Causes and Effects of Banking Distress in Nigeria Banking Industry

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Abstract

Banking distress possess a lot of threat and losing of confidence in the industry. Despite all the attempt made by the supervisory authorities the problem still remains the same. The problem of distress in the Nigeria banking industry has been a major issue to all the stakeholders, investors in the economy and also to the business world at large. This research work focused mainly on the causes and effects of distress of banking industry in Nigeria. It sought to address the following questions: History of banking distress in Nigeria, what is distress? What factors determine or bring about banking distress in Nigeria. Secondary data was adopted for the purpose of this research work through internet, central bank of Nigeria annual report, Nigeria Deposit Insurance Corporation (NDIC) Report, published journals.

Keywords: Distress, Banking Industry

Introduction

Bank distress usually affects all sectors of the economy. Globalization has also contributed to the bank been involved in distress in recent time. John, Gianni and Elena (2008) stated that banks distress can be triggered by weakness in banking system, characterized by persistent illiquidity, insolvency, undercapitalization, level of non-performing loans and weak, corporate governance among others. Distress in banking industry in Nigeria started between 1930 and 1950. As a matter of fact about 21 banks failed and were recorded in Nigeria between 1930 and 1958 when the central bank of Nigeria (CBN) was established. Examples of such banks are Alpha Merchant Bank, Financial Merchant Bank and Republic Bank (CBN statistical Bulletin, 1988).

Many people erroneously confuse bank distress with bank failure, which are technically distinct. Bank distress is the forerunner of bank failure. A bank in distress has chance to regained health, whereas a failed bank loses every chance of life. Its final destination, as in the case of Nigeria, is the Nigeria Deposit Insurance Corporation (NDIC), where it is finally liquidated. Attempt have been made by different experts to define “distress” in banks and in other financial industry. The advanced learners Dictionary defines distress as a state of great pain, discomfort or sorrow, while the oxford dictionary defines distress as enormous pressure or strains.

The banking industry in any economy in the world is the most important sector because of their ability to mobilize funds from the savings to the deficit sector of that economy. The principal objectives of bank in providing this service are to promote economic growth, profitability and liquidity to the economy (Solomon, 2012). According to oforegbunam (2011) the banking sector in Nigeria has passed through various evolutions starting from the advert of banking dated to 1892 to the present day of consolidation. Distress in the history of Nigeria banking industry is not an entirely new phenomenon and this has had far reaching consequences on the economy. Bank distress causes a lot of threat to the stability of the entire banking system. Saving mobilization, financial intermediation process and depositors confidence. Under this the public confidence in the system would be
completely destroyed. The finding of this research will contribute to the literature and also provide empirical support on the effect of bank distress on the Nigeria economy.

This research work is divided into 4 sections: the introduction, literature review, research methodology, conclusion and recommendation

**Literature Review**

**Definitions**:

**What is distress?**

According to oxford dictionary distress can be refer to as extreme anxiety, sorrow, or pain. Difficulty caused by lack of money. Merriam Webster online dictionary also defined distress as unhappy or pain; suffering that affects the mind or body. Distress could be financial, emotional, psychological, physical etc. distress as related to the Nigerian banking system has to do with problems or troubles that affects the productivity of staff as well as the growth of the sector.

A bank is said to be distress where such a bank have no financial capacity to pay its customers or depositors. Distress can be attributed to a lot of various reasons in the banking sector in Nigeria. Distress in Nigerian banking industry can be traced to several causes from both the government and the private sectors. In 1989, the Federal Government directed that its deposits and those of public institution be withdrawn from commercial banks to the CBN. This singular policy measure exposed the weak financial conditions of most commercial banks. Since this time the number of distressed bank has grown steadily as well as severity of problems associated with distress. Distress means a lot of things to the people in different perspectives is a condition where a bank cannot meet or has difficulty paying off, its financial obligations to its creditors, typically due to high fixed costs, illiquid assets or revenues sensitive to economic downturns. But in a nutshell a bank is said to be distress if such a bank failed or unable to achieve the purpose for which it was created for.

Distress in banks connotes an unhealthy situation, enormous pain in the operational activities of bank resulting from a combination of highly volatile factors among which are lack of continuity and inconsistent policies, management inefficiency, undercapitalization.

**Banking Industry:**

Banking industry in Nigeria started during the colonial era with the establishment of colonial banks with the primary aim of meeting the commercial needs of the colonial government. Banking system in Nigeria is regulated through the central bank of Nigeria. This apex bank started its operation on July 1 1959. in 1892 African Banking Corporation and British west Africa now first bank of Nigeria, were established in Nigeria. In 1948 the British and French bank for commerce and industry started operations in Nigeria which metamorphosed into the united bank for African. The Nigerian banking system, which is regulated by the Central Bank of Nigeria; is made up of; deposited money banks referred to as commercial banks, development finance institutions and other financial institutions which include; micro-finance banks, finance companies, bureau de changes, discount houses and primary mortgage institutions.

The CBN in 2004 under the governorship of Charles Soludo increase the minimum capital base of all the banks from #2 billion to a minimum of #25billion which reduced the number of banks from 89 to 25 in 2005 and later to 24. Financial institution in the country is been regulated by two main bodies one the Central bank of Nigeria (CBN), secondly the Nigeria Deposit Insurance corporation (NDIC).

Failures in banking industry is a big problem confronting the financial sector in the world not only happening in Nigeria.

**Objective of the Study:**

The objective of this work is to critically examine the causes, effect of distress in the banking sector in Nigeria.

1. To provide the conceptual meaning of banking distress.
2. To examine the factors that contribute to distress in the banking industry
3. To evaluate the effect of banking distress on Nigeria economy
4. To examine the role that should be play by regulatory body.

Research Methodology:
The data for this study were obtained from various secondary sources. First, the publications of the Central Bank of Nigeria (CBN) which includes, banking supervision and Annual report. Secondly, reports from the Nigerian Deposit Insurance Corporation (NDIC). Thirdly, further information were sought from various journals.

5.0 Causes of banking distress in the Nigeria banking Industry:
There are so many factors responsible for banking distress in the banking sector in Nigeria among of which include the following:

Fraud and Forgeries:
Fraud and Forgeries is one of the key factors causing distress in the banking sectors.in many cases fraud and forgeries have led to the liquidation of many banking in Nigeria.
The causes of frauds and forgeries can be classified under two generic factors namely: the institutional or endogenous factors and environmental or exogenous factors. Institutional causes of frauds and forgeries in banks include poor accounting and weak internal control systems, ineffective supervision of subordinates, uncompetitive remuneration and perceived sense of inequity in reward, disregard of Know Your Customers (KYC) rules, et cetera. Environmental causes of fraud include undue societal demands, low moral values, slow and tortuous legal process, lack of effective deterrent or punishment and, at times, reluctance on the part of individual banks to report fraud cases due to the negative publicity it could attract for their image.
Given the quantum of frauds and forgeries in 2010, as highlighted in this section, it is important that banks should strengthen their operational risk management frameworks in the areas of internal control and security systems to reduce the incidence of frauds and forgeries. Insured banks should also thoroughly screen prospective employees by obtaining status reports from previous employers and relevant agencies and should desist from deploying casual staff to sensitive positions. Table 1 below show the extend of fraud and forgeries in the Nigeria banking Industry between 2009 and 2010 as published by NDIC (2010) Bank returns.

<table>
<thead>
<tr>
<th>QUATER</th>
<th>YEAR</th>
<th>TOTAL NO. OF FRAUD CASES</th>
<th>TOTAL AMOUNT INVOLVED (#’M)</th>
<th>TOTAL EXPECTED LOST (#’M)</th>
<th>PROPORTION OF EXPECTED LOST TO AMOUNT INVOLVED</th>
</tr>
</thead>
<tbody>
<tr>
<td>1ST</td>
<td>2010</td>
<td>325</td>
<td>4,671</td>
<td>1,757</td>
<td>37.62</td>
</tr>
<tr>
<td></td>
<td>2009</td>
<td>372</td>
<td>2,674</td>
<td>1,276</td>
<td>47.72</td>
</tr>
<tr>
<td>2ND</td>
<td>2010</td>
<td>232</td>
<td>4,206</td>
<td>2,767</td>
<td>65.79</td>
</tr>
<tr>
<td></td>
<td>2009</td>
<td>282</td>
<td>22,152</td>
<td>4,227</td>
<td>19.08</td>
</tr>
<tr>
<td>3RD</td>
<td>2010</td>
<td>403</td>
<td>8,300</td>
<td>6,438</td>
<td>77.57</td>
</tr>
<tr>
<td></td>
<td>2009</td>
<td>456</td>
<td>4168</td>
<td>1,220</td>
<td>29.27</td>
</tr>
<tr>
<td>4TH</td>
<td>2010</td>
<td>572</td>
<td>4,114</td>
<td>717</td>
<td>17.43</td>
</tr>
<tr>
<td></td>
<td>2009</td>
<td>654</td>
<td>12,268</td>
<td>827</td>
<td>6.74</td>
</tr>
<tr>
<td>AVERAGE/TOTAL</td>
<td>2010</td>
<td>1532</td>
<td>21,291.41</td>
<td>11,679</td>
<td>54.85</td>
</tr>
<tr>
<td></td>
<td>2009</td>
<td>1764</td>
<td>41,265.50</td>
<td>7,549.23</td>
<td>18.29</td>
</tr>
</tbody>
</table>


Political crisis:
Politics in 1993 brought about by June 12 presidential election in the country could be ascribed as one of the courses of financial crisis in the banking sector in the country.as a consequence of the financial insecurity engendered by the crisis due to long closure of banks depositors withdraw their funds from the banking system which lead to a lot of problems in the banking sector that even lead to the distress of many banks.

Macroeconomic instability:
Goldstein and Tunmer (1986) noted that macroeconomic volatility can cause banks to be vulnerable if it alters the relationship between the values of bank assets and liabilities.

**Weak Corporate Governance:**
Particularly inside abuse and contravention of supervisory regulation provisions and overbearing directions interest in loan and advances or any credit facilities are major causes of banking distress especially in a developing country like Nigeria. A study conducted by the research department of the bank revealed that in one of the then distressed banks in Nigeria, four of the erstwhile banks directors abuse their privileges and breached their fiduciary duties by engaging in several activities to the detriment of the banks depositors and other stakeholders. Specifically they obtained insider loans that constituted about 520 per cent of the banks total risk assets or about 50.5 per cent of the total loans and advances when the bank was liquidated in 1998. CBN publication January-march 2010.

5.5 Overtrading, assets mismatch and excessive risk taking indicating high loan to deposits ratio are significant causes of banking distress. CBN publication January-march 2010.

**Inadequate Reserve Requirement:**
A reserve requirement are requirements regarding the amount of cash a bank must hold in reserve against deposits made by customers. Bank failures arises or occur because bank do not keep all their deposits in statutory reserve fund as mandated or require by the regulatory body.

**Deregulation of banks:**
This is one of the factors responsible for distress in the banking industry whereby government remove the regulations governing the financial sector exposing the bank to financial crisis. Edogah (1996) also emphasized that free banking encourages banks to engage in deceptive operations and over-expansion, which makes bank fail. The table 2 below show the number of distress bank between 1988 to 1995.

<table>
<thead>
<tr>
<th></th>
<th></th>
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<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>No of distress bank</td>
<td>7</td>
<td>8</td>
<td>9</td>
<td>15</td>
<td>16</td>
<td>26</td>
<td>45</td>
<td>57</td>
</tr>
</tbody>
</table>

Sources: NDIC Annual Report 1995

**Political Interference:**
This is also another major causes of banking distress in Nigeria most in most cases governments influenced banks to give loans to certain borrowers that discouraged banks from properly assessing the credit worthiness of borrowers and eventually destabilized banks financial standing. Goodhart (1998) point out that political directed lending leads to banking crisis. The NDIC/CBN study (1995) concluded that distress in the financial system was of generalized type based on the theory described above and in the light of available statistics and levels of the ratio of relevant variables. Table 3 below shows the selected indices of distressed banks in Nigeria between 1997 – 2004.

<table>
<thead>
<tr>
<th>Description</th>
<th>1997</th>
<th>1998</th>
<th>1999</th>
<th>2000</th>
<th>2001</th>
<th>2002</th>
<th>2003</th>
<th>2004</th>
</tr>
</thead>
<tbody>
<tr>
<td>No of distressed banks</td>
<td>9</td>
<td>26</td>
<td>60</td>
<td>47</td>
<td>30</td>
<td>18</td>
<td>14</td>
<td>8</td>
</tr>
<tr>
<td>Ratio of non-performing risk asset of total asset (%)</td>
<td>73</td>
<td>77</td>
<td>75</td>
<td>63</td>
<td>65</td>
<td>69</td>
<td>75</td>
<td>82</td>
</tr>
<tr>
<td>Amount required to recapitalize distressed banks(#Billion)</td>
<td>2</td>
<td>2.4</td>
<td>5.5</td>
<td>13.6</td>
<td>23.4</td>
<td>30.5</td>
<td>43.9</td>
<td>42.8</td>
</tr>
<tr>
<td>Total Deposit of distressed Banks(#Billion)</td>
<td>6.4</td>
<td>2.6</td>
<td>15.9</td>
<td>20.8</td>
<td>41.6</td>
<td>42.6</td>
<td>48</td>
<td>312</td>
</tr>
</tbody>
</table>

Source: NDIC Quarterly Report September/December 2004. As shown in the table above the number of distressed bank fluctuated from 9 in 1997 and rise to 60 in 1999 and later dropped to 47 in 2000 and continually till 2004. when CBN governor professor Charles chukuma soludo brought out banking recapitalization.
Effect of banking distress on Nigeria economy:
Financial distress has far reaching the economy of the country Nigeria some of the effect are:
As alluded to earlier, a healthy banking system generally contributes to strong economic growth, while banking crisis can present a substantial drag on the real economy as it reduces the amount of financial intermediation undertaken and consequently a decline in investment and aggregate economic activity in the economy. By the nature of their business, banks tend to be highly leveraged and incur a mismatch in the maturity of assets and liabilities, which make them susceptible to deposit runs. Banks’ intermediation function entails that they link most sectors of the economy. Hence, on one hand, banking sector difficulties have an effect outside the banking sector, and on the other, shocks to any one sector are reflected in bank performance and can be transmitted through the banking system throughout the economy. For instance, the fall in the price of oil has affected the banks indirectly. Banking crises intensify slowdown in economic activities, prevent loanable funds from being allocated to their most productive uses, reduce the availability and increase the cost of funds to small and medium-size businesses and seriously constrain the conduct of monetary policy, among others. In developing economies, like Nigeria, banks are the major participants in the financial systems. They operate the payments system, provide liquidity to fledging securities markets and are major purchasers of government securities. Given the major role of banks in these economies, it is easy to conclude that the collapse of the banking system causes serious negative externalities for the rest of the economy. These externalities take various forms.
Bank distress leads to increases in interest rate as depositors ask for higher rates of return for perceived higher chances of bank failure and consequent risk of financial loss.
Bank distress has degenerated into bank failure and loss of depositors funds. The maximum amount refundable to each account holder under the Nigeria Deposit Insurance Corporation(NDIC) cover for failed banks is #50,000 irrespective of the value of deposit. Depositors who have more than #50,000 outstanding to the credit of their account are not paid the difference.

Conclusion
Nigeria experienced distress in the banking industry started between 1930 and 1950 in fact between 1930 and 1958 21 banks failed in operation the reasons for the failures are not far-fetched. They included the absence of a supervisory and regulatory authority, outright fraud, and unfavorable competitive environment. This led to the loss of confidence in the banking industry
In an attempt to restore the confidence back to the people in the banking industry government created Nigeria Deposit insurance Corporation (NDIC) in 1988. The function of this NDIC was to give relief to depositors in the case of unexpected failure of the banks and also to examine the operations of the banking system in the country.
There is no doubt that NDIC has improved the confidence of people in the industry and also assisting monetary authorities in the formulation and implementation of policies so as to ensure sound banking practice and fair competition among insured financial institutions in the country.

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