

# **The Impact of Global Financial Crisis on Banking Sector in Nigeria**

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## **Abstract**

The global financial crisis, which was caused by the collapse of the economic ideology of free market forces, has the potential to escalate into unmanageable proportions for the Nigeria Financial System dominated by banking sector. The risk of global economic crises has heightened; global aggregate demand has fallen while commodity prices collapsed. Because the global economy is inter-related, the Nigeria banking system is vulnerable. If the situation is not tamed, it would snowball into worse scenario for the Nigeria banking system and the entire economy. This study examined the impact of global financial crises on the Nigeria banking system. The study revealed that the financial crisis has caused depression of the Nigerian capital market and drop in the quality of part of the credit extended by banks for trading in the capital market, exchange rate risk tightening of liquidity, greater loan-loss provisioning, slower growth rate of banks' balance sheet in response to the crisis and higher provisioning leading to lower profitability among others. It was recommended that the federal government should implement the 7-point agenda, put up proactive measures to conserve the foreign reserves and timely injection of liquidity into the banking system.

**Key words:** Financial crisis, capital outflows, recession, high liquidity, sub-prime mortgage

## **1. Introduction**

The global financial crisis started in the United State of America in August 2007 with sub-prime mortgage crisis as households faced difficulties in making higher payments on mortgages (Soludo, 2009). This was followed quickly by announcements of trouble among several big names in banking and investment in US by the first quarter of 2008, there was widespread credit “contraction”, as financial institution in the US tightened their credit standards in high of defer rating balance sheets. At the fourth quarter of 2008, increased delinquency rates affected not only sub-prime loans but also spill over into customer and other credits. The crisis although started as a result of events in the US housing market, has spread to all regions of the world with dire consequences for global trade, investment and growth. The financial crisis has important implications for banks, companies, investors and government. Around the world, stock markets have fallen, large financial institutions have collapsed or been bought out, and government in even the wealthiest nation have had to come up with rescue packages to bail out their financial system (Adamu, 2009).

The global financial crisis has presented significant challenges for African Countries. It has also exposed weaknesses in the functioning of the global economy. The effects of the crisis become evident in Africa because it happened when the region is making progress in economic performance and management. In Nigeria, the financial systems as well as, the stock market have been affected by the global crisis, particularly banks with off-shore credit lines. The impact of financial sector on real sector activity has become increasingly evident, propagating beyond the wide spread belief that Nigeria would not be affected by the crisis. The situation if not tamed could snowball into worse scenario economy.

## **2. Prior research on causes of global financial crises**

The current global financial crisis has some important common elements with the previous financial crisis in Asia, Mexico and Russia in terms of causes and consequences. Brief expositions of these crises are presented. The Mexican Peso crisis broke out on December, 1994 when the Mexican government suddenly announced that the Peso was devalued by 15% (Han, Lee and Suk, 2003). The Peso continued to fall as currency traders and investors panicked and sold their peso holdings. At the same tune, there was rapid capital outflow and the Mexican stock market (Mexican IPC) fell by 47.94% in one month. The “tequila effect” spread to neighbouring countries, especially Brazil (Sharma, 2001). Hence the main symptoms of the Mexican crisis were threefold: exchange rate depreciation fall in stock prices and have capital outflows. The 1997 East Asian Financial crisis has been attributed to different factors by different researchers; however, there is consensus that the main causes included large external deficits, property market bubbles and stock market bubbles. The main symptoms were the collapse of the exchange rate and stock prices (Grouzille and Lepetit, 2008) Also, the crisis is attributed to the presence of internal weaknesses in the financial sector, such as traditional banking practices and inadequate bank regulation.

Inadequate bank regulation and supervision was rampant to the extent that “new banks and finance companies were allowed to operate without supervision or adequate capitalization” In addition, the crisis is attributed to excessive foreign borrowing mainly by the private sector; “firms borrowed heavily to fund plant expansion and acquired unsustainable debt/equity ratios” (Jackson, 1999). The symptom of the crisis is that countries in the regions, were not directly vulnerable to contagion effects. According to Jackson (1999) cited in Murinde (2009), “Countries such as Singapore and Hong Kong escaped the spread of the crisis in the region because they had stronger financial system, including adequate bank regulation”. The 1998 Russian Financial crisis broke out in August 1998, approximately one year after the break out of Asian Financial Crisis. Russians’ foreign currency reserves fell sharply, the Rouble rapidly depreciated and huge capital outflows followed. The stock market index fell quickly. The Rouble depreciated further by 34% at the end of December 1998, amidst speculative panics that marked the outbreak of the Russian financial crises to

economic fundamentals, such as erosion of federal government revenues and collapse of financial discipline, which forced the government to borrow heavily by issuing bonds. Hence, the current global financial crisis has some important common elements with the previous crisis. First, these crises, especially the 1997 Asian Financial crisis and the current global financial crisis, can be attributed not simply to monetary issues or sub-prime mortgage problems, or any other form of credit crunch, but mainly to the spread of contagion effects due to financial globalization. Second, when the crisis occurred, key financial indicators, such as exchange rates, stock prices, short-term interest rates, asset prices, number of business bankruptcies and collapse of several financial institutions, produced very rapid deprivation in the host countries. However, the crises differ in terms of how quickly and to what extent the nucleus of the crisis has spread to the rest of the world. Third, the Asian financial crisis, Mexican Peso crisis and the Russian financial crisis, which occurred in the emerging economies, were characterised by uncertainty in capital flows.

The main reason is “in an emerging market financial crisis, an economy that has been the recipient of large-scale capital inflows stops receiving such inflows and instead faces sudden demands for the repayment of outstanding loans. This abrupt reversal of flows leads to financial embarrassment, as loans fall into default or at least are pushed to the brink of default (Radelet et al, 1998). Taking the views of the various authors into consideration, the current financial crisis is caused by the following: Goodhart (2008) categorizes the reason of the crisis as mix-pricing of risk, new financial structure, poor credit rating agencies and insufficient liquidity.

Similarly, Mizen (2008) acknowledges the period to exceptional macro stability, the global savings glut, and financial innovation in mortgage-backed securities. Raynes and Zwag (2009) cited in Murinde (2009) suggest that the proper valuation of those securities are seen as being crucial to resolving the financial crisis. Avgouleas (2008) cited in Adamu (2009) enumerated the causes of the crisis as: breakdown in underwriting standards for subprime mortgages: assessments of subprime Residential Mortgage back Securities (RMBS) and other complex structured credit products especially collateralized debt obligations (CDOs) and other Asset-Backed Securities (ABS): risk management weaknesses at same large US and European Financial Institutions; and regulatory policies, including capital and disclosure requirements that failed to mitigate risk management weaknesses. In his comments, Soludo (2009) summarizes the causes as follows, financial innovations (leverage, swaps, sub-prime lending etc); Loose regulatory regimes and product; uncoordinated and late interventions by Government and central bank; Easy monetary policy in the aftermath of 9/11 to avoid a recession; High liquidity; investor/lenders seek higher return through riskier investment.

### **3. Implication of the Global Financial Crisis on the Global Economy**

The current global financial crisis has important implications for banks; companies, investors and governments. The main implication for banks is the centrality of the financial intermediation role, such that there must be a stable source of funding for all types of banks, including commercial banks and investment banks. Hence, it is very important for banks to maintain capital ratios to avoid liquidity and solvency risks. For example, if commercial banks ignore the basic principal of deposits ratio and over-relying on the money market financing, once market confidence is lost, the liquidity crisis of banks may soon appear. The UK Bank Northern Rock is a typical case. The main business of Northern Rock is to provide residents with British mortgage buyers. However, unlike most commercial banks, Northern Rocks’ financial primarily relied on borrowing from money market with inter bank rate and selling its mortgage securities.

When the sub prime mortgage crisis broke out in 2007, the loss of market confidence made liquidity extremely difficult. Consequently, Northern Rock could not finance its business, and it ultimately ended up with United Kingdom Government nationalization. The main implication of the crisis for companies relates to executive compensation and corporate government: also sometimes

called “the fat cat problem” . The point is that companies must beware of high incentives used in management which led to uncontrollable risks. Research shows that in 2007 the United States executive’s salary level was 275 times that of ordinary employees. The ratio was only 35 to 1 about 30 years ago (Bloomberg, 2008). Incentives of executives of financial Institutions are often linked to short-term securities trading performance. Driven by attractive salary, the wall street “elite” in the pursuit of huge short-term returns, one after another test the water “toxic securities” from engaging in financial innovation and financial risk. High incentives which have been out of control are seen as the initiator and one of the chief culprits for this financial crisis. To this end, the U.S. government rescue plan has included some constraints on incentives and the tax deductibility of their income of executive in order to enhance market confidence and restore stability in the market order. Therefore, it is learnt that companies in any industry should have a reasonable margin of incentives, which must not breach the industry standard and appropriate balance of the principles of social equity. For investors, the main implications of the crisis are at least threefold.

The MSCI world index has plunged by more than 45% from its high (1682.35 as of October 31, 2007). More severely, many investors have lost nearly everything in this financial tsunami. Hence, the first lesson investors should bear is that high returns always involve high risk; however, high risk does not necessarily guarantee high returns at least not constantly. More importantly, investors should be aware of the extra risk they are taking at all time. Secondly, investors should correctly understand and avoid high levels of gearing, especially during such a volatile market condition. Gearing is absolutely a double-edged sword. No doubt, it can magnify investors potential gains, but it also and more often results imposition closures at a direction. The third lesson investor need to remember is the importance of diversification and government bonds in their portfolio management. Investor may head the old aphorism “Don’t put all your eggs in one basket” by forming a portfolio with diversified stocks. However, they have ignored the importance of ‘asset classes’ meaning that diversification is only impactful with actively ‘asset classed’ portfolio. Governments, in particular, have important lesson to learn from the current financial crisis.

First, all government must be aware of the extensive risks associated with rapid financial innovations, including the likelihood of causing financial bubbles. The ongoing financial crisis has been triggered and spread by the U.S. sub-prime mortgage losses due to improper uses of financial derivatives, such as securitisation of U.S. mortgage agencies (Fannie Mac and Freddie Mac) into mortgaged backed securities for sale in the market. Then, investment banks used their financial engineering technology to repackage and trade the securities. Second, governments should beware of the excessive uncertainties and risks resulted from over speculation. Looking back the history of financial crises, no matter big and small, almost all of them are connected and caused by the excessive speculation ignorance of risk control. Moreover, modern investment banking business is heavily engaged in financial derivatives, which have leverage effects, such that investors can easily enlarge profits (as well as risks) by bearing a small amount of trading margin. High leveraging ratio has made investment banks highly dependent on financing investments during the credit crunch, investment banks’ balance sheet deteriorated dramatically, rating agencies S&P and Moody’s therefore lowered their ratings so that the financing cost increased significantly.

#### **4. Africa and Global Financial Crisis**

The impacts of global financial crisis on Africa are both direct and indirect. The direct effect was felt mostly through the financial sector. For example, stock market volatility has increased since the outset of the crisis and wealth losses took place in major stock exchanges. In Egypt and Nigeria, the stock market indices declined by about 57 percent between March 2008 and March 2009. Kenya, Mauritius, Zambia and Bostwana also recorded significant losses. However, African financial system has not been strongly affected by the global crisis because most African banks do not have any significant exposure to the sub-prime mortgage market and asset backed securities. They are,

however, vulnerable to exposure effects arising from the high rate of foreign ownership of banks in several countries in the region. The countries that are highly susceptible to contagion from this source include Botswana, Cape Verde, Central Africa Republic, Chad, Cote d' Ivoire, Equatorial Guinea, Lesotho and Zambia. In these countries foreign ownership of banks is high. The global financial crisis also noticed in the Africa foreign exchange markets. There was large depreciation of currency against the dollar. Several of these countries have high foreign debt such that the expected depreciation had imposed serious debt service burdens on the region.

Furthermore, since several countries in Africa are net importers of food, the depreciation of the currencies is expected to increase domestic price of consumer goods and reduce access to food by vulnerable groups. Similarly, the financial crisis has increased the risk premium that African Countries had to pay in international capital markets. For example, Kenya, Nigeria, Tanzania and Uganda have cancelled plans; raise funds in international capital markets owing to difficulty involved. The drying up of this source of external finance posed serious setback for development in Africa because the raised interest would have been used for financing infrastructure developments, and boost growth. Generally, the global financial crisis had negative impact on trade for Africa Countries through decline in volume of exports, commodity prices and ultimately, decrease in export revenues. Also, the crisis has caused decline in private capital flows and worker remittances.

## **5. Impact on the Nigeria Banking System**

In a globalised world, transactions are carried out in different countries in integrated markets. The world has over the past two decades headed towards liberalisation and deregulation, with the goal of integrating world markets. Nigerian markets, although not well integrated into the world market, have been facing serious destabilising effects since the emergence of the global financial crisis in July 2008. The capital market has been shrinking: major international hedge funds have been withdrawn; and the international credit line has faded out of loadable funds for domestic industry. Soludo (2009) summarised the impact as follows:

- Tightening of liquidity due to net forex outflows and lower monetization of oil earnings
- Further tightening of liquidity as lines of foreign credits enjoyed by Nigerian banks were called in.
- Depression of the capital market and drop in the quality of part of the credit extended by banks for trading in the capital market (liquidity pressures as loans not fully serviced or repair)
- Greater loan-loss provisioning both due to capital market pressures and decline in growth of economic activities.
- Potential exchange rate risks on foreign lines due to depreciation of the exchange rate
- Liquidity pressures push up domestic interest rates which if not addressed could pose systemic threat
- Global credit crunch and re-pricing of risks push up interest rates on lines of banks' balance sheet in response to the crisis and higher provisioning, leading to lower profitability.

## **6. Policy Measures**

In the wake of the global financial crisis, the central bank of Nigeria (CBN) has taken some of the following measures to forestall the spill over of the crisis into the Nigeria economy.

**Liquidity** :- In order to lubricate the system, CBN has taken proactive steps to infuse more liquidity into the financial market. In September 2008, CBN reduced the monetary policy rate from 10.25% to 9.27%; cut down the liquidity ratio from 40 percent to 30 percent and then released another N1.2 trillion into the economy by reducing the cash reserve requirement from 4 percent to 2 percent.

These measures are aimed at strengthening the country's financial system against the brewing financial crisis.

**Foreign Reserve:-** The fundamentals of the Nigerian economy are strong. This is evidenced by the fact that as of October 1, 2008, the quantum of Nigeria's foreign reserve stood at about 63 billion, while the foreign direct investments (FDI) remained strong at 8.5 billion. These statistics prove that Nigerians' vulnerability to the credit induced crisis through currency depreciation is reduced.

**Banking system:-** The banking consolidation exercise undertaken in the *banking sector in 2006 has proved to be a buffer against the crisis. As it has* resulted in stronger Nigeria banks which are better able to withstand the financial crisis. In Addition, a few months ago CBN suspended the common accounting year-end policy for banks and also rescheduled existing bank facilities granted for the purpose of buying shares into longer term tenure thereby reducing the vulnerability of the Nigeria banks to a credit induced crisis.

**Fiscal Measures:-** The federal Government has also put in place mechanisms aimed at insulating the economy from the crisis.

- Under the 2009 Budget, the bench mark for crude oil was drastically reduced from an earlier proposed 62.5 to 45 dollar per barrel. This was done to reflect the global economy realities.
- The monetary policy committee (MPC) has also directed that CBN could hence forth buy and sell securities through the two-way quotes to further stabilise the Nigerian foreign exchange market
- Currently the federal Governments' economic team in an interaction with the senate has proposed another round of recapitalisation to make the banking sector ever stronger
- Encouragement of inter-bank lending within the financial sector.

## 7. Conclusion

The global financial crisis has threatened the economic and financial development of the world economy and trade. Although many causes are implicated, one generally accepted fact is that the global crisis has arisen as a result of the collapse of the economic ideology of free market forces. The economic meltdown has shown conclusively that the economy and its regulation cannot be left to the whims and caprices of free market forces and that government does have a strong and leading role to play not owing to the regulation of business and the economy but that it must also be a key player in the ownership and management of business and non-business institutions for the regulatory role to make the desired impact.

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