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Banking Recapitalization in Nigeria: Pathway to Economic Resilience

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CHAPTER ONE

INTRODUCTION

A banking system with capital deficiencies is undesirable for the Nigerian economy. Why? A bank primarily acts as an intermediary between depositors and borrowers – it accepts deposits and makes credit available for borrowers in various sectors of the economy, thereby driving economic activity. So, what would be the fate of the Nigerian economy if banks are unable to perform their role as financial intermediators due to an undercapitalized banking system? The severe implications on the economy would be catastrophic.

An empirical study of the effect of financial stability on economic growth in Nigeria from 1993 to 2017[1] shows a clear relationship between financial stability and economic growth in Nigeria. This content seeks to connect the dots between bank capital and economic resilience in view of the Nigerian apex bank’s objective for the achievement of a N1 trillion economy in Nigeria.

[1] Ozili, Peterson K. (2024). Impact of Financial stability on economic growth in Nigeria. MPRA Paper No. 120776

CHAPTER TWO

ANOTHER BANK RECAPITALIZATION – BACKGROUND AND NECESSITY

2.1 Overview of current economic landscape in Nigeria

According to Q2 report of the National Bureau of Statistics[2], the Nigerian economy is showing commendable growth despite headwinds such as inflation and exchange rate depreciation, with a 3.19% year-on-year increase in Gross Domestic Product (GDP) in the second quarter of 2024. This surpasses the 2.51% growth in Q2 2023 and 2.98% in Q1 2024, with the top sector contributors being the services sector, the agriculture sector and the industry sector. However, the acceleration of Nigeria's development progress has become a crucial concern in view of its development challenges.

In the same vein, the Governor of the Central Bank of Nigeria (the "**CBN**"), Mr. Olayemi Cardoso, disclosed the ambition of the Tinubu-led administration to achieve a US$1 trillion economy by 2030. To achieve this herculean task, it is imperative for the banks in Nigeria to increase their capital base to facilitate the realization of the Federal Government's agenda. In furtherance of this, the CBN announced its intention to undertake a fresh round of banking recapitalization for commercial, merchant and non-interest banks in Nigeria with a view to positioning the banks to meet the demands of the Nigerian economy.

2.2 Overview of the 2005 Banking Sector Reform

On 6th July 2004, Nigeria's apex bank, the Central Bank of Nigeria (the "**CBN**"), announced the recapitalization of banking sector from N2 billion to N25 billion with effect from 31st December 2005.

Although the recapitalisation exercise resulted in the shrinkage of banks from 89 to 25, there were significant benefits to the economy; the ensuing liquidity engendered by the inflow of funds into the banks resulted in an unprecedented 40% increase in lending to the real sector. In the wake of the recapitalization exercise, the banking sector acquired increased potential to finance big ticket transactions. There was noticeable increase in depositor confidence and the banks experienced economies of scale. Liquidity improved in the financial market and the total capitalization markedly increased[3].

However, the banking sector reform was not without its challenges, as the consolidation was a pioneering initiative of the CBN with no prior internal experience to draw from. In 2008, the Nigerian banking system was beleaguered by issues such as excessive margin lending and unhedged loans to importers of crude oil leading to a spike in non-performing loans and other credit malpractices in the wake of the equity bubble burst and further aggravated by the ripple effects of the global financial crisis[4].

[2] National Bureau of Statistics (2024). Nigeria Gross Domestic Product Report Q2. August 2024
[3] Kama, U. (2006). Recent reforms in the Nigerian banking industry: Issues and challenges. CBN Bullion, 30(3), 65-74
[4] Imala, O. I. (2005). Challenges of banking sector reforms and bank consolidation in Nigeria. CBN Bullion, 29(2), 25-35

Other challenges soon surfaced post-recapitalisation, such as lapses in bank governance and poor risk management, which caused systemic distress in the Nigerian banking sector. Some of these challenges plaguing the Nigerian banking sector necessitated a subsequent recapitalization exercise.

2.3 2024 Banking Sector Recapitalization Programme: Key Factors

On the 28th of March 2024, the CBN in furtherance of its statutory responsibility to promote a safe, sound and stable banking system issued a circular on the upward review of the minimum share capital requirement for commercial, merchant and non-interest banks in Nigeria. The minimum capital requirement is expected to comprise of paid-up capital and share premium only and Banks are required to ensure compliance within a timeline of twenty-four months commencing April 1, 2024- March 31, 2026.

Before embarking on another recapitalization exercise, the CBN assessed various factors in determining the appropriate level of the minimum capital requirements. These include:

a. Risk Profile of Banks

Risk profile in this context is a broad view of banks' tolerance to financial risk. Therefore, in determining the new capital requirements of banks, the CBN had to consider the level of risk that the various categories of banks can deal with adequately, by assessing the banks' overall capital adequacy in relation to their risk profile in keeping with the Guidelines for the Development of Risk Management Frameworks for Individual Risk Elements in Nigerian Banks.

b. Global and domestic headwinds and their potential impact on banks' balance sheets

The Nigerian banking industry has had its share of challenges and headwinds commencing with the seemingly ubiquitous shock wave and disruption occasioned by the Russia-Ukraine war with a significant impact on inflation, interest rates, trade and supply chain, foreign exchange volatility, and monetary policy changes such as the sudden increase in the Cash Reserve Requirement (CRR) and excessive tightening by the CBN in Q4 of year 2022, which impacted on liquidity.

c. Impact of inflation

Inflation has been identified as one of the most notorious macroeconomic variables challenging the economies of nations across the globe, because increased supply of money in the economy will typically result in inflation.

As aptly stated by Ceyda Oner (2010)[6], it is imperative for policymakers to find the proper balance between enhancing demand and growth where necessary without overstimulating the economy and causing inflation. In view of this, it was prudent for the CBN to incorporate inflation into considerations relating to the capital requirements of the banks in Nigeria.

[5] Oner, Ceyda (2010). Back to Basics: What Is Inflation? Finance & Development, March 2010, Volume 47, Number 1. International Monetary Fund

d. **Stress tests of banks' balance sheets, to gauge their resilience to absorb current and unexpected shocks**

Stress tests are financial examinations to check commercial bank solvency — whether banks have enough capital to absorb losses — and liquidity — whether they have enough cash to pay out their deposits and other debts. In the spirit of the stress testing principles of the Basel Committee on Banking Supervision[7], which recommend that the authorities consider the results of forward-looking stress testing exercises as part of assessing the adequacy of the bank's capital and liquidity, the CBN conducted stress tests on Deposit Money Banks (DMB) to measure the capital adequacy ratio of the DMBs vis-à-vis the minimum regulatory requirement.

In the light of these factors, the CBN introduced the regulatory initiative known as the Banking Sector Recapitalization Programme (the "Programme") requiring banks to increase their minimum paid-in common equity capital in accordance with their license category as indicated below:

Banks	License Category	Old Minimum capital (N Billion)	New Minimum capital (N Billion)
Commercial	International	50	500
	National	25	200
	Regional	10	50
Merchant	National	15	50
Non-Interest	National	10	20
	Regional	5	10

By increasing the minimum capital requirements, the CBN seeks to ensure banks in Nigeria have a robust capital base to absorb unexpected losses and develop capacity to contribute to the realisation of a resilient Nigerian economy.

[6] Stress Testing Principles issued by the Basel Committee on Banking Supervision on October 2018

CHAPTER THREE

OVERVIEW OF RECAPITALIZATION EXPERIENCES FROM OTHER ECONOMIES

We will briefly consider the bank recapitalization programs undertaken by other countries – namely Ghana, Japan and Finland - with a view to distilling their experiences into what we consider the most important learning points for Nigerian policy makers.

3.1 Ghana

The Ghanaian banking sector has embarked on three recapitalization exercises in the last sixteen years, first in 2007 when banks were tasked to recapitalize to GH¢60 million, then in 2012 where the minimum capital requirement rose to GH¢120 million and most recently in 2017 when the Bank of Ghana (BoG) in accordance with Section 28 (1) of the Banks and Specialized Deposit-Taking Institutions Act, 2016 (Act 930), undertook a 233.33% revision of the minimum paid-up capital for existing banks and new entrants from GH¢120 million to GH¢400 million the effective date of 11th September 2017, with the objective of further developing, strengthening and modernizing the financial sector to support the Ghanaian government's economic vision and transformational agenda. In furtherance of this directive, banks in Ghana were given the options to raise additional capital through fresh capital injection, capitalization of income surplus and combination of fresh capital injection and capitalization of income surplus by the end of December 2018.

Notable lessons from the Ghanaian experience

(a) Support from Parent Banks

Additional equity injection from highly capitalized multinational parent banks made it easier for foreign-owned banking subsidiaries in Ghana to obtain funds at a comparatively cheaper cost compared with domestic banks that had to raise additional capital through the Ghanaian capital market[7].

(b) Credit Risk Management

The rise in loan defaults indicated in some surveys[8] strongly suggest that banks should continually improve their credit risk management practices to avoid capital depletion which usually arises from high non-performing loans and their provisions thereof[9].

[7] Yalley, Stephen and Djibom, Hanania and Yiadom, Eric B. and Kunawotor, Mark. Bank Recapitalization in Ghana, Who Benefits the More? (September 10, 2018).
[8] Ibid
[9] Ibid

3.1.1 Japan

During Japan's financial crisis in the late 1990s, the national legislature of Japan, the Diet, enacted the Financial Function Stabilization Act, authorized the use of JPY 30 trillion in public funds and by March 1998, the government had injected JPY 1.8 trillion into all major (city) banks and several regional banks, most of which received JPY 100 billion in subordinated debt to improve their ratios and attain capital requirements.

In April 1998, Japan's Banking Bureau of the Ministry of Finance (MoF) officially introduced the Prompt Corrective Action for undercapitalized banks to take remedial actions in response to the significant volume of nonperforming loans that had accumulated in the financial sector. Following a review of the assets of 19 major banks by the Financial Supervisory Agency in 1998, the Diet doubled the available funds to JPY 60 trillion through the Prompt Recapitalization Act. In March 1999, to further strengthen the banking sector, a JPY 7.5 trillion capital injection was issued.

Notable lessons from the Japanese experience

(a) Appropriate Regulatory Mechanism

Resolution of uncertainty over banks' recapitalisation was pivotal for restoring market confidence in Japan[10], underscoring the necessity for a regulatory mechanism that ensures that undercapitalised banks are promptly identified and required to raise additional capital. In Japan, this required detailed and repeated inspections by bank supervisors based on transparent regulatory standards for credit classification and provisioning[11].

(b) Forbearance-related Risks

Evidence suggests that absence of a comprehensive legal framework to facilitate prompt recapitalisation and orderly resolution of failing banks resulted in regulatory forbearance which may have increased eventual losses at banks[12]. Though forbearance enables the survival of problem banks, it can potentially aggravate credit misallocation problems and increase eventual losses at such banks.

3.1.2 Finland

The global financial crisis of 2007-2009 (the "Crisis") placed a strain on Finnish banks, given that the global financial markets were intertwined in different ways that negatively impacted Finland. It is imperative to note that although Finnish banks were relatively insulated from this financial crisis due to conservative lending practices, the general economic deceleration coupled with stringent credit conditions necessitated government intervention and recapitalization efforts to stabilize the sector. Though the banks in Finland were generally better capitalized than their European counterparts, the Finnish government nonetheless took steps to ensure that banks had adequate capital buffers, encouraging banks to strengthen their capital positions through retained earnings and capital increases from private markets and thereby reducing the need for large-scale interventions by the Finnish government.

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[10]Benjamin Nelson and Misa Tanaka (2014) Dealing with a banking crisis: what lessons can be learned from Japan's experience? Bank of England Quarterly Bulletin 2014 Q1
[11]Ibid
[12]Ibid

Finnish banks were able to maintain strong capital positions, partly due to stringent regulatory requirements both at the national and European Union levels.

Notable lessons from the Finnish experience

(a) Supervision of Credit Expansion

The Finland experience suggests that indebtedness and financial risks within the private sector require close regulatory scrutiny, as studies show that debt expansion during the 1990s crisis was not contained and therefore the Finnish government had to socialize a considerable portion of the losses caused by the debt deflation process[13].

(b) Excessive Private Sector Leverage

Furthermore, studies indicate that the assets and liabilities of households and corporates deserve a great deal of attention, as the 1990s crisis showed that public debt to GDP can surge due to excessive leveraging in the private sector[14].

[13]Valimaki, Tuomas and Obstbaum, Meri (2020) Finland and monetary policy through three crises. SUERF Policy Note No. 190, 27 August.
[14]Ibid

CHAPTER FOUR

STRATEGIES FOR EFFECTIVE RECAPITALIZATION

4.1 Increased capital buffers

To appreciate the efficacy of capital buffers in boosting the resilience of the banking sector, it is noteworthy to consider the European situation during the Crisis. In the wake of the Crisis, the Basel Committee on Banking Supervision introduced the increased capital buffer as a measure to make banks more resilient to such procyclical dynamics; this required banks to build a capital buffer (of up to 2.5% of risk-weighted assets) in the periods of excessive credit growth and buildup of system-wide risk in the form of Common Equity Tier 1 capital - which is considered to be the highest quality component of a bank's capital - thereby ensuring that the banking sector increases its capacity to absorb shocks arising from financial and economic stress, rather than transmitting risk to the financial system and economy.

According to the Basel III framework, Common Equity Tier 1 capital consists of the sum of the following elements[15]:

- Common shares issued by the bank that meet the criteria for classification as common shares for regulatory purposes (or the equivalent for non-joint stock companies);
- Stock surplus (share premium) resulting from the issue of instruments included in Common Equity Tier 1 capital;
- Retained earnings;
- Accumulated other comprehensive income and other disclosed reserves;
- Common shares issued by consolidated subsidiaries of the bank and held by third parties (i.e. minority interest) that meet the criteria for inclusion in Common Equity Tier 1 capital; and
- Regulatory adjustments applied in the calculation of Common Equity Tier 1.

(this provision is analogous to the provisions of the revised Guideline on Regulatory Capital[16] developed by the Central Bank of Nigeria, per the Basel III standards)

The recommendation of the Basel Committee was that this capital be released in downturns to avoid regulatory capital requirements reducing credit growth, which could compromise the performance of the real economy and result in additional credit losses. Therefore, to achieve ensure effective recapitalization, banks in Nigeria should be disposed to use capital buffers, which would reduce credit losses and impact positively on the economy while ensuring the resilience of the Nigerian banking system is not undermined.

[15] Basel III: A global regulatory framework for more resilient banks and banking systems, December 2010 (revised June 2011)
[16] Guidelines on Regulatory Capital issued in September 2021 by the Central Bank of Nigeria per the Basel III standards

4.2 Asset quality improvement

Okwoli, Jim-Suleiman and Daboer (2022)[17] aptly describe asset quality as a measurement index utilized to determine the strength of the bank and the level of banks' exposure to risk. Asset quality is a crucial factor in determining the overall condition of banks, as it reflects the quantity of existing and potential credit risk associated with the bank's loan and investment portfolios. High amounts of non-performing loans are an indication of lower asset quality, while lower amounts of non-performing loans indicate higher asset quality. Once lower asset quality has attained a significant amount, it may result in bank insolvency and consequently, economic decline. A notable example of such occurrence is the collapse of the Nigeria Merchant Bank in the late 1990s, where poor asset quality was attributed as one of the major causes of the bank's failure after a special examination jointly conducted by the CBN and Nigeria Deposit Insurance Commission.

4.3 Governance and management reform

Corporate governance has been described as the development of structures, methods, and procedures that optimize long-term shareholder value through the managerial competence and firm performance. The absence of a good corporate governance has been attributed as a major cause for failure of many functioning banks. Several studies undertaken in several developing countries to investigate the relationship between corporate governance and the performance of banks in those jurisdictions in terms of their financial performance confirm the positive relationship between good corporate governance and the performance of the banks.

4.3 Regulatory oversight and reform

According to Perrero, Iorgova, Kisinbay, Lesle, Melo, Podpiera, Sacasa and Santos (2012)[18], a key challenge for policymakers is to ensure that any changes in banks' business strategies in response to tighter regulations do not result in a further buildup of systemic risks either in unregulated sectors or in locations with less onerous regulatory standards. Therefore, to achieve effective recapitalization, it is necessary for the regulators pertinent to the Nigerian banking sector to ensure that measures are put in place to mitigate such unintended consequences while also keeping negative outcome on banks' capacity to support the economic recovery.

[17] Effect of Recapitalization on Asset Quality of Quoted Deposit Money Banks in Nigeria, July – December 2022. Journal of Accounting, Vol. 11 (2)
[18] Perrero, Iorgova, Kisinbay, Lesle, Melo, Podpiera, Sacasa and Santos (2012). Impact of Regulatory Reforms on Large and Complex Financial Institutions. International Monetary Fund, 2012.

CHAPTER FIVE

ECONOMIC RESILIENCE AND THE IMPACT OF RECAPITALIZATION

There is a plethora of evidence to support the positive impact of bank recapitalization on the economy. We will briefly consider several ways that recapitalization in the banking sector can promote economic resilience vis-à-vis findings from empirical research conducted in this regard.

i. Restoration of confidence in the banking sector

A good illustration is the Japanese approach in the face of a systemic banking crisis; The Japanese authorities adopted a policy package that included the recapitalization of banks in Japan; this was undertaken through two rounds of public capital injection in 1998 and 1999 respectively[19], culminating in a sum of approximately 1.9% of Japan's GDP and was enforced through heightened supervision. One of the objectives of the Japanese government was to restore investor confidence in the Japanese banking sector, as well as to preserve the sector's capacity to provide credit to the economy.

ii. Increment in lending capacity and credit growth

Baseline analyses of the impact of capital injection into banks indicate that capital injections into banks stimulates increased lending, therefore suggesting that capital injection policies ease constraints on the banks and facilitate lending to companies. The findings of an analysis conducted by European Systemic Risk Board on the effect of bank recapitalizations on lending, funding and asset quality of European banks between 2000 and 2013[20] showed that banks that procured adequate recapitalization were able to increase lending, attract more deposits from customers and make provision for more loan losses.

iii. Promotion of economic growth and job creation

The banking sector plays a key role of facilitating access to capital necessary for economic expansion; capital injections into banks increases the banks' capacity to grant new loans, providing businesses and individuals with the capital they require to make investments and scale up, thereby powering economic growth. A 2006 review by Euromoney of the 2004 - 2006 bank sector reforms in Nigeria[21] noted that in the wake of the bank recapitalization exercises, lending to the private sector increased by 40% and consequently, growth in the non-oil sector of the economy surpassed the 7.4% of the overall economy in 2005 by growing at 8.5%.

[19] Toyama, Haruyuki (1999). The monetary, regulatory and competitive implications of the restructuring of the Japanese banking industry. BIS Conference Papers. 18 March
[20] Homar, Timotej (2016). Bank recapitalizations and lending: A little is not enough. Working Paper Series, No. 16/June 2016. European Systemic Risk Board.
[21] Euromoney (2006) Nigeria benefits from banking mergers and recapitalization. April 1

iv. Enhancement of financial stability

Empirical research has shown that adequately capitalized banks enhance financial stability by reducing the risk-taking incentives of the bank. A recent Global Financial Development Report[22] discusses the effect of capital regulation on financial access and stability, asserting that higher bank capital contributes to financial stability, by providing a buffer for absorbing losses during a crisis or other bank distress. According to the report, two ways that higher bank capital can lower bank risk-taking are by firstly, improving the screening and monitoring of borrowers, and secondly, opting for less risky asset portfolios.

[22] Global Financial Development Report (2019/2020). Bank Regulation and Supervision a Decade after the Global Financial Crisis

CHAPTER SIX

CONCLUSION

From the foregoing, the strong link between bank capital and the increase in the trade and production of goods and services in the Nigerian economy is clearly delineated, with emphasis on the role played by banks in stimulating economic growth required to achieve a resilient N1 trillion economy, including supporting consumer lending and investing in sectors that drive consumption and investment.

In view of lessons learned from the 2004 bank sector reforms and other jurisdictions, it is recommended that the CBN circumspectly select relevant financial stability indicators that best capture the appropriate extent of stability or fragility in the Nigerian financial system and heighten its surveillance of the developments in the said financial stability indicators. Furthermore, it is recommended that the CBN increase its supervision of the Nigerian banking sector to ensure that the perpetuation of behavior and activities that are not inimical to the financial stability in the banking system and the overall achievement of resilience in the Nigerian economy.

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