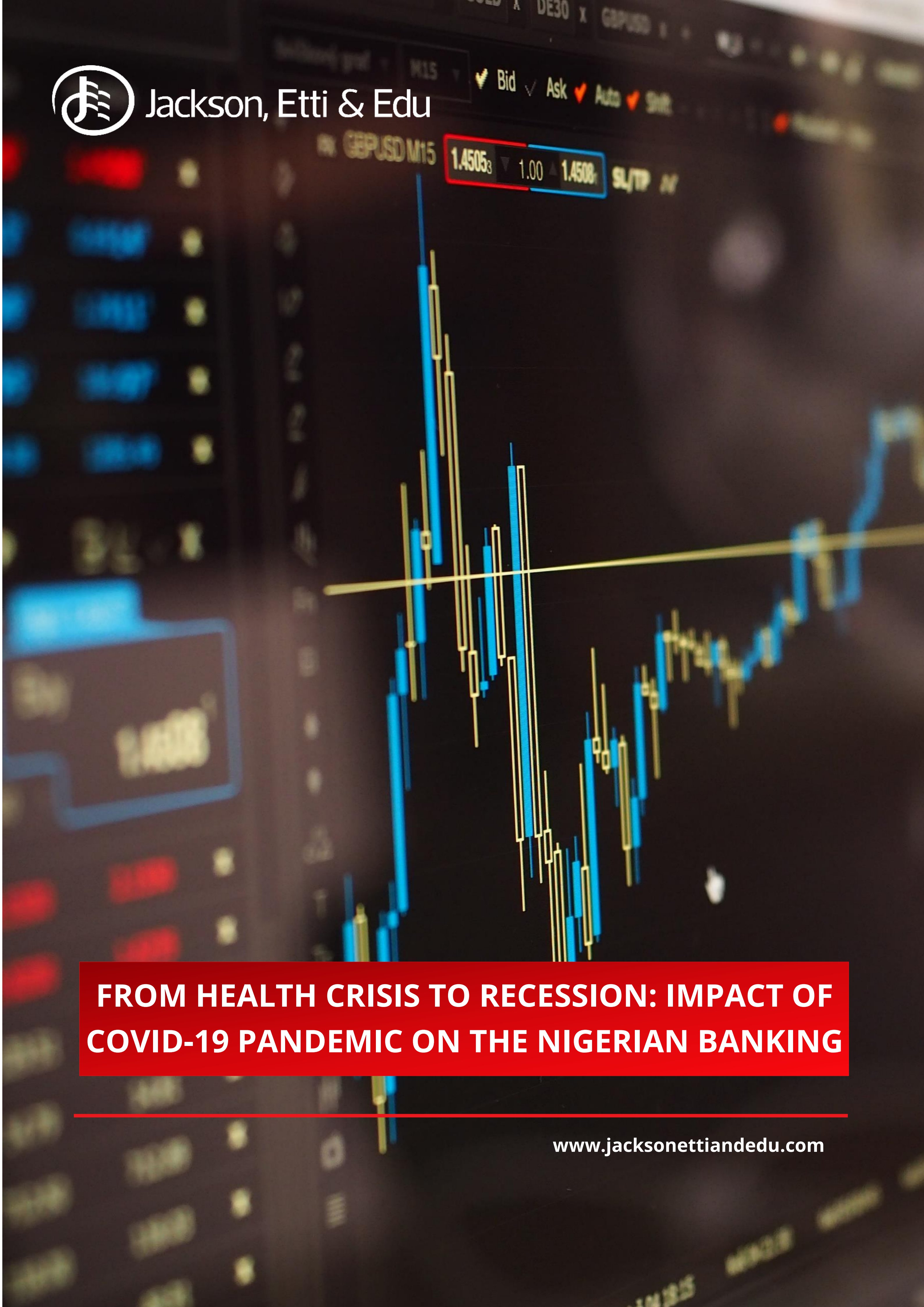

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FROM HEALTH CRISIS TO RECESSION: IMPACT OF COVID-19 PANDEMIC ON THE NIGERIAN BANKING

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INTRODUCTION

Robert Schiller, a 2013 Nobel Laureate in Economics, wrote in the Guardian UK on 1st April 2020 that the world is feeling the effects of not one, but two pandemics. First, there is the COVID-19 pandemic - the coronavirus pandemic has turned into one of the most difficult challenges for humanity in recent memory, as COVID-19 has infected millions of people across the world. The second is the economic consequences of the first. The 3-month period of worldwide lockdown has triggered an imminent global recession. The two pandemics are not unconnected; one feeds the other. Border closures, business closures, soaring unemployment and loss of income, restriction of movement of persons and supply of goods, etc. are the direct consequences of the COVID-19 pandemic.

IMAPACT ON THE GLOBAL ECONOMY

The impact of the pandemic in China cost global value chains US$50 billion in exports.[1] According to the United Nations Conference on Trade and Development (UNCTAD) 26th March 2020 forecast, foreign direct investment could shrink by 30-40% between 2020 and 2021. The International Labour Organization (ILO) predicts that the impact of COVID-19 will lead to a rise in global unemployment. On 29th April, ILO projected that the means of livelihood of 1.6 Billion workers in the informal sector are at risk. The first month of the crisis is said to have led to an 81% drop in income for informal workers in Africa and the Americas.

Just like other economic crises in the past, the financial market is severely impacted by the pandemic. In the global stock market, about US$6 trillion in wealth was erased in one week from 24th to 28th February 2020. The S&P 500 index also lost over $5 trillion in value in the same week in the US while the S&P 500's ten largest companies experienced a combined loss of over $1.4 trillion due to fear and uncertainty among investors about how the pandemic would affect the profit of firms. The travel restrictions imposed on the movement of people in many countries led to massive loss of business, the hardest-hit industries include the travel and tourism, hospitality, retail, construction, real estate, manufacturing, entertainment, and sports industries.

WILL COVID-19 LEAD TO FINANCIAL CRISIS?

There is no doubt that a global economic downturn of the magnitude caused by the COVID-19 pandemic can trigger a chain reaction in the financial sector, which may lead to a major financial crisis. Governments across the world are already taking proactive steps through large scale stimulus packages, bailouts, and interventions to maintain stability in the financial sector. A financial crisis can generally be described to include a wide variety of situations, where: (i) financial assets suddenly lose a large part of their nominal value (ii) asset prices see a steep decline in value (iii) businesses and consumers are unable to pay their debts, and financial institutions experience liquidity shortages.

A financial crisis may likely result in a panic or a bank run (a situation where a large number of customers of a bank or other financial institution withdraw their deposits simultaneously over concerns of the bank's solvency) or during which investors sell off assets or withdraw money from savings accounts because they fear that the value of those assets will drop if they

[1] https://unctad.org/en/PublicationsLibrary/ditcinf2020d1.pdf?user=1653

remain in a financial institution. Other situations include the bursting of a speculative financial bubble, a stock market crash, a sovereign default, or a currency crisis.[2] Major global financial crises in history show that the financial crisis may not be limited to banks or the financial services sector; it may cut across different industries. It may also spread globally or be limited to a country or region. Some of the notable financial crisis in recent history include the following:

The Credit Crisis of 1772 was a financial crisis that originated after a period of rapidly expanding credit in London and then spread to other parts of Europe, such as Scotland and Netherlands. Alexander Fordyce, a partner in a large bank Neal, James, Fordyce, and Down, lost a vast sum shorting shares of the East India Company and fled to France to avoid repayment. The resulting collapse of the firm stirred up panic in London. Economic growth at that period was highly dependent on the use of credit, which was primarily based upon people's confidence in the banks. As confidence started ebbing, paralysis of the credit system followed, and panic led to a run on English banks that left more than 20 large banking houses either bankrupt or stopping payments to depositors and creditors. The crisis quickly spread to much of Europe.

The Stock Market Crash of 1929, also known as the Great Crash, saw a sharp decline in US stock market values in 1929 that contributed to the Great Depression of 1930, which was felt worldwide for more than a decade. During the Stock Market Crash, share prices collapsed after a period of wild speculation, during which millions of people invested their savings or borrowed money to buy shares.

The 1973 OPEC Oil Crisis began in October 1973 when OPEC members started an oil embargo targeting nations perceived as backing Israel during the Yom Kippur War. The effects of the blockade were immediate. OPEC forced oil companies to increase payments drastically. By the end of the embargo in March 1974, the price of a barrel of oil quadrupled from US$3 to nearly US$12 per barrel. The ban caused an oil shock, with many short- and long-term effects on global politics and the global economy. Given that modern economies depend on oil, the higher prices and uncertainty led to the stock market crash of 1973–74, when a bear market persisted from January 1973 to December 1974, and the Dow Jones Industrial Average lost 45% of its value.

The Asian Financial Crisis of 1997–1998 started in July 1997 with the collapse of the Thai baht. Due to a lack of foreign currency, the Thai government was forced to abandon its US dollar peg and let the baht float. The result was a huge devaluation that spread to much of Southeast Asia, also hitting Japan, as well as a massive rise in foreign debt-to-GDP ratios. In its wake, the crisis led to better financial regulation and supervision.

The 2007-2008 Global Financial Crisis was a severe worldwide economic crisis. It is considered by many economists to have been the worst financial crisis since the Stock Market Crash of 1929 and the Great Depression of the 1930s**.** The crisis started with a depreciation in the subprime mortgage lending market in 2007 and expanded into a global banking crisis with the failure of investment bank Lehman Brothers in September 2008. Massive bailouts of financial institutions and other measures meant to limit the spread of the damage failed, and the global economy fell into recession.

[2] https://www.investopedia.com/terms/f/financial-crisis.asp

IMPACT ON NIGERIAN BANKS

The World Bank and International Monetary Fund (IMF) have predicted many countries, including Nigeria, will go into recession because of the pandemic. IMF forecasts a 3.4% GDP drop in 2020 for Nigeria after growing 2.2% in 2019.

Experts[3] have rightly captured the specific impact of the global lockdown on the Nigerian economy as follows:

1. The Covid-19 pandemic affected borrowers capacity to service loans, which give rise to non-performing loans that depress banks' earnings and eventually impair their soundness and stability. Subsequently, banks are reluctant to lend, as more and more borrowers struggled to repay the loans granted to them before the Covid-19 outbreak.

2. There was oil demand shock, which was reflected in the sharp decline in crude oil price, which dropped from nearly US$60 per barrel to as low as US$20 per barrel in April.

3. They were supply shocks in the global supply chain as many importers shut down their factories and closed their borders. Nigeria was severely affected because Nigeria is an import-dependent country, and as a result, it witnessed a shortage of crucial supplies like pharmaceutical supplies, spare parts, and finished goods.

4. The national budget was also affected. The federal government approved the 2020 budget back in December 2019 based on an oil benchmark of $57 per barrel. With oil now selling less than the benchmark, the government was compelled to revise the budget.

5. Finally, the Covid-19 pandemic affected the Nigerian stock market. The stock market plunged when investors pulled out their investments into so-called safe havens like US Treasury bonds.

As the world gears up for a major recession, for an emerging economy like Nigeria, a global economic crisis will mean a mixture of multiple structural and macro-economic issues. The banking sector is a critical driver of the Nigerian economy. In simple terms, any significant disruption to businesses or cashflows shortages means bad news for the banks. For majority of the banks, the issues discussed below will play a significant role in their decision making during and after the pandemic.

CRUDE OIL PRICE DROP

Global demand for crude oil dropped to an abysmal level due to the global lockdown and halt in industrial activities in the biggest consuming countries like China and India. Things were getting out of hand in the market, which was yet to recover from the impact of a price war between two of the biggest oil producers, Saudi Arabia, and Russia. By mid-March, scores of Nigerian vessels laden with crude were stranded at sea desperately in search of buyers. The oil and gas sector accounts for 75 percent of Federal Government revenue and 90 percent of its foreign exchange earnings. Nigerian banks are significantly exposed to shocks in the oil

[3] See Peterson Ozili in his paper titled "Covid-19 pandemic and economic crisis: The Nigerian experience and structural causes"

and gas sector. The ability of oil and gas borrowers to continue to meet their loan obligations raises a lot of uncertainties. As the Non-Performing Loans in the sector continue to mount, another source of concern is the fundamental upset of the underlying financial calibrations for these loans. Most of the outstanding loans were based on the benchmark oil price of $50; these assumptions are no longer realistic, given the current price of $20. Incidentally, while some of these exposures were hedged, some others were not. Hedging is a powerful financial management tool in the oil and gas industry. Due to price volatility of oil, hedging provides a good degree of revenue certainty, and it is always advisable for lenders to mandate oil and gas borrowers to utilise this useful tool to protect themselves against price risks (for the borrower, it is risks of loss of revenue, and for the bank, it is credit risk) associated with oil and gas sector. As a financial instrument, hedging guarantees locked in price for future oil production. There are various hedging options, such as swap contracts, futures contracts, and options commonly used in the industry. These products can be offered or arranged by the lending bank. Another concern is the growing uncertainty over the continued availability of foreign currency due to the dwindling foreign currency receivables.

SUSTAINABILITY OF REAL SECTOR LENDING

At a time like this, when the country is battling with the multi-dimensional impact of the pandemic, serious consideration needs to be given to the real sector. Most nations are looking inwards and taking a strong nationalist position to rebound from the economic impact of the pandemic. The real sector provides the catalyst for economic growth; however, the sector depends on credit to make any meaningful headway; hence the banks must play a critical role in catalysing the real sector. The likelihood of recession or an actual occurrence of recession will pressure the resilience of the market, particularly the ability of lenders to continue to provide facilities to the real sector. One obvious symptom of Nigeria's weak structural linkages is its over-dependence on external supply chains. The real sector is grossly exposed to external supply chain disruptions. This implies that business case for viable credit decisions will continue to diminish amidst continued supply-side shortages in the manufacturing and agro-allied sectors. Lenders will struggle to balance the need to comply with the regulatory loan to deposit ratio (LDR) requirements and identifying quality assets to channel funds. There are already limited options for banks to diversify investment as the Central Bank of Nigeria continues to shrink access to the financial market, coupled with the recent increase in cash reserve requirement. Available data shows that the majority of the banks leveraged more on their financial market activities than interest income in 2019.

MANAGING NON-PERFORMING LOANS (NPLs)

The present situation requires both conventional and creative loan management techniques. As businesses struggle to remain afloat, meeting loan obligations remain a major concern to both the lenders and the borrowers. Lenders will take a critical look at their loan books and make important decisions on how to keep the level of defaults within a manageable NPL level. According to the National Bureau of Statistics, NPLs of Nigerian banks stand at N1.05 trillion at the end of 2019, down from 1.79 trillion, which was recorded during the preceding year. The aggregate NPL ratio of most banks is 6.1 percent as against the regulatory limit of 5 percent. Most global responses to avoid large scale loan defaults (which could trigger financial crisis) - particularly by sovereign authorities - has been in the form of stimulus packages. The United States took a proactive step in reducing interest rates. The CBN also took a similar approach by lowering interest rates on its intervention facilities and also granting a 1-year moratorium on repayment.

Restructuring has always been a solution to loan default, although it may not always be the best fix in certain cases, as some see it as postponing the evil day. Restructuring options may include any of the following: (i) payment holiday/moratorium (ii) tenor extension (iii) refinancing (iv) repricing interest rate/charges (v) equity injection/corporate restructuring (vi) loan sale down, etc. It is not possible to have a one-size-fits-all approach to loan restructuring. However, this is time for lenders to apply creativity and innovation.

COST MANAGEMENT

Most Nigerian banks recorded a cost to income ratio above 60% in 2019. This implies that on average, Nigerian banks spend more than half of their income on operating expenses. This has a significant impact on their profitability. In view of the effect of COVID-19 on operating income, banks must devise efficient cost-cutting measures to ensure they maintain profitability. A significant chunk of bank's operating expenses is spent on personnel cost, particularly staff salaries. Other cost items are depreciation cost, travel, printing, advertising, professional fees, etc.

The reduction of personnel cost has always been a low hanging fruit for the banks. This may be in the form of rightsizing, or down-sizing depending on each bank's peculiar situation. To save jobs and reduce further hardship on households, the CBN and the Bankers Committee recently reached an agreement to stop retrenchment by banks except with the consent of the CBN where such is absolutely necessary. There are currently 104,000 employees in Nigerian banks. It is unlikely that the banks can afford to maintain their current operating expenditure. These banks may yet adopt right-sizing options such as salary cuts and staff redeployments. This is also a time for banks to consider other cost-cutting measures such as the deployment of electronic channels and the closure of some physical locations.

CONCLUSION

The COVID-19 pandemic has plunged the world into an unprecedented financial crisis. Nigerian banks and their customers are already feeing the economic implications of the pandemic. However, the extent to which this will go remains to be seen. The Federal Government and the Central Bank of Nigeria have introduced monetary and fiscal policies to provide economic support. These include providing funding through banks and other intervention measures at potentially advantageous terms, such as the provision of payment moratorium, among others. We hope that these measures will help cushion the adverse effects of the economic consequences of the pandemic in the banking sector, but more needs to be done.

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