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The Last Lender: Concepts and Impact on the Nigerian Economy

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Abstract

The recent sub-prime financial crisis raises serious questions about the role of a Lender of Last Resort. Drawing extensively from literature on monetary history, this paper provides historical and current insight to its importance. It identifies its use and relevance as an instrument of monetary policy by Central Banks the world over, in containing the global meltdown; and by the CBN in containing the near collapse of several banks within the Nigerian financial Sector. Given the shallow depth of our financial markets, infrastructural decay, proclivity to fraud, uninformed financial experts, it recommends that the regulatory authorities should intensify their activities to curtail the negative practices within the financial sector; the speedy commencement of operations and implementation of policies designed by Asset Management Corporation of Nigeria (AMCON) to guarantee a lot of stability in the nation's financial sector.

Keywords:
Subprime Financial Crisis,
Lender of Last Resort,
Central Bank of Nigeria,
Asset Management Corporation of Nigeria,
Financial Sector

Background to the Study

Recent developments in the global financial market have prompted renewed interest in banking regulation and supervision. More critical to the ongoing debate on banking regulation is the use of public funds to provide financial safety net for banks. Traditionally, bank supervisors (Central Banks), have used Lender – of – Last – Resort (LOLR) among other tools to provide emergency liquidity support to banks having liquidity challenges. Lender of last resort (LOLR) is a concept used to describe an emergency liquidity support that a central bank provides to an individual bank facing liquidity crises and has not succeeded in obtaining a "liquidity bailout" from all possible sources. As the name implies, if the central bank also refuse to provide such emergency liquidity support, the bank in question is bound to fail. Technically, LOLR is defined as; the discretionary provision of liquidity to a financial institution (or to the market as a whole) by the central bank in reaction to an adverse shock, which causes an abnormal increase in demand for liquidity that cannot be met from an alternative source. (Muktar, 2010).

The US borne subprime mortgage crisis (the term subprime refers to the credit quality of particular borrowers, who have weakened credit histories and a greater risk of loan default than prime borrowers: Bernanke, 2001), raises serious questions about the role of a lender of last resort and the appropriate role of monetary policy. Academics, policymakers and the financial press have debated the extent to which central banks should intervene in the market place, provide liquidity, and even purchase the non-performing assets of troubled financial institutions. Although economists and the media may debate the extent to which the lender of last resort function should be intensified in wake of the current financial meltdown, proponents and opponents of monetary policy generally agree that it is very difficult to identify the effect of the lender of last resort on financial markets. (Hughson & Weidenmeir, 2008).

Due to fractional reserve banking, in aggregate, all lenders and borrowers are insolvent. A lender of last resort serves as a stopgap to protect depositors, prevent widespread panic withdrawal, and otherwise avoid disruption in productive credit to the entire economy caused by the collapse of one or a handful of institutions. Borrowing from the lender of last resort by commercial banks is usually not done except in times of crisis. This is because borrowing from a lender of last resort indicates that the institution in question has taken on too much risk, or that the institution is experiencing financial difficulties (www.answers.com, 2010).For more than a century and half, central banks have been trying to avoid great depressions by acting as lenders of last resort in times of financial crisis. At first, this act provides liquidity at a penalty rate. Subsequently through open market operations, it lowers interest rates on safe assets. And finally, this process involves direct market support. Loans may be granted not only to commercial banks but also to any other eligible financial institution, even private companies, which are considered highly risky. Different institutions may act as a lender of last resort in different countries. For instance in Nigeria, the CBN serves as the lender of last resort. Its main purpose is to provide credit to financial institutions that are short of reserves,

prevent their bankruptcy and avoid negative impact on the economy. As a lender of last resort, the CBN encourages commercial banks to borrow funds from the "discount window". The banks may use these loans either to meet reserve requirements or to pay for large withdrawals. In the USA, the Federal Reserve serves as the lender of last resort. In the United Kingdom, it's the bank of England; in the Euro zone it's the European central bank. On a global level, the International Monetary Fund serves as an international lender of last resort. A non-central bank also may act as a lender of last resort. JP Morgan Chase and HSBC Holdings plc, the world's largest banking group, illustrates this case. History shows that even a physical person can assume the role of a lender of last resort. John Pierpont Morgan, an American financier and banker, has acted as a lender in the beginning of the 20th century, during the panic of 1907. (www.google.com.2010).

Objective of the Study

In view of the dissent raised by some section of the society on the policy and moral implications of the Lender of Last resort functions embarked upon by the CBN (during the sub-prime financial crisis), in curtailing the systemic failure of several banks within the financial sector, this paper intends to highlight the historical policy antecedents underlying the theoretical concept and rationale for the LOLR, as a monetary instrument and its effectiveness as a mechanism for financial crisis management in Nigeria.

Literature Review

Averting banking panics and crises is the job of the central bank. As a lender of last resort, it has the responsibility of preventing panic –induced collapses of the money stock. Traditionally, it has discharged this responsibility by making emergency loans of high-powered money to sound but temporarily illiquid banks at penalty rates on good collateral. Ideally the mere announcement of its commitment, by assuaging people's fears of inability to obtain cash, would be sufficient to still panics without the need for making loans. Banking scholars agree that the Bank of England since the 19th century was the lender of last resort par excellence. More than any central bank before or since, it adhered to the strict classical or Thornton-Bagehot principles of the LOLR concept. Those principles stressed:(1)protecting the aggregate money stock not, individual institutions,(2)letting insolvent institutions fail,(3)accommodating sound institutions only,(4)charging penalty charges,(5)requiring good collateral, and(6)pre announcing these conditions well in advance so that the market would know exactly what to expect. These principles have served the Bank of England so well; in fact, that the U.K. suffered no banking crises after 1866.Even today the Thornton-Bagehot Principles of the LOLR concept provides a useful benchmark or standard for central bank policy (Humphrey, 1989).

Henry Thornton in his classic: An Enquiry Into the Nature and Effects of the Paper credit of Great Britain (1802), identified three distinguishing features of the Lender Of Last Resort:(1)it must be the ultimate source of liquidity for the financial system. The LOLR must maintain and create a strategic stock of high-powered money that could be used to

satisfy demands for liquidity at critical times, (2) the LOLR must have special responsibilities as custodian of the country's external/foreign reserves. It must hold sufficient reserves to inspire full confidence in their ready availability in times of stress(internal & external).Also it must rely on its own resources to protect the reserves from depletion either due to internal or external shocks, and (3) the LOLR must have public responsibilities. Unlike an ordinary commercial banker whose responsibilities extend only to his stockholders, a LOLR's responsibilities extend to the entire economy. It includes preserving the aggregate quantity and hence purchasing power of the circulating medium during bank runs and panics and assisting the entire financial system in times of crisis. Thornton further postulated on the policy issues likely to confront the LOLR, proffering remedies and possible courses of action:

Monetary Control and the LOLR: this concerns a possible conflict between the central bank's responsibilities as a controller of the paper component of the monetary stock and its function as lender of last resort. The central bank must exercise a moderate and continued restraint on the rate of expansion of its own note issue, so as to protect its reserves from displacement by excess paper so as to maintain convertibility of its currency under fixed exchange rates or to prevent domestic inflation under floating exchange rate. But, coping with unusual liquidity strains or panics by exercising the LOLR function calls for abandonment of this restraint and relinquishing control over the growth of the money supply. Hence, an apparent conflict between the two objectives. Thornton, however, saw no inconsistency between a policy of stable monetary growth and the actions required to deal with liquidity crises. He distinguishes between the long-run target growth path of paper money and temporary emergency deviations from the path. The main responsibility of the central bank was to regulate paper money so that it expands at a steady non-inflationary rate roughly comparable to the long term growth rate of output. The bank must also control those factors/policies that periodically threatened to deplete its external reserves.

External factors leading to a temporary adverse balance of payments position can be met by drawing down on the stock of external reserves held precisely for that purpose. But a persistently adverse balance of payments position, capable of draining the country's reserves may require an expansionary policy. Such outflow would neutralize the depletion, prevent needless monetary contraction and the resulting disruption of the export industries, and thereby contribute to the correction of the trade deficit and a speedy build up of reserves.

By contrast, persistent external drains arising from inflationary over issue of paper calls for restrictive policy. Either by reducing inflated prices of home goods relative to foreign goods, or by creating an excess demand for money(selling treasury bills),which domestic residents attempt to satisfy by selling more goods and buying less. Such restrictive policy spurs exports and halts the depletion of external reserves. He saw monetary contraction as the correct remedy for persistent external drains.

Internal factors such as a panic would lead the bank to temporarily expand sharply both its note issue and loans to satisfy the public's demand for high powered money. This means that the bank must step off its path of stable note growth to prevent the money stock from shrinking. Indeed, the emergency expansion of bank notes is required to keep the total money stock on path in the face of panic induced demand for paper money. If the LOLR responds promptly and vigorously to the threat of a liquidity crisis, the panic will be quickly averted. Indeed, the mere expectation of such a response may be sufficient to stop the panic before additional notes are issued. Thus, the deviation of the paper component of the money base from its long-run target path will be small, both in magnitude and duration.

Macro vs. Micro Responsibilities: this concerns the extent of the LOLR's responsibility to individual banks as opposed to the banking system as a whole. Suppose these individual banks are unsound, must the LOLR act to prevent their failure? Are bailout operations necessary to preserve the stability of the payments mechanism? Thornton answered in the negative. He raised four cardinal points on the issue :(1) the LOLR's primary responsibility is to the market (the general interest) and not to the individual bank. It has no duty to sustain particular institutions. (2) It must recognize that when it makes liberal accommodation available it may create incentives that encourage laxity and recklessness in the lending practice of individual banks (i.e. moral hazard).Individual imprudence should be punished by losses. Only if the financial repercussions of such punishment threaten to become widespread should the lender of last resort intervene. (3) This aid (loans), should be extended sparingly and on relatively unfavorable terms, and (4) economic welfare is not always harmed when a bank fails. Public interest maybe better served by the demise of inefficient banks (no matter how large), because the resulting improvements in resource allocation may well outweigh any adverse spillover side effects of the failure.

Containing Contagion: the third issue was whether the lender of last resort should try to prevent shocks to the system. Thornton answered in the negative. The LOLR exists, not to prevent shocks but to neutralize their secondary repercussions. A "panic" could be triggered by any kind of "alarm" for example rumours of a foreign invasion, an initial bank failure etc. the central bank has no responsibility for stopping these triggering events, but it does have a responsibility for arresting the panic, stopping it from spreading throughout the system. The proper response is not to stop the initial failure, but to pump liquidity into the market. Because, the actual occurrence of a widespread panic, would be properly attributable, not to the initial bank failure, but to the central bank's failure to insulate the economy from the impact of that event. Closing any individual bank contributes very little to general distress. By contrast, policy errors of the LOLR create a general shock to credit that produces distress throughout the economy.

Protecting the Money Stock: Thornton identified the primary objective of the LOLR as the prevention of panic-induced declines in the money stock, declines that could produce depressions in the level of economic activity. He viewed the LOLR as essentially a

monetary rather than banking function. In other words, the LOLR's crisis-averting and run arresting duties were simply the means (albeit the most efficient and expedious ones) through which it pursued its ultimate objective of preserving the quantity, and hence the purchasing power of the money stock. The important thing was to prevent short-run shrinkages in the quantity of money, since hardship ensued from these rather than from bank runs or credit crises per se. He drew a distinction between bank credit (loans and discounts) and the stock of money. While the two aggregates tend to rise and fall together, it is the fall of the money stock that does the damage to the real economy. While credit indeed finances and supports business activity, such credit arises from money and not money from credit, it follows that monetary contractions rather than credit collapses per se are the root cause of lapses in economic activity. Thus, in summation Thornton's argument was essentially this; The LOLR must be prepared to offset falls in the money multiplier arising from panic-induced rises in the monetary base. By so doing, it maintains the quantity of money intact and therefore also the level of economic activity

Walter Bagehot in his seminal 1873 volume, Lombard Street, restated and concurred with many of the points earlier made by Thornton. He agreed for instance, that the best policy to containing external and internal drains on reserves referred to as Bagehot Rule: the provision of very large loans at very high rates (i.e. lend freely at a high rate).Bagehot also made several original contributions to the lender of last resort doctrine.

Preannounced Assurance: he distinguished between the central bank's extending support to the market after a crisis began and its giving assurance of support in advanced of an impending crisis. He argued that the LOLR's duty did not stop with the actual provision of liquidity in times of crisis, but also involved making it clear in advance that it would lend freely in all future crisis. This assurance alone would dispel uncertainty about and promote confidence in the central bank's willingness to act, thus generating a pattern of stabilizing expectations that would help avert future panics.

Penalty Rate: he advocated that last resort lending be made at a penalty rate. The central bank has a duty to lend, but it should extract a high price for its loans, a price that would ration scarce liquidity to its highest-valued users, just as a high price rations any scarce commodity in a free market. Moreover, a penalty rate also had the appeal of distributional equity, it being only fair that borrowers should pay handsomely for the protection and security afforded by the lender of last resort. Most importantly, the penalty rate would, provide an incentive for banks to exhaust all market sources of liquidity and even develop new sources before coming to the central bank. By encouraging individual banks to develop better techniques of money management and the capital market to develop new channels to mobilize existing liquidity, the penalty rate would promote allocative efficiency in the financial system.

Bagehot's analysis implies still another use for the penalty rate: providing a test of the soundness of distressed borrowers. A penalty rate set a couple of percentage points above the market rate on alternative sources of funds would encourage illiquid banks to turn to the market first. Success in obtaining accommodation at the market rate (defined

as the going rate on default-free short-term credit instruments) would indicate that lenders judge these borrowers to be sound risks, for the borrowers and their assets would pass the market test. On the other hand, resort to the central bank at the penalty rate would tend to indicate weakness in the borrowing institutions, suggesting that they may be unable to borrow in the market at the lower rate. Thus, the penalty rate would have provided a test of the bank's soundness.

Eligible Borrowers and Collateral: Bagehot also specified the type of borrowers the LOLR should accommodate, the kind of assets it should lend on, and the criteria it should use to determine the acceptability of those assets. The central bank should be willing to accommodate anyone with good security. The objective of the central bank in time of panic is to satisfy the market's demand for liquidity. It makes little difference, whether this objective is achieved via loans to merchants, to bankers, or to any other sound borrowers. Concerning the type of collateral on which the bank should lend, Bagehot's answer was clear: The bank should stand ready to lend on any and all sound assets ('on every kind of current security, or every sort on which money is ordinarily and usually lent').It implies that the LOLR should not be afraid to extend loans on normally sound assets whose current market value is temporarily below book value owing to depression in the securities market.

Unsound Institutions: Bagehot delineated the extent of LOLR's responsibility to individual banks as distinguished from the banking system as a whole. Concerning the question of whether this responsibility included assistance to insolvent banks, he answered in the negative. The job of the central bank is not to prevent failure at all costs but rather to confine the impact of such failure to the unsound institutions. Bagehot did not think it appropriate for the central bank to extend aid to poorly managed key banks. It is, instead, 'the sound' people, the people who have good security to offer who constitute the majority to be protected. The LOLR function should not be interpreted to mean that unsound banks should not be permitted to sound. Instead it implies that the failure should not be permitted to spread to sound institutions.

Strengthening Self-Reliance: Finally, Bagehot warned against undue reliance on the LOLR and stressed the need to strengthen individual banks. The LOLR was not meat to be a substitute for prudent bank practices. The basic strength of the banking system, rest not on the availability of last-resort accommodation, but rather on the resources and soundness of the individual banks.

Goodhart and Huang(2003),states that there have been few formal models seeking to analyze how and why Central Banks provide LOLR services, because some economists believe that providing LOLR to individual banks rather than to the market as a whole(via Open Market Operations),is fundamentally misguided. Economists, such as Bordo(1990) are of the view that central banks should not lend to individual banks, e.g. through a discount window, believing that the market is as well or better informed than the central bank about the relative solvency of a bank short of liquidity, i.e. Given an aggregate sufficiency of high-powered money, illiquid (but solvent) banks will be able to borrow in

the interbank market, whereas potentially insolvent banks will be driven out of the system. Continuing along the same line, Kane (1992), opined that the monetary authorities should exercise forbearance in rescuing banks that should have been closed; arguing that the pursuit of financial stability by direct intervention may divert central banks from achieving its primary goal of controlling the monetary aggregates so as to achieve price stability. Humphrey (1989), regards open market operations (OMO), rather than discount window accommodation, as the most effective way to deal with systemic liquidity crises. He argued further that had the technique of OMO being highly developed at that time, Bagehot would have approved of its use, since open marker operations are quite consistent with his dictum "that in time of panic" the central bank "must advance freely and vigorously to the public… on all good banking securities".

Contradicting this position, Mc Andrews and Potter (2002), argued that the potential for "market failure" made it imperative for the central bank to provide LOLR to an individual bank in crisis. Citing as an example, when the Bank of New York's computer malfunctioned in 1985 and would not accept incoming payments for bond market dealings, the resultant illiquidity position soon ballooned to a point where no one counterparty bank could take on the risk of making a sufficiency large loan. It would have required a coordinated syndicate, but such syndicates takes time to organize, and time was scarce. An even more dramatic example was given by the events of September 11th; 2001.The functioning of many markets was severely disrupted. In the ensuing crisis, the Federal Reserve System hugely expanded its discount window lending to many individual banks. Merton(1995) also argued that the supervisory role of central banks gives them access to additional information, not available in the market about the true position(s) of individual bank(s).Moreover, as I n the case of Bank of New York(mentioned above).when there is any large-scale need to redirect reserves, there must be a coordination problem. No one commercial counterparty can single handedly assume the credit risk, and there is no incentive for a single commercial bank to take on the time, effort and cost of coordinating the exercise of sorting out the problem. Hence the need for a central bank to dispense LOLR services to the distressed bank.

A coordination failure may be defined as a condition where a bank (or as in the case of 9/11, a set of banks), is solvent, but illiquid, but the market cannot resolve this difficulty, which would be temporary if resolved quickly. This may be because credit counterparty limits prevents any single institution doing the necessary lending, and thus requires coordinated lending, and no private sector body is willing to undertake the transaction costs of acting as coordinator; or because markets themselves are shut, or malfunctioning, as on 9/11;or for a variety of other potential reasons(Rochet and Vives,2003).

In the case of a coordination failure, the problem of illiquidity may affect only one bank, and, especially if rapidly resolved, may have no implications at all for other banks, as with Bank of New York in 1985.If that illiquidity problem is not rapidly resolved, however ,the attempts of the bank involved to sell assets, and to withdraw loans, to raise cash, and/or the implications of its enforced closure on depositor and market confidence, and on market prices, can then affect both the liquidity and solvency of other bank The

definition of contagious risk is an occasion where adverse developments in one bank whether due to illiquidity, or insolvency, or both, then threaten the viability of some other bank or group of banks.

It is possible to have coordination failure without contagious risk. This would occur, for example, when a financial institution, or bank which was illiquid, but not solvent, was forced into closure while still solvent, without any significant adverse implications for other banks, or financial institutions. This is most likely for small banks without important connections with other parts of the banking, or financial system. Such events are rarely memorable. It is certainly possible to have contagious risk without any coordination failure. This occurs whenever a big bank fails as a result of publicized solvency problems. Frequently, however, coordination failure can spark contagious risk. A contagious risk provides a strong compelling call for central banks to play the role of LOLR. Recent financial crises, such as Mexico(1985),Asia(1997-1998),Russia(1998),and Argentina(2000-2001),remind economists that contagious risks can cause banking panics, with depositors seeking to switch out of the deposits of banks perceived as riskier into currency, foreign exchange, or those banks perceived as safer (Goodhart and Huang,2003).

Theoretical Review

The financial crisis of 2007 to the present was triggered by a liquidity shortfall in the United States banking system (Ivry, 2008).It has resulted in the collapse of large financial institutions, the bailout of banks by national governments, and downturns in stock markets around the world. It is considered by many economists to be the worst financial crisis since the great depression of the 1930s.It contributed to the failure of key businesses, declines in consumer wealth estimated in the hundreds of billions of U.S. dollars, substantial financial commitments incurred by governments, and a significant decline in economic activity. Governments and central banks responded with unprecedented fiscal stimulus, monetary policy expansion, and institutional bailouts (Business news, 2009).

Steadily decreasing interest rates backed by the U.S Federal Reserve from 1982 onward and large inflow of foreign funds created easy credit conditions for a number of years prior to the crisis, fuelling a housing construction boom and encouraging debt financed consumption(Bush,2008).The combination of easy credit and money inflow contributed to the United States housing bubble. Loans of various types (e.g., mortgage, credit card, and auto) were easy to obtain and consumers assumed an unprecedented debt load. As part of the housing and credit booms, the number of financial agreements called mortgage-backed securities (MBS) and collateralizes debt obligations (CDO), which derived their value from mortgage payments and housing prices, greatly increased. Such financial innovation enabled institutions and investors around the world to invest in the U.S. housing market. As housing prices declined, major global financial institutions that had borrowed and invested heavily in subprime MBS reported significant losses. Falling prices also resulted in homes worth less than the mortgage loan, providing a financial incentive to enter foreclosure. The foreclosure epidemic that began in late 2006 in the U.S. continues to drain wealth from consumers and erodes the financial strength of banking

institutions. Defaults and losses on other loan types also increased significantly as the crisis expanded from the housing market to other parts of the economy. Total losses are estimated in the trillions of U.S. dollars globally (www.imf.org, 2010).These losses impacted the ability of financial institutions to lend, slowing economic activity. Concerns regarding the stability of key financial institutions drove central banks to provide funds to encourage lending and restore faith in the commercial paper markets, which are integral to funding business operations (Greenspan, 2009).

One of the first victims was Northern Rock, a medium-sized British bank. The highly leveraged nature of its business led the bank to request security from the Bank of England. This in turn led to investor panic and a bank run in mid-September 2007.Initial calls to nationalize the institution was ignored; however in February 2008, the British government (having failed to find a private sector buyer), relented and the bank was taken into public hands (Bank of England, 2007).Northern Rock's problems proved to be an early indication of the troubles that would soon befall other banks and financial institutions. Concerns that investment bank Bear Stearns would collapse in March 2008 resulted in its fire-sale to JP Morgan Chase. The financial institution crisis hit its peak in September and October 2008.Several major institutions failed, were acquired under duress, or were subject to government takeover. These included Lehman Brothers, Merrill Lynch, Fannie Mae, Freddy Mac, Washington Mutual, and AIG. In October 3, 2008 the United States government signed into law a$700 billion emergency bailout under The Emergency Economic Stabilization Act, which implemented the Troubled Asset Relief Program (Raum, 2008).

There is a direct relationship between declines in wealth, and declines in consumption and business investment, which along with government spending represent the economic engine. Since peaking in the second quarter of 2007, household wealth is down $14 trillion (CNN, 2009).To offset this decline in consumption and lending capacity, the U.S. government and federal Reserve had committed $13.9 trillion, of which $6.8 trillion has been invested or spent as of June 2009(FDIC, 2010). In effect, the Federal Reserve Bank has gone from being the “lender of last resort” to the “lender of only resort” for a significant portion of the economy. In some cases, it could now be considered as the “buyer of last resort”. An empirical study by Hughson and Weidner (2008),using the seasonal nature of financial crises during the National Banking period(1870-1913),as an identification strategy to isolate the impact of the introduction of a lender of last resort on financial markets, showed that financial crises have effects on the economy, and providing lender of last resort services reduces financial volatility.

The provision of liquidity by a lender of last resort can be very important for containing the spread of a financial crisis that can have significant macroeconomic effects, for instance; according to Kindleberger (1973), the 1929 Wall Street crash and its global consequences would have been of shorter duration in terms of business slowdowns and intensity, if a lender of last resort (such as the IMF) were effectively present and properly exercised.

Criticism

Critics of the backing of institutions point to the ability of having a lender of last resort as a temptation for an institution to take on more risk. A lender of last resort provides a safety net to insulate the institution from the full consequences of their risk. The lender does not underwrite the consequences but it could be that business failure can be hidden for longer by the extension of credit. A more theoretical critique of the institution of a lender of last resort is that its existence is predicated on the possibility of a "market failure": if the credit market accurately assesses risks, then institutions not able to receive loans would not be able to misuse the capital and the idea of a panic or "contagious" credit crunch spreading through the banking system would be impossible. A critique of the International monetary Fund as the international lender of last resort is that it is effectively an inefficient subsidy system, since it is mandated to provide loans to countries unable to raise funds through the bond market, with loans paying below interest rates (Economist, 2010).

Empirical Review

On the Caused Rates of Bank failure in Nigeria and its Management by CBN using LOLR

Financial system plays a fundamental role in the growth and development of an economy, particularly by serving as the fulcrum for financial intermediation between the surplus and deficit units in the economy. The financial system is made up of the set of institutions, instruments, markets, rules and regulations that guide the system as well as the mechanism by which the components of the system interrelate within the overall economic system. Thus, the financial system is the hub of productive activities, as it performs the vital role of financial intermediation, anchor payment services and serve as the bedrock of monetary policy implementation. The structure of the financial system changes in tandem with the developments in the economy (CBN, Briefs, 2009).

Prior to independence in 1960, not less than 33 different commercial banks were registered in Nigeria. However, by 1959 only eight banks, four expatriates and four indigenous, with a total of 160 branches were operating. The others had either failed or surrendered their licenses. Banks that failed during the period were largely those with problems of inadequate capital, fraudulent practices and bad management. The rapid rate of bank failure before 1959 led to the enactment of the 1952 Banking Ordinance which was the first effort directed at regulating the banking business in Nigeria (CBN, 2004)

The Central Bank of Nigeria was established by the CBN Act of 1958 and commenced operations on July 1, 1959.The major regulatory objectives of the bank as stated in the ACT is to: issue legal tender, maintain the external reserves of the country, promote monetary stability and a sound financial environment, and to act as a banker of last resort and financial adviser to the Federal Government.(www.wikipedia: Central bank of Nigeria,2010) Thus, with the establishment of the Central Bank, the Nigerian financial system has, continued to transform in ownership structure, depth, number of the financial instruments and institutions as well as regulatory framework in line with the economic environment within which the system functions.

Distress connotes an unhealthy situation or the inability of a financial institution to achieve its set goals and aspirations. It is associated with a cessation of operations of a financial institution (Alashi, 1993).The term "financial distress", is commonly used to describe two distinct but closely related conditions in an enterprise. These are illiquidity and insolvency. Illiquidity refers to a condition when a financial institution experiences a problem of cash flow. An illiquid financial institution will suspend payments to depositors wishing to withdraw. Liquidity problems thus, occur when there is a mismatch between the maturity of the assets and liabilities. Conversely, insolvency refers to a condition of a negative net worth of the balance sheet, with the sum of liabilities exceeding the sum of assets. A technically insolvent financial institution could remain liquid, after it became insolvent, implying that such institution has a stable and large deposit base (Glaessner and Mas, 1995).Distress in a financial system is visible when a fairly reasonable proportion of the institutions in the financial services industry are unable to meet their obligations to their customers, owners and the economy. The immediate consequences of distress in the financial system is a sharp reduction in the value of the systems' assets, resulting in apparent or real insolvency of many financial institutions accompanied by some runs and possible liquidation of some of these institutions. The signs of distress include persistent illiquidity, negative net-worth covered with paper profit, soaring saving deposits rates and accommodation of high-risk/high-return customers, and persistent contravention of rules coupled with the inability to honour obligations (Ogunleye, 1993).

Episodes of financial distress in Nigeria can be better appreciated, when categorized into various periods focusing on the causes, effects and the policy responses of the authorities. The periods covered were 1950's, 1990's and the recent cases (CBN, 2004).

Financial Distress in the 1950's

The first incidence of distress in Nigeria's financial system dates back to the 1950's when 21 bank failures were recorded. Thus, the distress in the financial system prior to independence was restricted to the banks as it was the dominant sub-sector. Historical evidence revealed that Nigeria's private sector realized that the existing expatriate banks would not give them assistance they required to promote trade. Thus between 1929 and 1959, 33 different banks were registered in Nigeria, mostly indigenous banks. Hence the moving spirit behind the spate of indigenous banking boom in 1929 to 1952 was the desire to break the monopoly of the few expatriate banks. By 1959, however, only eight banks including three expatriates' banks with a total of 160 branches were operating. The others had either failed or surrender their licenses.

Commercial Banks Registered in Nigeria from 1892 to 1959

S/No	Bank	Date Established	Remarks
1	African Banking Corporation	1892	Nil
2	Bank of British Corporation	1894	Now Standard bank
3	The Industrial and Commerce Bank	1929	Failed in 1930
4	The Nigerian Mercantile Bank	1931	Failed in 1936
5	Barclays Bank,D.C.O	1917	Now union Bank
6	National Bank of Nigeria	1933	Still in existence
7	Agbonmagbe Bank	1945	Now WEMA Bank
8	The Nigerian Penny Bank	1945	Failed in 1946
9	The African Continental Bank	1947	Failed in 1953
10	The Nigerian Farmers & Commercial Banks	1947	Failed in 1953
11	British and French bank	1948	Now United Bank in 1961
12	Merchants Bank	1952	Failed in 1954
13	Pan Nigeria Bank	1951	Failed in 1954
14	Standard Bank of Nigeria	1951	Failed in 1954
15	Premier Bank	1951	Failed in 1954
16	Nigerian Trust Bank	1951	Failed in 1954
17	Afro seas Credit Bank	1951	Failed in 1954
18	Onward Bank of Nigeria	1951	Failed in 1954
19	*Central Bank of Nigeria	1952	Failed in 1954
20	Metropolitan Bank of Nigeria	1952	Failed in 1954
21	Provincial Bank of Nigeria	1952	Failed in 1954
22	Union Bank of British Africa	1952	Failed in 1954
23	United Commercial Credit Bank	1952	Failed in 1954
24	Cosmopolitan Credit Bank	1952	Failed in 1954
25	Mainland Bank	1952	Failed in 1954
26	Group Credit and Agricultural Bank	1952	Failed in 1954
27	Industrial Bank	1952	Failed in 1954
28	West African Bank	1952	Failed in 1954
29	Muslim bank(W.Africa)Ltd	1958	Failed in 1954
30	Bank of Lagos	1959	Failed in 1965
31	Bank of the North	1959	Still in existence
32	Berini(Beruit-Riyad)Bank	1959	Still in existence
33	Banque de L.Afrique Occidentale	1959	Still in existence

Source: CBN Economic and Financial Review, 1968
*This has no connection with the Central Bank of Nigeria established in 1959

This first crisis was attributed to a number of factors including the under-capitalization of banks, mismanagement, and fraudulent practices. The capital deficiency was as a result of the fact that they were established with insufficient funds and over the years, the owners failed to increase the capital base. Mismanagement also contributed largely, to the poor procedures in their operations. Technical mismanagement inflicted on the banks was over expansion, poor lending, lack of internal controls and poor planning in the areas of business. Fraudulent practices prevailed among the banks. Thus, the rapid rate of bank failures led to the first effort directed at regulating the banking system. The policy response of the colonial government was the enactment of the 1952 Banking Ordinance, which represented the initial efforts directed at regulating the banking system in particular, and the financial system in general. The Ordinance provided for banking licensing requirements as well as procedures and standards for the conduct of banking business. Furthermore, the Ordinance also prescribed prudential requirements for capital and reserves. The main achievements of the enactment were the limitation of banking business to establishments holding valid license, prevention of the establishment of unviable banks, and the introduction of more orderly commercial banking practices (CBN, 2004).

Financial Distress in the 1990's

The distress recorded in the early 1990's was more serious in terms of depth and the extent of its impact on the financial system, as well as the economy. In the late 1980's,the deregulation of the economy(through the introduction of SAP) resulted in nearly five folds increase in the number of banks and other financial institutions operating in the economy. Remarkable expansion of the financial system was also witnessed in the establishment of capital market, development finance institutions, regional investment companies, mortgage institutions, insurance companies and pension funds.

However, the legal and supervisory frameworks were not strengthened rapidly to facilitate the exit of distressed financial institutions without impacting on the entire system. This constrained the ability of the supervisory agencies to prevent, contain, manage and resolve the distress syndrome early enough.

Number of Financial Institution in Nigeria (1990-2002)

Financial Institution	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002
Deposit money Banks	107	109	120	120	116	115	115	115	89	90	90	90	90
Community Bank	1	66	402	879	970	1355	1368	1015	1015	1014	881	747	769
Peoples Bank(Branches)	169	200	228	271	275	278	278	278	278	278	278	-	-
Primary Mortgage Institutions	-	23	145	252	279	280	288	115	194	194	194	79	80
Bureaux de change	92	102	132	144	191	223	240	250	244	260	260	80	83
Stock Brokerage Firms	80	110	140	140	162	162	217	226	226	226	n.a	n.a	n.a
Finance Companies	-	-	48	310	290	276	279	279	279		93	98	102
Insurance Companies	103	107	121	125	136	145	187	181	168	104	118	118	118
Discount House	-	-	3	3	3	4	5	5	5	5	5	5	5
Dev. Finance Institutions	4	4	4	4	4	4	4	4	4	8	8	6	6

Source: CBN Statistical Review and Nigerian Stock Exchange, Various issues

The onset of distress in the 1990's was generally preceded by high interest rate, reflecting the dominance of "distressed borrowing", generalized violations of rules and procedures and massive withdrawals of deposits. Thus, as the news of distress in the system spread, many depositors fled from weak institutions to more reliable ones, resulting in the closure of most of the banks. The major causes of the distress in the banking sub-sector included poor lending practices, bad management, fraudulent practices, inadequate internal control/supervision, policy inconsistencies and reversals during the 1980's and 1990's and macroeconomic imbalances such as current account deficit, high inflation, low domestic savings and deterioration in fiscal positions prior to the crisis.

As part of the policy response of the authorities, temporary financial assistance were offered to distress banks without necessarily taking over the institutions or eliminating the shareholders' position. The assistance took the forms of capital injections and purchase of non-performing assets of the institutions. This option allowed the operations of the institutions to continue uninterrupted. Shortly, after the liquidity crisis of 1989, the regulatory authorities packaged an accommodation facility amounting to N2.3 billion as LOLR for the affected banks. The financial assistance rescued nine troubled banks, allowing them to draw "bills of exchange" to the tune of their respective overdrawn positions. Although the measure temporarily reduced the illiquidity in the system and restored confidence, it failed to address the banks insolvency. Where the holding action

and self restructuring efforts failed to reverse the insolvent status of a problem bank, appropriate regulatory sanctions against the miscreant bank follows. Such rehabilitation measures took the form of either the assumption of control (take over) for purpose of restructuring the bank or revocation of license of the affected bank. In such circumstances, the CBN assumed control and management of the distressed banks, with the intention to acquire the failed banks for the purpose of restructuring and subsequently sell them to the public, merged or make an order revoking the bank's license and requiring its business to wound up. For instance, the bank sought the approval of the president to acquire 6 state owned and 17 privately-owned banks for a fee after due application to the Federal High Court in 1995.The Transitional Supervisory Board was therefore, set up in 1995 to manage and conduct the affairs of the distressed banks already taken over. Liquidation of terminally insolvent banks was adopted to restore market discipline. For instance, in 1998, the authorities revoked the operating licenses of 26 distressed banks (13 commercial and 13 merchant banks) bringing the number of banks that had their licenses revoked to 31(CBN, 1998).

Recent Financial Distress

Between August and October, 2009, the Central Bank of Nigeria (CBN) announced the dissolution of the boards of eight (8) banks respectively, following an audit exercise carried out on all the twenty four deposit-taking banks in Nigeria. Major reasons cited by the CBN for its actions were; liquidity crises and poor risk asset quality in those banks. Concerning liquidity crises in the affected banks (Oceanic Bank Plc, Unity Bank Plc, Intercontinental Bank Plc, Union Bank Plc, Spring Bank Plc, Fin Bank Plc, Afribank Plc, Bank PHB Plc), the CBN noted that, these banks together, have been utilizing about 89% of the money made available to the interbank market through an Expanded Discount Window (EDW) which was an indication of liquidity difficulties. Also, the CBN noted that, these banks were heavily exposed to two sectors that were in difficulties (the capital market sector and middle market in the oil and gas sector) aside the issue bordering on insider lending. Based on the assessment of the CBN, the combined effect of liquidity challenges and poor asset quality of these banks put them under serious threat of insolvency. The CBN however, noted that, due to the number of banks affected and their relevance, rescuing them is less costly to the financial system and the entire economy than allowing them to fail. The CBN therefore intervened by dissolving the boards of these banks and setting up new ones to manage them until they returned to sound financial health. The CBN also injected a total of N600 billion (approx. $4 billion) into these banks (Muktar , 2010).

It also facilitates the creation of the Asset Management Corporation of Nigeria (AMCON), signed into law in July, 2010 by President Jonathan. AMCON is a resolution vehicle (with a sinking fund of N1.5 trillion over the next 10 years, with CBN contributing N500 billion, while the banks will pool the rest), that is expected to soak the toxic assets of the CBN-intervened banks and provide liquidity to them as well as assist in their recapitalization (Nwaoba, 2009).In fact, AMCON recently bought over the toxic assets of 21 banks with a zero-coupon N1, 036,821,000.00(N1 trillion) bond. The bonds, due in December, 31st,2013 have a yield of 10.125% and have subsequently replaced toxic assets

in the coffers of the benefitting banks and putting them back in a comfortable position to resume lending (Ebulu and Nweze,2011).Thus, it is clear from the above that, having confirmed that some Nigerian banks were facing liquidity challenges, the CBN went a step further to assess the solvency of these banks and concluded that they faced the threat of insolvency. The CBN went ahead to inject funds into these banks as a LOLR because in the assessment of CBN the affected banks together, represents significant portion of the entire banking system and therefore, allowing them to fail would cause instability in the financial system.

Conclusion

Conclusively it is a credit to the CBN that not a single bank within the system experienced a panic, not to talk of a run as a result of the global meltdown. In fact, till date there are some who do not believe that there was a problem with any of these banks, based on the timely and effective intervention of the CBN in applying the principles of lender of last resort.

Recommendations

The immediate response of the CBN to ensure the maintenance of the banking system stability achieved great success. However, there is the need to provide long lasting policy measures that would address future threats of global shocks on the Nigerian economy (Abdullahi and Obiechina,2009),and the financial sector in particular.

1. The effort at injecting liquidity into the system needs to be sustained. This, however, needs to be done cautiously to avoid inflationary pressure. Moreover efforts should be made to channel these funds to the productive sectors of the economy by improving the infrastructure.

2. Adequate prudential supervision and regulation of the financial sector, especially the banking sub-sector is very important and should be pursued vigorously by the monetary authorities. Injection of funds and recapitalization of banks always leads to expansion of banks' credit as money balances increase. With a poorly supervised and weak banking system, the increase in commercial banks' reserves could encourage excessive risk taking in lending to unprofitable and speculative activities. Building a strong institution and implementing sound supervision and regulations will help in reducing the risk of financial and currency crisis. Strengthening banking systems is important to ensuring that funds are allocated to their most efficient uses, instead of being loaned to cronies or directed to inefficient state sanctioned projects.

3. The recently created Asset Management Corporation of Nigeria would also go a long way in serving as a recapitalization vehicle by taking up toxic assets in the financial sector. Hence, its activities should be well monitored and its policies speedily implemented.

Individually, none of those banks was “too big to fail”, but the fall of any of them would have triggered a run on the other banks, and ultimately the whole system and money stock would have shrunken, an eventuality the CBN is mandated to forestall. Thus,

recognizing that each of these banks was “too critical to fail”, LOLR was timely and expediously extended to those banks (the likelihood of contagion being the key factor affecting the CBN's incentive in providing LOLR).

Thus, while adhering to the major precepts enunciated by the Thornton-Bagehot doctrine in providing LOLR, the CBN did not just implement these principles blindly, but in line with the peculiarities of the Nigerian economy in order to accommodate certain developments in the financial markets. For instance, contrary to Thornton-Bagehot principle which requires that LOLR should be provided only to banks that have acceptable collateral, the CBN, considering that the seven banks are “too big to fail”, provided LOLR irrespective of whether the troubled bank has acceptable collateral or not. Contravening the principle of: Preannounced Assurance, the CBN refrained from announcing its plans for providing LOLR, and have remain vague about its intentions regarding the future ownership structure of the banks etc, in order to keep bank managers alert and prudent. Because recent developments indicates that bank managers, aware of this principle may abuse the system by creating problems which they personally benefit from and call on the supervisor(CBN) to shoulder the problem.

Finally, the CBN did not provide LOLR at a punitive rate as stipulated by the Thornton-Bagehot Principle, mainly because any additional rate would worsen the banks' already bad liquidity and solvency situation.

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