997. Among the factors responsible for the boom in cross-border capital flows was the abolition or relaxation of significant restrictions on investors buying assets abroad and controls on capital inflows in most countries. Globalization of financial institutions mainly through mergers and acquisitions (M&A) of banks and insurance companies has continued to surge in recent years. For example cross-border financial M&A at US$0.2 billion, which accounted for less than 1.0 per cent of the total in 1997, had risen to US$359.5 billion or about 40.0 per cent of the value of deals in 2006 (Caruana, 2007). About one-quarter of cross-border financial M&A or 10.0 percentage points of total financial M&A involved institutions are outside developed countries. The growth in globalization and transformation of financial markets has been observed to be positively correlated with the globalization of financial institutions.

The type of cross-border transactions that is in focus in this paper are:

- The foray of foreign banks into the Nigerian economy where Nigeria is host to such subsidiaries of foreign banks; and
- The branches and subsidiaries of Nigerian banks in other countries, thus, making Nigeria the home country.

In all, the four (4) foreign banks in Nigeria are subsidiaries of an off-shore bank from United States of America (USA), United Kingdom (UK), South Africa, and Economic

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community of West African States (ECOWAS). Even though Nigeria is a member of ECOWAS, Ecobank Nigeria is a subsidiary of Ecobank Transnational Incorporated with head office in Lome, Togo. Among the remaining twenty (20) banks in Nigeria, fourteen(14) of them have subsidiaries and branches in USA, UK and Africa. Many of these affiliates are subsidiaries as most of the host countries do not allow branches of foreign banks in their jurisdictions.

As a matter of fact the distinction between foreign branches and subsidiaries is now blurred and, henceforth, are referred to as subsidiaries in this paper. The activities of these DMBs as depicted by their deposits and credits will be our main focus. This is particularly so in view of the implications of deposits and credits for monetary control in an economy.

II. Stylized Facts on Cross-Border Banking Activities in Nigeria

II.1 Ownership Structures of Banks

The number of foreign banks in Nigeria, that is, banks in which foreign interest is above 50.0 per cent has come down from eight (8) pre-consolidation as at 31st December, 2005 to four (4) post-consolidation. The remaining 4 foreign deposit money banks (DMBs) in Nigeria are Citibank Nigeria Ltd, Ecobank Nigeria Plc, Stanbic IBTC Bank Plc, and Standard Chartered Bank Nigeria Ltd. These banks have vested interest in the activities of the 4 DMBs with foreign ownership in excess of 50.0 per cent as there are other eleven (11) DMBs in the country with pockets of foreign ownership ranging from 0.04 per cent to 25.07 per cent in 2007.

In contrast, the number of Nigerian DMBs with foreign subsidiaries increased from eight (8) out of 81 wholly Nigerian DMBs pre-consolidation to fourteen (14) out of 20 wholly Nigerian DMBs post-consolidation. As a matter of fact Nigerian DMBs appeared to have shifted competition to foreign land particularly the West African sub-region. The vogue in the Nigerian banking industry at present appears to be ownership of foreign subsidiaries. It is, therefore, not surprising that foreign subsidiaries of Nigerian DMBs increased significantly from eight (8) as at 31st December, 2005 to 41 as at 31st December, 2008. Put differently, 14 Nigerian DMBs had 41 foreign subsidiaries as at 31st December, 2008. It should be noted that the number of foreign subsidiaries of Nigerian DMBs was 8 in 2006 and 18 in 2007.

II.2 Factors that Influenced Cross-Border Activities

We would consider some of the factors that have influenced foreign DMBs to come to Nigeria and those that have driven Nigerian DMBs to have foreign subsidiaries. The factors have been listed below but not in any particular order.

(a) Direct investment by other developing country banks tends to be driven by economic integration, common language and proximity. This partly explains the prominence of cross-border transactions of Nigerian DMBs in West Africa in view of the anticipated second monetary zone involving mainly the English-speaking West African countries and the prospects of a single monetary zone in ECOWAS in future.

(b) The increased cross-border economic activity in both financial and non-financial markets has also continued to fuel cross-border acquisition of banks. Just as this used to be the main factor that led to the infiltration of foreign banks into Nigeria, it has propelled many Nigerian DMBs to have subsidiaries particularly in the West African sub-region and London. For example, some companies with substantial Nigerian interest have relocated partially or fully to some other West African countries from Nigeria despite the fact that Nigeria remains their dominant market.

(c) Cross-border expansion of DMBs to emerging markets (developing and underdeveloped countries) is being influenced by the prospects of faster business and profit growth, especially given the relative underdevelopment of their financial markets and institutions. The rush of Nigerian DMBs to other ECOWAS countries is principally driven by this reason. By 2009, there are likely to be more subsidiaries of Nigerian DMBs in The Gambia and Sierra-Leone.

(d) According to IMF (2007, Chapter 111), some DMBs have internationalised based on expectations that knowledge and efficiencies in undertaking business and risk in one market can be transferred into others; that economies of scale and scope can be achieved when carrying out multi-country operations; and that a cross-border group can better allocate a large and stable capital resources profitably across business lines to those where profitability is expected to be greatest, while also diversifying risk geographically. The outcome of the banking sector consolidation in Nigeria made many DMBs to have the perception that they had excess capital which could be judiciously utilised for sustainable and improved return on capital. That notion had driven many of them to explore business opportunities outside Nigeria with a view to enhancing their performances. The mere size of their nominal capital visa-vis limited expansion opportunities coupled with heightened competition in Nigeria and prospects of higher profit in the host countries lured them into foreign countries.

(e) Advancement in information and communications technology (ICT) has increased cross-border banking transactions. Berger, et al(2003) discovered that technological innovations in risk management, back-office support, and transaction processing have enabled banks and other institutions to manage risks at lower cost without geographic proximity to the customers. Many banks have taken advantage of ICT to diversify into foreign countries.

III. Analysis of Balance Sheet Structure of Deposit Money Banks with Foreign Subsidiaries

The task here is to review the activities of foreign DMBs in Nigeria and the activities of Nigerian DMBs with foreign subsidiaries. The second leg of the review would have been the review of the activities of foreign DMBs in their home countries and those of Nigerian DMBs in their host countries. However, due to paucity of data, this second aspect cannot be undertaken here. The essence of the review of the activities of DMBs with foreign subsidiaries is to appreciate the significance of their effects on monetary control in the home and host countries.

The basic parameters we have considered from their balance sheet in this review are total assets, credits and deposits. Even though the share of foreign DMBs' assets in total assets of the Nigerian banking sector more than doubled from 3.4 per cent pre-consolidation to 7 per cent post-consolidation, the proportion does not appear significant to warrant banking crisis in Nigeria in the event of any disruption to their activities (see Table 1). Similarly, their share in total credits at 6.1 per cent and total deposits at 5.7 per cent as at 30th June, 2009 make them fringe players in the Nigerian banking market. The effect of risk of failure on the economy either due to their activities in their home country or within Nigeria appears mild on the Nigerian banking sector and the economy.

Table 1: Activities of Foreign DMBs in Nigeria

Type	Total for all DMBs (NBn)		Foreign DMBs (Nbn)		Proportion in Total for all DMBs (%)	
	31/12/05	30/06/09	31/12/05	30/06/09	31/12/05	30/06/09
Assets	5,445.3	14,804.2	184.8	1,030.0	3.4	7.0
Credits	1,818.7	7,671.7	62.0	466.5	3.4	6.1
Deposits	2,469.1	8,746.1	124.5	499.0	5.0	5.7

The activities of the Nigerian DMBs with foreign subsidiaries at home are very dominant in the three parameters. They accounted for 35 per cent, 34.8 per cent and 50 per cent of total assets, credits and deposits pre-consolidation and galloped to a share of 82.4 per cent, 82.7 per cent and 82.2 per cent of total assets, credits and deposits post-consolidation, respectively (see Table 2). In effect, their activities could be closely monitored at home and in their host countries in view of the adverse effects their failures could cause the Nigerian economy. The adverse effect of the distressed condition of six (6) of these banks on the Nigerian economy is still very fresh. Even though there was nothing to suggest that their problems were caused by their foreign subsidiaries but it is evident that the activities of some foreign subsidiaries had been known to cause the failures of parent banks. See the Appendix lifted from IMF (2007) for the familiar examples of banks that collapsed due to the activities of their foreign subsidiaries.

Table 2: Activities of Nigerian DMBs with Foreign Subsidiaries

Type	Total for all DMBs (NBn)		Nigerian DMBs with Foreign Subsidiaries (NBn)		Proportion in Total for All DMBs (%)	
	31/12/05	30/06/09	31/12/05	30/06/09	31/12/05	30/06/09
Assets	5,445.3	14,804.2	1,908.0	12,198.0	35.0	82.4
Credits	1,818.7	7,671.7	633.3	6,345.0	34.8	82.7
Deposits	2,469.1	8,746.1	1,246.8	7,189.4	50.5	82.2

IV. Cross-Border Transactions and Implications for Monetary Control

Banks through their activities provide fundamental services to the economy and yet they can experience bank runs. There are various problems in a parent bank that can easily spread to foreign subsidiaries and vice versa and, therefore, contagion risk is a reality. Contagion risk can even be more serious in banking activities as problems in one bank can easily spread to other banks within the same country and even banks in other jurisdictions. The global financial crisis of 2007 2009, which was triggered by the high rate of default in sub-prime mortgage loans, is a classical example of contagion.

There appears to be a consensus in the literature that the impact of cross-border activities of DMBs on global financial stability is mixed. While it is established that it has helped to improve financial stability, IMF (2007) observed that an increase in international linkages within and across institutions may make crisis more broad-ranging and complicated to deal with. According to Gieve (2006), financial systems may now be more efficient at sharing risk but also at transmitting shocks. In order words, crisis may be less common but more severe.

Despite all these, banking regulation for safety and soundness and economic stability is essentially a national affair. The concern of policymakers on the cross-border activities of DMBs is, therefore, understandable in view of their effects on monetary control and economic stability. This probably informed the statement credited to Sanusi Lamido Sanusi, CBN Governor (2009) that he would meet with African Central Bankers at the IMF Conference in October 2009 to find a way to build a regulatory framework for the continent. He was quoted to have said: "I am concerned that we have got banks that are spreading across different African countries and while we sign MoUs with other regulators, we don't have an African framework for cross-border supervision". He went on, "I think the Nigerians, the South Africans, the Ghanaians, the BCEAO (West African Central Bank for French-speaking Countries), the Central African regulators can together build a framework that makes sure all banks that operate anywhere in Africa are closely regulated." According to him, Nigerian banks have subsidiaries spread across Africa and that poses credit and market risk as well as risk to the reputation of the country's banking industry as a whole.

The reputational risk is even very highly significant given the initial reaction of customers of foreign subsidiaries of Nigerian DMBs during the recent banking reform in Nigeria. Many of these customers were apprehensive that all Nigerian banks were distressed and should not be patronised. Of course, the outcome of the reform exposed the 10 distressed DMBs in Nigeria and we are living witnesses to the proactive measure of the CBN in bailing eight (8) of them out with N620 billion. That spontaneous action allayed their fears and made the foreign subsidiaries of the affected DMBs to avert losses due to reputational risk. As part of efforts to stave off reputational risk from foreign subsidiaries of Nigerian DMBs, the CBN Governor had started visiting Governors of Central Banks where Nigerian DMBs have subsidiaries. He already visited the Governor of the Bank of Sierra Leone where there are at least nine (9) subsidiaries of Nigerian DMBs. Given these background information, we have encapsulated some issues for monetary control in both home country (Nigeria) and host countries in ensuing sub-parts.

IV.1 Level of Credit

The level of credit targeted for the economy necessary for the anticipated level of growth and development in a particular year affects the control of money by the central bank. The DMBs with foreign subsidiaries are mandatorily required to consolidate their balance sheet and, therefore, the level of credit is for the home and host countries. However, it is easy to separate the credit for the home country from the consolidated credit in the balance sheet. Even at that, can we categorically say that the level of credit in the books of Nigerian DMBs for the home country is real?

Given the possibility that a parent bank can extend credit in Nigeria and for such credit to be partly or fully utilised in another country where the bank has foreign subsidiaries, it thus implies that it will be difficult to know the quantum of credit utilised in Nigeria. The DMB may not even know that the credit will not be utilised within Nigeria. For example, Unilever Nigeria Plc can access credit in Nigeria and since it has factories in Ghana, such credit can partly be used in Ghana. In essence, it will be erroneous to think that the whole facility borrowed from a DMB within Nigeria in favour of Unilever Nigeria Plc is utilised in Nigeria. In the same manner, Unilever in Ghana can obtain credit from subsidiaries of Nigerian DMBs in Ghana and utilise part of such credit in Nigeria. It was even reported that some directors of a Nigerian DMBs went and obtained credit in their Ghanaian subsidiary. Such credit can easily be utilised partly or wholly in Nigeria.

Given such information asymmetry, monetary control will be a problem both in the home country and host countries. Let us consider the scenario where the CBN has estimated that credit growth in Nigeria is targeted at x per cent on the basis of which the level of money supply is premised. Assume that the growth is actually x per cent based on the balance sheet figures, but in reality, the growth is either (x+a) per cent or (x-b) per cent as part of the credit meant for the host countries has been diverted to Nigeria or credit in Nigeria is diverted to the host countries without the knowledge of the DMBs with foreign subsidiaries. Such a distortion will make money stock necessary for monetary and price stability to be difficult to determine.

Also, in a situation where DMBs with foreign subsidiaries are confronted with problems to the extent that they cannot lend in their home country, they are likely to raise their level of credit in their host countries. Such host countries may not have the capacity to absorb such level of credit thus precipitating high credit default. Meanwhile, money control in such host countries will be difficult as they never envisaged such a level of credit. At the same time, the home country will experience credit crunch which can destabilise the economy.

Similarly, economic downturn in host countries can lead to a deluge (diversion) of credit to home country beyond the level of credit required for the anticipated level of economic activity. The implication for monetary control in both home and host countries in this type of situation is very apparent.

IV.2 Money Laundering

The control of money will no doubt be affected adversely in both home and host countries where money laundering is involved. Money laundering has implications for monetary control in home country and host countries of DMBs involved in money laundering. Whether the money is laundered through the parent bank to the subsidiary(ies) or through foreign subsidiary(ies) to the parent bank, monetary control in the countries involved will be affected. The parent bank and its foreign subsidiaries may not even be involved directly, but they should be able to identify such customers through effective customer due diligence (CDD) and Know Your Customers (KYC) principles.

Foreign subsidiaries of Nigerian DMBs involved in money laundering may not even need to launder such funds into Nigeria for monetary control to be affected in Nigeria. Once it is discovered that such foreign subsidiaries of Nigerian DMBs are being used to launder funds reputational risk that can adversely affect the country's image internationally will easily set in. The outcome will definitely affect monetary control in Nigeria given the interdependence between nations.

IV.3 Rendition of False Returns

Some DMBs are known to render false information to the regulatory authorities. The ownership of foreign subsidiaries by such DMBs will make it easier for them to hide information on their activities particularly the level of their deposits and credits. Rendition of false returns adversely affects the banking system and the economy given the credibility problems associated with it. In a situation where unreliable information is available to central banks, monetary policy will be based on such unrealistic figures and may not be effective. This is likely to be so in the home country and host country(ies) of the DMBs.

IV.4 Informal Trade

Informal trade between countries has been a major factor that makes it difficult for the level of money supply to be determined precisely. The existence of foreign subsidiaries in countries involved in informal trade is expected to bring such transactions into formal trade through banks and enhance government revenue in both home country and host country(ies).

IV.5 Policy Change in Host Countries

Possibilities of a policy change in some host countries that would affect the parent DMBs cannot be ruled out. Following the perceived success of banking consolidation in Nigeria, some countries in Africa had increased or contemplated increasing the minimum capital of DMBs in their jurisdictions. In some countries like Ghana, the *minimum* capital requirement of a foreign DMB is higher than those of DMBs owned by indigenes. No doubt some of these countries could use the policy of capital increase as a means to attract foreign direct investment. Such a policy would not only deplete the capital of the parent DMBs but also would have implications for monetary control in the home country.

Given the large number of foreign subsidiaries of Nigerian DMBs in countries like Ghana, Sierra Leone, the Gambia, and the United Kingdom a substantial increase in the minimum capital requirement in any of them would engender capital flight from Nigeria. Such a capital outflow would weaken the performance of the affected DMBs in Nigeria and affect our money supply especially if the notice for the change is short as it was also the case in Nigeria. Let us not reason that many of these countries would not contemplate such a policy at the same time. The bandwagon effect that followed banking consolidation in Nigeria should be a pointer that many countries can embark on such a measure within a short period. For example, the recent banking reform in Nigeria could be copied by some of the sub-Sahara African countries where Nigerian DMBs have foreign subsidiaries. Rather than their own central bank bailing out all DMBs with capital and/or liquidity shortfall, foreign banks could be asked to shore up their own capital and/or liquidity. The implication of such policy for monetary control in the home country is apparent.

IV.6 State of Corporate Governance

With the benefit of hindsight, we can affirm that a DMB with poor corporate governance will inevitably face crisis either in the short run or long run. In effect, Nigerian DMBs with poor corporate governance would export such poor corporate governance to their foreign subsidiaries which could ultimately face crisis. The weak financial position of foreign subsidiaries of Nigerian DMBs would have implications for money supply in Nigeria and their host countries. Imagine if the eight (8) distressed DMBs recently bailed out with N620 billion by the CBN were foreign DMBs. The CBN measure would likely be different to the extent that monetary control of home countries of such distressed foreign DMBs would be affected as it would be in the host country, Nigeria.

V. Conclusion

The panacea to monetary instability due to the activities of DMBs with foreign subsidiaries that we want to consider are basically two. We believe that if the monetary authority in Nigeria can address them, then the activities of Nigerian DMBs with foreign subsidiaries will not likely have adverse effects on monetary control. Before a Nigerian DMB is allowed to have a foreign subsidiary in another country, the regulatory authority in the prospective host country should seek the consent of the CBN, the apex regulatory authority of financial institutions in Nigeria. Our recommendation in this respect is that before such consent is given in future, such a Nigerian DMB should have sound corporate governance. Any Nigerian DMB with poor corporate governance no matter its sound financial condition and size should not be allowed to,have foreign subsidiaries. This is our clarion call to the CBN which we hope on implementation will make for a more potent monetary control measures.

Since each national regulatory authority has an overriding role to play in ensuring that DMBs are regulated for safety and soundness and for economic stability, the CBN should not allow Nigerian DMBs to own subsidiaries in countries with weak regulatory regime. This is particularly so as the CBN will have to rely on such national regulatory authorities for effective regulation and supervision of subsidiaries of Nigerian DMBs in their jurisdictions, moreso that, consolidated supervision across-borders may not materialise in the short run. It is even easy for the CBN to easily know countries that do not meet its minimum regulatory standards. Any country that has not complied substantially with the Core Principles for Effective Banking Supervision as enunciated by the Basle Committee of Banking Supervisors should not be allowed to host subsidiaries of Nigerian DMBs.

Among the main goals for supervising DMBs, apart from the primary goal of protection of depositors, are for the implementation of monetary policy for protection of the economy from the vagaries of the banking system, and to ensure that they play their proper role in economic development. Cross-border transactions of DMBs can make the realisation of these goals elusive given their adverse effects on monetary control if they are not effectively regulated.

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Appendix
Examples of Bank Failures with Cross-Border Dimensions

Herstatt Bank

The bank was closed down by the (West) German authorities in 1974 after they found out that it was insolvent (due mainly to large losses in the foreign exchange market).The action was taken after the European markets had closed for the day, but while New York was still open. The European leg of foreign exchange deals had been settled, but once news of the closure reached New York all trades involving Herstatt were suspended, so that counterparties already debited in Europe did not receive the corresponding dollar amounts due to them in New York. As noted by Latter (1999), this episode prompted central banks to pay much more attention to settlement risk in payments procedures, particularly in cross-border foreign exchange transactions.

Bank of Credit and Commerce International (BCCI)

The closure of BCCI in 1991 ranks among the biggest single-bank failures. At the time of its collapse, BCCI was operating in more than 70 jurisdictions. It had lost money on lending operations and foreign currency dealings, and failed owing more than $18 billion to its creditors. BCCI was made up of layers of entities, linked through a complex series of holding companies, affiliates, subsidiaries, and other relationships. The BCCI case highlighted the challenges involved in cross-border failures. For example, the different treatment of set-off led to problems in the BCCI liquidation, in which Luxembourg law differed from that in the United Kingdom, leading to the differential treatment of creditors (Campbell,2002). However, the contagious impact of BCCI's failure on other banks was limited (Kanas, 2004).

Barings

An institution with roots going back 233 years, Barings suffered a $1.3 billion trading loss in February 1995. The event was precipitated by a Singapore-based trader who eventually pleaded guilty to two counts of fraud and was sentenced to a six-year jail term. The loss was larger than the bank's entire capital base and reserves. Barings was forced to declare bankruptcy and was later purchased by the Dutchbank ING for £1, and an agreement to assume the fallen bank's substantial debts. From the view point of this analysis, the important point is that even though Barings was a merchant bank headquartered in London, its problems resulted from overseas operations in Singapore.

Rijecˇka Banka

This case illustrates that foreign ownership, while often playing a useful role, is not a panacea when pressures accumulate in a local subsidiary. Rijecˇka Banka was the third largest Croatian bank when it incurred $97 million in losses on foreign exchange transactions between 1998 and 2002 (nearly three quarters of the bank's capital). According to the Croatian National Bank, the losses had become so large partly because the bank's majority owner, Bayerische Landesbank of Germany, did not put in place adequate control mechanisms (Croatian National Bank, 2003). In the aftermath of the losses, Bayerische Landes bank did not inject additional capital; instead, it sold its 59 percent share in Rijecˇka Banka back to the Croatian government, for a price of $1. Rijecˇka Banka was ultimately re-privatized to Erste Bank of Austria.

Argentine and Uruguay crises

Several "ordinary" single-country banking crises included cross-border issues to a limited extent. For example, the macroeconomic crisis in Argentina in the early 2000s involved numerous bank failures; however, only one international bank was harmed when its subsidiary failed because of a dispute over the provision of liquidity. In 2002, neighboring Uruguay suffered a severe banking crisis. The withdrawal of non-resident depositsaccounting for more than one-half of total depositsdue to the crisis in Argentina triggered a general run on deposits in Uruguayan banks. The liquidity pressures and a sharp increase in nonperforming loans after a devaluation, combined with corporate governance problems, led the authorities to restructure the banking system, including strengthening liquidity and capital adequacy to improve the system's capacity to withstand shocks (IMF, 2006b).