

Evidence Determination of Bank Failure Eradication in the 21st Century Nigeria

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Abstract

The banking industry has lost its position as the bedrock of Nigerian economy due to abysmal performance of the economy. The industry is known to have contributed in no small measure to the development of the economy. This industry is the enabling hub of national and global payment systems, which facilitate trade transactions within and amongst numerous national, regional and international economic units and by so doing; it enhances commerce, industry and exchange. An effective failure resolution mechanism is critical for sustenance of public confidence. A number of failure resolution options exist, some of which are used for salvaging a distressed institution from total collapse. Notwithstanding the option used, an effective resolution option should among others, focus on: maintaining public confidence and stability in the banking system; ensuring fairness, equity, transparency and accountability; instilling market discipline while discouraging moral hazards; and achieving minimum disruption to the payment system. The research is empirical. The study covers the banking industry with the use of corporate questionnaire to gather data from each of the sample representatives which are One hundred and five (105) bank customers in Gombe metropolis. Pearson product coefficient of correlation was used to compute the collated data.

Keywords: Bank failure resolution options in Nigeria; Resolution framework; Customer confidence and Stability in the Nigeria Financial system

Introduction

Background to the study

Banking institutions perform essential intermediation functions in the economy. They allocate financial resources from savings to investments and consumption, provide vehicles for wealth accumulation, and perform maturity transformation functions that facilitate the financing of long-term projects, provide liquidity, and facilitate a payment, clearing and settlement function in the economy, including cross-border payments. As these institutions grow in size and sophistication, they provide economies of scale, cost-effectiveness, efficiencies and risk-management processes that benefit their customers and the economy at large. Without a well-developed, safe and efficient financial system, growth in the real economy is constrained.

However, as financial institutions become larger and more sophisticated, they also become increasingly complex, interconnected and integrated into the fabric of the real economy. As a result, the failure of a single Banking institution could result in a deadlock in critical financial markets and services, which could quickly spread through the financial system to other markets and institutions, and which could result in economic costs that vastly exceed the costs of the initial single failure. Past experience has shown that normal corporate insolvency arrangements are inadequate to deal with the potential financial system instability caused by the failure of some banking institutions. Because of the destructive impact that the failure of some Banking institutions could have on the real economy, especially if such institutions are large, complex or very interconnected, they are often regarded as being 'too big to fail', with a general expectation among depositors and investors that they will always be rescued if they do fail, most likely with taxpayer funds. Financial institutions that have the potential to dislocate a whole financial system and cause severe real economic costs if they fail have come to be referred to as systemically important financial institutions.

Banks are most likely to be designated systemically important financial institutions from a resolution perspective because of their

deposit-taking, maturity transformation and payment system roles. One of the key functions of banks in the economy is to facilitate the maturity transformation of money, that is, to turn short-term savings into long-term credit. Banks fund themselves mainly through deposits and deposit-like instruments with relatively short maturities. They use this short-term funding to provide longer-term credit, such as mortgages. This balance-sheet structure exposes banks to liquidity risk (i.e., the risk that short-term funding can be withdrawn instantly, while longer-term loans are only repaid over years).

Because of banks' high liquidity risk, they require a different approach to their rescue or resolution than other types of businesses. A non-bank corporate normally approaches insolvency over an extended period and the deterioration of its financials becomes apparent over time. However, even a relatively well-managed and profitable bank can experience liquidity problems, sometimes as a result of external factors. When the public or financial markets lose confidence in a bank or the banking sector, deposits are withdrawn and sources of short-term funding dry up. Even a solvent bank can fail if it cannot access funding with which to service its expenses, repay deposits and other liabilities as they become payable, and finance its longer-term loans and other assets. Resolving a bank in these circumstances requires immediate intervention, which is not provided for in the normal insolvency processes.

Another reason why banks, in particular, require specific resolution arrangements is because they are closely interconnected with each other, the rest of the financial system and the real economy. The failure of a bank, in particular a large bank, can have catastrophic socioeconomic

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consequences, cause severe hardship among depositors and disrupt financial stability. Unlike other types of companies, it is not only the shareholders and creditors that bear the losses of the institution, but also the broader economy and often the taxpayer. Therefore, a special resolution framework should be in place to enable and empower the regulators and authorities to intervene in a distressed bank at an early stage, without necessarily having to wait for the initiative and approval of shareholders or the Board of Directors (Board) or for the point of balance-sheet insolvency.

The financial intermediation role of banking institutions exposes banks to the risk of failure with losses capable of undermining public confidence in the banking system and consequently affecting the other sectors of the economy. This scenario was vividly demonstrated in the global financial crises which originated from United State of America in 2008 and spread to the rest of the world, in spite of the sophistication and intensity of banking supervision by the United State Regulatory Agencies.

In Nigeria jurisdiction, the history of banking business is replete with periodic and generalized failures. From the available record, there was rapid growth in the number of indigenous banks within a spate of few years between 1947 and 1952 with no supervision. The outcome was that, the collapse of these banks was just as rapid as they were established. In all, a total of 25 indigenous banks failed in the early 1950s Adeyemi.

During the reference period, there was no banking regulation framework in place and the period is refer to as the era of free banking. The main causes of bank failure in the free banking era included under-capitalization. Inadequate management skills and lack of regulation and supervision (CBN/NDIC) [1]. Furthermore, there was no formal or informal deposit protection scheme in place and hence all the depositors of the failed banks had to bear the burden of the failure with associated erosion of public confidence in the banking system. That experience partially led to the establishment of the Central Bank of Nigeria (CBN) in 1958 and the Nigeria Deposit Insurance Corporation (NDIC) in 1988.

Problem statement

The Nigeria experience with respect to bank failures did not, however, end with the establishment of the CBN nor was bank failures exterminated by the development and evolution of the financial safety architecture principally comprising of bank regulation and supervision, lender of last resort facility of the CBN and the deposit insurance cover from the NDIC. In particular, the country experienced a quick succession of generalized bank failures between 1994 and 2008.

After the banking consolidation of 2004-2005 which shrank the number of banks in Nigeria from 89 to 24, it was generally believed that a major banking crisis had been averted. It was the consensus amongst financial experts then that the emerging local mega-banks had the muscle and financial resilience to withstand any form of financial misfortunes. Barely two years later, it was quickly realized that there appeared to be no relief in the sight as more than 40% of the “24 megabanks” were soon to be classified as failing or failed banks which invariably created a wrong perception and eroded public confidence in the Nigeria banking system. An effective failure resolution mechanism is critical for sustenance of public confidence. A number of failure resolution options exist, some of which are used for salvaging a distressed institution from total collapse. Notwithstanding the option used, an effective resolution option should among others, focus on: maintaining public confidence and stability in the banking system;

ensuring fairness, equity, transparency and accountability; instilling market discipline while discouraging moral hazards; and achieving minimum disruption to the payment system.

Objective of the study

In the light of the above, the objective of the study include:

1. To identify Bank failure resolution options applicable in the Nigeria context.
2. To examine how these resolution options create stability and maintain public confidence in the Nigeria financial system.

Statement of hypotheses

Two hypotheses were formulated to be tested as follows:

Ho: The Bank failure resolution options adopted in Nigeria has not enhanced public confidence and stability in the Nigeria Financial system.

H1: The Bank failure resolution options adopted in Nigeria has enhanced public confidence and stability in the Nigeria Financial system.

Literature Review

Introduction

The disposition plan by a regulatory authority for a failed or failing banking institution is refers to as Bank failure resolution. Such a resolution is often operationally designed to protect insured deposits partly of fully. In protecting the depositors, the regulatory authority, generally called “Deposit Insurance Institutions” would often choose resolutions strategies that tend to minimize the cost of such intervention. The objective of minimizing the cost of resolution stems from the fact that the insurance premiums paid by the insured financial institutions generally fall far below the cost of protecting depositors especially if the failure of banks is generalized and systemic in nature.

Resolution framework and strategy

In resolving failing or failed banks worldwide, the practice is to have some arrangement to protect depositors and the most common strategy in contemporary times is to establish the deposit insurance supervisory agency which is backed by the necessary enabling laws of the particular jurisdiction, otherwise there would be more and series of litigations from aggrieved owners and directors of the failing banks.

The banking system in virtually all countries of the world seem to be fragile, illiquid or insolvent, whether one refers to United States, Germany, France, Benin Republic Nigeria etc. However, the nature and the extent of the bank fragility differ greatly and consequently, there is a broad variation in the countries’ framework and practice to resolve banks failure. While some countries rely entirely on judicial pronouncements declaring banks insolvent, others delegate such responsibility to bank regulators and supervisors with little or no ex-post court intervention or injunctions. In some countries especially Brazil, the deposit insurance company is set up as a pay-office to settle depositors of failed banks whereas in other jurisdictions such as United State, the deposit insurer has both supervisory and resolution roles for failing banks. This is the model that Nigeria has adopted in which the mere supervision of banking institutions in an indirect resolution strategy on its own because it is a preventive and monitoring strategy against the probability of failure.

The effective and timely intervention and resolution of failing banks often prevents aggressive risk taking by banks thereby reducing bank fragility and in spite of the need for such timelines, deposit insurers (NDIC in particular) are often slow or cautious in closing banks allowing for a reasonable period of regulatory capital forbearance, especially if the failing banks individually or jointly are of systemic importance to the economy. The Nigeria experience in 2009 -2011 supports this scenario where the troubled banks were really not closed due to their systemic importance. Indeed, Nigerian banking regulators and policy makers often have great difficulties and less success in dealing with the situation when a large or too-big-to-fail banks or even the banking industry as a whole is faced with a crisis. Since the establishment of the NDIC in 1988 in Nigeria, the choice of bank failure resolution has always depended on the causes and degree of bank failure in the country. In dealing with failing or failed banks therefore, the CBN and NDIC in Nigeria have available to them, a menu of resolution options.

Bank failure resolution options

There are four bank failure resolution methods available to a regulatory agency: 1. Liquidation (Deposit payoff and closure), 2. Takeover by another bank (purchase and assumption), 3. Government ownership (Nationalization), and 4. Open bank assistance without transfer of control (forbearance) [2,3]. Excluding forbearance, the other three policies usually have the same effect on bank equity holders- they lose, possibly everything.

Empirically, the way bank failure is handled by different regulators diverge considerably. Dewatripont and Tirole [3] compare bank failure resolution policies used in the U.S, Japan, Finland, Sweden, and Norway. Goodhart and Schoemaker survey 104 bank failure in 24 countries between 1970 and 1992 and find that liquidation is the exception rather than the rule [4]. Freixas characterizes the optimal regulatory policy in an individual bank crisis on the basis of a cost benefit analysis [5]. His main finding is that, depending on a bank's characteristics, the optimal policy may be either to bail out the failed bank or to use a mixed strategy.

It has been a tradition that the regulatory authorities (NDIC and CBN in the case of Nigeria) hardly closed any bank without a reasonable period of warning. Before any resolution option is determined, the bank supervisor (CBN) and the deposit insurer (NDIC) often strategize a sequence of action for the failing bank(s) to follow. The strategic pills often recommended to cure or prevent further deterioration include amongst others:

1. Requesting the failing bank to provide a recapitalization of capital improvement plan.
2. Arrange for the appraisal of assets and liabilities of the failing bank.
3. Place the failing bank into what is called conservatorship.
4. Grant the failing bank the opportunity to visit the Central Bank of Nigeria's special window called "Expanded Discount Window".
5. Granting the failing bank special facility.

It is after all these efforts fail that the failure resolution menu is visited. It should be noted that the deposit insurer and the bank supervisors often apply a mix of such resolutions as was the case in 2010-2011 contemporary bank failure resolution in Nigeria when a combination of Bridge bank, Purchase and assumption and Asset purchase were used [6].

Purchase and assumption

The purchase and assumption resolution strategy is a scenario where a healthy bank or a healthy group of financiers or investors assume all or some of the obligations and purchase some or all of the failed bank's assets [7]. The regulators always prefer the assumption of all the liabilities. The objectives of choosing this resolution model are:

1. The cost of Purchase and Assumption is less than the cost of payout in most cases.
2. It is less disruptive because the services and operations of the failed bank can continue under the new owners, thus preserving confidence in the failed bank and the system.
3. It covers all deposit and redemption can actually be negotiated and spread out in a less painful manner.

Bridge bank

This is a situation when a temporary bank is created out of the failing or failed bank and is usually managed by an interim management board chosen by the supervisory agency. Generally, a failed bank turned into a bridge bank is recapitalized by a government agency and that is why it is also known as national bank. This was the case of the three failing banks that were taken over by the CBN/NDIC in Nigeria in 2009. In this particular scenario, former Afribank became Mainstreet Bank, Bank PHB changed into Keystone Bank while Spring Bank transfigured into Enterprise Bank [8]. The essence of a Bridge Bank is to allow the bank to be run and prepared for eventual sale to willing and able buyers. As in the case of the three bridge banks formed in Nigeria, Mainstreet Bank and Enterprise bank have been successfully sold to Skye Bank and Heritage Bank respectively while Keystone Bank is still under process. The principal reason for a bridge bank resolution options are:

1. Bank has an attractive franchise and reputation and in danger of failing so rather than allow it to fail, a bridge is formed.
2. To maintain daily operations and functions of the bank because of its name and franchise.
3. If the bank is systemic importance or too-big-to-fail, bridge can be form until a new, willing and able suitor is found to buy the bank.
4. In the case of Nigeria, this is the first of its kind and it made the depositors and the creditors of the Bridge bank to have more confidence in the system as well as their bank.
5. The establishment of the bridge provides the Regulatory Agencies more time to prepare the bridge bank for sale.

Asset purchase

In this type of resolution, the supervisory agency or a non-performing asset resolution company such as the Resolution Trust Corporation (RTC) in the United States or the Non-performing Assets Recovery Tribunal (NPART) in Ghana of the Asset Management Corporation of Nigeria (AMCON) is allowed to purchase the assets of the failed bank. The main reason for this resolution strategy are:

1. To maximize future recoveries and minimize resolution cost.
2. It can help greatly in restructuring the failed bank.

This option was partly utilized in Nigeria when Asset Management Corporation of Nigeria (AMCON) purchased virtually all the toxic assets of failed banks in order to reduce their liquidity pressure and

mountain of non-performing risk assets. Thus their books were cleaned in preparation for sale to new investors and this explained why some of the acquired failed banks namely Oceanic Bank International, Finbank, Union bank, Equatorial Trust Bank and Intercontinental Bank found willing and able buyers [9].

Research Methodology

The population for this study is taken from selected customers of some banks in Gombe metropolis that were affected by the contemporary bank failure resolution options in Nigeria. The sampling method used to select one hundred and five (105) customers out of the population was simple random sampling technique [10]. With this sampling procedure, every customer had an equal chance of being selected out of the population of the study. The statistical technique for data analysis and test of hypothetical proposition is the Pearson product coefficient of correlation (r), used in analyzing and interpreting responses connected with the main variables of the hypothesis. A survey approach was adopted in generating data for the study. This was achieved through the distribution of 110 copies of questionnaires (only 105 were returned) and secondary data were sourced from NDIC publication and reports.

Model specification

The statistical formulae Pearson product coefficient of correlation (r) was used in analyzing and interpreting responses connected with the main variables of the hypothesis. The Pearson product moment of correlation is given as:

$$r = \frac{n \sum xy - \sum x \sum y}{\sqrt{\{n \sum x^2 - (\sum x)^2\} \{n \sum y^2 - (\sum y)^2\}}}$$

From the formula:

n=number of options

x=points allocated to the options

y=number of responses from respondents

Where X and Y are the variables being considered. The dependent variable is denoted as Y while the independent variable is denoted as X.

The interpretation of the result of r is that when r=0, there is no relationship between the variables tested. When 0<r<0.4, there is weak correlation between the variables and when r ≥ 0.5 then there is a strong correlation between the variables. When r is negative the (-) the variables are inversely related and if positive (+) the variables are directly related.

A reliability test was done on the result of the data analysis by means of a test of significance in order to determine the reliability of the findings and further justify the result of the correlation test done. The test of significance was used to justify the results. The decision rule here is that once the t calculated (t-cal) is greater than the t tabulated (t-tab) value at a chosen significance level and at a given degree of freedom. We would then reject Ho and accept Hi otherwise we accept H0 and reject H1. H0=Null Hypothesis and H1=Alternate Hypothesis. The chosen significance level is 95% (P value=0.05) and the degree of freedom (d.f) is given as d.f=n-2=(5-2)=3, therefore the degree of freedom is 3. The essence of the significance test is to prove the relationship of two variables as it has been argued that a correlation coefficient does suggest a relationship between two variables. The reason for this type of data collection was to enable easy clarification of data.

One hundred and Ten (110) questionnaires were administered in this study. The questionnaires that were returned by the selected customers were one hundred and five (105).

The data analysis and hypotheses testing are presented below:

Hypothesis Testing

Hypothesis 1: Ho: The Bank failure resolution options adopted in Nigeria has not enhanced public confidence and stability in the Nigeria Financial system.

I: To test this hypothesis, the responses to the statement “there has been effective bank failure resolution options in Nigeria that enhanced public confidence and stability in the Nigeria financial system “contained in the questionnaire was used (Table 1).

Options	Point (X)	Responses (Y)	XY	X ²	Y ²
SA	5	58	290	25	3364
A	4	44	175	16	1936
SD	3	0	0	9	0
D	2	0	0	4	0
UD	1	3	3	1	9
Σ	15	105	468		5309

Table 1: Calculation of correlation.

The questionnaire was close ended and designed in a simple-to-answer form with liker scale in use: Strongly Agree (SA), Agree (A), Strongly Disagree (SD), Disagree (D) and undecided (UD) with scores 5,4,3,2 and 1, respectively.

$$r = \frac{n \sum xy - \sum x \sum y}{\sqrt{\{n \sum x^2 - (\sum x)^2\} \{n \sum y^2 - (\sum y)^2\}}}$$

$$r = \frac{5(468) - (15)(105)}{\sqrt{\{5(55) - 15^2\} \{5(5309) - 105^2\}}}$$

$$r=0.8684$$

Decision: Since r is 0.8684 and it is greater than 0.4 we reject Ho and accept H1. This means that Bank failure resolution options adopted in Nigeria has enhanced public confidence and stability in the Nigeria Financial system.

Significance Test:

$$t = \frac{n-2}{\sqrt{1-(r)^2}}$$

$$0.8684 \sqrt{\frac{5-2}{1-0.754118}}$$

$$T \text{ calculated} = 3.03$$

Final Decision: Since the t calculated of 3.03 is greater than the 2.32 at 95% significance level where degree of freedom is 3, therefore we simply reject the Ho and accept H1. From this we conclude that, Bank failure resolution options adopted in Nigeria has enhanced public confidence and stability in the Nigeria Financial system.

Secondary Data Presentation

The resolution framework was tested during the crisis in 2009 where the authorities, after conducting the special examinations, invoked various resolution measures to resolve eight banks in Nigeria. The Table below summarizes the resolution measures taken (Table 2).

Resolution Tool	Relevant Time	Banks Involved
Replaced management in eight banks and the injection of ₦620 billion of liquidity into the banking sector.	August 2009 and Oct 2009	Intercontinental Bank
		Bank PHB
		Spring Bank
		Wema Bank
		Oceanic Bank
		Union Bank
		FinBank
		AfriBank
Recapitalization with shareholder's vote	Sep-10	Wema Bank Unity Bank
AMCON bought NPLs	Jan-11	Intervened banks and others
M&A with shareholder's approval and court sanction	Jul-11	Intercontinental Bank (Access Bank)
		Oceanic Bank (EcoBank Transnational)
		FinBank (FCMB)
		Equatorial Trust Bank (Sterling Bank)
		Union Bank (African Capital Alliance)
Bridge-banks and recap by AMCON	Aug-11	Keystone Bank (Bank PHB)
		Enterprise Bank (Spring Bank)
		Mainstreet Bank (AfriBank)

Source: NDIC2017

Table 2: Resolution framework.

Findings

Adequate care has been taken in this study to examine the bank failure resolution options in Nigeria. The research work also examined the extent to which the resolution options used enhanced public confidence and stability in the Nigeria financial system.

Respondents agreed that the resolution options used by the NDIC in the 21st Century Nigeria have enhanced their confidence in the Nigeria Financial system and that the regulators assertion that Nigeria Banks are too big to fail will really stand.

Conclusion

The Nigerian financial system experienced a contemporary banking crisis in 2008-2009, partly triggered by the global financial crisis and by domestic events. A special examination revealed that 8 banks, accounted for about a third of the banking system assets were either insolvent or undercapitalized. The authorities responded with a comprehensive range of measures that ultimately mitigated the shock of the banking crisis. The Central Bank of Nigeria (CBN) injected ₦620 billion of liquidity into the banking sector. The Asset Management Corporation of Nigeria (AMCON) was established to purchase nonperforming loans (NPLs) of banks and to recapitalize banks. The decisive crisis response effectively stabilized the banking system and create confidence in the Nigeria financial system.

Therefore, it is recommended that the new code of corporate

governance for banks should be strictly adhered to by all banks in the nation, as this will enable banks to operate in a safe and sound manner and as such, lead to restoration of public confidence in the banking system. Thus, ensuring a better economy.

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