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Financial Stability and Depositor Protection: The Nigerian Bridge Bank Mechanism

Content:

Introduction

Events of the past weeks brought into focus the different mechanisms for resolving failing banking institutions in Nigeria, which hitherto were centered on provision of financial assistance. Prior to the recent restructuring, the average Nigerian believed that only two options were open to a bank in financial difficulty: receive money from the government to shore up the bank's capital or be liquidated by the Nigerian Deposit Insurance Corporation (NDIC). Little did most know that the Nigeria Deposit Insurance Corporation Act (NDIC Act) which was passed in 2006 contains other mechanisms by which a bank in dire financial straits may be restructured to infuse confidence within the system and protect depositors of such insured institutions. This newsletter examines the various mechanisms for restructuring failing financial institutions in Nigeria with a special focus on the bridge bank mechanism.

Background

In July 2009, a special audit of the Twenty-Four deposit banks in Nigeria was undertaken by the Central Bank of Nigeria (CBN), with particular focus on their liquidity, capital adequacy, risk management and corporate governance practices.

At the end of the assessment, ten banks were adjudged to be in a grave state with respect to their capital adequacy. Of these, eight of the banks also had significant deficiencies in liquidity, risk management practices and corporate governance policies. The executive management of these eight banks were immediately replaced by CBN appointed management teams while all ten banks received capital injections of approximately N620billion in the form of Tier 2 Capital. The CBN subsequently set September 30, 2011 as the deadline for the recapitalization of these banks by their management teams.

While two of the banks [1] successfully recapitalized, Union Bank of Nigeria, Intercontinental Bank, Finbank, Oceanic Bank International and Equitorial Trust Bank (ETB) have signed Transaction Implementation Agreements (TIAs), which going by CBN's pronouncements, constitute a significant step towards recapitalization.

However, by a press statement dated 5 August 2011 [2] the NDIC announced the closure of three banks, Spring Bank Plc, Bank PHB Plc and Afribank of Nigeria Plc for failing to show ability to recapitalize by the deadline set by the CBN. Bridge Banks were formed to absorb the assets and liabilities of the three banks as follows: Enterprise Bank Limited, [3] Keystone Bank Limited [4] and Mainstreet Bank Limited.[5]

[1] Wema Bank Plc and Unity Bank Plc.
[2] NDIC Press Statement available at http://www.cenbank.org/Out/2011/pressrelease/gvd/NDIC%20PRESS%20RELEASE.pdf, last assessed 30/8/2011.
[3] For Spring Bank Plc.
[4] For Bank PHB Plc.
[5] For Afribank Plc.

Upon assumption of control, the NDIC sold the bridge banks to the Asset Management Corporation of Nigeria, the government's established distressed assets manager which injected N675billion into the banks and appointed executive management teams to run their operations.

Thus, this newsletter examines the issues surrounding NDIC's adoption of the bridge bank mechanism while considering similar practices in the United Kingdom (UK) and United States of America (US).

Mechanisms for Restructuring Failing Financial Institutions in Nigeria

The NDIC as a Regulator works alongside the CBN in matters relating to banks and other financial institutions in Nigeria. The NDIC's statutory mandate is four-fold: (a) insure all deposit liabilities of insured institutions;[6] (b) give assistance to insured institutions in the interest of depositors; (c) guarantee payments to depositors, in case of imminent or actual suspension of payments by insured institutions up to the maximum amount specified in section 20 of the NDIC Act;[7] and (d) act as liquidator of failed insured institution.

With respect to failing financial institutions, the NDIC Act made provisions for three

[6] Section 2(1)(a) of the NDIC Act defines insured institutions as licensed banks and other deposit taking financial institutions.
[7] N200,000 from the Deposit Insurance Fund of licensed banks and N100,000 from the Deposit Insurance Fund of other licensed deposit-taking financial institutions.

resolution mechanisms in the event of a crisis. It provides for the grant of financial assistance where an institution has difficulty in meeting its obligations to depositors and creditors, persistently suffers liquidity deficiency, or has accumulated losses which have nearly or completely eroded its shareholders' fund.[8] Alternatively, the NDIC may take over the management of a failing insured institution until such a time as the institution's financial position may improve.[9]

A third alternative is the adoption of a bridge bank mechanism which would allow bridge banks to assume the assets and liabilities of a failing insured institution pending further resolutions or sale.[10]

Interestingly, save for the provision on financial assistance which may be made at the request of the insured institution, the NDIC Act failed to mention any event or occurrence that will trigger the adoption of the other two resolution mechanisms.

However, it would appear that some triggering events are contained in the Banks and Other Financial Institutions Act, 2004 (BOFIA).[11] That law requires CBN to carry out routine examinations on banks and other financial institutions. It requires the CBN to take legal steps to secure the affairs of institutions as well as protect depositors, where upon an examination it is of the opinion that a bank is in a grave situation.[12] BOFIA also mandates the CBN to turn over the control and management of the troubled bank to NDIC where after taking the requisite steps as above, the affairs of the bank failed to improve.[13]

Significantly, it is only after the NDIC has assumed control of a bank and finds that the bank is under-capitalized[14] that the NDIC may require the bank to submit an acceptable recapitalization plan within a stipulated period.[15] This BOFIA provision seems to be supported by the definition of a "failing insured institution" under the NDIC Act. Section 59 of that Act defines such an institution as one whose capital to risk weighted assets ratio or regulatory capital is below the minimum prescribed by the CBN.

Events in recent past seem to suggest that bank regulators do not follow this particular provision of the Act.[16] Rather, these events suggest that the CBN as the banking supervisor carries out these examinations, and upon detecting such circumstances which in its opinion amounts to requisite triggers, proceeds to direct the affairs of the banks,[17] while also imposing recapitalization requirements.

[8] Section 37 NDIC Act.
[9] Section 38 NDIC Act.
[10] Section 39 of the Act.
[11] Cap B 3 Laws of the Federation of Nigeria 2004.
[12] Section 35 (1)(d) BOFIA.
[13] Section 36 BOFIA.
[14] Where the bank's risk weighted assets ratio is below 5 percent but above 2 percent.
[15] Section 37 (a) BOFIA.
[16] That is section 37 (a) BOFIA.
[17] By appointing managers and directors.

Some may argue that such actions by the CBN serve a crucial purpose, which is to ensure stability as well as enhance confidence within the system. Others, including these regulators may argue that because of the constant collaborations between the CBN and the NDIC, [18] due processes are followed in the regulation of banks. However, going by the process adopted in the case of the eight banks cited by the CBN as shown above, [19] the CBN concluded all resolutions including recapitalization before turning over the management of Spring Bank, Bank PHB and Afribank to the NDIC. Little wonder therefore that this mode of resolution generated many furors within the country, especially from shareholders of the affected banks.[20]

No doubt arguments in favor of stability is supported by the prime position which the CBN occupies in the Nigerian economy, as well as section 2(d) of the Central Bank Act, 2007 which imposes on the CBN the duty of promoting a sound financial system in Nigeria. However, such exercise of powers in relation to those conferred on the NDIC still needs to be clarified to enhance certainty within the system.

While it is clear that the CBN may rely on the provisions of section 35 (2)(b) of BOFIA to require a failing bank to take any steps or actions as may be necessary in relation to its business, which in this case could be read to include recapitalization, one question which springs to mind is at what point does the bank get an opportunity to submit recapitalization plans to the NDIC pursuant to section 37 (a) of BOFIA? Can the bank do this while it is still an under-capitalized failing institution under the NDIC management? If so, at what point then does the NDIC have the power to adopt the bridge bank mechanism as a resolution process? If the intention is to have alternative resolution mechanisms, what circumstances would give rise to the adoption of one as opposed to the other?

These are very crucial areas of uncertainty that should be resolved.

The Bridge Bank Mechanism

BOFIA provides for the NDIC to remain in control of a failing bank until such time as the CBN decides that it is no longer necessary to do so.[21] The NDIC Act also provides that the NDIC may take over the management of a failing institution or direct specific changes to be made in the management of the institution until such time as the financial position of such institution improves.[22]

However, while both BOFIA and the NDIC Act contain extensive provisions on how a

[18] See section 53 NDIC Act,
[19] Page 2 above.
[20] Issues in bank's nationalization, available at http://www.independentngonline.com/DailyIndependent/Article.aspx?id=38857&print=1, last assessed 30/8/2011.

[21] Section 38 BOFIA.
[22] Section 38 (1)(a) and(b).

bank should be controlled when it is put under the NDIC management, nothing was said under BOFIA in relation to the bridge bank mechanism. One explanation could be that the NDIC Act being a 2006 Act is a more recent legislation. However, as we shall see below, no mention was made under the NDIC Act of the events that would trigger the adoption of the bridge bank mechanism.

The NDIC Act provides for the establishment of bridge banks to assume the assets and liabilities of failing insured institutions.[23] It permits the NDIC to advance funds to aid the operation of such bridge banks, as well as appoint and remove members of the board of directors. Typically, the bridge bank will have a life span of two years from the date it was issued a license[24] unless a merger, consolidation or sale causes an earlier termination of its affairs. The NDIC act also made provisions for liquidation of the bridge bank's business upon the end of its life.

Interestingly, the paragraph immediately above contains virtually all the provisions on the bridge bank as a resolution process. No supporting provisions were included; the definition included in section 59 of the NDIC Act merely points to section 39 of the same Act which contains the provisions detailed above, giving an indication that the mechanism was included by the draftsman only as an afterthought. There is also nothing to indicate when and how the mechanism should be adopted.

It is possible to argue that the NDIC can validly adopt the bridge bank mechanism as an option for resolution in view of section 39 of BOFIA. That section allows the NDIC to recommend other resolution measures to the CBN in the event that the bank over which the NDIC has assumed control cannot be rehabilitated. However, if that section is strictly construed, it would appear that such "other resolution measures" (bridge bank inclusive) would only be triggered after the NDIC has assumed control of the failing bank, not before. Nothing in the present scenario with Spring Bank, Bank PHB and Afribank, indicates that the NDIC assumed control before recommending the adoption of the bridge bank mechanism.

This is a crucial area requiring clarification to enhance certainty within the system. It is important to specify the events that would trigger the adoption of the bridge bank mechanism. Where the same events as those that give rise to assumption of management and control of a failing bank are intended, rules should be adopted to promote clarity.

NDIC's adoption of the Bridge Bank Mechanism: the case of Spring Bank, Bank PHB and Afribank

As earlier indicated, the three banks having failed the CBN audit in 2009 were

[23] Section 39 (1).
[24] Except extended to a maximum of three additional one year one year periods.

subsequently bailed out alongside the other 5 banks and mandated by the CBN to recapitalize by September 30, 2011. While other banks had executed Transaction Implementation Agreements, these three banks were yet to have any plan approved by the CBN, leading to the assumption of their assets by the bridge banks, Enterprise Bank, Keystone Bank and Mainstreet Bank.

The nationalization of the three banks has caused a ripple effect and an outcry particularly amongst investors and depositors. It would appear that the issue which generated a barrage of controversy is not really whether the NDIC has the powers to create bridge banks, but the manner in which the exercise was carried out and its effects, particularly that the CBN revoked the licenses of the three banks way before the September 30, 2011 deadline for recapitalization.

Some of the fallouts from the nationalization include panic withdrawals in branches of the three banks across the country and more painfully, panic offloading of bank stocks from the exchange. [25] Furthermore the shares of the affected banks have been placed on full suspension which implies that the shares would be delisted and therefore no longer in existence. Consequently, shareholders appear the worst hit with N32 billion worth of shares believed to have gone with the three nationalized banks.[26] A breakdown of the shareholding structure of the banks shows that Spring Bank had 11.3 billion ordinary shares valued at N9.6 billion, Afribank 13.6 billion ordinary shares worth N9.49 billion, while Bank PHB had 20.2 billion ordinary shares put at N10.7 billion. But at the end of trading on August 5, 2011 when the banks were nationalized, the share prices of the banks were N0.64 for Afribank, N0.57 for Bank PHB and N0.84 for Spring Bank.[27]

The market capitalization of the listed equities on the Exchange, which stood at N7.484tn before the announcement of the nationalization of banks, fell by N339bn or 4.5% to close at N7.145tn as at Wednesday, August 10, 2011.[28] Also, the Nigerian Stock Exchange (NSE) All-Share Index which measures the volume of trading was down by 4.5% or 1,061.69 basis points from 23,397.44, down to 22,335.75 points. The NSE-30 Index, which measures the performance of the top 30 stocks, also fell by 5.2% in the same period, from 1,044.69 to 990.12 points.[29]

These repercussions suggest an apparent lack of certainty within the system. Whilst it is appreciated that regulators should adopt resolution tools that would enhance confidence and stability within the system, these tools ought to be properly aligned

[25] Udeme Ekwere; **NSE begs investors not to dump shares** available at. http://www.punchng.com/Articl.aspx?theartic=Art201108118253131, last assessed 30/8/2011.

[26] Ibid.
[27] Ibid.
[28] Ibid.
[29] Ibid.

with the rights of shareholders of these banks whose interests are affected by the resolution. Thus, the need for clarity on the circumstances that would trigger the adoption of the bridge bank mechanism as well as the other resolution tools cannot be overemphasized.

The UK's Special Resolution Regime

Following the failure of the Northern Rock, the deficiencies of the UK regime to deal with banks in distress which was dependent on the application of corporate insolvency law was exposed. [30] As part of the policy response, the authorities enacted the Banking Act 2009 to strengthen the statutory framework for financial stability and depositor protection. The Act established a Special Resolution Regime (SRR), providing the tripartite authorities, the Financial Services Authority (FSA), Bank of England (BoE), and the Treasury with special tools to resolve failing banking institutions. The UK Banking Act indicates that the main purpose of the SRR for banks is to address situations where all or part of the business of a bank has encountered, or is likely to encounter financial difficulties.

The UK regime consists of three parts: the three stabilization options, the bank insolvency procedure and the bank administration procedure. The stabilization options for failing banks include: (a) transfer to a private sector purchaser; (b) transfer to a bridge bank; and (c) transfer to a temporary public ownership.

The Act provides that the stabilization options may be exercised only when certain preconditions or circumstances are met. These are, that the FSA is satisfied (a) that the bank is failing, or is likely to fail, to satisfy the threshold conditions imposed for carrying on regulated activities under the Financial Services and Markets Act 2000; and (b) that having regard to timing, it is not reasonably likely that action will be taken by or in respect of the bank that will enable it satisfy the threshold conditions.[31]

In addition, special conditions must exist to trigger the BoE's exercise of stabilization powers with respect to private sector purchaser and the bridge bank resolutions tools.[32] Condition A requires that the power be exercised where it is necessary, having regard to the stability of the UK financial systems, to maintain public confidence in the stability of the UK banking systems, and to protect depositors. The BoE must consult the FSA and Treasury before making a determination and deciding how to proceed.

The triggers for the Treasury's exercise of stabilization powers are specified in section 9 of the Act. The first condition is met where

[30] Peter Brieley; **The UK Special Resolution Regime for failing banks in an international context** available at http://www.bankofengland.co.uk/publications/fsr/fs_paper05.pdf, last assessed 30/8/2011.

[31] Section.7 of the Banking Act.

[32] Section 8 of the UK Banking Act.

the exercise of power is necessary to resolve or reduce serious threat to the stability of financial systems of the UK.

Following the implementation of the Act, a Code of Practice was issued in November 2010 to provide guidance on how and in what circumstances the authorities will use the special resolution tools. The Code stipulates that resolution by way of bank insolvency may be the best option where the most appropriate outcome would be the winding up of the affairs of failed institutions in the interest of creditors and where prompt pay outs to eligible depositors or bulk transfer of their accounts to another institution is assured.

Where the public interest considerations weigh in favor of an exercise of a stabilization option, resolution by way of transfer to a private sector purchaser is likely to be the best resolution option if it can be achieved in a cost effective way, and so long as a willing purchaser is readily available.

Furthermore, the Code of Practice explains that resolution by way of transfer to a bridge bank is appropriate where an immediate private sector sale is not possible, and where a stable platform is needed to prepare for and effect the onward sale of all or part of the bank to a private sector purchaser. Temporary public ownership is appropriate only where it is necessary to resolve or reduce a serious threat to the stability of the UK's financial system, such as for instance, where the Treasury has advanced a significant amount of public funds to a failing institution in order to stabilize it prior to its entry into the SRR.

The Act also contains extensive provisions on bridge banks and the transfer of property of a failing bank. It sets out the provisions that a property transfer instrument may contain. It requires that the BoE take appropriate steps to specify in given circumstances which property, rights and liabilities of a failing banking institution have been transferred. It made provisions for operating strategy as well as reporting requirements in relation to bridge banks.

As opposed to the Nigerian provisions, the UK regime contains far reaching provisions to promote certainty within the system.

The US Failing Bank Resolution Process

The Federal Deposit Insurance Corporation's (FDIC) formal resolution process for failing banks typically begins when a financial institution's chartering authority sends a "failing bank letter" advising the FDIC of the institution's imminent failure.[33] This letter provides the requisite trigger upon which the FDIC relies to structure the resolution tool to adopt while it sends out teams to carry out special examination on the failing

[33] Overview of the Resolution Process available at http://www.fdic.gov/bank/historical/managing/history1-02.pdf, last assessed 30/8/2011.

bank in order to identify the bank's assets and liabilities, as well as value the assets.

Typically, the FDIC may adopt any of these three options with respect to a failing bank: (a) sell all or part of the assets of the failing bank to another bank; (b) pay off eligible insured depositors and dispose of the failing bank's assets; or (c) establish a bridge bank to assume the assets of a the failing bank.[34]

The FDIC carefully considers the circumstances surrounding the particular banking institution before settling for a resolution process. It notes that when a large bank with a complex structure, such as a multi-bank holding company is in danger of failing, creating a bridge bank allows it to take control of the bank and stabilize it.[35] The FDIC lists some of the benefits of adopting the bridge bank tool as: (a) granting it sufficient flexibility to market the bank; (b) thorough assessment of the bank's condition and complete evaluation of alternative forms of resolution; and (c) allowing additional time for due diligence by interested parties without interrupting the day to day operations of the bridge bank for its depositors.[36]

Whilst it would appear that Nigeria adopts similar resolutions tools for failing banks as the US especially with respect to the bridge bank process, it is important to point out here that the US made detailed provisions of not only the circumstances that would trigger the adoption of the process, but also of the operational requirements for such bridge banks.

Conclusion

There is no doubt that the NDIC rose to the challenge of promoting financial stability and protecting depositors, albeit at the expense of the shareholders. The bridge bank option constitutes a veritable tool for enhancing depositor protection and promoting confidence by ensuring seamless continuity of banking operations in spite of challenges in the internal structure of a bank and should be appropriately utilized.

While this paper is not advocating for a wholesale adoption of the UK provisions, it is important for Nigerian regulators to consider a review of some of the provisions relating to banking institutions. Being a recent legislation, the UK SRR may provide some useful examples from which to learn. However, given that the UK market is vastly different from what is currently obtainable in Nigeria, only such provisions that would lead to predictable results and ultimately enhance confidence in the Nigerian situation should be adopted.

[34] 12 U.S.C. section 1821 (n).
[35] Bridge Banks available at http://www.fdic.gov/bank/historical/managing/history1-06.pdf, last assessed 30/8/2011.
[36] Ibid.

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