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Challenges of Bank Consolidation to the Central Bank of Nigeria: A Descriptive Analysis

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Abstract

Consolidation is one of the trends that characterize banking industry restructuring in Nigeria. However, the emerging scale of bank mergers raises challenging policy questions that must be addressed by policy makers in the course of promoting economic efficiency while safeguarding the nation's financial system. This paper analyses the challenges of the banking consolidation to the Central Bank of Nigeria (CBN). The paper is descriptive and uses literature survey method. Data was collected from secondary source through CBN publications, local and international journals and other published materials. The paper argues that the recent consolidation poses new challenges to the regulatory authority, particularly in the area of financial system stability. It therefore, recommends that CBN's policies aimed at providing financial system stability and efficiency should take into consideration the process of banking consolidation and increasing globalisation of financial transactions.

Introduction

Recent years have witnessed remarkable changes in the banking industry around the world. Nigeria has been no exception. The Nigerian banking industry has experienced two important changes since the beginning of year 2000. The first important change is strong growth and increase in efficiency largely due to development in information technology and telecommunications, which have set in motion an electronic revolution in the sector. The second is market consolidation and higher concentration due to bank megamerger.

These higher penetration and consolidation have changed the banking industry structure. Many aspects of the process, particularly consolidation, have important implications for the way central banks accomplish their work, particularly as regards ensuring financial system stability (Ahumada and Marshall, 2002).

Since the announcement of the Central Bank of Nigeria (CBN)'s reform agenda for the banking industry in July 2004, a number of fears have been expressed concerning the new challenges posed particularly by the adopted mergers and acquisitions as a strategy for consolidation of the industry, with a view to enhancing banking efficiency, size and developmental roles.

Against this background, this paper analyses the challenges posed by the recent consolidation of the banking industry to the Central Bank of Nigeria (CBN) with the hope of providing appropriate recommendations that will improve the measures taken by the regulatory authority to address the new challenges abound the consolidation project. The paper is a descriptive survey, which involves the collection of data from CBN publications, Journals and other published materials for the purpose of describing the new challenges of the recent banking industry consolidation.

We organise the paper in six parts. The next part gives a background on the recent consolidation. Part three presents a review of relevant literature. Part four analyses the challenges of banking consolidation. Part five appraises the policies of CBN for banking consolidation, while part six presents conclusion and recommendations.

Background On Recent Consolidation

The Nigerian banking industry has undergone remarkable changes over the years, in terms of the number of institutions, ownership structure, as well as depth and breath of operations. As at the end of June 2004, there were 89 deposit money banks in Nigeria, comprising institutions of various sizes and degrees of soundness (Soludo, 2004).

The structure of the sector, argues Ago (2004) is highly concentrated, where by the sector has very few large banks accounting for about 50% of the industry's total assets and liabilities. That, many felt was not healthy to the economy. The small size of most of the banks, each with expensive headquarters, separate investment in software and hardware, heavy fixed costs and operating expenses, and with bunching of branches in few commercial centres, lead to very high average cost for the industry. The implications of this, argued Soludo (2004), Ago (2004) and Eke (2003) are high cost of intermediation (high lending rates) and unnecessary pressure on banks to engage in sharp practices, sometimes, unscrupulous, as means of survival.

An assessment of the Nigerian banking industry shortly before the pronouncement of the consolidation agenda shows that while the overall health of the system could be described as generally satisfactory, the state of some banks was less cheering. Specifically, as at the end of March 2004, the CBN's ratings of all the banks, classifies 62 as sound/satisfactory, 14 as marginal and 11 unsound, while two of the banks did not render any returns during the period. The fundamental problems of the marginal and particularly, unsound banks according to Soludo (2004) have been identified to include persistent illiquidity, poor assets quality and unprofitable operations. He further summarises the major problems of many Nigerian banks to include weak corporate governance, gross insider abuses, insolvency, weak capital base and over-dependency on public sector deposits.

This negative development necessitated the move for strengthening and consolidating of the Nigerian banking system. The reform, according to the regulatory authority, is designed to

ensure diversified, strong and reliable banking sector. The reform further adopts mergers and acquisitions as an instrument for enhancing banking efficiency, size and developmental roles. The intention of stimulating mergers, besides creating bigger banks, is to increase competition, enhance performance and productivity and allow more resources to be made available for the creation and development of new technologies. One of the key elements of the reform agenda of the CBN is the requirement that minimum capitalisation for banks should be N25 billion with full compliance by the end of December 2005.

Right from the day the new policy was handed down to the industry players in July 2004, the atmosphere has never been the same. The development sparked off protests from several quarters but all door for negotiations were shut. Banks had no other alternative than re-adjust and re-strategise. In fact, Ago (2004) observes that banks had the options of meeting up the N25 billion through new capital raising programmes; luring foreign equity participation; opening up for group consolidation; or outright mergers and acquisitions.

By 31st December 2005, twenty-five banks have emerged from 75 banks. According to CBN (2006), the successful banks account for about 93.5% of the deposit liabilities of the banking system.

Literature Review

In recent years, there has been a wave of bank consolidations that has spread across the world either for strategic reason or for promotion of government policy (Sawada and Okazaki, 2004).

Bank consolidation simply means a reduction in the number of banks and other deposit taking institutions with a simultaneous increase in size and concentration of the remaining entities in the sector (Basu et al, 2004). In general terms, consolidation of the banking industry involves the resources of the industry becoming more tightly controlled either because the number of key firms is smaller or the rivalry between firms, growth among leading firms, or industry exit of weaker institution (OECD, 2001).

The key characteristic of consolidation is change of control, which takes place through a transfer of ownership (Ayadi and Pujals, 2004). The primary methods of consolidation employed by firms are mergers and acquisitions (M&A). With both these methods, two formerly independent firms become commonly controlled. The distinction between a merger

and an acquisition is somewhat vague. A merger is often defined as a transaction where one entity is combined with another so that at least one initial entity loses its distinct identity. An acquisition is often classified as a transaction where one firm purchases and controlling stake of another firm without combining the assets of the firm's involved. Relative to acquisitions, mergers provide a greater level of control, because there is only one corporate entity. Acquisitions are not appropriate when there are operational, geographic or legal reasons to main separate corporate structures. M&A are also sometimes distinguished by defining mergers as transactions involving two firms that are essentially equal size, while acquisitions are transactions where one party clearly obtains control of another (OECD, 2001).

Review of available literature suggests that there are a number of possible economic drivers for consolidation through megamergers, from economic efficiency to the self-interest of bank management. Proponents of banking consolidation argue that four economic forces that may be driving consolidation through mergers and acquisitions are: economies of scale, economies of scope, potential for risk diversification and management's personal incentive (Kwan, 2004). According to ILO (2001), value maximisation, managerial ego, mimicry, the need to reduce uncertainty and defensive considerations, high level of corporate reserves, and share valuation are among the motives for banking consolidation.

On his part, Soludo (2006) argues that banking consolidation has the benefits of causing drastic fall of interest rate due to liquidation, greater potential for banks to finance big-ticket transactions, dilution of ownership of banks to tame the monster of insider and corporate governance abuse, more effective supervision, earning greater confidence of depositors, and economies of scale.

Researches conducted confirm most of the benefits outlined by Soludo. In a research on the benefits of megamergers, Akhavein et al (1997) found that merged banks experienced higher profit efficiency from increased revenues than did a group of individual banks, because they provided customers with higher value-added products and services. In addition to increased bank returns through revenue, Basu et al (2004) demonstrate that mergers and acquisitions improve efficiency, which is central to making the case for the consumer benefits of mergers and in assessing their potential impact on consumers. ILO (2001) therefore posits that since mergers are said to improve efficiency, then larger combined banks may be expected to pass some savings onto consumers through lower prices or improved service.

Research suggests that geographical expansion would provide diversification benefits to a banking organisation not only by reducing its portfolio risk on the asset side, but also by lowering its funding risk on the liability side, as it spread funding activities over a larger geographical area (Hughes et al, 1999). This means that a bigger bank is expected to be less vulnerable to economic shocks. It is also expected to reap the benefits of economies of scope and scale that come mainly from the production process. The assertions that size generates economies of scale essential to compete in global markets have been disputed on the grounds that size is irrelevant to international competitiveness and cross-border mergers. It is however argued from a pro-merger perspective that rather than size problems, banks have excess capacity in their domestic markets, which drives up their costs, making them uncompetitive both domestically and internationally. According to this argument, mergers enable rationalization of networks and associated cost reductions.

In Chile, a survey of the post-merger banking industry reveals that banks are becoming less specialized entities and traditional boundaries between market segments are tending to disappear, and customers favour obtaining most services from a single institution, as they can reduce search and transaction costs. (Ahumada and Marshall, 2002). This clearly indicates that market forces encourage high concentration.

Another feature of consolidation is the emergence of a single category of bank, providing an increasingly wide range of financial services. Evidence from the banking sector in the United States supports the assertion that consolidation breads inter and intrastate branching, technological innovation in distribution networks and new financial products (Stiroh and Poole, 2000).

Laderman (2003) found that changes in concentration of local banking markets were quite modest despite the large degree of consolidation in banking business over the past 20 years in the United States.

According to a report prepared by International Labour Organisation (ILO) in 2001, smaller countries are also encouraging consolidation to counter growing competition from larger institutions in neighbouring countries.

Challenges of Banking Consolidation

The recent consolidation of the banking industry witnessed in Nigeria is not to be seen without odd. Bank megamergers pose new challenges to the regulatory authorities, particularly in the area of financial system stability. As Kwan (2004) puts it, ever-growing scale of bank mergers raises challenging policy questions that must be addressed.

Ahumada and Marshall (2002) identified three effects of an increase in concentration: higher systematic risk in the banking industry, transition risk and difficulties for monetary policy management. Other challenges posed by banking consolidation relate to negative consequences of consolidation for the competitive environment. ILO (2001) added that banking consolidation raises important public policy concerns, notably with respect to employment.

First and foremost, bank mergers have the potential to raise antitrust concerns. The reason is simply that bank mergers can alter banking market structure and because market structure influences banking competition and hence the price of banking services to customers. Research suggests that the markets for many banking products and services remain local in nature, despite the advances in information technology and electronic commerce (Rhoades, 2000). In view of this, and in consideration of the drive for globalisation of world's finance, Kwan (2004) posits that where merger results in an unacceptably high level of concentration in local banking markets, regulatory authorities will face the challenge of preserving meaningful competition. Ahumada and Marshall (2002) however, conclude that the degree of competition in the banking industry strongly depends on the quality of the regulatory and supervisory framework, international financial openness, degree of penetration of the banking sector in the economy and overall economic stability.

The ongoing bank consolidation in Nigeria is expected to foster the emergence of large and few number of banks. Large banks are typically diversified with complex risk matrix. From the central bank stand point, the main challenge of banking consolidation is its effect on systematic risk and hence on financial system stability. When banking activities are concentrated in a few very large banking companies, shock to these individual companies could have repercussions to the financial system and the real economy. Kwan (2004) adds that the increased potential of systematic risk created by megabanks also intensifies concerns about these banks being considered "too-big-to-fail" (TBTF). Zubairu (2006) adds clamour

for low premium rates and overstretching of deposit insurance to cover non-banking activities of large banks.

Transition risk relates to dynamics of consolidation and industry restructuring. Rapid consolidation, through accelerated growth or acquisitions, tends to disrupt some institutions and threatens financial system stability.

Further, Zubairu (2006) argues that one of the principal backlashes of the banking sector restructuring in Nigeria is the sheer number of bank employees that are thrown and are continuously being thrown out in the labour market, unprepared and unskilled. The consequences both to the banks and employees are many. Newly emerged banks have to bear the liquidity pressure of paying off disengagement and severance packages to the staff that are being disengaged. This had posed a serious threat in the past. ILO (2001) reports that employment in the banking sector in Nigeria dropped from 78,514 workers in 1990 – 1991 to 54,292 in 1999 – 2000. It is estimated that more than one-third of workers would loose their jobs between 2006 – 2007.

CBN's Policies And Banking Consolidation

The Central Bank of Nigeria needs to adapt its policy framework to the new integration challenges posed by the recent consolidation in the banking industry. Soludo (2006) explains that CBN has taken measures to address possible risks and challenges that may crop up as a result of the megamerger. The measures are:

1. New draft code of corporate governance for banks in the spirit of transparency and constructive consultation
2. Close monitoring to ensure documents for merger schemes are complied
3. Black book of discredited practitioners
4. Zero tolerance regarding infractions, misreporting and non-transparency

While these measures are hopely going to reduce the risks of consolidation, although their efficacy is yet to be tested, a lot more need be done by the CBN. Judging by existing trends and changes in the banking industry, and given the fact that consolidation is an ongoing process, additional consideration needs to be given to better understanding its consequences and policy implications. Of particular importance, promotion of transparency and efficiency in financial markets and trying to maintain competitive equity in financial markets will make

for genuine competition among institutions reducing the adverse consequences that banking consolidation may have.

Conclusions And Recommendations

The recent restructuring of the Nigerian banking industry is largely characterized by consolidation. Although, the level and magnitude of changes in the system brought about by the reform is yet to be ascertained, the trend interrelates with the expansion of banking activities in the domestic economy and globalisation of the financial sector.

Banking consolidation is a matter of concern to central banks of the world as it may have adverse consequences on systematic stability. The magnitude of this effect however, depends on specific circumstances of each economy, such as quality of the regulatory framework, supervision practices, competition equity and financial market sophistication.

Now that Nigeria is witnessing serious reforms in her financial system, attention should be given to the risks that arise from banking consolidation. Policies aimed at providing financial system stability and efficiency should take into consideration the processes of complexity of banking consolidation and increasing globalisation of financial transactions.

Regulatory authority should note that a 25bn banking failure will be a disaster and a 25bn-banking rescue will be too expensive. Therefore, key economic policies such as better regulatory guidelines and incentive for banks to fully participate in real sector financing must complement banking reforms. Managing a large commercial banking business is about managing risks, serving customers and controlling costs.

Since consolidation is likely to continue, further policy measures may be desirable in order to maintain a healthy competitive environment and strengthen market efficiency. In order for the CBN to achieve this, policies so designed will have to work with the incentive structure of market forces, including technological progress and internationalisation of financial activities.

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