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Review

Risks and liquidity management issues in Nigerian banks

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Sunday C. Nwite

Department of Insurance and Risk Management Enugu State University of Science and Technology ESUT– Enugu

Author's Email: nwitewhite2006@yahoo.com
Tel:+23480-37743134

The paper evaluated various risks and liquidity management issues in Nigerian banks. Liquidity management involves the routine control of the level of liquidity in the economy in order to maintain monetary stability. This will help to strike a balance between inflation and deflation. The source and size of liquidity would suggest the type of securities the Central Bank of Nigeria (CBN) would need to introduce. In Nigeria, the main sources of liquidity include, the federal government fiscal operation, earning from oil; especially the monetization and sharing of the oil windfall; and the excess creation of credit by Deposit Money Banks. The broad objective of liquidity management in Nigerian banks include to facilitate efficient operations as well as to foster overall development of the money market and maintain a stable banking system and to maintain an optimum level of liquidity that is consistent with non-inflationary growth, through the use of market-based techniques, among other things. However, it was discovered that the major challenges confronting monetary policy liquidity management in Nigeria are excess liquidity and dearth of appropriate intervention securities. This study further examines the various strategies used by CBN to combat these challenges. These include, Open Market Operation (OMO), Cash Reserve Requirement (CRR), discount window operations, Interest Rate Regulation, Deposit Insurance and the withdrawal of public sector funds from Deposit Money Banks to the CBN. Liquidity and the distress syndrome in Nigerian banks were traced, while stating the implications of effective liquidity management in Nigerian banks. This paper recommended that CBN should design more durable instruments, ensure that Fiscal Responsibility Bill (FRB) is passed and fully implemented, build more branches and always publish realistic data to enable CBN formulate up-to-date monetary policies to ensure effective liquidity management in Nigerian banks.

Key words: Liquidity risk, CAMEL rating, monetary policy, fiscal policy, reserve requirements, distress syndrome

INTRODUCTION

Liquidity management involves the routine control of the level of liquidity in the economy in order to maintain monetary stability. This is necessary because an excess supply of money will result in an excess demand for goods and services, which would lead to rising prices, exchange rate depreciation and/or deterioration of the balance of payment position. The major problems confronting monetary policy management by Central Bank in developing countries are excess liquidity and dearth of appropriate instrument securities. To overcome these problems, Central Banks of Nigeria introduced various intervention instruments side by side with existing government treasury securities. Consequently, the CBN has introduced a number of other measures, including the issuance of its own intervention instrument (CBN Certificate) in 2001 to complement the traditional instruments to help manage liquidity in a more effective manner. This paper therefore evaluates risks and liquidity issues in Nigerian Banks.

The concept of risk

Risk has different definitions; A lot of authorities have defined risk in various ways.

Hansel (1999), defines risk as chances of loss; chances of mishap. Mordi (1989) defines risk as chances of miscalculation, chances of an event happening or not happening. All these definitions stress on one thing (loss or mishap). For the purpose of this paper, we define risk as the chances of financial loss.

Risk can be classified into six but paired into three; pure and speculative risk, particular and fundamental risk, static and dynamic risk and most recently systematic and unsystematic risks.

- Pure risk are said to be risks that have chances of occurring and not occurring, that is loss or no loss.
- Speculative risks are risks that have three chances: loss, no loss and gain. It is uninsurable risk. For instance if one is a car dealer who buys some vehicles for sale, it is either that such vehicles are sold at exact price (no loss no gain) or with gain or loss. (Austin, 2001)
- Particular risk: A risk can be said to be particular when the impact affected a particular person and it is not universal in nature and the origin can be traced. For instance, if one hired a vehicle to carry goods from Lagos to Enugu, and on the road accident occurred and the goods were damaged. The loss has only affected one particular person.
- Fundamental risks are those risks which the origin is not traceable to a particular person and the impact is always universal in nature. Example; flood risk, unemployment risk, earthquake, storm etc. These are the types of risks that once it occurs, it affects so many people and it is caused by Act of God. (Nwude, 2003)
- Static risks: A risk is said to be static when it does not change with environment like earthquake, flood, drought, etc. whether the economy is good or bad, it does not determine the happening of such risks. It is called natural occurrence.
- Dynamic risk on the other hand is such risk which happens because the other (dependent and independent) variables. The political instability in the economy made foreign investors not to invest in Nigeria, the level of poverty in Nigeria has made fraudulent act to grow. These are examples of dynamic risks.

Currently a new classification of risk was introduced, systematic and unsystematic risks. This is more familiar to financial experts and organizational managers.

The activities of Nigerian banks

The activities of Nigerian banks can simply be referred to as the functions of Nigerian commercial banks. For the purpose of clarity, we shall discuss these activities of commercial banks on two separate headings; primary activities and secondary activities.

Primary activities of commercial banks

The primary activities (functions) of commercial banks are as follows:

i. Accepting Deposits: This has to do with money deposited / kept by customers in the bank for safe keep. This is the most important activity of a commercial bank. Commercial banks mobilize deposits from the public depending on the type and nature of deposit and funds deposited with banks also earn interest. (Anyanwokoro, 1999)

ii. Granting of Loans and Advances: This is the second important activities of a commercial bank. Funds mobilized from customers who have enough fund to save in the bank are used by banks to give out loan and advances to customers that are in need of funds for investment. Such loans and advances are given to members of the public and the business community at a higher interest rate than allowed by banks on various deposit accounts. This is because there is no total regulations of interest charged by banks. (Ugwuanyi, 1999)

Secondary activities of commercial banks

The secondary activities (functions) of commercial banks are as follows:

i. Undertaking safe custody of valuables, important documents and securities by providing safe deposit vault lockers.

ii. Issuing letters of credit, travelers cheques, circular notes etc.

iii. Providing customers with facilities of foreign exchange.

iv. Transferring money from one place to another and from one branch of the bank to another.

v. Standing guarantee on behalf of its customers, for making payment for purchase of goods, machinery etc.

vi. Collecting and supplying business information

vii. Issuing demand drafts and payment orders.

viii. Providing reports on the credit witness of customers

ix. Agency services

x. General utility services.

Other services of commercial banks

In this modern time, banks have made their services increasingly convenient through electronic banking. They have made tremendous improvement in their service delivery. The range of services offered differs from bank to bank depending mainly on the type and size of the bank. Internet banking has changed the operation of banking industry. (Anyafo, 1994).

Various types of risk that arises in the activities of Nigerian banks

Liquidity Risk

The danger of a bank running out of cash when cash is needed to cover deposit withdrawals and to meet the credit request of good customers is known as liquidity risk. If a bank cannot raise cash timely it is likely to loose many of its customers and suffer loss in earning from its owners. If the cash shortage persists, this may lead to runs on the bank and ultimate collapse.

Credit Risk

This is a type of financial risks resulting from customers' inability to service or pay bank borrowed fund and the interest charged on the principal. When borrowing customers fail to make some or all their promised interest and principal repayments, these defaulted loan and securities result in losses that can eventually erode with bank's capital. When ever a bank gives out any credit facility it is expose to credit risk. (Sanusi, 2010)

Operating Risk

Banks also face significant operating risk due to possible breakdown in quality control, inefficiencies in producing and delivering services, or simple errors in judgment determined by management fluctuations that affects the demand for each bank's services.

Interest Rate Risk

The probability that fluctuating interest rates will result in significant appreciation or depreciation of the value of and the return from the bank's assets is known as interest rate risk.

Exchange Risk

Large banks face exchange rate risk from other dealings in foreign currency due to fluctuations in exchange rate. (Nwude, 2003).

Crime Risk

Banks encounters significant crime risk, fraud or embezzlement by bank employee or directors can weaken a bank severely and in some instance lead to its failure. In fact, fraud and embezzlement from insiders constitute one of the prime causes of recent bank failures. The focus of bank robbery has shifted somewhat with changes in banking technology. Theft from ATMs and from persons using other money machines have become one of the most problematic aspects of bank crime risk today.

liquidity management in Nigerian banks

CAMEL model means Capital Adequacy, Asset quality, Management experience, Earning strength, and Liquidity levels. Meanwhile, this section will highlight the liquidity aspect of credit risk management.

Liquidity management involves the routine control of the level of liquidity (money in circulation) in the economy in order to maintain monetary stability.

This is necessary because an excess supply of money will result in inflation (excess demand for goods and services which would lead to rising prices), exchange rate depreciation and/or deterioration of the balance of payments position (Nwabueze, 2000).

The major problems confronting monetary policy management by Central Banks in developing countries as stated earlier are "excess liquidity and dearth of appropriate intervention securities". To overcome these problems, Central Banks in these countries have introduced various intervention instruments. Consequently the CBN introduced a number of other measures, including the issuance of its own intervention instrument (CBN Certificate) in 2001 to complement the traditional instrument to help manage liquidity in a more effective manner.

The source and size of liquidity would suggest the type of securities the Central Bank would need to introduce. In Nigeria the main sources of liquidity include the federal government fiscal operation; earnings from oil, especially the monetization and sharing of oil windfall and the excess creation of credit by deposit money banks. Resulting from the expansionary fiscal operations of the three tiers of government in the last few years, which were financed mainly through the CBN by Ways and Means of Advanced to the government, excess liquidity has persisted in the economy.

There is therefore the need for CBN to design more durable instruments to manage the anticipated liquidity.

Objectives of liquidity management in Nigerian banks

The main or broad objectives of liquidity management in Nigerian banks are:

- To facilitate efficient operations as well as foster overall development of the money market and maintain a stable banking system.
- To maintain an optimum level of liquidity that is consistent with non-inflationary growth, through the use of market-based techniques.
- To promote the safety and soundness of financial institutions through on-going evaluation and monitoring, including the assessment of risk management system, financial conditions and compliance with laws and regulations.

Strategies of liquidity management in Nigerian banks

Given the size of the excess liquidity in the economy, a number of options as well as strategies would be required in designing the liquidity management strategies (intervention instruments) in the Nigerian banking industry. The system of seeking to manage excess liquidity put the CBN in the defensive, as banks are sometimes compelled to find ways and means to mop-up excess liquidity, for which there are no ready-made instruments (Anyafo, 1994).

Central Bank of Nigeria has made relative success in the application of indirect monetary tools to manage shortage and excess liquidity in Nigeria.

To enable banks manage liquidity shortages. To be able to do this, an enabling environment is consciously created overtime by adapting appropriate policy actions. The government therefore sources all borrowing requirement from the capital market. This has the effect of drawing excess liquidity in the system on a continuous basis, thereby making credit institutions to begin each day with shortages.

Against the backdrop, the introduction of medium to long term instruments by the CBN was designed to reduce excess liquidity in the economy to the level that would enable the bank to adopt the strategy of managing liquidity shortages and thereby ensurimg effective implementation of monetary and foreign exchange operations.

Open Market Operation (OMO) has remained the primary instrument of monetary management in Nigeria; since 1993, Open Market Operation (OMO) conducted mainly in Nigeria Treasury Bills (NTBs). However, the paucity of Nigerian Treasury Bills necessitated the rise of the Nigerian Treasury Bonds in the secondary market for the conduct of Open Market Operation in 2004.

These are complemented by Cash Reserve Requirement (CRR), discount window operations and the withdrawal of public sector funds from deposit money banks to the CBN

CAMEL model it also one of the Central Bank of Nigeria's strategies or tool for determining financial conditions of banks in Nigeria.

It may be further remarked that the rationale for imposing minimum capital adequacy regulations on banks arises out of moral hazard due to their shareholders limited liability, which creates an incentive for banks not to protect themselves against negative shocks to profits that are larger than their existing equity base. Banks have an incentive to take on large amounts of lending risks and to minimize their own equity base. This would mean that depositors are exposed to significant risks of capital losses. One solution is for deposit contracts to reflect that risk and to thereby discipline bankers.

Deposit insurance is also another strategy. This has to be accompanied by direct capital adequacy regulations that penalizes banks for maintaining insufficient equity buffer, and thereby exposing taxpayers to the risk of capital losses (Somoye, 2008)

Challenges of liquidity management in Nigerian banks

Inspite of the significant efforts to address the problems of excess liquidity in the Nigerian economy, the CBN still faces a number of challenges in trying to achieve an effective and efficient mechanism for liquidity management.

- First, fiscal expansion and the concomitant large fiscal deficits have militated against the efficiency of liquidity management in Nigerian.
- In particular, the monetary financing of large fiscal deficits and the monetization of excess crude oil receipts have continued to pose serious challenges to liquidity management in the country.
- Furthermore, there is the challenge of the country having limited number of bank branches and absence of banking facilities, especially in the rural areas where access to banking services is practically impossible for a large sectors of the population. This has led to a great number of financial transactions still being carried out outside the banking system.
- Another major challenge is the problem of inefficient payment system in the country. Until recently, up-counting cheques used to take about 21 working days to get cleared, while intra instruments take 12 days.
- Finally, the poor data quality from banks and other sources poses a great challenge for liquidity management in Nigeria. The indirect approach which the CBN currently employs to manage liquidity in the banking system requires up-to-date information and monitoring. The lack of high frequency and reliable data renders economic analysis difficult. Thus, the unrealistic data returned by banks and other sources undermine the setting of accurate targets.

Liquidity and the distress syndrome in Nigerian banks

A bank that is illiquid or insolvent or both is distressed and therefore in crisis. If many banks in a country are distressed to the extent that it becomes systemic, the country can be said to be having banking crisis. It therefore implies that banking crisis can be in a bank or a country or a region. As a matter of fact, if many banks are in crisis in all the regions of the world at the same time, global banking crisis can ensure even though the situation has not degenerated to that extent. It does follows that a typology of banking crisis is easily discernable.

- Illiquid but solvent
- Insolvent but liquid
- Liquid and insolvent

Also, degrees of banking crisis are continuum from mild to severe. Banking crisis become severe when a bank reveals most of or all of the following conditions:

i. Gross under-capitalization involved to the level and character of business.

ii. High level of non-performing loans to total loans.

iii. Illiquidity reflected in the inability to meet customers' cash withdrawals and / or persistent overdrawn position of with the CBN.

iv. Low earning resulting in huge operational losses, and

v. Weak management as reflected by poor asset quality, insider abuse, inadequate internal controls, frauds, including unethical and unprofessional conduct, squabbles, high staff turnover etc.

i. bank runs that lead to the closure, merger, takeover by the public sector of one or more financial institutions;

ii. if there are no runs, the closure, merger, takeover or large-scale government assistance of an important financial institutions or group of institutions that marks the start of a string of similar outcomes for other financial institutions.

The CBN and NDIC (2002) have adopted this definition and specify that a systemic banking crisis would be said to have occurred in Nigeria when at least one of the following situations arises:

i. The bank(s) that are critically distressed control 20% of the total assets in the industry.

ii. 15% or more of the deposit are threatened and

iii. 35% of the banking system's total loans are not performing.

There is need also to emphasize that banking crisis is not synonymous with banking instability, of course, banking crisis if not adequately managed and curtailed could result to banking instability. Instability in the banks is not making adequate profit.

Implication of effective liquidity management in Nigerian banks

The implications of effective liquidity management in Nigerian banks are not far-fetched, being highlighted as follows:

i. It leads to stability in the banking sector of the economy.

ii. It enhances an efficient payment system which promotes timely clearing and settlement of financial obligations.

iii. It facilitates efficient operations as will foster overall development of the money market and maintain a stable banking system.

iv. Effective liquidity management helps the Central Bank of Nigeria to use instruments of monetary policy effectively

v. It helps to maintain an optimal level of liquidity that is considered with non-inflationary growth, through the use of market-based techniques.

vi. It promotes the safety and soundness of financial institutions through on-going evaluation and monitoring including the assessment of risk management system, financial conditions and compliance with laws and regulations.

vii. Finally, it facilitates economic growth and development of Nigeria.

Conclusion

In conclusion, it was discovered that liquidity management is very important in Nigerian banks. This is because it helps to control the level of liquidity (money in circulation) in the Nigerian economy at large. However, the problems confronting monetary policy management by central bank are excess liquidity and dearth of appropriate intervention securities. These have made such economics to introduce various intervention instruments side by side with existing government treasury securities. Consequently, CBN has introduced a number of other measures, including the issuance of its own intervention instrument (CBN Certificate) in 2001. Central Bank of Nigeria has made relative success in the application of indirect monetary tools to manage shortages of excess liquidity in the Nigeria banking system. Be that as it may, there is still room for improvement to ensure efficient and effective banking sector that could be compared to that of the developed economies.

Recommendations

From the findings of this study, the following recommendations were made:

i. There is need for the CBN to design more durable instruments to manage the anticipated liquidity.

ii. Government should always ensure that the fiscal Responsibility Bill is passed by the National Assembly and fully implemented.

iii. The urgent implementation of the Wide Area Network (WAN) in the banking system by bank is highly recommended.

iv. Banks should build more branches especially in the rural areas.

v. There is the need for government and banks to collaborate in developing efficient and reliable payment system in Nigerian e.g. RTGs should be embraced.

vi. Banks should endeavor to publish realistic data to enable the CBN to make up-to-date policies to manage the banking sector of the country.

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