'Nigerian Banks are Strong Enough to Withstand IMF Predictions'

The Nigerian banking sector has for over a decade now received its fair share of legal and regulatory attention resulting from the massive failures of financial institutions that characterised the 90s. With the Central Bank of Nigeria's recapitalisation exercise, Nigerian banks have since grown stronger and more risk conscious. On how Nigeria's economy has fared generally in the face of the current global recession, May Agbamuche-Mbu, Jude Igbanoi and Tobi Soniyi tracked down Chike Obianwu who expressed strong views on Nigeria's banking sector, stock market and the coming of age of Nigerian lawyers in Mergers & Acquisition.

In 2011, you were appointed to a committee of experts to advise the Security and Exchange Commission (SEC) on the proposed demutualisation of the Nigerian Stock Exchange. Can you explain the rationale behind this exercise and its impact on the Nigerian economy?

Historically, stock exchanges around the world tended to be organised as membership organisations, cooperatives or mutual societies. The membership tended to be made up of trading members or brokers, and decision-making was often based on one vote per member. These exchanges tended not to be profit oriented.

Starting with the Stockholm Stock Exchange in 1993, the trend over the last 20 years has been for stock exchanges previously organised in this way to restructure into limited companies. This is essentially what demutualisation is about – transforming from a mutual society into a company limited by shares.

Put very simply, the rationale for this is to give the exchanges access to a lot more capital and broader investor participation. As companies limited by shares, they can issue shares and even go on to list those shares on their own exchange or other exchanges. With the capital they raise in this way they are better able to compete across borders in today's globalised world. Some exchanges have gone on to acquire other exchanges in other countries. Also, demutualised exchanges tend to be better able to implement massive improvements in technology and operational efficiency, all thanks to their easier access to capital, economies of scale, their newfound governance as regular companies and their keener devotion to the profit motive.

So what was the outcome of the work of your Committee?

Our own Nigerian Stock Exchange is currently registered as a company limited by guarantee, which among other things means that it cannot distribute profits to its members and if it were to be wound up today, any assets left over after paying its debts cannot legally be handed over to its members.

Our committee found that there is currently no mechanism under the CAMA that allows for a company of that nature to be restructured into a company limited by shares. So we recommended an amendment of the CAMA to allow for this.

The SEC recently published draft Demutualisation Regulations for review and comments by the market. I have done a quick review of the regulations, and they are broadly consistent with our recommendations, except that they do not address the need for the amendment of the CAMA, and they also suggest that at least 10% of the shares in a demutualised exchange should be reserved for the Nigerian Government – I do not recall that we recommended that.

Due to the growing popularity of Mergers and Acquisitions in Nigeria. Some have argued that since the SEC is already in charge of the regulation of the stock markets and the dematerialisation of stock certificates, Nigeria needs an independent governmental agency such as the Federal Trade Commission's Bureau of Competition in the United States and the UK Competition Commission and Office of fair trading in the UK. Would the establishment of an Independent governmental agency to regulate competition aid compliance with Anti-trust laws in Nigeria?

I agree that the SEC in its current form is not fully equipped to regulate competition and fair trade. But I am not a big fan of proliferation of regulatory agencies.

I think the starting point is to pass a well-considered Competition Act and to attract and train the right selection of experts to implement it. Whether or not these people sit inside the SEC or in a dedicated Competition Commission is a secondary question. I would have even dared to suggest that they sit in the Federal Ministry of Justice, but our ministries are not famous for diligence or rigour or efficiency.

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How would you assess the proficiency of Nigerian lawyers to handle M & A transactions?

Among the leading business law firms, I think there is significant knowledge of the law relating to M&A transactions. However, some of the complaints you hear over and over again are that quite a number of us are not sufficiently commercially sensitive and that many are not as proactive or responsive as we should be.

Over the years there has been a dramatic increase in Mergers and Acquisitions in Nigeria especially during the 2005 Central Bank recapitalisation exercise. Did the consolidation exercise achieve its objectives of liquidity, capital adequacy and corporate governance?

Looking back, I would say it has been a mixed bag, but in my opinion, a lot more positive than negative. Our banks are certainly bigger and stronger. Their securities are traded all around the world in the form of GDRs and Eurobonds. Their capacity to fund projects has definitely increased in leaps and bounds.

If we look back 12 – 14 years ago, when we advised the foreign and local lenders on the initial financings that were done by a company like MTN Nigeria, I can tell you that it was considered a ground-breaking achievement that the Nigerian banks on one of those deals lent US$250 million out of a total of US$395 million that the company borrowed. It was also remarkable that we achieved a total loan tenor of 7 years on that deal.

Transactions like that are now commonplace in Nigeria. And we have seen Nigerian banks get together to lend nearly US$1 billion on more recent projects. We have also seen our banks expand and excel in various parts of Africa. So we have certainly made tremendous progress on account of the 2005 recapitalisation of banks. The events of 2009 to 2010 however exposed some of the governance challenges that plagued the banks, both before and after the Soludo recapitalisation exercise. Righting these wrongs is work in progress and I think we are largely on course.

The mergers and acquisitions in the Nigerian banking sector shored up the financial base of all Nigerian banks. Given the ongoing global recession, how would you assess Nigerian financial institutions in the face of these global trends?

The global financial crisis that started in 2007/2008 did not affect our banks directly in the same way it affected banks in more mature emerging economies in South East Asia, and elsewhere. But this was mainly because our banking system was not as closely integrated to the global financial system as say those ones. So we had no direct exposure to the fallout of the US subprime mortgage crisis etc.

The problems that our banks faced had a fairly local flavour to them. There were corporate governance lapses. Outrageous insider loans that were either never repaid or properly secured. And of course, there was a massive exposure of banks to the Nigerian Stock market, which had practically collapsed at the time. A sharp drop in oil price and the resulting devaluation of the naira combined with all these to take a toll on our banks which were almost all equally exposed to both the stock market and the oil and gas industry. Soon after, foreign banks that were exposed to Nigerian banks began to withdraw their lines of credit to our banks, and liquidity further tightened.

Now let us fast forward to 2015. How are Nigerian banks faring in the current environment? The price of oil has once again gone down drastically. Our foreign reserves have taken a hit and the naira has been dramatically devalued. For now, our banks appear to be weathering the storm a lot better than back in 2009, but it is still early days.

A joint stress testing of the Nigerian banking sector conducted by the IMF, the World Bank and the CBN around 2013 considered the possible impact of a sharp drop in the price of oil to around US$50 per barrel, and they predicted that the volume of non-performing loans in the industry could double as a result, and that the naira to dollar exchange rate would suffer a 30 percent depreciation. That dire prediction regarding exchange rate devaluation has more than come true. And although our banks are not as highly exposed to the oil and gas industry today as they were back in 2009, the risks of a crisis of non-performing loans in that sector remain high today. I have seen for example the case of one bank whose exposure to that industry is as high as 40 percent of its entire loan portfolio. But by and large, the general expectation is that our banks are collectively strong enough today to withstand even the IMF prediction if it were to come to pass.

The interest rate in the Nigerian banking sector is said to be among the highest in the world. Do you share the view that Nigeria has a hostile banking environment?

Interest rates in Nigeria are certainly high. If I remember correctly, the current CBN Governor gave a speech shortly after he took office in which he confirmed that our interest rates were something like the second highest compared to economies that are similar to ours.

But truth be told, the subject of interest rates is a lot more complicated than such comparisons. A lot about our high interest rates is traceable to our overdependence on imports, to the borrowing habits of our governments, and to the attempts by the Central Bank to use monetary policy measures to contain inflation and discourage overdependence on imports. It is almost a vicious circle if the government is not doing its part on the fiscal side of things.

Now let me explain this a little further. If the Federal Government is issuing one-year treasury bills at 18% and 10-year bonds at 16.5%, then surely the banks would be lending to the private sector at above those rates. It is as simple as that. Because the rate at which the Federal Government borrows is the risk-free rate and other borrowers in the market would borrow at the risk -free rate plus some extra.

And then there are such other factors as the Cash Reserve Ratio that banks have to maintain: 20% in respect of private sector deposits and 75% in respect of the public sector. And then there is the Liquidity Ratio of 30%. In other words, for every N100 of private sector deposit a bank takes, it must keep N20 for Cash Reserve Ratio and N30 in Liquid Assets to meet Liquidity Ratio requirements, and that effectively leaves the bank with only N50 to lend.

If you add to that what the banks have to spend on staff costs, diesel, technology, security, and losses due to fraud, you begin to get a clear picture of why interest rates are so high in Nigeria.

In your assessment and general overview of the Nigerian banking industry, is it safe to say the era of failed banks is gone for good? What further statutory and regulatory measures would you suggest to strengthen the banks, especially under the present circumstances?

Is the era of bank failure over? I would not put it that way. If you look at more mature and better regulated financial services markets, you would find that they still experience bank failures. So I do not think that is the goal. But certainly, one can easily say that our banks are less likely to fail today than back in 2009.

The Central Bank today is a lot more risk conscious, and so are the banks. The banks today do not have anything like the level of exposure to the equities market that they had in the days of the Nigerian Stock market crash of 2008/2009.

To the best of my knowledge, the vast majority of the banks are still within the 5% limit of non-performing loans to gross loans ratio. And still on the subject of risk management, there is a lot of effort today on the part of banks to stress test their loan portfolios taking account of such possible scenarios as falling oil price and currency devaluation. Surely, they are unlikely to have accurately predicted the current levels of drop in oil price or naira devaluation but at least some of the current decline we have seen was already factored into the calculation of the banks before now. So we have definitely made good progress.

Now, there are potential problems in the power and oil and gas sectors. And it remains to be seen how close we get to the predictions of the IMF stress test of 2012 to 2013.

Whatever the case, the Central Bank has to remain vigilant, continue to place emphasis on risk management and transparency in the reporting standards of banks. And it has to strive to scale up the capacity of its people – to acquire the knowledge and experience required for their job, particularly the implementation of the IFRS and the aspects of Basel 2 and 3 that are being implemented by the CBN. The CBN's staff need to stay ahead of the banks that they regulate, rather than play catch-up.

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Recently, experts have observed that the sudden drop of the Naira against the Dollar will result in a lot of bad debts for banks. Do you share this opinion?

Absolutely. A lot of Nigerian projects and businesses have US dollar loans but receive their revenue in naira. In the days when the naira was relatively stable against the dollar this strategy made some sense, because the interest rates for US dollar loans were a lot lower than those for the naira. However, the recent sharp decline in the naira would almost certainly mean that their naira revenue would buy them a lot less dollars than in the past. So it will not be long before you begin to see more businesses being unable to meet their US dollar obligations.

This is even further complicated by the recent restrictions that the CBN has placed on the foreign exchange market which has effectively made US dollars extremely scarce, thereby further driving demand for dollars to the parallel market at a much higher rate than the already high rate on the interbank market. If you add to that the flight of naira savings to US dollars and the huge demand for US dollars that is connected to the impending elections, the picture is not at all pretty.

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What do you think of the recent restrictions that the CBN has placed on the use of export proceeds?

I believe you are referring to the CBN Circular of 20 February by which it limited the previously unfettered access that exporters had to their export proceeds in their foreign currency domiciliary accounts.

The effect of that circular has been unbelievable. While exporters used to be able to spend their export proceeds at will or sell them to others in the market who, for example had naira to exchange for the relevant currency, the

Circular says those export proceeds can only be used for Eligible Transactions and other trade-related transactions or sold to banks, who in turn can only use them for Eligible Transactions.

On account of this Circular, banks are no longer allowing exporters to freely transfer their export proceeds out of Nigeria. I also understand that some oil companies may have been prevented by their banks from using export proceeds to pay Royalties and Petroleum Profits Tax to the Nigerian Government. Now this may have been a misreading of the CBN Circular on the part of this bank, but if it was not then that is troubling.

Whatever the case, the effect of the Circular is far-reaching, and I hope that the Central Bank makes haste to reach a resolution on this with the market.

What impact is the devaluation of the Naira having on the Nigerian economy at this point in time?

As I previously mentioned, this would impact heavily on foreign currency loans. As a matter of fact, in my practice, we have already started to see a number of companies converting their existing US dollar loans to naira loans. So there would definitely be a lot of debt restructuring coming out of this debacle.

And then there is the obvious point that because we are so heavily import-dependent the prices of almost anything in Nigeria is almost certain to start going up in the near term.

The growth in African economies have resulted in a shift from traditional investment assets to private equity funding. Are Private Equity Funding Transactions viable in Nigeria considering the fact that funds are tied up for a long time?

Yes I think they are viable and the typical gestation period of three to seven years is not that big a concern given that the investors in PE funds are typically sophisticated medium to long-term players.

At Templars, we have advised on the formation of quite a few Private Equity funds. And we have also acted on numerous Private Equity investments either for the PE houses or for the Nigerian investee companies, and the usual feedback tends to be that Nigeria is an extremely challenging business environment but it offers pretty decent financial returns in exchange.

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Tax evasion and avoidance are the greatest setbacks to effective tax administration in Nigeria. How would you advise the government to address these issues in tax administration?

As a business lawyer who is very familiar with the time-honoured legal principle that a taxpayer should be at liberty to, acting within the law, organise her affairs in a manner that results in the lowest tax possible, I would not say that I am instinctively sympathetic to the government's views on tax avoidance.

Having said that I think whatever measures the government adopts in combating tax evasion (which is a crime) and tax avoidance (which is generally not a crime), the government must strive towards clarity and certainty in its policies and practice.

In my experience, business people would much rather have clarity and certainty and higher taxes than uncertainty.

Tax evasion as I said is clearly a crime and the government would do well to enforce the relevant laws. The use of more indirect taxes may be a good way to increase tax revenue in an environment like ours where income tax compliance is not particularly high, but the downside to that is that the handful of people that are compliant, which is mostly those in the public sector and the organised private sector – would end up suffering the double tax blow of continued direct taxes and more indirect taxes.

Regarding tax avoidance, the tax authorities already have general and specific anti-avoidance powers under existing tax laws. So for example, where the revenue considers a given transaction to be artificial or fictitious, it has the power to adjust the transaction and tax it as adjusted. A key concern is that the revenue should not exercise this power capriciously.

The revenue also has powers to tax on a deemed distribution basis. And of course the excess dividend tax provisions of the Companies Income Tax Act have been famously problematic in the context of the franked investment income of non-operating holding companies both during the recent restructuring of banks decreed by Sanusi in 2010 and thereafter.

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The NIPC has recently taken steps to inform taxpayers that pioneer tax holidays that it granted to certain businesses in the recent past should have been for a period of 3 years instead of the 5 years that it granted in many of its letters. What is your view on this?

That's an excellent question and I think what has happened with pioneer status grants in the recent past represents an egregious abuse on the part of the government. First, the government grants tax holidays on what it is now suggesting was an incorrect basis, and after several years of businesses and investors relying on the promises and clear policy of the government on the subject, the same government is looking to go back on the self-same promises. This goes back to my point about there being a desperate need for our government and in particular our tax authorities to be clear and consistent in their policies and the application of the law.

Now there are some good arguments on both sides of this issue. But no matter where you stand on this pioneer status controversy, I think there is clearly something to be said for the argument that a government should never be at liberty to represent to a corporate citizen that it is exempt from taxes for a 5-year period, and then return several years after to say "oh no, I am so sorry but your tax holiday should have been for 3 years – and here is your tax bill for the last 2 years". A citizen to whom that representation was made in the first place should surely have a legitimate expectation that the government would not go back on its word.

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I am in two minds about this. But here is what I would tell you – I would not support an across-the-board increase in VAT. Perhaps, the government should leave the rate as it is in relation to most goods and services and instead specifically target luxury goods and services for a rate hike.

Considering the fall in crude oil prices. What other sectors of the economy should the country invest in to diversify the economy from oil dependence?

I am not an economist, but by most accounts the major thing we need to do first is begin to tackle our infrastructure deficit. The power sector privatisation appears to be stalling of late. That needs to be fixed. The same goes for transportation, the ports, the free movement of goods, and bulk storage and processing facilities for agricultural produce.

It is widely accepted that once these basic infrastructural challenges are addressed, the real potential of the non-oil sectors of our economy would be unleashed.

Another critical element of any effort to wean us of over-dependence on oil is that the Federal Government and the State Governments need to rethink their positions on the Sovereign Wealth Fund controversy and then work together to establish a disciplined regime for saving a substantial portion of our oil export receipts.

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