LEGAL ISSUES IN CREDIT RISK CONTROL AND THE PREVENTION OF BANK FAILURES IN NIGERIA*

by

SANUSI LAMIDO SANUSI

Executive Director
Risk & Management Control
First Bank of Nigeria Plc

*(*Being a paper presented at the DISTINGUISHED GUEST PROGRAMME organized by Messrs Templars (Barristers & Solicitors) and held at their Conference Room at No. 13A, A. J. Marinho Drive, Victoria Island Annex, Lagos on Tuesday, June 6, 2006)*

LEGAL ISSUES IN CREDIT RISK CONTROL AND THE PREVENTION OF BANK FAILURES IN NIGERIA

by

SANUSI LAMIDO SANUSI

Executive Director

Risk & Management Control, First Bank of Nigeria Plc

Lagos, June 6 2006

I have been invited by Messrs Templars (Barristers & Solicitors), the organizers of this programme, to speak on the topic *Legal Issues in Credit Risk Control and the Prevention of Bank Failures in Nigeria* as their "Distinguished Guest" for this month. Although the programme organizers indicated that I was free to alter the title or subject matter of the topic to suit my preference, I felt I should honour the organizers by attempting to do justice to their own topic. Since I am a mere Risk Manager, this entry into the terrain of the "learned gentlemen" seems to me extremely brave. I do hope, therefore, that it shall turn out to be a duly calculated and well-managed risk.

Credit Risk Control refers to the process by which all loans, advances, credit facilities or accommodation granted by a bank to a customer are administered to ensure that the facilities run satisfactorily according to the terms governing them and are ultimately re-paid on due date. The process involves monitoring, reviewing, upgrading and downgrading as the case may be, the process of dealing with loan delinquency and collectibility and ultimately re-payment.

Basically, the objective of the Credit Risk Control function is to enable a bank keep abreast of all developments impacting loans and advances granted by it with a view to ensuring that the terms governing the loan or credit are adhered to so that there is no default. The idea is to allow the bank to be proactive and take appropriate, and indeed, proactive initiatives to protect its Risk Assets in order to forestall default or mitigate default if it does occur. This function is therefore an important aspect of banking business. A well managed and effective Credit Risk Control process is important to every bank, as large loan losses could lead to non-profitability and the eventual collapse and liquidation of a bank. A well structured and managed Credit Risk Control function no doubt, helps to keep a bank afloat as well as profitable.

I shall now proceed with a discussion of some of the general legal considerations in Credit Administration before going on to identify the legal issues involved in Credit Risk Control and the prevention of bank failures in Nigeria.

The first consideration deals with the capacity/authority of the borrower. The customer/borrower is expected to be either a natural person or a non-natural person. In the case of a natural person, a bank is expected to deal with adults of sound mind and body, while in the case of non-natural persons, banks are expected to deal with duly incorporated companies, corporations, clubs, associations, firms and government agencies. Indeed, banks are expected to ascertain the legal capacity of the borrower -- both natural and non-natural persons -- to enter into contracts before extending credits to them.

The second legal consideration deals with the legality or otherwise of credit transactions. For a contract to be valid it must be legal. If the purpose of the contract is considered illegal in law, then such a contract cannot be valid or enforceable. Illegality of contracts will arise either by express stipulation of the law or by the rules of common law. Illegality by law will arise where a law or government regulation precludes or prohibits certain things or acts. Any contract in pursuance of such a thing or act will not only be illegal but will also be null and void. For example the law or regulation may stipulate the need for a licence to sell, import or export or to carry on a certain type of business activity. Any contract to finance that line of business without the requisite licence will be illegal, void and unenforceable. In this regard, it is instructive to note the decision of the Supreme Court in the case of *Alhaji Taofik Alao Vs. ACB Ltd (1998) 2 NWLR Part 542* where it held that a banking transaction was illegal and unenforceable because a licence required under the Exchange Control Act was not obtained by the customer prior to his dealings with the bank. It is therefore imperative in some cases for banks to ensure the existence of necessary consents, permits, licences and authorizations from relevant regulatory and/or governmental agencies before entering into loan transactions.

Having dealt with the general legal considerations in credit administration, I shall proceed to dwell on the legal issues in Credit Risk Control and the prevention of bank failures in Nigeria.

When a bank and a borrower successfully negotiate a loan, a contractual relationship is thereby established viz;

(i) The bank grants the borrower the use of its funds for a specified period of time.

(ii) The borrower agrees to repay the loan with interest on a specified date.

(iii) Where the loan is secured, the borrower allows the bank to sell his assets to offset the loan if he is unable to repay.

The above contractual relationship is initiated by the bank through the issuance of an Offer Letter to the customer. The Offer Letter is the basic document by which a lending relationship between a bank and a borrower is established. When a bank has agreed to grant a loan to a customer, it sets the process in motion by causing an offer letter to be addressed to the customer offering him the approved facility subject to the terms and conditions (either precedent or subsequent to drawdown) stipulated therein. Where the customer accepts the terms of the facility as indicated in the offer letter, the next logical step becomes the preparation and execution of a Loan Agreement between the parties. The Loan Agreement sets out the contractual relationship between the lender and the borrower as well as the terms and conditions governing the facility, including the rights and remedies available to the parties in the event of default (i.e. events of default).

Another important legal issue in Credit Risk Control is security documentation. Once lending is approved subject to provision of security by the customer, it behoves the bank to ensure that appropriate security is engrossed and perfected. Security could be in the form of a legal mortgage, debenture, stocks/shares, bills of sale, life policies, equipment on lease, guarantees and indemnities and other such securities as may be prescribed. Indeed, lending against security is one of the ways in which banks seek to mitigate credit risk, and the quality and value of collateral are often linked to their perceived default probability. Where credit risk of a borrower is high, there is a need for being well-secured, preferably by high-quality collateral that is valuable, controllable and realisable.

Still on legal issues in the prevention of bank failures in Nigeria, it would be recalled that at the commencement of banking business in Nigeria in 1894 by the then Bank of British West Africa, which was the forerunner of the present day First Bank of Nigeria Plc, there was no legislation governing the business of banking. The customs, principles and practice of the business were essentially at the discretion of the operators.

The first ever legislation on banking in Nigeria was the Banking Ordinance of 1952 and subsequently the 1958 Banking Ordinance, which established the Central Bank of Nigeria. Between 1894 and now, the industry has witnessed periods of boom and distress. Indeed the ordinances of 1952 and 1958 were prompted by a boom in the industry at about the year 1947 followed by a burst. The same pattern continued in the early sixties and with the benefit of these experiences, government decided to put statutory regulations in place to regulate the business of banking. This led to the enactment of the Banking Act of 1969 – which, subject to some amendments within the period, became the primary legislation on banking in Nigeria until the enactment in 1991 of the Central Bank of Nigeria Act 1991 (as amended) and the Banks & Other Financial Institutions Act of 1991 (as amended). These two pieces of legislation became the fundamental laws regulating banking in Nigeria.

Other legislations relating to banking generally include the:

1. Nigeria Deposit Insurance Corporation Act, 1988.
2. Failed Banks (Recovery of Debts) & Financial Malpractices in Banks Act, 1994
3. Money Laundering Act, 1995.

All these laws impact the business of banking generally. However, with regard to the legal issues in the prevention of bank failures in Nigeria, the relevant laws are the CBN Act, Banks & Other Financial Institutions Act and the Failed Banks (Recovery of Debts) & Financial Malpractices in Banks Act. We shall proceed to examine the legal issues/considerations in the prevention of bank failures by looking at salient provisions of these Acts.

CENTRAL BANK OF NIGERIA ACT

Under Section 39, the CBN is empowered to:

a) require that all applications by banks for loans exceeding such amount as the CBN may specify shall be submitted to the CBN for approval and that no such loans shall be made without such approval.

b) fix a ceiling on the volume of loans, advances and discount outstanding at each bank and it may fix ceilings for the different categories of each such loans, advances and discounts.

c) fix ceilings on the aggregate amount of loans, advances and discounts granted by any bank and outstanding at any time and the CBN may place limits on the rate of increase in the aggregate amount of such loans, advances and discounts within a specified future period of time.

This section also empowers the CBN to prohibit any bank which fails to comply with its directives from extending new loans and advances and from undertaking new investments. Section 39 is, therefore, an important clause relating to the powers of the CBN to regulate loans and advances granted by banks.

The CBN's directives on monetary, banking and financial policies are usually issued by circular. These circulars which are issued annually at regular intervals cover such areas as interest rate policy, bank credit expansion, sectoral allocation of credit, Prudential guidelines, bank returns, etc.

BANKS & OTHER FINANCIAL INSTITUTIONS ACT

Section 20 of the Act which has the title "Restriction on Certain Banking Activities" prohibits banks without the prior written approval of the CBN from granting any loans, advances, credit facility, financial guarantee or incur liability on behalf of any one person such that the total value of banking accommodation to that one person is in excess of 20% of the bank's shareholders funds unimpaired by losses. This figure has been subsequently increased to 35%, but moves are under way to reduce it to 25% in line with the practice in other dispensations.

For this purpose loans to subsidiaries or associates of a body corporate will all be taken into consideration in determining the percentages. This is what is known as the "single obligor rule". The intention is to avoid a situation whereby a bank is overly exposed to a single company or individual. The position being encouraged is for banks to spread their risks. By so doing, more customers are being financed than would otherwise have been the case and all the bank's eggs are not concentrated in one basket. Diversification is a recognised strategy in portfolio management and a diversified portfolio is less risky than one with pockets of concentration. It is because of this single obligor rule that sometimes the need to have syndications arises.

Also under this section, banks are discouraged from granting loans and advances against the security of their own shares. In other words, loans cannot be granted to a shareholder on the strength of the shares owned by him in the bank or even to a third party using shares held in the bank as security.

Furthermore, under this section, unsecured loans and advances are not allowed unless authorized in accordance with the rules and regulations of a bank and where such rules and regulations require security such security must be obtained and deposited with the bank.

Under the provisions of Section 20(2) of the Act, banks shall not without the prior approval in writing of the CBN permit to be outstanding unsecured advances, loans or unsecured credit facilities aggregating in excess of N50,000.00 to its directors whether or not such loans are obtained jointly and severally. Also officers and employees are precluded from being granted unsecured loans or advances in excess of one year's emolument of such officer or employee. The essence of these provisions is to restrict the granting of unsecured loans and advances generally and in particular to directors, managers, officers and employees of banks and companies or firms in which either the bank by itself or its directors have interests.

Finally under this section, banks are precluded without CBN's prior approval in writing from remitting in whole or in part, the debts owed them by their directors, including past directors.

FAILED BANKS ACT

Under the provisions of Section 19 of this Act, it is an offence for any director, manager, officer or bank employee to grant credit facilities

i) without adequate security or collateral contrary to policy

ii) with no security or collateral contrary to policy

iii) with a defective security

iv) without perfecting the security required

The provisions of this section are couched in a manner as wide as possible such that any one connected with the actual grant of the credit or the approval process could be caught by the provisions.

Also this section makes the granting of interest waiver or debt forgiveness where the borrower is known to have the ability to repay the loan and interest an offence punishable under the Act.

Although it could be argued that the provisions of this Act are only applicable to failed banks or banks whose capital risk to weighted assets ratio is below the minimum percentage as may be prescribed from time to time by the CBN, it should be borne in mind that every bank is a potential failed bank or at least could find itself below the CBN's prescribed ratio in the event of which the provisions of the Act would become applicable.

The prevention of bank failures in Nigeria is an objective that can be realized if the Central Bank of Nigeria (CBN) and the Nigeria Deposit Insurance Corporation (NDIC) exercise the powers respectively vested in them by the Banks and other Financial Institutions Act 1991 (BOFIA) (as amended) and the Nigeria Deposit Insurance Corporation Act 1988 (as amended) strictly, diligently, impartially and fearlessly.

It should be borne in mind that, in order to ensure that every licensed bank keeps within the condition of its licence and approved guidelines, the BOFIA provides in Sections 30 to 38 for routine supervision and special examination or investigation of the books and affairs of a bank by the Director of Banking Supervision of the CBN and the Governor of the CBN.

The NDIC Act also contains provisions for routine and special examination or investigation which are very similar in all essential respects to those of the BOFIA. The main difference is that the powers exercisable by the CBN Governor and the Director of Banking Supervision under the BOFIA are, under the NDIC Act, vested in the Board of NDIC and its Managing Director. A strict, diligent, impartial and fearless exercise of these powers by the CBN and NDIC will reduce, if not prevent, the incidence of bank failures in Nigeria.

Furthermore, since under Section 44 of the BOFIA, every bank is required, before appointing any Director of Chief Executive, to seek and obtain the CBN's written approval for the proposed appointment, it behoves the CBN to always satisfy itself before approving such appointment that the proposed appointee is, by conduct and character, fit to hold office as a Bank Director. If the CBN is meticulous in ensuring that only fit and proper persons are appointed as Bank Directors or Chief Executives, this would help in bringing about good corporate governance in banks and in reducing (if not eliminating) bank failures in Nigeria.

RISK MANAGEMENT ISSUES

I have tried to identify some, if not the most important legal considerations that come to play in Credit Administration before proceeding to highlight some of the legal issues in Credit Risk Control. The rationale for my approach is that getting it right *ab initio* is the crucial first step in Credit Risk Control. This is particularly so as the granting of improper or invalid credits would naturally lead to losses which would invariably jeopardize a bank's chances of survival.

Permit me, gentlemen, to conclude as a Risk Manager, by explaining the relevance of the legislations discussed in this paper to the theory of credit risk management. There are, in theory, three key drivers of credit risk and one driver of portfolio risk.

The drivers of credit risk in an individual exposure are

1. Probability of Default,
2. Exposure at Default, and
3. Loss Given Default.

The first refers to the riskiness of the borrower or counter-party and is analysed by reviewing environmental/industry risk factors as well as financial and non-financial indicators of risk such as market share, profitability of core business, cashflow, leverage, ownership structure, management quality, corporate governance and reputation. Every bank ideally sets its own "risk appetite" and defines its target market based on a calculation of this risk through credit ratings or score cards.

The second factor is the total exposure at risk at the time an obligor defaults.

The third factor, loss given default, is the inverse of the recovery rate.

In simple language, when a bank lends money to a counter-party, its credit risk is a function of the perceived credit-worthiness of the obligor (the higher the worthiness, the lower the risk); the size of the loan (the larger it is, the higher the risk); and the amount that can be recovered through collateral/guarantees in the event of default (the higher the recovery rate, the lower the risk).

Good credit risk management is, therefore, about lending to good customers, setting prudent limits and taking adequate collateral.

As for the total portfolio, the driver of credit risk is diversification/concentration. The more diverse the risk assets held by a bank (by obligor, industry, geography, product, etc), the less risky the bank's portfolio. This is because default in an asset potentially leads to delinquency in correlated assets. The more highly correlated a bank's risk assets are, therefore, the higher the potential losses and loss norms on its portfolio.

We can now see the relevance of legislations governing exposure limits, sectoral allocations, secured lending, corporate governance, regulatory supervision, etc on credit risk.

I shall only add here that some work still needs to be done on the legal side to improve credit risk control. For example, although banks often do take precautionary steps of obtaining adequate collateral for loans to customers, experience has shown that collateral does not often translate into recovery of loans in this country. The legal process is cumbersome and expensive. While it is understood that the courts must protect debtors from exploitative banks, the reality is that many of those who benefit from the protection are crooks who borrow with no intention of paying and who divert funds from the purposes for which loans were explicitly granted/procured. Something needs to be done about this, especially if the middle-class is to gain access to a potentially large mortgage market and begin to own its own abode.

A second example is the issue of bounced cheques. Although there is in the body of laws provision for treating this as a criminal offence, cheques do not count for good security in this country as issuers bounce them with impunity.

There is a need to look closely at these laws, among others, to improve the control of credit risk.

CONCLUSION

It is my hope that I have spoken to the subject from both legal and risk management perspectives. The focus has been on not just highlighting the law, which you all know better than I do, but stressing the logic behind legislation and its roots in risk management best practices.

It is hoped that this modest contribution to the topic will lead to further discussions and comments, as well as reforms of the law.

Thank you once more for this honour and for your kind attention.

SANUSI LAMIDO SANUSI
Executive Director, Risk & Management Control
First Bank of Nigeria Plc
June 2006