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Nigeria

Catch 22: Navigating Basel Standards in Nigeria's Fragile Banking Sector

Florence Dafe

Introduction

If there is one word that has been used extensively since the mid-2000s to characterize Nigeria's banking sector, it is the term 'potential'. Financial industry experts, be they international consultants, financial journalists, or bankers, have hailed the size of Nigeria's banking sector, its international expansion, and the adoption of global standards like Basel II and IFRS. That said, there is broad agreement among both public authorities and financial industry experts that Nigeria's banking sector is far from realizing its potential. The banking sector has witnessed significant and extended periods of fragility since the 1990s; Nigeria's regulators have been slow to implement and enforce Basel standards and mock compliance has been an important feature of the engagement with Basel standards in Nigeria. What explains this gap between aspiration and reality on the ground, which is so characteristic of Nigeria's economy in general? This chapter explores why Nigeria's banking regulators, the Central Bank of Nigeria (CBN) and the National Deposit Insurance Corporation (NDIC), moved to adopt Basel I, II, and III but were slow to implement and enforce, and how this is related to the fragility in Nigeria's banking sector.

Two factors, namely conflicted preferences and the international-connectedness of regulators, help to explain Nigeria's engagement with Basel standards. The adoption and implementation of Basel II, which is the main focus of this chapter, has primarily been driven by regulators with strong links to international finance. The two CBN governors who most pushed for the adoption of Basel II—Joseph Odele Sanusi, who was in office from 1999 to 2004 and Sanusi Lamido Sanusi, who was in office from 2009 to 2014—had both had careers in the management of internationally active Nigerian banks before joining the CBN. For the former, Basel adoption was imperative for the international expansion of Nigerian banks. For the latter, Basel II was the best available practice to manage risks in the

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Nigerian banking sector. Senior staff in CBN and NDIC, who attended training courses on Basel standards run by international consultants and foreign regulators like the US, considered Basel II the most appropriate set of regulatory standards to make Nigeria's large, internationalized banking sector more stable.

While Basel II adoption was not a salient issue among Nigeria's domestically oriented politicians, Nigeria's internationally oriented banks welcomed the implementation of Basel II, which began in 2013. These international banks consider Basel II an important means to enhance their competitiveness and signal soundness to markets, regulators, and their peers in the international and domestic arena. In addition, the banks hope that a later move from standardized approaches to advanced internal rating-based components will allow them to reduce their capital charges.

Given the support for the adoption of Basel II among Nigerian regulators and bankers, why the slow movement towards implementation and weak enforcement? The evidence presented in this chapter suggests that this is because Nigerian regulators have conflicting preferences. On the one hand, Nigerian regulators promote Basel II because they consider it the best available set of rules for Nigeria's large and internationally expanding banking sector. On the other hand, regulators are reluctant to move faster on implementation and enforcement because if they do, several fragile banks would have to be restructured, if not resolved, and could therefore no longer play their envisaged role in supporting economic development by providing employment and access to finance for the private sector. Nigerian regulators are concerned about the developmental costs of bank resolutions because the CBN has a formal mandate to support the country's economic development. In addition, bank interventions are politically difficult because Nigerian politicians, often lobbied by the banks, tend to oppose them, supposedly to ensure the banks' contribution to economic development. Reluctant enforcement of prudential regulation perpetuates, however, the weakness of a banking sector that is already fragile because of its exposure to a volatile oil sector. All this is, in the words of a financial sector expert, a catch-22 situation.[1] As mock compliance is driven by the conflicted preferences of regulators, it is a case of regulator-driven mock compliance.

The chapter is based on official documents by Nigerian authorities and international financial institutions (IFIs), local press reports, and twenty-three semi-structured interviews. The interviews were conducted with regulators, bankers, financial industry experts from the private sector, academia, the donor community, and IFIs in Abuja, Lagos, and London.

[1] Interview, financial industry expert, Lagos, 22 September 2017.

Large, international, and fragile: banking in Nigeria since the 1990s

Three features of Nigeria's resplendent and complex political economy seem to bear particular importance for developments in Nigeria's banking sector. First, the size of the economy. In 2012 Nigeria overtook South Africa as Africa's largest economy, not least because of significant growth in telecommunications, banking, and construction sectors. However, in 2016 Nigeria's per capita income was merely about 2500 US$. Thus, it falls into the World Bank's category of lower-middle-income countries (Table 11.1).

Second, oil has been at the centre of economic accumulation in Nigeria since the 1970s. While in 2013 oil only made up 13 per cent of GDP, it accounted for over 95 per cent of exports and three quarters of government revenue (IMF, 2017a). Because of oil-induced boom and bust cycles, oil dependence has been a continuous source of economic volatility and vulnerability. Another consequence of oil abundance is the limited reliance on IFIs like the World Bank and international donors more generally. For instance, official development assistance averaged a mere 0.5 per cent of GNI between 2010 and 2015, and Nigeria has not borrowed from the International Monetary Fund (IMF) since the 1980s. As a result, donors and IFIs do not hold sway in Nigeria. A former official concludes, for instance, that 'Nigeria had very few IMF programs and even when there was one, there was only little influence'.[2] Another important consequence of oil dependence is the central role of the state in the economy. Owing to the public ownership of oil and gas reserves, the state has access to significant amounts of oil revenues. As a result, businesses seek to either do business with the state or to benefit from public financial assistance, for instance in the form of subsidized credit.

Table 11.1 Nigeria: key indicators

Nigeria	
GDP per capita (current US$, 2017)	1969
Bank assets (current US$)	81.7 bn
Bank assets (% of GDP)	20.2
Stock market capitalization (% of GDP)	8.8
Credit allocation to private sector (% of GDP)	15.7
Credit allocation to government (% of GDP)	5.8
Polity IV score (2017)	7

Note: All data is from 2016 unless otherwise indicated.

Source: FSI Database, IMF (2018); GDI Database, World Bank (2017a); Polity IV (2014)

[2] Interview, former IFI official, Lagos, 8 September 2017.

The third important feature of Nigeria's political economy is that the state has used its resources and central position to intervene significantly in the economy. Activist policies have been employed to support the development and diversification of the economy as well as to redistribute oil rents to certain constituencies to foster political support.

The above features of Nigeria's political economy—size, oil-, and state-centred economic development—are epitomized by Nigeria's banking sector. Nigeria has, at least in absolute terms, the second largest banking sector in Sub-Saharan Africa, just behind South Africa. Both assets and profits accounted for about a quarter of the region's total in 2014 (EY, 2015).

The banking sector, which in 2017 consisted of twenty-two commercial banks and five investment banks (referred to as merchant banks), has other notable features. One is domestic ownership. Only four commercial banks are foreign-owned. Their headquarters are in South Africa, Togo, the United Kingdom, and the United States, respectively. In 2011, 75 per cent of commercial banking assets were held by domestic, privately owned banks (IMF, 2013a).

This highlights another characteristic, namely private ownership. Domestic, privately owned banks emerged in large numbers in the wake of Nigeria's financial sector liberalization, which was an element of Nigeria's Structural Adjustment Programme (SAP) which lasted from 1986 until 1992. By the early 1990s, the number of banks amounted to more than a hundred because of profitable business opportunities arising from arbitrage opportunities in money markets and parallel foreign exchange markets as well as from fraudulent activities such as pyramid schemes.[3] The number of banks only shrank because of bank failures in the 1990s, and the CBN's decision to increase the minimum capital requirement twenty-five-fold in 2004 in an effort to create larger and well-capitalized banks. The 2004 reform reduced the number of banks from eighty-nine to about twenty-five banks, all of which were privately owned. While three banks came under state-ownership in the wake of Nigeria's systemic banking crisis in 2009 to 2011, these banks have since been resolved. Government-ownership does, however, prevail in Nigeria's seven specialized development banks. These banks provide subsidized credit for segments of the economy which are considered a priority for development, such as small and medium enterprises (SMEs).

Nigeria's banks also stand out in the region through their international orientation. As Figure 11.1 shows, about a dozen Nigerian banks have major operations in Sub-Saharan African countries, with Nigerian subsidiaries holding more than 20–30 per cent of deposits in Benin, Gambia, and Sierra Leone (IMF, 2017b). In addition, some of the leading banks have opened subsidiaries and representative offices outside Africa, notably in the US, UK, and Dubai.

[3] For an excellent analysis of how the process of financial liberalization rendered the Nigerian banking sector the locus of rent-seeking see Lewis and Stein (1997).

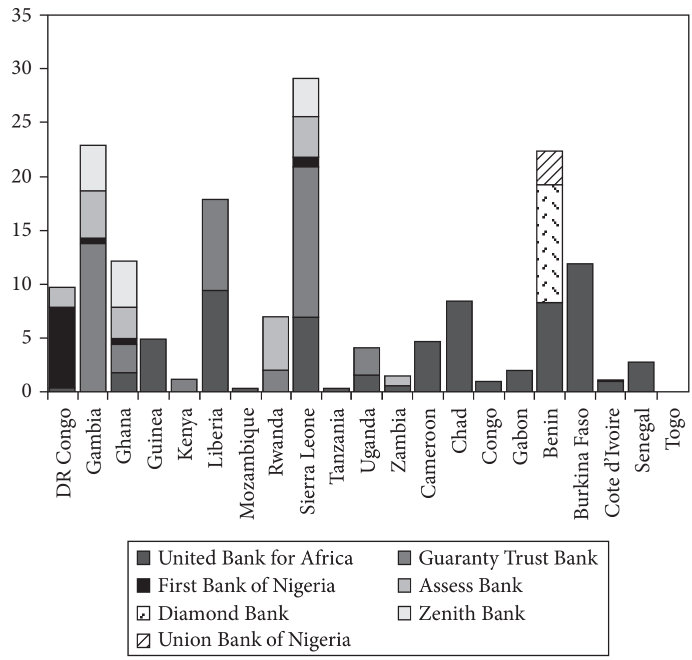

Figure 11.1 Nigeria: banks' share of deposits abroad, 2013 (%).
Source: IMF (2017a)

Where Nigeria's banking sector is lagging behind is the provision of access to finance to Nigeria's private sector. On average, bank credit to the private sector as a share of GDP amounted to about 14 per cent between 2011 and 2016, which is below the Sub-Saharan African average of 29 per cent (World Bank, 2017b) (see Figure 11.2). Lack of competition, as indicated by the fact that five banks held on average 60 per cent of banking assets between 2011 and 2015, might partly explain the limited lending. More important seems to be, however, that it is both profitable and safe to lend to the government.

Moreover, as Table 11.2 shows, a dominant share of bank credit is allocated to the oil sector, highlighting the dominance of oil in the economy. In sum, Nigeria's banking sector is suggestive of a negative relationship between oil abundance and development outcomes and thus of a resource curse in the financial sector.[4]

The centrality of oil has not only shaped lending patterns in Nigeria but also contributed considerably to the vulnerability and fragility of the banking sector. As in the case of Angola, oil dependence has been a source of financial distress. An important cause of Nigeria's systemic banking crisis of 2009 was that the banking sector had significant investments in the oil sector, which were negatively

[4] For empirical evidence on the resource curse in finance see Beck et al. (2011) and Bhattacharyya and Hodler (2014).

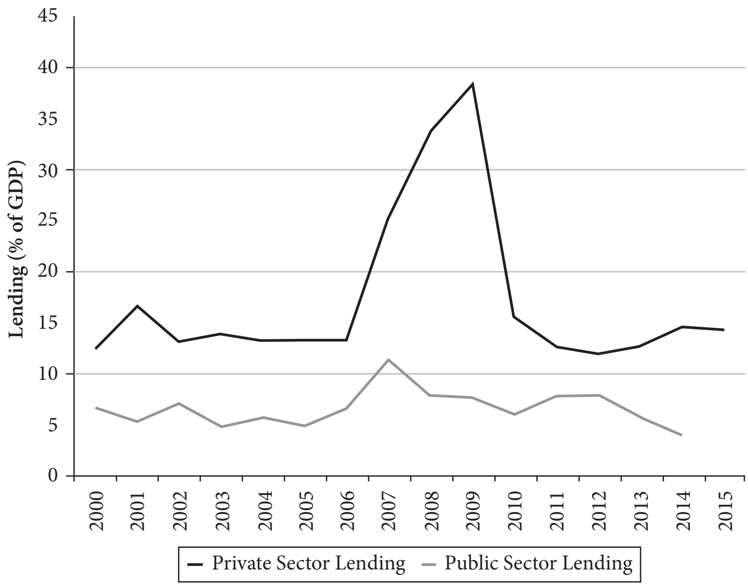

Figure 11.2 Nigeria: Public and private sector lending.
Source: World Bank (2017a)

Table 11.2 Nigeria: sectoral distribution of credit

Sector	June 2016		December 2016	
	₦[2] billion	Share of total (%)	₦[2] billion	Share of total (%)
Oil and gas	4511.34	28.78	4890.91	30.02
Manufacturing	2030.67	12.95	2214.98	13.59
Governments	1386.61	8.84	1376.89	8.45
General	1363.54	8.70	1324.10	8.13
General commerce	1071.57	6.83	1038.92	6.38
Information and communication	960.85	6.13	859.16	5.27
Real estate activities	737.96	4.71	820.32	5.03
Finance and insurance	692.94	4.42	737.65	4.53
Power and energy	685.23	4.37	726.29	4.46
Construction	609.68	3.89	633.62	3.89
Agriculture, forestry, and fishing	482.71	3.08	529.06	3.25
Transportation and storage	458.85	2.93	452.19	2.78

Source: Redrawn from CBN (2017a)

affected when oil prices declined in 2008. The decline in oil prices since 2014 has also been a major factor underlying the distress in the banking sector, which is evident in the increase in non-performing loans (NPLs) shown in Figure 11.3. In early 2017, there were officially three undercapitalized banks. These banks had a ratio of minimum capital to risk-weighted assets (CAR) below 8 per cent and accounted

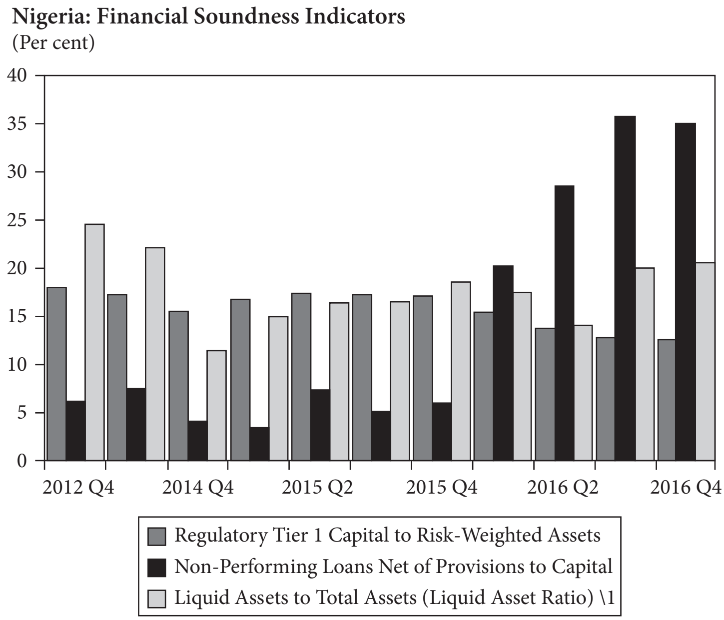

Figure 11.3 Nigeria: financial soundness indicators (%).
Source: IMF (2017b)

for 5 per cent of assets (IMF, 2017b). While on average CARs in the commercial banking sector amounted to 15 per cent in 2016, the same figure was about 3 per cent among small banks. In times of low oil prices, financial distress does not only arise because NPLs to the oil sector increase but also because government entities and businesses in other sectors find it difficult to service their loans because their revenues are highly dependent on a booming oil sector. That said, the banking sector distress in the 1990s and late 2000s was not only linked to oil price drops but also to mismanagement and fraud (Apati, 2012; Lewis and Stein, 1997).

The strong role of the state in the economy, facilitated by the state's command of oil revenues, is also visible in the financial sector. The state's developmental strategy, which envisages that banks support economic development and diversification, is best epitomized by the CBN. The CBN has a mandate not only for promoting price and financial stability but also for supporting economic development. From the perspective of the CBN, the role of the central bank in a developing economy must be different from and more activist than the role of a central bank in advanced economies.[5] An important part of the CBN's activities is therefore to support the activities of development finance institutions, through the provision of financial resources and administering some of the schemes for the provision of

[5] See for instance Sanusi (2010) or Emefiele (2014).

subsidized credit. The IMF and the World Bank have repeatedly criticized these activities but have had little influence on the CBN because the state is not dependent on their financial assistance.[6]

Basel standard adoption, implementation, and compliance in Nigeria

As Table 11.3 shows, Nigeria has been an early adopter of Basel standards. In 1990, amidst an environment of increasing banking sector distress, the CBN introduced a minimum CAR of 7.5 per cent. Two years later, the CBN brought the CAR more in line with Basel I and required banks to hold a minimum CAR of 8 per cent, with at least half of that being first-tier capital or paid-up share capital and reserves (World Bank, 1994). To position the Nigerian banks for the introduction of Basel II, the CBN increased the minimum CAR to 10 per cent in 2003 (CBN, 2003). This ratio is still in place and was even raised to 15 per cent for Nigerian banks with international authorization in response to Nigeria's banking crisis in 2009/10. While the current levels of minimum CARs exceed Basel standards, the definition of eligible elements for capital in Nigeria diverges from international rules. The Financial Sector Assessment Programme (FSAP) of the IMF and World Bank highlighted in 2012, for instance, that in Nigeria Tier 1 capital is defined to include

Table 11.3 Nigeria: adoption of Basel standards

Basel component	Adoption	Implementation
Basel I	CBN Circular 1990	Various CBN circulars, notably CBN Circular BSD/11/2003 1990 minimum CAR of 7.5% 1992 minimum CAR of 8% 2003 minimum CAR of 10%
Basel II	CBN banking supervision annual report 2000 CBN banking supervision annual report 2001 speech by CBN Governor Sanusi 2002	2013 CBN circular BSD/DIR/CIR/GEN/LAB/06053, in force since 2014 Credit risk: Standardized approach Market risk: Standardized approach Operational risk: Basic indicator approach advanced approaches—no rules issued
Basel III	2013 Framework for the regulation and supervision of domestic systemically important banks in Nigeria	2014 (BSD/DIR/CON/LAB/07/026) D-SIB minimum CAR of 15%

6 For such criticism see for instance IMF (2011) and IMF (2013a).

statutory reserves and reserves for SMEs even though they do not meet the requirement of being available immediately to absorb losses.

The extent to which Basel I was enforced in the 1990s and 2000s varied over time and is difficult to assess with precision. While the CBN had been reluctant to intervene in the banking sector and to let banks fail before 1990s, the government and regulators displayed less willingness to accommodate bank distress through liquidity injections from 1990 onwards and stepped up regulation (Brownbridge, 1998). For instance, between 1991 and 1996 alone, the CBN and NDIC took over the management and control of twenty-four distressed banks (NDIC, 2017). That said, a major criticism in the FSAPs of 2002 and 2012 was regulatory forbearance and the limited willingness of regulators to resolve distressed banks. The 2012 FSAP for instance concludes: 'Notwithstanding the important and substantial progress since 2009, the concern remains that, though the legal and regulatory framework relating to corrective, enforcement and sanctioning actions has improved substantially, the willingness to act may still be weak' (IMF, 2013b, p. 140).

There are some parallels between the process of Basel I adoption and enforcement and Basel II adoption and enforcement in Nigeria. The CBN's Governor Joseph Sanusi announced the adoption of Basel II already in the early 2000s. An important year was 2001, when the BCBS issued a proposal for the new accord and Nigerian regulators, following the discussions in Basel, responded by setting up a CBN-NDIC committee to prepare a roadmap for the implementation of Basel standards in Nigeria (CBN, 2002a). While Nigerian regulators broadly supported the implementation of Basel, they were also aware of the challenges to transplant the standard to Nigeria's environment. As a former CBN regulator who sat on the committee during its inception recalls: 'We pointed it out from day 1 [when the new accord was announced] that Basel should be adopted . . . We did not set out to reinvent the wheel . . . but you have to adapt it to the depth of the financial sector, the skillset of the regulator, the capacity, the public policy environment'.[7] In line with this, the 2001 annual report of the CBN's banking supervision department made clear that advanced approaches would not be considered initially (CBN, 2002a, p. 88).

It would, however, take another decade until Basel II implementation began. While work in the CBN-NDIC Basel II committee continued throughout the 2000s, the focus shifted under the next governor, Charles Soludo, towards the consolidation of the banking sector and dealing with its repercussions. Only in the wake of Nigeria's banking crisis, which began in 2009, did Basel II move again to the top of the regulatory agenda. Under CBN governor Sanusi Lamido Sanusi, Basel II implementation was formally announced in a circular in 2013. The new rules, which delineated the basic approaches for the calculation of credit, market, and operational risks in Pillar I, as well as guidelines for the implementation of

[7] Interview, former CBN official, Lagos, 20 September 2017.

Pillar II and III, came into effect in 2014. While the 2013 circular also announced the future implementation of Basel III, a draft regulation has not yet been issued. Yet the CBN did, in line with Basel III, specify some rules for domestic systemically important banks (D-SIBs), notably an increase of the minimum CAR to 15 per cent.

Despite the formal commitment to Basel II, its enforcement seems to be challenging. In 2016 and 2017, for instance, there were officially three undercapitalized banks and the CBN exercised regulatory forbearance (IMF, 2017a). Both regulators and industry experts think the number of undercapitalized banks is even higher.[8] In addition, the CBN is not enforcing the higher loss absorbency requirement it had set for the seven identified D-SIBs because some of them are struggling to meet more stringent regulatory requirements.[9] Mock compliance has thus become a feature of the regulatory process. What is more, while some banks seem to lack the capacity to provide adequate data to the supervisors, others seem to make every effort to hide their dismal state.

This is not to say that the CBN has not made significant efforts to address weaknesses in regulation and supervision over the past two decades. While Nigeria was judged to be compliant or largely compliant with fourteen out of twenty-five Basel Core Principles in the 2002 FSAP, it was judged compliant or largely compliant with eighteen out of twenty-five core principles in the 2012 FSAP. Moreover, some of the deficiencies highlighted in the 2012 FSAP such as weaknesses in the Framework for AML/CFT, the lack of a framework for consolidated supervision, and the lack of consideration of market risk have been addressed in recent years.[10] That said, the 2012 FSAP also highlighted deficiencies with respect to enforcement and the regulation of related party lending, large exposure rules, and the definition of Tier 1 and 2 capital. What emerges is thus a picture of early adoption of Basel standards but slow implementation and enforcement.

The political economy of Nigeria's engagement with Basel standards

This section deals with the five major phases of Nigeria's engagement with Basel standards. The international orientation of regulators and conflicted preferences are critical factors in explaining the gap between the declared commitment to Basel standards and the translation of these standards into concrete policies.

[8] Several interviews, regulators, and financial industry experts, Abuja and Lagos, September 2017. See also CBN (2017b).

[9] Several interviews and regulators, Abuja and Lagos, September 2017.

[10] Nigeria was blacklisted by the FATF in 2012 because of weaknesses in its AML/CFT framework. In 2013, however, Nigeria was removed from the list because Nigeria's Presidential Committee on the Financial Action Task Force managed to reform the framework quickly. The risk of losing correspondent banking relationships seems to have been an important reason for the quick action and high-level political commitment.

The explanation for Nigeria's path of early adoption and slow implementation and enforcement presented in this section centres on the tension between regulators' incentives to employ best-practice prudential regulation and to enhance the banking sector's contribution to economic development in the short term.

Basel I adoption in an inward-looking, fragile environment, 1990–2000

When the BIS issued Basel I in the late 1980s, Nigeria's banking sector was in a state of chaos. As a result of the financial liberalization and privatization process, a core element of Nigeria's SAP, the number of banks exploded, increasing from forty in 1985 to 107 in 1990 (World Bank, 1994). By 1990, the banking sector was very distressed because of a combination of banks' fraudulent activities, loose regulation, and weak supervisory capacity (Brownbridge, 1998).

When the CBN implemented a minimum CAR in 1990 it did so mainly with an eye to the domestic sphere. The aim was to stabilize the banking sector through a reform package which included a rise in minimum CARs besides other measures such as requiring banks to classify loans according to performance and higher requirements for minimum paid-up share. The policy preferences of regulators were shaped by domestic rather than international debates because the CBN's senior staff, including the governors, were only weakly embedded in international regulatory debates, as also Table 11.3 shows. While there was some exchange between Nigerian regulators and the staff of the IMF and the World Bank in the early 1990s, the role and influence of the IFIs were limited because they provided only little financing and technical assistance as part of Nigeria's SAP (Herbst and Soludo, 2001).[11] If anything, the domestic orientation of Nigerian technocrats increased during the 1990s as Sani Abacha's military regime became internationally increasingly isolated because of human rights abuses and the reversal of structural adjustment reforms.

Enforcing minimum CARs and other regulations proved difficult for three main reasons. One reason was political interference. Politicians limited the autonomy of regulators and protected banks from regulatory intervention because they played an important role in enhancing regime stability. Nigerian banks were largely owned by military officials or individuals that were connected to members of the military regimes of Ibrahim Babangida (1985 until 1993) and of Sani Abacha (1993 until 1998). Politicians benefited from cheap loans from these 'political' banks. Bank owners, in turn, were able to earn exorbitant rents from arbitrage opportunities in parallel foreign exchange markets and fraudulent activities like

[11] Nigeria embarked on the SAP mainly because international creditors had made an SAP a precondition for debt negotiations, and less to gain access to foreign aid.

Table 11.4 Nigeria: central bank governors, 1980s to the present

Name	Term in office	Embeddedness in international networks
Alhaji Abdulkadir Ahmed	1982–93	Limited; career in Nigerian civil service before becoming CBN governor
Paul Agbai Ogwuma	1993–9	Limited; career in Nigerian domestically oriented bank before becoming CBN governor
Joseph Odele Sanusi	1999–2004	High; CEO of internationally active bank before becoming CBN governor
Chukwuma Charles Soludo	2004–9	High; Visiting scholar in European and US universities and in the IMF as well as consultant for international organizations before becoming CBN governor
Sanusi Lamido Sanusi	2009–14	High; CEO of internationally active bank before becoming CBN governor
Godwin Emefiele	2014–present	High; CEO of internationally active bank before becoming CBN governor

money laundering, and in exchange supported the regime (Boone, 2005; Lewis and Stein, 1997).

A second reason for weak enforcement was that banks made every effort to evade and circumvent supervision (Lewis and Stein, 1997). Most banks were set up to exploit arbitrage opportunities in Nigeria's foreign exchange and money market and were thus firmly domestically oriented. Given the fragile states of their finances and banks' limited interest in attracting foreign investors or expanding internationally, the banks had limited incentives to support engagement with international standards.

A final and, for Nigeria's story, important factor is that regulators had conflicting preferences. On the one hand, they considered stricter regulations, including a high minimum CAR, important to enhance banking sector stability. On the other, regulators were keen to avoid a collapse of confidence in banks and hesitant to disclose the full extent of problems in the banking sector (Lewis and Stein, 1997). Regulatory interventions risked causing a breakdown of the system that the CBN sought to develop as part of its developmental mandate.

Looking outward: Basel II adoption, 2001–4

When Abacha died in 1998 and Olusegun Obasanjo won elections in 1999, the environment for the engagement with Basel standards changed markedly in Nigeria.

Like his predecessors, Obasanjo's government had a development strategy that emphasized state-led and oil-financed development and was thus broadly domestically oriented. However, Obasanjo also made significant efforts to reform economic governance. In particular, he reformed the public sector by replacing key personnel. In addition, Obasanjo was more internationally oriented than his predecessors, seeking to achieve Paris Club debt relief and to attract foreign investment by improving Nigeria's international reputation and the business environment (Apati, 2012; Reuters, 2000).

The reform orientation of Obasanjo's government shaped financial sector governance in two ways. First, regulators kept more abreast of international policy debates because Nigeria's efforts to secure debt relief required them to engage more with IFIs. Second, Olusegun Obasanjo replaced the leadership of the CBN and appointed, as Table 11.4 also shows, Joseph Oladele Sanusi, an internationally oriented career banker, as CBN governor. With a professional background in internationally active African banks, Sanusi was familiar with developments in financial regulation in the international sphere and convinced of the need to improve the capacity of regulators if they were to keep up with developments in domestic and international finance. In line with his professional background in banking, Sanusi placed a major emphasis on two processes. One was the professionalization of the CBN through trainings and hiring well-qualified staff. The second was the reform of the framework for banking regulation, a centrepiece of which was the adoption of Basel II.[12]

It is in this context that the CBN adopted Basel II in the early 2000s. For Sanusi, the adoption of Basel II was not only an attempt to enhance the stability of the domestic and international banking system but also a way to benchmark Nigeria's performance (CBN, 2002b). Moreover, in his view Basel II should 'be embraced if we are not to be excluded from the international financial system. Since our banks are competing in a global market, we cannot continue to operate on rules that fail to meet international standards' (CBN, 2002b, p. 4). CBN and NDIC staff on the operational level also supported the move towards Basel II but more because of domestic concerns. As a former CBN official recalls: 'We saw it [Basel II] as an opportunity to upscale our regulation … Basel is at the frontiers of knowledge; we wanted to take advantage of it'.[13] Thus, for Nigerian regulators, developments at the international level offered an opportunity to advance their domestic concerns, namely to stabilize a fragile banking sector.

Other actors did not oppose the adoption of Basel standards. The regulators had sensitivized the government and the adoption of Basel II was in line with the government's broader strategy of reintegrating into the international community following the relative isolation under Abacha's regime and of improving regulatory oversight over the banking sector (NNPC, 2004). In fact, in the early 2000s there emerged a consensus in the presidency that significant financial sector reforms would be needed because criminal investigations, in Nigeria and the

[12] Interview, former bank CEO, Lagos, 8 September 2017.
[13] Interview, former CBN official, Lagos, 20 September 2017.

United States, repeatedly showed the extent of malpractice, including money laundering and other financial crimes, in Nigerian banks (Apati, 2012). Bankers were only informed after the regulators had already decided to adopt Basel but were invited to consultations on the implementation of the framework. Largely excluded from the discussions were politicians outside the government and representatives from the IFIs. Politicians paid little attention to Basel II because it did not have enough political salience, especially compared to other regulatory issues such as the level of interest rates and bank closures. Nor did the IMF and World Bank shape discussions about the adoption of Basel II. While both institutions criticized weaknesses in Nigeria's system of banking regulation, notably the limited enforcement of existing rules, there is little evidence that the institutions pushed for or discouraged the adoption of Basel II or that regulators listened to their views on Basel II adoption.

Having been preoccupied with closing and resolving banks in the previous years, regulators' focus shifted in 2002 towards Basel implementation. Regulators were aware that implementation would take time. The 2001 annual report of the CBN's banking supervision department highlights a number of challenges that stood in the way of implementation such as the infancy of the credit rating agency sector, data availability, and supervisory capacity (CBN, 2002a). Another factor that turned out to be a crucial impediment in the following years was the lack of prioritization of implementing Basel II.

Standstill of Basel II implementation in the context of banking sector fragility, 2004–12

Even though financial reform and supporting the international expansion of Nigeria's banking sector remained at the top of the agenda of the CBN, efforts to implement Basel II slowed down when Obasanjo appointed Charles Soludo as CBN governor in 2004. The reason was not a lack of regulatory autonomy or interest in international debates. Soludo had been Obasanjo's chief economic advisor and enjoyed presidential backing for financial reform initiatives. Moreover, as Table 11.3 shows, Soludo was well integrated in international policy and academic circles because he had been a visiting scholar at the IMF and various universities in the UK and US and had worked as a consultant for donors like the World Bank. However, when Obasanjo was re-elected for a second term in 2003 his priority was to appoint a central bank governor who was focused on promoting economic growth, diversification, and development (Apati, 2012) and Soludo, who shared these developmental aspirations, oriented financial reform towards achieving these goals.

For Soludo, Nigeria's banking sector exposed major deficiencies, notably: a significant portion of weak banks with persistent illiquidity, poor asset quality, and unprofitable operations; a weak capital base; reliance on public sector deposits rather than making efforts to mobilize savings from the public; and the preference of lending to the government rather than to the productive sectors (Soludo, 2004). In his view, addressing these weaknesses required a major financial reform, the centrepiece of which was the consolidation of the banking sector through an increase of the minimum capital requirement for banks from about US$15 million to US$190 million. The rationale for the increase in capital requirements was that banks with a large capital base would be internationally competitive because of their size, be stronger because of the ability to absorb losses, and face greater incentives to lend to the real economy (Soludo, 2004). In other words, the reform sought to overcome the fragility and marginality of Nigeria's banking sector and to position Nigerian banks better for financial intermediation. Banks were given eighteen months to comply with the requirement, which was envisaged to be achieved through mergers and acquisitions by 2005.

It is difficult to say precisely why Soludo focused on the banking sector consolidation to address the fragility and marginality of the banking sector rather than on Basel II implementation. One factor seems to have been learning from emerging economies considered as peers. Soludo looked in particular to Malaysia and Indonesia, where regulators first sought to consolidate the banking sector before implementing Basel II.[14] In addition, the focus on consolidation was encouraged by advice from international management consultants, with whom the CBN works intensively. Another important factor seems to be that Soludo did not want to prioritize the goal of financial stability as would have been implied by a focus on Basel II implementation but sought to promote simultaneously financial and economic development. Large, well-capitalized banks would, in Soludo's opinion, meet the two goals of banking stability and creating a financial sector that served the real economy. A final factor is that neither the banking sector, which was still largely domestically oriented, nor politicians championed Basel II implementation.

Once the process of the banking consolidation began, there was little prospect for moving forward with the implementation of Basel II. At first, banks were preoccupied with meeting the significant increase in capital and the banking supervisors were preoccupied with overseeing the consolidation. When the consolidation was achieved and the number of banks declined from eighty-nine to twenty-five, supervisory capacity was still bound. One reason was that highly capitalized banks had expanded their operations significantly. Specifically, the consolidation had encouraged universal banking, retail lending, and expansion of banks in the African region, each of which demanded significant supervision. Second, even after the banking consolidation, many banks remained fragile, demanding the attention of the supervisors. While some banks had found it relatively easy to meet the new capital requirement, others had struggled and merged

[14] Interview, former IFI official, Lagos, 8 September 2017.

with other struggling banks. Moreover, many banks sought to meet the capital requirements through margin lending and engaged in insider-lending and other fraudulent activities to invest the large amount of capital they had. As stated above, the drop in the oil prices magnified the risks in Nigeria's large but fragile banking system and in 2009 bank examinations revealed that ten out of twenty-five banks, accounting for about a third of banking system assets, were either insolvent or undercapitalized.[15]

The CBN-NDIC committee on Basel II continued to exist in the years following the consolidation. However, all regulatory capacity was focused on overseeing the consolidation. Moreover, the committee lacked the support of the CBN's management to drive forward additional reforms since the primary concern of the management was to ensure that the consolidation was a success and to avoid measures that threatened it. Indeed, the evidence suggests that there was some regulatory forbearance with respect to Basel I and other prudential regulations in an effort to mask increasing banking sector fragility (Sanusi, 2010). It was not until Sanusi Lamido Sanusi, who became CBN governor in 2009, resolved the banking crisis that Basel II implementation in Nigeria moved forward.

Implementing Basel in the context of a stabilized banking sector, 2013–15

Two factors combined to support the implementation of Basel II and the introduction of a framework for D-SIBs from 2013 onwards. One factor was that the banking sector had gained some stability following Sanusi's resolution of the banking crisis through a combination of liquidity injections and regulatory reforms. Banking sector stability was a precondition for the implementation of Basel II because the CBN wanted to ensure that Basel II would not result in widespread intervention, loss of confidence, and a decline in credit to the private sector, which had just recovered from the crisis. Negative effects on credit were not only a general concern for the CBN, which sought to increase bank lending to the real economy, but also for politicians (Apati, 2012).[16]

The second important factor supporting the implementation of Basel II was the commitment of the CBN, notably of its new leadership, to implement international best practice. Sanusi's commitment to Basel II was rooted in his career in two large, internationally active Nigerian banks, first as risk manager and later in their top management. In fact, he had been nominated by President Umaru Musa Yar'Adua as CBN governor because of his insider knowledge of the banking sector which provided Sanusi with strong credentials to spearhead reforms to strengthen

[15] For an overview of the causes of the banking crisis see Sanusi (2010) and World Bank (2010).
[16] Interview, consultant, London, 3 October 2017.

banking sector stability. For Sanusi, Basel II was the best available standard for risk management since it required banks to understand and monitor different types of risks but had to be adapted to the Nigerian context.[17] This view was shaped not only through the debates prevailing in the banking community but also through his experience in guiding the transition of two Nigerian banks towards the voluntary operation of Basel II in the late 2000s. The post as governor provided Sanusi, who had taken pride in upgrading the banks 'to the highest standard', with the opportunity to implement this standard at the industry level.

The international orientation of CBN and NDIC staff at the operational level also helps to explain why regulators drove Basel II implementation. In particular, senior staff learned about Basel II through regular attendance at training in the US and continuous exchange with foreign advisors, some of which were funded by donors and IFIs. These regulators considered the need to focus on risk management as a major lesson of Nigeria's banking crisis of 2009 and Basel as the best practice.[18] In addition, CBN staff supported Basel II out of a logic of appropriateness. They considered Basel II the most appropriate framework for a country with a large and internationalized banking sector like Nigeria.[19] Moreover, Nigerian regulators pride themselves on adopting international best practices. As one regulator explains, Basel II 'allows us to benchmark us with other emerging economies. We do not compare ourselves to Sub-Saharan Africa except South Africa; rather we look to Malaysia, India and the Philippines'.[20]

While banks were not driving the Basel II implementation, it was probably of no small importance that they welcomed it. Large, internationally active Nigerian banks supported the move to Basel II and a handful of them had even begun to operate voluntarily according to Basel II in the late 2000s, when regulatory reporting still had to meet Basel I standards. Large banks' support was primarily based on the view that Basel II helped to signal investors, regulators, and their competitors that they were 'up to the highest standards' and financially sound. A reputation of soundness would, these banks believed, also enhance their competitiveness vis-à-vis other banks operating in African markets, for instance South African banks (Layegue, 2013).[21] Moreover, when Basel was implemented in 2013, large banks hoped that the CBN would soon move to more advanced models as these allowed, from their perspective, a more 'efficient'—that is, cost-effective—use of capital.[22] While smaller banks were more concerned about implementation costs, they also supported a gradual implementation of Basel II because they did not want to be seen as non-compliant. In addition, the simpler

[17] Interview, CBN official, Abuja, 11 September 2017.
[18] Interview, CBN official, Abuja, 18 September 2017.
[19] Interview, consultant, London, 3 October 2017.
[20] Interview, former CBN official, Lagos, 20 September 2017.
[21] Several interviews, bankers, Lagos, 9 and 21 September 2017.
[22] Interview, financial industry expert, Lagos, 8 September 2017.

financial market structure (for instance, the lack of derivatives and the lack of historical data) implied that the use of complex models would not be required initially, lowering the costs of adoption.

Gradual implementation and consideration of the domestic environment were also principles guiding the CBN's implementation of Basel II. The CBN, for instance, excluded development banks from the operation of Basel II. In addition, the CBN required the use of a risk weight of 100 per cent for all corporate credit given the limited reach of international and domestic credit rating agencies. The CBN has also used some national discretion in defining risk weights, for instance assigning a higher risk weighting to exposures to the oil sector in 2014. Most importantly, the CBN did not permit the use of advanced approaches, even though some banks lobbied to move towards them. The reason was that the CBN believed that both regulators and most of the banks lacked the capacity for these approaches.[23] In addition, the CBN had a deep distrust of the data provided by Nigerian banks. Moreover, by 2013 there were major debates in international policy circles about the misuse of advanced approaches, confirming the CBN's distrust of internal ratings-based approaches.

The consideration of the domestic environment does not mean that external actors did not shape the design of the Basel II guidelines. The CBN studied the approaches of countries considered as peers like Malaysia. International accounting firms and management consultants were hired to contribute to selected elements of Nigeria's Basel II framework or offered their services pro bono. In addition, donors and the IMF have provided technical assistance. The influence of IFIs on implementation was, however, limited. The FSAP of 2012 did criticize the absence of some elements of Basel II like the lack of a consideration of operational and market risk by Nigerian regulators. Yet as a senior IFI official points out, 'FSAPs are pushing on many things. Governments then choose to implement some and remain lagging on others; it is up to the authorities what to push and they tend to and implement what is least politically costly'.[24]

Tied hands: Basel standard engagement in times of crisis, 2015 to the present

The benign economic and political environment for the push for Basel standards came to an end in 2015. Banking supervisors remain committed to Basel II and the CBN's new governor, Godwin Emefiele, has been exposed to debates about global banking standards because he worked in the management of an internationally active bank before he succeeded Sanusi as CBN governor in 2014. However, in the

[23] Interview, regulator, Abuja, 18 September 2017.
[24] Interview, IFI official, Abuja, 13 September 2017.

second half of 2014, oil prices declined sharply and in 2016 Nigeria experienced a recession with growth collapsing to –1.5 per cent. One important consequence of the drop in oil revenues and thus of foreign exchange availability was that the newly elected government of Muhammadu Buhari exerted significant pressure on the CBN to focus on exchange rate management and financing government expenditure (CBN, 2017b). As a result, the autonomy of the CBN declined and domestic policy priorities have shaped central bank policy.

The decline in oil revenues has also increased banking sector fragility because of banks' exposure to the oil sector and the devaluation of the Naira. In 2017, four out of twenty-two commercial banks are officially undercapitalized, one of which is an internationally active bank (CBN, 2017b). Industry stakeholders consider the number of banks which fail to meet their minimum CARs even higher.[25] D-SIBs have also struggled to meet their higher CARs and HLA requirements. The real extent of banking sector fragility is, however, difficult to know since regulators face challenges in validating banks' data, partly because of stretched supervisory capacities, and partly because some banks conceal their true status.

The CBN has responded to the environment of banking sector fragility and limited autonomy as it did in earlier periods, namely by slowing down the implementation and enforcement of Basel standards. In particular, the CBN has been slow to publish documents that specify banks' requirements with regard to Pillar II and Basel III guidelines. Moreover, the CBN exercises regulatory forbearance with regard to the four undercapitalized banks and to a breach of single obligor limits. The banking sector, in turn, does not push for implementation and enforcement because it has been hit hard by the decline of the oil price and thus struggles to meet the costs of Basel II compliance, which became more evident over the course of implementation.

The reasons for slow implementation and regulatory forbearance are twofold. On the one hand, regulators are keen to avoid a collapse of confidence in the sector. On the other, there seems to be a concern that enforcing regulation and resolving banks will have adverse consequences on economic development through effects on employment and access to finance.[26] In 2015, for instance, the CBN revoked a rule specifying a risk weight of 125 per cent for loans to the oil and gas sector, which it had issued in 2014. The reason was that oil and gas is considered a development priority sector, not least because of its links with other sectors in the economy and the CBN wanted to avoid negative effects on lending to the oil sector. 'This', a regulator explained, 'is one example for the trade-offs between Basel II and economic development'.[27]

[25] Several interviews, former CBN official and bankers, Lagos, September 2017.
[26] Several interviews, regulators and financial industry experts, Lagos, September 2017.
[27] Interview, regulator, Abuja, 18 September 2017.

The CBN has taken significant steps to discipline banks in recent years.[28] However, the catch-22 situation remains where, on the one hand, the CBN seeks to promote Basel II because it is considered the best available set of rules to govern Nigeria's large, internationalized banking sector. On the other hand, regulators are reluctant to move faster on implementation and enforcement because this may require intervention in distressed banks which, they fear, has negative implications for economic development. Widespread bank intervention clashes with the developmental mandate of the CBN and mobilizes resistance by politicians, who are often lobbied by the banks themselves. Both banks and politicians argue that bank interventions must be avoided because of their effects on employment and access to finance.[29]

Conclusion

This chapter has addressed the puzzle of early adoption and slow implementation and enforcement of Basel standards in Nigeria. The case study has three main findings. First, Nigeria's story suggests that an internationalized banking sector provides strong incentives for the adoption of Basel II and III. Banking regulators drove the adoption of these standards because they believed this would enhance the competitiveness of Nigerian banks abroad and because they considered these standards to be more appropriate for a large, internationally oriented banking sector than Basel I. This belief stemmed from learning from the experiences of countries considered as peers and from the experiences the central bank governors Joseph Sanusi and Sanusi Sanusi had as CEOs of internationally active banks.

The IMF and the World Bank have had, despite the international orientation of regulators and in contrast to findings of other studies on Basel standard adoption in developing countries, little influence on regulatory preferences because oil revenues have limited the susceptibility of the Nigerian state to advice from the IFIs.[30] It was, however, important that regulators had political backing for the adoption of these standards because it seemed that there were no evident contradictions between their adoption and the larger developmental strategy. Banks, in turn, welcomed the fact that regulators drove Basel II adoption because they believed that embracing these standards would improve their international

[28] For instance, the CBN removed the management of a bank which breached regulatory thresholds in 2016.

[29] Both banks and politicians have made similar claims during previous episodes on banking sector fragility. Politicians, for instance, requested that Sanusi give greater consideration to the effects of his actions to resolve the banking crisis of 2009 on growth and employment (Apati, 2012). It is difficult to say whether the objections by politicians merely reflect concerns about economic development or whether such objections also serve to protect politically connected bankers.

[30] See for instance Wilf (2016) or the case studies of Kenya and WAEMU.

reputation and competitiveness. An important parallel to Pakistan's case is that a financial reform that resulted in the internationalization of the business model prevailing in the banking sector generated incentives to implement Basel standards.

The second major finding is that conflicting preferences may lead to mock compliance. Nigeria is, as one financial industry expert explains, 'a country of rules in books that are not really implemented'.[31] While Nigerian regulators have had strong incentives to engage with Basel II and III because of their international orientation, they have had equally strong incentives for slow implementation and enforcement in a context of oil-induced banking sector fragility because bank interventions involve high developmental and thus political costs. Conflicting preferences also help to explain weak enforcement of Basel I, notably in the run-up to Nigeria's banking crisis which began in 2009. This is an important parallel to Angola's case where mock compliance also results from a clash between domestic political realities and imperatives to adopt international standards arising from an internationally oriented banking sector. With reference to our analytical framework, as mock compliance is driven by the conflicted preferences of regulators, this is a case of regulator-driven mock compliance.

The final, broader point is that Basel standards are not neutral from a developmental perspective. Enforcing these standards may, at least in the short term, involve costs, by affecting lending to development priority sectors and requiring bank interventions, which has effects on employment and access to finance. Considerable work lies ahead not only in examining the developmental consequences for Basel II and III implementation and enforcement but also in determining what strategies could be adopted to reduce the developmental costs of Basel standard adoption in the context of fragile, extraverted financial systems.

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