

Are Nigerian Banks Too Strategic to Fail?

Martin N. Oluba Ph.D., DBA is the President/CEO of ValueFronteira Limited. He is also Professor of economics & finance at the SMC University, Switzerland; faculty (mentor) for doctoral dissertations at Northcentral University, Arizona USA. Send him your comments at martin@valuefronteira.com or visit his personal website at www.martinoluba.com for his views on other subjects of national concern.

Many of the positions taken by analysts in the wake of the current banking sector reform derive from the oftentimes wrongly situated premise that banks are too strategic in the life of the economy to be allowed to fail. Because of the implications of their failure on shareholders and depositors and potential loss of confidence on the entire financial system, the argument holds that they should be saved from failure at all cost. Even in the face of obvious economics and financial criminality. Bank failures are painful and cuts across the larger economy as hundreds of thousands of depositors' means as well as the funds of shareholders are flushed into a drain created by inept monitoring and supervision by the regulatory agencies as well as the supportive moral hazards. But be that as it may, they do not constitute enough reason why bank's excesses should be tolerated "at all cost". Preventing their occurrence through the enactment of rules, processes and structures for detection and resolution of emerging challenge on a sustainable basis is obviously preferred.

The questions however that those who pursue the premise that obviously insolvent banks should not be allowed to fail do not ask are whether (a) the protection of few insolvent banks at the cost of a greater damage to the larger economy is worth it, (b) fraud, criminality and insider abuses in banks should be tolerated because of fear that the banks should fail (c) the misguidance and blurring of the path of monetary policy effectiveness should be allowed to subsist merely because we want to protect few banks from collapse (d) the indirect but catastrophic destruction of millions of other entrepreneurial activities by these banks should be permitted because we believe that they are strategic. And so on. A description of the macroeconomic instability-orchestrating process and consequences of allowing dead-banks to keep living is necessary to drive home our points. The hitherto life-support given to the five banks currently standing trial are good cases in point.

According to the Central Bank, these five banks constitute about 90% patronage of the expanded discount window. This window is an overly generous bailout facility to assist recuperation of a suspect dying candidate bank. But beyond these are very fundamental questions namely: Who pays for this subsidy? Where does this money come from? Why was it necessary that the bailouts be given to these banks? What are the implications of these bailouts on the economy particularly on small and medium-sized businesses? As we know, the Central bank's income or 'money' is part of the community fund owned by all of us. This fund is consequently given to a few banks who might have abused the lending process or merely suffered genuine business difficulties to arrive at their present precarious situation. However, from history particularly with reference to the many bank failures of the early 90s, insider abuses of the lending process or insider lending resulted to approximately 95% of all non-performing facilities that eventually grounded the banks. In the current context, evidence so far emanating from the Economic and Financial Crimes Commission indicate that the cause of the current situation is not divorced from this same underlying cause of the failures in the early 1990s. In effect, what it means is that the Central bank technically utilizes the money meant for the growth and development of the larger economy to finance the survival of banks that created their own problem by abusing clearly stipulated lending procedures.

Now what if the Central Bank created or printed new monies or in order to successfully maintain the life support facility extended to these banks. First, it is important to realize that the additional money stock created in order to revive the dying banks equally

belongs to all of us and thus is covered in the earlier argument. But beyond that is the macro-economic stability orchestrating consequences of creating money out of nothing in order to finance something that has no positive economic value-added. Let's juggle the argument a bit. If a bank is insolvent, that means it no longer creates any positive economic value on average. It has become technically a bad product and will need new injections of smart entrepreneurial capacity and money to bring it back. But as long as this latter recovery process has not taken place, most often than not, bailouts merely constitute throwing good money on bad product. What is usually omitted by analysts is the destructive consequence of volumes of new money created essentially to be poured out so generously on something of no value: dead bank. The implication is clear: inflationary balloons are created. The more the outpouring of such monies, the more the inflation which destroys tens of millions of more businesses than is usually imagined. Curiously too, these banks are shielded from the inflationary impact of the newly created or printed money as they receive it first and use them before they work their way through the macroeconomic system where through the expanded spending pressure cause more inflationary instability.

Another important factor is the impact that allowing dead banks to be alive will have on overall monetary policy effectiveness. One clear effect is the subtle diversion of the interest rate anchor from either the monetary policy rate or the rates that would naturally prevail in the interbank market if the banks placed on life-support were not allowed to participate to the benchmarking of the rates that the pressured/supported banks would be willing to pay. Naturally, banks or businesses facing potential risks of failure will be willing to do things out of the ordinary in order to survive. And so would these banks be willing to pay far more higher rates in order to attract some liquidity into their systems. The higher rate proposals in the interbank market become attractive albeit at a higher attendant risks thus causing the abandonment of the MPR effectively as an anchor. Thus more funds that ordinarily would have been available to entrepreneurs or even for base infrastructure provision are injected into these banks with little if any impact on macroeconomic productivity. Meanwhile manufacturers and other real sectors who cannot possibly bid for funds at the new rates determined by these risky-banks are left out without access to the badly needed funds for their activities. Thus it may not be surprising to hear the central bank announce interest rate reduction and yet actual rates will be speeding to the peak.

Furthermore, support for unhealthy banks particularly without attendant openness heightens the uncertainty which consequently affects savings-deposit mobilization. When it is not clear which banks are healthy or not, a simple expectation would be that those who keep their monies in the banks primarily for safe-keeping will be cautious. There are a range of cautious behavioural possibilities which may result from these and comprise, (a) spreading ones savings thinly across several banks based on the premise that all banks will not fail at the same time, (b) keeping ones savings outside the banking system entirely either by holding them as cash or buying up physical assets, (c) keeping ones savings in hard currencies or in banks abroad etc. Whichever method is adopted, one thing is clear and that is that the volume of long-term funds that the banks can potentially mobilize becomes impaired. This consequently feeds into the overall financial system capacity to finance long-term investments. Without the availability of long-term funds, the ease of business expansion becomes challenged.

Following our arguments so far, it is ironical to maintain that banks are too big or too economically strategic to fail when indeed their actions leads to the deaths of millions of other business in the country. All the consequences mentioned above have clearly adverse implications for the survival of many entrepreneurial endeavours, yet these problem-causing banks in total relative to the rest of these economic lives harmed do not constitute any significant number in true economic evaluation. And many still consider it fair to allow many businesses to die so that the banks can live.

Beyond these reasons, the most fundamental impact on the economy of giving banks the impression that they will not be allowed to fail even when they deserve to is that it excessively heightens the recklessness and abuses by these banks. These in turn fast-track their eventual woes as the case in recent times clearly show. But the central bank in its recent reform has been fair, clement and ingenuous in trying to arrest these situations with yet a window that allows the bank to exhale.

Martin Oluba is the President/CEO of ValueFronteira Limited.

martin@valuefronteira.com