
The Future of Nigerian Banking System: Separate Structures and Holding Company Arrangement

Content:

Abstract

Background

Recent CBN Regulations

Holding Company Arrangement

Conclusion

Abstract

The Central Bank of Nigeria (CBN) recently reviewed the universal banking model in favour of separate banking licenses under the Banks and Other Financial Institutions Act (BOFIA).¹ The Regulations² require banks to divest from all non-banking businesses and obtain fresh licenses to operate as commercial, merchant, specialized or development banks. This newsletter examines some of the issues surrounding the recent regulatory requirement.

Background

The Universal Banking (UB) model adopted in 2001 allowed Nigerian banks to diversify into non-banking businesses, as against the banking businesses specified under BOFIA, including the business of receiving deposits or current account, savings account or other similar account, paying or collecting cheque drawn by or paid in by customers, provision of finance or such other business as the Governor of CBN may, by order published in the Gazette, designate as banking business.³ However, banks did not immediately diversify until the post-consolidation exercise in 2005 when they experienced significant boost in their capital, causing the big banks to diversify into non-banking businesses, including insurance, stock broking and other proprietary trading in capital markets. The UB model currently practiced in Germany represents a structural form of integration where banks combine commercial and investment banking within a single corporation but conduct other financial activities through separately

¹ Cap B 3 Laws of the Federation 2004

² CBN Regulation Nos. 1, 2 & 3, 2010

³ Section 66 BOFIA



capitalized subsidiaries owned by the universal bank. The German grossbanken (“big banks”), including Deutsche Bank and Commerzbank are organized in this way as are many regional banks.⁴

The CBN Governor, Mallam Sanusi Lamido Sanusi, in a recent address titled “Reform of the Nigerian Banking System”⁵ announced a new model under which banks would no longer be allowed to invest in non-bank businesses. He said that banks wishing to continue with such investment would be required to divest or spin-off the businesses to holding company that will be licensed by the CBN as other financial institution. This followed an earlier speech⁶ where the Governor announced CBN’s proposal to adopt the “Volcker Rule” or some version of Glass-Steagall in the Nigerian banking industry. These represent present and past banking regulations in the United States of America (US). The US Banking Act of 1933 (also known as the Glass-Steagall Act) separated commercial and investment banking. It prohibited commercial banks from engaging in brokerage, insurance, real estate and most underwriting activities. It also prohibited investment banks and insurance companies from engaging in commercial banking activities. The reasoning behind the Glass-Steagall Act was the widely-held belief, at the time, that the US bank failures of 1930-1933 resulted from the risks banks took in the stock

market. Thus, the Act effectively erected a wall between commercial and investment banking.

The “Volcker Rule”⁷ on the other hand is a recent promulgation in the US in response to the global crisis and makes improvements to regulation of banks and savings associations holding companies and depository institutions. It prohibits insured depository institutions from engaging in proprietary trading; or acquiring or retaining any equity, partnership or other ownership interests in or sponsoring hedge funds or private equity funds. Section 619 of the Dodd-Frank Act (to be codified at 12 U.S.C section 1851(h)(4)) defines “Proprietary trading” as engaging as a principal for the trading account of a banking entity or supervised non-bank financial company in any transaction to purchase or sell, or otherwise acquire or dispose of, any security, any derivative, any contract of sale of a commodity for future delivery, any option on any such security, derivative, or contract, or any other security or financial instrument that the appropriate Federal banking agencies, the Securities and Exchange Commission and the Commodity Futures Trading Commission (US Regulators) may, by rule as provided in subsection (b)(2) determine.” This means that the types of investments which the Volcker Rule prohibits are those made for the “trading accounts” of a banking entity or supervised non-bank financial entity. Even then, the scope of the “trading account” is limited to cover only “near term” transactions or transactions that involve “short-term price movement.”⁸ The Act however permits US Regulators to

⁴ See www.oecd.org for *Harold D. Skipper, Jr*; Financial Services Integration Worldwide: Promises and Pitfalls

⁵ See www.cenbank.org for Keynote Address on “Reforms in the Nigerian Banking System;” September 23, 2010

⁶ See www.cenbank.org for “The Nigerian Banking Industry: what went wrong and the way forward” delivered at a Convocation at Bayero University, Kano on February 26, 2010; Page 17

⁷ Implemented by Title VI of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) and named after former Federal Reserve Board Chairman, Paul Volcker

⁸ See www.skadden.com for “Skadden Commentary on the Dodd-Frank Act;” July 9 2010



expand the scope of definition of “trading account” whenever they deem it necessary.

Recent CBN Regulations

The CBN recently released Licensing Regulations⁹ to back its policy statements, which effectively repealed the UB guidelines in favour of licenses permissible under BOFIA. These Regulations require Nigerian banks to restructure as:

- a) solely commercial banks,¹⁰ in which case they would be required to operate as:
 - i) Regional banks within a minimum of six or maximum of twelve contiguous states in Nigeria and not more than two Geo-Political Zones, as well as within the Federal Capital Territory (FCT Abuja). “Geo-Political Zones” means the geo-political grouping of states constituting the Federal Republic of Nigeria, including North Central Zone, North East Zone, North West Zone, South East Zone, South West Zone and South South Zone;
 - ii) National banks with operations within every state of Nigeria; or
 - iii) International banks with operations in every state, as well as offshore operations in any country of choice with the approval of CBN.

“Permitted Activities” for such commercial banks are specified in section 3 of the Regulation. Most importantly, however, these commercial banks are prohibited from engaging in the following activities:

- i) Insurance underwriting
- ii) Loss adjusting
- iii) Re-insurance
- iv) Asset management
- v) Issuing house and capital market underwriting services
- vi) Investment in equity and hybrid-equity instruments save and except for those investments permissible under BOFIA
- vii) Proprietary trading, save as permitted by the Regulation
- viii) Provision of financial advisory services other than in accordance with the provisions of section 3(h) of the Regulation; and
- ix) Any other business activities that may be restricted by CBN from time to time.

- b) Nigerian banks may also restructure solely as merchant banks. These banks are required to undertake most of the activities prohibited from commercial banks.¹¹ They are, however, prohibited from accepting deposit withdrawals by cheque, granting retail loans or engaging in any form of retail banking, holding equity interest acquired in a company for more than six months while managing an equity issue and providing insurance underwriting services, loss adjusting, re-insurance or other related insurance activities.¹²
- c) A third category of banks permitted under the Regulations¹³ are classified as specialized institutions, including non-interest banks (regional and national), primary mortgage

⁹ www.cenbank.org

¹⁰ Regulation No. 1, 2010

¹¹ Section 3 Regulation No. 2, 2010

¹² Section 4 Regulation No.2, 2010

¹³ Regulation No. 3, 2010



institutions, microfinance banks, development banks and discount Houses.

These Regulations seem to support the pronouncement of the Governor of CBN relating to the intention of CBN to restructure Nigerian banking industry in line with the "Volcker Rule" or some version of "Glass-Steagall." It would appear that, just like the Volcker Rule, the Regulation¹⁴ permits trading transactions in government securities and on behalf of customers. However, while the Volcker Rule specifically allows deposit institutions to engage in underwriting and market-making transactions, to the extent that they do not exceed near term demands of clients, customers, or counterparties,¹⁵ the CBN Regulation for deposit institutions categorically prohibits underwriting (insurance, issuing houses and capital market underwriting services). Furthermore, Volcker Rule permits certain risk-mitigating hedging for insured depository institution's holdings, and investments in small business investment companies, public welfare, and qualified rehabilitation expenditures.¹⁶ Most of these seem to have been prohibited by the CBN. In addition, while the Volcker Rule makes provisions for US Regulators to permit additional activities to the extent that they promote and protect the reliability of banking organizations as well as the financial stability of the US, CBN's Regulations appear to have placed a cap on permitted activities.

Nigerian banks are required to submit plans of ensuring compliance with CBN Regulations no later than ninety days from 4 October 2010 (when the Regulations became effective).

¹⁴ Regulation No. 1, 2010

¹⁵ See www.skadden.com for "Skadden Commentary on the Dodd-Frank Act;" *ibid*

¹⁶ *ibid*

Volcker Rule, on the other hand, would only become effective upon the earlier of two years after its enactment or 12 months after the issuance of final rules. Even after the Rule becomes operative, banking organizations would be given additional two years within which to divest or discontinue prohibited activities.¹⁷ The Rule permits US Regulators to grant specific one year extensions for up to three additional years to enable required transitions and wind down.¹⁸ Where there are outstanding contractual obligations, Volcker Rule empowers the Board of Governors of the Federal Reserve System to grant a banking organization a single extension of up to five years to take or retain its ownership interest in, or provide additional capital to, "illiquid funds," during which time the organization would be allowed to make additional investments in illiquid funds pursuant to its contractual obligations.¹⁹ The wordings of CBN Regulations seem to suggest full compliance (from an uncertain date), notwithstanding any contractual obligations. Therefore, where Nigerian banking institutions fail to draft their planned divestment to accommodate outstanding contracts, they may be exposed to litigations notwithstanding that the divestments were made in compliance with regulatory requirements.

In his key note address of September 2010, the Governor of CBN also stated that banks wishing to continue with their non-bank investments would be required to "spin-off" their businesses to holding companies that would be licensed by the CBN as other financial institutions. It would appear that by this pronouncement the CBN has allowed a "holding company structure" in the Nigerian banking industry. It is therefore necessary to

¹⁷ *ibid*

¹⁸ *ibid*

¹⁹ *ibid*



briefly examine the “bank holding company model” practiced in other jurisdictions, for instance the US.

Holding Company Arrangement

The meaning of “holding company” in Nigeria can be gleaned from the definition of the term “subsidiary” in section 338(1) of the Companies and Allied Matters Act (CAMA).²⁰ The section defines a company as a subsidiary of another if:

- a) the latter company –
 - i) is a member and controls the composition of its board of directors; or
 - ii) holds more than half in nominal value of its equity share capital; or
- b) it is a subsidiary of another company which is the company’s subsidiary.

The expression is given further elucidation in subsection (5)²¹ where the Act states that “a company shall be deemed to be the holding company of the other if the other is its subsidiary.”

The US adopts Bank Holding Company (BHC or US BHC) arrangement; typically, this involves an arrangement where a non-operational company owns all the shares in separately incorporated and capitalized sectoral subsidiaries. The Bank Holding Company Act of 1956 was the first legislation to regulate Bank Holding Companies (BHCs) in the US. It defines a “BHC” as any company which has control over any bank or over any company that is or becomes a BHC by virtue of the Act.²² A company is said to have control of another if:

- a) the company directly or indirectly or acting through one or more persons owns, controls or has power to vote 25 per centum or more of any class of voting securities of the bank or company;
- b) the company controls in any manner the election of a majority of directors or trustees of the bank or company; or
- c) the Board of the Federal Reserve System determines, after notice and opportunity for hearing, that the company directly or indirectly exercises a controlling influence over the management or policies of the bank or company.²³

A US BHC may engage in banking and non-banking investments (mortgage banking, consumer and commercial finance and loan servicing, leasing, collection agency, asset management, trust company, real estate appraisal, financial and investment advisory activities, management consulting, employee benefits consulting, career counseling services and certain insurance-related activities). A BHC can also make investments in companies engaged in activities that are not closely related to banking, but these investments must not exceed 5 percent of the target company’s voting stock. While the US Securities and Exchange Commission and the Federal Deposit Insurance Corporation (FDIC) regulate federal depository institutions, BHCs are regulated by the Federal Reserve System. In spite of the extent of permitted activities, US banks remained largely segregated under the Bank Holding Company Act until the Gramm-Leach Bliley Act of 1999 (also known as the Financial Services Modernization Act), which allowed BHCs to declare as Financial Holding

²⁰ Cap C20 Laws of the Federation of Nigeria, 2004

²¹ Section 338 CAMA

²² Section 2(a)(1)

²³ The Bank Holding Company Act 1956; section 2(a)(2)



Companies (FHCs). These companies were allowed to engage in financial activities, including securities underwriting and dealing, insurance agency and insurance underwriting activities, and merchant banking activities. The Financial Services Modernization Act granted FHC, a hybrid form of BHC, additional authority to make financial investments. The combination of the Glass-Steagall Act and Gramm-Leach Bliley Act, however, limited the ability of BHCs to engage in commercial, insurance, and other non-bank financial activities.

What the Volcker Rule has now done, is prohibit depository institutions (most of which constitute subsidiaries of BHCs) from engaging in the proprietary trading activities defined above.²⁴

BHC structures are known to have some advantages, one of which is the cost effect the group enjoys, mainly from scope of production and operational efficiencies. BHC structure allows corporations to engage in multiple activities which they would, otherwise, have been unable to engage in if they were acting in separate capacities, allowing affiliates to leverage on the success of other parts of the enterprise. BHCs' engagement in greater product range may enhance their earning potential and thus, increase profit. Similarly, a holding company arrangement may result in consolidated tax arrangement requiring contribution from all the companies within the group, and this may ultimately create some tax advantage to the group. However, depending on the jurisdiction, the holding company must own a certain level of stock, usually between 50-80 percent, to be able to file a consolidated tax return. A significant disadvantage occurs where separate tax returns are required to be filed for the parent company and the

subsidiary(s), and where inter-corporate dividends are subject to additional tax. In spite of these advantages, the holding company arrangement also has a number of weaknesses. The holding company may make unsound loan or risky investment to an affiliate, which could jeopardize the financial resources it has to support other subsidiaries. Furthermore, it is not always possible to insulate banks from holding company problems. Situations may arise where the holding company may be financially exposed, and thus place pressure on the subsidiaries to engage in risky investments.

Going by its recent pronouncements, it appears that the CBN has adopted a version of the Glass-Steagall Act on the one hand, thus completely separating commercial banks from investment banks and other specialized institutions. On the other hand, it creates a BHC arrangement in Nigeria. What is unclear, however, is whether these BHCs will be allowed to undertake the full complement of services that BHCs were allowed to undertake in the US. It would appear from CBN's pronouncements that Nigerian BHCs would be allowed to own insurance, asset management and other investment banking subsidiaries, such that affiliates of depository institutions could engage in the non-bank activities prohibited under CBN Regulations. Under this arrangement, banks have the choice of moving certain activities that were previously conducted in-house, or in a subsidiary of the bank, to an affiliate outside of the bank.

Furthermore, it is clear that Nigerian BHCs would be regulated as other financial institutions; however, the nature of relationship between the holding company and companies comprised under it, and between banks and non-bank affiliates remains unclear. For instance, it is unclear

²⁴ See also section 619 of the Dodd-Frank Act.



whether a non-operating holding company option is allowed or whether holding companies are required to be operating companies. There is also no legal or regulatory framework to insulate banks from financial problems that might occur in the holding company affiliates of the banks, such as “firewall provisions” to regulate bank lending to holding company affiliates, requirements that transactions with affiliates be on market terms, and provisions that would prevent holding companies from extracting excessive dividends from banks enough to deplete banks’ capital. Presently, the framework for operating BHCs in Nigeria seems to be hugely inadequate with significant cost implications for restructuring that are yet to be addressed; this could explain why majority of banks in Nigeria have chosen to divest their interests and restructure their operations to fit into the categories (commercial, merchant and specialized banks) specified by the CBN.

If reports in the media are anything to go by,²⁵ it would appear that Nigerian BHCs are required to be non-operating. It might also be safe to assume that the BHCs are required to adopt the form specified in section 338 of CAMA. This would mean that banks held as subsidiaries of the holding company must be de jure controlled by the parent holding company. That is, the parent must own a majority of the bank’s shares. The difficulty would then be the criteria to adopt in determining the remaining shareholding. Since no other indication is given, it would also appear that the other financial institutions affiliates of the bank must also be de jure controlled by the parent holding company in line with CAMA. Furthermore, it would appear that the parent holding company and its downstream holdings will be subject to

consolidated supervision with a risk-based focus. This means that supervision will focus on those activities of the group that may pose material risks to the bank and other regulated financial institutions which form part of it. However, it is unclear whether the holding company group will be subject to consolidated capital adequacy requirement or whether the parent holding company and respective subsidiaries will be subject to capital requirements as prescribed by the CBN in line with their nature of business. The latter appears to be the most logical option, as consolidated capital adequacy requirement may expose banks to greater risks.

Conclusion

Media reports suggest that because of the perceived difficulties and complications associated with adopting the holding company arrangement, Nigerian banks are currently interested in divesting their non-bank subsidiaries and re-structuring their operations to form commercial, merchant banks and other specialized institutions as required by the CBN.²⁶ This may not continue, as some may subsequently decide to form BHCs; there are reports that First Bank and Skye Bank plan to adopt the holding company option.²⁷ Without adequate legal and regulatory frameworks, such arrangement may pose significant difficulties and create complications within the Nigerian banking and financial system. There is, therefore, the need to provide appropriate frameworks for a BHC arrangement. Only a proper definition of the holding company model, ownership structure and nature of operation, as well as relationship with the stand-alone model, would ensure stability within the system.

²⁵ www.vanguardngr.com

²⁶ Ibid

²⁷ Ibid

Disclaimer: This document serves merely as a note and is not intended to provide legal advice to any person or group of persons whether natural or corporate regarding the issues discussed herein. All persons desirous of legal advice should therefore contact a lawyer. Aina Blankson LP shall not be liable for any breach or loss resulting from reliance on any part of this newsletter.

For further information, please contact:

- *Abayomi Alabi* a.alabi@ainablankson.com
- *Chinonyelum Uwazie* c.uwazie@ainablankson.com
- *Kanayo Okoye* k.okoye@ainablankson.com
- *Paul Okonji* p.okonji@ainablankson.com