Developing Country Studies
ISSN 2224-607X (Paper) ISSN 2225-0565 (Online)
Vol 2, No.10, 2012

Universal Basis of Bank Failure – The Nigeria Case

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Abstract

Many nations have experienced bank failures with very high costs which can lead to systemic risks. The causes of bank failure are numerous, in theory, and include regulation of banking activities such as forbearance; asymmetric information leading to a moral hazard problem and connected lending. The history of banking system in Nigerian has been occasioned with a lot of problem which resulted to distress. The recent consolidation and recapitalisation exercise in the sector was in a bid to resolve this dilemma. In this paper we appraised the causes and outcomes of bank failures. In this article, we looked at the theoretical level and other root causes, consequences of bank failure and lessons within the Nigeria perspective. Finally, the options and measures to prevent further systemic hazards were recommended.

Keyword: bank failure, Nigeria, mismanagement, corruption.

1. Introduction

The number of failing banks has been on the increase as reported around the world. Bank failures are usually followed by unfavorable consequences on stakeholders outside the failed banks themselves. Sometimes the consequences are felt by the non-banking system as a whole. A failure can result in much harm to employment, earnings, financial development and other associated public interests. Smith & Walter (1997: 158). According to Hooks (1994) and Benston & Kaufman (1996, cited by Kaufman, 1996), the failure of a bank has great adverse effect on the economy and so is considered very important. The literature on banking crises identify that the conventional banking structure is inherently unstable and, therefore, itself contributes to the occurrence of crisis, Bryant (1980); Diamond and Dybvig (1983). Being a deposit taking institution the liabilities of a bank, at any given point in time, are fixed and a fixed interest is promised on them. Whereas its assets are in the form of loans earning variable interest and subject to credit risk. This also leads to interest rate risk. Similarly, its demand deposits by nature are of shorter maturity while its loans are for longer duration. Therefore, there always exists a risk of maturity mismatch. These features of the assets and liabilities render the banking sector prone to crisis in wake of any shock or decreased confidence of the depositors.

The failure of banks and the related costs have also been emphasized by many writers. Kaufman (1996) explains that banking crisis generates losses to stakeholders by disturbing the settlement system, and even has a systemic effect on the entire economy. Caprio & Klingebiel (1999) also present information on 114 episodes of banking crises in 46 countries. Given the focus on a Ghanaian bank, we think that the costs of failures of some African banks (table 1) might be of particular interest. The costs of the failures shown in the table differ from country to country. Different costs are included in total cost differently by each country. Examples of such costs are those related to corporate restructuring and restructuring/recapitalization of the banking system. The estimated total losses/costs shown in this table exclude the portion incurred by depositors and borrowers from non-performing loans. Additionally, some of the figures exclude costs related to indirect methods used to bail out banks. Most empirical studies on banking failures consider a financial institution (bank) to have failed if it either received external support or was directly closed. Here, a financial institution will be considered to have failed if it fits into any of the following categories (Bongini, Claessens, and Ferri 2001; Gonzalez-Hermosillo 1999); the financial institution was recapitalized by either the central bank or an agency specifically created to address the crisis, and/or required a liquidity injection from the monetary authority; the financial institution's operations were temporarily suspended ("frozen") by the government; the government closed the financial institution; the financial institution was absorbed or acquired by another financial institution. These categories involve a broader concept of economic failure than the more restrictive concept of *de jure* failure (closure). One potential limitation is that category (iv) could include banks that were merged or absorbed for strategic reasons during the crisis period, and not due to insolvency reasons. As a result, a sensitivity analysis is performed that excludes this category.

2. A Literature Review on Causes of Bank Failure

It is useful for all stakeholders, that is, managers, depositors, borrowers and regulators in the financial sector to know what causes a bank failure in order to help prevent the failure. The issue especially concerns managers and external regulators. This is because most managers are dismissed and regulators are blamed when banks fail. It is also very important for other stakeholders to understand the causes of bank failure, in order for them to help to avoid it. We should also note that the social costs of the failure of a bank can be higher than the costs incurred by the failed institution, the consumer can lose when an institution fails, even if there is no systemic impact and this is the reason why all the interested party should be at alert regarding issues of bank failure. In this section, we will examine and review some of the various theories which deal on the factors behind banking crisis and failures. They are as follows:

Deteriorating Economic Factors

Hooks (1994: 5) points out that deteriorating local economic conditions (e.g. inflation, interest rates, and exchange rates) cause bank failure. Eisenbeis (1986, cited by Hooks, 1994: 10) adds that macroeconomic factors (e.g. sudden adverse movements in a country's terms of trade and sharp fluctuations in world interest rates**,** real exchange rates and inflation rates) worsened by regulations that are imposed on banks result in a bank failure. Like Hooks and Eisenbeis, Goodhart et al. (1998: 47) emphasize that interest rate fluctuations contribute to banking crisis.

Regulation of Banks

O'Driscoll (1988, cited by Hooks 1994: 9), Eisenbeis (1986, cited by Hooks, 1994: 10), Dothan & Williams (1980, cited by Hooks, 1994: 36) share the opinion that government intervention causes bank distress. Hempel & Simonson (1999: 17) state that when governments intervene in saving banks from failing, creditors and customers tend to rely on the government to protect their interests. The intervention, however, is a disincentive for other institutions, creditors and customers to effectively monitor their interests in banks in an independent way. Llewellyn (1996, cited by Goodhart et al., 1998: 2-3) notes the following situations, which could cause a bank failure: (i) Too many stringent rules could cause banks to disregard the measures as they may be seen by the banking sector as superfluous. (ii) Some dangers that banks are exposed to may be too difficult to be addressed by general laws. (iii) A rigid system of rules could inhibit banks from selecting the most efficient means of achieving regulatory goals set for them and may serve as a disincentive for improvement. While Spollen (1997: 28) concludes that ineffective regulatory system causes bank failure, White (1984, cited by Hooks, 1994:3, 36) also notes that government regulation is neither needed nor advantageous.

Government Deposit Insurance Scheme

Goodhart et al. (1998: 45) observe that in the absence of any measure to rescue distressed banks, they could be exposed to depositors' runs. However, when complete deposit insurance schemes and other rescue measures are in place, stakeholders other than banks are discouraged from controlling the activities of intermediaries. This is why regulators protect the interest of the public by encouraging the reduction of risk-seeking behaviors. Kareken (1981, 1983, cited by Hooks, 1994: 3) and Kareken & Wallace (1978, cited by Hooks, 1994) state that a fixed-rate deposit insurance motivates banks to engage in risky investment activities. Hooks (1994: 39) agrees with the above by stating that a flat-rate fee deposit insurance is an incentive for banks to make risky investments. Palubinskas & Stough (1999) stress that the scheme results in unpaid loans, since banks and customers have nothing at stake when deposits are badly managed or lost through fraudulent actions. White (1993: 108-109) concludes that a government deposit insurance scheme encourages unskilled management and fraudsters, irrespective of the regulation.

Regulation as Regards Putting a Ceiling on Deposit Interest Rates

Selgin (1996: 211) states that the purpose of putting a ceiling on deposit interest rates is to prevent banks from mobilizing deposits by giving borrowers big amounts of funds with high interest income to the bank. Dothan & Williams (1980, cited by Hooks, 1994: 36) state that a limit on deposit interest rates motivates banks to make risky investments. Additionally, banks often try to overrule the ceiling by rendering more services to depositors, which results in higher transaction costs and lower income. Selgin (1996: 211) concludes that instead of decreasing the

prospects of bank failures, the ceiling reduces a bank's capability to mobilize funds when it becomes illiquid. A ceiling on deposit and loan interest rates, therefore, it is argued, can cause bank failure.

Prohibition of Banks from Establishing Branches and Limiting Bank Investments

Selgin (1996: 200) states that geographical limitations pose significant threats to banks. Additionally, such limitations result in the following situations, which may cause bank failure: a bank's vulnerability to different threats is raised; systemic risk is encouraged and private market forces are hindered from preventing failures. Hooks (1994: 8, 49-50) observes that branching restrictions could constrain banks from spreading their investment activities in different locations. These geographic restrictions, coupled with prohibition from investments, result in unsuccessful diversification by banks. Hooks also notes that limiting a bank's investment chances could lower its diversification operations. Goodhart et al. (1998: 38) add that lack of appropriate diversification causes bank failure. Hempel & Simonson (1999: 18) argue that without branches, banks cannot mobilize substantial amounts of stable retail deposits. Such a position compels banks to rely extensively on unstable funding bases attracted from money market creditors. O'Driscoll (1988, cited by Hooks, 1994: 9) observes that banks may use flexible investment freedom to focus on limited higher-risk categories. Selgin (1996: 210) adds that even though the justification of geographical limitation is to stop banks from excessive clustering and avoid competition, this perception misinterprets the impact of bank branching and the importance of competition. White (1986, cited by Selgin, 1996: 209) states that branching limitation raises a bank's vulnerability to risks for its liabilities as well as its assets. In the same way that branching restrictions rules have motivated banks to high risk-taking investments, some regulations have also constrained banks from engaging in many different banking operations. Selgin (1996: 208) concludes that regulation in respect of branching limitation contributes to the possibility of banks failing, by constraining their chances to prevent risk and by supporting bank risky operations. To him, the worst regulation is branching restriction.

Capital Requirements

The lower a bank's capital, the higher the probability of its failure (Polizatto, year not given). Goodhart et al. (1998: xvii, 49, 57) agree with this statement and add that as a bank's capital decreases, the higher its motivation for actions towards survival. This leads to more dangerous risk-taking operations. Therefore, the risk of failure rises with the decline of equity. Palubinskas & Stough (1999) also observe that one of the measures used to stop the increase of bank crisis is to increase the ceiling as regards capital held by banks. This requirement compels banks to hold much capital, or combine their businesses with other banks, or forfeit their licenses. According to Polizatto (year not given) capital is essential to cushion losses incurred by banks. When banks have inadequate capital, they usually conceal the situation for fear of exposing the illiquidity. If stakeholders such as bank management and regulators do not effectively address a capital erosion situation early, it could result in bankruptcy. A similar view as the above has been expressed by Goodhart et al. (1998: 57) who state that adequate funds reduce risk-taking while insufficient capital motivates banks to engage in actions towards survival at all costs.

Inadequate Reserve Requirements

A reserve requirement is a portion of cash to total deposits which banks are obliged to maintain. This ensures prudential and fiscal control of the activities of banks (www.bog.gov.gh). White (1999) adds that a government obliges banks to reserve the funds in order to improve the actual need for base money. Friedman (1960, cited by Hooks, 1994: 37) states that bank failures arise because banks do not keep all their deposits in statutory reserve funds.

Forbearance

Hempel & Simonson (1999: 18) note that some regulatory bodies exercise forbearance. This contributes to bank crisis by permitting distressed banks to continue their operations instead of liquidating them. This action aims at assisting banks to make profits. Its effect is rather disadvantageous to banks because usually when banks lack adequate funds, and remain in operation, their capital situation deteriorates (Hempel & Simonson, 1999: 18).

Lender of Last Resort

Selgin (1996: 214) and White (1999: 74-77) state that governments use the lender of last resort mechanism to help some stakeholders of banks which are failing. When bank failures rise, any money reserved to deal with the

situation decreases. The only option then is to either replenish the reserves or combine the operations of distressed banks. However, if prospective beneficiaries of this approach perceive that the central bank may intervene when every bank fails, the measure could rather encourage banks to engage in more risky activities.

Mismanagement

Management is a key to a successful business. Mismanagement caused many banks to fail in the 1980s and early 1990s. Banking crisis mostly comes from the absence of good managerial ideas in management decision-making. Therefore, competence and focus play a major role in banking (Spiegel, et al. 1996: 51). According to Pantalone & Platt (1987, cited by Hooks, 1994: 41- 42), mismanagement, especially excessive risk-taking, is the main cause of bank failure. On the other hand, White (1993: 110) notes that even though bankers are accused of misconduct, it is difficult to prove that the negligence of management is the only cause of bank failure. Spollen (1997: 25-26, 32, 51) has however, listed the following as underlying the failure of businesses which, to us, are also relevant to the purpose of this study:

- Inability of management to appreciate and control a business.
- Inability of management to ensure compliance with laid down procedures. In many situations where there is a loss of a business, the failure is attributed to either lack of policies, and if policies existed at all, they are inadequate or existing policies are not observed.
- Insufficient number of staff, particularly middle management, which can subject a small number of employees to over-time work, which could eventually result in the failure of a bank. The issue is whether an organization has adequate staff complement and whether it appreciates their interests and addresses them (Spollen 1997: 86, 94).
- The situation when fundamental control procedures are ignored.
- The situation when internal audit does not play its role in the formulation of a board of directors' policy and its procedures.
- The situation when the board of directors does not effectively address audit queries.
- Over-reliance on one member of staff. Most of the time organizations are defrauded by some of their own workers, mostly those who have been with organizations for long periods of time and whose work is not supervised. Excessive authority is given to an employee because he seems to be very effective on his schedule. Individuals in this category are trusted, devoted to duty and work extra hours under the guise of showing much commitment Spollen (1997: 20, 34-36, 90-91). Like Spollen, Heffernan (1996: 282-288) states a practical case of such a situation that contributed to the failure of Barings Bank.

Goodhart et al. (1998: 49) add that if worker compensation is tied to performance and output is below expectation, the managers could manipulate the output for fear of being dismissed. This risk behavior could eventually cause a bank to fail (e.g., Barings Bank failure). Palubinskas & Stough (1999) state that a shortage of competent bankers as regards loans' risk appraisal, scrutiny of financial information of customers, appraisal of cash flow, or calculation of fundamental profitability, contributes to many of the loan defaults. They continue saying that lack of skills leads to a situation where there is no credit evaluation - where bankers only enforce and supervise the credit manual, which is not updated to reflect varying periods. Goodhart et al. (1998: 38) agree with this perception. White (1993: 110) notes that currently it is not easy for banks to attract skilled managers.

Fraud and Corruption

Smith & Walter (1997: 157) stated that fraud causes banks to fail as happened in the case of Banco Ambrosiano, BCCI, Crédit Lyonnais and Herstatt. Heffernan (1996: 293) adds that corruption and fraud have been the general causes of many failed banks. White (1993: 108-109) argues that bank failures are seen by many to be caused by mismanagement, fraud and deregulation. However, fraud is not the primary cause of banking crisis, since according to White, bank failures were rampant in the 1930s when there was no fraud.

Poor Risk Management Procedures Such as Lending Practices of Banks

Hempel & Simonson (1999: 388) state that the main activity of bank management is not deposit mobilization and giving credit. Effective credit administration reduces the risk of customer default. The competitive advantage of a bank is dependent on its capability to handle credit risk valuably. Bad loans cause bank failure. Palubinskas & Stough (1999) note that the failure of a bank is mainly seen as a result of mismanagement because of bad lending decisions made with respect to wrong appraisal of credit status, or the repayment of non-performing credits and

excessive focus on giving loans to certain customers. Goodhart et al. (1998: xvii, 38) also state that poor credit control, which results in undue credit risk, causes bank failure. Goodhart et al. (1998: xvii, 38) connected lending to the causes of bank failure. Again, Palubinskas & Stough (1999) note that lack of dependable financial information on borrowers to help in assessing creditworthiness causes a bank failure. Yet mismanagement is not a result of immaturity all the time. Most of the time, principals and agents know that major faults in the banking regulation in respect of internal changes permit them to exploit a bank's funds. Sometimes these two groups of stakeholders attempt to accomplish their short term earnings objectives by acquiring high risks in the bank. Polizatto (year not given) points out that financial information disclosed by banks is often false. He explains that the absence of existing and adequate financial data underlies the keeping of security based credit because bankers are unable to assess creditworthiness. Goodhart et al. (1998: 49) state that re-stating financial earnings from previous years to current years could lead to the falsity of financial information of banks.

Polizatto again observes that in many cases asymmetric information exists between banks and investors. Goodhart et al. (1998: 13-14, 46) also add that the common problem of prudential rules is the asymmetric information issue between the customer and the bank. Heffernan (1996: 2, 22) adds that bank structures generate asymmetric information leading to moral hazard and adverse selection. These writers further state that organizations give extended agreements whose worth to the customer is based on the organization's attitudes and performance subsequent to the date of the agreement. The problem and rigidity of rules are because every stakeholder (e.g. government, bank, depositor and borrower) has dissimilar information, incentives and positions. For instance, how can savers or the government discern the risk actions of banks? If the authorities could monitor the total risks of an intermediary inadequately, is it feasible to initiate laws that minimize runs on banks?

Spollen (1997: 9, 30, 58-60) states that irregular meetings of loans committees, false loans, large treasury losses, high sums of unrecorded deposits and money laundering in large amounts, contribute to bank failure. He adds that some lending decisions involving high amounts of money are made by an individual worker because of the status of the recipients of the loans. Kindleberger (1989, cited by Hooks, 1994: 37-38) observes that over-investment is directly related to high risk-taking and this causes bank failure. Additionally, some employees disregard laid down procedures and rather work according to instructions from certain areas. In some cases a worker of a Credit Department of a bank obtains signatures from every member of the loan committee in irregular ways sanctioning a loan. Hempel & Simonson (1999: 16-17) mention loans to the "energy producers and commercial real estate developers**"** as examples of risky investments, especially when the economy is good and the lending decision is based on improper projection. White (1993: 12) adds that the failure of banks is mainly due to risky credits they give. Hempel & Simonson (1999: 390) conclude that all banks incur certain loan losses when some borrowers default in repaying their loans. Irrespective of the extent of the risk involved, good credit management can reduce the default.

Deregulation of Banks

Hooks (1994: 3-4) states that deregulation results in higher risk-taking by banks and could lead to bank failure. Chu (1996) emphasizes that free banking encourages banks to engage in deceptive operations and over-expansion, which makes banks fail. With respect to deposit insurance schemes, Kareken (1981, 1983, cited by Hooks, 1994) notes that deregulation is unsafe for banks. He explains that when banks have freedom of investment and diversification, the situation leads to higher risk-taking. Like Kareken, Hooks (1994: 49) adds that if regulatory authorities eliminate the application of strict maximum deposit interest rates imposed on banks, resulting in the increase of deposit interest rates, banks will engage in high risk investments. He therefore concludes that deregulation results in more risky investments.

Political Interference

Goodhart et al. (1998: 38) point out that politically directed lending leads to banking crisis. To buttress this assertion, Caprio & Honohan (1999) observe that governments can cause banks to fail in many ways. Some dishonest leaders exploit the funds of banks as happened in the Philippines in the 1980s. In most cases, governments influenced banks to give loans to certain borrowers that discouraged banks from properly assessing the creditworthiness of borrowers and eventually destabilized banks' financial standing. The implication of this is that such loans are not paid off. Occasionally, the credits are given to government suppliers leading to the failure of the banks involved.

3.0 HISTORICAL OVERVIEW OF BANK FAILURES

3.1.Biggest Global Bank Failures

Many important industrial nations have experienced upsetting bank failures such as the following: Banco Ambrosiano in Italy (Smith & Walter, 1997: 157; Heffernan, 1996: 272-273), Barings Bank in the United Kingdom (Gray et al., 2001: 23-24; Heffernan, 1996: 282-288), Rumasa in Spain (Caprio & Honohan, 1999), Crédit Lyonnais in France (Smith & Walter, 1997: 157; Heffernan, 1996: 387-406; and Daiwa Bank in Japan (www.lectlaw.com). The Bank of Credit and Commerce International (BCCI), founded in Karachi, Pakistan in 1971 and once the 7th largest private bank in the world and holding over $20 billion USD in assets failed in July 1991 because of widespread fraud (Smith & Walter, 1997: 157; Heffernan, 1996: 280-282).

Herstatt Bank of Germany has a special place in bank failure lore, triggering a debacle that resulted in a new international regulation. German regulators seized the ailing Herstatt and forced it to liquidate on June 26, 1974. The same day, other banks had released Deutsch Mark payments to Herstatt, which was supposed to exchange those payments for US dollars that would then be sent to New York. Regulators seized the bank after it received its DM payments, but before the US dollars could be delivered. The time zone difference meant that the banks sending the money never received their US dollars.(Smith & Walter, 1997: 157; Heffernan, 1996: 271). There is also the case of Hokkaidō Takushoku Bank, Ltd. Japan which is possibly the most notable failure of the Asian financial crisis, "Hokutaku" went bankrupt in 1997, almost 100 years after its inception as a "special bank" To Promote development on the island of Hokkaido. The bank specialized in long term, low-interest loans and debt insurance that would help grow specific sectors on the island, like fishing and agriculture. In 1939, the government deregulated Hokutaku, allowing it to offer short-term financing and bank accounts. The bank grew and eventually became involved in risky real estate investments during Japan's late-1980s real estate bubble. In 1991, the Southeast Bank of Miami, the second largest bank in Florida failed. This was caused by a slump in the regional commercial real estate market, combined with 1980s S&L Crisis fallout. Also in December of 1931, New York's Bank of the United States fell victim to "contagion," when a string of unrelated banks fail for unrelated reasons. The bank's name had something to do with it. Many New Yorkers felt that if the bank of the United States could fail, then any bank could fail. At the time of the collapse, the bank had over $200 million in deposits, making it the largest single bank failure in the nation's history. There is also the case of Franklin Square National Bank, founded in 1926, the bank piloted now-standard features such as hiring high school students as tellers, building drive-up teller windows, and offering bank credit cards. The bank's integrity went out the window when shady financier Michele "The Shark" Sindona purchased a controlling stake. Sindona used Franklin to launder money and build a Mafia-linked banking empire in the United States. Within two years, currency speculation, bad loans, and fraud drove Franklin into a fire sale. While the Great Depression may not have affected European banks as badly as those in the U.S., the Creditanstalt-Vienna is one notable example of a large healthy bank that failed. Founded by the Rothchild family in 1855, Creditanstalt became the largest bank in Austria-Hungary. A poor economy and failure to deal with dwindling deposits forced it into bankruptcy in 1931. Its failure sent shockwaves through in Europe, causing bank failures in Germany, Hungary, Czechoslovakia, and Poland. Long-Term Credit Bank of Japan LTCB was one of the top three banks in Japan responsible for postwar economic growth. In 1989, it was considered the 9th largest company in the world by asset value. Then Japan's asset bubble burst, poisoning LTCB with more than $19.2 billion in bad debt. In 1998, the Japanese government nationalized LTCB, and then restructured it as a commercial bank named Shinsei Bank. (www.businesspundit.com/25-biggest-bank-failures).

Sachsen LB, Germany, in August of 2007, board members reported that even though Sachsen was involved in Irish and US mortgage markets, they were not exposed to sub-prime loans and held sufficient liquidity for the long term. Then, in September, worldwide markets crashed. Within the next three months, most of the board was fired or resigned. Inside consultants accused Sachsen LB of blatant accounting errors and no "visible action" to reduce risks. On the 13th of December 2007, Sachsen LB was taken over by Landesbank Baden-Wuerttemberg (LBBW), with financial guarantees of roughly EUR2.75 billion by the state of Saxony. Bank of New England (BNE), along with its two sister banks, Maine National Bank and Connecticut Bank and Trust, failed on January 6, 1991. In a surprising move for the time, the FDIC decided to insure all deposits- even if they exceeded the $100,000 insurance limit. BNE was the largest bank in the New England area. With its sister banks, it had assets totaling

$21.8 billion and deposits totaling $19 billion. Bad loans and heavy ties with bond creditors BNE led to its downfall. A settlement provided $140 million to creditors. Continental Illinois National Bank and Trust, The concept of "too big to fail" started with Continental Illinois National Bank and Trust. In 1984, it was the 6th largest bank in the U.S., with nearly $40 billion in assets. The bank collapsed in 1984 due to losses stemming from recently acquired Penn Square Bank. In response, the FDIC infused capital and bought preferred shares, basically nationalizing the bank. Continental's huge number of assets, which included the largest commercial and industrial loan portfolio in the country, made it too big to fail. In addition to giving guarantees to depositors, the FDIC infused billions of dollars to recapitalize the bank. IndyMac, Los Angeles-based IndyMac used to be the largest loan originator in the country. Founded in 1995 as Countrywide Mortgage Investment, IndyMac fueled its aggressive growth through risky loan products like Alt-A mortgages, concentrating on inflated real estate markets like California and Florida, and relying heavily on borrowed funds, especially from the FHLB (Federal Home Loan Bank). The U.S. woke up to the first and largest bank failure in recent memory on July 11, 2008, when the FDIC seized the bank's assets (over $30 billion) and closed its doors, (www.businesspundit.com/25-biggest-bank-failures).

3.2 Bank Failures in Nigeria – An Overview

The health of Nigerian banks cannot be divorced from their antecedents. As could be recalled, when modern banking business commenced in Nigeria by 1892, it was solely a business for foreigners. The skewness in the ownership structure in favour of foreigners largely contributed to the observed lack of access to banks' credit by indigenous Nigerian entrepreneur during that period. Nigerian entrepreneurs who came into banking from the late 1920s to early 1950s did so with the principal aim of redressing the situation and meeting the financial requirements of Nigerian businesses. Due to problems such as inadequate capital, mismanagement, overtrading, lack of regulation and unfair competition from the foreign-owned banks, 21 of the 25 indigenous banks that were established up to 1954 failed. The failures were resolved mainly through self-liquidation. The mass bank failure was a bitter experience for the economy as it brought untold hardship to depositors who lost their money and lost confidence in the ability of Nigerians to manage a banking business.

It was not until government started to regulate banking through the Banking Ordinance of 1952 and the establishment of the Central Bank in 1959, which was followed by the promulgation of the Banking Degree of 1969 that the banking system started to stabilise in the country. The oil boom, which commenced in 1973, and the economic growth, which ensued, made banking to thrive and to be very lucrative. The economic downturn, noticeable from mid-1981, brought strains to the Nigerian economy that soon became depressed. As economic agents were not able to moderate their boom consumption habits in line with the realities of the depressed economy, the financial condition of individuals, firms and governments worsened and they were unable to honour their contractual obligations of loan repayment to banks thus impairing banks' portfolio quality. This economic predicament, combined with other factors such as mismanagement, adversely affected the health of many banks. Tables 1 and 2 below show the trend of bank liquidation and acquisition.

Table 1: Banks Under Liquidation As At December 2009

S/N	BANK IN LIQUIDATION	DATE OF CLOSURE	REMARKS
1	Financial Merchant Bank Ltd	21-Jan-1994	
2	Kapital Merchant Bank Ltd	21-Jan-1994	
3	Alpha Merchant Bank Plc	8-Sep-1994	
4	United Commercial Bank Ltd	8-Sep-1994	
5	Republic Bank Limited	29-Jun-1995	
6	Abacus Merchant Bank Ltd	16-Jan-1998	
7	ABC Merchant Bank Ltd	16-Jan-1998	
8	Allied Bank of Nigeria Plc	16-Jan-1998	

9	Amicable Bank of Nigeria Plc	16-Jan-1998	
10	Century Merchant Bank Ltd	16-Jan-1998	
11	Commerce Bank Plc	16-Jan-1998	
12	Commercial Trust Bank Ltd	16-Jan-1998	
13	Continental Merchant Bank Plc	16-Jan-1998	
14	Cooperative & Commerce Bank Ltd	16-Jan-1998	
15	Credite Bank of Nigeria Ltd	16-Jan-1998	
16	Crown Merchant Bank Ltd	16-Jan-1998	
17	Great Merchant Bank Ltd	16-Jan-1998	
18	Group Merchant Bank Ltd	16-Jan-1998	
19	Highland Bank of Nigeria Plc	16-Jan-1998	
20	ICON (Merchant Bankers) Ltd	16-Jan-1998	
21	Ivory Merchant Bank Ltd	16-Jan-1998	
22	Lobi Bank of Nigeria Ltd	16-Jan-1998	
23	Mercantile Bank of Nigeria Ltd	16-Jan-1998	
24	Merchant Bank for Africa Ltd	16-Jan-1998	
25	Nigeria Merchant Bank Plc	16-Jan-1998	
26	North-South Bank Limited	16-Jan-1998	
27	Pan African Bank Limited	16-Jan-1998	
28	Pinacle Commercial Bank Ltd	16-Jan-1998	
29	Prime Merchant Bank Ltd	16-Jan-1998	
30	Progress Bank of Nigeria Ltd	16-Jan-1998	
31	Royal Merchant Bank Ltd	16-Jan-1998	
32	Victory Merchant Bank Ltd	16-Jan-1998	
33	Premier Commercial Bank Ltd	20-Dec-2000	
34	Rims Merchant Bank Ltd	20-Dec-2000	
35	Peak Merchant Bank Ltd	28-Feb-2003	Under Litigation

36	Allstates Trust Bank Plc	16-Jan-2006	
37	Afex Bank Limited	16-Jan-2006	
38	Assurance Bank Nig. Limited	16-Jan-2006	
39	City Express Bank Plc	16-Jan-2006	
40	Eagle Bank Limited	16-Jan-2006	
41	Fortune International Bank Plc	16-Jan-2006	Under Litigation
42	Gulf Bank Plc	16-Jan-2006	
43	Hallmark Bank Plc	16-Jan-2006	
44	Lead Bank Plc	16-Jan-2006	
45	Liberty Bank Plc	16-Jan-2006	
46	Metropolitan Bank Limited	16-Jan-2006	
47	Trade Bank Plc	16-Jan-2006	
48	Triumph Bank Limited	16-Jan-2006	Under Litigation

Source: NDIC Annual Report 2009

Table 2. Closed Banks Under Purchase and Assumption (P&A)

S/N	CLOSED BANKS	ASSUMING BANK	HANDOVER DATES
1	Afex Bank Plc	UBA Plc	9 October 2007
2	Allstates Trust Bank Plc	ECOBANK Plc	16 October 2006
3	Assurance Bank Nig. Ltd	Afribank Plc	16 August 2006
4	City Express Bank Ltd	UBA Plc	9 July 2007
5	Eagle Bank Ltd	Zenith Bank Plc	14 January 2008
6	Gulf Bank Plc	UBA Plc	14 January 2008
7	Hallmark Bank Plc	ECOBANK PLC	24 July 2007
8	Lead Bank Plc	Afribank Plc	11 August 2006
9	Liberty Bank Ltd	UBA PLC	23 June 2008
10	Metropolitan Bank Ltd	UBA Plc	11 June 2007
11	Trade Bank Plc	UBA Plc	15 January 2007

Source: NDIC Annual Report 2009

4. Consequence of Bank Failures

According to a number of empirical studies, examine not only what causes crises but also how crises affect the rest of the economy. For example, summarizing several case studies, Lindgren, Garcia, and Saal (1996) conclude that bank fragility has adversely affected economic growth. Measures of output loss relative to trend during financial crises have been used to compare the severity of these events. For instance, Bordo et al (2001) show that financial crises (currency crises, banking crises, or both) entailed similar-sized output losses in recent years as compared to previous historical periods. Crises, however, are more frequent now than during the gold standard and Bretton Woods periods, and are as frequent now as in the interwar years. Hoggarth et al (2002) make the point that output losses associated with banking crises are not more severe in developing countries than in developed countries.

An obvious question raised by these studies is whether causality goes from output losses to banking crises or the other way around. The answer has obvious policy implications: if crises indeed have real costs, then the case for generous bank rescue operations is strengthened, even though these policies have large fiscal costs and adverse incentive effects *ex ante*. Conversely, if the output slowdown is mainly the result of exogenous shocks, then bailouts might not be beneficial. Sorting out causality, however, is a challenging task. As the literature surveyed in the preceding section shows, crises are accompanied by worsening macroeconomic performance triggered by adverse shocks, such as a tightening of monetary policy, the end of a credit boom, or a sudden stop in foreign capital inflows. A distressed banking sector, in turn, may be a serious obstacle to economic activity and aggravate the effect of adverse shocks. For instance, when banks are distressed, firms may be unable to obtain credit to deal with a period of low internal cash flow. In fact, lack of credit may force viable firms into bankruptcy. Similarly, lack of consumer credit may worsen declines in consumption and aggregate demand during a recession, aggravating unemployment. In extreme cases, bank runs and bank failures can threaten the soundness of the payment system, making transactions more difficult and expensive. These mechanisms suggest that fragile banks hinder economic activity (the credit crunch hypothesis).

On the other hand, there are several channels through which exogenous adverse shocks to the economy might cause a decline in credit and economic activity even if the banking sector itself is relatively healthy. For instance, adverse shocks may trigger a fall in aggregate demand, leading firms to cut production and investment and consequently, credit demand. Increased uncertainty may also cause firms to delay investment and borrowing decisions. Finally, adverse shocks might worsen agency problems and complicate lending relationships, for instance by reducing the net worth of borrowers. This, in turn, might cause banks to abandon high risk borrowers (flight to quality) or raise lending spreads. So output and bank credit may decelerate around banking crises even if there is no feedback effect from bank distress to credit availability. Existing studies of individual country experiences have found conflicting evidence on the relationship between bank distress and real activity. In a study of the so-called capital crunch in the United States in 1990, Bernanke and others (1991) argue that a shortage of bank capital had little to do with the recession. Domaç and Ferri (1999) reached the opposite conclusion for Malaysia and Korea during 1997–8. They found small and medium-sized firms to have suffered more than large firms during the crisis. Since these firms are usually more dependent on bank credit than large firms, this is evidence of a credit crunch. Data from a survey of Thai firms, on the other hand, suggest that poor demand rather than lack of credit caused the decline in production, although many firms complained about high interest rates (Dollar and Hallward-Driemeier, 2000). For Indonesia and Korea, Ghosh and Ghosh (1999) test an aggregate model of credit demand and supply and find evidence of a credit crunch, but only in the first few months of the crisis. Finally, using firm-level data from Korea, Borensztein and Lee (2002) show that firms belonging to industrial groups (*chaebols*) lost their preferential access to credit during the banking crisis, although this was not necessarily evidence of a credit crunch.

A few studies have used cross-country empirical analysis to study which intervention policies can minimize the costs of a banking crisis. This question is as important to policymakers as it is difficult to answer through empirical analysis. One problem is that compiling accurate information on intervention policies for a large enough sample of crises is a laborious task. Another difficulty is that the sequence, timing, and specific modalities of a bank support strategy are crucial to the outcome, and it is difficult to capture these complex dimensions through quantitative measures of policies. Honohan and Klingebiel (2003) construct a database with estimates of the fiscal cost of 40 banking crises and catalogue the policies adopted in each episode, classified according to five broad

categories: blanket guarantees to depositors, liquidity support to banks, bank recapitalization, financial assistance to debtors, and forbearance. With this database, the authors explore how the different intervention policies affect the fiscal cost of the bailout, after controlling for country and crisis characteristics. They conclude that more generous bailouts resulted in higher fiscal costs.

Further evidence on the determinants of the fiscal costs of crises is provided by Keefer (2001), who focuses on the political economy of crises resolution. He finds that when voters are better informed, elections are close, and the number of veto players is large, governments make smaller fiscal transfers to the financial sector and are less likely to exercise forbearance in dealing with insolvent financial institutions. Thus, transparency, information dissemination, and competition among interest groups play an important role is shaping crisis response policies. In Nigeria, unethical practices, regulatory failure, poor governance structure, small capital base, macro-economic instability caused by large and sudden capital inflows and weaknesses in the business environment were some of the factors that triggered the weak financial system. The current CBN Governor admitted that internal structure within the Apex bank was weak. While Professor Charles Soludo, the former CBN Boss, tried to resolve the capital inadequacy by recapitalizing Nigeria banks the Governance issues in banks and at the Apex banks were not adequately handled. Unchecked governance malpractices at consolidation within the banks became a way of life with Chairman/CEO possessing unfetter powers over the bank. The board committees were inactive maybe because 'the cake' in their mouths couldn't make them talk. It was also discovered in the recent bank examination conducted that several abnormalities were done in the consolidation exercise. Mallam Sanusi put it this way: "One bank borrowed money and purchased private jets which we later discovered were registered in the name of the CEO's son. In another bank the management set up 100 fake companies for the purpose of perpetrating fraud. A lot of the capital supposedly raised by these so called "mega banks" was fake capital financed from depositors' funds. 30% of the share capital of Intercontinental bank was purchased with customer deposits. Afribank used depositors' funds to purchase 80% of its IPO. It paid N25 per share when the shares were trading at N11 on the NSE and these shares later collapsed to under N3. The CEO of Oceanic bank controlled over 35% of the bank through SPVs borrowing customer deposits. The collapse of the capital market wiped out these customer deposits amounting to hundreds of billions of naira. The Central Bank had a process of capital verification at the beginning of consolidation to avoid bubble capital. For some unexplained reason, this process was stopped. As a result, there were a lot of malpractices which led to the discovery that many banks never raised the capital they claimed they did (Okubadejo, 2010).

5. Conclusion, Lessons and Recommendations

Bank failures and financial crises are economic hazards. While their direct economic costs are the dead-weight loss. The indirect costs in the form of derailed economic policies and damage to the growth of banking and finance are even greater. There are many other causes that are common with conventional banking industry. We have experienced cases of exchange rate shock coupled with liquidity crunch and eroded depositor confidence in the banking system which precipitated a run on banks in Nigeria. Stakeholders should be on alert to pre-empt some symptoms of distress as indicated by Ogunleye (1993), they include; late submission of returns to the regulatory authorities, falsification of returns, rapid staff turnover, frequent top management changes, inability to meet obligations as and when due, use of political influence, petitions /anonymous letters, persistent adverse clearing position, borrowing at desperate rates, persistent contravention of laid-down rules and persistent overdrawn current account position at the CBN.

Banks also have to be careful not to invest in any interest bearing asset, even if this means foregoing lucrative short-term investment opportunities. This will not only ensure their stability at the time of financial crisis but also increase their credibility with the depositors. Measures which are taken by banks for ensuring its liquidity needs may not be enough during the time of crisis and this calls for collective efforts, pooling of liquidity, and reaching out for outside institutional support if need be. In equity based financing it is natural for the funds to flow where monitoring costs are lowest. Therefore banks tend to invest in their affiliated and connected companies where their control is greatest. In doing this, the banks should be careful not to increase maturity and currency mismatch between assets and liabilities. It is very easy to increase such risks because the banks' interests get locked in with these firms.

There should be some criteria for membership in the Board of Directors of Banks so that those selected are people who have sense of responsibility towards improving corporate governance in the institution. They should not be

rubber stamp members and should have knowledge of the financial and economic facts and experience of working in the financial sector. They should also be well informed of the country specific and international regulatory rules and laws which have implications for the bank, and above all, people of proven and impeccable integrity. Moreover, in order to minimize the effect distress on banks clientele and the economy as a hole and also avoid the encroachment of the factors responsible for distress into the banking system, the regulatory authorities may have to use better measures of evaluating the features of distress at an early stage. This will no doubt create sufficient lead-time to apply remediable solution before serious damage is done. The Apex banks should also put in place procedure to ensure that credits are only granted to credit worthy customers. Credit scoring systems of banks should be integrated with the Apex bank's Credit Rating Management System (CRMS). Let's ask if the CRMS of the Apex bank is even working effectively? Credit scoring agencies should be made CBN consultants and be paid by the Apex Bank. By so doing, they have regulatory backing. Data capturing should be robust and reflects high level of integrity. Governments must also move more quickly to balance their budgets, although, this is easier said than done but nevertheless, real economic growth cannot be sustained with borrowed money.

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