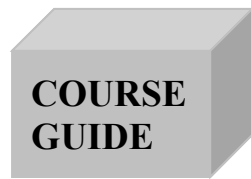




NATIONAL OPEN UNIVERSITY OF NIGERIA

COURSE CODE :MBF 716

**COURSE TITLE:
BANK CREDIT ANALYSIS**



MBF 716
BANK CREDIT ANALYSIS

Course Developer	Ayano D. A.
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Introduction

The primary role of banks and other financial institutions is to mobilize funds from surplus unit of economy to the deficit unit of the economy for the purpose of efficient and productive investment. Therefore, it is important for any bank seeking excellence in the industry to serve the role of financial intermediation effectively and efficiently in order to be able to remain in the business. This could be done through adequate skills acquired by the credit officers and all other personnel involved in loan administration and management.

What You Will Learn in the Course

During this course, you will be learning overview of the financial and banking industry, where you are going to be acquainted with players in the financial industry, types and functions of banks. Also, the course will review causes and effect of bank distress in Nigeria. In the course of this study, emphasis will be upon the following viz: bank regulatory authorities, and bank consolidation. Furthermore, the course will discuss the credit market, the theory of bank credit, process of credit creation, constraints to credit expansion, financial statement analysis, key ratios, risk in bank, risk analysis, risk management, risk measurement and control, credit organization.

Course Aims and Objectives

This course aims at:

- Giving you an understanding of the concept of credit and credit management in banking industry.
- Making you to be able to define and explain the concepts
- Enabling you to understand the applicability of credit theories in bank decision making on loans and advances to customers
- Making you to appreciate the role of bank officers in analyzing credit and risk before granting any loans and advances for any specific project.
- Enabling you to understand the rating of performance of banks through the use of financial ratios
- Enumerating the major roles of treasury management in banking industry when all the above are considered, we can conclude that the major aim of the course is to expose you to various tools, methods and techniques of credit analysis in banking industry.

Working through this Course

For you to complete this course successfully, you are required to read the study units, reference books, and other resources that are related to the unit. Each unit of the course contains Tutor Marked Assignment.

The Tutor-Marked Assignment (TMA) is to be done immediately and submitted to your tutorial course facilitator for assessment.

The medium to be used and the time to submit the TMA will be specified to you later. This course is a 2-credit course. As such you are expected to spend a minimum of two hours every week studying the course. You are expected to complete the entire outline within a period of 18-25 weeks.

Course Evaluation

As stated before, every unit of this course has an assignment attached to it. You are required to keep an assignment file. After every unit the assignment should be done. At the end of the course, the evaluation shall be as follows:

- Assignment – 30%
- Examination – 70%
- Total = 100%

Out of all the assignment you will do, each one shall be marked and converted to 3%. At the end, the best 10 shall be selected so as to make up to 30%. The examination at the end of the course shall cover all aspects of the course.

Study Units

In this course, credit and risk analysis skills as well as treasury management and administration of loans and advances techniques that could be helpful to you as a banker shall be considered under different topics. Based on this, the following units have been designed for the course.

Modules 1

Unit 1	Overview of the Financial and Banking Industry
Unit 2	Review of Bank Distress in Nigeria
Unit 3	Bank Regulatory Authorities
Unit 4	Bank Consolidation Unit
Unit 5	The Credit Market

Module 2

Unit 1	Theory of Bank Credit
Unit 2	Financial Statement Analysis
Unit 3	Risks in Banks
Unit 4	Risk Analysis/Rating of Banks
Unit 5	Measurement and Control of Bank Risk

Module 3

Unit 1	Managing the Lending Portfolio
Unit 2	Managing Individuals Risk
Unit 3	Lending Principles and Business Borrowers
Unit 4	Bank Credit Organization
Unit 5	Treasury Management

These units must be treated sequentially; as a logical link exists in the arrangement. Every previous unit lays a foundation for subsequent ones. A maximum period of one week is required for every unit.

Textbooks and References

As was earlier mentioned, materials relevant to the course include not only the ones below but also others that you can lay your hand on. But for now, the following references are recommended.

Central Bank of Nigeria Economic and Financial Review

Nwankwo G.O. (1991). *Bank Management (Principle and Practice)*., U.K. Oxford: Malthouse Publishing Ltd.

Shekhar K.C. (1990). *Banking Theory and Practice*. New Delhi, India: Vikas Publishing House PVT. LTD.

Vincent B. (2003). *Bank Treasury Management*. Institute Financial Service

Presentation Schedule

Specific dates for particular activities, such as submission of assignment, tutorial schedules and examination dates shall be made available to you on a later date. This will enable you plan your activities in the same line. The method of submitting your assignment and receiving other course materials shall be agreed upon on a later date. You should endeavour not to be falling behind the schedule whenever it is given.

Conclusion

By the time you exhaust this course, you will find it useful not only in solving credit analysis problem in banking industry but also your day to day credit analysis problem.

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MODULE 1

Unit 1	Overview of the Financial and Banking Industry
Unit 2	Review of Bank Distress in Nigeria
Unit 3	Bank Regulatory Authorities
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UNIT 1 OVERVIEW OF THE FINANCIAL AND BANKING INDUSTRY

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2.0	Objectives
3.0	Main Content
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3.2	Types of Banks in Nigeria
3.2.1	Banks with Federal Government Ownership
3.2.2	Banks with State Government Ownership
3.2.3	Local Private Sector Banks
3.2.4	Universal Banking in Nigeria
3.3	Functions/Roles of Bank in Nigeria Economy
4.0	Conclusion
5.0	Summary
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1.0 INTRODUCTION

A financial system is a composition of various institutions, markets, instruments and operators that interact within an economy to provide financial services. It can also be seen in the context of sets of rules and regulations, and heap of financial arrangements within the financial sector. Such services may include resource mobilization and allocation; financial intermediation; and foreign exchange transaction to enhance international trade, among others. The financial system thus plays important role in the process of economic growth and development in a country.

In Nigeria, the financial system has undergone remarkable changes in terms of ownership, structure, the depth and breadth of instrument employed, the number of institutions established, the economic environment and the regulatory framework within which the system operates.

The Nigerian Financial System has witnessed remarkable evolution for past two decades.

2.0 OBJECTIVES

By the end of this unit, you should be able to:

- describe various types of banks in Nigeria
- identify major players in Nigeria Banking industry.

3.0 MAIN CONTENT

3.1 Players in financial Industry

Central Bank of Nigeria (CBN)

The Banks and Other Financial Institutions Decree (BOFID) brought the activities of a myriad of financial institutions under the supervision of the Central Bank of Nigeria (CBN) the Decree empowers the Bank to issue guidelines to persons and institutions engaged in the provision of financial services as well as having the last say in formulating operating rules and codes of conduct. Also, the Bank is empowered under BOFID to undertake special investigations of these institutions if the Governor of CBN considers it necessary. These provisions of the BOFID and the CBN Decrees, therefore, give the Bank clear and substantial powers to regulate the activities of all financial institutions operating in the country.

Nigeria Deposit Insurance Corporation (NDIC)

Decree No. 22 of 1988 of deposit insurance and related services to banks, in order to promote confidence in the banking industry, established NDIC. This empowered NDIC to examine the books and affairs of insured banks and other deposit-taking financial institutions.

Securities and Exchange Commission (SEC)

SEC was set up in 1979 by an Act as the apex regulatory organ of the country's capital market. The Companies and Allied Matters Decree of 1990 further empowers SEC to approve and regulate mergers and acquisitions and authorize the establishment of unit trust.

National Insurance Commission (NAICOM)

The National Insurance Commission (NAICOM), established in 1997, is the regulatory authority in the insurance industry. It replaced the

National Insurance Supervisory Board (NISB), which was established by the Insurance Special Supervision Fund (Amendment) Decree No. 62 of 1992 to take over the regulation and supervision of insurance business from the Federal Ministry of Finance.

Federal Mortgage Bank of Nigeria (FMBN)

Federal Mortgage Bank of Nigeria was set up by Decree 7 of 1977. The adoption of National Housing Policy in 1990 and subsequently promulgation of Decree No 7 of 1991 empowered the bank to license and regulate primary mortgage institutions in Nigeria.

Financial Services Regulation Coordination Committee (FSRCC)

FSRCC was inaugurated in 1994 due to the emergence of many regulatory bodies in the nation's financial sector. The objective of FSRCC is to coordinate and standardize the regulatory policies of all financial institutions in the system under the chairmanship of the Governor of the CBN, with a view to evolving some cooperation among regulatory agencies.

Money Markets

The money market can be defined as a market for short-term debt instruments. The major function of this market is to facilitate the raising of short-term funds from surplus sector to the deficit sector of the economy.

Short-term securities used in trade are:

- Treasury Certificates
- Call Money
- Certificates of Deposit and
- Commercial Paper

The Central Bank of Nigeria further deepened the market with the commencement of its Open Market Operations activities.

Money Market Institutions

The money market institutions are those institutions that participate actively in the markets. These included Discount houses, Commercial, Merchant and Community Banks.

The Capital Market

The Capital Market is a veritable channel for mobilizing long-term funds. The main institutions in the market include Securities and Exchange Commission, which is at the apex and serves as the regulatory authority of the market, the Nigerian Stock Exchange, the Issuing Houses and the Stock Broking Firms. The Capital Market is classified into three. These are the Primary Market, which are markets for new issues of securities. The mode of offer for the securities traded in this market includes offer for subscription, right issues. The secondary market is a market for trading in existing securities. It consists of exchanges and over-the-counter markets where securities are bought and sold after issuance in the primary market.

The third one is the unit trust scheme which is a mechanism for mobilizing the financial resources of small and big savers and managing such funds to achieve maximum returns with minimum risks, through efficient portfolio diversification. It offers the advantages of low cost, liquidity and high returns.

3.2 Types of Banks in Nigeria

3.2.1 Banks with Federal Government Ownership

Public sector ownership has been a dominant feature of the banking system in Nigeria since the mid 1970s, although its importance has diminished with the growth of the local private sector since the mid 1980s and the sale of Federal Government equity to the private sector in 1992/93. During the 1970s the Federal Government acquired controlling equity stakes in the first and second generation foreign banks in Nigeria. Most of these were subsequently operated as joint ventures with the foreign shareholders which retained minority stakes, which included Standard Chartered, Barclays (which subsequently disinvested), Banque Nationale de Paris, BIAO, Bank of America and Bank of India. The Federal Government had major share holdings in eight commercial and five merchant banks, nine of which were joint ventures with foreign investors: it also had a minor stake in one other merchant bank. The banks in which the Federal Government had a share holding included the four largest commercial banks and three of the five largest merchant banks ranked according to total assets in Nigeria. As part of the privatization programme, the Federal Government sold most of its equity holdings in seven commercial banks and two merchant banks to Nigerian private investors in 1992/93, although it threatened to re-establish controlling stakes in the four largest commercial banks in 1995. The motivation for Federal Government equity participation in banking was the desire to control strategic industries and to further the

policy of indigenization. The Federal Government's explicit policy towards the banks in which it held equity was to appoint board members, including the chairman, and to set out the broad outlines of policy while leaving day to day operational decisions to the banks' management, which initially was largely controlled by the foreign shareholders. Federal Government ownership of banks therefore reinforced the controls employed by the CBN to influence resource allocation by the banking industry, most notably in three different aspects of banking policy.

First, the management of the Federal Government banks was almost entirely indigenised by the end of the 1980s: only a few specialized posts were still filled by expatriates.

Second, these banks were in the forefront of the programme to establish branches in the rural areas.

Third, credit policies were influenced by 'policy lending', i.e. extending credit to the public sector, to locally owned businesses and to the priority 'productive sectors' as set out in the credit guidelines. The second and third of these developments adversely affected the banks' financial performance. Most of the rural branches established under the rural banking programme have not been profitable mainly because the volume of business generated in the rural areas has been insufficient to cover overheads. The banks accumulated substantial volumes of non performing debts as a result of lending to the public sector or as a result of lending in line with credit guidelines. The accumulated non-performing loans of the four largest commercial banks amounted to an average of 40 per cent of each banks' total loan portfolio in 1994. The financial performance of the Federal Government banks during the 1970s and 1980s did not appear to have been very good while the quality and efficiency of their services were poor. The four largest commercial banks all recorded profits during this period, although their returns on assets were low and returns to equity not especially impressive when inflation was taken into account. However assessment of their financial performance was impeded because, until 1990 when the CBN issued new prudential guidelines, they were not required to classify loans according to quality and make provisions for non-performing loans, or to suspend the accrual of income from unpaid interest. Hence published accounts are likely to have overstated earnings. When the new prudential guidelines were introduced in 1990, First Bank recorded large losses as a result of having to make provisions for bad debts, while the profits of the other three major banks were sharply reduced. Their financial position would have been less secured had they not been allowed to spread the necessary provisions over a period of four years. Nevertheless the four major Federal Government

banks remained solvent and avoided the distress which afflicted many of the state government and private sector banks in Nigeria, as well as public sector banks in some other African countries. These banks have avoided serious trouble for a number of reasons.

3.2.2 Banks with State Government Ownership

The involvement of the regional and state governments in banking dates back to the 1950s. Two of the earliest indigenous banks, National Bank and African Continental Bank, had close links with politicians in the Western and Eastern Regional Governments. The regional governments acquired equity in these banks when they got into financial difficulties in the mid 1950s and eventually became the majority shareholders. In 1959 the Bank of the North was established by the Northern Regional Government in partnership with Lebanese investors.

Another indigenous bank (Agbonmagbe Bank, since renamed Wema Bank) was taken over in 1969. During the 1970s the state governments, which had replaced the regional governments in the late 1960s, began setting up their own banks: by 1980 there were ten banks in which state governments held equity and this number had risen to 25 by 1989. The primary motivation of the state governments in setting up these banks was to access funds for development projects in the states and to expand lending to indigenous businesses (Nwankwo 1980: 74).

Most of the state government banks are joint ventures with local private investors: state governments hold majority share holdings in 11 of these banks and minority share holdings in the other 14. The state government banks accounted for 20.5 per cent of total commercial bank assets in 1994. Most of these banks are relatively small: only two (Wema Bank and Bank of the North) are among the largest ten banks in terms of lending.

The financial performance of most of the state government banks has been very poor. Ten distressed state government banks were taken over by the CBN during 1992-95, and it is very likely that several more state government banks are among the more than 50 banks regarded as distressed by the regulatory authorities (with the exception of those taken over by the CBN. The distressed banks have not been officially named). In addition to the banks taken over by the CBN, a further three state government banks have not published annual reports for at least two years. The banks which appear to have remained solvent are mainly those in which state government participation has been limited to minority share holdings.

The financial problems afflicting the state government banks are attributable to a number of factors. The quality of their management has been very poor because of political interference in the appointment of directors, managers and staff. Appointments were determined by political patronage rather than merit while boardroom disputes and the insecure tenure of board and management due to frequent changes in the political control of state governments further undermined the quality of management (Ebhodaghe 1994: 17). Earnings have been eroded by high operating expenses: the 14 state government banks in the survey by Ibe incurred operating expenses amounting to 76 per cent of net earnings compared to 49 per cent for other banks (Ibe 1992: 250). Many of the banks were set up without adequate capital and were unable to meet the minimum capital requirements when these were raised in the late 1980s and early 1990s.

3.2.3 Local Private Sector Banks

Since the mid 1980s the locally owned private sector banks (henceforth local banks) have grown rapidly, and now account for a substantial share of commercial and especially merchant banking markets. Local banks are defined here as those banks which were set up with local private sector investors as the major shareholders, rather than by foreign investors or the public sector. In 1992 there were 33 local commercial banks and 48 local merchant banks in operation. Foreign investors held minority stakes in seven of the local commercial banks and seven of the merchant banks: the rest were wholly owned by Nigerian private investors. Most of these banks were set up between 1986, when financial markets were first liberalised, and 1991, when the CBN suspended issuing new licenses in response to the emerging signs of distress in the industry. The local banks are very heterogeneous: whereas a few banks have grown into major market participants, establishing a reputation for providing efficient professional services and attracting a blue chip corporate clientele, many others have been associated with fraud and mismanagement and have experienced severe financial distress in the 1990s. This section examines the reasons for the growth of this sector, the salient characteristics of these banks, and the causes of the distress which emerged in the early 1990s. The first local banks were established in Nigeria during the late 1920s and 1930s at a time when banking was effectively unregulated and entry unrestricted. The banks were set up by local businessmen, many of whom had encountered difficulties in obtaining credit from the expatriate banks. After the end of the Second World War there was an indigenous banking boom with 185 so called 'mushroom banks' registered between 1947 and 1952, although most did not actually commence operations. Most of the banks that did start operating collapsed within a few years due to a combination of mismanagement, insider lending and inadequate

capitalisation. Only four of the banks set up by local investors during the colonial period survived until independence in 1960, all with the aid of substantial financial support from the regional governments, whose explicit policy was to support the efforts of indigenous banks to finance local businesses. These banks were also used to finance political activity and to channel loans to party supporters as well as the banks' directors. The introduction of the 1952 Banking Ordinance, which for the first time in Nigeria imposed entry conditions for banks such as minimum capital requirements, and the loss of public confidence induced by the failure of local banks, brought the indigenous banking boom to an end by the mid 1950s (Nwankwo 1980: 45-53). For a period of almost 25 years until the mid 1970s, few new banks were set up by Nigerian private investors: new investment in banking was largely initiated by foreign banks and the public sector. The Nigerian private sector began to return to banking in the mid 1970s, initially in partnership with foreign investors. From the mid 1970s until 1986, 13 private sector banks were set up in which Nigerian investors were majority shareholders in ten of these banks. Foreign investors mostly established foreign banks such as Societe Generale.

Following the introduction of the SAP in 1986 local banks were set up in much larger numbers. During 1987-92, approximately 27 local commercial banks and 42 local merchant banks were established. Not only did the rate of new entry accelerate sharply in this period, but there was also a qualitative shift in the composition of ownership, with foreign partnership limited to only four of these banks. The rest were wholly owned by the Nigerian private sector. The late 1980s and early 1990s also saw the rapid growth in the number of finance houses, some of which were affiliated to banks. In 1992, 666 finance houses were operating, but many subsequently collapsed.

The growth in the local banks can be attributed to several factors. First, the inefficiencies of the public sector banks provided opportunities for new entrants to target corporate and high income urban customers. The local banks were able to attract these customers by offering higher interest rates on deposits following interest rate deregulation in 1987. A few of the local banks have attracted customers by providing more efficient services, such as much faster loan appraisals, and innovative products. Second, many of the banks were set up primarily so that their owners could obtain foreign exchange which could be resold at a premium. The foreign exchange market was liberalized in 1986, with the introduction of a foreign exchange auction system. Although the specific mechanism changed several times, the essence of the system involved the CBN auctioning the available foreign exchange to the banks. Only the banks were authorized to bid for foreign exchange, which were then expected to supply their customers. To ensure that the available foreign

exchange was distributed widely among the banks, ceilings were placed on the amount which each bank could bid for. The auction system did not eliminate the parallel market, in which a premium over the auction rate could be obtained from the sale of foreign exchange. This premium averaged 33 per cent during 1987-90 (Olisadebe 1991: 178).

Consequently those with access to the foreign exchange auction could make substantial profits by reselling the foreign exchange at parallel market rates. In 1989 bureaux de change began operating, in which exchange rates approximated those on the parallel market. This provided another outlet for the banks to resell foreign exchange purchased from the auction.

3.2.4 Universal Banking in Nigeria

Following the approval-in-principle granted by the CBN Management in 1999 for the introduction of universal banking (UB), and its subsequent publication in the year 2000 Monetary Policy Circular No. 34, a committee comprising members from the CBN, Nigeria Deposit Insurance Corporation (NDIC), Securities and Exchange Commission (SEC), National Insurance Commission (NAICOM) and representatives of commercial banks, merchant banks and discount houses was set up to draft the guidelines for the practice of universal banking in Nigeria. The committee completed its assignment by the middle of the year and submitted its report to the CBN management. The CBN Governor, in the exercise of the powers conferred on him by section 61 of the Banks and Other Financial Institutions Act (BOFIA) 1991 (as amended), published the new definition of banking business in Nigeria, through an official Government Gazette No. 91 Vol. 87 of December 31, 2000. The Guidelines for the practice of UB in Nigeria were also issued to take effect from January 1, 2001. According to the guidelines, all conventional banks (commercial and merchant) were to be granted uniform licenses to practice UB. With such a license, the distinction between commercial and merchant banking would be removed and banks would have the liberty to undertake, in addition to traditional banking functions, capital market activities as well as insurance marketing services, either directly or through subsidiaries. Each of these activities is expected to be approved by the relevant regulatory bodies. The challenges of UB as highlighted in the 1999 edition of the Banking Supervision Annual Report were considered in the formulation of the Guidelines. Accordingly, crucial areas like consolidated supervision of financial conglomerates, which might emerge, were addressed. In this regard, while the CBN was accorded the apex regulator status in the case of banks that would engage in other activities, the need for further co-operation and co-ordination of regulatory efforts, through the Financial Services Regulation co-ordinating Committee (FSRCC), was

emphasized. The imperative of adequate training and exposure of the supervisory staff of each sub-sectoral regulatory agency was also given prominence.

Similarly, the co-operation of operators in the banking system, through the activities of Self Regulatory Organizations (SRO) and other bodies in the banking system was also solicited, to ensure the successful implementation and operation of UB in Nigeria. The committee on the guidelines for UB noted the need to review all the relevant laws, such as BOFIA 1991 (as amended), Securities & Investment Act and the Insurance Act. Consequently, it identified areas of conflict and made necessary recommendations for their amendment.

3.3 Functions/Roles of Banks in Nigerian Economy

Many developing countries, including Nigeria are characterized by low level of capital income and inequalities in both the distribution of the meager income as well as low propensity to save at different levels of income. It is widely acknowledged as posited by Uzoaga (1983), that the availability of financial capital is a pre-requisite for the rapid development and transformation of any country's economy. This can only be facilitated by the existence of appropriate financial institutions in the economy. Therefore, banks have a vital role to play by making their financial resources available for financing and promoting development. There is no doubt that this role of banks is very pertinent to developing countries considering their peculiar circumstances. Banks have been able to bring relief from these handicaps through their activities of mobilizing financial resources from the surplus sector of the economy to the deficit units of the economy through the extension of loans and credits. The banks also have the additional responsibility of allocating the resources at their disposal in such a way as to ensure the promotion of rapid development of the nation's economy.

Despite the role banks are performing in the Nigerian economy, it is crystal clear that the banking system will have to brace up for more challenges, which are bound to be posed in the future. The challenges as enunciated by Edozien (1989) include:

1. The challenges as contained in the National Development Rolling plan where it was stated that banks are expected to play a dynamic role in channeling adequate amounts of their investible funds to the productive sector.
2. The expansion and diversification of the range of financial products available and the further widening of the scope of

banking services to enhance the performance of their role in the promotion of economic development.

3. The need to give due cognizance to the peculiarities of the Nigeria situation in their practices and programme. Nigeria, being a highly fragmented financial structure which is characterized by the co- existence of both formal and informal credit markets, a significant population of investible funds is likely to be trapped in various nook and crannies of the economy without being successfully mobilized in form of savings.
4. The need for increasing co-operation between the government and Banking system. It is certain that the policies of the banks are not always in consonance with the country's needs and aspirations for economic development and the government could not remain oblivious to this fact. An attempt must therefore be made to modify the banking practices in a way that would ensure that the pursuit of the profit motives was not at the expense of the country's development objectives.

4.0 CONCLUSION

In conclusion, financial and banking industry has a lot of players which, this study have discussed above. Therefore with the appropriate reference to the foregoing you can understand the operations of banks and financial industry.

5.0 SUMMARY

Summarily, it is obvious from the foregoing that the phenomenal of growth in the Nigerian Banking industry has suggested keen competition, which necessitated the adoption of marketing strategies and adequate credit analysis. For effective marketing of financial services, banks should recognize the constraints posed by the environment and ensure that the credit analysis elements are carefully selected to produce the deserved results both in terms of profitability and customer satisfaction.

6.0 TUTOR-MARKED ASSIGNMENT

Mention and discuss major player in bank and financial industry?

7.0 REFERENCES/FURTHER READINGS

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UNIT 2 REVIEW OF BANK DISTRESS IN NIGERIA

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- 1.0 Introduction
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 - 3.2 Effects of Bank Distress
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- 5.0 Summary
- 6.0 Tutor-Marked Assignment
- 7.0 References/Further Readings

1.0 INTRODUCTION

In the 1980s and early 1990s several countries, including developed economies, developing countries, and economies in transition have experienced severe banking crises. Such proliferation of large scale banking sector problems has raised widespread concern, as banking crises disrupt the flow of credit to households and enterprises, reducing investment and consumption and possibly forcing viable firms into bankruptcy. Banking crises may also jeopardize the functioning of the payments system and, by undermining confidence in domestic financial institutions, they may cause a decline in domestic savings and/or a large scale capital outflow. Finally, a systemic crisis may force sound banks to close their doors. In most countries policy-makers have attempted to shore up the consequences of banking crises through various types of intervention, ranging from the pursuit of a loose monetary policy to the bailout insolvent financial institutions with public funds. Even when they are carefully designed, however, rescue operations have several drawbacks: they are often very costly for the budget; they may allow inefficient banks to remain in business; they are likely to create the expectation of future bail-outs reducing incentives for adequate risk management by banks; managerial incentives are also weakened when - as it is often the case - rescue operations force healthy banks to bear the losses of ailing institutions. Finally, loose monetary policy to shore up banking sector losses can be inflationary and, in countries with an exchange rate commitment, it may trigger a speculative attack against the currency.

2.0 OBJECTIVES

By the end of this unit, you should be able to:

- explain the causes of distress in banking industry
- classify major effects of distress in banking industry.

3.0 MAIN CONTENT

3.1 The Causes of Financial Distress among Local Banks

Financial distress has afflicted numerous local banks, many of which have been closed down by the regulatory authorities or have been restructured under their supervision. Many of the bad debts were attributable to moral hazard: the adverse incentives on bank owners to adopt imprudent lending strategies, in particular insider lending and lending at high interest rates to borrowers is the most risky segment of the credit markets.

A. Insider lending

The single biggest contributor to the bad loans of many of the failed local banks was insider lending. In at least half of the bank failures referred to above, insider loans accounted for a substantial proportion of the bad debts. Most of the larger local bank failures in Kenya, such as the Continental Bank, Trade Bank and Pan African Bank, involved extensive insider lending, often to politicians. Insider loans accounted for 65 per cent of the total loans of the four local banks liquidated in Nigeria in 1995, virtually all of which was unrecoverable (NDIC, 1994, p. 48). Almost half of the loan portfolio of one of the Ugandan local banks taken over by the BOU in 1995 had been extended to its directors and employees. The threat posed by insider lending to the soundness of the banks was exacerbated because many of the insider loans were invested in speculative projects such as real estate development, breached large-loan exposure limits, and were extended to projects which could not generate short-term returns (such as hotels and shopping centres), with the result that the maturities of the bank's assets and liabilities were imprudently mismatched. The high incidence of insider lending among failed banks suggests that problems of moral hazard were especially acute in these banks. Several factors contributed to this.

First, politicians were involved as shareholders and directors of some of the local banks. Political connections were used to obtain public-sector deposits: many of the failed banks, particularly in Kenya, relied heavily on wholesale deposits from a small number of parastatals. Because of political pressure, the parastatals which made these deposits are unlikely to have made a purely commercial judgment as to the safety of their deposits. Moreover, the availability of parastatal deposits reduced the need to mobilize funds from the public. Hence these banks faced little pressure from depositors to - establish a reputation for safety.

Political connections also facilitated access to bank licenses and were used in some cases to pressure bank regulators not to take action against banks when violations of the banking laws were discovered. All these factors reduced the constraints on imprudent bank management.

In addition, the banks' reliance on political connections meant that they were exposed to pressure to lend to the politicians themselves in return for the assistance given in obtaining deposits, licences, etc. Several of the largest insider loans made by failed banks in Kenya were to prominent politicians. Second, most of the failed banks were undercapitalized, in part because the minimum capital requirements in force when they had been set up were very low. Owners had little of their own funds at risk should their bank fail, which created a large asymmetry in the potential risks and rewards of insider lending. Bank owners could invest the bank's deposits in their own high-risk projects, knowing that they would make large profits if their projects succeeded, but would lose little of their own money if they were not profitable. Of the 13 distressed local banks taken over by the CBN in 1995, all except one had paid-up share capital which barely exceeded the minimum required by law of N50 million and N40 million, for commercial and merchant banks respectively, at the end of 1994. The average paid-up share capital of the four commercial banks taken over by the CBN was N51 million compared with an average of N94 million for all 36 private-sector commercial banks, while the average paid-up share capital of the nine merchant banks taken over by the CBN was N52 million compared to an average of N68 million for all 48 private-sector merchant banks. The paid-up share capital of these 13 failed banks amounted to an average of only about 4 per cent of their total loans.

The third factor contributing to insider lending was the excessive concentration of ownership. In many of the failed banks, the majority of shares were held by one man or one family, while managers lacked sufficient independence from interference by owners in operational decisions. A more diversified ownership structure and a more independent management might have been expected to impose greater constraints on insider lending, because at least some of the directors would have stood to lose more than they gained from insider lending, while managers would not have wanted to risk their reputations and careers.

B. Lending to High-Risk Borrowers

The second major factor contributing to bank failure was lending, at high interest rates, to borrowers in high-risk segments of the credit market. This involved elements of moral hazard on the part of both the banks and their borrowers and the adverse selection of the borrowers. It was in part motivated by the high cost of mobilizing funds. Because

they were perceived by depositors as being less safe than the established banks, local banks had to offer depositors higher deposit rates. They also had difficulty in attracting non-interest bearing current accounts because they could offer few advantages to current account holders which could not also be obtained from the established banks. Some of the local banks relied heavily on high-cost interbank borrowings from other banks and financial institutions, on which real interest rates of over 20 per cent were not uncommon.

The high cost of funds meant that the local banks had to generate high earnings from their assets; for example, by charging high lending rates, with consequences for the quality of their loan portfolios. The local banks almost inevitably suffered from the adverse selection of their borrowers, many of who had been rejected by the foreign banks (or would have been, had they applied for a loan) because they did not meet the strict creditworthiness criteria demanded of them. Because they had to charge higher lending rates to compensate for the higher costs of funds, it was very difficult for the local banks to compete with the foreign banks for the "prime" borrowers (i.e. the most creditworthy borrowers). As a result, the credit markets were segmented, with many of the local banks operating in the most risky segment, serving borrowers prepared to pay high lending rates because they could access no alternative sources of credit. High-risk borrowers included other banks and NBFIs which were short of liquidity and prepared to pay above-market interest rates for interbank deposits and loans. In Nigeria some of the local banks were heavily exposed to finance houses which collapsed in large numbers in 1993, as well as to other local banks (Agusto and Co., 1995, p. 40). Consequently, bank distress had domino effects because of the extent to which local banks lent to each other. Within the segments of the credit market served by the local banks, there were probably good quality (i.e. creditworthy) borrowers as well as poor quality risks. But serving borrowers in this section of the market requires strong loan appraisal and monitoring systems, not least because informational imperfections are acute: the quality of borrowers' financial accounts are often poor, many borrowers lack a track record of successful business, etc. The problem for many of the failed banks was that they did not have adequate expertise to screen and monitor their borrowers, and therefore distinguish between good and bad risks. In addition, credit procedures, such as the documentation of loans and loan securities and internal controls, were frequently very poor. Managers and directors of these banks often lacked the necessary expertise and experience (Mamman and Oluyemi, 1994).

Recruiting good staff was often difficult for the local banks because ~the established banks could usually offer the most talented bank officials better career prospects. Moreover, the rapid growth in the number of

banks in countries such as Nigeria outstripped the supply of experienced and qualified bank officials.

C. Macroeconomic Instability

The problems of poor loan quality faced by the local banks were compounded by macroeconomic instability. Periods of high and very volatile inflation occurred in all four of the countries covered here. During the 1990s, inflation reached in Zambia 191 per cent, in Kenya 46 per cent, in Nigeria 70 per cent, and in Uganda 230 per cent. With interest rates liberalized (except in Nigeria), nominal lending rates were also high, with real rates fluctuating between positive and negative levels, often in an unpredictable manner, because of the volatility of inflation (Collier, 1993, pp. 19-20). Macroeconomic instability would have had two important consequences for the loan quality of the local banks. First, high inflation increases the volatility of business profits because of its unpredictability, and because it normally entails a high degree of variability in the rates of increase of the prices of the particular goods and services which make up the overall price index. The probability that firms will make losses rises, as does the probability that they will earn windfall profits (Harvey and Jenkins, 1994). This intensifies both adverse selection and adverse incentives for borrowers to take risks, and thus the probabilities of loan default. The second consequence of high inflation is that it makes loan appraisal more difficult for the bank, because the viability of potential borrowers depends upon unpredictable developments in the overall rate of inflation, its individual components, exchange rates and interest rates. Moreover, asset prices are also likely to be highly volatile under such conditions. Hence, the future real value of loan security is also very uncertain.

D. Liquidity Support and Prudential Regulation

Deposit insurance schemes were not crucial factors in contributing to moral hazard in the failed banks. Kenya and Nigeria have provided deposit insurance since the late 1980s, but only for deposits below a specified minimum amount. Many of the failed banks' deposits were not insured, because they were too large (as in the case of most of the institutional deposits) and/or because they were from sources not covered by the insurance scheme. But the willingness of the regulatory authorities to support distressed banks with loans, rather than close them down, was probably an important contributor to moral hazard. Many of the failed banks in Kenya, Uganda and Zambia had been able to borrow heavily from their respective Central Banks for several months and in some cases for more than a year, before they were closed. The extent of imprudent management in the failed banks indicates that there were

serious deficiencies in bank regulation and supervision. When many of the banks were set up in the 1980s or early 1990s, banking legislation was outdated and Central Bank supervision departments were seriously understaffed. In Kenya and Nigeria many banks avoided being inspected for long periods because the rapid expansion of banks in the second half of the 1980s overwhelmed supervisory capacities (Kariuki, 1993, pp. 300-9). Furthermore, political pressure was brought to bear on Central Banks to exercise regulatory forbearance. The Central Banks often lacked sufficient independence from the government to refuse liquidity support to politically connected banks and to strictly enforce the banking laws. In particular, for those banks with strong political connections, the expectation that regulators could be pressured to exercise forbearance must have seriously undermined discipline and incentives for prudent bank management.

3.2 Effects of Bank Distress

In the 1980s and early 1990s several countries, including developed economies, developing countries, and economies in transition have experienced severe banking crises. Such proliferation of large scale banking sector problems has raised widespread concern, as banking crises disrupt the flow of credit to households and enterprises, reducing investment and consumption and possibly forcing viable firms into bankruptcy. Banking crises may also jeopardize the functioning of the payments system and, by undermining confidence in domestic financial institutions and they may cause a decline in domestic savings and/or a large scale capital outflow. Finally, a systemic crisis may force sound banks to close their doors. In most countries policy-makers have attempted to shore up the consequences of banking crises through various types of intervention, ranging from the pursuit of a loose monetary policy to bailout insolvent financial institutions with public funds. Even when they are carefully designed, however, rescue - operations have several drawbacks: they are often very costly for the budget; they may allow inefficient banks to remain in business; they are likely to create the expectation of future bail-outs reducing incentives for adequate risk management by banks; managerial incentives are also weakened when - -as it is often the case -rescue operations force healthy banks to bear the losses of ailing institutions. Finally, loose monetary policy to shore up banking sector losses can be inflationary and, in countries with an exchange rate commitment, it may trigger a speculative attack against the currency.

Empirical studies show that credit to the private sector and aggregate output do in fact decelerate during banking crises. However, this is not necessarily that banking problems contribute to the decline in output: first, the same exogenous adverse shocks that trigger banking problems

may also cause a decline in aggregate demand, leading firms to cut investment and working capital and, ultimately, demand for bank credit. These same shocks may also cause a temporary increase in uncertainty, leading firms to delay investment and borrowing decisions. In addition, adverse shocks might hurt borrower balance sheets and exacerbate the effects of asymmetric information and limited contractibility, prompting banks--even healthy ones--to curtail lending to riskier borrowers ("flight to quality") or raise lending spreads. To summarize, output and bank credit are likely to decelerate around banking crises even in the absence of a feedback effect from bank illiquidity and insolvency to credit availability. To identify the real effects of banking crises it is necessary to sort out this joint endogeneity problem.

4.0 CONCLUSION.

In the course of this study we have been able to establish various causes and effects of bank distress in Nigeria and other local banks in Africa. Thus one can conclude that bank distress eroding the confidence of populace in banking industry and this has led to decrease in saving and investment in the economy.

5.0 SUMMARY

This unit was able to classify various causes of bank distress among which are insider lending, lending to high risk borrower, macroeconomic instability, liquidity support and prudential regulation. It also discussed various effects of bank distress which include; disrupt the flow of credit to households and enterprises, reducing investment and consumption and possibly forcing viable firms into bankruptcy. Banking crises may also jeopardize the functioning of the payments system and, by undermining confidence in domestic financial institutions.

6.0 TUTOR-MARKED ASSIGNMENT

Discuss the causes and effect of bank distress in Nigeria economy?

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UNIT 3 BANK REGULATORY AUTHORITIES

CONTENTS

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1.0 INTRODUCTION

The banking sector has been subject to extensive regulation by the CBN as well as direct participation by the Federal Government and state governments during the post independence period. Economic nationalism and developmental aspirations were important motivations for interventionist policies. The character of these policies was that of financial repression, in it that controled depressed interest rates and channelled resources away from areas where private rates of return would have been high.

The allocation controls have been liberalised to some extent since 1986, although controls over key areas remain in force.

2.0 OBJECTIVES

By the end of this unit, you should be able to:

- establish the purpose of bank regulation
- explain various areas bank operations are guided by the regulation
- identify various bodies responsible for formulation and implementation of regulation.

3.0 MAIN CONTENT

3.1 The Regulatory Authorities

These are institutions, which are responsible for the orderly development of the financial system. They ensure compliance with laid down rules and regulations guiding their operations.

They are made up of the following institutions and organizations:

1. Central Bank of Nigeria;
2. Nigeria Deposit Insurance Corporation;
3. Securities and Exchange Commission;
4. Federal Ministry of Finance;
5. National Insurance Commission;
6. Federal Mortgage Bank of Nigeria; and
7. National Board for Community Banks.

3.1.1 The Central Bank of Nigeria.

The Central Bank of Nigeria was established by Act of 1958 and commenced operations on 1st July 1959. The Act, which has undergone some amendments, was re-enacted as the CBN Act No 24 of 1991. In addition, Banks and other financial Institutions Act No 25 of 1991 was promulgated. The two Acts with necessary amendments up to 1999 gave CBN more flexibility in regulating and supervising the banking sector and licensing finance companies, which hitherto operated outside any regulatory framework.

The CBN today stands as the apex regulatory authority of the financial system by virtue of the functions it has to perform in the Nigerian economy. It also serves as the principal regulator and supervisor in the money market, as well as the activities of finance companies and specialized in the development of finance institutions.

Functions of the Central Bank of Nigeria

The CBN performs a myriad of functions, which are derivable from its objectives to:

- a) Issue legal tender currency;
- b) Maintain the external value of legal tender currency;
- c) Promote monetary stability and sound financial system;
- d) Banker and financial adviser to the Federal Government;
- e) Banker to the banks;

With various organs of the CBN its functions can be classified into two broad categories, namely: core, and developmental functions.

Its core functions include currency issue and distribution, banker to other banks, banker to the government; promotion and maintenance of monetary stability and sound financial system, debt Management, foreign exchange management and providing facility to entertain public complaints.

The developmental functions carried out by the apex bank include the promotion of the financial markets, introduction of money market instruments, facilitating capital market institutions and instruments and sponsoring specialized institutions.

The specialized institutions sponsored by CBN over the past 4 decades include the following:

- BOI -Bank of Industry.
- NACRDB -Nigerian Agricultural Cooperative and Rural
- Development Bank.
- NAIC -Nigerian Agricultural Insurance Corporation;
- NDIC -Nigerian Deposit Insurance Corporation;
- NEXIM -Nigerian Export Import Bank;
- SEC -Securities and Exchange Commission; and
- Specialised schemes and funds such as:
 - ACGS;
 - Rural banking scheme (1977-1980; 1980-1985; 1985-1989);
 - NERFUND. ,
 - SMB (Apex) Unit loan scheme and
 - SMIEIS.

3.1.2 Nigerian Deposit Insurance Corporation

The growth in the banking sub-sector of the financial system at the dawn of the 1980s resulted in rapid licensing of new Banks most of which could not compete effectively given the prevailing economic environment. This growth in the number of operating banks brought a lot of pressure on the CBN in the conduct of its supervisory roles. The collapse of some of these new banks necessitated the establishment of the Nigerian Deposit Insurance Corporation. This was to complement the regulatory and supervisory role of the Central Bank of Nigeria. The NDIC was established by Decree No. 22 of 15th June 1988 and took off in February 1989. It was set up principally to provide deposit insurance and related services for banks in order to promote confidence in the

banking industry. It was empowered to examine the books and affairs of insured banks and other deposit taking financial institutions.

3.1.3 The Securities and Exchange Commission

This regulatory organ for the capital market operation was formerly called Capital Issues Commission and was established by SEC Act of 27th September 1979 and further strengthened by SEC Decree of 1988.

It is the apex regulatory authority of the Capital Market and was established to promote an orderly and active capital market. The commission ensures adequate protection of the investing public as well as determines the prices and the time companies' securities are to be sold, the sales volume, registering all securities dealers to ensure professionalism. It is empowered to approve and regulate mergers and acquisitions and authorize the establishment of unit trusts as well as maintain surveillance over the market to enhance efficiency.

3.1.4 The Federal Ministry of Finance

The Federal Ministry of Finance caters for the Federal Government's involvement in the financial system. The Ministry is primarily in charge of the fiscal policy of the Federal Government. It advises the Federal Government on its fiscal operations, which influence monetary policy. It cooperates with the CBN on monetary matters as well. The ministry had some responsibility for foreign exchange management prior to 1986 deregulation. This function is now performed solely by the CBN.

3.1.5 National Insurance Commission

At the apex of the Insurance sub-sector is the National Insurance Commission (NAICOM), which replaced the Nigerian Insurance Supervisory Board established by Decree No. 62 of 1992. NAICOM is responsible for effective administration, supervision, regulation and control of the business of Insurance in Nigeria. By law, it is expected to establish standards for the conduct of insurance business and protection of insurance policy holders. It ensures adequate capitalization and reserves, good management, high technical expertise and judicious fund placement by the Insurance companies it supervises.

3.1.6 The Federal Mortgage Bank of Nigeria (FMBN)

This body is at the apex of mortgage financial institutions in the country. The FMBN was established by Decree No.7 of 1977 and immediately took over the assets and liabilities of the Nigerian Building Society, which was performing the statutory regulatory role before then. The

FMBN provides banking and advisory services and research activities pertaining to housing in Nigeria. It was empowered by the letters of the National Housing Policy in 1990 to license and regulate primary mortgage institutions in Nigeria and act as apex regulatory body for mortgage finance industry.

3.1.7 National Board for Community Banks

The Board was established by government as apex regulatory body with the responsibility of licensing and supervising the activities of the community banks in the country. It was established in 1992 to accept and process applications from interested communities, provide guidelines for operations and ensuring compliance. The Board is expected to monitor, inspect and supervise the operations of Community Banks and apply sanctions when necessary. It also carries out promotional activities for enlightenment purposes. Most of the above functions are now vested in the CBN and the Board is presently hamstrung to perform them due to this fact. Efforts are still being made to resolve the conflict arising from this duplication of regulatory functions.

3.1.8 Financial Services Coordinating Committee (FSCC)

This committee was established by the Federal Government to coordinate the supervision of activities of all the regulatory institutions in the financial system. It is chaired by the Governor of CBN, and consists of Director General of the Securities and Exchange Commission, the Commissioner for Insurance, the Registrar-General of the Corporate Affairs Commission (C.A.C), and a representative of the Federal Ministry of Finance (FMF).

This committee is saddled with the responsibility of coordinating the supervision of financial institutions, especially conglomerates. It is expected to cause reduction of arbitrage opportunities usually created by differing regulation and supervision standards among supervisory authorities in the economy. This it does by creating a forum to discuss such conflicts without creating unnecessary tension in the system. The Committee also deliberates on problems experienced by members in their relationship with any financial institution. In so doing, it eliminates any information gap encountered by regulatory agencies in their relationship with groups of financial institutions. Finally, the committee articulates the strategies for the promotion of safe, sound and efficient practices by financial intermediaries. The roles are currently being performed satisfactorily as there are reduced conflicts among the financial system's regulatory authorities.

4.0 CONCLUSION

In conclusion, bank regulation authorities are responsible for the formulation and implementation of rules and regulations that guide the performance and operation of banking industry.

5.0 SUMMARY

In summary, in this unit, we discussed various institutions and bodies in charge of formulation and implementation of rules and regulation and these institutions include: Central Bank of Nigeria, Security and Exchange Commission, NDIC, etc.

6.0 TUTOR-MARKED ASSIGNMENT

State and discuss the bodies responsible for bank regulation in Nigeria?

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UNIT 4 BANK CONSOLIDATION

CONTENTS

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 - 3.2 Implications of Banking Reform on the Real Economic Sector
 - 3.3 Banking Sector Reform and the Downstream Petroleum Sector
 - 3.4 Mergers, acquisition and challenges in Nigeria Banking Industry
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- 5.0 Summary
- 6.0 Tutor-Marked Assignment
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1.0 INTRODUCTION

If bank merging is well managed and effectively monitored, only short' run problems such as unemployment would be experience as the lay-off staff of the failed banks would join the millions of graduates yet unemployed, this has multiplier effects of poor standard of living, prostitution, thievery and many other corruption practices. But the prospects largely envisaged is more of long run, since consolidation improves financial, technical managerial capacity of the banking sector all things being equal, expansion in the banking sector is inevitable and this comes with the multiplier effects such as employment generation in large number. Management of the Foreign Reserves by the mega banks would enable the bank finance high capital intensive projects, manufacturing, oil and gas, agriculture sectors to mention but few. The multiplier effect of all these brings about employment in other sectors. More importantly, bank consolidation reduces the tension of bank liquidation in Nigeria and both local and foreign investors.

2.0 OBJECTIVES

By the end of this unit, you should be able to:

- describe the background of Banking Sector Reform/ Consolidation in Nigeria
- recognise the implications of Banking Reform/consolidation on the real Economic Sector

- explain the Banking Sector Reform and the Downstream Petroleum sector
- discuss mergers, acquisition and the challenges in Nigeria Banking Industry.

3.0 MAIN CONTENT

3.1 Background of Banking Sector Reform/Consolidation

Over the years, the banking sector has been unable to significantly support the long-term financial needs of the real sector. This is in spite of the fact that the growth of the national economy hinges on the extent to which the real sector is effectively supported by the banking and finance sector, which play a catalytic role in the growth process. Most investments in the real sector are of medium to long-term nature. Unfortunately, funding for such investments are not always forthcoming from the banks because of the short-term nature of their deposit liabilities and the inappropriateness of using such deposit base to support long-term lending. Also, given the widespread lucrateness of rent-seeking activities, bank depositors often demand such rates of return that are usually realizable on such quick businesses that exist in the economy. The combined effect of these is the prevalence of short-term lending at high cost against the need for long-term funds at minimal cost by the real sector firms (Ndiokho, 1996). The structural weakness of the banking system, which has hindered the performance of its developmental role in the economy and seriously curtailed the achievement of Governments objectives of ensuring price stability, economic growth and high employment level prompted the CBN to embark on the current reform of the sector. The purpose of the banking sector reform is to enable the Nigerian banks give priority to, and make available, cheap and competitive credits, to the real sector so that the economy can grow. The banking reform package is anchored on a I3-point programme, some of which include: increase in the minimum capital base requirement of the banks from N2 billion to N25 billion; consolidation of banking institutions through mergers and acquisitions; and the establishment of an Asset Management Company as important vehicle for banking system distress resolution (Soludo, 2004).

Bank consolidation through mergers and acquisition and the establishment of Asset Management Company to purchase the non-performing risk assets of the banks would have the salutary effect of cleaning up the banking sector, as well as lead to the emergence of big banks that would ably support the growth of the real sector, as well as compete in the international arena (Soludo, 2004). The resultant appearance of mega banks with robust capital and asset base on the national economic landscape would provide the spring board for

launching the economy to greater sustainable heights and in the process achieve the long term goals of reducing the level of poverty in the system, providing employment in the wider economy and creating wealth for all.

3.2 Implications of Banking Reform on the Real Economic Sector

The reforms in the banking system are likely to have the following implications on the development of the real sector:

- The policy is likely to adequately position the banking industry to be able to mobilize international capital for on-lending to the real sector for the development of the economy.
- The policy is likely to drastically reduce banks' cost of funds and perhaps reduce the pressures on banks that engage in sharp practices as a means of survival. This will affect the rate of interest charged on loans to real sector operators.
- The policy will promote an efficient financial system. This policy will support the mobilization of savings and lending to small medium scale enterprises. For instance, considering the fact that each Nigerian bank has to provide basic infrastructures for its operations, it was obvious that there was a regulatory requirement among others. In the new dispensation, overlapping of functions and unnecessary duplications will be avoided. Efficiency will also be promoted through the existence of increased scale economies in producing financial services. All these are likely to translate to lower interest rates in the country.
- The establishment of an Asset Management Company would help banks clean up their balance sheets. When this is combined with the strengthening of the existing legislative framework for debt recovery, it would put banks in a more comfortable position to fund the activities of the real sector operators.
- It is expected that cost of funds would drop significantly and margins would decline due to stiffer competition. However, another concern could be that larger banks would exploit their greater market power to reduce lending and by implication increase loan rates.
- Future profits may benefit from cost reductions arising from economies of scale- that is, the ability to spread fixed costs, including particularly those that are technology -related, over a larger scale of operations. Cost economies can also be achieved by

eliminating duplications in branch networks, functions and staff. There may also be a reduction in risk, and therefore saving in costs due to geographic or product diversification and the ability of larger institutions to invest in more sophisticated risk management systems. All these are likely to impact positively on the availability and cost of lending to the real sector.

- Apart from pricing considerations, the new reforms could reduce the amount of credit available to small businesses. This argument is based on the observation that small banks grant small loans (since they do not have large enough balance sheets for more sizeable loans often required, by larger businesses) assumed to go to small firms, and that large banks tend to lend to large businesses (as the monitoring costs of many small companies would be too high for them). Therefore, a large proportion of the population might end up not being served by the formal banking system. There is therefore a need for non bank financial intermediaries to be strengthened to cater for the needs of small-scale real sector operators

3.3 Banking Sector Reform and the Downstream Petroleum Sector

Oil and gas sub-sector constitute one of the important components of the reform program for the real sector of the national economy. The key elements of the reform agenda in this respect is the de-regulation of the downstream sector through the privatization of the nation's four refineries and product haulage, appropriate pricing of petroleum products through the withdrawal of subsidy and the attraction of private capital investment in this sector. Indeed the privatization of the downstream sector would not be fully achieved without the active support and collaboration of the banking and finance sector. The intermediary role of the banking sector would enable the channeling of the necessary funds with which to fully and effectively re-position the oil and gas sector to perform its developmental role in the economy. Private sector investment in the de-regulated downstream sector requires long term financing arrangement and that explains the relevance of the consolidation of the banking sector which is one of the thirteen point reform agenda for the banking sector announced by the CBN Governor. When it becomes fully operational, the banking sector reform would unlock and make available alternative funding schemes to support the emergence and growth of local private capital in the oil and gas sector. It would also accelerate the privatization of the refineries and product haulage.

3.4 Mergers, Acquisition and Challenges in Nigeria Banking Industry

No doubt, reforming the financial sector, especially the banks were never going to be an easy task due to rigidities in the system. But the ultimate goal of government was to right size the banks to make them bigger, stronger, more commercially nimble and competitive regionally and globally.

This meant rightsizing to deal with the vulnerabilities associated with their small sizes, restructuring, re-engineering, reprofessionalizing and refocusing the banks. All these rested on the NEEDS programme of government.

Essentially, 'NEEDS', as a developmental strategy, is anchored on the private sector as the engine of growth. The government is the enabler, the facilitator, and the regulator, while the private sector takes charge as direct investor, executor and manager of businesses.

The NEEDS vision is to create a strong competitive and reliable financial system that is part of the global change. A system, which depositors can trust, and investor can rely upon. During the reform, banks are expected to imbibe best practice corporate governance procedures, improve on self regulation, institute IT driven culture and seek to be competitive in today's globalize world. Thus, the origin of Mergers and Acquisition came as a result of new economic reform agenda tagged NEEDS (National Economic Empowerment Development Strategy) whose major challenge was to restructure the Nigerian economy with special interest in the banking industry. Mergers and Acquisition, therefore, are twin concepts regarded as investment proposal where a company or part of a company is either merged with another or taken over completely with the aim of consolidation. By way of definition therefore, an acquisition (also called takeovers) is the purchase of a controlling interest in one company by another company; while a merger is an amalgamation between two separate companies to form a single company. Thus, both acquisitions and mergers are forms of business combinations.

For an acquisition or merger to be worthwhile, there should be synergy, that is, a situation by which a firm, after a takeover or merger looks for a combined result to reflect a better rate of return than that which was achieved by the same resources used independently before the takeover of such separate operations. This is described, as combined performance is greater than the sum of its parts. Synergy can therefore be more achievable if the companies involved in the acquisition or merger is engaged in related line of business. A classical case of merged banks is the Standard Trust Bank and the United Bank for Africa.

Why Banks in Nigeria Merged?

Banks merged and some of them acquired others as a policy driven directive from the apex bank (Central Bank of Nigeria) to secure maximum security and lay confidence on the growing populace who are depositors in the banks. However, there are a variety of reasons why the Nigerian banks go for merger or acquisition bids. These reasons can be as follows:

- To realize operating economies by eliminating duplication and unhealthy competition
- To acquire aggressive and competent management
- To eliminate or reduce competition
- To diversify, that is, spreading of risk
- To bolster asset banking
- To improve quality of earnings
- For protection against market infringement and unwanted take over

And finally to seek rapid growth and improve liquidity and ability to raise new finance through acquisition of a more financially stable bank.

Consequences of Mergers and Acquisition

The framework for analyzing an acquisition or merger is similar to that of internally generating investment proposals. The strategic fits and potential synergies must be articulated. In doing that, the following steps in the evaluation process must be followed:

- Determining the relevant cash flow that is, the future cash flow or income that the acquisition is expected to add. Ignoring financing decision in determining the cash flow estimates can do this, the expected incremental cash profit should be adjusted for taxes, the horizon of the project should also be determine, and also the use of probability estimated to obtain accurate estimate of cash flow must also be ascertained.
- Determining the required rate of return or cost of capital using the weighted average cost of capital for both quoted and unquoted companies

The major challenges bank consolidation faces include:

- **Loss of Power**

Corporate consolidation, which may be by way of mergers and/or acquisition, may be resisted by management with fear of loss of control and erosion of their powers.

- **Rigidity of Bank Ownership**

The rigidity of bank ownership include a complicated web of cross shareholding the bids banks to insurance companies and other banks. These rigidities can block mergers.

- **Lacier Sizes**

As a result of mergers and acquisition, consolidation often means larger sizes, larger shareholders bases and larger number of depositors. The project revenue stream from the consolidation must justify this cost of increasing cost of maintaining several deposit accounts.

- **Fear for Job Loss**

Some of the smaller merger partners will be jobless because the dominant bank will not be able to absorb all the staff of the smaller bank leading to job losses arising for mergers..

Challenges in Change Management in the Banking Sector

Any form of right sizing, re-engineering, re-focusing, business re-invention, or repositioning through Mergers, Acquisition and Take Overs in the banking Sector would no doubt create great challenges for the institutions involved, not only would they be longer as we have discovered, the resulting banks are now multi cultural, multi market, multi management and in some cases multi national.

They are all thus facing the challenges of integration and ultimate CONSOLIDATION. They are also challenged in innovativeness in product market development and IT driven delivery methods. This is where the management of strategic change becomes paramount.

Change must occur due to the following:

- It is shift in the behaviour of an entity in response to some internal or external stimuli;
- Change demands appropriate responses to achieve the original state of equilibrium or to take advantage of new events in order to improve the current equilibrating state. It occurs through:

- Product market repositioning.

- Refocusing;
- Restructuring;
- Down sizing, right sizing and up sizing;
- Re engineering;
- Business reinvention;

Painless change must therefore:

- Relate to existing corporate vision;
- empower people to generate personal commitment;
- indicate improved benefits arising there from;
- remove corporate blockers to action;
- develop new management skills and flexibility in job performance.

Change is a fact of life, corporate life and governance inclusive. The only thing that is permanent is change. A company may have decided on its vision upon which a mission statement is expressed, goals and objectives determined, policies formulated and strategic directions chosen based on its perception of the internal and external environments within which it expects to operate and its assumptions about developments within these environments. In other words, it has put together appropriate response mechanisms for profitably benefiting from the productive relationships of its resources in interaction with its operating environments. But, no matter how "perfect" these response strategies may be for a given environmental scenario, they begin to lose their essence and value when changes take place. Unless these strategies are constantly reviewed, refined, redefined and overhauled to suit the changes that are continuously occurring in the operating environment, sub-optimality in expected results due to the lack of competitiveness will begin to emerge. In the corporate operating environment there is no stasis only dynamism and sometimes turbulence, in effect, change.

Change

What is change within the context of corporate strategic management? How would a company set about managing change in a proactive profitable way? Change is the shift in the behaviour of any entity, be it organic or mechanistic. It is shifts from one position to another either in response to some internal or external stimuli or for no apparent reason at all.

But however induced, change always demands appropriate responses to achieve the original state of equilibrium, or to take advantage of new events in order to improve the current equilibrium state.

Corporate operating environments change because macro and micro economic policies are constantly changing. They change in the banking

sector because the CBN decrees a new N25 billion minimum equity base for the banks. But most importantly, environments change because the way of doing business has changed. Corporate entities are then expected, nay required if not compelled, to respond to these changes if they are to survive in the market place.

Apart from the external operating environment of a company, changes do occur in its internal environment as well. Managerial attitudes, skills, aptitudes and perceptions are constantly on the boil. Leadership styles are changing, use of technology is changing and shifts are continually occurring in managerial ages and thus their approach to management as well as in the configuration of the superior subordinate hierarchical chain of command. Every company must then create the necessary organizational framework for dealing proactively with these changes.

But the major driving force of corporate change competition in the market place is not only for opportunity share but more for profit share.

So long as there is constant competition, so long will there be non stop organizational change in the pursuit of efficiency, cost effectiveness, Innovativeness and business/industry dominance. Change is a necessity for organizational survival and corporate dominance. Change is also a learning process not only for the individuals and stakeholder within an organization but for the organization itself. Unfortunately however, change tends to be more people dominated and hence often untidy, irrational and frustrating to execute. Therefore, the change process has to be handled carefully, planned for, within the context of a well articulated and accepted programme of action and pursued constantly and relentlessly.

Why Change?

There are several reasons why organizations change:

The internal environment is changing; the external environment is changing; increasing complexity involved in the way business is done. Technology, culture, new products, markets, processes; organizational pressures for change; societal pressures;

- Changing environmental values;
- Changing competition; and
- Globalization and the move towards market integration.

As a result, organizations are compelled to study their past histories, assess their present competitive positions, evaluate the environments within which they expect to fit into in future. This results in several strategic options open to them from the several scenarios that may have been built. An appropriate response option in the form of a strategic

intent is selected to deal with the future. This continuous reflection, review and assessment of the competitive environment must then evolve into constant repositioning of the organization in terms of its products, markets and/or processes and functions within the context of its vision and mission in effect, change.

4.0 CONCLUSION

In the course of this study you were able to establish various reform or consolidation process in Nigeria. The consolidation as a strategy in financial industry has proved to enhance a viable economy environment for bank and other financial services industries in Nigeria.

5.0 SUMMARY

In summary, this study discussed the meaning of consolidation as strategy in financial industry and one of strategy of NEEDS programme in Nigeria. The discussion also focuses on merger and acquisition: its process, and application in Nigeria banking industry.

6.0 TUTOR-MARKED ASSIGNMENT

What do you understand by consolidation? Discuss merger and acquisition process as related to recent reform in Nigeria banks?

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UNIT 5 THE CREDIT MARKET

CONTENTS

- 1.0 Introduction
- 2.0 Objectives
- 3.0 Main Content
 - 3.1 The Financial Markets and Institutions
- 4.0 Conclusion
- 5.0 Summary
- 6.0 Tutor-Marked Assignment
- 7.0 References/Further Readings

1.0 INTRODUCTION

Ordinarily, a market denotes a place for buying and selling. However, a more conceptual approach would reveal that the term market connotes all means through which buyers and sellers of commodities (products or services) are brought into contact. Therefore credit market is a place where funds are made available by the surplus unit of the economy to the deficit unit of the economy. The credit market includes both money market and capital market where short and long terms finances are made available for interest.

2.0 OBJECTIVES

By the end of this unit, you should be able to:

- classify various sources of funds
- identify the role and functions of various credit markets
- differentiate between money market and capital market.

3.0 MAIN CONTENT

3.1 The Financial Markets and Institutions

Money Markets

The money market can be defined as a market for short-term debt instruments. The major function of this market is to facilitate the raising of short-term funds from surplus sector to the deficit sector of the economy.

This is done through trading in short-term securities such as Treasury Bills, Treasury Certificates, Call Money, Certificates of Deposit, and Commercial Papers. The Central Bank of Nigeria further deepened the market with the commencement of its Open Market Operations activities.

Money Market Institutions

The money market institutions are those institutions that participate actively in the markets. These institutions include Discount houses, Commercial and Merchant Banks as well as Community Banks.

The Capital Market

The Capital Market is a veritable channel for mobilizing long-term funds. The main institutions in the market include Securities and Exchange Commission, which is at the apex and serves as the regulatory authority of the market, the Nigerian Stock Exchange, the Issuing Houses and the Stock Broking Firms.

The Capital Market is classified into three. These are the Primary Market, which are markets for new issues of securities. The mode of offer for the securities traded in this market includes offer for subscription, right issues and private placements.

The Secondary Market is a market for trading in existing securities. It consists of exchanges and over-the-counter markets where securities are bought and sold after issuance in the primary market.

The Unit trust scheme is a mechanism for mobilizing the financial resources of small and big savers and managing such funds to achieve maximum returns with minimum risks, through efficient portfolio diversification. It offers the advantages of low cost, liquidity and high returns.

The Nigerian Stock Exchange was established to provide facilities to the public for the purchase and sale of stocks and shares of any kind and the investment of money etc.

Development Finance Institutions

These are specialized banks and development finance institutions established to contribute to the specific sectors of the economy. They include the Bank of Industry (BOI), Nigerian Export-Import Bank (NEXIM), URBAN DEVELOPMENT BANK (UDB), Nigerian Agricultural and Rural Development Bank (NARDB) among others.

Other Financial Institutions and Funds

Other financial institutions and funds under the financial system include Insurance companies, Finance companies, Bureaux de Change, Primary Mortgage Institutions, The National Economic Reconstruction Fund (NERFUND), and the Nigerian Social Insurance Trust Fund (NSITF).

4.0 CONCLUSION

This unit briefly examines the financial market which is the market where money is a product that exchange hands. The various institutions responsible for raising funds are mentioned.

5.0 SUMMARY

In summary, this unit focused on various market that are responsible for funds raising for investment purpose. These include money market, capital market, development finance companies and other financial institutions.

6.0 TUTOR-MARKED ASSIGNMENT

Mention and discuss various markets in bank and financial industry?

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MODULE 2

Unit1	Theory of Bank Credit
Unit2	Financial Statement Analysis
Unit3	Risks in Banks
Unit4	Risk Analysis/Rating of Banks
Unit5	Measurement and Control of Bank Risk

UNIT 1 THEORY OF BANK CREDIT

CONTENTS

1.0	Introduction
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3.1.2	Central Bank Credit in the Payment System
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1.0 INTRODUCTION

The study of the mechanics of market exchange is a distinct field of inquiry. Payment economics is no narrow technical specialty, either. It builds on monetary theory, since its use in payments defines monetary instruments. It also draws on banking theory, based on the observation that virtually all institutions that we usually think of as banks are significantly involved in payments intermediation.

2.0 OBJECTIVES

By the end of this unit, you should be able to:

- differentiate between Self-liquidating papers Theory Vs. Anticipated Income Theory
- analyse various theories that guide the bank credit

- identify views of various bodies about credit and loan administration
- discuss the payment theory
- discuss the role of central bank credit settlement arrangements.

3.0 MAIN CONTENT

3.1 Bank Credit Theories

3.1.1 Self-liquidating paper Theory vs. Anticipated Income Theory

Traditional banking theory favoured by the conservative bankers holds that the earning assets of a bank should be limited to short-term self-liquidating productive loans. These include self-liquidating commercial papers or short-term loans intended to provide the current working capital, which in itself is of a self-liquidating nature. The merit of the self liquidating theory of commercial bank assets is mainly derived from the fact that such loans are considered to liquidate themselves automatically out of the sale of goods covered by such a transaction. For instance, let us take the case of a bill of exchange, a typical example of a self-liquidating paper, drawn for the purpose of purchasing raw materials. The bill is covered by a genuine commercial transaction. And a banker is justified in giving a loan against such a paper, because self-liquidating papers are automatically providing the banks with liquidity through loan repayments. Not only that but they are also shiftable to the central bank in times of emergencies, as the central bank, being the lender of the last resort, prefers such self-liquidating papers. The loss avoiding aspect of liquidity is also present here because of the very short periods for which these loans are given. Moreover, they protect the business world against inflation because of their elastic nature to correspond with the trade demands because they increase as production increases and decrease as production decreases. No wonder the traditional bankers heavily favoured the claims of self-liquidating theorists.

However, the validity of self-liquidating theory has been challenged by certain writers. They contend that the transaction covered by a self-liquidating paper does not by itself always guarantee liquidity of the loans especially where there is an abnormal fall in the price of those commodities. It is said that customers' loans are to provide their current working capital and not a safe and reliable source of bank liquidity. The contention that self-liquidating commercial loans provide a protection against inflation has also being challenged by the critics. They argue that during boom periods, when business conditions are prosperous, the borrowers increase their loans by offering more and more self-

liquidating papers. As full employment is reached, the prices increase because of the increase in money supply as compared to the output, introducing inflationary trend in the economy. They conclude by saying that the theory of self-liquidating are fallen out of date. And as an alternative, they advocate new theory of bank liquidity viz, 'Anticipated Income Theory of liquidity'. The origin of the theory lies in the extension of terms of loan by the commercial banks of the United States for financing long-term capital needs of industry. The loan is granted on the specific condition on the part of the borrower to conduct the financial and other affairs in such manner as agreed upon between him and banker. The loan is to be liquidated out of the anticipated earnings.

Whatever be the merit of such a theory, a point may be said in favour of the traditional theory of commercial bank assets. When a banker provides short- term self-liquidated productive loans, it is fairly easy for him to gauge the liquid position of his customer because of the short length covered by such a loan. Whereas in the case of long-term loans, given on the basis of anticipated incomes of such loans, the question involved is not one of gauging the current liquidity position of the borrower, but the future earning capacity which depends on the correct assessment of a number of factors, which may go wrong. It is because of this that the English bankers still find favour with the view that it is always good for commercial banking to make short-term self-liquidating productive loans.

3.1.2 Central Bank Credit in the Payment System

Central banks have traditionally viewed the provision of credit to the banking system as an essential tool for achieving their goals. The lender-of- last-resort function is a widely accepted role for central banks to play in responding to emergency liquidity needs. Bagehot's prescription to lend freely but only at a high rate on good collateral to solvent institutions, is one of the most well-known maxims in central banking, although some of these distinctions can be tricky to apply in practice.

It is important to recognize, however, that central bank lending involves two distinct actions. The first is an increase in the deposit account liabilities of the central bank. The second is the acquisition of a private liability. In Bagehot's time, acquiring private liabilities was the main method of altering the aggregate supply of central bank deposit liabilities, and so the lender-of- last-resort policy he prescribed was the natural way to provide for an elastic supply of deposits when demand for those deposits spiked. The founding of the Federal Reserve System was motivated by a similar desire to prevent interest rate spikes when the demand for reserves surged. The advent of open market operations

in liquid government securities, however, made it less obvious that acquiring private liabilities was the best way to manage the supply of central bank deposits. Most central banks now treat open market operations aimed at pegging overnight interbank interest rates as distinct from lending to individual banking institutions. In fact, pegging interest rates automatically sterilizes the effect of such lending on aggregate deposit supply. Discount window lending now represents a form of fiscal policy a public sector loan to a private entity. It is no longer necessary to the provision of an elastic supply of reserves.

The lender-of-last-resort function typically involves overnight credit. Many central banks provide intraday credit in the course of operating interbank payment systems that provide payment finality. Of course, daylight credit that is not extinguished by the end of the processing day becomes overnight central bank credit of some form or another. Central banks have taken different approaches to the provision of daylight credit. The Swiss used to just say no; now they lend via intraday repurchase agreements. Most central banks provide daylight credit on fairly liberal terms. Many insist that such credit be fully collateralized. The Federal Reserve System currently allows daylight credit to be uncollateralized, but charges a fee equivalent to 36 basis points at an annual rate on daylight credit above a certain threshold.

3.1.3 Payments Theory

What does economics have to say about the role of central bank credit in the payments system? The nature of the problem provides some guidance, I believe, regarding the methodology one needs to bring to bear. To evaluate the role of central bank credit, one needs to assess the costs and benefits of alternative policy regimes governing the provision of that credit. To do that, one needs to understand how bank behaviour will change when one changes central bank credit policy. In other words, how will deposit balances and the timing and magnitude of payment flows differ from one regime to another? Empirical analysis of payments systems data can provide some assistance here by providing an understanding of the underlying patterns of payment flows among banks. But such analyses invariably run into the "Lucas Critique" -that is, that estimated relationships from the status quo regime may shift dramatically in response to a change in regime. To the extent that one is evaluating an alternative regime that differs substantially from current policy, one must identify the "structural" determinants of bank behavior that are invariant across regimes. Thus, evaluating alternative payment policy regimes calls for a theoretical framework, although observations from history or across countries might also provide some insights. The analysis of a system's likely response to a major shift in policy requires a

plausible model that incorporates the effects of central bank policy on equilibrium private sector behaviour.

What should we look for in models of payment activity? One important principle is embodied in William Baxter's (1983) Dictum-that the issuance, use, clearing and settlement of a payment instrument is a service of joint benefit to the buyer and the seller and that service is provided jointly by all parties to clearing and settlement. As a result, a sound economic evaluation of alternative payment policies requires assessing the effect of those alternatives on the well-being of and costs incurred by all of the parties involved. Models that omit the parties for whom banks are clearing and settling payments to the "end-users" will fail to satisfy Baxter's Dictum, and will be potentially misleading.

Payments arrangements are communications networks, and these often take the form of club goods. Private agents that find themselves in such environments will tend to create multilateral institutions to efficiently cope with their interdependencies. A good payments model should recognize that payment instruments and institutions are not exogenous, but are determined by the nature of the information and other frictions facing traders in the model environment. This endogeneity of payment behavior is what makes the application of carefully specified models essential for thinking about the consequences of significant changes in central bank policies.

Viewing instruments and institutions as endogenous adaptations to the structure of the economy has important methodological implications. First, whenever possible, models of payment behavior should be fully articulated general equilibrium models, specified in the words of an old but useful slogan, at the level of preferences, endowments and technologies. This is essential for drawing welfare conclusions about alternative policies. Second, the endogeneity of institutions places mechanism design at the heart of payments theory, as is true for modern monetary theory. Under a mechanism design approach, payment instruments are seen as messages that embody contingent contracts, and one can model the information and risk allocation characteristics in a way that takes into account the limitations imposed by real-world payment technologies. For example, the costliness and falsify-ability of communication, verification and authentication.

3.1.4 The Freeman Model

Scott Freeman (1996) developed a model that meets these criteria and has proven useful for studying the role of central bank credit in settlement arrangements. In the environment of the Freeman Model, both fiat money and private liabilities serve as means of payment.

Moreover, each period many agents meet at a central location, some bearing private payment instruments that they want to exchange for money, and others are bearing money with which they will redeem their debt. The (exogenous) timing of agents' arrivals and departures are such that early in the meeting there is an imbalance between agents bearing debt they wish to redeem for money and agents with money to offer for debt. Without central bank intervention, the debt sold at a discount early in the period, is inefficient relative to frictionless settlement. In this model, the central bank can purchase debt for newly minted money and later retire that money by presenting the debt to issuers for payment.

The Freeman Model was developed to study the central bank's ability to accommodate a temporary bulge in the demand for money in connection with settlement in a way that does not create inflation. Freeman makes reference to Milton Friedman and Anna Schwartz's (1963) discussion of seasonal movements in money demand in the U.S. during the 19th century. But the series of central bank transactions described above can be interpreted as a short-term or even intraday loan from the central bank to the issuer of the debts. Under this interpretation, Ruilin Zhou (2000) has shown that the optimal terms for the central bank transaction are equivalent to daylight credit at a zero interest rate.

One important observation on the Freeman model is due to Ed Green (1997). By constructing a mechanism by which a coalition of private agents can achieve the same outcome as central bank intervention in the Freeman Model, Green showed that central bank credit was not essential for achieving an optimal allocation. In fact, the coalition described by Green's Theorem resembles the private clearinghouses which stood at the apex of the U.S. clearing and settlement systems before the creation of the Federal Reserve. This result highlights the lesson that the need for (perhaps quite complicated) multilateral coordination does not by itself create a need for public sector involvement in a payments system. This lesson is buttressed by the observation that many private net settlement arrangements exist alongside central bank gross settlement systems. As I noted earlier, this reasoning suggests that the question of the central bank role in payments is less about efficiency and more about the distribution of costs and benefits.

Another important observation on the Freeman Model involves its finding that the optimal interest rate on intraday central bank credit is equal to zero. A key feature of his environment that helps deliver this result is the absence of intraday discounting. An interest rate is the intertemporal price of consumption, and in the Freeman model, consumption is discounted only period-to-period, not within the settlement period. This amounts to saying that there is no within period (intraday) opportunity cost of consumption or money, an assumption

that mayor may not be a good approximation to the operation of large value payments systems. Whether it makes sense to posit that all discounting takes place overnight is an important open research question, especially when the overnight period lasts just 2½ hours, as it does for Fedwire.

It is worth noting that the motivation for daylight credit in the Freeman Model is unrelated to any risk of so-called "gridlock." People describe gridlock as occurring when banks strategically delay payments within the day, thereby increasing the system's processing burden late in the day. The option to delay payment is not available in the Freeman Model. In more general settings, one important question regarding the potential for gridlock is the extent to which repeated interaction can constrain the incentive for strategic misbehavior. It is also worth considering whether gridlock could itself be a consequence of the status quo policy regime.

Yet another noteworthy feature of the Freeman Model is that the central bank's extension of daylight credit is risk-free. From this perspective, one might view a daylight overdraft fee as compensation for risk. Ideally, one would want to set this fee in Pigovian fashion so as to eliminate banks' incentives to overuse daylight credit. One might think that setting the fee at a level that compensates the central bank for its credit-risk exposure would do the trick, but this would ignore the role of the deposit insurance fund. A central bank's claim on a failing bank's collateral simply reduces the liquidation value of the institution and thereby increases the cost to the deposit insurance fund. Moreover, central bank lending can allow the chartering agency to delay closure and facilitate the exit of uninsured creditors, further shifting losses from private counterparties to the public sector and exacerbating moral hazard. Either way, Federal Reserve risk exposure is the wrong metric against which to benchmark overdraft fees. It is essential, in my view, to evaluate the risks associated with central bank credit from the comprehensive perspective of the consolidated fiscal balance sheet rather than from a purely central bank point of view.

While it is widely recognized that credit risk is an element of the benefit-cost calculus surrounding daylight credit, assessment of this risk is fraught with difficulty. When financial conditions are generally strong, the risk of actual loss due to daylight credit exposure is likely to be small, and even a small benefit in the form of a smoother functioning payment system might appear to make the provision of central bank credit worthwhile. Daylight credit is often particularly useful during a severe operational disruption, as illustrated by the aftermath of the terrorist attacks of September 11, 2001. While some banks delayed payments out of concerns about incoming funds, the availability of daylight credit built confidence that payments would flow. On

September 11, 2001, the general condition of the banking system was quite strong. Should a major operational disruption occur when some financial institutions are generally more fragile, then an expansion of central bank credit could involve a substantial increase in exposure.

Operational disruptions aside, weak banking institutions can create broader moral hazard problems regarding daylight credit. Large banks build sophisticated payment processing systems assuming the availability of automatic daylight credit. Reconfiguring a bank's operations to cope with a denial of daylight credit can be very costly and highly visible to counterparties. This makes it difficult for the Federal Reserve to withdraw daylight credit in the case of weak or failing institutions, and this in turn can substantially weaken market and supervisory discipline.

3.2 Process of Bank Credit Creation

Bankers always try to minimize their holdings of idle cash to the lowest extent possible in their attempt to achieve this end, they unwittingly increase the total amount of money in circulation in the community. It does not mean the total amount of legal tender currency will increase. When we say that a banker is lending money, he is actually lending money in the form of deposit credit with a right to the borrower to draw cheques against it. For instance take the case of a loan granted to customer. Instead of paying away the whole loan at once, the banker is actually placing the sum to the credit of the borrower. Thus the borrower acquires a claim against the bank, just as a sum of money deposited by him with the banker creates a claim against the bank. Let us assume that the borrower draws cheques in favour of other people. They pay them into their own banks for collection, and their deposits go up. Here we may agree with Hartly Withers in that 'every loans creates a deposit'. Again by purchasing securities or any other assets also a banker is adding to the total supply of money. When he buys securities, he pays for them by his own cheque. This cheque like a currency note issued by the Central Bank, which is merely the IOU of the Central Bank, is an IOU of the bank issuing it. And this is accepted by the seller of the securities because of his faith in the ability of the banker to produce cash on demand. The seller deposits this cheque in the very same bank or in any other bank where he has an account, thereby creating additional deposit money. The commercial bankers as a system can and do increase the total amount of money in circulation, by increasing the purchasing power of the people through deposit money created by them.

A close analytical study of the mechanism of banking will simplify matters more. Let us take the case of a community with only one bank and where the people are highly banking minded so that all the

transactions are settled by means of cheques. Further let us assume that the total amount of money in circulation is N10 Million and the banker knows by experience that 10 per cent of its deposits as reserves is sufficient to meet demands from customers.

Since there is only one bank in the community, people will deposit all their money in that particular bank. The balance sheet of the bank then would be:

Liabilities N	Assets N
Deposit 10,000,000	cash in hand 10,000,000

According to our assumption, the banker needs to maintain only a cash reserve of 10 per cent of the deposits and can safely lend the balance amount of N9,000,000 to those who are in need of funds. This amount the banker will place to the credit of the borrowers giving them the right to operate their account with cheques. Their deposits will consequently go up by this amount. The balance sheet, then would be:

Liabilities N	Assets N
Deposit (original) 10,000,000	cash in hand 10,000,000
Deposits (credit balance of borrower) <u>9,000,000</u>	loans to clients <u>9,000,000</u>
<u>19,000,000</u>	<u>19,000,000</u>

These deposits now standing to the credit of the borrower are, as we know, claims against the bank and as such they command a purchasing power and so they may be considered as good as money. Now, suppose the borrowers draw cheques in favour of their creditors. The payees of the cheques will not require cash over the counter, since they are highly banking minded, according to our supposition. On the other hand, they will pay these cheques into our supposed single bank for collection. Here what happens is merely a transfer of the credit balance of the borrowers to the credit of the account of the payees of their cheques. In short, although the total amount of legal tender currency in circulation in the community is only to the order of space N10 million, our banker, by the process of creating additional deposit money, has brought into effective circulation an additional amount of space N9million, thereby raising the supply of money from N10million to N19million. The power of the banker to increase the amount of money in circulation does not come to an end here. He can further increase the supply of money.

As shown in the balance sheet, the amount of the deposits of the bank is now N19million. And our assumption is that the banker should maintain only a cash ratio of 10 per cent. To maintain this the banker needs only

to provide an additional amount of N900,000 over and above the amount of N1,000,000 which he already maintains.

Even then there is a balance of N8,100,000 in the vaults of the banker, which he can lend without undergoing any risk. Now the balance sheet would be:

Liabilities N		Assets N	
Deposit (original)	10,000,000	cash in hand	10,000,000
Deposits (deposited by The payees of the first borrowers' cheque)	9,000,000	loans to clients 9,000,000 8,100,000	17,100,000
deposit (credit balance of borrowers	<u>8.100.000</u>		
	<u>27.100.000</u>		<u>27.100.000</u>

Here the banker has to keep an additional cash reserves increase to N27,100,000. Still here is balance of loanable funds with the banker amounting to N7,290,000.

Thus, the banker can go on increasing the creation of additional money. But can he go on increasing credit without any limit? Is the power of the banker to increase the supply of deposit money unlimited? The answer is definitely in the negative.

3.3 Constraint/Limitation of Credit Expansion

The power of commercial bankers to create credit is limited mainly by the cash reserves which they have to hold against their deposits and the total amount of legal tender currency issued by the central bank. Every bank has to meet the demands of its customers to pay cash over the counter. So a working reserve of liquid cash is always necessary for every banker. Of course, if the people are highly banking minded, a lower cash reserve will suffice. But in the case of a community, where the banking habits are not well developed, a higher cash reserve is essential. In either case, a cash reserve is necessary and this acts as break on the power of banks to create credit. If a banker wants to expand credit further, either there should be an additional supply of liquid cash, which entirely is a prerogative of the monetary authorities or the cash ratio should be lowered, which can be done only at his own peril. Moreover, law in most countries prescribes a minimum reserve ratio. Thus, a banker's power to create credit is limited by two factors viz., the cash ratio and the total amount of cash in the country.

4.0 CONCLUSION

In the course of this unit you should explain various theories that guide credit issuance and administration in banking industry. These theories serve as basis of operations in banking industry. Also, we discussed process of credit creation and the constraints of credit expansion.

5.0 SUMMARY

In summary, this unit focused on various theories that guided bank operations among which are Self-liquidating paper theory versus Anticipated theory, payment theory etc. Also, we established how credit can be created to increase money in circulation. However, there are two major limitations to this creation of credit which include the cash ratio and the amount of cash in the country

6.0 TUTOR-MARKED ASSIGNMENT

1. Discuss payment theory
2. How can credit be created in an economy?

7.0 REFERENCES/FURTHER READINGS

Shekhar K. C. (1990). *Banking Theory and Practice*. New Delhi, India: Vikas Publishing House PVT. LTD.

UNIT 2 FINANCIAL STATEMENT ANALYSIS

CONTENTS

- 1.0 Introduction
- 2.0 Objectives
- 3.0 Main Content
 - 3.1 Principle and Components of Financial Analysis
 - 3.2 Ratio Analysis
 - 3.3 Constraint/Limitation of Credit Expansion
- 4.0 Conclusion
- 5.0 Summary
- 6.0 Tutor-Marked Assignment
- 7.0 References/Further Readings

1.0 INTRODUCTION

Financial statement analysis is the analysis of the borrower's financial statement as it relates to the project and as it relates to the amount asked for. The first establishes the end and need for the loan as well as the repayment ability while the second will establish how much is required, for how long, when required, and whether the loan demand conforms to the existing directives guidelines both of the head office and of the Central Bank

2.0 OBJECTIVES

By the end of this unit, you should be able to:

- verify the various ratios in financial statement of banks
- apply the principles of financial ratios for bank credit analysis.

3.0 MAIN CONTENT

3.1 Principle and Components of Financial Analysis

One is the analysis of borrower's financial statement as it relates to the project and as relates to the amount asked for. The first establishes the need for the loan as well as the repayment ability while the second will establish how much required, for how long, when required and whether the loan demand conforms to the existing directives and guideline both of head office and of the Central Bank.

In analyzing the end use, the banker should endeavour to establish whether all reasonable estimated costs are allowed for, and whether the

estimates are realistic, He should also attempt to establish whether the sources of finance contemplated by the sponsors will be adequate and whether they would, in fact be forthcoming. Otherwise the banker will be stuck with his own lending. Finally, he would attempt to ascertain the likely impact of the project on the level of production, sales, net earnings, borrowings etc. of the borrower, and when the project is expected to break even and start yielding profit.

Having established the above, the banker then turns to analyzing the amount of the loan asked. An up-to-date audited balance sheet or the appropriate financial statement normally gives some clues.

Generally, the capital employed including any undistributed profits, is one guide to how much the customer can borrow; while the figures for creditors of all kinds, of stock and work-in-progress and of trade debtor show the liquid position of the business and may indicate the difficulty with which credit can be paid regularly. All in all, the objective must be to determine that the amount demanded is neither too much nor too small but is just adequate and that magnitude of the available surplus or profits, including any other cash accruals, will be adequate to service the loan effectively through repayment of principal and interest plus a margin for incidentals. The point to emphasize is that there should be a proper perspective of the financial position of the concern. For this purpose a single year's performance as revealed in the profit and loss account and the balance sheet will not be adequate. A dynamic view has to be taken of the organization both in prospect and retrospect (Nwankwo, 1991 pp.125)

3.2 Ratio Analysis

Ratio analysis is a useful tool in financial statement and project analysis. It is used in the initial stages to reduce the large number of individual items in the financial statements to a fewer number of meaningful ratios that assist the lending officer to analyze the borrowers' current position. It helps also to identify critical areas for further detailed examination. The basic commonly used ratios relate to liquidity, management efficiency, leverage or debt, and profitability. The ratios are not universally applicable to all situations. Inventory turnover, for instance is not relevant and meaningful in the analysis of service firms but very relevant and important in the analysis of retail or manufacturing firms. The table below shows the key ratios commonly used by analysts.

Table 7: Commonly used Management Ratio in Credit Analysis

Types of Ratio	Name	function	How measured
(1) Liquidity	a) Current Ration	Indicate the extent to which claims of short-term creditors are covered by assets that can be readily converted into cash without loss. High values suggest high safety margins for short-term creditors but does not consider quality of receivables and inventories	$\frac{\text{Current asset (CA)}}{\text{Current liabilities (CL)}}$
	b) Quick (Acid test) ratio	A more reliable measure of liquidity than the current ratio. Purges the current ratio of lack of concern for the quality of receivables and inventories. NB: a and b, each measures the ability of the firm to generate cash to meet short-term obligation	$\frac{\text{CA} - \text{Inventories}}{\text{Current liabilities}}$
(2) Profitability	a) Net Profit Margin or Return on Sale (ROS)	Measures profitability of the firm relative to sales	$\frac{\text{Net Income}}{\text{Sale}}$
	b) Return on Equity (ROE)	Measures profitability of the firm relative to net worth or owner's equity in the firm.	$\frac{\text{Net Income}}{\text{Total Equity or Net worth}}$
	c) Return on Asset (ROA)	Measure profitability of the firm in relation to assets employed.	$\frac{\text{Net Income}}{\text{Total Assets}}$
(3) Leverage	a) Debt to Asset	Measures the amount of debt employed by the firm in relation to the total assets of the firm. The bigger the debt the more volatile the earnings because of the fixed charged.	$\frac{\text{Total Debt}}{\text{Total Assets}}$
	b) Debt to Equity	Measure the amount of debt employed by the firm in relation to total equity or net worth.	$\frac{\text{Long-Term Debt}}{\text{Total Equity (Net Worth)}}$
	c) Times Interest or Financial Charges coverage	Measure the coverage of interest payment in the debt.	$\frac{\text{Earning before Interest + Taxes}}{\text{Annual Interest expense}}$
	d) Account Payable Turnover	Measures account payable in relation to purchases	$\frac{\text{Average accounts Payable}}{\text{Av. Purch. Per day}}$

(4) Activity or Management Efficiency	(a) Collection Period	Measures the degree of efficiency with which management collects receivables	$\frac{\text{Average Account Receivables}}{\text{Sales per Day}}$
	b) Total Assets Turnover	Measures the degree of efficiency with which management utilizes assets in relation to sales	$\frac{\text{Sales}}{\text{Total Assets}}$
	c) Inventory Turnover	Measures management efficiency in turning over inventories to generate profit i.e. inventory control	$\frac{\text{Sales}}{\text{Av. Inventory}}$
	d) Fixed Asset Turnover	Measures net sales over net fixed assets	$\frac{\text{Sales}}{\text{Net Fixed Assets}}$
	e) Receivables Turnover	Measures sales over receivables	$\frac{\text{Credit sales}}{\text{Account Receivables}}$

For better results, common size ratios should be obtained by expressing each balance sheet item as a percentage of total revenue and each expense item as percentage of total expenses. The ratios should also not be analyzed in isolation as there are no absolute standard for them. They can be analyzed cross sectionally by comparing the firms ratios with the ratios of peer firms in the industry or at a point in time. Another way is time series. This deals with historical trends in the ratios, in effect measuring the firm against itself at different time periods. This helps to detect looming problems before they occur. A firm experiencing rapid sales but steadily declining profit margin because of rising costs may find, through time series analysis, that the rapid growth may have masked the dangerous slide in profit margins and would then try to do something about it – get away from the euphoria of rapid growth and correct deficiencies in costing matrix and therefore in profit margins.

It is also usually advisable not to rely on a single ratio but on combination of ratios. Return on equity, for instance can be broken down to its constituents such as leverage, profit margin, activity and common size ratios. This enables analyst to simultaneously view the key relationships governing the business enterprises.

4.0 CONCLUSION

In this unit of the study we are able to establish the principles and components of financial statement analysis and the use of financial ratios to summarize the detail of banks' operations.

5.0 SUMMARY

This unit focused on the analysis of credit through financial ratios. These ratios include liquidity ratio, profitability ratio, leverage ratio, and finally, activity or management efficiency ratio.

6.0 TUTOR-MARKED ASSIGNMENT

Use an annual report of a selected bank and analyze both the profitability and liquidity ratios.

7.0 REFERENCES/FURTHER READINGS

Nwankwo G. O. (1991). *Bank Management (Principle and Practice)*.
U.K. Oxford: Malthouse Publishing Ltd.

UNIT 3 RISK MANAGEMENT POLICY AND STRATEGY

CONTENTS

- 1.0 Introduction
- 2.0 Objectives
- 3.0 Main Content
 - 3.1 Taxonomy of Banking Risks
 - 3.2 Risk Management Policy and Strategy
- 4.0 Conclusion
- 5.0 Summary
- 6.0 Tutor-Marked Assignment
- 7.0 References/Further Readings

1.0 INTRODUCTION

Risk, the possibility of loss, injury, damage, or peril is inevitable in life. No aspect of human endeavour is devoid of, or can escape it. It is inherent in everyday life, and more so in the life of a banker. His business has been, and continues to be, taking risks. This he does through maturity transformation - borrowing short and lending long. The foundation for doing this is the probability that he will not be called upon at anyone time to redeem all his obligations, provided he manages his affairs prudently. This implies having adequate capital and earnings, and adequate liquidity to honour his obligations as they fall due. It also means avoiding excessive risks. He cannot avoid risk altogether. He will be out of business if he tries to do so. The risk he takes must be compatible with profitability, liquidity and prudence. Managing risk, like managing capital and liquidity is therefore the centrepiece of banking and this has been increasingly so since the beginning of the eighties.

2.0 OBJECTIVES

By the end of this unit, you should be able to:

- classify the taxonomy of banking risks
- describe various risks in banking industry
- identify risk management policy and strategy.

3.0 MAIN CONTENT

3.1 Taxonomy of Banking Risks

Banking risks can be classified into two broad categories. One is fraud risks and the other is market risks. Fraud is deliberate deception, trickery or cheating for unlawful gain or unjust advantage. Through outright thefts, defalcations and embezzlement. Frauds result in largest losses to depositors and creditors, including deposit insurance agencies. They are rampant, pervasive, and the biggest single cause of bank failures. Benson (1973) found that 66% of the bank failures in the US during 1959/71 were due to fraud and irregularities. Hill (1975) also found that 88% of 67 failures during 1960- 7 4 were due to improper loans, defalcations, embezzlement and manipulation.

The second broad category of bank risks is market risks. This takes any forms. They comprise all exposures in bank operations in the market place that subject the bank to the prospect of loss and hence to the weakening capital resources.

According to Nwankwo (1989), it is the pervasiveness of these risks and failure of the market to effectively control them that explains why banks are more heavily regulated from cradle to grave than any other commercial or industrial undertaking. Although, it is emphasized that the ultimate responsibility for evaluating risks and for setting limits commensurate to a bank's financial strength, resides with bank management, it is observed that without regulation, an undue percentage of financial institutions are likely to take "excessive risks". However, despite regulation, and partly resulting from the costs of regulation, risks have increased as banks innovated around the control through a series of off-balance sheet totals, risks increased.

Taxonomy of banking risks is as follows:

	Types	Source
1.	Confidence	Loss of confidence on the bank by depositors, the general public and the regulatory authority.
2.	Liquidity	Faulty balance sheet, financing mismatches, changes in assets prices.
3.	Fraud	Theft, defalcation, forgery, and embezzlement
4.	Credit	Default or delay in fulfillment of obligation.

5.	Interest Rate	Mismatches between interest sensitive assets and interest sensitive liabilities.
6.	Earning or Profits	Changes in operating expenses and interest rates, excess of expenses over income.
7.	Operation	Operating errors, inefficiency, faulty control procedure.
8.	Investment	Changes in interest rate and changes in asset prices.
9.	Currency or Foreign Exchange	Speculation, mismatches in foreign exchange exposure.
10.	Funding	Inability to purchase funds or otherwise obtain funds to meet obligations as they fall due -a form of liquidity and investment risks.
11.	Counterparty	Default or delay by counterparty i.e. related or affiliated party to honour obligations as they fall due.
12.	Country	Failure or delay by a country to honour obligations as they fall due.
13.	Sovereign	Inability to take action or obtain redress when a country defaults owing to sovereign immunity.
14.	Insured	Arising from excess clauses or insured risks, risks not covered by insurance.
15.	Regulatory	Arising from violations, or sudden imposition of laws and regulatory authorities.
16.	Off-balance sheet	Arising from operations that do not show in balance sheet

3.2 Risk Management Policy and Strategy

As in other areas of bank operations, an effective management of banking risks requires a well-articulated risk management policy and strategy. Summarized in "Guidelines for Risk Management in the Bank", such a policy assists bank management to think through the totality as affecting the bank as a corporate entity rather than as individual risks affecting separate departments and units of the bank, assign responsibilities, and establish the machinery for implementation, appraisal and review.

The policy should be in three sections: objective criteria, strategy, and procedures. The objective criteria section should specify the objectives

of risk management in the bank, identify the types of risks in all the bank's operations both on and off-balance sheet, and their implications and specify responsibility for managing the risks. As usual, while the overall responsibility resides with the board, the responsibilities for loan and investment portfolio in particular, should be emphasized.

After identifying, assessing the implications and assigning responsibility, the next stage will be strategy to be adopted. Three strategies may be identified: risk prevention and loss reduction, risk transfer and risk retention.

Prevention refers to measures to prevent the occurrence of the risks while loss reduction refers to measure to minimize the loss after the risks have occurred. Risks transfer refers to measure to transfer the risks or loss from one to another agency through, for instance insurance or guarantees. Retention, on the other hand, can be regarded as a form of self-insurance. In general all the three approaches are adopted together.

Risks cannot be totally avoided in banking, as in life. No effort, no matter how effective, to minimize the loss can totally eradicate it. Similarly, some loss must be retained in the institution because not all risks are transferable; and insurance and guarantee are only limited in the amounts they cover. In specifying the strategy, a review of each department's operating policies and their daily implementation should be made to find out if they adequately cover each form of risk exposure and what changes in the policies and operating procedure are necessary to more fully respond to each department's risk exposure.

Having specified the strategy, the next stage is to specify the procedure for implementation, appraisal and review. Matters to emphasize for this purpose include a comparative assessment of risk management policies and strategies and their daily implementation across all departments to make sure there is uniformity and consensus for the bank as a whole and to ensure adequate co- ordination across all departments. The objective is to make sure that the policies and strategies in all the departments are harnessed and work together and that policies and procedures in one department do not expose other departments to additional *or* unanticipated risks. In establishing the necessary machinery for implementation, approval and review, management must analyze the banks' responses to the various types of risk strategies - short term as well as long range and satisfy itself that the responses to various types of risks are consistent with bank's current plan and planning process, and with the overall corporate strategy of the bank.

4.0 CONCLUSION

This unit established various types of risks as reflected in the risk taxonomy. You also had discussion on various strategies on policies formulation for risk management in banking industry.

5.0 SUMMARY

In summary, the units focused how to manage risk in banking industry by adopting the guidelines for risk management in bank which enhance bank to think about its operation and the risks embedded. The unit focused on three sections of policy namely objective criteria, strategy and procedures.

6.0 TUTOR-MARKED ASSIGNMENT

Briefly discuss how effectively and efficiently risk should be managed in banking industry?

7.0 REFERENCES/FURTHER READINGS

Nwankwo, G. O. (1991). *Bank Management (Principle and Practice)*. U.K. Oxford: Malthouse Publishing Ltd.

UNIT 4 RISK ANALYSIS/RATING OF BANKS

CONTENTS

- 1.0 Introduction
- 2.0 Objectives
- 3.0 Main Content
 - 3.1 Risk Analysis
 - 3.2 Credit Investigation
 - 3.3 Security Analysis
- 4.0 Conclusion
- 5.0 Summary
- 6.0 Tutor-Marked Assignment
- 7.0 References/Further Readings

1.0 INTRODUCTION

This is a loan function that is basic to minimizing loan losses. Through risk analysis the bank attempts to determine the ability of the borrower to repay legitimate loans extended to him. By refusing credit to a potential borrower whose analysis reveals insufficient financial strength, the bank hopes to improve on its chances to avoid unnecessary losses in its portfolio.

2.0 OBJECTIVES

By the end of this unit, you should be able to:

- apply strategy for risk analysis
- guide bank officer on risk analysis
- investigate credit.

3.0 MAIN CONTENT

3.1 Risk Analysis

In view of the risks inherent in bank lending and need to minimize or curtail the risks (since they cannot be entirely avoided), and in view of the need for liquidity and profitability consistent with safety and regulatory constraints, the central issue in managing the lending portfolio is balancing the potential risks with returns. This involves credit analysis. The borrower's ability to repay the loan has to be determined: this involves familiarity with the type of lending and the economic activity involved -whether agriculture, manufacturing, real estate or residential housing. The borrower's capacity and capital have to be assessed; these require financial statement and security analysis to

project the income and cash flows, assess the source of repayment and the economic and technical feasibility of the project. It also requires the assessment and forecast of the economic and political environment to ascertain whether, even if the proposition is profitable now it is likely to continue to be profitable at least until the loan is fully paid.

Basically credit analysis is the process of assessing the risk of lending to a business or individual against the benefits to accrue from the loan. The benefits can be direct, such as interest earnings and possibly deposit balances required as a condition of the loan; or indirect, such as initiation or maintenance of a relationship with the borrower which provide the bank with increased deposits and with demand for a variety of bank services.

Credit risk assessment has two aspects. One is qualitative, and generally the more difficult; and the other is quantitative. To evaluate the qualitative risk, the loan officer has to gather and appraise information on the borrower's record of financial responsibility, determine his true or correct need for borrowing, identify the risks facing the borrower's business under current and prospective economic and political situations and estimate the degree of his commitment regarding the repayment. The quantitative assessment is much simpler; it consists of the analysis of historical financial data and the projection of future financial results to evaluate the borrower's capacity for timely repayment of the loan and indeed, the ability to financially survive possible industry and economic reverses.

3.2 Credit Investigation

This is an integral part of credit and risk management. The purpose of credit investigation is to acquire enough information about the applicant to determine or assess his willingness and capacity to service the loan, if made in accordance with the terms of the loan agreement. It enables the bank to determine the degree of risk he is willing to assume, and the amount of credit that can be prudently extended, given the risks involved, and the terms and conditions for making the loan. It is, in other words designed to determine the borrower's credit worthiness.

Banks normally consider six factors for this purpose. These are the five Cs credit investigation plus management. These are character, capacity, capital, collateral, conditions and management. Banks are interested not only in the borrower's ability to repay the loan but also, in his legal capacity to borrow. Few loans are made to a minor or infant and these are only under exceptional or special conditions- since they can disaffirm or disown the obligation later unless the proceeds of the loan are used for essential purposes in the minor or infant's interest. In the

few exceptions when such loans are made, banks, in order to protect themselves, usually insist on the co-signature of a parent or guardian of legal age.

If the borrower is a partnership or a corporation, it is advisable to inspect the partnership agreement or the article of memorandum of association to ascertain the capacity to borrow and to ensure that those signing have the capacity to commit the borrower to the loan. Banks also insist on a resolution by the partnership or corporate body to borrow; and they may find it advisable even then to make the loan unless certain other creditors of the borrower agree to subordinate their claims to that of the bank.

Character is difficult to evaluate. It refers to attributes of honesty, integrity, industry and morality. As it relates to the credit transactions, it means not only the willingness but also a strong desire to repay the debt and honour all the obligations under the loan contract. This is usually revealed through three channels: face to face interview; an examination of his past records and character references. This is where personal knowledge proves very helpful. Since this is not always possible, the analysis for character hinges on the borrower's economic and financial profile, the objective being to determine whether the borrower is a good citizen to be trusted with the loan and the obligation to honour the terms of the loan agreement.

Equally important is the borrower's capacity to obtain the funds with which to effect repayment. If payment is to come from earnings, such earnings must be sufficient for the repayments of principal and interest. Banks usually insist on the primary source of repayment coming from earnings, derived from the cash flow of the borrower's business. They object to foreclosure or liquidation of collateral to repay as this is time consuming, involves a costly process, and at any rate damage the bank's public relations. Unless contemplated at the negotiating stage, banks also frown against repayment with funds raised from sale of assets or borrowed funds from another bank or institution unless a firm commitment with the institution exists. Circumstances may change and make these other sources unreliable. If the firm does not produce attractive profits, the market reception for the share flotation may be withheld or proved difficult.

3.3 Security Analysis

The essence of the financial statement analysis is to establish that, all things being equal, the loan will be safe, properly used and repaid on schedule. But this is a gamble in the future. All things may not be equal and things may go wrong such that the basis and optimism established

and expected do not materialize. This why the banker should not be left uncovered. He must ask for and take adequate collateral securities as a manifestation of customer's confidence in his own project and as something upon which the banker can fall if things go wrong and expected results are not achieved. In this connection, it must be emphasized that the banker is lending other people's money and therefore must have something in return to show for it. The types of security asked for and the valuation placed on it depends on the nature and circumstances of the loan and of the customer. In this connection few points should be stressed on security analysis as follows:

The first is that collateral should be taken; secondly, this should come after the technical and economic feasibility as well as the profitability of the project has been established and not before. Thirdly, the collateral security need not always be in a tangible form. Indeed in some cases integrity can be the most valuable and important security (the so-called unsecured loans are after all really secured by the borrower's integrity). Finally, the security must be deposited or taken before drawn down -not only taken, but properly perfected.

4.0 CONCLUSION

This unit established various risks that is attached with credit administration in banking industry. It also discussed security analysis.

5.0 SUMMARY

In summary, the unit, focused on risks that embedded in lending activities of bank. It further advised banking officers on how to investigate creditworthiness of the potential borrowers before loan approval. In additional, the unit emphasized the use of 5Cs of credit analyses.

6.0 TUTOR-MARKED ASSIGNMENT

1. State and discuss various sources of risks in banks?
2. What do you understand by credit investigation analysis?

7.0 REFERENCES/FURTHER READINGS

Nwankwo, G. O. (1991). *Bank Management (Principle and Practice)*. U.K. Oxford: Malthouse Publishing Ltd.

UNIT 5 MEASUREMENT AND CONTROL OF BANK RISKS

CONTENTS

- 1.0 Introduction
- 2.0 Objectives
- 3.0 Main Content
 - 3.1 Indicators for Measuring Banking Risks
 - 3.2 Procedures for Risk Control
 - 3.2.1 Risk Avoidance and Minimization
 - 3.2.2 Risk Transfer Strategy
 - 3.2.3 Risk Retention
- 4.0 Conclusion
- 5.0 Summary
- 6.0 Tutor-Marked Assignment
- 7.0 References/Further Readings

1.0 INTRODUCTION

Having identified and analyzed the risks, in this unit we shall measure or assess risk. Because risk relate to events that may occur in the future, accurate or exact measurement is not possible. Besides, not all of the risks are amenable to quantitative assessment, or measurement. Even where they can be rationalized, the ratios are subject to serious reservations. What therefore is required is some indication of the probability and extent of the risks, whether quantitatively, as a guide or trigger factors for bank management in its efforts to control risks, minimize them, maximize profitability and safety consistent with prudential and regulatory constraints.

2.0 OBJECTIVES

At the end of this unit, you will be able to:

- identify indicators for measuring banking risks
- produce risk control procedures.

3.0 MAIN CONTENT

3.1 Indicators for Measuring Banking Risks

1. Failure risk or defaults – can be indicated by the ratio of a bank's stock price to its annual earnings per share, or by ratios of net worth to total assets, total liabilities and total deposits. A decline

in these ratios-under-funding or under-capitalization and therefore increased risks in relation to the volume of business undertaken. Another measure is the ratio of purchased funds maturing in one year to total liabilities due in one year. An increase in the ratio tends to indicate increased risk exposure, while the lower the ratio, the less is the risk exposure.

2. liquidity risk can be indicated and measured by the ratio of total cash assets to total assets; cash assets plus government securities to total assets; total loan to total assets; core deposits to total liabilities; purchased funds to total assets; and finally foreign branch liabilities and total assets. An increase in the ratio tends to indicate decreased risk exposure, while the lower the ratio, the higher is the risk exposure.
3. Interest Rate Risk – the most widely used measures include the ratio of interest sensitive assets to interest sensitive liabilities, money market assets over money market liabilities, uninsured deposits over total deposits and assets maturing within one year over liabilities due in one year. An increase in these ratios indicates increased interest rate exposure. In particular if interest sensitive-assets exceed interest sensitive liabilities in a particular maturity ladder, the bank would be vulnerable to loss if interest rates falls, and if interest sensitive liabilities exceed sensitive assets, the bank would be vulnerable to loss from increases in interest rates.
4. Earning Risk -this could be measured as:
 - variance of net income before or after taxes over some designated period say three or five years
 - variance of return on equity (ROE) or return on assets (ROA) over a designated period.
5. Fraud Risk -this has to do with:
 - quality of security measures,
 - Management control systems
 - internal audit
 - insurance, and
 - Operating procedure.
6. Confidence Risk – this is a function of the banks in the following areas:
 - liquidity

- capital adequacy
 - earnings,
 - market rating,
 - regard by regulatory authorities
7. Foreign Exchange/Currency Risk – these concerns:
- currency mismatch
 - interest rate mismatch,
 - exchange rate mismatch,
 - settlement dates, and
 - Counterparty obligations.
8. Country Risk – exposure over equity and provisions, also function of debtor country's
- overall debt; its spread and its concentration
 - Debt servicing capacity,
 - economic prospects,
 - debt burden
 - Political stability,
 - character of government
 - creditors government support,
 - multilateral development banks e. g. IMF, World bank
 - creditor Central Bank's policies.

3.2 Procedures for Risk Control

Identifying and measuring banking risks are only the preliminary steps in managing and controlling risks in banking. The next essential step is the strategy. Management must specify what strategy best meets the objectives of its risk management and control. Three strategies may be identified. One strategy is to attempt to prevent the risks from occurring and having occurred to minimize the loss. Another is to adopt measure to transfer the risk to some external agency and the third is to assume and retain the risk.

3.2.1 Risk Avoidance and Minimization

Banks make considerable use of the avoidance strategy in their operations. Both their assets based and liability based approaches to balance sheet management are designed to avoid and minimize risks in bank funds management. Banks are prepared to match increased credit risk with higher returns only within narrow limits. They would, in fact prefer not to touch medium lending at all. In many cases this risk

avoidance and minimization strategy is reinforced by regulatory prohibitions through moral suasion and other stipulations that limit the scale of particular balance sheet activities such as currency and interest rate swaps and options and other hedging devices are among the methods banks use to avoid and minimize risks

3.2.2 Risk Transfer Strategy

No amount of avoidance and minimization measures, no matter how comprehensive and effective, can completely eradicate risks. Whatever bank management does, some risks must remain. One strategy to address these remaining risks is to transfer them to an external agency; for instance, an insurance institution. This requires that the cost and benefits of the transfer should be carefully weighted in terms of feasibility, practicability and the insurance premium. However while some risks are insurable, such as theft, fraud fire, etc., some are not insurable, such as risks arising from changes from interest and exchange rates. Besides, 'excess clauses' imply that there are limits to the insurance coverage even for the insurable risks. These margins and the insurance premium have to be taken into consideration in the decision to transfer risks to an insurance agency.

Insurance, however, is not the only form of transfer. Collective guarantees and guarantees of governments and their agencies are other possibilities. In the wake of the high debt problems of the third world countries since the eighties, many international banks now demand guarantee of creditor governments and the underpinning of key international financial institutions, the International Monetary Fund and the World Bank, as a condition for new lending to developing countries. Even here, there are limitations. It is difficult to predict a collective guarantee covering the entire operations of the banks. Guarantees are usually limited to some particular sections of the operations. An example is a loan guarantee. While some governments papers e.g. treasury bills and government bonds have implicit guarantees, governments rarely guarantee entire operations.

3.2.3 Risk Retention

If risk avoidance measures cannot prevent or avoid all risks, and if not all risks are transferable, it follows that some risks must remain and bank management must devise a strategy or strategies to address the remaining risks. One such strategy is risk assumption. The bank assumes those that cannot be avoided. Risk assumption or retention is a form of self insurance. The insurance fund is the networth and incomes earned on current operations which serve as the insurance premium required to keep the networth at an adequate level. One way of course to address

assumed risks is through interest margin charged on operations and designed to cover operating expenses and some losses. However, over and above normal losses, abnormal losses can occur in bank operations resulting in reduced profits or even large losses. Accordingly, adequate capital backing is indispensably important.

4.0 CONCLUSION

In this unit our discussion focused on various indicators of bank risks as well as control measures techniques. It follows therefore that various indicators and strategies employed in banks could be used as guides towards lender assessment, as well as organization and administration of credit.

5.0 SUMMARY

In the course of this study, we were able to analyze measurements of some risk indicators among which are: failure risks, liquidity risk, interest rate risk, earning risk, etc. the study also covered some of the strategies which could be used to manage risks in banks among which include: risk avoidance and minimization; risk transfer; and finally, risk retention.

6.0 TUTOR-MARKED ASSIGNMENT

1. Discuss, various indicators for measuring bank risks in Nigeria?
2. Briefly state and discuss three strategies for bank risk control?

7.0 REFERENCES/FURTHER READINGS

Nwankwo, G. O. (1991). *Bank Management (Principle and Practice)*.
U.K. Oxford Malthouse Publishing Ltd

MODULE 3

Unit 1	Managing the Lending Portfolio
Unit 2	Managing Individuals Risk
Unit 3	Lending Principles and Business Borrowers
Unit 4	Bank Credit Organization
Unit 5	Treasury Management

UNIT 1 MANAGING THE LENDING PORTFOLIO

CONTENTS

1.0	Introduction
2.0	Objectives
3.0	Main Content
3.1	Lending Policies Criteria
3.2	An Articulated Lending Policy
3.3	Factors in Loan Policy Formulation
3.4	Taxonomy of an Articulated Lending Policy
4.0	Conclusion
5.0	Summary
6.0	Tutor-Marked Assignment
7.0	References/Further Readings

1.0 INTRODUCTION

Commercial banks are general all purpose retail bankers. They mobilize deposits from all and sundry in retail as well as in wholesale markets. They lend to all and sundry, both wholesale and retail and for all purposes. In this way, they differ from many other financial intermediaries, most of whom specialize in particular loan or deposit markets and particular economic sectors. The commercial banks' lending is more diverse and the criteria are more complex.

2.0 OBJECTIVES

At the end of this unit, you should be able to:

- discuss lending policy criteria
- describe articulated lending policy
- state factors in loan formulation
- explain taxonomy of articulated lending policy.

3.0 MAIN CONTENT

3.1 Lending Policies Criteria

Like other items in the balance sheet—capital, reserves, investments etc., the importance of the loan portfolio derives from the functions lending performs for banks. It is for instance the highest earning asset in the bank balance sheet. It contributes materially to the bank's achievement and fulfillment of the objectives of profitability by providing higher return than other financial assets. It helps bank management to satisfy the legal and other regulatory objectives of the monetary authorities. It is a key element in the creation and maintenance of depositor relationships, particularly with business firms. It is a vehicle through which bank management attempts to satisfy the credit needs of the community or the credit markets the bank serves or intends to serve.

The importance of lending in banking cannot be over emphasized. All the technical training a banker receives is heavily geared towards lending. When it is said that one is a good or an astute banker, what in fact is meant is that one is a shrewd lender i.e one who lends money safely and profitably.

While being the highest earning assets, the loan portfolio is also the most illiquid of bank assets. Although a banker has the statutory right to call in the loans after three days notice, any attempt to enforce this may either be interpreted in the market place as a sign of serious financial weakness; or it may succeed only at a cost of chasing and losing the customer to the competitors, which is also the most risky of banks' operation. Bank loans finance a diverse lap. Apart from being the most illiquid assets, the lending portfolio is grouping the economy; manufacturers, farmers, traders, professionals, real estate developers, individuals etc. in the process, the bank incurs risks and experiences some losses when certain borrowers fail to repay their loans. Besides, since banks borrow short and lend long, failure to repay bank loans prejudices the bank's capability to honour their own obligations.

3.2 Articulated Lending Policy

Lending involves the creation and management of risk assets and is an important task of bank management. As in liquidity and portfolio management, effective management of the lending portfolio requires an articulated lending policy. The policy should set out the banks' lending philosophy and objectives including the modalities for implementation, monitoring, appraisal and review. For clarity and ease of communication to all concerned, the policy should be in a written form.

Since lending means taking risks and assessing risk of defaults and movement in interest rates, a written policy will act as a signpost to guide management and lending officers. Well-conceived lending policies and careful lending practices are essential to facilitate the credit creating function and minimizing risk in lending. A carefully articulated lending policy is also essential in ensuring that the lending and lending portfolio are in line with the objectives and aspirations of the bank, of the government and of the community the bank serves or intends to serve. Finally, a lending policy is required by bank examiner, and the Deposit Insurance Fund, where one exists. It is usually one of the first items called for during bank examination and usually occupies most of the examiner's time. In many cases, its quality is taken as an indicator of the quality of management.

3.3 Factors in Loan Policy Formulation

In formulating the loan policy, banks normally take a number of factors into consideration. One is the constraints on lending. These are both internal and external. The internal constraints include the bank's capital, its earnings its liquidity, the size, structure, maturity and volatility of its deposits and the quality and competence of its management. Within limits, these internal constraints are within their control and can be influenced by the bank. Bank capital, for instance, serve as a cushion for the protection of deposits and its relation to deposits influences the amount of risk the bank can afford to take and the amount of loans it can commit to a single borrower or to a group of related borrowers. If it wants to take more risks and grant more loans, the bank can increase its capital funds, subject to market sensitivity and receptivity.

Since earnings supplement the capital fund and in fact constitute the principal method of increasing net worth, all banks consider earning as an important factor in formulating their loan policies. Emphasis, of course may differ from bank to bank. Banks that emphasize earnings might adopt a more aggressive lending policy, committing more funds to a long term lending or consumer loans since these earn higher than short term loans. In the process, however, the bank may be increasing its risk exposure and therefore will be subject to prudential limits.

Bank also considers the structure of their deposits in formulating their loan policy, in terms of sources, mix and volatility. Banks provide for loan funds only after providing for primary and secondary reserves. Even after these provisions, banks nevertheless are usually not unmindful of liquidity considerations in allocating the loan funds to different types and categories of the loan portfolio. Again, banks can influence the size of deposits through variations in the costs they charge and pay on such deposits and through purchased funds by liability

management subject, as always, to the limits of prudence, liquidity and profitability.

Another internal constraint is the technical competence of management. With respect to lending, this refers to the ability, technical knowledge and experience of the bank's personnel in lending. A bank may have competence in one area e.g. in industrial lending, and little or none in say, consumer or real estate lending and these may be the emerging horizon in lending. A bank wishing to capitalize on the emerging opportunities can decide to upgrade or retool the lending personnel or buy the necessary expertise in the market, subject to or course to the cost/return considerations.

On the other hand external constraints cannot be influenced by banks since these are generally exogenous and beyond their control. The exogenous factors include the macro-economic elements in the economy like political and economic conditions, the impact of monetary and fiscal policies, the balance of payments and the credit needs of the state or zone the banks serve or intend to serve. These forces influence deposit inflows and outflows in the loan portfolio. While the macro-economic factors may have been forecast and incorporated in the bank's overall corporate plan, the fact that it cannot be predicted with exactitude means they cannot be ignored in formulating the loan policy.

3.4 Taxonomy of an Articulated Lending Policy

A. Preamble

(a) Recognition of the function of lending in banking:

- highest earning asset, cultivation and maintenance of customer relations, a means of satisfying legal and other regulations, vehicle for satisfying legitimate credit needs of the community, and the most illiquid of bank assets.

(b) Recognition of needs for a written policy:

- compass for management and lending officers in terms of philosophy, objectives and strategy;
- mechanism for assessing performance.

(c) factors to consider in lending policy formulation:

- internal constraints: capital adequacy, earning liquidity, size, structure and maturity of deposits and their volatility, competence of management.

- external constraints -the macro-economic environment, political and economic conditions, impact of monetary and fiscal policies, legitimate credit needs of the community;
- all the factors that influence the deposit and loan inflows and outflows
- regulatory constraints.

B. The Lending Policy

Part one: General objectives and criteria:

- the lending philosophy and mission;
- objectives; keeping funds fully invested profitably at all times consistent with liquidity, profitability, safety and regulatory constraint;
- trade area to be served -whole country, state or zone;
- types of lending and activity sectors (proportion stated);
- quality of loans, collateral requirements, acceptable and unacceptable loans and collaterals, secured and unsecured lending.
- Specification that final authority and responsibility resides with board of directors
- Reporting, appraisal and review modalities.

Part Two: Machinery for loan and Administration:

- delegation of authority to loan committees and loan department;
- definition of limits of authority down to loan officers, reporting relationships upwards-downwards;
- information and documentation requirements and methods of interpretation and application
- machinery for routine administration /
 - pricing interest rates, draw-down
 - perfection of collaterals, monitoring covenants;
- machinery for handling problem loans;
- machinery for appraisal and review
- miscellaneous items -loans to directors, staff, insider transactions etc.
- monitoring compliance with legislative and other regulatory requirements.

Part Three: Credit Investigation and Credit Analysis:

- objective ascertain credit worthiness of borrower, his capacity and willingness to repay loans as agreed, and maximize returns while minimizing risks;
- procedures, credit investigation, five Cs of credit analysis- character, capital, capacity, collateral, conditions.
- Management capacity
- Financial statement and security analysis
- Environmental appreciation
- Judgmental ability
- Loan packaging
- The loan agreement
- Covenant etc.

4.0 CONCLUSION

In conclusion, lending policy criteria, articulated lending policy, factors in loan formulation, and taxonomy of articulated lending policy have been able to emphasize the importance of appropriate lending policy in banks. Thus through effective implementation of the foregoing, there will be proper management of lending portfolio.

5.0 SUMMARY

This unit focused on the management of lending portfolio through lending policy criteria which emphasized that bankers must lend safely and profitably through various kinds of training. In addition this study stated that an articulated lending policy is also essential in ensuring that the lending and lending portfolio are in line with the objectives and aspirations of the bank, of the government and of the community the bank serves or intends to serve are lending constraints and structure of their deposits. Finally, the unit shows the taxonomy of articulated lending policy by giving the functions and structures.

6.0 TUTOR-MARKED ASSIGNMENT

Briefly discuss how you can manage lending portfolio of your bank?

7.0 REFERENCES/FURTHER READINGS

Nwankwo, G. O. (1991). *Bank Management (Principle and Practice)*. U.K. Oxford: Malthouse Publishing Ltd.

UNIT 2 MANAGING INDIVIDUAL RISKS

CONTENTS

- 1.0 Introduction
- 2.0 Objectives
- 3.0 Main Content
 - 3.1 Credit Risk and its Management
 - 3.2 Liquidity Risk and Its Management
 - 3.3 Interest Rate Risk and Its Management
 - 3.4 Foreign Currency or Exchange Rate Risk and Its Management
 - 3.5 Country Risk and Its Management
- 4.0 Conclusion
- 5.0 Summary
- 6.0 Tutor-Marked Assignment
- 7.0 References/Further Readings

1.0 INTRODUCTION

In managing or controlling individual risks, banks recognize that all the headings under which risks occur are closely related. The rate of inflation, the level and changes in interest rates and fluctuations in foreign exchange rates, tend to go together and these are sources risks under many headings. In addressing these, it is also recognized that two factors are the core of the risks in terms of occurrence and magnitude. One is mismatching - whether of expenses to revenue of interest rates or currency mismatching. The other is concentration in types of activity, sectors and regions. These two core factors appear like recurring decimal in risk management and control.

2.0 OBJECTIVES

At the end of this unit, you should be able to:

- explain credit risk and its management
- describe liquidity risk and its management
- find interest rate and its management
- describe foreign exchange rate and its management
- explain Country risk and its management.

3.0 MAIN CONTENT

3.1 Credit Risk and Its Management

This is the risk that the interest or the principal or both on loans and securities will not be paid as agreed. When some loans become uncollectible and are written off, the bank loses both earning assets and some portion of its expected revenues. If loan losses continue to mount and persist for several years, the bank's cushion for capital eventually becomes eroded and unless additional funds are injected, the bank may be forced to liquidation.

A number of factors indicate the degree of credit risk in the banks' loan and investment portfolios. One is the extent of the range of interest rates on the portfolios and the proportion of the portfolio.

3.2 Liquidity Risk and Its Management

As liquidity is a sine qua non of banking, an essential first step to managing liquidity risk by recognition of its components in funding risk, time risk and call risk. The diversity of the sources of liquidity in stored asset liquidity and purchased liquidity should also be noted. While the former relates to ability to sell, discount or pledge assets at short notice without loss, the latter refers to the ability to buy liquidity at short notice in the short term or wholesale market or more generally by matching expected outflows with the expected inflows.

The second requirement is an appreciation of maturity transformation as an inevitable feature of banking and the desirability (inadvisability and impossibility) of achieving a balanced maturity structure in the sense of identity between the maturity profiles of assets and liabilities in the balance sheet.

The third stage is to draw up maturity profile or ladder that satisfactorily permits a comparison of assets and liabilities within each maturity range. This gives a useful insight into liquidity. But its limitation can be recognized. It does not tell the whole story, it does not distinguish between asset qualities nor does it take account of off balance sheet operations. Besides, it does not and cannot address the standing of the bank in the market place -an essential indicator of borrowing ability.

Finally, instruments and markets should be mobilized for correcting or adjusting any unacceptable or seriously mismatched profile. Possibilities include organizing committed line of credit from other banks, rediscount or short-term assets, using the lender of last resort facilities, lengthening inter-bank borrowing.

3.3 Interest Rate Risk and Its Management

Banks manage interest rate risk (which arises from mismatch between rate sensitive assets and rate sensitive liabilities. As in the case of the liquidity risk, a balanced maturity profile is neither practicable nor desirable since maturity mismatch is inherent in banking. Another way is through rollover techniques whereby interest rate conditions are periodically adjusted in the light of changes in some contractually agreed reference indicators, usually an interbank deposit rate or a base lending rate. By this approach a better rate matching of assets and liabilities is achieved and the interest rate risk reduced by transferring the risk of the extra cost of an interest rate risk on to borrowers. This does not, however, eliminate the entire risk because it converts interest rate risk to credit risk. Banks remain exposed to possible interest losses whenever the maturity structure of their interest bearing liabilities does not coincide perfectly with the length of the rollover period, especially when the market condition exhibit sharp and rapid modifications.

Another technique is gap management. This requires the analysis of the gap between maturing assets and maturing liabilities to arrive at the amount of variable rate assets that are financed or required to be financed by the fixed rate liabilities. It provides three options for matching rate sensitivity assets to rate sensitivity liabilities, and the formula is to maintain a positive gap at all times, to adjust the gap as circumstances dictates ,to enhance and stabilize the net interest margin, increase the gap when rates are rising and narrow it when rates are declining.

Finally, interest risk can be addressed by hedging through the use of financial futures and options. Combine with the gap management, options and futures enable a bank to maintain predetermined spread and lock in an anticipated rate of return, either to reduce risk or to achieve additional portfolio returns. The formula in this case is to purchase future put option where there is a negative maturity gap and interest rates are rising or expected to decline. On the other hand, if the gap is positive, the bank should sell future put options if rates are falling and buy future call options if rates are rising.

3.4 Foreign Currency or Exchange Rate Risk and Its Management

It involves elements of other risks such as interest rate, liquidity, credit and funding risks. Besides, as movement in exchange rates frequently correlate with movements in interest rates, a mismatched currency position and mismatched interest rate position will frequently not be independent risks.

Accordingly, most of the instruments and techniques for addressing these other risks, particularly the interest rate risk, are also used for

managing the foreign currency exposure risk. These include appropriate matching profiles gap management, option trading, hedging setting limits and diversification.

3.5 Country Risk and Its Management

Country risk, heightened by the international debt crisis, is being managed in a number of ways. One is critical, perhaps conservative creditworthiness analysis and the setting of limit on exposures to countries and geographical regions or zones. The second is debt rescheduling and restructuring, usually on an annual basis, but recently on a multi-year basis, in some respects. The third method is improvements in the capital adequacy position of the banks through increased provisions. Fourth method is reduction in exposure through retrenchment of lending which began in 1982, and by selling some of the debts in the secondary market even at loss and through consolidation of the debt in a smaller number of countries through exchange of loan claims. Finally, with a view to avoid letting the debtors get into a hopeless situation which could involve the total loss of the asset, creditor banks are providing some concerted lending conditioned on the debtor signing a structural adjustment programme with the IMF.

4.0 CONCLUSION

It should be emphasized in conclusion that in managing risk, no bank can expect to get it right always. Mismatched positions are therefore inevitable, so also are potential losses. These rise with increases in volatility of interest rates and exchange rate fluctuations. It is therefore necessary to decide just what risk a bank can afford to bear, monitor continually the actual and potential exposures and act necessary to ensure that the risks are kept within established limits.

5.0 SUMMARY

In the course of this study, emphasizes were laid upon how individual risk can be managed in banking industry. Here five major types of risks and their management were discussed among which are: credit risk, interest rate risk; liquidity risk; foreign currency or exchange risk and finally, country risk.

6.0 TUTOR-MARKED ASSIGNMENT

List and discuss four types of risks, which you have studied, and their corresponding management in banking industry?

7.0 REFERENCES/FURTHER READINGS

Nwankwo, G. O. (1991). *Bank Management (Principle and Practice)*.
U.K. Oxford: Malthouse Publishing Ltd.

UNIT 3 LENDING AND BUSINESS BORROW

CONTENT

- 1.0 Introduction
- 2.0 Objectives
- 3.0 Main Content
 - 3.1 Four Basic Credit Factors
 - 3.1.1 The Borrower's Character and Soundness
 - 3.1.2 Use of Loan Funds by Borrowers
 - 3.1.3 Primary Source of Repayment
 - 3.1.4 Secondary Sources of Repayment
 - 3.2 Credit Investigation
 - 3.2.1 Customer Interview
 - 3.2.2 Internal Source of Information
 - 3.2.3 External Sources of Information
 - 3.2.4 Spread Sheet and Statement Spreading
- 4.0 Conclusion
- 5.0 Summary
- 6.0 Tutor-Marked Assignment
- 7.0 References/Further Readings

1.0 INTRODUCTION

In its fullest meaning, credit analysis is the process of assessing the risk of lending to a business or an individual. Credit risk must be evaluated against the benefits the bank expects to derive from making the loan. The direct benefits are simply the interest and fees earned on the loan and, possibly the deposit balances required as a condition of the loan. Indirect benefits consist of the initiation or maintenance of a relationship with the borrower that may provide the bank with increased deposit and with demand for a variety of bank services.

2.0 OBJECTIVES

At the end of this unit, you should be able to:

- identify four basic credit factors,
- perform Credit investigation
- calculate working Capital and Financial Projection.

3.0 MAIN CONTENT

3.1 Four Basic Credit Factors

The essence of all credit analysis can be captured in four basic credit factors or line of inquiry

1. The borrower's character and soundness
2. The intended use of loan funds
3. The primary source of loan repayment
4. Secondary sources of repayment

3.1.1 The Borrower's Character and Soundness

Most bankers agree that the paramount factor in a successful loan is honesty and goodwill of the borrowers. Dishonest borrowers do not feel morally committed to repay their debts. A determined, skilled and dishonest borrower usually can get a loan through misrepresentation. Because loan officers must spread their time over many loan relationships, they do not have time to uncover elaborate schemes to defraud the bank. To be sure, it is important that default does not always occur because of moral failing and willful neglect on the part of the borrower. Perhaps equally important are intelligence, personal discipline, and managerial skills and instincts. These qualities are sometimes easier to evaluate than blatant dishonesty -but not so much easier. Loan officers must devote ample time in attempting to determine the competence of borrowers.

The bank must protect itself from dishonest, incompetent or overly subjective borrowers by thoroughly investigating the credit background of the borrower. The borrower's previous credit relationships can be evaluated from records of the local credit bureau, suppliers, past banking relationships, and customers. If the borrower has built a record of prompt payment of interest and principal, it is likely that future loans will be similarly serviced. If the borrowers has been routinely late in paying past debts, the reason should be determined. If previous creditors have experienced losses, the loan officer should almost automatically reject the application.

3.1.2 Use of Loan Funds by Borrowers

At first glance, the borrower's need and proposed use for funds usually seem perfectly clear. In many commercial loans, this is frequently not the case. More often than not, determining the true need and use of funds requires good analytical skills in accounting and business finance. An understanding of the loan's intended use helps the analyst to understand whether the loan request is reasonable and acceptable.

Ostensibly, most business loans are made for working capital purposes - usually additions to current assets. However, the specific purpose for the loan may be substantially different. The loan proceeds may provide emergency funds to meet the firm's payroll; they may be used to pay aggrieved suppliers' overdue accounts; they may be used to replace working capital that was depleted through operating losses. A common need for funds arises when collection of receivables slow down. The analyst should also determine whether working capital needs are seasonal or permanent.

Frequently, short-term loans are made to finance working capital needs that initially appear seasonal but subsequently proved to be permanent needs arising from general sales growth. As a result, short-term loans often become de facto term loans that support permanent increases in account receivable, inventory, and fixed assets.

Assets financed by long-term commercial loans should meet the legitimate needs of the borrower's business. An asset purchased in the hope of profiting from its resale is speculative. Banks ordinarily do not lend for such a purchase because it does not contribute to the economic needs of the business.

3.1.3 Primary Source of Repayment

The analyst's accounting and finance skills are crucial in determining the ability of the borrower to repay a loan from cash flow. For seasonal working capital loans, cash flows are generated by means of the orderly liquidation of the seasonal build up in inventories and receivables. In term loans, cash flows are generated by means of the orderly liquidation of the seasonal buildup in inventories and receivables. In term loans, cash flows are generated from earnings. The analyst must ascertain the timing and sufficiency of these cash flows and evaluate the risk of cash flows' falling short.

Sources of payment other than cash flows from operations should be viewed with caution. The borrower may plan on a future injection of investor capital to repay the loan. Unfortunately, if the firm fails to produce attractive profits, outsiders usually withhold future investment in the firm. The customer may be depending on borrowing (takeout funds) from another institution to repay the bank loan. Unless a formal commitment exists from another institution, this source suffers from the same limitation as a planned equity injection. An exception is the interim construction loan in which another long-term lender has formally committed to provide takeout funds. The future sale of a fixed asset usually is not a reliable source of loan repayment.

3.1.4 Secondary Sources of Repayment

In general, cash flow from business operations is the most dependable source of loan repayment. However, if sufficient cash flows fail to materialize, the bank can prevent a loss if it has secured a secondary source of repayment. Collateral should always be viewed as a secondary, not primary source of repayment. Banks hope to avoid foreclosing on collateral because foreclosure entails much time and expense. Collateral value should cover, in addition to the loan amount interest due, the legal costs of foreclosure and interest during foreclosure proceedings. Collateral is the preferred secondary source of repayment. Other secondary sources are guarantors and co-makers. However, collection from guarantors and co-makers often requires expensive litigation and results in considerable ill will between bank, borrower and guarantor.

3.2 Credit Investigation

The purpose of credit investigation is to acquire enough information to determine the loan applicant's willingness and capacity to service the proposed loan. The investigation attempts to develop an understanding of the nature of the borrower in terms of the four basic credit factors just discussed: the borrower's character, the true purpose of the loan, the primary source of repayment, and the secondary source of repayment. There are three fundamental sources of information: customers, internal bank sources, and external sources available through institutions outside the bank.

3.2.1 Customer Interview

Despite possible lack of objectivity, the loan customer ordinarily will provide the most important information needed in credit investigation. The prospective borrower should indicate the type and amount of loan requested, designate the proposed source and plan of repayment, identify the collateral or guarantors, name other previous and current creditors, list primary customers and trade suppliers, identify the firms accountant, indicate the principal officer and shareholders, and give personal and business histories. The borrower also should provide documents needed to establish the lending relationship including such items as the latest three or more years of business financial statements, personal financial statements, personal income tax returns, borrowing authorities, evidence of insurance and continuing guarantees.

Lenders can quickly gather a wealth of supporting information using well planned questions during the interview. What are the characteristics

of the borrower's market? How are the products sold and distributed to the market? How important is price, quality or service in selling the product? What is the production process? Are labour relations a problem? Who are the principal owners and executives, and what are their experience and educational backgrounds? Who would be in charge in the event that the present chief executive officer became unavailable? Does the firm have a strategic planning program? How will future markets of opportunity differ from those of today, and what resources will be needed to serve them? These and related questions serve to build the lender's comprehensive grasp of the strengths and weaknesses of a loan applicant.

3.2.2 Internal Source of Information

If the loan customer has existing relationships with the bank, a great deal of information is internally available to the bank about the customer's willingness and capacity to service the proposed loan. The investigator should study credit files on any current or previous borrowings, examine checking account activity and review other deposits previously or currently held. These sources will indicate the degree of the bank's satisfaction with past payment of performance, and they may reveal any tendency to overdraw deposit accounts. These sources will also identify primary customers, suppliers and other creditors with whom the borrower has had financial transactions.

3.2.3 External Sources of Information

Several service agencies provide credit reporting on businesses and business principals.

Business Information Report provides a composite credit rating, describes the promptness of trade payments by the subject firm, and indicates the highest credit balance carried during the most recent year. Other detail includes balance sheets sales and profit records, insurance coverage, lease obligations, biographical information on principals, the firm's history, and its recent business trends.

3.2.4 Spread Sheet and Statement Spreading

Spreading Bankers generally use so called spread sheets for recording a credit applicant's financial information. Spreadsheets permit the analyst to organize financial data in a consistent manner. This frequently requires that certain data submitted by the applicant be reclassified to match the bank's purpose. For example, an item included as a current asset in the applicant's statement might be reclassified as non-current on the spread sheet if the credit analyst has doubts about its liquidity. An

example of such an item might be a note due from one of the business's officers or principal. The spreadsheet is arranged to allow easy comparison of current and historical trends and is readily updated as the column are completed from left to right. Spreadsheets typically are structured to permit entry of up to five years of financial statement history. Columns are provided for common size ratios for each balance sheet and income statement account. Space is provided for several key financial ratios and for analysis of changes in net worth and working capital. Supplementary forms are often used to enter a time series of other key ratios.

4.0 CONCLUSION

It should be emphasized in conclusion that, in lending principles and business, borrower must involve both quantitative and qualitative assessment of borrowers by bankers who have the appropriate skills for such assessment in order to safeguard various forms of risks that may arise in future.

5.0 SUMMARY

In the course of this study emphasizes were laid on lending principles and business borrower where the following were critically examined: four basic credit factors viz. character and soundness, intended use of loan funds, primary source of loan repayment and finally, secondary sources of repayment. Also, credit investigation revealed three fundamental sources of information viz. customers internal bank sources, and external sources available through institutions outside the banks.

6.0 TUTOR-MARKED ASSIGNMENT

1. List and discuss four basic credit factors?
2. What do you understand by credit investigation?

7.0 REFERENCES/FURTHER READINGS

Vincent Baritsch (2003). Bank Treasury Management Institute of Financial Services.

UNIT 4 BANK CREDIT ORGANIZATION

CONTENTS

- 1.0 Introduction
- 2.0 Objectives
- 3.0 Main Content
 - 3.1 Machinery for Loan Administration
 - 3.2 The Lending Organization
- 4.0 Conclusion
- 5.0 Summary
- 6.0 Tutor-Marked Assignment
- 7.0 References/Further Readings

1.0 INTRODUCTION

Most bankers believe that defining business of banking is lending. Also, bankers know that, historically the main path to professional advancement and high salary as a bank employee has always been through the lending function, although today other major paths to progress increasingly are opening as bank operations, financial management, trust activities, and other activities become more crucial and complex. Bank loans finance diverse groups in the economy. Manufacturers, distributors, service firms, farmers, builders, home buyers, commercial real estate developers, consumers, and others all depend on bank credit. The way in which banks allocate their loanable funds strongly influence the economic development of the community and the nation. Most bankers believe it is in their own best interests to supply credit within their own communities because credit helps community to grow. Every bank bears a degree of risk when it lends to private borrowers such as business and consumers, and without exception, every bank experiences some loan losses when certain borrowers fail to repay as agreed. Whatever the degree of risk taken, loan losses can be minimized. This could be organizing and managing the lending function in a highly professional manner.

2.0 OBJECTIVES

At the end of this unit, you will be able to:

- draw the organogram of loan management and administration in banks
- explain various personnel responsible for loanable funds
- identify committees and departments responsible for proper management of loans.

3.0 MAIN CONTENT

3.1 Machinery for Loan Administration

After the loan policy has been formulated, provision for its proper execution must be made. Certain individuals must carry out the loan policy and provision made for its periodic review and evaluation and to effect changes as necessary, depending on changes in economic conditions.

Section two of the loan policy sets down the machinery for the day-to-day administration of the loan, including routine administration. This involves the definition and functions of the loan administration department, its structure and authority and the assignment of responsibilities and reporting and approving channels within the department and from the department to general management. The types of information and documentation required should also be specified as well as the modality or criteria for interpreting the information. The machinery for routine administration should also be indicated. Guidelines here include those for insurance, draw downs, excess line, margin requirement, supervision of, observance of covenants and management of problem loans.

Several factors determine the actual machinery a bank adopts. These include the attitude of the board of directors towards the extent of authority to be delegated, the character and quality of the lending officers, the size of the bank and of the loan portfolio and the types of loan being made or to be made. While the legal responsibility and authority reside in the board, some boards play more important roles than others. In general, however, larger banks do delegate lending authority and specialize in lending more than small banks.

Usually there is a Directors Loan Committee (DLC) including Managing Director and Chief Executive, and an Officers Loan Committee (OLC) or Committees. In some banks there is additionally an Officer Loan Review Committee (OLRC). The Directors Loan Committee oversees the banks loan portfolio, acts on loan requests beyond the powers of officer's loan committee and that of the Chief Executive and deals with requests dealing with policy. The DLC also reviews the responsibilities and actions of the Officers Loan Committee. It usually meets once in a quarter, on call for special meetings and has powers to make prudent changes in the bank's loan management; and it reports to, and is subordinate to, the Board.

The OLC and OLRC are the operating committees of loan management. Usually made up of the Executive Director with loan portfolio responsibilities, the OLRC reviews and approves loans up to a specified amount while the OLRC has responsibilities to safeguard the quality of

the bank’s loan portfolio on a continuing basis. It meets over troubled or distressed loans and reports to Chief Executive and to the Board. It follows up weak loans until their weakness is corrected or the loan is collected. It has the authority to reassign the loan if the Loan Officer in charge does not make satisfactory progress correcting the observed weaknesses or recovering the loan.

In addition to monitoring loan quality and reducing loan losses, the OLRC aims at detecting actual or potential problem loans as early as possible, enforcing uniform documentation and enforcing loan policy stipulation.

3.2 The Lending Organization

The organizational structure of the lending functions varies with bank's size and type of business. An officer of a small bank may perform all the detailed work associated with making a loan, including credit investigation and analysis, negotiation, customer contact, periodic review of the loan file, and at times, collection. In larger banks, individual loan officers specialize in consulting and negotiating with customers and there is greater compartmentalization of support functions such as credit analysis, loan review and loan collection.

Figure 1: Typical Lending Organization in a Medium-Sized Bank

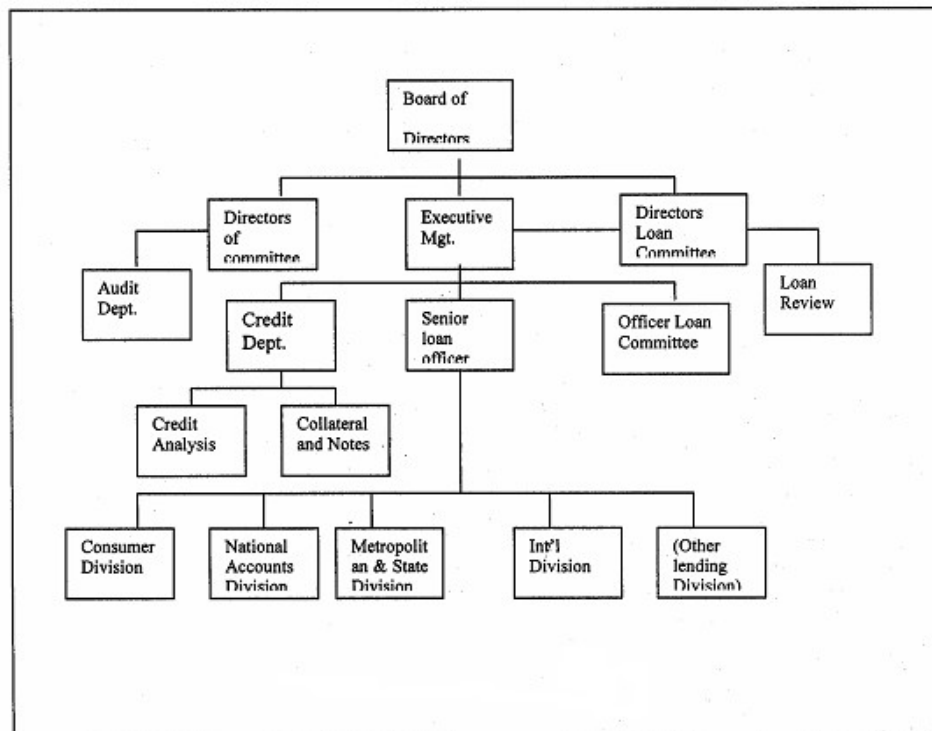


Figure 14 shows a representative loan organization for a medium-sized bank. An important check and balances feature of lending organization is to have the loan review department and the audit department report

directly to the board of directors via appropriate directors' committees. The arrangement preserves the independence of these functions and protect them from the undue influence of the officers who make loans and who may not want to face up to potentially adverse information about their loan customers.

Loan Divisions

The various loan divisions as shown in figure 14 perform the basic functions of generating loan business and supporting customers. Larger banks are organized along geographic, industry, or product line. Large banks develop lending expertise in such specialized businesses as energy, mining, public utilities, specialized line of manufacturing, or commercial real estate. Separate loan divisions are necessary to service the special needs of these industries. At the same time, national regional loan division that cut across different industries is needed to serve geographically dispersed customers.

Credit Department

The primary mission of the credit department is to evaluate the credit worthiness and debt payment capacity of present customers and new loan suppliers. Because of the technical nature of its credit evaluation functions, the credit department is an excellent place to train new loan officers. Trainees are exposed to a variety of good and not so good loan cases on which they assist loan officers in making credit decisions.

The department may also be responsible for loan review, although in larger banks this function is likely to be handled by a separate department. Credit departments are sometimes responsible for collections of past-due loans. This function is usually handled by specialists within the department.

Collateral and Note

A crucial and complex loan function is the perfection of the bank's security interest in collateral offered in support of a loan. This department also performs the discount function; the monitoring and crediting of payments received on outstanding notes.

Loan Committees

Loan committees are responsible for approving banks larger loan requests. All banks need effective committees for the review of major loan proposals and loan delinquencies. Usually, two or three committees are needed: a directors' loan committee, an officers' loan committee, and for banks with an excessive number of troubled loans, a special assets committee. Loan above certain minimum sizes must be submitted to the officers' loan committee, consisting of the bank's most experienced loan officers. The officers' committee meets frequently. In larger banks it may meet daily or once a week.

The loan officers' committee serves as a check on, not a substitute for the individual loan officer's judgment. The committee's duties are as follows:

- Review major new loans
- Review major loan renewals and ascertain the reasons for renewal
- Review delinquent loans and determine the cause of delinquency.
- Ensure full documentation of loans
- Ensure consistency in the treatment of loan customers.

Banks differ in how they structure the loan approval process. Some banks give relatively large loan limits to their loan officers, with the ability to combine their limits with other officers to approve most of the acceptable loan applications. Other banks grant smaller loan limits, do not permit combining of loan limits, and rely mostly upon loan committees to approve loans. The first system result in greater flexibility and efficiency; the second system results in greater control and safety.

The directors' loan committee reviews major loans approved by the officers' committee. It is usually composed of the bank's president, the most senior loan officers, and two or more external members of the board of directors. The committee makes a final judgment on the officers' loan committee decisions, giving closer scrutiny to the largest credits. It is especially concerned with conformance to bank loan policy. The directors' loan committee also reviews significant past-due loans and credit problems.

A special assets committee is sometimes created in banks that have experienced a significant increase in regulator-criticized loans. This committee monitors the progress of problem loans and tries to determine how to work out effectively the loans through creative cooperation with distressed borrowers and through persistent collection efforts.

4.0 CONCLUSION

In conclusion, it could be observed that appropriate loan and credit administration as well as good lending organization constitute part of effective and efficient way by which banks' directors, officers, and various committees can handle credit and loans.

5.0 SUMMARY

In summary, the unit revealed various machineries for loan administration and the specified procedure. The study stated some guidelines which include those for insurance, draw downs, excess line, margin requirement, supervisions, and adherent of covenants and management of problem loans. Also, the unit showed a typical lending organization chart that specified the relationship among various departments and status.

6.0 TUTOR-MARKED ASSIGNMENT

1. What do you understand by lending organization?
2. List and discuss various departments in loan administration?

7.0 REFERENCES/FURTHER READINGS

Vincent Baritsch (2003). Bank Treasury Management Institute of Financial Service.

UNIT 5 TREASURY MANAGEMENT

CONTENTS

- 1.0 Introduction
- 2.0 Objectives
- 3.0 Main Content
 - 3.1 Development of Treasury Function
 - 3.2 The Remit of Treasury Functions
 - 3.3 Front-Office Activities
 - 3.4 Back-Office Activities
- 4.0 Conclusion
- 5.0 Summary
- 6.0 Tutor-Marked Assignment
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1.0 INTRODUCTION

A corporate treasury function will deal with the management of the company funds, be it the raising of equity capital, working capital or investing surplus funds. It also has to ensure that funds are available when they are needed to support the main business. Its role is therefore a key head office function that enables the business managers to focus on their own areas of expertise, be it for example, the sales department or the manufacturing plants. Whether such a company has a separate treasury function or whether this is incorporated into their finance department does not change the nature of the underlying activity. The key is that treasury management is a function that supports the main business activity. It thus attempts to improve the net worth of the company by managing its funds in the most appropriate manner. The same applies to a bank's treasury function. The only difference is that most banking activities directly deal with money and thus the grey area between what is clearly a treasury activity and what is not. It is this grey area, which explains why there is such variety between the roles that treasury functions are given in different banks. Nevertheless, the underlying objective remains to improve business performance and increase the net worth of each bank.

2.0 OBJECTIVES

At the end of this unit, you should be able to:

- deal with these operations, internal audit and compliance
- manage balance sheet exposures (funding, liquidity, and cash management)

- explain risk management principles for market, operational and credit risks
- identify regulatory requirements and capital adequacy
- the functions and characteristics of financial markets
- discuss financial products, practice, and procedures.

3.0 MAIN CONTENT

3.1 Development of Treasury Function

Increasing net worth initially meant that treasury function had to ensure effective cash and liquidity management. They needed to ensure sufficient cash was available for business transaction and that available funds were invested to ensure that the bank remained liquid. To meet these goals of managing firm's liquidity, treasury functions need the ability to determine what the actual exposures are. This in turn requires the ability to monitor changes on an on-going basis and to some extent the need to control the activities of other business areas to ensure these do not endanger the treasury function remit. For example, a treasury function will need to know when and in what currency large payments are due, to avoid a potential default when a payment demand is made.

The emergence of more complex bank treasury management and new approaches to risk management were driven by changes in the competitive environment faced by banks.

3.2 The Remit of Treasury Functions

Finance theory says that high returns can only be achieved at the expense of taking higher risks. Thus, a bank with a high risk appetite also faces potentially higher levels of losses. Such a high-risk appetite would be exhibited if a bank invested spare cash in high-yield bonds rather than UK gilts. Assuming that an institution has decided in favour of a low risk appetite, then it will be up to the treasury function to buy low risk investment products. This is dealing and settlement role of a treasury function. Clearly, in large institutions, the governing body will only be able to give broad guidance with the instruments that best fit the broad guidance being decided at the level of the treasury function. The function will thus require an excellent knowledge of the financial instruments available in the market.

A treasury function can thus be seen as the function that implements and executes the decision taken by the company's governing body, most often the Board of Directors or an Executive Committee of a bank. This senior committee will have to set the general business strategy of the bank, the mix of activities and risk parameters for the execution of these

activities. In larger organizations, the more detailed formulation of these will have been delegated to sub-committees, such as an Asset and Liability Management Committee that exists in many financial institutions. At the same time, the high-level committee will also need assurances that its decisions are implemented correctly and that they are appropriate, given the constraints of external market developments. It will also need to advise on the trade-offs between various business activities.

This large role sees bank treasury management as being an exercise of portfolio management. A bank's balance sheet can be seen as a large portfolio of investments. To determine how a portfolio is invested, the bank's governing body will not only need underlying research, but also detailed information on the positions within this portfolio. This monitoring function and its extension to risk management, forms an increasingly important part of bank treasury management. In practice, however such portfolio management requires the involvement of variety of functions, which will be located differently within each bank. Irrespective of specific arrangement, the competitive environment banks face means that each bank needs a function that can ensure the general risk appetite relating to balance sheet exposure expressed by its governing board is implemented and adequately controlled.

Thus, the execution function of a treasury area, i.e. its dealing and settlement role, cannot be undertaken in isolation of the risk management functions that bank require. Although risk management and treasury activities are often split into different areas for the sake of systems and control, the two should always be considered together to ensure the bank's net worth is maximized.

Dealing and settlement role of treasury unit: - For the avoidance of doubt, it should be pointed out that treasury activities are conceptually different from proprietary trading functions. Proprietary trading unit are departments that utilize the bank's funds to trade actively in such areas as bond and equity markets. While a treasury function supports and facilitates the running of the bank in general, proprietary trading is more akin to other business units, such as retail banking or international trade finance.

Despite these conceptual differences, the trading activities of both treasury functions and proprietary trading units share many similarities. For example, both require dealing desk and settlement departments. Indeed, in many banks, the two utilize the same systems as the instruments traded are often similar. Furthermore, systems and controls that apply to trading operations are often the same, particularly as it does make business sense to combine similar back-office activities. It is thus

not surprising that in many banks proprietary trading and treasury management are undertaken within the same department.

In practice, many banks only treat their equity and bond trading as proprietary trading units. These activities tend to be less driven by risk management aspects and therefore can be separated more easily into clearly defined business units. In contrast, it is almost impossible to distinguish between those money market or currency dealings that are related to risk management and those that are not. Such arrangements make sense where a treasury function is mainly seen as having to ensure assets and liability management. This in short requires the management of liquidity by ensuring that sufficient funds are available for other business activities, and ensuring those funds that are not required immediately are utilized to maximize returns. On that basis, the dealing activities of treasury functions will deal with ensuring the liquidity and cash management, both in domestic currency, foreign and potentially eurocurrency markets, support and improve the bank's net worth.

As the raw material of banking is money, this money must be generated at the lowest fund cost. Operational effectiveness at the lending and investment front can become incidental if the cost of funds is too high to create acceptable margin, particularly in the modern competitive environment.

3.3 Front-Office Activities

Dealer, as dealmaker, will seek to conclude transactions, but products must be priced in order to generate the necessary level of margin. Often the ultimate level of profit will be unknown until the deal has run its course, defaulted or realized any of the risks underlying the transaction. For example, depending on interest rate and foreign exchange risk, the final profit could be higher or lower than priced initially. Throughout the dealing day, the bank needs to optimize its cash flows in order to ensure that shortfalls are fully funded, and any surpluses are invested in order to maximize its returns. These activities can be placed under the heading 'cash management'. Doing the deal is classed as 'front-office', whereas the reconciliation of payments is 'back payment'. Dealers and back office managers have to forecast activity in order to ensure prudence is being applied in its trading activities and that all liabilities can be met in the course of the trading day or week.

A dealer will input the deal to be electronically transferred to the back office for processing. Historically, the dealer wrote the detail of the deal on a slip of paper, which was later input into the system by the back-office. In either case, the transactions delivered from the dealing room

will be processed alongside all the other different forms of balance-sheet activity taking place.

A good treasury function will be expected to be innovative in its approach to maximizing profitability by loan types and in various geographical markets and across client bases. In order to fund these activities more profitably, the bank's senior management will expect treasury team to develop new ways of attracting the cheapest funds. In the competitive markets in which the banks now operate, these funding costs are key, as is the need to maximize the flow of income. More recently there has been a trend towards charging fees for various services around loan, advances and credit lines, securities and new financial instruments. This off-balance sheet income is very attractive for treasury managers who will often be the party to encourage their use.

In the same way that banks must take care not to concentrate their loan book geographically or by client or industrial sector, similar considerations arise when looking at deposits. If the source of funds is equally concentrated, then the bank is vulnerable to the removal of these funds, and will need to seek out new funds in the future. Over concentration on short-term inter bank funding was one of the reasons for the difficulties experienced by Continental Illinois in the US in the 1980s, precipitating its collapse. By maintaining a portfolio of deposit sources, the bank reduces the 'concentration risk' that could sit alongside the other risks banks face.

In order to have the ability to make loans for periods in excess of one year, extending into the medium and long term, it is necessary for the bank to attract deposits on a long term basis. A bank will need to exercise a great deal of prudence in matching assets and liabilities, while at the same time, taking the necessary steps to maintain confidence in the bank. In turn this will help to promote stability in deposit levels. But by definition, the short term funds sought and attracted not in themselves matched to the bank's asset portfolio.

The same situation arises in investment portfolio as well as in loan portfolios. Inevitably, investment portfolio life spans will exceed the funding that lies behind them, whereas at the other end of the spectrum trading portfolio do require short-term funds for short-term transactions. Three month money would normally be the maximum funding requirement for engaging in short-term trading.

One of the bank's objectives therefore will be to have depositor's rollover their money held in deposit, so that short term deposit effectively becomes medium -term funds for bank. The higher the proportion of the funds is being rolled over, the more likely it is that the

banks can respond to changes in market conditions. The extent to which the bank is prepared to mismatch its assets and liabilities is another consideration for senior management on a day-by-day, period-by-period basis, but inevitably maturity transformation will form part of that policy. Ensuring that a bank can cope with this maturity transformation role is a key area of treasury functions.

3.4 Back-Office Activities

Once a deal has been done in the front-office, it will need to be cleared and settled. This is generally seen as the role of the back-office.

Clearing covers all the activities prior to settlement such as trade comparison and matching, trade netting, securities messages and numbering and, if applicable, securities lending. The first part of the clearing process is trade comparison and matching. This involves confirmation between the counterparties that a deal has been done and that the detail of the deal are the same on both sides. A next step may involve netting of trades. During the course of a trading day, a bank may deposit \$50 million in the inter bank market with a specific counterparty. Later in the day, it may borrow \$30 million from the same counterparty, for example if it had an unexpected outflow of funds. This means that at the end of the day the treasury function may, depending on contract, only have to transfer the difference of \$20 million, rather than transferring the full \$50 million and having to await receipt of the second deal.

Settlement deal with the actual transfer of ownership in exchange for cash or security and the subsequent confirmation that the transfer has taken place. Although back-office activities are sometimes seen as less glamorous than front-office activities, this crucial area needs robust systems and controls. Otherwise, a bank may face the potential risk of being unable to settle its respective outstanding, a situation that can arise for reasons of fraud, poor management, exceptional circumstances and system failure.

4.0 CONCLUSION

In conclusion, one could see that treasury management involve sourcing and application of funds by the treasury department of banks. Therefore, appropriate allocation and utilization of funds is a symbol of effective and efficient treasury management.

5.0 SUMMARY

This unit emphasized the functions of treasury Management in banking industry. It also discussed of both the front office and back-office activities of the treasury department of the banks.

6.0 TUTOR-MARKED ASSIGNMENT

Discuss the importance of treasury management in banking industry?

7.0 REFERENCES/FURTHER READINGS

Vincent Baritsch (2003). Bank Treasury Management Institute of Financial Services.