Bullion

Volume 34 | Number 3 Article 3

9-2010

Banking reforms for effective monetary policy transmissions.

O. A. Uchendu
Central Bank Nigeria

BANKING REFORMS FOR EFFECTIVE MONETARY POLICY TRANSMISSIONS[3]

BY

O. A. UCHENDU, Ph.D

DIRECTOR OF MONETARY POLICY

CENTRAL BANK OF NIGERIA

O. A. Uchendu, Ph.D

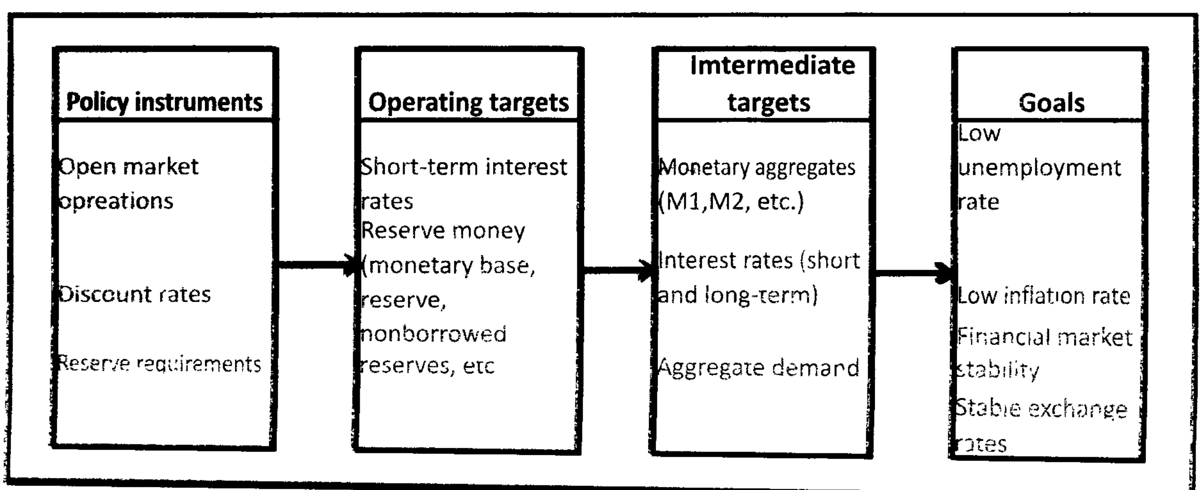
1.0 Introduction:

Monetary policy is concerned with the attempts of the monetary authorities to influence some measure (or measures) of money supply or the level and structure of interest rates. The objectives of monetary policy usually include price stability, high employment and growth. However, there seems to be overwhelming consensus that central banks could effectively achieve only the objective of price stability, given the instruments at their disposal.

There are basically two major instruments of monetary policy namely: instruments of market intervention; and instruments of portfolio constraint. The instruments of market intervention comprise mainly of Open Market Operation (OMO) which involves the sales/purchases of short term securities by the monetary authorities with a view to reducing/expanding reserves and the monetary base, thus lowering/raising the money supply. The major attraction of OMOs is accuracy. In other words, it could be used for major or minor changes in the amount of liquidity in the system. Besides, OMOs could easily be reversed. Another instrument of market intervention is discount policy, which is the rate at which the monetary authorities are prepared to lend to the Deposit Money Banks (DMBs) via the discount window. Typically, the discount facility is used to provide liquidity to the banking system and its origin lies in the role of central banks being lender of last resort to the banking system. Manipulations of the rate on discount facility by the monetary authorities can therefore influence short-term rates in the market.

The instruments of portfolio constraints refer to those controls that may be imposed by the monetary authorities on the portfolio structure of financial institutions with the purpose of influencing credit creation and, possibly, the type of lending taking place. The major components include reserve requirements, special deposits, moral suasion, and direct controls. Generally, the use of portfolio constraints as a tool of monetary policy has been de-emphasized, the world over, in recent years mainly because defining and implementing effective portfolio constraints have been difficult and open to controversy because of deregulation and increasing competition in the provision of financial services and products. Besides, the portfolio constraints are more effective under a system of foreign exchange control. Here, movements of funds to and from abroad are restricted thereby preventing borrowers from seeking finance from overseas when

Figure 1: Monetary Policy Tools, Targets and Goals



Handa (2009:307)

[3] The views expressed in the paper are those of the author and do not in any way represent the official position or thinking of the Central Bank of Nigeria. The author acknowledges the comments and criticisms of anonymous reviewer.

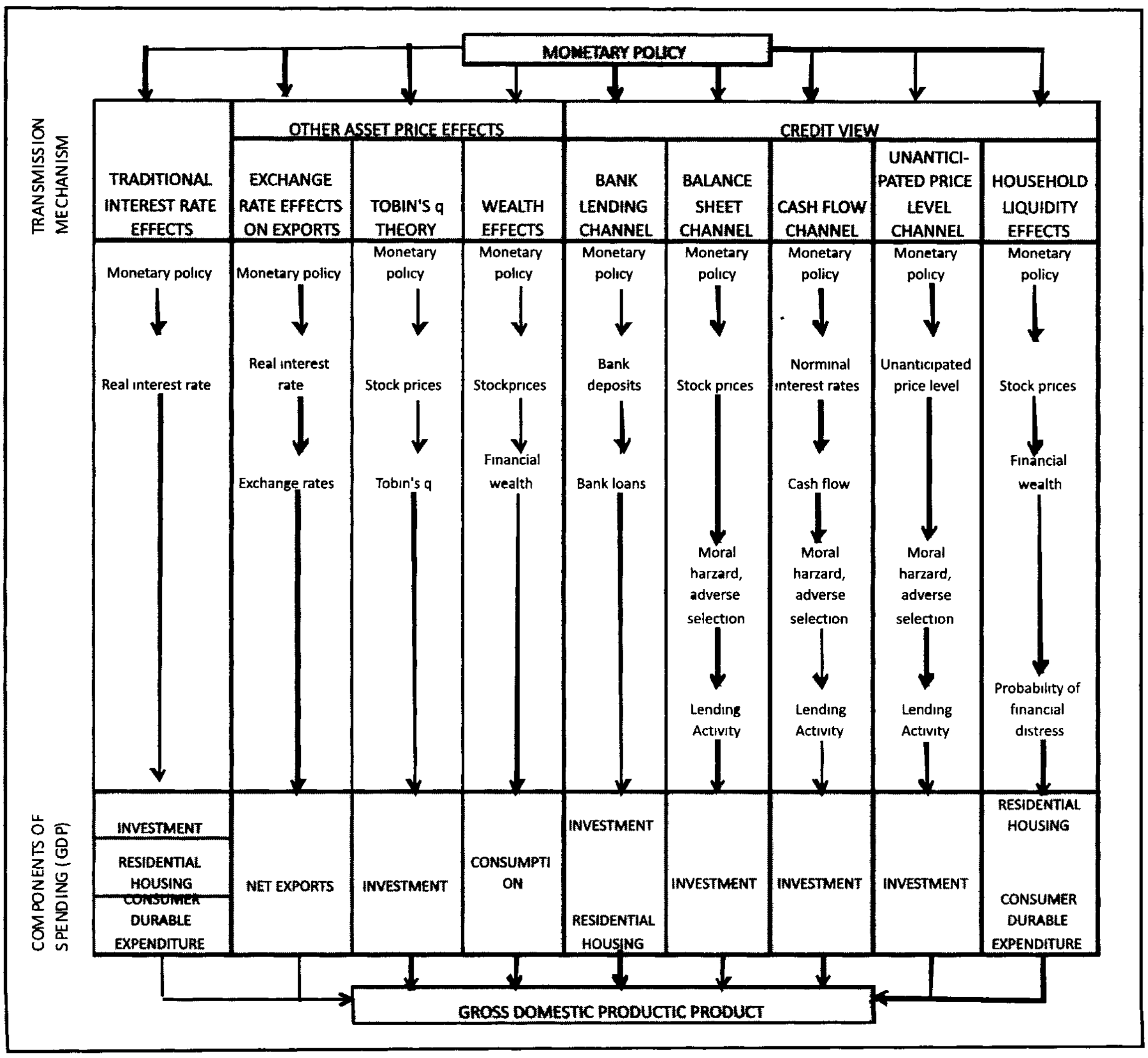
domestic monetary policy is restrictive. In such situations, exchange controls lead to portfolio constraints. Despite these challenges, portfolio constraints, particularly, reserve requirements, are still used in developing countries and most especially in Nigeria.

The main purpose of monetary policy is to achieve certain national goals which have historically included full employment (or a low employment rate), full employment output (or a high output growth), a stable price level (or a low inflation rate), and a stable exchange rate (or a desirable balance of payments). These variables are often referred to as the "ultimate goals" of monetary policy. These goals are usually achieved indirectly by the monetary authorities (central banks) by their use of monetary policy instruments mentioned above. However in formulating monetary policy, monetary authorities usually set targets whose values the policy maker wants to change. The targets could be ultimate (final goals, such as output/its deviation from the full-employment level, inflation rate (or the price level) or its deviation from a desired value, and employment); intermediate (variables that the central bank seeks to influence such as the monetary supply or the interest rate), or operating (variables the central bank can influence directly using the instruments at its disposal). However, since a given variable can fall in any one of these categories, there is no hard and clear-cut separation between these categories.

It is important to note that the effectiveness of monetary policy depends on the existence of an efficient and stable banking /financial system. Where none exist reforms become necessary. Nigeria has, over the years, witnessed several banking sector reforms all aimed at improving the efficiency and stability of the banking system. How these reforms have improved transmission of monetary policy is a matter of great concern.

This paper will, among others, evaluate the effects of the recent banking sector in Nigeria on monetary policy transmission. The remainder of this paper is structured as follows: section two dwells on the transmission mechanism of monetary policy; section three examines the features of the banking sector that affect the conduct of monetary policy; section four presents banking sector reforms in Nigeria while section five examines the impact of the reforms on monetary policy. Section six presents the challenges while section seven concludes.

FIGURE 2 : Monetary Transmission Mechanism



Source : Mishkin, 2007: 599

2.0: Transmission Mechanism of Monetary Policy

The transmission mechanism of monetary policy is the process through which monetary policy decisions affect the economy in general and the price level in particular. The main transmission channels are outlined below.

i. **Interest Rate Channel**: This channel focuses on how monetary policy influences the spending decisions of companies and households. A change in monetary policy stance by the monetary authorities would affect interest rates, leading to change in the cost of capital for companies with implication of change in borrowing for investment purposes. Similarly, households would change their pattern of borrowing and ultimately a change in their spending. The actions of both companies and households lead to changes in aggregate demand in the economy.

ii. **Asset Price Channels**: There are three different channels under this category. These are discussed below.

- **Exchange Rate Channel**: Monetary expansion/contraction would lead to a fall/rise in real domestic interest rate, making local currency denominated deposits less/highly attractive relative to deposits denominated in foreign currencies. As a consequence, the value of local currency deposits relative to other currencies depreciates/ appreciates, making domestic goods cheaper/costlier than foreign goods thus increasing/ decreasing net exports. The rise/fall in exports leads to an increase/decrease in demand and production.

- **Equity Valuation Theory:** Monetary expansion/contraction increases/decreases stock prices (investors have more/less money to buy equities) and this increases/decreases the market value of firms relative to their book value. This encourages/ discourages firms to invest more thus increasing/decreasing demand and output.

- **Wealth Effects**- Monetary expansion/contraction by the monetary authorities increases/decreases stock prices, making investors to become richer/poorer. This invariably leads to increase/decrease in consumption with the ultimate effect on output and demand.

iii. **Credit Channels**: These channels, like asset price channels, have three different channels as discussed below.

- **Banking Lending Channel:** Expansionary/contractionary monetary policy reduces/ increases real interest rate which would lead to increases/ decreases in bank reserves and deposits and therefore increases/decreases the quantity of loans available. Borrowers whose only source of credit is the banking system (typically small firms and households) will borrow more/less causing company investment and consumer spending to rise/reduce thereby increasing/decreasing demand in the economy.

- **Balance sheet channel**: Expansionary/contractionary monetary policy increases/ decreases company stocks prices and this raises/reduces the net worth of firms (lenders have more/less collateral for their loans) and this encourages/ discourages lending which feeds through into more/less investment by firms.

- **Cash flow Channel**: This is a form of balance sheet channel whereby expansionary/ contractionary policy increases/ decreases firms' cash flow thus encouraging/ discouraging investment.

3.0: Features of banking Sector that Affect the Conduct of Monetary Policy

A careful examination of the various transmission channels mentioned above shows that all of them pass through the banking sector to the real sector of the economy. Consequently, a major aim of banking reforms is to ensure a strong and reliable banking sector, which is a pre-requisite for effective conduct of monetary policy. Some of the features of the banking sector that affect monetary policy are presented below.

i. **Balance Sheet Structure of the banking Institutions**: A distinguishing feature of banks is that their assets are largely illiquid term loans while their liabilities comprise predominantly unsecured short term deposits. In general, the assets are not readily marketable while the deposits are paid out in full on a first - come-first served basis. This feature of banks' balance sheet, if not properly managed, could create serious problem for the conduct of monetary policy. For example, if banks use their deposit liabilities to create assets (loans and advances) above certain threshold without leaving some amount in liquid form (cash), it would create problem in the conduct of monetary policy. In an attempt to meet the demand for repayments of deposits from depositors, such banks would be willing to borrow from the inter bank market at a prohibitive rate, thereby rendering the policy rate of the monetary authorities, which suppose to anchor other rates, irrelevant.

ii. **Characteristics of Financial Contracts**: The core of a bank's business is to extend loans based on private information about the borrowers. Depositors are not easily able to observe the financial condition of the banks and the depositors-bank relationship therefore, potentially gives rise to agency problems (depositors entrust their money to banks and rely on them to invest it prudently). If depositors believe that banks are behaving imprudently, they can withdraw their funds, or in the alternative demand for higher interest rate. Evidence from literature suggests that large, wholesale depositors are capable of disciplining banks by demanding higher interest rates whereas small depositors do not behave in that way. This is perhaps not surprising because small deposits are protected by deposit insurance. If the depositors discipline the banks by demanding for higher interest rates, it could make the policy rate of the monetary authorities ineffective. On the other hand, if the depositors convert their deposits into cash or other non-bank assets, this creates liquidity outside the banking system, and thereby raises concern about inflation.

iii. Degree of competition within the banking Sector: The most ideal structure for the banking sector is a perfectively competitive market where no single bank could influence the market. Where there is skewness in the distribution of assets and liabilities such that it gives rise to either monopolistic or oligopolistic structure, the efficiency of monetary policy would be impaired. For example, if there is excess liquidity in the banking sector as a whole but about 80 per cent of the liquidity is concentrated in one or two banks, it would be difficult for the monetary authorities to manage the economy with conventional tools of monetary policy.

iv. Ownership pattern of banking sector: The ownership pattern of a bank significantly influences the quality of decisions at the top management level. Where the ownership pattern is not broadened enough to accommodate sound and quality decisions at the top management level, it may lead to loss of confidence, with implication of depositors run. This invariably would lead to excess liquidity outside the banking system.

v. Availability of financial instruments and substitutability; Most of the times, there is always trade off in policy. For example, the use of cash reserve requirements to ease monetary stance could threaten the stability of the banking sector. In such situation, the monetary authorities could use another instruments such as TBs rate. If there are inadequate financial instruments, then the efficiency of monetary policy becomes impaired.

vi. Degree of development of financial markets: The transmission of monetary policy takes place through the financial market. The extent of the depth and width of the financial market contributes significantly to the effectiveness of monetary policy. For example, an increase in the policy rate by the monetary authority is intended to control inflation through reduction in aggregate demand. The process is premised on the assumption that demand for credit would reduce, however, where majority of households or firms obtain credit from the informal financial system due to lack of access to the formal financial system, the use of policy rate by the monetary authority to manage the economy would be ineffective.

vii. A well-functioning payment system: A reliable and efficient payment system is crucial to effective conduct of monetary policy. In the absence of a good payment system, business transactions would be largely cash based. This implies that the significant proportion of money in circulation would be outside the banking system. Consequently the ability of the monetary authority to control the level of money in circulation would be difficult.

4.0: Banking Sector Reforms in Nigeria

Banking sector reforms refer to measures or series of measures taken to correct distortions in the banking system. The specific objectives could include reduction of financial repression of interest rates and credit allocation; transition from direct to indirect monetary policy; restructuring of banks balance sheet with a view to restoring solvency; developments of financial markets especially Treasury Bills, and improvement in financial infrastructure, supervision, auditing, accounting and corporate governance. The concern of central banks about the safety and soundness of the banking sector, and by extension banking sector reforms, is borne from a strong linkage between banking sector stability and monetary stability (outcome of monetary policy). A phenomenon that makes the banking system unstable and look more hazardous would generate a flight from broad money, and exacerbate the rate of inflation through a variety of mechanism. According to the banking school of thought in the Bank of England "there is a need for central banks to meet the legitimate needs of commerce". They stress that by acting as lender of last resort, the monetary authority could stabilize the business cycle, contributing to greater stability in not just the real variables of the macroeconomy, but possibly the nominal variables as well.

The Nigeria banking sector has undergone series of reforms since 1960s. However, the discussion in this paper would be restricted to reforms in recent years, the 2004 and 2009 banking reforms in Nigeria.

4.1: The 2004 Banking Reforms

In the pre 2004 era, the Nigerian Banking sector was characterized by the following:

- Oligopolistic Structure with 10 out of the existing 89 banks controlling more than 50 per cent of the total industry assets and portfolios
- A weak and inefficient banking system: Total indebtedness to the CBN was N71.36 billion while about 62 out of the existing 89 banks were rated unsound.
- Poor asset quality: Industry non-performing assets were 23.19% against the trigger point of 25%.
- Overdependence on public sector fund and income from foreign exchange trading
- Lack of capacity to support the real sector of the economy
- Weak corporate governance

It is against this backdrop that the 2004 banking reforms were undertaken. The key elements of the 2004 banking reforms include the following:

- Recapitalization of bank capital base to a minimum of N25 billion through either Mergers, Acquisition, or Initial Public Offerings (IPOs)
- Minimum reliance of banks on public sector funds
- Adoption of a risk focused and rule-based regulatory framework.
- Adoption of zero tolerance in the regulatory framework; especially in the area of data / information rendition/ reporting and infractions.
- Expeditious automation process for rendition of returns by banks and other financial institutions through the Electronic Financial Analysis and Surveillance System (e-FASS).
- Stricter enforcement of corporate governance principles for banking
- Strict enforcement of the

Contingency Planning Framework for Systematic Banking Distress
- Work towards the establishment of an Assets Management Company as an important element of distress resolution.
  - Revision and updating of relevant laws for effective corporate governance. Ensuring greater transparency and accountability in the implementation of banking laws and regulations

4.2 Background to the 2009 Banking Reform

Nigerian economic growth was robust between 2006 and 2008, underpinned by high commodity prices and strong growth in the non oil sector. This was supported by an unprecedented rally in stock prices as All share Index (ASI) rose from about 20,000 in January 2006 to about 65, 000 by January 2008. The banks raised a significant amount of fresh capital of about N1, 600 billion between 2006 and the first quarter of 2008. The increase in capital supported banks' balance sheet growth with banking sector assets as a percentage of GDP increasing rapidly to 60 per cent from about 30 per cent in 2004. With significant capital and greater liquidity, banks were under pressure to create risk assets amidst limited product innovation and diversification. The problem was compounded by poor risk management as well as weaknesses in corporate governance, leading to concentration of assets in certain areas, in particular margin lending and oil trading/marketing companies. Total banking sector exposure to these two sectors was approximately N1.6 trillion as at December 2008. In specific terms, the banking system was characterized by:

i. Inadequate Economic and Macro prudential Management. The Nigerian Economy was not insulated from massive liquidity inflows from oil and investment between 2006 and 2007. The real economy could not absorb the excess liquidity resulting in an unsustainable capital market bubble. Furthermore, the CBN macro-prudential management did not sufficiently address the impact of these oil-related inflows while fiscal policy was also pro-cyclical, exacerbating the crisis.

ii. Poor Corporate Governance at banks: Governance malpractice within banks, unchecked at consolidation, became a way of life in large parts of the sector, enriching a few at the expense of many depositors and investors. This is in addition to general weakness in risk management.

iii. Lack of Disclosure and Transparency: Banks reports to the CBN and investors were often not accurate, depriving the CBN the right information to effectively supervise the industry and depriving investors of information required to make informed investment decisions.

iv. Poor Regulatory Framework and Prudential Regulation: Lack of co-ordination among regulators prevented the CBN from having a comprehensive consolidated bank view of its activities. In addition, regulations covering the major causes of the crisis were incomplete.

v. Poor Business Environment: The legal process, absence of reliable rating agencies and poor infrastructure further contributed to non-standard banking practice.

By mid-2008, the global financial crisis had affected both the oil and gas sector and the Nigerian capital markets. This was followed by a sharp deterioration in the quality of banks' assets which immediately led to concerns over banks' liquidity. To support banks experiencing liquidity problems, the CBN Discount Window was expanded to accommodate money market instruments such as Bankers' Acceptances and Commercial Papers. The expanded discount window, however, could not address the liquidity problem which was due to significant erosion in capital base of some of the banks, thus necessitating the reform of 2009.

4.3 The 2009 Banking Sector Reform

The historical approach to resolving banks crisis in Nigeria has been to transfer the banks on to the Nigerian Deposit Insurance Corporation for liquidation. Under this approach, depositors and creditors as well as shareholders suffer significant losses. However, the CBN's reform in 2009 represents a step-change in the historical process of resolving banking sector crises in Nigeria. The objective was to ensure depositors and creditors interests were protected. The 2009 banking reform was based on four main pillars namely:
- Enhancing the quality of banks
- Establishing Financial Stability
- Enable healthy Financial Sector evolution
- Ensuring that the financial sector contributes to the real economy.

The Key Elements of 2009 banking reform include the followings:

i. Capital Injection: Intervention in form capital injection of N620 billion to nine banks that were found to have significant erosion in their capital base. The injection was in form of tier-II capital to be repaid from proceeds of recapitalization in the near future.

ii. Removal of Managing Directors of Banks: The Managing Directors/Chief Executive Officers of eight banks who were found to have compromised their positions were removed and replaced with the CBN appointed management Teams.

iii. Proposal to Establish Asset Management Corporation of Nigeria (AMCON): The AMCON will be owned by the CBN and the Federal Ministry of Finance. It will, among others, free banks of their toxic assets burden and enable them to extend credit to the real sector. The AMCON bill was signed into law by the President of the Federal Republic of Nigeria on July 19, 2010.

iv. Establishment of the Financial Stability Committee (FSC): The Committee was established to strengthen systemic stability in the financial system through formulation of monetary policy and macro-prudential rules.

v. Improved Supervisory Framework: The CBN has taken several steps to improve the

ii. Moderation of Interest Rate: One of the channels of monetary policy transmission, as discussed above, is interest rate. The effectiveness of this transmission channel presumes that the interest rate is fairly stable in order to anchor the expectations of economic agents. If the interest rate is not stable, it implies, among others, that there are other factors that influence the direction of interest rate other than the policy rate of the monetary authority. Loss of confidence in the banking sector during a banking crisis is one of such factors that exert significant influence on interest rate apart from the cost of fund. Apart from the injection of the N620 billion, additional reform measures taken by the CBN include reduction of liquidity ratios, cash reserve requirement, and quantitative easing into specific priority sectors.

The trend in the Inter bank call rate (IBCR) and Open Buy Back (OBB) rate from December 2008 to June 2010 is shown in Chart 2. The rates were fluctuating and trending upwards up to August 2009 when it commenced deceleration. This shows that the reform measures undertaken by the CBN contributed to moderating the volatility, hence improvement in the transmission of monetary policy mechanisms.

iii. Improvement in Lending Capacity of DMBs: Another transmission channel of monetary policy that is significantly affected by banking reforms is the lending channel of the DMBs. Theoretically, the channel presumes that the monetary authority could adjust the cash reserve requirement rate which in turn would affect the deposit base of the DMBs and by implication their capacity to lend. Under a banking crisis regime, however, the effect of flight in deposit - due to loss of confidence in the banking sector, would definitely be greater than the adjustment effect of cash reserve requirement, thereby constraining the bank lending channel.

The supply condition, represented by the ratios of various measures of credit to broad money for the DMBs from the first quarter of 2008 to June 2010 is shown in chart 3. The trend shows an increasing tight condition up

Chart 2: Trend in Inter Bank Call Rate and Open Buy Back ate from December 2008-June 2010

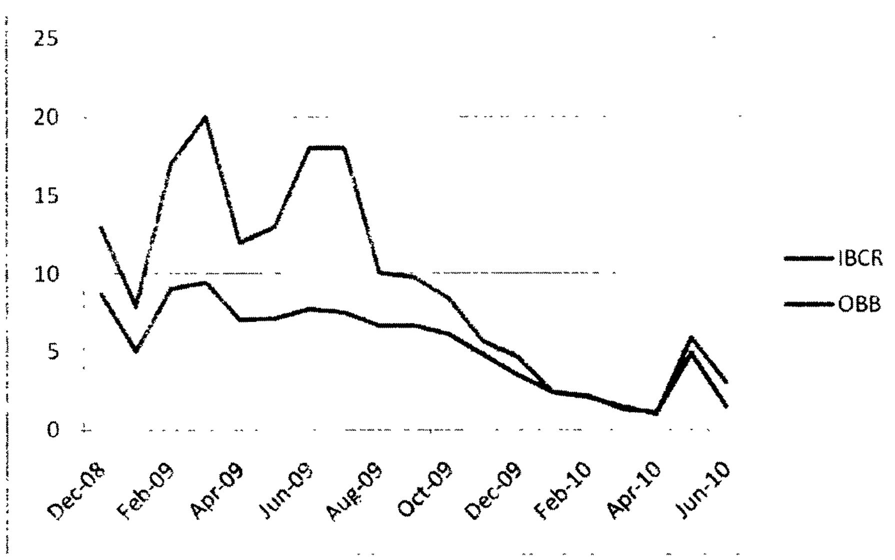
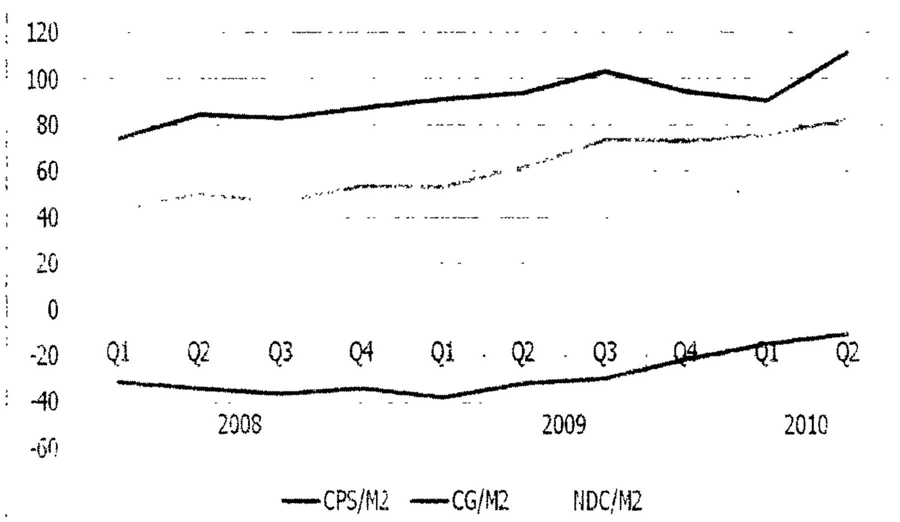


Chart 3: Ratio of Credit to Private Sector, Credit to Government and Net Domestic Credit to Broad Money from 2008q1-2010q2



to the third quarter of 2009 even when cash reserve requirement had been reduced to 1 per cent since April 2009. Following the broad reform measures in the third quarter of 2009, particularly the capital injection and the quantitative easing measure, the upward trend in tightness was moderated. Hence, the reform measures have contributed to improving the bank lending channel of monetary policy transmission.

i. Moderation in Inflation: The ultimate goal of monetary policy is price stability. In an environment of unstable banking system, there is a flight from broad money and other measures of deposit liabilities of DMBs to physical assets, thereby fueling inflation. As a result, the strength of DMBs to perform financial intermediation function is weakened due to eroded deposit base with implication of reduction in the effectiveness of monetary policy transmission. Consequently, banking reforms that succeed in restoring confidence to the banking sector would help in reducing inflation while at the same time enhance the effectiveness of monetary policy transmission mechanisms. This is reflected in chart 4 below as various measures of inflation moderated in the last quarter of 2009.

REFERENCES

Bank of England (2007) "Surplus Liquidity: Implications for Central Banks" Lecture Series no.3, Centre for Central Banking Studies

Central Bank of Nigeria (2009). *Fifty Years of Central Banking in Nigeria*

Handa, J. (2009), *Monetary Economics*, Rutledge

Mishkin, F. (2007), The Economics of Money, Banking, And Financial Markets. 8th Edition.

Sanusi Lamido (2010) "The Nigerian Banking Industry: What went wrong and the way forward" Paper presented at the Annual Convocation Lecture of Bayero University, Kano

Uchendu, O.A (2009) "An overview of Monetary Policy in Nigeria" *CBN Bullion, Vol. 30, No. 2, June.*

Wrightsman, D. (1976); *An Introduction to Monetary Policy Theory and Policy*, New York, The Free Press.