Restructuring and Reenergizing Troubled Banks: The Role of Bank Supervisors and Regulators

By
Mr. Haruna Mustafa
Director, Banking Supervision Department
Central Bank of Nigeria

11.0 Introduction

Globally, the role of financial regulators and supervisors is to maintain a safe and stable financial system within the broad spectrum of macroeconomic stability. Financial stability gained importance in the early 1930s during the Great Depression era in the United States. Reported cases of banks' inability to meet customers' withdrawal requests due to cash shortages generated public panic prompting the Government to take steps to protect bank depositors through legislation and regulation. Financial regulators and supervisors, therefore, began to pay greater attention to the conduct of banking business to ensure the stability of the system while also preserving the confidence of customers in the banking system.

Despite the efforts of financial regulators and supervisors to maintain financial stability, evidence abounds that several bank failures have occurred across the globe since the Great Depression[23]. According to Adeyemi (2011), the Nigerian banking sector has experienced no fewer than 64 bank failures since the promulgation of the 1952 Banking Ordinance. Factors responsible for these failures were largely idiosyncratic, some of which were ownership structures, capital inadequacy, poor corporate governance, weak/ineffective internal control, and poor credit administration processes resulting in a huge non-performing loan portfolio. It should be noted that bank failures cannot be absolutely obliterated by Regulators and Supervisors nevertheless. As a result of the heavy impact of this ugly and recurring development, regulators and supervisors in the Nigerian financial system, such as the Central Bank of Nigeria (CBN) and Nigeria Deposit Insurance Corporation (NDIC), continue to develop reforms and regulations to foster stability in the financial system.

This paper, therefore, discusses the role of regulators and supervisors in restructuring and reinvigorating troubled banks, with a focus on the CBN's efforts in this regard. The paper is divided into five sections. Following the introduction is Section 2, which discusses the concept "troubled bank." Section 3 looks at the legal and regulatory tools available to manage troubled banks. Section 4 evaluates the CBN's experience in managing and restructuring troubled banks. Section 5 discusses the future outlook for Regulators and Supervisors in ensuring that the banking system remains resilient, and Section 6 concludes the paper.

11.1 Concept of a Troubled Bank

The International Association of Deposit Insurers defined a troubled bank as "a bank that has, or will have, impaired liquidity or solvency unless there is a major improvement in its financial resources, risk profile, strategic business direction, risk management capabilities and/or quality of

[23] The Great Recession was the sharp decline in economic activity during the late 2000s. It is considered the most significant downturn since the Great Depression. The term Great Recession applies to both the U.S. recession, officially lasting from December 2007 to June 2009, and the ensuing global recession in 2009.

management." Other literature describe a bank as "troubled" or "failing" when its indicators of financial soundness begin to deteriorate due to unsound practices or systemic factors. Generally speaking, a troubled financial institution exhibits one or all of the following characteristics:

(a) gross undercapitalization in relation to the level of operation;
(b) high level of classified loans and advances;
(c) illiquidity reflected in the inability to meet customer's cash withdrawals;
(d) low earnings resulting from huge operational losses and
(e) weak management as reflected by poor credit quality, inadequate internal controls, high rate of frauds and forgeries, and labor turnover.

In the Nigerian banking industry, Section 34 of the BOFIA 2020 and the Supervisory Intervention Framework for Nigerian Banks (2011) encapsulates criteria for recognizing that a bank is tending towards failure. The BOFIA describes a bank as failing if such as bank:

(a) is likely to become unable to meet its obligations under the Act;
(b) is about to suspend payment to any extent;
(c) is insolvent; or
(d) where, after an examination, the CBN is satisfied that the bank is in a grave situation.

The Supervisory Intervention Framework for Nigerian Banks, on the other hand, leverages financial soundness indicators of capital, liquidity, asset quality, and earnings as the basis for identifying a troubled bank.

11.2 Legal and Regulatory Tools for managing Troubled Banks

The failure of a financial institution can destabilize the domestic economy and imperil public confidence in the financial system. The responsibility of the Regulator and Supervisors, therefore, in detecting early and taking proactive steps to remedy the indicators of possible failure of a bank cannot be over-emphasized. Having provided a contextual perspective in the preceding section on the characteristics which a troubled bank exhibits, this section discusses the powers and tools available to the CBN in the legislative and regulatory frameworks to nurture a failing or troubled bank back to financial soundness.

11.2.1 Provisions of BOFIA 2020

The BOFIA 2020 was enacted to strengthen the regulatory and supervisory framework of the Nigerian banking industry, the key of which is prioritizing the rescue of troubled institutions to avert eventual failure. The Act provides a range of options and tools for the CBN to deploy in preventing the failure of a bank. These are summarized as follows:

i) ***Section 33*** - On the order of the Governor, a special examination of the books and affairs of a bank can to commissioned to detect beforehand concerns that could lead to the failure of the bank if not remedied early.

ii) ***Section 34 (2) (a – i)*** - on the written order of the Governor, the following restrictive and holding actions can be imposed on a bank in troubled waters with the aim of restoring the bank to soundness.

- ***Prohibition of further extension of credit facilities*** – troubled banks can be stopped from granting new loans and loan enhancements where credit administration is weak, resulting in the build-up of non-performing loans and the gradual erosion of capital.

- ***Suspension of any payment or delivery obligations on a contract*** – contractual obligations to make payments can temporarily be suspended to prevent pressure on the bank's liquidity.
- Removal of any director, managers, or officers as the CBN may deem necessary to strengthen corporate governance.
- Appointment of any person or persons as directors of the bank.
- Appointment of Advisers for the bank.

The Section further empowers the CBN to:

- ❖ Require 3rd party service providers to the bank to continue in that capacity for such period as may be specified in the Order; and
- ❖ Acquire the shares of the troubled bank to a level that confers control on the CBN.

iii) ***Section 37 – 42:*** where the restrictive actions above do not restore the bank to soundness, Sections 37 – 42 of the BOFIA stipulate rescue tools that can be utilized by the CBN.

- ❖ ***Bail-in*** – the CBN may issue a bail-in-certificate to cancel, modify, convert or change the form of any eligible instrument issued by the failing bank;
- ❖ ***Asset separation*** – assets of the failing bank can be transferred by the CBN to a private asset management vehicle without the consent of the shareholders.
- ❖ ***Sale of business*** – the CBN is empowered to transfer shares or other instruments of ownership issued by the failing bank to a purchaser on commercial terms.

iv) ***Section 36*** – Agencies of Government are mandated in this section to cooperate with and render assistance by granting waivers and forbearances as may be required by the CBN to resolve a banking crisis.

11.2.2 Provisions of the CBN's Supervisory Intervention Framework for Nigerian Banks 2011

The Supervisory Intervention Framework for Nigerian Banks, issued by the CBN in February 2011, provides general and specific thresholds for regulatory interventions in banks in respect of the specified prudential indicators of capital, liquidity, asset quality, and earnings. The Framework stipulates Prompt Corrective Action (PCA) be taken in response to any financial institution's deteriorating compliance or performance in respect of each indicator, some of which are stated below.

i) Deficiency in Capital Adequacy Requirement – PCA for under-capitalized to critically under-capitalized banks include:

- ❖ Restriction of investment in subsidiaries and related companies;
- ❖ Restriction of investment in fixed assets;
- ❖ Restriction on dividend payments;
- ❖ Restrict new lending to recoveries made on non-performing loans;
- ❖ Conduct of special examination;

The Management of the bank may be requested to submit a business plan to recapitalize the bank, and where the recapitalization is unsuccessful, the CBN can take over and inject funds to stabilize the bank or appoint the NDIC to restructure and create incentives for an acquisition by a healthier bank.

ii) ***Illiquidity*** – for banks adjudged slightly illiquid to critically illiquid, the regulatory actions that can be taken to reverse the trend include:

- ❖ CBN to conduct a spot check on the bank to investigate the cause of the illiquidity;
- ❖ Invitation of the Board and Management for discussion on how the problem would be addressed;
- ❖ Request the bank to realize assets that do not qualify for inclusion in liquidity computation;
- ❖ Request the bank to embark on debt recovery;
- ❖ Advise the bank to divest from subsidiaries or related companies;
- ❖ Advise the bank to seek short-term liquidity support from the NDC,

The CBN can also provide financial support to the ailing bank as a lender of last resort. PCA is specified for poor asset quality and deteriorating earnings.

11.2.3 Regulatory forbearances

Regulatory forbearances are the discretionary decision of the CBN to refrain from applying certain regulatory requirements or reducing the scope of regulation to prevent contagion that may lead to a financial crisis. It can also be described as the decision by the CBN to grant additional time to a troubled bank, to meet regulatory requirements without applying relevant provisions of the law, including sanctions and penalties. Regulatory forbearance is exclusively at the discretion of the CBN to exercise when prevailing circumstances do not favor the application of rescue options or tools on an ailing bank. Other factors that influence the grant of regulatory forbearances are the cost of resolution, political pressure, concerns about the overall health of the financial system, etc.

11.3 The CBN's Experience in the Restructuring of Troubled Banks

Looking at the last two decades, four distinct periods of intervention by the CBN to safeguard the banking system from collapse can be discussed. These were the banking consolidation of 2005, the second-round effect of the global financial crisis of 2007- 2008, the period of the economic downturn in 2015/2016, and the very recent COVID -19 pandemic-induced crisis of 2019/2020.

11.3.1 The 2005 bank consolidation programme – The bank consolidation programme was part of a 13-point banking reform agenda announced by the CBN Governor on July 6, 2004, to the Bankers Committee. The two major elements of the reform agenda were the requirement for banks to increase their Shareholder Funds to a minimum of N25 billion by December 31, 2005, and consolidation within the industry through mergers & acquisitions (Imala 2005). The objective was to ensure the safety of depositors' funds, position banks to play an active developmental role in the Nigerian economy, become major players in the sub-regional, regional and global financial markets, and compete favorably with international banks (Odeleye 2014). The Guideline and incentives on consolidation issued by the CBN in August 2004 specifically recognized only 2 legal modes of consolidation; mergers and outright acquisition/takeovers. In addition to the regulatory-induced business combinations, the CBN made pronouncements to write off 80% of the debt owed to the CBN as forbearance for the weaker banks. Several incentives were also declared by the CBN to drive the consolidation programme. This included tax incentives, participation in the foreign exchange market, etc.

At the close of the year 2005, 25 well-capitalized banks emerged from the recapitalization and consolidation programme, while the operating licenses of 14 banks that were unable to meet the new capital requirements were withdrawn, and the banks liquidated.

11.3.2 The 2nd round effect of the global financial crisis – According to Wikipedia, the global financial crisis of 2007/2008, which began with the United States of America, was the result of predatory lending targeting low-income homebuyers, excessive risk-taking by global financial institutions and the bursting of the United States housing bubble Mortgage-backed Securities tied to American real estate collapsed in value. Financial institutions worldwide suffered severe losses reaching a climax with the bankruptcy of Lehman Brothers in 2008 and a subsequent international banking crisis. By the last quarter of 2008, European and US declared an economic recession in their regions.

The initial impact of the crisis was not felt by the banking industry in Nigeria as the banks, though well-capitalized, were not major global players. However, as the recession deepened, the second-round impact of the crisis affected the domestic banks and the economy, given Nigeria's high dependence on proceeds from crude oil exports and foreign capital inflows. Inflows from both sources, however, thinned out considerably due to the recession in the global economies. The effect of the crisis was most felt in the Nigerian capital market, where the All Share Index (ASI) declined by 45.8 % from the end of 2007 to the end of 2008, while equity market capitalization declined by 32.4%. The capital market downturn had a negative impact on the bank's balance sheet through increased provisioning for bad debts and lower profitability, as the banks were exposed to the tune of N1.6 trillion as at December 2008 (Sanusi, 2012). The oil & gas sector was likewise severely affected. The deterioration in the quality of the assets of the banks put a significant number of the banks in dire straits. Regulatory actions taken by the CBN to avert a total collapse of the banking system, strengthen the industry, and protect depositors' funds included:

- i) A joint special examination by the CBN/NDIC of the books of the 24 banks. The examination brought to the fore nine banks adjudged to be in a grave situation. A further independent diagnostic audit of the nine banks confirmed the outcome of the special examination.
- ii) The CBN, in collaboration with the NDIC and FMF, injected N620 billion as Tier 2 capital in the nine banks to ameliorate the liquidity pressures the banks were experiencing.
- iii) Removal of the Executive Directors of eight out of the nine banks and replacement with managers of proven integrity.
- iv) Guaranteeing of both local and foreign counterparties to ensure continued liquidity support for the banks.
- v) Establishment of the Asset Management Corporation of Nigeria (AMCON), under the 3rd pillar of the 4-pillar banking reform programme. AMCON freed the balance sheet of the banks of toxic assets and recapitalized eight out of the nine failing banks.

Resolution of four of the nine banks through acquisitions/takeover by stronger and healthier banks, while three were resolved, in collaboration with the NDIC, through the bridge bank model, as stipulated in Sec 39 of the NDIC Act 2006. The last two banks remain going concerns.

11.3.3 Forbearance regime of 2016 – It is noteworthy that the CBN, in furtherance of its mandate to maintain a safe and stable financial system, has granted regulatory forbearances for breaches of prudential ratios by banks. In 2016, the CBN granted a one-off forbearance to banks to write off fully provisioned loans without waiting for the mandatory one-year period of retention of such loans in the books of the banks. The forbearance regime of this period included:

i) Suspension of deductions in respect of breaches of single obligor limit from eligible capital;
ii) Suspension of the application of higher risk weights in the computation of CAR in respect of breaches of concentration limits;
iii) Reversal of the requirement for General Provision of 2%.
iv) Non-Revocation of the operating license of some institutions for CAR Deficiency.

Forbearances are, however, not a stand-alone measure as they are usually accompanied by stringent conditions, such as more intrusive supervision or deployment of a Resident Examiner to the bank (for example, Heritage Bank Plc), to ensure that the bank is prudent and committed to rectifying the issues for which forbearance was granted.

11.3.4 The COVID-19 pandemic crisis – the advent of the global health crisis which precipitated the shutdown of world economies was unprecedented. The pandemic catalyzed disruptions in global supply chains, drastic reductions in crude oil prices, turmoil in global stock and financial markets, cancellation of sporting activities and business events, and international travel restrictions. In summary, a deafening silence engulfed the world, causing fear and uncertainties both for households and businesses alike. In a bid to ameliorate the adverse economic impact of the pandemic and attendant lockdown on the banking industry, the CBN took the proactive step of granting regulatory forbearances to avert the downturn of financial indicators. Some of these forbearances were:

i) Extension of a moratorium on all CBN intervention facilities by one year.
ii) Reduction of interest rates on CBN Intervention facilities from 9% to 5%.
iii) Restructuring of the tenor and terms of loan exposures to households and businesses most affected by the pandemic, particularly the oil & gas sector, agriculture, and manufacturing.
iv) Strengthening of the Loan/Deposit Ratio regime and introduction of incentives to encourage banks to grant longer termed facilities.

These industry-targeted regulatory actions, along with other initiatives of the CBN in collaboration with the Fiscal Authorities, have sustained the stability of the banking industry through this trying period and revitalized the economy.

11.4 Future Outlook for the Regulator and Supervisors

Having examined the myriad of options available to the Regulators and Supervisors to nurture a failing bank to viability, this section presents an outlook for the future. There is no gainsaying that the re-enactment of the BOFIA has strengthened the regulatory and supervisory powers of the CBN over banks and other financial institutions, nevertheless the rapid evolution in the financial landscape, with technological advancements and new entrants, places an ever-increasing responsibility on the CBN and NDIC to ensure the system remains resilient, more so as the aftereffects of the pandemic far from over.

It would not be out of place to say that the regulatory actions of the CBN in the last year were the needed leverage for the banking industry to weather the storm of COVID-19 in the face of heightened risks from the economic downturn. The industry remained resilient through the peak periods of the pandemic, and as normalcy gradually returns, the stability of the industry is not in doubt. This is evidenced by the Financial Soundness Indicators at the end of the third quarter of 2021, where Capital Adequacy Ratio (CAR), Non-performing Loans (NPLs), and Liquidity Ratio (LR) stood at 15.0%, 5.4%, and 42.0%, respectively. Notwithstanding this achievement, new challenges for regulation and supervision continue to emerge, specifically with the rapid adoption of digital transformation in service delivery. While digital transformation undoubtedly comes with convenience and situates comfortably with the new age, the flip side accentuates risks such as cybercrime, data security, anti-money laundering, etc., for the industry. This places a call for increased and intensive regulatory scrutiny to proactively monitor development to ensure the continuous safety and soundness of the industry. The following initiatives would, therefore, greatly enhance the future of regulation and supervision in Nigeria.

11.4.1 The Implementation of Basel III

The CBN recently commenced the implementation of the Basel III framework in Nigeria, having carried out the following activities:

i. Quantitative Impact Survey of the Implementation of the Basel III framework on the stability of the banking system
ii. Development of the following Basel III Guidelines for Nigerian banking:
    a. Guidelines on Liquidity Coverage Ratio (LCR);
    b. Guidelines on Liquidity Monitoring Tools (LMT);
    c. Guidelines on Leverage Ratio (LeR);
    d. Guidelines on Large Exposures (LEX); and
    e. Guidelines on Regulatory Capital (which encompasses standards for risk-based capital definition (RBC), capital conservation buffer (CCB1), countercyclical buffer (CCB2), and higher loss absorbency (HLA)).
iii. Engagement of industry stakeholders, including operators, auditors, and international agencies, including the World Bank and the IMF.

Basel III standards are minimum requirements to strengthen the regulation, supervision, and risk management of banks, especially internationally active banks. For full implementation, therefore, the supervisors and operators likewise need to make investments to enhance the capacity of staff.

11.4.2 Implementation of Macro-Prudential Agenda

The macro-prudential regulation policy has been aptly defined by the Financial Stability Board as a policy that uses primarily prudential tools to limit systemic or system-wide financial risk, thereby limiting the incidence of disruption in the provision of key financial services that can have serious consequences for the real economy.

A central element of global regulatory reforms following the global financial crisis was the requirement that financial regulatory authorities adopt the macro-prudential supervisory approach, with explicit considerations of threats to the stability of the financial system. The macro-prudential policy, therefore, can be regarded as the missing pillar in the architecture of financial stability, aimed at minimizing the risk of financial disruptions that are sufficiently severe to inflict significant damage on the broader economy. The conduct of effective macro-prudential policy would involve considerable challenges requiring actions on several fronts. Supervisory authorities will have to address the non-availability of data to support systemic risk identification and modeling. Improved access to quality information will help authorities better understand the key interconnections within the financial system and the development of analytical tools to gauge the likelihood or impact of reactions to shocks that can amplify market responses and precipitate severe system-wide stress.

11.4.3 RegTech and SupTech

These are not unfamiliar terms to the CBN and NDIC, but to put them in proper context, RegTech and SupTech are subsets of Financial Technologies used by Supervisors to digitize reporting and regulatory processes for more efficient and proactive monitoring of risk (IAIS, 2019). RegTech is a technology that enables the delivery of regulatory requirements more efficiently and effectively, while SupTech is an innovative technology for supervisory oversight. According to the BIS, RegTech and SupTech solutions are emerging for a wide range of regulatory focus areas, including regulatory change tracking, fraud detection, Know-Your-Customer (KYC), Countering the Financing of Terrorism (CFT), conduct and prudential risk management, systematized regulatory reporting, associated auditable record-keeping and real-time risk alerts which enables pre-emptive rather than curative oversight. Technological solutions are, therefore, the future of regulation and supervision, and the CBN and NDIC must brace up for this challenge by investing in the acquisition and continuous updating of knowledge and skills.

11.4.4 Liquidity support for the industry – As a lender of last resort, the CBN would continue to provide liquidity support and guarantees to illiquid banks to ensure the smooth operations of the payment system.

11.4.5 Licensing of Private Asset Management Companies – leveraging on the accomplishments of AMCON in the last decade, the focus would shift to developing the private asset management subsector.

11.4.6 Development of a Framework for managing systemic risk – The shocks from the global financial crisis and the COVID-19 pandemic have, more than ever, reinforced the need for the development of a framework for managing systemic risk in the country.

11.4.7 The continuous use of existing policies to safeguard the resilience of the industry – these policies include the Global Standing Instruction, the Code of Corporate Governance, deployment of Resident Examiners to challenged banks, discretionary use of the Cash Reserve Requirement regime, etc.

11.5 Conclusion

The Nigerian banking system is the most regulated and supervised of all sectors of the nation's economy. There is no gainsaying that for the sector to be properly regulated and supervised, appropriate structures must be put in place, not only to forestall regulatory arbitrage arising from improper coordination of supervisory efforts but also to mitigate other inherent supervisory challenges. It is in this light that the authorities in Nigeria have, over the years, designed regulations to ensure the effective supervision of the system. The CBN, as the apex regulatory/supervisory authority, is not oblivious to the enormous responsibility it has in ensuring a safe and sound banking system that has the capacity to support and catalyze the economic development of the nation. Considerable human and material resources have been deployed toward the development of an appropriate regulatory framework that meets the aspirational needs of Nigerians now and in the years to come.

References

Adeyemi, B. (2011). Bank Failure in Nigeria: a consequence of capital inadequacy, lack of transparency and non-performing loans: Banks and Bank Systems, Vol 6 Issue 1. Retrieved from https://www.businessperspectives.org/images/pdf/applications/publishing/templates/article/assets/3818/BBS-en-2011-01-Adeyemi.pdf

Bello Y.A.: Banking System consolidation in Nigeria and some regional experiences: Challenges and prospects: The Bullion Vol 29 No. 2. April/June 2005. Retrieved from Bullion Apr-Jun-05,Banking Sector Reforms and Bank Consolidation in Nigeria.47-54.pdf (cbn.gov.ng)

BOFIA 2020: Impact on the Financial Services Industry KPMG Nigeria, April 2021. Retrieved from bofia-2020-review.pdf (assets. KPMG)

Bank for International Settlement (2015): Guidelines for identifying and dealing with weak banks. Retrieved from https://www.bis.org/bcbs/publ/d330.pdf

BIS Innovation Hub work on Suptech and Regtech. Retrieved from https://www.bis.org/about/bisih/topics/suptech_regtech.htm

Circular to Deposit Money Banks and the General Public on CBN Policy measures in response to COVID-19 outbreak and spillovers, March 2020.

Guideline and Incentives on Consolidation in the Nigerian Banking Industry, August 2004. Retrieved from CENTRAL BANK OF NIGERIA.PDF (cbn.gov.ng)

Imala, O.I.: Challenges of banking sector reforms and bank consolidation in Nigeria: The Bullion Vol 29 No. 2, April/June 2005. Retrieved from Bullion Apr-Jun-05,Banking Sector Reforms and Bank Consolidation in Nigeria.26-37.pdf (cbn.gov.ng)

Odeleye A.T.: Pre-consolidation and post-consolidation of the Nigerian banking sector: A dynamic comparison: January 2014, published by Researchgate. Retrieved from https://www.researchgate.net/publication/286598374_Pre-consolidation_and_post-consolidation_of_Nigerian_banking_sector_A_dynamic_comparison

RegTech and SupTech: Implication for Supervision: International Association of Insurance Supervisors, March 2019. Retrieved from https://www.a2ii.org/sites/default/files/2019-07/regtech_and_suptech_implications_for_supervisors_consultation_call_report.pdf

Sanusi L. Sanusi: Global financial meltdown and the reforms in the Nigerian Banking Sector: CBN Journal of Applied Statistics, Vol 2 No.1. 2012. Retrieved from Sanusi L Sanusi ATBU (cbn.gov.ng)

Supervisory Intervention Framework for the Nigerian Banking Sector (2011).