Zenith Economic Quarterly

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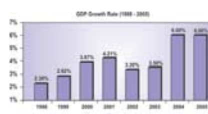

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Despair, Dilemma... And Now Hope!

Nigeria's chequered experience at economic growth and development illustrates the many definitions of 'reform'and 'transformation' in the literature. Nigerians generally seem agreed on the essence of economic reform- a paradigm shift from government's control of 'commanding heights' of the economy (with the dominance of 'state owned enterprises'), to a market determined, private sector led, economic growth and development (with government limited to its traditional sovereign functions and nominal role of regulatory intervention). However, there seemed to be no consensus on how to handle the cost and forgone alternatives required to effect the shift.

The Nigerian nation-state (apologies to critics) has truly transformed-from the era when Agriculture accounted for over 60% of GDP growth, the several gigantic projects under the various National Development Plans from the early 1970s to the days of the austerity measures and economic reform fuelled by the oil boom-doom phenomenon. Like a plague, the international crude oil market *got reformed and transformed* and then events began to occur in quick succession locally, the rest is history.

Nigerians had become impatient and 'reform fatigued.' The dilemma grew worse with continuing fluctuations in crude oil prices and increasing public sector inefficiencies. But only a reform of gargantuan proportion could create a window of opportunity for achieving a new Nigeria. And Reforms have their costs, trade-offs and benefits.

Nigeria had caught the dreaded 'Dutch disease'- that pervasive dislocation of the economic and social fabric of a society resulting from unbridled spending of the proceeds of economic prosperity arising from the discovery of a natural resource (e.g. crude oil) - exchange rate effects, the economy's absorption capacity problems, revenue volatility and expenditure stabilization, debts, the dilemma of revenue exhaustibility/saving for the future, consequent degenerating economic performance, diminished accountability (corrupt practices and 'value for money' issues), rising failure rate in governance schemes, etc. End product? – Poverty, economic down turn, social and political instability, etc

At the peak of it, Nigeria was a pariah nation internationally. How a country, so well endowed in natural and human resources, could now become so deficient with a bleak future, painting a sorry state of **despair**... Reforms became inevitable. There had been a handful with limted successes especially in the 1980s. Nigerians had become impatient and 'reform fatigued.' The **dilemma** grew worse with continuing fluctuations in crude oil prices and increasing public sector inefficiencies. But only a reform of gargantuan proportion could create a window of opportunity for achieving a new Nigeria. And reforms have their costs, trade-offs and benefits. Remember the Marshall Plan, Poland's debt cancellation deal and the Asian success story?

Lee Kuan Yew's account of the rise of Singapore *'From Third World to First: The story of Singapore 1965-2000*, highlights the level of staying power, the pains, costs and benefits of a successful reform and aptly captures the wisdom in such an effort.

Recent reform efforts, (the NEEDS) if sustained, would help strengthen the foundation for unleashing the growth necessary for activiating the process of transforming Nigeria from a 'third world' to 'first world'.

Just think of it: the Paris Club Debt exit scheme and the end to high debt servicing as an expenditure item (discount the economics against huge lump sum pay out). Then the improved fiscal/public expenditure management, institutional reforms - civil service reforms (monetisation), tax reform legislation, accelerated privatisation programme, concessioning of public utilities and infrastructure. Also the improved macroeconomic environment - exchange rate stability, growing external reserves (thanks to the consistently high price of crude oil) improving fiscal deficits level. Finally the pervasive sector reforms – telecommunication, electric power sector , pensions reform, Trade reforms. The list can be longer.

The success of the financial sector reforms- public debt restructuring, consolidation in the Insurance and Banking sectors, is very critical because the sector plays a catalytic role in the economy. The **hope** it holds out for the entire economy is, to say the least, reassuring.

And so in this edition of the ZEQ, Mr. Marcel Okeke's contribution on Reforms: Rising Tempo and Deepening Impact, focuses on how reforms are beginning to set the stage for the expected transformation. Dr 'Biodun Adedipe and Mr. Mike Uzor in their contributions x-ray the genesis and importance of the banking sector reforms, the race to meet the recapitalisation deadline, the outcome, the new challenges and the future direction of banking in Nigeria. Mr. Nnadi's contribution focuses on auditing and corporate governance, complementing Dr. J.D Sullivan's international perspective on Business ethics as an essential component of corporate governance. Global watch gives a brief insight into the future outlook in 2006 based on a review of 2005. The segment on facts and figures gives an overview of the economy in the last quarter of 2005.

Chris 'E. Onyemenam.

Reforms: RISING TEMPO, DEEPENING IMPACT

* By Marcel Okeke

Reforms in various sectors of the Nigerian economy assumed a very high pitch in 2005, especially by the last quarter of the year when the first phase of the banking industry consolidation came to an eventful close. Phenomenal progress in the reforms was recorded in virtually all sectors including pensions, insurance, capital market, oil and gas, telecommunications, energy/power, maritime, solid minerals, mortgage/housing, agriculture, tourism, among others. During the year, the reforms were so evident and pervasive that 2005 has come to be seen as a re-defining year in the annals of the country's economic development.

Apparently, as initial fruits of the 'comprehensive' reforms during the year (especially in the last quarter), all economic indicators improved in desired directions, either hitting or surpassing set targets. The exchange rate of the Naira remained stable; the inflation rate dropped while foreign reserves kept growing steadily. Both deposit and lending interest rates plummeted, with seminal effects on the real sector; foreign direct investment (FDI) inflow improved, just as the nation's external debt overhang got whittled down significantly. Industrial capacity utilization improved in most sub-sectors.

As the year drew to an end, the tempo of activities in all institutions and agencies associated with reforms rose to a feverish pitch. In fact, the reforms literally moved to an advanced phase. Specifically, the Central Bank of Nigeria, for example, was immersed in the run-up to the close of the first phase of its bank consolidation programme which culminated in the collapsing of the hitherto 89 deposit money banks in the banking industry to 25 re-capitalized ones. Fourteen others that could not meet the requirement are already facing liquidation by the regulatory authorities.

Monetary Policy Targets (Growth in %)

	Key Policy Target	2003	2004	2005
(i)	Broad Money Growth (M2)	15.00	15.00	15.04
(ii)	Narrow Money (M1)	13.80	10.60	11.38
(iii)	Aggregated Credit to the domestic economy	25.70	24.50	22.54
(iv)	Credit to Government	150.30	29.90	14.01
(v)	Credit to the Private Sector	32.30	30.00	25.24
(vi)	Inflation Rate	9.00	10.00	10.00
(vii)	GDP	5.00	5.00	6.00

Source: CBN Economic Report for First Half 2005

By the close of 2005, the apex bank also formulated and issued the "Micro Finance Policy, Regulatory and Supervisory Framework" for the provision of diversified microfinance services on a long-term and sustainable basis. This was an integral part of the package for the International Year of Micro-credit as (2005 was) declared by the United Nations. The Bureau of Public Enterprises (BPE) similarly rounded off the sale of not a few public–owned companies during the quarter while the National Communications Commission (NCC) was fashioning the modalities for the enthronement of the unified licensing regime. The Economic and Financial Crimes Commission (EFCC) made 'big catches' in the anti-graft drive during the period, just as the Debt Management Office (DMO) took concrete steps in the domestic debt securitization/bond issues.

Exchange rates

The stability of the exchange rate of the Naira against major world currencies stands out as one of the key gains of the economy-wide reforms in the past two years. Like in 2004, the national currency rather than depreciate in 2005, remained generally stable and even made slight appreciations at some points. Through some policy mix, including the introduction of the special forex auction sessions, the CBN realized its plus/minus three percent band in the Naira exchange rate fluctuation. Thus, on the average, the exchange rate of the Naira remained stable at around N130 to the dollar in the Dutch Auction System (DAS). The Naira also appreciated against the Pound Sterling and the Euro in both the official and parallel markets.

In the last quarter 2005, the weighted average exchange rate of the Naira vis-à-vis the US dollar appreciated from N129.61 per dollar in September to N129.54 per dollar in October. It further appreciated to N129.39 per dollar in November, closing at N129.00 per dollar at year-end. Both inter-bank and parallel market rates followed a similar trend during the period. As at October, the parallel market exchange rate of the Naira was about N144.50 to the dollar, appreciating to N143.30 in November and rounded off the year at N143.20 to the dollar.

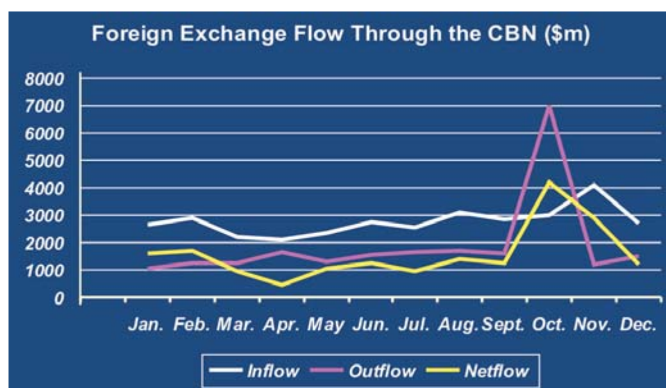
The implication of this is continued narrowing of the gap between the official and parallel/black market exchange rates of the national currency. This, in point of fact, is a pointer to the determination of the CBN to achieve a partial or total convergence of the various 'exchange rates' of the Naira in the market. Thus, the apex bank introduced 'special auctions' in the market at the beginning of the second half of the year, and through this, intervened to moderate actual or perceived gyrations in the Naira exchange rate. Further to this, the CBN very early in January 2006, liberalized the utilization/disbursement of export proceeds by exporters - a development that has eased pressure on the Naira at the DAS - reflecting in marked drop in the demand for foreign exchange.

The relative stability of the exchange rate of the Naira all through the review period is also partly attributable to the consistently rising inflow of foreign exchange. This was largely due to the steady increase in oil receipts, owing to the burgeoning oil prices in the international market. On the average, oil receipts accounted for about 75% of the monthly foreign exchange inflow for the better part of 2005.

External Reserves

As a concomitant of the consistently rising foreign exchange proceeds from oil, the nation's external reserves rose steadily in 2005, from US$16.9 billion at year-end 2004 to nearly US$29 billion. This trend was however, slightly disrupted in October sequel to Nigeria clearing of US$6.3 billion in Paris Club (PC) arrears during that month in accordance with the debt treatment earlier agreed between the country and the PC members. Under the debt relief granted Nigeria in June 2005 by the PC members, Nigeria is to pay in tranches, the US$18 billion involved in the deal, subject to a successful conclusion of a 'Policy Support Instrument' (PSI) approved by the International Monetary Fund.

Thus, Nigeria's gross external reserves at end-October, 2005 stood at US$23.92 billion, indicating a decline of 16.5 per cent from the US$28.64 billion recorded in September, 2005. Beside this isolated drop, the external reserves rose from month to month all through 2005, a development that was partly sustained by the mutual decision of the Federal and state governments to sterilize excess crude oil revenues. This is in line with the oil-price-based fiscal rule which makes for partial de-linking of budgeting from the oil price and therefore leads to a fiscal surplus. Under the National Economic Empowerment and Development Strategy (NEEDS) programme, external reserves target for 2005 was merely US$9.7 billion.



Source: CBN Monthly Reports

Inflation Level

One of the major challenges that confronted the monetary authorities all through 2005 was that of achieving stable prices under an expansionary fiscal policy regime—marked by some monetization of higher oil receipts. Thus, year-on-year inflation level at year-end 2005 stood at 11.6 per cent, missing the target of 10 per cent or a lower figure. The Consumer Price Index (CPI), the most widely accepted measure of inflation levels, which stood at 9.80per cent in January 2005, rose to a worrisome figure of 28.20 per cent in August but maintained a downward trend thereafter for the rest of the year. While the figure for September was 24.0 per cent, it dropped to 18.6, 15.1 and 11.6 per cent in the subsequent months of September, October, November and December, respectively.

The consistent drop in the inflation level in the last quarter, 2005 was attributable to two factors namely: the continued harvesting of agricultural produce, which moderated rising food prices and the relative stability in the prices of petroleum products. For the greater part of the year, inflation pressures were driven essentially by rising food prices. Thus, food price inflation (year-on-year) jumped from 18.0 percent in June to 35.6 per cent in July and 36.1 per cent in August, according to the National Bureau of Statistics.

On the other hand, the non-food (or core) inflation declined from 16.2 per cent in June to 10.76 per cent in July but rose to 13.0 per cent in August (measured on year-on-year basis). Overall, the non-food or core inflation has remained stable, while the food price inflation has been volatile and rising almost steadily. Thus, because of the high weight attached to food under the current methodology for arriving at the CPI (about 63%), food-price impact on overall inflation levels remained quite substantial.

In 2005, despite the good food harvest, prices of foodstuffs remained high for some reasons including: the new initiative to export cassava which has reduced domestic supply and the draught in the neighbouring Niger Republic that necessitated increase in the export of staple food products from Nigeria. Also, imported inflation arising from increases in the pump price of petroleum products—which increased inflationary pressures in most countries of the world—impacted on the domestic price level.

Interest Rates

For most part of 2005, there was a general decline in banks' deposit and lending rates, relative to the previous year. The CBN reviewed downward the Minimum Redis-

count Rate (MRR) from 15 per cent to 13 per cent, while still maintaining the maximum lending rate at MRR+4.00%. This was obviously to further reduce lending rates in the economy. In the same vein, the CBN reduced the Cash Reserve Ratio (CRR) from 11.00 per cent to 5.00 per cent, while the difference of 6.00 per cent would be invested in special CBN instruments with tenor of 91 days at 3.00 per cent per annum. This reduction in CRR shows the inclination of the apex bank to drag down the cost of funds (to banks) and by doing so, impact positively on interest rates.

In line with this trend, interest rates in the inter-bank market were lower in 2005 than in the previous year. The average Nigeria Inter-bank Offer Rate (NIBOR) for 7-day tenor and 90-day-tenor in 2005 were 14 per cent and 16 per cent respectively, as against 19 per cent and 17 per cent in year 2004.

In the last quarter 2005, the CBN introduced into the money market, the 182-day Treasury Bill (TB) partly to assist in restructuring the debt profile of the Federal Government. This instrument during the year attracted the highest and lowest spot rates of 16 and 5 per cent respectively.

However, in the tail end of 2005, the liquidity management strategy of the apex bank in form of withdrawal of public sector funds from deposit money banks, put some upward pressure on inter-bank rates. Thus, the weighted average inter-bank call rate which stood at 8.2 per cent in October, rose significantly to 16.9 per cent in November 2005, reflecting the liquidity squeeze in the banking system. Mainly, the transfer of the Nigeria National Petroleum Corporation (NNPC) funds from the commercial banks to the CBN compounded the liquidity crunch toward the year-end.

Component Members of Consolidated Banks

	Bank Name	Members of the Group
1	Access Bank Plc	Marina Capital Bank International Access
2	Afribank Plc	Afribank Afrimerchant
3	Diamond Bank Plc	Diamond Bank Lion Bank African International Bank (AIB)
4	Ecobank	Ecobank
5	ETB Plc	Equatorial Trust Devcom
6	FCMB Plc	FCMB Co-operative Development Nig-American Midas Bank
7	Fidelity Bank Plc	Fidelity Bank FSB Manny
8	First Bank Plc	FBN Plc FBN Merchant MBC
9	FirstInland Bank Plc	IMB Inland Bank First Atlantic NUB
10	Guaranty Trust Plc	GT Bank
11	IBTC-Chartered Bank Plc	Regent Chartered IBTC
12	Intercontinental Bank Plc	Global Bank Equity Gateway Intercontinental
13	NIB	Nigerian International Bank
14	Oceanic Bank Plc	Oceanic Bank International Trust
15	Platinum-Habib Bank Plc	Platinum Bank Habib Bank
16	Skye Bank Plc	Prudent Bank Bond Bank Coop Bank Reliance Bank EIB
17	Springbank Plc	Guardian Express Citizens Bank Fountain Trust Omega Bank TransInternational ACB
18	Stanbic Bank Ltd	Stanbic Bank
19	Standard Chartered Bank Ltd	Standard Chartered Bank Ltd
20	Sterling Bank Plc	Magnum Trust Bank NBM Bank NAL Bank INMB Trust Bank of Africa
21	UBA Plc	STB UBA CTB
22	Union Bank Plc	Union Bank Union Merchant Bank Universal Trust Bank Broad Bank
23	Unity Bank Plc	New Africa Bank Tropical Commercial Bank Centre-Point Bank Bank of the North NNB First Interstate Bank Intercity Bank Societe Bancaire Pacific Bank
24	Wema Bank Plc	Wema Bank National Bank
25	Zenith Bank Plc	Zenith Bank Plc

Source: CBN

Banking sector

The run-up to the close of what has become the first phase of the banking sector reforms dominated activities and attention in the entire financial services sector during the later part of last year. Alignment and re-alignment of merging bank groups trying to achieve the required N25 billion minimum capital base created a thick air of uncertainty and apprehension among a broad spectrum of operators as well as the banking public. Up to the last minute on December 31, 2005, when the Central Bank of Nigeria (CBN) drew the curtain on the re-capitalization exercise, several mergers and acquisitions (M & A) deals were yet being sealed.

However, on January 2, 2006, the CBN released the outcome of the consolidation exercise, showing that 25 banks emerged from 75, out of a total of 89 banks that existed as at June 2004. According to the apex bank, the successful banks accounted for about 93.5% of the deposit liabilities of the banking system. In the process of complying with the minimum capital requirement, N406.4 billion was raised by banks from the capital market out of which N360 billion was verified and accepted by the CBN. The exercise also led to an inflow of Foreign Direct Investment of US$652 m and £162,000.

EQUITIES MARKET STATISTICS

	2005	2004
Turnover (Volume)	26.7 billion	19.8 billion
Turnover (Value)	N262.937 billion	230.44 billion
Closing NSE All-Share Index	24,085.76	23844.45
Change in NSE All-Share Index	1.01%	18.46%
Closing Market Capitalisation	N2,523.49 billion	1925.9 billion
Listed Equities	214	207

Source: NSE

Further to the release of the list of the 25 emerging banks, the CBN subsequently revoked the licenses of 14 unsuccessful ones. In the words of the CBN Governor, Prof. Charles Soludo while sealing the fate the un-recapitalized: "in the exercise of the powers conferred upon us by the Banks and Other Financial Institutions Act, the operating licenses of the 14 banks are hereby revoked". The affected banks are: African Express Bank, Allstates Trust Bank, Assurance Bank of Nigeria, City Express Bank, Eagle Bank, Fortune International Bank, Gulf Bank and Hallmark Bank. Others include Lead Bank, Liberty Bank, Metropolitan Bank, Societe Generale Bank, Trade Bank and Triumph Bank.

Pursuant to the liquidation of these banks, the CBN also removed their directors and appointed an interim management for each of them. The management committees are expected to "determine the overall condition of the banks; ascertain the level of the asset-stripping (if any), and to advise regulatory authorities of specific ways to satisfy the key stakeholders of the bank". One bank which featured neither among the recapitalized ones nor among those "under liquidation" was African International Bank Limited; its acquisition by Diamond Bank however got consummated soon afterwards.

Despite the far-reaching and desperate efforts which saw many operators breasting the recapitalization tape, a few banks were able to 'stand alone' and made/surpassed the N25bn minimum capital requirement. In this category are two leading and wholly Nigerian banks, namely, Zenith Bank Plc and Guaranty Trust Bank Plc. Others that made up this group include four banks with either foreign affiliation or outright ownership—Nigeria International Bank (Citibank Group), Standard Chartered Bank, Stanbic Bank and EcoBank.

Capital Market Developments

Like the first three quarters in 2005, activities in the capital market during the last quarter were still largely driven by the recapitalization exercise in the banking sector and its concomitants. By the close of the year, there were about 49 applications for new issues valued at N693.0 bn as against 37 applications for new issues valued at N518.0 bn in the previous year. A breakdown of the figures shows that the banking sector accounted for 34 applications valued at N517.6 bn, representing about 75 per cent of the total value while the Federal Government Bond issued accounted for N140 bn during the entire year.

Activities in the secondary segment of the capital market in 2005 resulted into a marginal rise by 1.0 per cent in the Nigeria Stock Exchange All-Share Index. The NSE-ASI closed the year at 24,085.76. In 2004, the Index increased by 18.5 per cent. The stunted rise of the index in 2005 was attributable to a number of reasons: the banking sector reform caused much of investment interest to be shifted to the primary segment of the capital market; unimpressive results by companies moved many shareholders to switch their investments to patronizing new issues; poor liquidity/paucity of investible funds attendant to the CBN's funds withdrawals from the financial system, etc.

In sync with developments in the banking sector during the year under review, the industry accounted for 70.14 per cent of the volume of transactions in the capital. Market capitalization increased by 31.03 per cent to close at N2.5trn. The total turnover for the year under review was 26,838,911,431, an increase of 35.56 per cent over the preceding year. In value terms, the market turnover in 2005 stood at N263.7trn, an increase of 16.62 per cent over the 2004 level. The significant difference in volumes between

the two periods was due to the additional shares of banks that were listed from Private Placements, Initial Public Offers Rights Issues and Public Offers.

Federal Budget 2006

On October 12, 2005, the Federal Executive Council approved a N1.695 trillion draft budget for fiscal 2006, with projected revenue of N1.52 trillion, subject to legislative deliberations and approval. Of the sum, N442bn was capital expenditure, while N686bn would go into recurrent expenditure, including payroll and pensions. The 2006 budget proposal is N100bn less than the N1.8 trillion passed by the National Assembly for fiscal 2005. The deficit in the 2006 budget proposal is N170bn, as against N201bn in 2005 and N142bn in 2004.

The projected revenue of N1.52 trillion is premised on an oil price benchmark of US$33 per barrel, at an annual combined production estimate of 2.5 million barrels per day. An inflation rate of 9.5% is envisaged, while the exchange rate of the Naira is expected to stay at between N132 and N134 to the US Dollar. Unlike in the past, the Federal Government would be setting aside N75bn to support petroleum products subsidy; while the state governments would provide another N75bn to bring the total subsidy to N150bn in 2006.

Some key thrusts of the 2006 budget proposal include the completion of about 500 uncompleted projects, creation of employment and the provision of basic infrastructure (like power and roads), agriculture and healthcare. Also, settlement of debts owed local contractors ranks among the priorities in the budget. At present, the Federal Government owes local contractors almost N1trillion; some of these would be paid through bonds issuance, especially debts to contractors and pensioners.

Overall, education, health and works sectors have the highest allocations in the budget. Education would gulp about N126bn, as against N27bn in 2005; health N86bn, as against N21bn in 2005; and works N90bn.

Paris Club Debt Treatment

During the last quarter 2005, Nigeria achieved a major stride in her external debt management by clearing US$6.3billion in the Paris Club arrears. Nigeria had earlier in the year struck a deal with the Paris Club (PC) of creditors in which 60 per cent of her US$30 billion indebtedness to the PC members, amounting to US$18 billion, would be written off, leaving the country with a balance of US$12billion to pay up. The agreement was with a condition that Nigeria obtained a Policy Support Instrument (PSI) from the International Monetary Fund (IMF), attesting to the country's economic reforms.

Under the agreement, the payment of the US$12.4 billion will be in three tranches within a two-year period. The US$6.3 billion paid last October was the first of the tranches. With this, it is expected that six months thereafter, Nigeria would 'buy back' the remaining US$8.3 billion in debt, at a 24% discount for US$6.1 billion. This will result in total debt cancellation of around US$18billion and the country's eventual exit from PC-indebtedness. It is expected that Nigeria's public external debt will fall to 5% of GDP on conclusion of the deal by April 2006.

NEW ISSUES IN 2005

S/N	ISSUER	ISSUE TYPE	NUMBER OF SHARES	OFFER PRICE	SUBSCRIPTION LEVELS (%)
1	WAPCO	Rights	1,286,400,002	8.00	90.75
2	Wema Sec. and Fin. Plc	Private Placement	300,000,000	1.80	125.00
3	Union Dicon Salt Plc	Rights	200,000,000	5.00	36.17
4	Wema Bank Plc.	Subscription	5,000,000,000	3.50	95.11
5	Great Nig. Assurance Plc	Subscription	800,000,000	1.20	28.36
6	African Petroleum Plc	Private Placement	36,526,901	40.00	100.00
7	EIB Int'l Bank Plc	Subscription	5,500,000,000	1.80	58.06
8	FCMB Plc	Subscription	4,000,000,000	4.00	102.00
9	Valucard Nig. Plc.	Private Placement	46,452,060	8.00	100.00
10	Wema Bank Plc.	Subscription	273,267,900	3.50	95.11
11	Standard Trust Bank Plc	Subscription	2,000,000,000	7.00	101.00
12	Fidelity Bank Plc	Rights	562,368,030	1.25	108.00
13	Fidelity Bank Plc	Supplementary	2,000,000,000	1.25	100.00
14	Fidelity Bank Plc	Private Placement	2,492,885,149	1.25	254.65
15	Africabank Nig. Plc	Subscription	2,500,000,000	6.80	98.73
16	Incar Nigeria Plc	Rights	251,250,000	1.20	81.00
17	Akwa Ibom State Govt.	Bond	60,000,000	100.00	100.00
18	Vono Products Plc	Subscription	154,933,188	1.60	107.46
19	Vono Products Plc	Rights	96,711,208	1.60	110.99
20	Access Bank Plc	Subscription	3,000,000,000	2.90	131.84
21	FlourMills Nig.	Rights	436,800,000	12.00	109.15

Source: Nigerian Stock Exchange

Privatization

The Bureau of Public Enterprises (BPE)—the driver of the nation's privatization efforts—in March 2005, launched an agenda of privatizing 21 enterprises during the rest of the year. This was a sequel to the change of leadership at the agency by the end of the first quarter 2005. By year-end 2005, the Bureau had brought a total of 24 enterprises to financial bid stage, with a substantial number of them handed over the strategic investors. All these translated into fresh revenue of about N43billion for the federal government. The effort to sell NITEL was however unsuccessful; it is now

slated for a Public Offer soon in the capital market.

During the period, the BPE made efforts towards concluding the reform of the port sector and introduction of private sector participation through the concession programme. The power sector reforms also got some push that saw the establishment of the regulatory agency—the Nigerian Electricity Regulatory Commission (NERC). The seven-man Commission was inaugurated in October 2005 and has since commenced work. Further to this, the unbundling of NEPA (now Power Holding Company of Nigeria) was concluded in November 2005, with the incorporation of 18 successor companies to PHCN at the Corporate Affairs Commission.

Out of the 18 successor companies that were incorporated, eleven are to operate as distribution companies with their registered offices located in Enugu, Ibadan, Abuja, Jos, Benin, Port-Harcourt, Kaduna, Kano, Eko (Lagos Island), Ikeja and Yola. Each of the successor companies has o paid-up share capital of N5 million and the shareholding for each firm is 80% by the BPE and 20% by the Ministry of Finance Incorporated (MOFI) on behalf of the Federal Government.

During the period under review, the BPE also executed its reform agenda in the areas of the transport and downstream oil sectors. In the transport sector, the Bureau developed a new Transport Policy which key features include the establishment of a new regulatory framework, the promotion of the principle of inter-modal transport amongst the various modes of transport that exist, the establishment of a National Transport Commission, etc.

Highlights of the FG Budget 2006

S/N		
1.	Total Budget	N1.88tr
2.	Revenue Projection	N1.57tr
3.	Budget Deficit (to be financed through the sale of public properties, privatization& domestic borrowing)	N357bn
4.	Recurrent expenditure	N841bn
5.	Capital expenditure	N540bn
6.	National Judicial Council	N35bn
7.	Universal basic Education	N30bn
8.	NDDC	N21bn
9.	Domestic & external debt servicing: external=(N70bn; unlike N170bn in 2005); domestic= (N220bn; unlike N186bn in 2005. Contractors owed N100m & below would be paid off with about N25bn, while a 2-5 years bond would be floated for the others)	N290bn
10.	Petroleum Support Fund (States to also provide another N75bn to subsidize crude price in 2006	N75bn
11.	Millennium Development Goals (being the sum saved due to debt forgiveness, to be allocated to education, health, water, power, etc)	N100bn
12.	Ministries, Departments and Agencies (MDAs) Payroll & pensions = N648bn; Overheads = N193bn	N1.5tr
13.	VAT (Revenue of N450bn targeted)	10%
14.	Crude production Projection	2.5m pd
15.	Crude Oil price benchmark	$33 pb
16.	GDP Growth Forecast	7%
17	Inflation Rate Forecast	9%
18	Exchange Rate to the US$	N129

Source: R&EIG/Budget Office

The New Power Projects

Desirous of improving the power generation/supply situation in the country, the Federal Government offered the extension of Petroleum Profits Tax Act fiscal incentives to upstream oil companies to develop Independent Power Projects (IPPs). This incentive has paid off, with virtually all Exploration and Production (E & P) oil companies building power plants to relieve the worrisome shortage in power generation in the country. Sill, Government, on its part, has made progress with the location and building of some power plants, especially in the Niger Delta area.

By year-end 2005, the Federal Government had embarked on seven new power projects in the Niger Delta. These include the Omoku Thermal Power Station in Rivers State; Gbaran/Ubie Thermal Power Station, Bayelsa State; Sapele Thermal Power Station, Delta State and Ikot Abasi Thermal Power Station, Akwa Ibom State. Others include Eyaen Thermal Power Station, Edo State; Egbema Thermal Power Station, Imo State and Calabar Thermal Power Station, Cross River State.

Apart from these, Government has also embarked on the following power projects in other parts of the country: Geregu Thermal Power Station, Kogi State; Omotosho Therma Power Station, Ondo State; Papalanto Thermal Power Station, Ogun State and the Alaoji Thermal Power

Station, Abia State. There are also ongoing IPP projects by some state governments, at Omoku (Rivers state), Obajana (Kogi state), Ibom power (Akwa Ibom state).

The E & P oil companies' involvement in the IPP commenced with the Shell Petroleum Development Company (SPDC) entering into a 'Repair, Operate and Transfer', ROT, agreement with the Federal Government on the Afam 1-IV plants, and 'Lease, Operate and Transfer', LOT, accord on Afam V plant (all in Rivers state). Subsequently, other oil firms embraced the IPP, with Total Nigeria building one near its gas-gathering facility at Obite. ExxonMobil, Chevron and others are at various stages of Building their IPPs. Agip in 2005 completed one of 480 MW capacity at Okpai, Delta State. It is projected that all these will boost Nigeria's power generation from the current level of about 3,000 MW to 10,000MW by 2007.

Tax & Trade Reforms

With regard to tax policy, nine pieces of legislation amending existing Personal Incomes Tax, Value Added Tax, Company Incomes Tax laws and other taxes and levies were sent to the National Assembly for enactment in 2005. There is also legislation designed to strengthen tax administration and better position the Federal Inland Revenue Service to be a modern revenue agency.

During the last quarter 2005, Nigeria achieved a major stride in her external debt management by clearing US$6.3billion in the Paris Club arrears.

As at year-end 2005, the National Assembly had held public hearings on these legislation. The thrust of the tax reform is to simplify our tax system, reduce the multiplicity of levies and get better compliance. Generally referred to as the Federal Inland Revenue Service Bill 2005, some the Tax Reform Bills before the National Assembly include: the Federal Inland Revenue Service Bill, Company Income Tax Act Amendment, National Sugar Development Council Act Amendment and Petroleum Profit Tax Amendment. Others are: the Personal Income Tax Act Amendment, Value Added Tax Act Amendment, Customs Excise Tariff Consolidation Act, National Automotive Council Act Amendment, etc.

In a related measure, the Federal Government began implementation of the ECOWAS Common External Tariff October 1 2005. This means that all goods that arrive Nigerian ports or customs points from October 1, 2005, would be subject to the new tariffs. The CET simplifies Nigeria's trade regime by bringing the tariff bands down from 20 to 5 as follows: 0% for necessities such anti-retroviral drugs and for machinery and equipment (this is being implemented for a year only in the first instance); 5% for raw materials; 10 % for intermediate goods; 20% for finished goods and 50% for goods in which the country has a comparative advantage for production, also for certain luxury goods.

Solid Minerals Sector

Reforms and developments in the Solid Minerals sector in 2005, were a reflection of the new premium and priority being accorded the sector by the Government. Thus, the Ministry of Solid Minerals Development (MSMD) during the period under review undertook measures aimed at attracting investors (foreign and local) into the sector. These include putting in place the processes for the review of existing legislation, the enactment of fresh ones, massive public enlightenment of the opportunities and incentives in the sector, etc. There is also the establishment of a world class Geological Survey of Nigeria Agency to provide reliable data for investment decisions in the industry.

During the period under review, a number of parastatals and agencies under the Ministry were packaged for privatisation to make it function as a 'market facing entity'. These include the Nigerian Coal Corporation, the Nigerian Mining Company, among others. A new Minerals Policy Framework with emphasis on private sector management of the sector and government regulatory role and was concluded by the Ministry and approved by the National Council on Privatisation. During the last quarter 2005, the Ministry also put in place a framework for a bid round for coal and bitumen concessions along the principles of the Nigerian Extractive Industries Transparency Initiative (NEITI).

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Micro Finance Policy, Regulatory and Supervisory Framework for Nigeria

Chapter 1

Introduction

1.1 Robust economic growth cannot be achieved without putting in place well focused programmes to reduce poverty through empowering the people by increasing their access to factors of production, especially credit. The latent capacity of the poor for entrepreneurship would be significantly enhanced through the provision of microfinance services to enable them engage in economic activities and be more self-reliant; increase employment opportunities, enhance household income, and create wealth.

1.2 Microfinance is about providing financial services to the poor who are traditionally not served by the conventional financial institutions. Three features distinguish microfinance from other formal financial products. These are: (i) the smallness of loans advanced and or savings collected, (ii) the absence of asset-based collateral, and (iii) simplicity of operations.

1.3 In Nigeria, the formal financial system provides services to about 35% of the economically active population while the remaining 65% are excluded from access to financial services. This 65% are often served by the informal financial sector, through Non-Governmental Organization (NGO)-microfinance institutions, money lenders, friends, relatives, and credit unions. The non-regulation of the activities of some of these institutions has serious implications for the Central Bank of Nigeria's (CBN's) ability to exercise one aspect of its mandate of promoting monetary stability and a sound financial system.

1.4 A microfinance policy which recognizes the existing informal institutions and brings them within the supervisory purview of the CBN would not "only enhance monetary stability, but also expand the financial infrastructure of the country to meet the financial requirements of the Micro, Small and Medium Enterprises (MSMEs). Such a policy would create a vibrant microfinance sub-sector that would be adequately integrated into the mainstream of the National financial system and provide the stimulus for growth and development. It would also harmonize operating standards and provide a strategic platform for the evolution of microfinance institutions, promote appropriate regulation, supervision and adoption of best practices. In these circumstances, an appropriate policy has become necessary to develop along-term, sustainable microfinance sub-sector.

1.5 The purpose of this policy paper, therefore, is to present a National Microfinance Policy Framework for Nigeria that would enhance the provision of diversified microfinance services on a long-term, sustainable basis for the poor and low income groups. The policy would create a platform for the establishment of microfinance banks; improve the CBN's regulatory/ supervisory performance in ensuring monetary stability and liquidity management; and provide an appropriate machinery for tracking the activities of development partners in the microfinance sub-sector in Nigeria.

1.6 This policy has been prepared in exercise of the powers conferred on the Central Bank of Nigeria by the provisions of Section 28, sub-section (1) (b) of the *CBN Act* 24 of 1991 [as amended] and in pursuance of the provisions of Sections 56-60 (a) of the *Banks and Other Financial Institutions Act [BOFIA]* 25 of 1991 [as amended].

1.7 The policy paper has benefited from wide consultations, through the conduct of a baseline Survey on the activities of micro finance institutions (MFIs) in Nigeria, na-

tional and international consultative stakeholders' fora, as well as study tours to India, Pakistan, Indonesia, Philippines and Uganda.

Chapter 2

Overview of Microfinance Activity in Nigeria

2.1 The practice of microfinance in Nigeria is culturally rooted and dates back several centuries.

The traditional microfinance institutions provide access to credit for the rural and urban, low-income earners. They are mainly of the informal Self-Help Groups (SHGs) or Rotating Savings and Credit Associations (ROSCAs) types. Other providers of microfinance services include savings collectors and co-operative societies. The informal financial institutions generally have limited outreach due primarily to paucity of loanable funds.

2.2 In order to enhance the flow of financial services to Nigerian rural areas, Government has, in the past, initiated a series of publicly-financed micro/rural credit programmes and policies targeted at the poor. Not able among such programmes were the Rural Banking Programme, sectoral allocation of credits, a concessionary interest rate, and the agricultural Credit Guarantee Scheme (ACGS). Other institutional arrangements were the establishment of the Nigerian Agricultural and Co-operative Bank Limited (NACB), the National Directorate of Employment (NDE), the Nigerian Agricultural Insurance Corporation(NAIC), the Peoples Bank of Nigeria(PBN), the Community Banks (CBs), and the Family Economic Advancement Programme (FEAP). In 2000, Government merged the NACB with the PBN and FEAP to form the Nigerian Agricultural Co-operative and Rural Development Bank Limited (NACRDB) to enhance the provision of finance to the agricultural sector. It also created the National Poverty Eradication Programme (NAPEP) with the mandate of providing financial services to alleviate poverty.

2.3 Micro finance services, particularly, those sponsored by government, have adopted the traditional supply-led, subsidized credit approach mainly directed to the agricultural sector and non farm activities, such as trading, tailoring, weaving, blacksmithing, agro-processing and transportation. Although the services have resulted in an increased level of credit disbursement and gains in agricultural production and other activities, the effects were short-lived, due to the unsustainable nature of the programmes.

2.4 Since the 1980s, Non-Governmental Organizations (NGOs) have emerged in Nigeria to champion the cause of the micro and rural entrepreneurs, with a shift from the supply-led approach to a demand-driven strategy. The number of NGOs involved in microfinance activities has increased significantly in recent times due largely to the inability of the formal financial sector to provide the services needed by the low income groups and the poor, and the declining support from development partners amongst others. The NGOs are charity, capital lending and credit-only membership based institutions. They are generally registered under the *Trusteeship Act as* the sole package or part of their charity and social programmes of poverty alleviation. The NGOs obtain their funds from grants, fees, interest on loans and contributions from their members. However, they have limited outreach due, largely, to unsustainable sources of funds.

Chapter 3

Justification for The Establishment of Microfinance Banks

From the appraisal of existing microfinance-oriented institutions in Nigeria, the following facts have become evident:

3.1 Weak Institutional Capacity:

The prolonged sub-optimal performance of many existing community banks, micro finance and development finance institutions is due to incompetent management, weak internal controls and lack of deposit insurance schemes. Other factors are poor corporate governance, lack of well defined operations and restrictive regulatory/supervisory requirements.

3.2 Weak Capital Base:

The weak capital base of existing institutions, particularly the present community banks, cannot adequately provide a cushion for the risk of lending to micro entrepreneurs without collateral. This is supported by the fact that only 75 out of over 600 community banks whose financial statements of accounts were approved by the CBN in 2005 had up 10 N20 million shareholders' funds unimpaired by losses. Similarly, the NACRDB, with a proposed authorized share capital of N50.0 billion, has N10.0 billion paid up capital and only N1.3 billion shareholders' funds unimpaired by losses, as at December, 2004.

3.3 The Existence of a Huge Un-Served Market:

The size of the un-served market by existing financial institutions is large. The average banking density in Nigeria is one financial institution outlet to 32,700 inhabitants. In the rural areas, it is 1:57,000, that is less than 2%of rural households have access to financial services. Furthermore, the 8 (eight) leading Micro Finance Institutions (MFls) in Nigeria were reported to have mobilized a total savings of N222.6 million in 2004 and advanced N2.624billion credit, with an average loan size of N8,206.90. This translates to about 320,000membership-based customers that enjoyed one form of credit or the other from the eight NGO-MFls. Their aggregate loans and deposits, when compared with those of community banks, represented percentages of 23.02 and 1.04, respectively. This, reveals the existence of a huge gap in the provision of financial services to a large number of active but poor and low income groups. The existing formal MFls serve less than one million out of the over 40million people that need the services. Also, the aggregate micro credit facilities in Nigeria account for about 0.2 percent of GDP and less than one percent of total credit to the economy. The effect of not appropriately addressing this situation would further accentuate poverty and slow down growth and development.

3.4 Economic Empowerment of the Poor, Employment Generation and Poverty Reduction:

The baseline economic survey of Small and Medium Industries (SMls) in Nigeria conducted in 2004, indicated that the 6,498 industries covered currently employ a little over one million workers. Considering the fact that about 18.5 million (28%oftheavailable work force) Nigerians are unemployed, the employment objective/role of the SMls is far from being reached. One of the hallmarks of the National Economic Empowerment and Development Strategy (NEEDS) is the empowerment of the poor and the private sector, through the provision of needed financial services, to enable them engage or expand their present scope of economic activities and generate employment. Delivering needed services as contained in the Strategy would be remarkably enhanced through additional channels which the micro finance bank framework would provide. It would also assist the SMls in raising their productive capacity and level of employment generation.

3.5 The Need for Increased Savings Opportunity:

The total assets of the 615 community banks which rendered their reports, out of the 753 operating community banks as at end-December 2004, stood at N34.2 billion. Similarly, their total loans and advances amounted to N11.4billion while their Aggregate deposit liabilities stood at N21.4 billion for the same period. Also, as at end-December 2004, the total currency in circulation stood at N545.8billion, out of whichN458.6billionor 84.12per cent was outside the banking system. Poor people can and do save, contrary to general misconceptions. However, owing to the in adequacy of appropriate savings opportunities and products, savings have continued to grow at a very low rate, particularly in the rural areas of Nigeria. Most poor people keep their resources in kind or simply under their pillows. Such methods of keeping savings are risky, low in terms of returns, and undermine the aggregate volume of resources that could be mobilized and channeled to deficit areas of the economy. The microfinance policy would provide the needed window of opportunity and promote the development of appropriate (safe, less costly, convenient and easily accessible) savings products that would be attractive to rural clients and improve the savings level in the economy.

Owing to the in adequacy of appropriate savings opportunities and products, savings have continued to grow at a very low rate, particularly in the rural areas of Nigeria.

3.6 The Interest of Local and International Communities in Micro financing

Many international investors have expressed interest in investing in the micro finance sector. Thus, the establishment of a micro finance framework for Nigeria would provide an opportunity for them to finance the economic activities of low income groups and the poor.

3.7 Utilization of SMEEIS Fund:

As at December, 2004, only N8.5 billion (29.5%) of the N28.8billionSmalland Medium Enterprises Equity Investment Scheme (SMEEIS) fund had been utilized. Moreover, 10% of the fund meant for micro credit had not been utilized due to lack of an appropriate frame work and confidence in the existing institutions that would have served the purpose. This policy provides an appropriate vehicle that would enhance the utilization of the fund.

Chapter 4

Microfinance Policy

4.1 Policy Objectives

The specific objectives of this microfinance policy are the following:

i. Make financial services accessible to a large segment of the potentially productive Nigerian population which otherwise would have little or no access to financial services;

ii. Promote synergy and mainstreaming of the informal sub-sector into the national financial system;

iii. Enhance service delivery by microfinance institutions to micro, small and medium entrepreneurs;

iv. Contribute to rural transformation; and

v. Promote linkage programmes between universal/development banks, specialized institutions and microfinance banks.

4.2 PolicyTargets

Based on the objectives listed above, the targets of the policy are as follows:

i. To cover the majority of the poor but economically active population by 2020 thereby creating millions of jobs and reducing poverty.

ii. To increase the share of micro credit as percentage of total credit to the economy from 0.9 percent in 2005 to at least 20 percent in 2020; and the share of micro credit as percentage of GDP from 0.2 percent in 2005 to at least 5 percent in 2020.

iii. To promote the participation of at least two thirds of state and local governments in micro credit financing by 2015.

iv. To eliminate gender disparity by improving women's access to financial services by 5% annually; and

v. To increase the number of linkages among universal banks, development banks, specialized finance institutions and microfinance banks by 10% annually.

4.3 Policy Strategies

A number of strategies have been derived from the objectives and targets as follows:

i. License and regulate the establishment of microfinance Banks (MFBs)

ii. Promote the establishment of NGO-based microfinance institutions

iii. Promote the participation of Government in the micro finance industry by encouraging States and Local Governments to devote at least one percent of their annual budgets to micro credit initiatives administered through MFBs.

iv. Promote the establishment of institutions that support the development and growth of microfinance service providers and clients;

v. Strengthen the regulatory and supervisory framework for MFBs;

vi. Promote sound microfinance practice by advocating professionalism, transparency and good governance in microfinance institutions;

Vii. Mobilize domestic savings and promote the Banking culture among low-income groups;

viii. Strengthen the capital base of the existing micro finance institutions;

ix. Broaden the scope of activities of micro finance institutions; Strengthen the skills of regulators, operators,

and beneficiaries of micro finance initiatives;

x. Clearly define stakeholders' roles in the development of the microfinance sub-sector; and

xi. Collaborate with donors, coordinate and monitor donor assistance in micro finance in line with the provisions of this policy.

Chapter 5

The Goals of Microfinance Bank

The establishment of microfinance banks has become imperative to serve the following purposes:

(i) Provide diversified, affordable and dependable financial services to the active poor, in a timely and competitive manner, that would enable them to undertake and develop long-term, sustainable entrepreneurial activities;

(ii) Mobilize savings for intermediation;

(iii) Create employment opportunities and increase the productivity of the active poor in the country, thereby increasing their individual household income and uplifting their standard of living(iv) Enhance organized, systematic and focused participation of the poor in the socio-economic development and resource allocation process;

(V) Provide veritable avenues for the administration of the micro credit programmes of government and high net worth individuals on a non-recourse case basis. In particular, this policy ensures that state governments shall dedicate an amount of not less than 1 % of their annual budgets for the on-lending activities of microfinance banks in favour of their residents; and

(vi) Render payment services, such as salaries, gratuities, and pensions for various tiers of government.

Chapter 6

Policy Measures and Instruments in the Establishment of the Framework for Microfinance Banks.

Private sector-driven microfinance banks shall be established. The banks shall be required to be well--capitalized, technically sound, and oriented towards lending, based on the cash flow and character of clients. There shall be two categories of Micro Finance Banks (MFBs), namely:

(i) Micro Finance Banks (MFBs) licensed to operate as a unit bank, and

(ii) Micro Finance Banks (MFBs) licensed to operate in a state.

The recognition of these two categories of banks does not preclude them from aspiring to having a national coverage, subject to their meeting the prudential requirements. This is to ensure an orderly spread and coverage of the market and to avoid, in particular, concentration in areas already having large numbers of financial institutions.

An existing NGO which intends to operate an MFB can either incorporate a subsidiary MFB, while still carrying out its NGO operations, or fully convert into a MFB.

(I) MFBs Licensed to Operate as a *unit bank* (a.k.a. Community Banks)

MFBs licensed to operate as unit banks shall be community- based banks. Such banks can operate branches and/or cash centres subject to meeting the prescribed prudential requirements and availability of free funds for opening branches/cash centres. The minimum paid-up capital for this category of banks shall be N20.0 million for each branch.

(ii) *MFBs Licensed to Operate in* a *State*

MFBs licensed to operate in a State shall be authorized to operate in all parts of the State (or the Federal Capital Territory) in which they are registered, subject to meeting the prescribed prudential requirements and availability of free funds for opening branches. The minimum paid-up capital for this category of banks shall be N1.0 billion.

Chapter 7

Organic Growth Path for MFBs

This policy recognizes that the current financial landscape of Nigeria is skewed against macro, Small and Medium Enterprises (MSMEs) in terms of access to financial services. To address the balance, this policy framework shall promote an even spread of microfinance banks, their branches and activities, to serve the un-served but economically active clients in the rural and ur-ban areas.

7.1 The level of spread and saturation of the financial market shall be taken into consideration 1fore approval is granted to an MFB to establish branches across the Local Government Areas and/or States, in fulfillment of the objectives of this policy. Specifically, an MFB shall be expected to have a reasonable spread in a Local Government Area or *State* before moving to another location, subject to meeting all necessary regulatory and supervisory requirements stipulated in the guidelines. This is to avoid concentration in already served areas and to ensure extension of services to the economically active poor, and to micro, small and medium enterprises.

7.2 In order to achieve the objectives of an organic growth path, a microfinance bank licensed to operate as a unit bank shall be allowed to open new branches in the same State, subject to meeting the prescribed prudential requirements and availability of minimum free funds of N20 million for each new branch. In fulfillment of this requirement, an MFB licensed to operate as a unit bank can attain the status of a State MFB by spreading organically fromone location to another until it covers at least two -thirds of the LGAs of that State. When an MFB has satisfactorily covered a state and wishes to start operations in another state, it shall obtain approval and be required to again grow organically by having at least N20 million free funds unimpaired by losses for each branch to be opened in the new state.

7.3 An MFB licensed to operate in a State shall be allowed to open a branch in another State, subject to opening branches in at least two-thirds of the local governments of the State it is currently licensed to operate in the provision of N20.0 million free funds and, if in the view of the regulatory authorities, it has satisfied all the requirements stipulated in the guidelines.

7.4 The regulations to be issued from time to time shall be such that would encourage the organic growth path of the MFBs at all times.

7.5 However, an MFB may wish to start operations as a State Bank from the beginning and therefore not wish to grow organically from branch to branch. Such an MFB may be licensed and authorized to operate in all areas of the state from the beginning subject to the provision of a total capital base of N 1 billion. In other words, the preferred growth path for MFBs is the branch by branch expansion to become State Banks. But anyone wishing to start as a big state institution from the beginning can do so subject to availability of N 1 billion and proven managerial competence.

Chapter 8

Ownership of Microfinance Banks

8.1 Microfinance banks can be established by individuals, groups of individuals, community development associations, private corporate entities, *ad* foreign investors. Significant ownership diversification shall be encouraged to enhance good corporate governance of licensed MFBs. Universal banks that intend to set up any of the two categories of MFB as subsidiaries shall be required to deposit the appropriate minimum paid-up capital and meet the prescribed prudential requirements and if, in the view of the regulatory authorities, have also satisfied all the requirements stipulated in the guidelines.

8.2 No individual, group of individuals, their proxies or corporate entities, and/or their subsidiaries, shall establish more than one MFB under a different or disguised name.

Chapter 9

Participation of Existing Financial Institutions in Microfinance Activities

9.1 Universal Banks:

Universal banks currently engaging in microfinance services, either as an activity or product and do not wish to set up a subsidiary, shall be required to set up a department unit for such services and shall be subjected to the provisions of the MFB regulatory and supervisory guidelines.

9.2 Community Banks:

All licensed community banks, prior to the approval of this policy, shall transform to microfinance banks licenced to operate as a unit bank on meeting the prescribed new capital and other conversion requirements within a period of 24 months from the date of approval of this policy. Any community bank which fails to meet the new capital requirement

within the stipulated period shall cease to operate as a community bank. A community bank can apply to convert to a microfinance bank licenced to operate in a State if it meets the specified capital and other conversion requirements.

9.3 Non-Governmental Organization -Micro Finance Institutions (NGO-MFIs):

This policy recognizes the existence of credit-only, membership-based microfinance institutions which shall not be required to come under the supervisory purview of the Central Bank of Nigeria. Such institutions shall engage in the provision of micro credits to their targeted population and *not* to mobilize deposits from the general public.

The registered NGO-MFIs shall be required to forward periodic returns on their activities to the CBN.

NGO-MFIs that wish to obtain the operating licence of a microfinance bank shall be required to meet the specified provisions as stipulated in the regulatory and supervisory guidelines.

9.4 Transformation of the Existing NGO- MFIs:

Existing NGO-MFIs which intend to operate an MFB can either incorporate a subsidiary MFB while still carrying out its NGO operations or fully convert into an MFB. NGO-MFIs that wish to convert fully into a microfinance bank must obtain an operating licence and shall be required to meet the specified provisions as stipulated in the regulatory and supervisory guidelines.

Chapter 10

Justification for the Capital Requirements

10.1 The present capital base of N5 million for community banks has become too low for effective financial intermediation. Indeed, to set up a community bank, at least N5 million is required for the basic infrastructure, leaving zero or a negative balance for banking operations. From a survey of community banks, an operating fund of N50 million is about the minimum capital (own capital and deposits) a community bank needs to provide effective banking services to its clients. However, it is recognized that since many community banks are based in rural areas, their promoters may not be able to effectively raise N50 million as shareholders' funds. Hence, the stipulation of N20 million as shareholders' funds for the unit microfinance banks. The banks are expected to engage in aggressive mobilization of savings from micro-depositors to shore up their operating funds.

10.2 A State coverage microfinance bank that would operate multiple branches would be expected to take off with funds sufficient to operate a full branch in at least two-thirds of the Local Government Areas in that State. Hence, a minimum paid-up capital of N1.0 billion shall be required to obtain the licence to operate a State coverage MFB. Expansion to another State shall be subject to the provision of N 1.0 billion minimum shareholders' funds unimpaired by losses, *and* after opening branches in at least two- thirds of the Local Government Areas of the State it is currently licensed to operate in, *and* if in the view of the regulatory authorities, it has satisfied all the requirements stipulated in the guidelines.

Any community bank which fails to meet the new capital requirement within the stipulated period shall cease to operate as a community bank.

10.3 The experience of other countries sheds light on the level of capitalization required for microfinance banks. In most countries, the level of capitalization depends on the geographical coverage of the banks, and for some countries, even for a particular scope of coverage (district or province), the population and volume of business of the area further determine the level of capitalization. The capitalization requirements in other countries were also considered in arriving at the capitalization levels for the two categories of MFBs in this policy.

Chapter 11

Setting up a Framework for the Supervision of Microfinance Banks

11.1 Licensing and Supervision of Microfinance Banks

The licensing of microfinance banks shall be the responsibility of the Central Bank of Nigeria. A licensed institution shall be required to add "microfinance bank"; after its name. All such names shall be registered with the Corporate Affairs Commission (CAC), in compliance with the *Companies and Allied Matters Act (CAMA) 1990.*

11.2 Establishment of a National Microfinance Consultative Committee

A National Microfinance Consultative Committee (NMFCC) shall be constituted by the Central Bank of Nigeria (CBN) to give direction for the implementation and monitoring of this policy. Membership of the committee shall be determined from time to time by the CBN. The Microfinance Support Unit of the CBN shall serve as the Secretariat to the Committee.

11.3 Credit Reference Bureau

Due to the peculiar characteristics of microfinance practice, a credit reference bureau, which shall provide information on microfinance clients and aid decision making, is desirable. In this regard, the present Credit Risk Management System in the CBN shall be expanded to serve the needs of the microfinance sector.

11.4 Rating Agency

The CBN shall encourage the establishment of private rating agencies for the sub-sector to rate microfinance institutions, especially those NGO-MFls which intend to transform to microfinance banks.

11.5 Deposit Insurance Scheme

Since MFBs are deposit-taking institutions and in order to reinforce public confidence in them, MFBs shall qualify for the deposit insurance scheme of the Nigeria Deposit Insurance Corporation (NDlC).

However, it is recognized that since many community banks are based in rural areas, their promoters may not be able to effectively raise N50 million as shareholders' funds.

1.6 Management Certification Process

In order to bridge the technical skills gap, especially among operators of microfinance banks, the policy recognizes the need to set up an appropriate capacity building programme for MFBs. To this end, the CBN shall put in place a microfinance bank management certification process to enhance the acquisition of appropriate microfinance operational skills of the management team of MFBs. A transition period of twenty four (24) months shall be allowed for the take-off of the programme, with effect from the date of launching the policy.

11.7 Apex Associations of Microfinance Institutions

The establishment of an apex association of microfinance institutions to promote uniform standards, transparency, good corporate practices and full disclosures in the conduct of MFI businesses shall be encouraged.

11.8 Linkage Programme

The policy recognizes the importance of the provision of wholesale funds for microfinance banks to expand their outreach. Pursuant to this, the CBN shall work out the modalities for fostering linkages between universal development banks, specialized finance institutions and the microfinance banks to enable the latter source for wholesale funds and refinancing facilities for on-lending to their clients.

11.9 Establishment of a Microfinance Development Fund

In order to promote the development of the sub-sector and provide for the wholesale funding requirements of microfinance banks, a Micro Finance Sector Development Fund shall be set up. The Fund shall provide necessary support for the development of the sub-sector in terms of refinancing facility, capacity building, and other promotional activities. The Fund would be sourced from governments and through soft facilities from the international development financing institutions, as well as multilateral and bilateral development Institutions.

11.10 Prudential Requirements

The CBN recognizes the peculiarities of microfinance practice and shall accordingly put in place appropriate regulatory and prudential requirements to guide the operations and activities of the microfinance banks.

11.11 Disclosure of Sources of Funds

Licensed MFBs shall be required to disclose their sources of funds, in compliance with the *Money Laundering Prohibition Act 2004.*

11.12 Corporate Governance for Microfinance Banks

The board of directors of MFBs shall be primarily responsible *for* the corporate governance of the microfinance banks. To ensure good governance of the banks, the board of directors shall be responsible for establishing strategic objectives, policies and procedures

that would guide and direct the activities of the banks and the means to attain same, as well as the mechanism for monitoring Management's performance. Thus, while management of the day -to - day affairs of the banks shall be the responsibility of the Management 'team, the board of directors shall, however, be responsible for monitoring and overseeing Management's actions. Consequently, the licensed microfinance banks shall be expected to operate under a diversified and professional board of directors.

Chapter 12

Regulatory Incentives

12.1 The new window of opportunity for the emerging microfinance banks in bringing financial services to people who never had access to such services before, would require the support of government and those of regulatory authorities. The CBN shall collaborate with the appropriate fiscal authorities in providing a favourable tax treatment of MFBs' financial transactions, such as exemption from value added tax (VAT) on lending, or tax on interest income or revenue.

12.2 Similarly, the principle of exemption from profit tax shall be applied to any MFB that does not distribute its net surplus but ploughs it back and reinvests the surplus to finance more economically beneficial micro, small and medium entrepreneurship.

12.3 Furthermore, a Rediscounting and Refinancing Facility (RRF) shall be made available to MFBs for purposes of providing liquidity assistance to support and promote microfinance programmes. This would enable MFBs that have met the CBN prudential requirements to, on a sustainable basis, provide and render micro credits and other services to their clients.

Chapter 13

The Roles and Responsibilities of Stakeholders

The roles and responsibilities of stakeholders shall include the following:

13.1 Government

Government shall be responsible for:

(i) Ensuring a stable macro-economic environment, providing basic infrastructures (electricity, water, roads, telecommunications, etc), political and social stability;

(ii) Fostering adequate land titling and other property rights sufficient to serve the collateral needs of borrowers and financial institutions;

(iii) Instituting and enforcing donor and foreign aid guidelines on micro-finance to streamline their activities in line with this policy; and

(iv) Setting aside an amount of not less than 1 % of the annual budgets of state governments for on-lending activities of microfinance banks in favour of their residents.

13.2 Central Bank of Nigeria (CBN)

The roles of the CBN shall include the following:

(i) Establishing a National Microfinance Consultative Committee;

(ii) Evolving a clear micro-finance policy that spells out eligibility and licensing criteria, provides operational/ prudential standards and guidelines to all stakeholders;

(iii) Evolving a microfinance sub-sector and institutional policies aimed at providing regulatory harmony,

promoting healthy competition and mainstreaming micro-financing with formal intermediation;

(iv) Adopting an appropriate regulatory and supervisory framework;

(v) Minimizing regulatory arbitrage through periodic reviews of the policy and guidelines;

(vi) Promoting linkage programmes between universal/development banks, specialized finance institutions and the microfinance banks;

(vii) Continuously advocating market determined interest rates for government-owned institutions and promote the channelling of government microfinance funds through MFBs; and

(viii) Implementing appropriate training programmes for regulators, promoters and practitioners in the sub-

sector, in collaboration with stakeholders.

13.3 MicroFinance Institutions (MFIs)

Microfinance service providers shall:

(i) Provide efficient and effective financial services, such as credit, deposits, commodity/inventory collateralization, leasing, and innovative transfer/payment services;

(ii) Undertake appropriate recruitment and retention of qualified professionals through transparent and competitive processes;

(iii) Adopt continuous training and capacity building programmes to improve the skills of staff; and

(iv) Strictly observe their fiduciary responsibility, remain transparent and accountable in protecting savers' deposits.

13.4 Public Sector Poverty Alleviation Agencies

The MFB policy recognizes the roles of public sector MFIs and poverty alleviation agencies such as the National Poverty Eradication Programme (NAPEP) in the development of the sub-sector. They shall be encouraged to perform the following functions:

i. Provision of resources targeted at difficult- to-reach clients and the poorest of the poor;

ii. Capacity building;

iii. Development of MFIs' activities nation- wide;

iv. Nurturing of new MFIs to a sustainable level; and

v. Collaborating/partnering with other relevant Stake holders.

13.5 Donor Agencies

Donor agencies offer free or subsidized funds, donations or technical assistance for the development of the microfinance industry in Nigeria. They include bilateral and multilateral institutions, NGOs and missionaries with a pro-poor orientation. The services provided by donor agencies include grants, donations, technical assistance, etc.

The donor agencies, in conducting their microfinance activities, shall comply with the relevant provisions of this policy. The target clients for donors' support may include: MFIs, NGOs, regulators and other relevant agencies. However, for the purpose of leveraging the evolving micro financing initiative, donors are expected to direct most of their assistance to licensed MFBs to ensure an orderly resource injection, transparency and synergy.

14.0 Conclusion

14.1 There exists a huge untapped potential for financial intermediation at the micro and rural levels of the Nigerian economy. Attempts by Government in the past to fill this gap, through supply-driven creation of financing institutions and instruments, have failed, due to the poor capitalization of such schemes and restrictive regulatory and supervisory procedures, among other factors. The community banks were designed to fill the gap, but their low capital base and isolated mode of operation have not enabled them to make meaningful contributions to micro financing.

14.2 The microfinance banks being established in line with this policy framework shall be adequately capitalized, appropriately regulated and supervised to address the need of financing at the micro levels of the economy. The two categories of microfinance banks shall be Microfinance Banks licensed to operate unit banks (a.k.a. community banks) and Microfinance Banks licensed to operate in a State.

14.3 Microfinance Banks licensed to operate unit banks shall require a minimum paid-up capital of N20 million and shall operate branches and / or cash centres. A Microfinance Banks licensed to operate in a State shall require a minimum paid-up capital of N1.0 billion and shall operate multiple branches within a State, subject to satisfactory prudential requirements and availability of free funds for branch expansion.

14.4 The existing community banks shall transform to Microfinance Banks within 24 months of approval of this policy, by increasing their shareholders' funds unimpaired by losses to a minimum of N20.0 million. Any community bank which does not meet the new capital requirement within the stipulated period shall cease !o operate as a community bank.

14.5 The Central Bank of Nigeria shall supervise and regulate the microfinance banks: The Nigeria Deposit Insurance Corporation shall insure the deposits of microfinance banks.

14.6 The provisions of this policy shall be subject to review from time to time at the full discretion of the regulatory authorities.

Re-Inventing INTERNAL AUDIT For Effective CORPORATE GOVERNANCE

* By Godson S. Nnadi

Recent developments in the financial world, particularly the collapse of US energy trading firm ENRON and the reported case of WORLDCOM, have triggered a more focused attention on the activities of accountants and auditors. Furthermore, as companies continue to struggle with profitability in a sluggish and complex economy, internal audit functions are further being challenged to demonstrate their contributions to their organisations. There is no doubt that internal audit functions are increasingly under pressure to meet strategic business goals and support internal value drivers. Terms like internal accounting control, operational auditing and internal audit mean different things to different people. Many public companies and accounting firms are arriving at potentially dangerous and different interpretations of what internal auditing, operational audit and internal accounting control entail.

In this paper, we will evaluate the traditional roles as well as emerging ways of engaging internal audit towards enhancing effective corporate governance and ensuring business growth and development.

INTERNAL AUDIT: PURPOSE AND NATURE

The role of internal audit has been evolving in response to changes in business environment and the expectation of management. At the earlier stage, internal audit was more concerned with detection of systems failure, frauds and irregularities. Today, however, it has been observed that the emphasis of internal audit has significantly shifted from detection to prevention. More and more internal audit resources are also being directed to functions which can contribute proactively to the attainment of business objectives. All the same, the role and importance assigned to internal audit depends, to a large extent, on the understanding of the management of what internal audit is all about. It is therefore necessary to state one or two definitions of internal audit to guide us in this discussion.

Internal auditing had been defined as " ***an independent appraisal activity established within an organisation for the review of operations as a service to management. It is a managerial control which functions by measuring and evaluating the effectiveness of other controls".***

The Institute of Internal Auditors in the US states that internal audit ***"examines and evaluates the planning, organising, and directing processes to determine whether reasonable assurance exists that objectives and goals will be achieved."***

From the above definitions, it is evident that all systems, processes, operations, functions, and activities within the organisation are subject to internal audit evaluation. Such evaluation, in the aggregate, provide information to appraise the overall system of control.

It is an obvious fact that without internal audit, accounting, internal and other control systems are likely to lose their steam because there will be no mechanism for monitoring and evaluating the effectiveness of these systems on a continous basis. The traditional responsibilities of internal auditors in an organisation are amongst others:

a) Review and appraisal of the soundness, adequacy, reliability and application of internal accounting controls and other operating controls and promoting them at reasonable costs;

b) Ascertaining the extent of compliance with established policies, plans and procedures;

c) Ascertaining the extent to which organisations' as-

sets are safeguarded from possible losses which may arise from fraud, waste, operational inefficiency, mismanagement and poor value for money;

d) Examination of financial and operating information. This includes review of means used to identify, measure, classify and report such information and specific inquiry into individual items including detailed testing of transactions, balances and procedures;

e) Recommending operational improvement to management;

f) Making special enquiries at management's direction;

g) Reviewing operational practices to promote increased efficiency and economy;

h) Evaluating the reliability of management information.

MAKING INTERNAL AUDITORS MORE EFFECTIVE

For internal auditors to be effective in today's business environment, the following minimum conditions must prevail:

a) An in-depth understanding of the accounting and internal control systems of the organisation and people working in the organisation.

It is an obvious fact that without internal audit, accounting, internal and other control systems are likely to lose their steam because there will be no mechanism for monitoring and evaluating the effectiveness of these systems on a continous basis.

b) It is essential for the auditor of a computer-based system to be knowledgeable enough about computers and their related systems to be able to evaluate that system; he must be able to spot weaknesses both in controls that have to be adapted from those in manual systems and in the additional features that are essential if there is to be assurance that a computer-based system will not get out of control. In fact, he has to be knowledgeable enough about computers and their functions to be able to do any meaningful job.

c) Independence: The organisational level of internal audit function must be high enough to enable it operate independently. It is preferable if the internal auditor reports to a board of directors or an internal audit committee rather than to the chief accountant or the financial controller.

d) Segregation of audit functions from accounting functions: For internal auditing system to be effective, internal audit functions must be segreted from the accounting functions and should have nothing to do with operating activities.

e) Internal audit reports must be accorded deserved treatment: The treatment given to internal audit reports affects the effectiveness of the internal audit functions. In an environment where internal audit reports are not promptly and firmly acted upon, employees are not likely to comply with company's rules and regulations. They are also likely to involve themselves in fraud and other offences because they know that no action will be taken when such irregularities are discovered and reported by internal auditors. In such a circumstance, the internal auditor will become just a toothless bull-dog whose reports are dumped in a thrash can and this is likely to affect his morale.

f) Diplomacy of audit staff: An internal auditor must have the charisma to deal with people. He must therefore carry out his assignments in a way that suggests that they are in the interest of his fellow employees. In most cases, internal auditors carry themselves as if they are the policemen of their organisations. Although not armed, they carry out their functions with intimidating mien. Their concern is always how to find offenders who should be reported to management. With this attitude, the internal auditor is always prone to losing sight of his core duty.

THE NEW ROLES OF INTERNAL AUDIT

The internal audit function has not been left out of the monumental changes taking place in all spheres of life. It is now being seen, and rightly too, as a real resource that must add value to business growth and development. The internal auditor can only respond effectively to these new roles by being proactive. Some of the new roles are briefly discussed below:

FOCUS ON THE DESIGN STAGE OF SYSTEMS AND PROGRAMMES DEVELOPMENT

In the past, internal audit resources were mainly concentrated on measurement and evaluation of the effectiveness of control systems put in place by management. The posthumous approach is no longer adequate as today's internal auditors need to focus their attention on getting the system right from the beginning, if they must

work closely with management and provide services that can contribute positively to the achievement of business objectives.

Internal auditors, being a segment of the organisation that understands all facets of organisation's operations and problems, must now get themselves actively involved in design stage of systems. They should use their expertise to suggest system improvement at the design stage.

INFORMATION TECHNOLOGY & AUDITING

In a world driven by technology, Auditors need to have a firm grip of operations based on the Automated Information Systems (IS) - the entire automation infrastructure, organization, personnel, components, processes and procedures for the collection, processing, storage, transmission, display, dissemination and disposal of information. IS facilitates the acquisition and production of easily understandable reports.

IS offers three levels of control which facilitates information management and provides an adequate basis for planning and enhancing an audit work namely: preventive, detective and corrective. It makes the auditors job easier because it enables automated, routine audit checks and inspections, timely automatic notification to management when fraud indicators are detected, the monitoring of performance of operators as well as data extraction and analysis, accurate and complete records as well as risk assessment and scheduling, time-keeping, flowcharting and report generation.

Several IS enabled audit software have since been introduced into the profession. Hence to take full advantage of IS, auditors must be very familiar with Computer Aided Audit Techniques (CAATS). The most common CAATS are: Audit Command Language (ACL), Audit & Security Associate, IDEA Data Analysis Software (Clement Isah & Partners), APEX, Computerised Accounting Records Comparison System (CARCS), Team mate (Audit planning/working papers).

Contemporary auditing is transiting from 'Traditional Models' as we know it to the Continuous supervisory process model requiring 'continuous online auditing' (COA). This methodology uses online information technology which provides different forms of assurance thus expanding traditional audit to cover a wider scope including electronic commerce.

Benefits of Continuous Audit

Continuous audit methodology utilizes online information technology which facilitates simultaneous /immediate audit trail with wide ranging benefits which helps monitor operations, comparing and identifying deviations from standard or expected characteristics, alarms are triggered where significant discrepancies occur and must be acknowledged by Operations Managers, Auditors and top management, produces audit results simultaneously within (or) a short period of time after event occurred, is timelier, closer to event, semi-supervisory function, has potential for independent assurors, stakeholders and firms can introduce new assurance product, is real time online reporting 'key driver' of this model, is one of the most important introductions of the Sarbanese/Oxley Act 2002 to IS auditing and professional practice.

Automated Information System: Risks and Threats

The technology that enables automated Information Systems ironically poses grave dangers to the system it enables. Major threats come from hackers, viruses, Trojans, spoofing, denial of service (DoS), IP weaknesses, etc. This is a major constraint to an IS based Audit.

In IS Audit and Control, 'every time you build a better mousetrap, the mice get smarter'. While the new forms of fraud, error and lack of probity are difficult to predict, a library of tests for known cases of these events can be built and applied against existing entity data flows at nominal cost. Auditors must continue to update their IT capacities and take advantage of the benefits of 'continuous online auditing (COA) in spite of the infrastructure constraints. IS based audit is a 'must do', an important component of corporate governance in the information society.

For more information, see presentation on the subject by Jim Ovia, MD/CEO, Zenith Bank Plc on www.zenithbank.com or e-mail us at zeqeditor@zenithbank.com

FOCUSING MORE ON RISK MANAGEMENT

By risk, we mean the probability that an event or action may occur which will adversely affect the ability of an organisation to achieve its goals. All organisations are exposed to one risk or the other and the only way to reduce risk to zero is to cease business. Risk impacts on the ability of a company to compete, to maintain its financial bearing, to maintain the quality of its products or services and to retain highly competent personnel. The effects of risk on a company can take any of the following forms:

i) Taking erroneous decisions arising from the case of wrong, untimely, inadequate or otherwise unreliable information;

ii) Erroneous record keeping, inappropriate accounting, fraudulent financial reporting, financial loss and exposure;

iii) Inability to adequately safeguard assets;

iv) Loss of customers' patronage, negative publicity and damage to organisation's image and reputation;

v) Failure to adhere to company's policies, plans, and procedures, or not complying with relevant laws and regulation;

vi) Failure to achieve established objectives and goals for operations and programmes; and

vii) Acquisition of resources in an uneconomical manner and/or utilising them inefficiently and ineffectively.

Internal auditors are now focusing on risk assessment in their organizations. Two reasons can be adduced for this: one, it is an intrinsic part of internal audit function and secondly, risk assessment enables internal audit function

to operate effectively. Risk assessment helps the internal audit staff to know the amount of resources to be committed to each area of the organization, given its level of risk exposure. It also influences the amount of audit work to carry out in each area.

USING INTERNAL AUDIT AS A TRAINING GROUND FOR FUTURE MANAGERS

By its nature, internal audit leads her staff to understand the organization in its entirety. The scope of their work is such that makes it unavoidable to be involved in all facets of a company's operations. In order to be able to function effectively, internal audit staff need to understand and document their organization's control environment. This includes management philosophy, the entity's organization structure, functions of the Board of directors and its committees, the management control methods for monitoring and following up on performance, the company's human resource management policies and practice, and the competitors.

The need to understand all the various facets of the organization gives the internal audit staff the "bird's eye view" of the organization. Internal audit is therefore an ideal training ground for future managers of any organization.

Furthermore, the training of audit staff for managerial positions facilitates the audit process when the trainees eventually become managers outside the internal audit functions.

INTERNAL AUDITORS AND IRREGULARITIES

The responsibility for prevention of irregularities lies with the management of any company. As a result, management usually puts in place adquate internal, accounting and other control measures which can check the occurrence of irregularities. Internal auditors, on the other hand, owe it as a duty to ensure that these measures are adhered to and remain relevant at all times.

However, irregularities can still take place in spite of any control measures because of the following reasons:

i) Beakdown of physical safeguards;

ii) Breakdown of revew procedures that are in place to detect irregularities;

iii) Collusion - possibility that a number of individuals in an organization can enter into an unholy alliance to dupe the organization; and

iv) Management override - possibility that management can use its position to overturn control systems. This is most obvious when the fraud or irregularity is designed to benefit the organzation generally.

As we have said earlier, one of the duties of internal auditors is the protection of company's assets against losses that may arise from fraud and other irregularities. In order to perform this role creditably, internal auditors must possess investigative skills. In this wise, an internal audit executive would need a deep understanding of different types of fraud that are possible in their organizations. They also need to study their environment and consider if there is any potential motive for employees to perpetrate irregularities. If the answer is in the affirmative, they should find ways by which the irregularities can be perpetrated and examine the opportunity to perpetrate them. They can then come up with procedures that can reveal whether such opportunity has been utilised. It should also be noted that to be successful in their fraud detection role, internal auditors would need to think as though they were fraudsters.

REPORTING IRREGULARITIES

What should an internal auditor do when he detects irregularities? There is no precise answer to this question as the probable action would depend very much on the nature of the irregularities, who perpetrates them, against whom and for what purpose. Under this, we are going to consider two possible scenarios:

i) Irregularities by lower and middle level staff against their organization: Where an internal auditor detects these, he has no option than to report them to management of the company. His role in this regard should not stop at reporting fraud but also should extend to stating the magnitude of the fraud, methods of excution, and the people involved. Furthermore, he must analyse the weaknesses in the company's control systems that made the fraud possible.

ii) Irregularities perpetrated by management against the company or third parties e.g. government, customers, suppliers and the general public. The role of the internal auditor under this circumstance is **whistleblowing** - a term used to describe an unauthorized disclosure or reporting of some management misdeeds to an authority outside

management or to the general public.

The dilemma that an internal auditor faces is whether it is proper for him to "blow whistle". In resolving this, he will unavoidably experience personal conflicts for two reasons. One, he is employed by management and his service is expected to be aiding management in its activities. In other words, he, under normal circumstance, must be loyal to management. Reporting management misconduct to a higher authority would seem to be tantamount to betrayal of trust and may cost the internal auditor his job. This is also likely to affect his future career because he might be seen as a troublemaker and other organizations might be reluctant to employ him.

On the hand, the internal auditor also owes allegiance to his concience and to his creator. The urge to live a high moral life geared towards protection of the interests of individuals, the state and the general public may force him to report management irregularities to outside parties. Failure to report management misconduct which is likely to cause harm to shareholders, creditors, government or other third parties is nothing but sheer irresponsibility and elevation of personal interest above public good.

Notwithstanding this conflict, the best line of action to follow is for internal auditors to report to a higher authority any management irregularities with potential adverse consequences. This higher authority may be the shareholders, police authority, government or the audit committee set up under Companies and Allied Matters Act 1990.

The case of WORLDCOM-US telecom giant buttresses our stand on this: It was the company's **internal audit** that revealed that transfers of $3.055 billion for 2001 and $797 million for the first quarter of 2002 were not made in accordance with generally accepted accounting principles.

OUTSOURCING OF INTERNAL AUDITING SERVICES

Recently, a new dimension in the quest for effective internal auditing was added: contracting out internal auditing services. This is defined **as the arrangement where an organisation's internal auditing functions are performed by auditors on a contract or "extended audit service".**

The proponents of this system posit size factor as well as economic and efficiency factors as reasons for adopting this system; others argue that the outsourcing will take a final toll on internal auditing profession with more and more internal auditors losing their importance and their jobs as well as impairing the independence of external auditors. However, this can be properly harnessed by contracting internal audit services to one accounting firm while engaging another firm to perform external audit functions.

CONCLUSION

In this paper, we discussed the need for reinventing internal audit for effective corporate governance. We started by examining the scope and traditional roles of internal audit and then proceeded to high-light the new roles that internal audit must assume if it must contribute proactively to business growth.

From our analysis, we came to the conclusion that internal audit must now focus on prevention rather than detection of errors and irregularities if it is to be able to relate closely with line managers and provide services that add value to business survival and growth. We also emphasized the need for internal audit to focus more attention on risk management and systems design.

Finally we stressed the need to change the perception of an internal auditor from that of a policeman to that of a provider of services. It is our considered opinion that if companies conscientiously adopt the suggestions made in this paper, internal audit will become the pivot for effective corporate governance.

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Banking: Post-Consolidation CHALLENGES & TRENDS

* By Mike Uzor

The Nigerian banking industry has gone through the refinery fire of the Central Bank and at the end of an 18-month regulatory surgery; the shape of a new banking industry has begun to emerge. History has been made in the banking reform that was a regulatory filtering of the entire banking industry, isolating the weak banks and creating a new industry free of financial distress. It was an opportunity to unmask the deep defects in the system and tackle finally the problem of systemic distress in the industry.

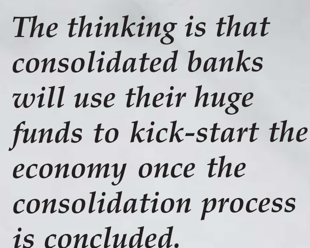
It is indeed a regulatory feat to have shrunk the 91 banks in the system to about 26 in a matter of 18 months. A change is being made from mushroom to mega banking and banks with much bigger financial muscles have begun to take their places in an industry that is entirely reborn.

For many banks, the consolidating process took off to a faulty start due to the inexperience in mergers and acquisitions in Nigeria. But even

those numerous memoranda of understanding that were signed and discarded did put the banking industry in motion that was necessary to maintain depositors' confidence as the industry struggled through the most challenging regulatory overhaul.

Banking consolidation strategies have followed two main approaches and each has its implications on performance quality in a post consolidated operating environment. The first is using large outstanding reserves to meet the minimum capitalisation, which is the route followed by the largest banks. Such banks now have relatively low volume of shares in issue, which means rates of return are not likely to decline.

The second approach is through mega offers that have significantly increased the volume of shares in issue. Many of the banks following this approach are likely to record considerable decline in rates of return in the short-term. Only a few of them that are growing well above the industry average can rank with the first group in terms of ability to preserve rates of return.



The question of what will be the nature and challenges of the banking industry in a post consolidated era depends on what the banking reform has been able to accomplish and what it has not. The answers will yield themselves by considering whether those macroeconomic concerns and financial markets conditions that prevailed before the policy and even warranted its introduction have been decisively dealt with.

Economic Policy Question

The state of the Nigerian economy in a post consolidated banking industry remains a matter of great concern. There seems to be a presumption that the reform in the banking sector is all that is required to fix the economy. Recapitalisation of the banking industry has involved drawing much of the money from the rest of the economy into the banking industry and that presents one sided reform that is not matched with equal capacity building in the real economy.

Much of the difficulties that banks were facing before the consolidation policy began reflect the inability to achieve stimulatory growth in the real sector as domestic output remained subdued and aggregate demand remained increasingly insufficient to support the service capacity of the banking sector. This warranted heavy dependence by banks on government business in confirmation that private sector business is insufficient to support all the banks in operation. These hard economic fundamentals have not been addressed in the banking reform and there is no doubt that banks will continue to face the difficulties emanating from the poor state of the economy.

Notwithstanding some cases of abuse of the credit system by management in banks, it is important to recall that stunted growth in the real sector resulted in significant credit losses for banks as loan repayment difficulties impaired asset quality conditions industry-wide. The loan repayment difficulties facing banks is an issue that requires a comprehensive economic policy approach. It has led the operators to become extremely cautious in growing risk asset volumes. The asset structure of banks will therefore most likely continue to wear a short-term maturity profile as long as economic performance remains disappointing.

Banking consolidation will not in itself encourage banks to increase lending in a situation of rising credit losses. The revenue structure of even the largest banks shows that they have been earning more from treasury operations than from core lending activity over the past several years. There are yet no regulatory changes in place to redirect this trend.

The entire economy has been on hold for almost 18 months and everything seems to be waiting for the conclusion of the banking consolidation. The thinking is that consolidated banks will use their huge funds to kick start the economy once the consolidation process is concluded. But this expectation is limited by the fact that banks, being service institutions, can only service the operators they see in the economy.

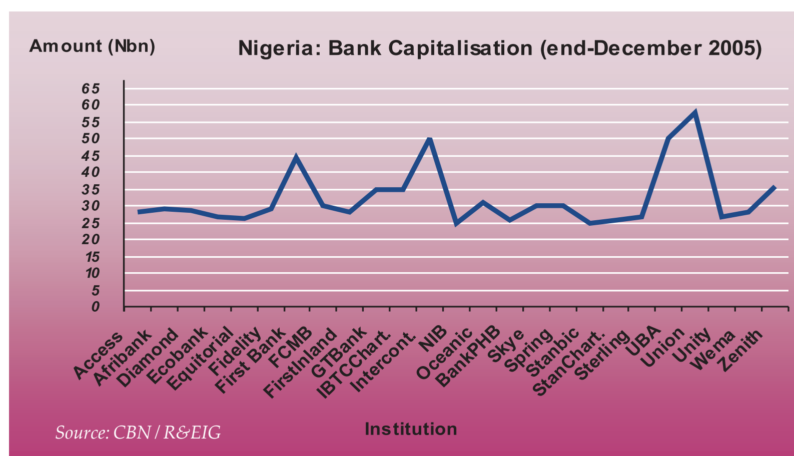
For the big money the banking sector has mobilised to be useful to the economy, there needs to be a large number of operators in the real sector ready and able to utilise it productively. A sign for such readiness is a rising number of new businesses setting up and big expansion projects taking place in the industrial sector and elsewhere side by side with the capacity building process in the banking sector. What is happening instead are business stagnation, factory closures and downsizing.

The regulatory authorities need to watch the situation because it is a bad signal that there could be a mismatch

between a consolidated banking industry and the real sector in terms of available investment opportunities and business volume targets of banks. While there are a lot of small scale businesses and micro enterprises to cater for there will be big banks looking for volumes not easily available from local businesses.

It is important that the economy does not end up with a banking sector that is oversized to it. There is the need to define clearly the place of small scale and micro enterprises in a post consolidated banking industry. The banks' SMEIS scheme is not an answer to this because the issue here is one of businesses that are already accessing bank credit in the normal course of business coming under threat of being swept aside as big banks naturally weed off relatively penny accounts.

In a post recapitalised banking industry therefore there will be highly capitalised banks but adequate capitalisation will not make up for the other equally important indices of measuring the soundness of a bank. Recapitalisation will raise liquidity in the short-term but will not guaranty a conducive macro-economic environment required to ensure high asset quality and good profitability. In the absence of an enabling environment, banks will devise their own means of attaining those goals and that will not lead to the full realization of the goals of the reform.



Source: CBN / R&EIG

One of the major concerns arising from the consolidation policy is the limitation of the reform measures to the banking sector instead of a comprehensive set of macro-economic policies that address real sector-linked challenges facing banks. Because banking is a service industry, it ought not to be the starting and ending points of economic reform since it should follow the direction of the industrial and other sectors it serves.

The Central Bank on its part believes banks should drive those sectors to recovery and growth. The banking reform itself was not a vote winning policy in banking circles but the Central Bank believes it is the best way of reorganising the banking sector, uplifting its performance and advancing it. But without a clear vision of where the rest of the key economic sectors are headed and how far they can go the reform in the banking sector will have a limited impact. There is therefore no clear understanding, agreed strategy or blue print as at now on how the banking sector reform will translate into high economic growth.

Reconciling Size With Quality

The new banking policy has set the operators on a mission of building size but how this eventually reconciles with service quality isn't getting the desired attention yet. The big banks are driven headlong by the objective of getting bigger in order to continue to rule the industry in terms of size and market share. Banks are competitively aspiring to attain some high sounding targets on equity base and the size of the balance sheet but how to deal with the challenges of managing size isn't receiving equal attention.

Being big and being efficient haven't been found to go together. The consolidation policy has provided the spur for banks to build the sizes of their balance sheet but most of them haven't got firm strategies to deal with the challenges of becoming big. One of the major challenges of a post consolidated banking industry will therefore be the issue of how to preserve operating efficiency and service quality of banks. Banks that fail to build operating structures that match efficiency with volume growth will face serious pressures on operating efficiency and service quality.

A post consolidated banking industry will present leadership challenges at the top management levels in banks. There will be a need for new vision; new competitive strategies will also be needed. The decision making base of banks will need to be broadened and decentralisation of the management function will be a major requirement.

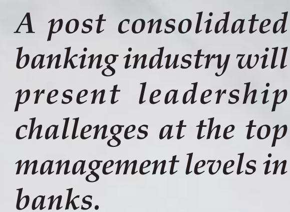
The leadership force needed to keep every part of a mega banking structure streaming round will need to double. Consolidation will obviously create in every bank, new demands of management that the present executive capacity may not posses. There will be the need to develop new competences in order to reinforce operating strengths and competitive advantages. Banks therefore

need to build adequate capacity at top management levels to be able to meet the demands for a much more effective leadership in a post consolidated banking industry.

Getting the operating structure right is a key factor in banks going through mergers and acquisitions. The parts need to fit into themselves for the new entities to be able to function properly in the marketplace. This challenge becomes even more pronounced in an environment in which mergers and acquisition were imposed rather than a development warranted by identified business opportunities.

There is a small group of medium sized banks that stand as a testimony to the success of new generation banking. The leading new generation banks, being relatively moderate about size, are the banks to watch in a post consolidated banking industry. They are reasonably cautious about the implication growing big has on service quality and are either adding small banks to themselves or are standing alone. With growth rates that are above industry average, these more strategically focused banks constitute the real competition in the new industry.

The banking industry is indeed clearly positioned for a leadership contest between the big old dependables and the emerging new generation generals. The first generation giants are coming under pressure to take the steps that will preserve their volume leadership in the industry. The high growth driven new generation challengers will aspire to grow volume with performance quality. They already have brand reputations that rank them at par with the big banks on safety of public deposits. There is likely to be a situation where the leading new generation banks close in with the big banks on volume while still maintaining the edge on operating efficiency and performance quality.



A post consolidated banking industry will present leadership challenges at the top management levels in banks.

The leading new generation banks will come face to face with the challenges of becoming big suddenly almost overnight. A big hurdle in their way is how to manage size and defend quality at the same time. There will be pressure on efficiency standards and the tendency for performance quality to weaken. There is the possibility that some of the banks here may suffer a decline in quality standards while those that will be able to sustain their performance quality benchmarks will have to run an extra mile.

Whether any member of this group will be able to defend its superior performance quality in a post consolidated banking industry depends on the adequacy and firmness of management responses to the demands of the new operating environment. A visible change in the style of management is a necessity for any bank to continue to maintain leadership in any aspect of banking business in the post consolidated environment.

The emergence of big banks will tend to level up niche banking opportunities and make competition flat in the industry. This means every bank will have a complete menu of essentially the same financial services. The only way to maintain competitive edge in the industry will be product differentiation and a lot of marketing noise can be expected in this area. Banks will need new product offerings to tap into new markets.

A New Round of Bank Closures

A number of weak banks that cannot find places under the consolidating groups risk withdrawal of their banking licences and closure by the Central Bank. A new round of bank closures and liquidation is therefore likely to be a major activity in a post consolidated banking industry. More than N200 billion is trapped in the proven cases of five terminally distressed banks and the chance is high that some more banks will join the liquidation list.

Closing the banks will place a final seal on depositors' hopes for an eventual survival of the banks sinking with their deposits. The likely negative impact of this on public confidence in banks can be expected to be tempered by the reinforcement the banking reform has made to the banks standing in a post consolidated industry. Bank closures and liquidation are therefore not expected to have a serious negative impact on the banking industry. However, the banks that emerge in the base in a new ranking of business volume and capitalisation may be vulnerable with time, as safety conscious depositors will gradually seek to move up the ladder.

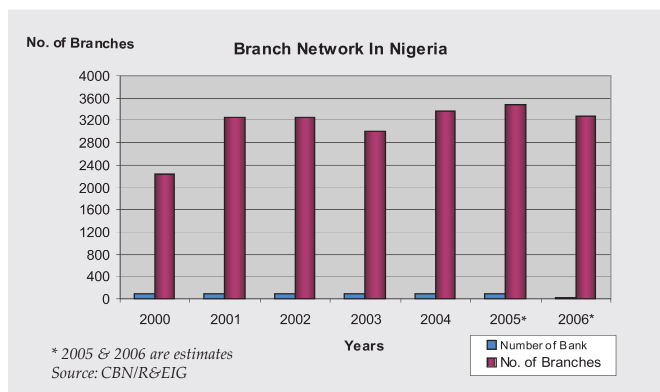
The Central Bank's consolidation policy was only adding a regulatory force to an already ongoing industry trend. Long before Prof. Charles Soludo took over the leadership of the Central Bank the business of banking had been shifting to the big banks perceived by the public as safe. The fact that there have been over 90 banks in the system is only in name. In reality, the business of Nigerian banking is in the hands of not more than 10 banks. With the number of banks in a post consolidated industry likely to

stand at more than two and half times that number, it does not appear that the industry induced consolidation has ended.

Twenty six banks are still a crowd in an industry that has for several years been shifting on its own towards an oligopoly. A big economic prosperity will be required in the economy to sustain that number. There are no signals yet for output and consumption-led economic expansion to happen any time soon. By post consolidated banking industry standards, institutions that end up in the category of small banks are not likely to be major destinations of safe haven seeking depositors.

It can be expected that the Central Bank induced mergers and acquisitions have now been planted in Nigeria's business culture. The experience has been acquired and banks can therefore be expected to continue to seek and use mergers and acquisitions on their own as a tool for strategic repositioning and stimulating growth. The eyes of corporate boards seem to have been opened to the benefits derivable from mergers and acquisitions.

This is but the first round; business opportunity induced consolidation will come next. It is highly desirable that banks, finding themselves competitively disadvantaged, will take early steps to merge with others rather than heedlessly hanging out until they sink with depositors' funds. Apart from troubled institutions it can be expected that there will be healthy banks coming together on their own seeking to establish competitive edge through mergers and acquisitions. In the medium-term the number of banks will possibly drop further.



* 2005 & 2006 are estimates
Source: CBN/R&EIG

Operating Developments To Watch

The Central Bank believes the enhanced capacity of banks will place them in a position of strength to concentrate on their core function of financial intermediation to the benefit of productive lending in the medium-term. However in an environment of rising credit losses, most banks are likely to become extremely cautious with new lending.

Banks will need reinforcing their strength in credit administration matters preparatory to shifting the new money to the high earning asset side of the balance sheet. They need to implement measures and adopt strategies to preserve and enhance risk asset performance standard for some reasons. The first is the continuing difficulties facing the industrial sector as already highlighted. The second is the likely decentralisation of lending powers that is a necessity for mega banks. The third is that merchant banks entering the retail market for the first time need a lot of caution to avoid costly lending mistakes.

The ability of banks to grow revenue and profit numbers in the short-term is limited. The banking industry is presently facing a revenue constraint and three major factors are likely to continue to restrict revenue and profit growth in the sector. The first is the decline in interest rates, which has reduced the average interest yield per naira of loans and advances. With a further decline in interest rates in 2005 following the downward review of the minimum rediscount rate from 15 to 13 per cent, bank earnings will come under bigger pressures still. Interest income, which is the main revenue line for banks, has continued to slow down, accounting for a declining proportion of gross earnings. This will continue to have a depressive impact on revenue growth.

The second is the discouragement to grow risk asset volume in the environment of rising credit losses and the difficulties facing the industrial sector. The only way to compensate for the decline in the lending rate is expansion in credit volume but this is not happening because the rest of the economy has not been equally empowered to create productive opportunities for bank financing.

The third is greater regulatory attention on banks that have closed cheap profit opportunities. With greater policing of the foreign exchange market, a big channel for easy profit has closed for the banks.

Two main cost elements are likely to strain bank earnings. Interest cost isn't moderating as fast as interest in-

come and this is because competition for funds has remained high. Again, the relatively cheap funding windows in the public sector have been shut against banks. Operating cost is also rising ahead of gross income and that is encroaching deeper into gross revenue.

Likely fallout of the low interest rate objective is discouragement of domestic savings. Average deposit rates of banks have approached the low end of single digit. This needs to be well managed because it has the capacity to erode bank deposit base from two angles. The first will be a natural outflow of financial capital in search of higher return in other forms of investments. The second will be the tendency for many savers to consume their savings as rising cost of living squeezes the people's propensity to save.

One of the major hurdles on the path of low interest rates is the high rate of inflation. The reason that the price of money went so high in the first place was because the general price level is high and rising. The most potent factor in attaining the low interest rate objective is therefore getting inflation rate to single digit as well. That is the only way the supply of money can be maintained by reducing its price.

Dealing with inflation is key because as long as inflation rate remains in double digit, investors will press to earn positive real rate of return on their money. That means banks are not likely to see many depositors willing to give them money they can lend at low interest rate. The resulting scarcity of loanable funds will be because while there is clamour for low interest rates there will be nobody willing to stand still in an inflationary environment to subsidize the price of money.

A post consolidated banking industry will appear to be a much better risk than hitherto. Banks are therefore most likely to press for a reduced deposit insurance premium to reflect this position. The pressure for a risk weighted premium can be expected to mount. As deposit liabilities of merging banks become aggregated, the deposit insurance premium bill will become weighty.

The Nigeria Deposit Insurance Corporation will most probably have to yield ground in certain areas. It may finally settle for a risk categorisation of banks for the purpose of deposit insurance premium, which is in line with the risk based capital adequacy standard. In the alternative it may consider a reduction in its premium rate, which is currently 15/16 per cent or limit premium to the maximum amount of deposits covered by deposit insurance now being increased to N200, 000.

Government Fiscal Policy

The nature of government fiscal conduct is a major factor in shaping a post consolidated banking industry. The management of oil revenue presently does not show that government recognizes the cyclical nature of the oil market – a boom is followed by a burst. By running fiscal deficits at a time that its revenue is at an exceptionally high level, government fiscal behaviour puts the economy at the risk of financial crisis in the event of a downturn in crude oil prices. In the absence of adequate reserve capacity to finance expenditures any time government revenue drops, the Nigerian economy skates on a thin ice year after year. The banking industry needs to appreciate this risk and provide for it in its contingency plan.

Government spending seems not to be empowering the private sector as well. More than 80 per cent of government spending constitutes recurrent expenditure, which is not stimulating the nation's productive capacity. There are neither reasonable savings nor so many infrastructural projects to show for the longest running oil boom seen so far in Nigerian history.

The financing of the fiscal deficits is hurting the economy from two angles. The first is the inflationary stock of money the Central Bank's monetization of fiscal deficits adds to the economy. This keeps inflation rate above the level of interest rates and erodes the real value of savings and investment.

The second is the crowding out effect on the private sector. By selling government debt instruments to the public, government is further withdrawing from the already thin resources of the private sector to overgrow its size. This is not an appropriate fiscal path for a government that is downsizing and promising to prop up the private sector. By drawing more resources from the private sector at a time it is handing over more responsibilities to it, government is not creating the environment for a prosperous private sector.

Government spending pattern needs to strengthen the productive capacity of the private sector and the Central Bank needs to cut off the supply of inflationary stock of money. A significantly supportive government fiscal conduct is required to stimulate the industrial sector. Banks must find a burgeoning private sector to be able to deliver the rewards of the reform.

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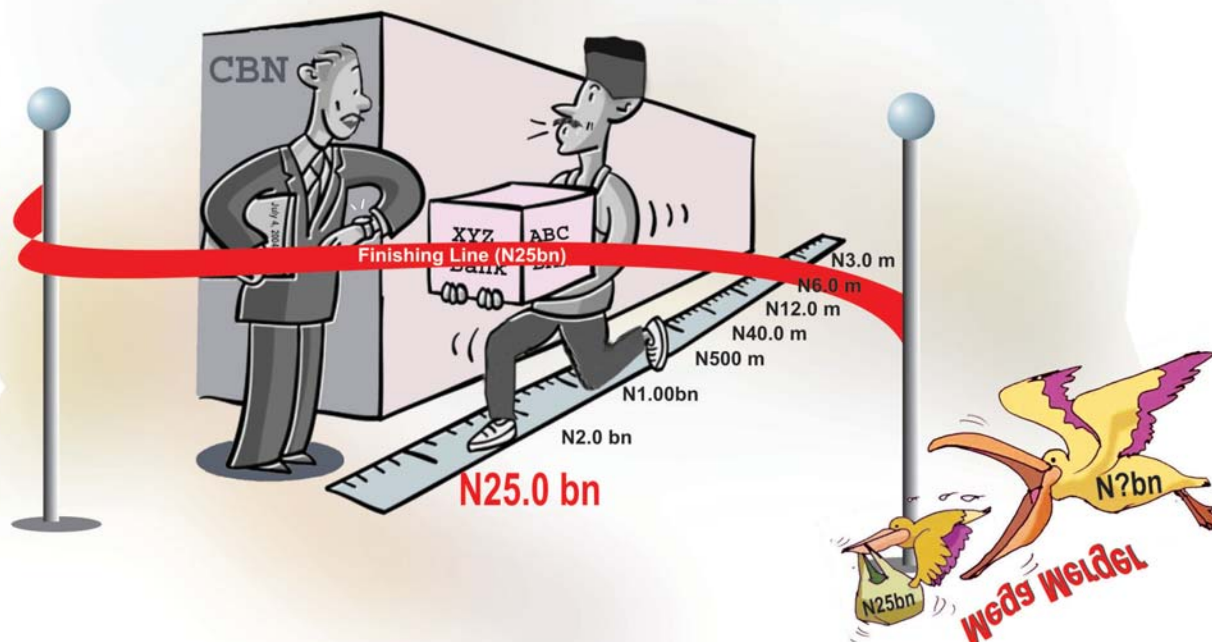


Bank Consolidation:
Breasting The Tape, Facing New Challenges

* By Dr. 'Biodun Adedipe

INTRODUCTION

The history of the Nigerian banking system is replete with growth and burst cycles in the number of operating banks and their branches. Usually, growth spurts are experienced when the policy environment presents strange business opportunities in the banking sector, or there is a sudden policy shift that makes it easy for ordinary business people (not professionals in banking) to initiate a process that creates access to public funds in the name of bank deposits. Perhaps the most far reaching of such bursts was in 1947, when as many as 145 banks were registered because there was no banking legislation in operation and it was quite fashionable to own an indigenous bank! The opportunistic institutions ended up in liquidation, either on account of inadequate capital and/or liquidity crisis that got out of hand. In fact, the minimum capital requirement of ₦25,000 in the 1952 Banking Ordinance resulted in the demise of many of the mushroom banks, at which time there was no consideration for consolidation to meet the capital re-

quirement.

Also, the pattern had always been that of dominant personalities in most of the institutions, creating avenue for unwholesome practices that resulted in the collapse of such institutions and substantial losses to their various stakeholders. This occurred either through unsecured insider credit, or foreign exchange transfers that had no tangible business basis.

The pattern of going it alone that existed in the system did not encourage thought of consolidation. Equally, previous increases in the minimum capital requirements were not significant as to motivate banks to merge, under whatever arrangement, in order to comply with the requirements. As well, consolidation has never been mandatory for Nigerian banks, even if it was capital induced.

Bank consolidation has often fallen into two categories of voluntary and policy-induced. It is voluntary when an industry shakeout is market-driven, with players seeking consolidation partners as a possible route to survival, relevance, growth and profitability. The peculiarity of the voluntary consolidation is that not many players are involved at once, and as such the disruptions to business activities and the financial system are minimal and have often not posed any serious danger to industry stability. The policy-induced and mandatory consolidation, in spite of its many benefits, has the capacity to disrupt business activities and threaten the stability of the financial system. There is no doubt that the challenges of the latter are more formidable, and that is what Nigeria has been grappling with since the July 2004 pronouncement by the Governor of the Central Bank of Nigeria.

The peculiarity of the voluntary consolidation is that not many players are involved at once, and as such the disruptions to business activities and the financial system are minimal and have often not posed any serious danger to industry stability.

The challenges also fall into two planks, namely:

1. In-consolidation, representing the period from 6th July 2004 to 31st December 2005, during which the 89 licensed banks were supposed to raise their shareholders' funds to ₦25 billion, through either going it alone or merger/acquisition.

2. Post-consolidation, which represents what the banks will likely become from January 2006, what the consolidated banks must grapple with and what the banking/general public should expect.

This paper addresses these two planks of the bank consolidation in Nigeria during 2004/2005, and the expectations thereafter. In the first section, a quick review of the purpose of bank consolidation in global terms is reviewed vis-à-vis the need for it in Nigeria. Section two deals with the strategies and activities engaged in by the banks to achieve the end-December 2005 hurdle placed before them by the Central Bank of Nigeria (CBN), while section three is a prognosis of post-consolidation challenges. The paper concludes with a few remarks on the issues needing further attention.

WHY CONSOLIDATE?

There are as many reasons and strategies for bank consolidation as there are banking jurisdictions. When the opportunities in the operating environment for banks, either within the boundaries of a country, an economic zone or geographical sphere, become amenable only to consolidated institutions, there is a tendency for market-induced consolidation. Many cases of bank consolidation that have been recorded to date in the modern history of banking are of this kind, and ready examples are the European and American bank mergers and acquisitions of the 1980s and 1990s.

Market-induced consolidation normally holds out promises of scale economies, gains in operational efficiency, profitability improvement and resource maximization. The outcomes have however, not totally confirmed these supposed benefits and they have varied across jurisdictions, especially when compared with the particular pre-consolidation expectations.

Bankers have always claimed that scale economies is the primary objective of mergers. As such, there was an average of 190 mergers per year through the period from 1960 to 1982, rising to 423 per year during 1980 to 1994 to produce total merger transactions of 6,347. In all these, it was hard to find any evidence of scale economies. In Europe, there were between 50 and 90 mergers per year during 1986 to 1994. The merger of Chase Manhattan and Chemical banks in 1995 produced the largest bank in the USA, representing 8.7% of total assets in the banking system. This triggers the thought of possible mega merger, involving say, First Bank and Union Bank, or any of these banks with Zenith Bank!

Hughes and Mester (1997) provided evidence to suggest that there are scale economies in banking, bank managers are risk averse, and banks use the level of their financial capital to signal the level of risk. This is an area of interest in Nigerian banking, especially when the return on equity is calculated in another two to three years and then compared with the historical industry average.

Rhoades (1996) reported that American banks consolidated in response to the removal of restriction on bank branching across States, while Hughes, Lang, Mester and Moon (1998) concluded that the economic benefits of consolidation are strongest for those banks that engaged in interstate expansion, and in particular the expansion that diversifies macroeconomic risk. Vender Vennet (1997) found that domestic mergers improved profitability and operational efficiency, but cross-border (national, not inter-State) acquisitions were a surer source of cost efficiency.

Hughes, Mester and Moon (2000) provide evidence that scale economies exist in banking, but they are elusive because they fail to account for risk. Thus, scale economies that result from consolidation and diversification do not produce better performance in banking, unless that choice makes the bank's management more conscious of risk and moderates its decisions and actions appropriately. Larger scale of operation that leads to diversification can only reduce liquidity and credit risk under the ceteris paribus assumption, and they argue that this is not always so. The implication for bank consolidation in Nigerian banking is whether the bigger (not yet mega) banks will seek a good balance between growth and risk management.

Solanes and Penarrubia (2001) examined mergers and acquisitions in European banking, and found that industry consolidation was beneficial (by providing social benefits) in the first economic integration stages, but could damage welfare in the more advanced stages as the few big banks safeguard price agreements to forestall foreign competition. Perhaps the most important social benefit that Nigerian banks (after the first round of consolidation ended 31st December 2005) would confer on the banking public and the national economy is a sharp drop in lending rates. Even if this unlikely scenario occurs, there is the likelihood that fewer

Table 1 **Nigeria: Increases in Banks' Capital Requirement**

Year	Amount (₦ million)	Increase	Compliance Period
1952	0.025	n.a.	3 years
1962	0.500	1900%	n.a.
1968	0.06 (1.5 Foreign)		n.a.
1977	10 (6 Merchant)	1900%	n.a.
1989	20 (12 Merchant)	100%	n.a.
1992	50 (40 Merchant)	150%	n.a.
1998	500	100%	2 years
1999	500 (1,000 New)	100%	n.a.
2002	1,000 (2,000 New)	100%	2 years
Jan 2004	2,000	100%	n.a.
July 2004	25,000	1150%	18 months

Sources: 1. Various issues of the Annual Report and Statement of Accounts of the Central Bank of Nigeria. 2. Prof. Green Nwankwo, History of Nigerian Banking, a Collections of Papers and Articles, in celebration of his 50 Years in Banking.

and colluding banks (especially during the second phase of consolidation that is envisaged) will pursue their own business interests more than they would the national or social interest!

The other side to European mergers and acquisitions was the intent to encourage banks to grow big and thus become impossible of failure. This, of course, ignores the fact that no bank can ever be too big to fail. All it takes for a bank to fail is for “bad news” about a bank to get to its stakeholders (especially depositors) and they all walk in at the same time to take their funds! For such bank to survive, it must have sufficient liquid assets to meet all maturing and long-dated obligations.

However, there appears to be divergence between the state of the banking industry in Nigeria vis-à-vis the vision of the government and regulatory authorities for the industry. This, in the main, was the reason for the policy of mandatory consolidation, which was not open to dialogue and its components also seemed cast in concrete.

Prior to the major policy shift by the Central Bank of Nigeria (CBN), Nigerian banking experienced a steady increase in the number of distressed deposit-money banks, i.e. those rated by the CBN as marginal or unsound. This created the fear that Nigerian banking could be heading towards systemic distress. The marginal and unsound banks increased in number from 17 in 2001 to 23 in 2002 and 2003, and then 27 in 2004. This number represented 30% of the operating banks in the system, rising from 17% only three years earlier! It can be argued though that sudden policy shifts (especially the withdrawal of public sector funds from the banks) was partially responsible for the increase in the number of marginal and unsound banks in

Bankers have always claimed that scale economies is the primary objective of mergers. As such, there was an average of 190 mergers per year through the period from 1960 to 1982.

2004. The corollary is that the institutions concerned have had inherent and deep-seated weaknesses that the policy shift exposed, and no matter what, they would have eventually become distressed.

While Nigerian banking had not gotten to systemic distress by end-June 2004, it made a lot of policy sense to preempt the destabilizing effects of such occurrence by initiating reforms at the time the Central Bank did. The agenda had all the ingredients of contemporary banking reforms, but the implementation plans had some flaws.

Table 2 Nigeria: State of the Banking Industry

	Number of Banks			
Category	**2001**	**2002**	**2003**	**2004**
Sound	10	13	11	10
Satisfactory	63	54	53	51
Marginal	8	13	14	16
Unsound	9	10	9	10
	90	**90**	**87**	**87**

Source: CBN

As such, there was initial resistance, which nonetheless soon whittled down to insignificance because of the strong political support the policy had and the sheer executive will to force it through. When this became clear to the stakeholders in Nigerian banking, the 18-month race to the tape began in earnest.

It is important to mention here the initial confusion as to whether the new rule applied to the paid-up share capital or the shareholders’ funds. If it was the former, compliance would be a massive tall order. The indication by the central bank that it was the latter ignited hope in banking operators and the race to the tape was fully ignited.

As well, it is to be noted that just before the policy pronouncement in July 2004, two of the leading banks in Nigeria (Zenith Bank Plc and Guaranty Trust Bank Plc) went to the capital market to raise substantial sums. The timing of these new issues drew remarks that the managements of these banks probably had an inkling of the impending policy. Such argument is easy to debunk because the regulatory approvals were obtained long before the new Governor of the Central Bank of Nigeria that introduced the reforms assumed office. The only thing that can be said about these banks would be that their managements were proactive and had a correct reading of the economic climate in Nigeria, and perhaps the globe.

AT THE STARTING BLOCK

The first major interpretation of the policy was to seek out how many players the regulators/government possibly desired at the end of the exercise. This, as would be shown later, should give an indication of what to expect after the deadline of 31st December 2005.

Based on the capital plus reserves of banks operating in Nigeria by end-December 2003, assuming no growth

was recorded in 2004, it appeared that the policy shift was designed to reduce the number of operating banks from 89 at June 2004 to 11 – a figure derived from splitting the aggregate capital of ₦291.25 billion for end-2003 among the 89 banks in operations. The number improved slightly to 14, using the aggregate capital at end-2004. See Table 3. This perhaps was why the Central Bank in January 2005 indicated it expected 15 mega banks to emerge from the consolidation exercise.

By the beginning of August 2004, the race proper had started and banks immediately fell into three groups, namely:

1. Those that already had capital in excess of the minimum, and could only think of acquiring other banks and/or expanding their capital base. This group included First Bank of Nigeria Plc and Union Bank of Nigeria Plc.

2. Those that could go it alone and had the capacity for it. This included those having obvious market recognition and standing that left no stakeholder in doubt that they could make it on their own. It is in this category that foreign banks or banks having substantial foreign shareholding belonged. The other category in this group were those that had the hope of breasting the tape alone, but the investing and general public did not see that possibility – the trust was by and large self-propelled.

3. Those that obviously had no hope of making the ₦25 million on their own, but had capacity to enhance their capital through new issues in the capital market or private placement. With their enhanced capital base, such banks were sure that they would be attractive to other banks or bank groupings.

By the end of 2004, the banking sector was a pleasant surprise to most watchers, as the pattern of dominance it exhibited over the period from 1999 till date again reflected in the new issues market. The Securities and Exchange Commission (SEC) stated in January 2005 that the sector accounted for ₦147.4 billion (78.8%) out of a total capital amount of ₦187 billion raised in the Nigerian capital market in 2004. Just eight banks accounted for ₦123.3 billion of this total amount. See Table 4 for the details. This development was important in three different ways, namely:

1. The Nigerian capital market had the capacity to produce the volume of investible funds demanded by the new minimum capitalization in Nigerian banking.

2. Some banks were underrated in terms of their ability to mobilize capital from the investing public.

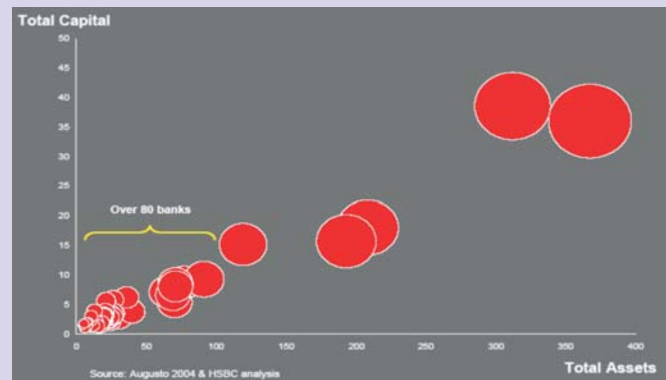
3. Other banks that imagined they had no hope of raising funds from the capital market gained confidence from the roaring success recorded by the early movers.

THE JOURNEY TO THE TAPE

One of the initial fears, which still remains an issue, is that the time limit for the implementation of the consolidation programme was rather short. The scramble to meet the deadline caused banks whose owners ordinarily would not have come together in a business venture or combine to seek shelter under a common umbrella in order to escape the possible loss of investment. This brought together "strange bedfellows", who for the sake of survival came into the same boat, but have every tendency to begin bickering post-consolidation.

An indication of this was in the plurality of memorandum of understanding (MOU) that banks signed with each

Nigerian Banking: Pre-Consolidation Structure



other, signifying either a big bank that intended to acquire a smaller bank, or two (or more) medium-sized banks aiming to merge, with specific amounts for each member to raise from the capital market and then beef up its capital base. The latter was what happened in the cases of the initial Sterling Bank and Astra Bank, whose members had divergent objectives that led to the collapse of the MOU.

Under the first scenario, several banks sent proposals to the big banks in the system for outright acquisition. The arrangement and the stiff timeline put the big banks at an advantage, dictating terms that were at times quite ridiculous. The smaller banks of course, had little or no choice, if they wanted to survive. This played out towards the end of December 2005, when a few banks got ditched by the big banks they were negotiating with. There were two cases of irreparable disagreement over share valuation (Lead Bank with Wema Bank and Trade Bank with Afribank), while the other failed negotiations were largely to do with the quality of the risk assets and general state of health of the banks concerned (Union Bank vis-à-vis Hallmark Bank, Gulf Bank and a few others). There were indications also that one of the problems Afribank had with Trade Bank was the quality of the latter's risk assets.

Table 4 **Nigeria: Capital Market Funds Raised by Banks (June Dec 2004)**

Institution	Amount Raised		
	Initial	Supplementary	Total
Guaranty Trust Bank Plc	10.60	10.60	21.20
Zenith Bank Plc	8.70	11.70	20.40
Oceanic Bank International (Nigeria) Plc	17.00	0.60	17.60
Access Bank Plc	8.70	-	8.70
Afribank Nigeria Plc	17.00	-	17.00
Intercontinental Bank Plc	16.50	-	16.50
Wema Bank Plc	17.50	-	17.50
Standard Trust Bank Plc	-	4.40	4.40
	96.00	**27.30**	**123.30**

Source: Nigerian Stock Exchange

The coming together of several small and medium-sized banks also had its problems. There was mutual distrust, which largely arose from the possible sharing of key Management and Board positions. This resulted in a number of MOUs being abandoned, and new ones signed hurriedly. For example, what started as Sterling Bank split into two groups of one retaining the name "Sterling", while the other group emerged as Skye Bank. This particular split was a positive one because the net gain to the banking system and economy were two banks whose combined capitalization came to ₦57 billion, which together they probably would have not pooled. There was much carpet-crossing, although there was no case of litigation on abandoned merger, as the recent celebrated case between Johnson & Johnson and Guidant in the United States of America (USA) where the latter sued the former because it threatened to withdraw from the merger negotiations on account of loss in market value of Guidant because its investors reacted to a piece of "bad news" about the company! More remote in this environment is the evolving pattern still in the USA of Silicon Valley mergers, where the first step is to sue a prospective merger partner, then follow with negotiation and eventually merge!

In the course of implementation of the programme, the CBN announced the desire to eliminate family banks, as many of the distressed banks have been found to get into that situation because of certain dominant figures in them. This blanket statement did not separate between the banks that are professionally managed from those in which opportunists were in charge. Coming to see the likes of Oceanic Bank, First City Monument Bank and Diamond Bank come out strongly after the consolidation exercise was a sort of relief. This seemed to confirm the argument that banks fail not because of their strong links with particular families, but because of poor and/or "rogue" management primarily. The positive fallout of this is that these banks are now more widely held, than prior to July 2004.

The race to the consolidation tape by Nigerian banks also involved considerable financial engineering and reengineering, which was more of a danger to the system than the flaws in the programme itself. The reconstruction of balance sheets of banks towards presenting clean book for merger partners and eventually to the regulatory authorities raised both professional and ethical issues. While some were done professionally and would pass the test anywhere in the world, there were some that were mere window-dressing to make the tape. The latter were easily and quickly exposed in the course of due diligence (DD), even though there were some that probably escaped the sharp eyes of the professionals that conducted the DD.

The Central Bank was quite sure that the DD that banks conducted on themselves was necessary to expose irregularities in the merging banks, and should throw out banks whose cases were bad. Such banks, it was presumed,

would not find "suitors". The argument though is that this condition is not sufficient to determine the health of an institution in the Nigerian scenario. Some banks probably scaled through for reasons other than the strength of their balance sheet, but because of the prospects of the emerging bank, going forward, when it has to compete for business in order to survive, grow and be profitable. As well, there could be one or two cases of banks that were liquidated at the end of the exercise that, for this same reason, whose last minute acquisition should have been allowed where some banks indicated intent to acquire them.

The consolidation process was quite expensive, and there was no indication that the banks got the kind of support envisaged when the regulatory authorities made promises on tempering the cost implications of the programme. The promise was enough to goad the bankers into a frenzy of activities, without sparing cost. There was the case of a bank that spent almost as much as the amount it managed to raise from its public issue!

The banks were also offered incentives in various forms, ranging from those for acquiring/acquired and merged banks to forbearance in terms of past misdeeds that are brought into the open. The latter was quite significant because of the extent of rot that was in the system and the assurance of escape from prosecution if there was self-reporting of such misdeeds. The promise of forbearance of debit balances in the banks' operating accounts with the Central Bank meant several billions of Naira, which at first, generated public uproar as to the basis for selecting which of the distressed banks would benefit from the offer and the allocation formula for the amount earmarked. The end result was that this further revealed how weak and sick the system was.

The x-ray of the journey to the consolidation tape would be incomplete without a mention of the proposed Alliance Bank Plc (in formation). Ordinarily, some 20 or so banks would have been taken out of the industry by the third week of October 2005, when the banks in merger talks indicated to the Central Bank of Nigeria (CBN) their partner banks. Most of the banks left out formed Alliance Bank, which was supposed to be a "bridge bank", designed to warehouse those banks until their collective problems are resolved or their orderly liquidation could be effected. The CBN then gave them two conditions:

1. Produce an organogram, establishing the management structure and indicating who will fill each position.

2. Recover some ₦10.5 billion out of the insider-related credit, which was the major factor in the negative shareholders' funds of about ₦77 billion.

While the bank (in formation) had no difficulty meeting the first condition, although there were doubts as to why any member of the management team that mismanaged the member banks, in the first place, should aspire to be in the team that will manage the bridge bank. Though not specifically disclosed, this could be one of the major reasons that made the CBN foreclose the bridge bank idea. It was also most unlikely that any acceptable professional (to the CBN) would risk taking the job, unless s/he was appointed by the CBN and assured of the support necessary to achieve turnaround of the bank.

The performance of Alliance Bank on debt recovery was dismal, as the group managed to raise only some ₦5.5 billion (₦3 billion from a single borrower of one of the banks). This meant that the banks were completely out of the forbearance window that allowed write-off of the debit balance in their CBN operating accounts.

The other side to European mergers and acquisitions was the intent to encourage banks to grow big and thus become almost impossible of failure.

The last ditch effort to save the 14 banks that were eventually liquidated was to allow the banks that had crossed the ₦25 billion mark to propose acquisition of the unattached banks – referred to as cherry-picking. The indications were made right on time, but the transactions failed because the follow-up step of consummation of the process was stipulated by the CBN for one week (which included two days of public holiday). Perhaps one of them (African Express Bank) should have been saved from the hangman's noose, as it recovered some ₦3 billion of insider credit, had an acquiring bank agreed to restructure the balance in line with the bank's restructured balance sheet. The position of CBN remained though that the deadline was well past – already two weeks into 2006 and beyond the deadline!

AFTER THE DUST IS SETTLED

The new challenges that face the Nigerian banking industry, post-consolidation, include the following that cut across the operators and regulators.

Consummating the Mergers and Acquisitions

Some of the mergers and acquisitions that were concluded before the deadline of 2005 evolved from a rushed process to comply with the rule. The scenario seems like a comparison of a wedding ceremony with marriage, where the former has all the trappings/glamour of posturing and making lasting impression on the guests and witnesses, the latter is the reality of living together in peace and productively.

Integration challenges have often focused on information and communication technology (ICT), whereas it is all embracing. Processes, procedures, people, cultures, etc need to be integrated as well. The extent of the challenge this poses is easily appreciated in these two instances:

1. A group of banks that had Board and Management relationship merged, but the staff of the lead bank in the group regard the others as "inferior" somewhat and treat them as intruders who came to dilute the culture.

2. Another bank that acquired others simply defined its culture as inviolable, and that the staff of the acquired banks must accept its poorer remuneration. If any of such staff does not find this acceptable, s/he would be shown the door immediately.

As such, what is happening is more of creating a façade of a fully integrated bank, whereas there is real trouble within that the institutions would never admit outside. There is the likelihood that the integration challenges might trigger "divorce" eventually, the worst case in merger history being a transaction that failed after almost ten years of unsuccessful efforts to integrate.

Table 6 Nigeria: Bank Capitalization (end-December 2005)

	Institution	Capital Amount (N' billion)
1	Access Bank Plc	28.00
2	Afribank Nigeria Plc	29.00
3	Diamond Bank Plc	28.60
4	Ecobank Nigeria Plc	27.00
5	Equitorial Trust Bank Plc	26.50
6	Fidelity Bank Plc	29.00
7	First Bank of Nigeria Plc	44.60
8	First City Monument Bank Plc	30.00
9	First Inland Bank Plc	28.00
10	Guaranty Trust Bank Plc	35.00
11	IBTCChartered Bank Plc	35.00
12	Intercontinental Bank Plc	50.00
13	Nigeria International Bank Limited	25.00
14	Oceanic Bank International Plc	31.10
15	PlatinumHabib Bank Plc	26.00
16	Skye Bank Plc	30.00
17	Springbank Plc	30.00
18	Stanbic Bank Limited	25.00
19	Standard Chartered Bank Limited	26.00
20	Sterling Bank Plc	27.00
21	UBA Group Plc	50.00
22	Union Bank of Nigeria Plc	58.00
23	Unity Bank Plc	27.00
24	Wema Bank Plc	28.20
25	Zenith Bank Plc	36.00
		810.00

Source: CBN Report

Disengagement of Surplus Employees

One of the arguments made when the consolidation was announced was the inevitability of disengagement of "surplus" staff. The logic was quite simple. If the number of banks in operation comes down from 89 to 11, at least 78 bank-managing directors would lose their jobs or be down graded. If this scenario runs through the entire organizations, some jobs would certainly have to go. This produced an estimated figure of 31,980 job losses, which the CBN dismissed as unlikely because the need for expansion by the bigger banks would mean retention or recall of the affected staff. See Adedipe (2004).

The reality of post-consolidation is that it is practically impossible for a bank that has staff complement of 5,000 or 9,000 (these are real figures) to retain all of these unwanted staff. For sure, duplicated positions would have to be streamlined. If four banks came together, that means staff occupying certain positions would have to be rationalized – only one out of four company secretaries, training managers, etc! Take Unity Bank for example, it emerged from the marriage of nine banks. There is no magic that will prevent the bank from disengaging 20% to 35% of its staff, if not more.

The unfortunate fallout of this is the high possibility that competent hands could be shown the way out, while mediocres are retained because they represent certain interests. As well, the eventual filling of growth-induced vacancies is unlikely to be with the same hands that were disengaged. Indeed, this has become an industry-wide phenomenon.

Return on Banking Equity

Maintaining the historical return on banking equity in Nigeria will pose a formidable challenge to the management of banks. The five-year average return on equity

was about 43.92% during 1998 to 2002. If the banks must maintain this, then a profit figure averaging between ₦11 billion and ₦19.8 billion would be the new target. The race towards this is already on.

While the industry picture could follow this expectation, the performance of individual banks will vary considerably from the average. Some discerning investors expressed this concern during the capital raising efforts of the banks. The argument was that how long would it take the investor to recoup his/her investment from a banking stock through dividends, except s/he trades the stock actively to take advantage of capital gains.

Tremendous growth has been observed in the balance sheet of banks that made the ₦25 billon mark long before the deadline of December 2005. This leads into another major challenge – that of risk management.

Risk Management

Consolidated banks are bigger and should reap the benefits of scale economies through their capacity to finance large ticket transactions that hitherto warranted syndication. Where syndications are necessary, even bigger transactions would now fall within the capacity of Nigerian banks. The risk implications will however, pose a huge challenge to the banks and require them to improve their risk management capability.

The race to grow the balance sheet and generate commensurate income to sustain the historical return on equity is a challenge on its own. The average of equity to balance-sheet footing that ranges between 4% and 5.5% globally suggests that a ₦25 billion would need to grow its balance sheet to a figure between ₦454.5 billion and ₦625 billion. Certainly, the risk implication of a balance sheet this size cannot be compared with that of a balance sheet of say, ₦25 billion.

Another dimension to the risk management challenge is the branch network of the emerging banks, which makes them become so widespread that control could become a major issue. Take for example, a bank MD/CEO who was running a bank with branch network of 27 branches suddenly now having to take charge of 150 branches. It is an entirely different ball game!

Capacity Building and Retention of Deep Smarts

The disengagement of bank staff is likely to be more at the senior level, where responsibilities cannot be multiplied anyhow. As such, experienced hands will exit the industry and create a need to train aggressively the younger and less experienced hands that are available.

The deep smarts have a combination of experience and exposure that is not easily replicated in the younger generation of bank employees. The challenge then is how to select from among the senior staff those to retain for the purpose of passing down the deep smarts of their respective organizations, and those to release into the labour market. This requires a professionally handled staff audit, possibly including the conduct of psychometric tests and rigorous selection interviews handled by external consultants, to eliminate bias and favouritism.

Good Corporate Governance

The preceding challenges will create a fresh challenge of their own – maintaining the tenets of good corporate governance. The CBN has helped in this by announcing a fresh code of good corporate governance, but it does not have the power to enforce. At best, the apex bank will employ moral suasion, and should be well advised to seek collaboration with the Chartered Institute of Bankers of Nigeria (CIBN). There is no better time for a focused and restructured CIBN that will earn and retain the confidence of the leaders in the banking industry.

As well, individual banks should be encouraged to comply and maintain self-discipline. Key to this will be effective and efficient surveillance and supervision. A banker who knows that s/he cannot easily escape the peering eyes of the regulator will become more wary about breaking the rules.

Conflict and Dispute Resolution

The reference made earlier in this paper to the hurriedly packaged bank mergers being borne of the coming together of strange bedfellows brings to mind again the ugly incidents of the early 1990s, when bank directors fought openly and engaged thugs to attack their fellow directors

over disagreements on how the affairs of the banks should be governed, and the sharing of "loot".

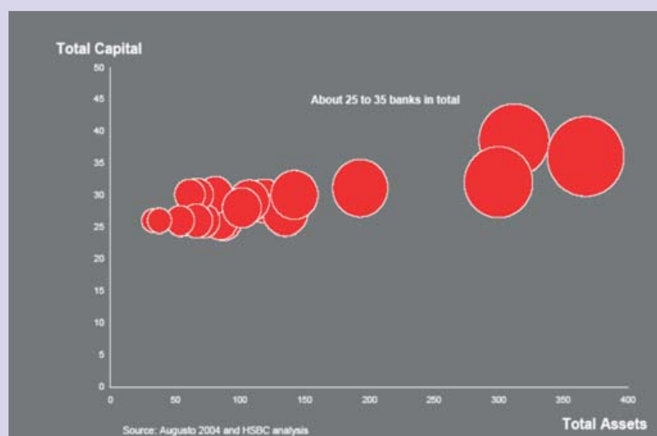
There is no doubt that merger partners would make startling discoveries post-consolidation that will drive them to either engage in litigations or seek alternative dispute resolution strategies. The Central Bank should set in motion the machinery for identifying quickly and moving to resolve disputes that arise from the consolidation exercise.

Strengthening the CBN's Supervisory Capacity

The argument has been made repeatedly that a supervisor is effective to the extent of its ability to understand fully the operations and antics of the operators. Staying a step ahead of operators, rather than abreast of them is the key to effectiveness of the Central Bank.

The staff of CBN should begin to build capacity in banking operations from the operator's perspective, rather than what is traditionally referred to as banking operations within the apex bank.

Nigerian Banking: Post-Consolidation Structure



Fresh Capital Raising and Mergers

Perhaps the greatest challenge of all is the likelihood of a fresh round of capital raising and mergers that will produce the real mega banks. Some banks could be aiming at ₦100 billion capital or more (perhaps the equivalent of $1 billion), and begin to dream of balance sheet size of ₦1 trillion in a few years' time. This will also raise the challenge of management capacity.

The pointer is in the direction of preparing future Nigerian banking leaders that would be able to hold their own in the increasingly complex financial world, and sustain the benefits of the present round of bank consolidation. This applies to the operating banks as much as the Central Bank of Nigeria.

SUMMARY AND CONCLUSION

The Nigerian brand of bank consolidation obviously is unique in several ways. It was sudden and set very high hurdles for operators to scale within such limited time space that many were skeptical about its success. There were gaps in the programme, which nonetheless had the strong support of the executive arm of government.

Banking operators therefore, scrambled to meet the requirements to beat the deadline, in order to remain relevant. Substantial sums were raised from the capital market, defying all predictions about the capacity of the Nigerian stock market. At the end of the period of 18 months allowed, 25 banks (19 consolidated and six stand-alone) scaled through and provided vehicles for 75 out of the 89 banks in operation prior to the policy shift.

One major gap in the consolidation programme is the absence of the Asset Management Company (AMC), even though the CBN promised to establish it. The CBN's position that it would not fund the AMC totally ignored the crucial role that the company would have played in factoring the poor risk assets of the marginal and unsound banks that had no merger/acquisition partners. The Malaysians employed this scheme successfully (the company was named Danaharta) during the bank consolidation programme of the late 1990s and early 2000s.

The post consolidation challenges in Nigeria are enormous, but their early identification sure holds out promises of resolving and handling them effectively. Suggestions were made on what needs to be done in respect of each of the challenges discussed. This will be the signpost to the ultimate destination of Nigerian banking.

Important in the scheme of things would be collaboration between the regulators and operators. Dialogue and continuous exchange of ideas, as well as mutual trust and respect are key to the survival and prosperity of the banking system, towards making a more robust contribution to economic development.

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Given financial scandals and the resulting new mandates on business, firms find themselves pressed to develop strong codes of ethics to guide the behavior of board members, managers, and employees. Although the concern with ethics has always been a part of doing business, business leaders today are beginning to think about ethics as a set of principles and guides of behavior rather than a set of rigid rules. In this sense, business ethics is not only an attempt to set a standard by which all of the employees of a firm can know what is expected, but it is also an attempt to encourage employees, managers, and board members to think about and make decisions through the prism of a shared set of values.

Business Ethics: The Essential Component of Corporate Governance

*** By Dr. John D. Sullivan**

Business ethics and corporate governance have become key factors influencing investment decisions and determining the flows of capital worldwide. In part, this is the result of recent scandals in both developed and developing countries. However, in a more positive sense, the growing demand for good governance also flows from the lessons learned about how to generate rapid economic growth through market institutions. From this perspective, the emphasis on anti-corruption and good governance is based both in moral standards as well utilitarian considerations of improved market performance.

While ethics and an ethical business culture are at the heart of the corporate governance framework, the two are approached somewhat differently. Corporate governance is concerned mainly with creating the structure of decision-making at the level of the board of directors and implementing those decisions. In this sense governance can be thought of as steering the corporation. In fact, the very word governance itself comes from the Greek word for steering. Moreover, corporate governance is about accomplishing the core values of transparency, responsibility, fairness, and accountability. Because these values are also key concerns for business ethics, the two can be seen as being directly related. However, the corporate governance aspect deals with setting up the structures through which these values are attained, while ethics is both a

guide for behavior and a set of principles (or a moral code). While a good ethics system includes the core values of responsibility, transparency, fairness, and accountability, it goes into many other dimensions as well.

This paper summarizes the general issues of corporate governance; provides an overview of the philosophy of ethics; discusses business ethics in some depth; presents some of the various approaches and guidelines for developing an ethical code; reviews some of the special factors of ethics in business and banking; and describes the responsibility and approaches that a company or a bank can take to develop an ethics program. Finally, the conclusion reviews some of the benefits and challenges arising from the consideration of business ethics in the international environment.

Review of Corporate Governance

In its most basic form, corporate governance is about creating a set of principles and a decision making system to govern the modern corporation. Historically, the concept of corporate governance was defined by Berle and Meanes as the principal agent problem1 – the separation of ownership and control. As the British and American capital markets developed, and to a lesser extent the capital markets in continental Europe, there came about a separation between those who owned the underlying assets of the company and the actual hired management.

So the key challenge became how to ensure that the owners, or the stockholders, could control and demand accountability from the hired management, or, in other words, the considerations of shareholder protection gained importance. Following the Asian financial crisis and other international crises, the Organisation for Economic Co-operation and Development (OECD) came to develop the "OECD Principles of Corporate Governance" that today are accepted as the international standard (see Box 1).

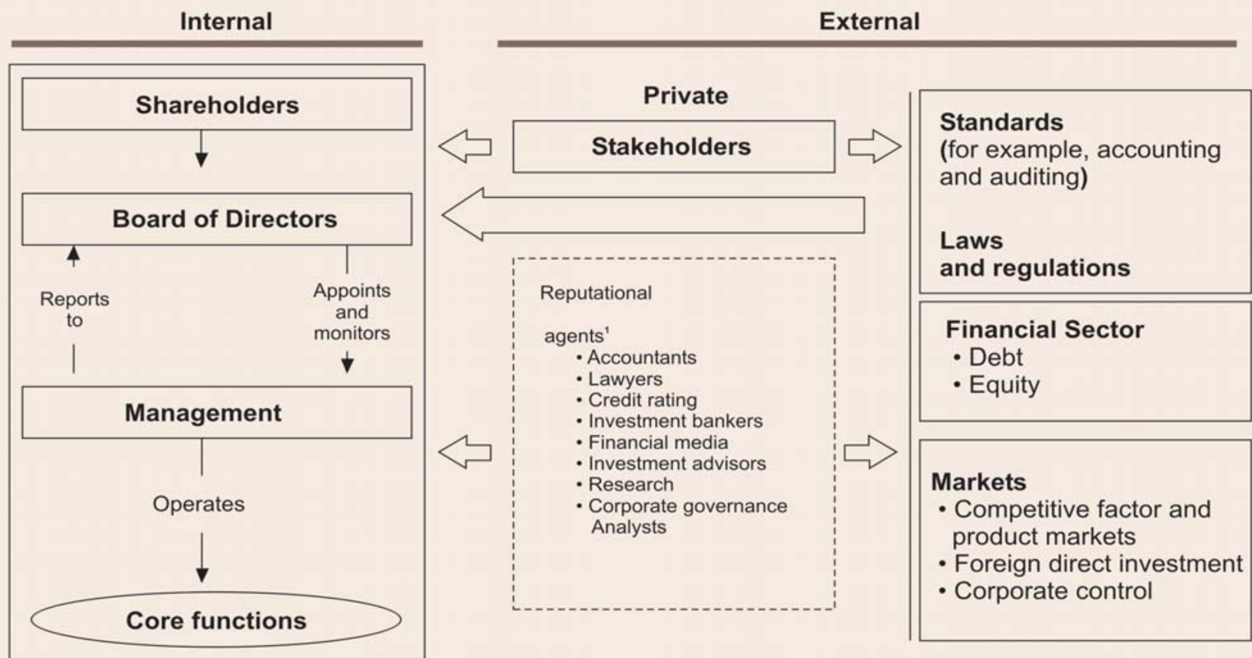
The implementation of the OECD Corporate Governance Principles, however, requires a whole set of supporting and enforcing market institutions. As can be seen from the first principle, there is a specific recognition of the role of market institutions, the framework of law and regulations. Interestingly, this principle was added in 2002 based on the review of the developing countries' realities. The original set of principles assumed that these institutions were in place, but the recognition of the developing countries' realities reflects the expansion of corporate governance into emerging markets. In these markets, great consideration has to be given to the overall structure of institutions, which ensure that corporate governance does not only exist on paper but is implemented and fairly enforced.

Box 1. OECD Corporate Governance Principles.

1. Ensuring the Basis for an Effective Corporate **Governance Framework:** The corporate governance framework should promote transparent and efficient markets, be consistent with the rule of law and clearly articulate the division of responsibilities among different supervisory, regulatory and enforcement authorities.
2. **The Rights of Shareholders and Key Ownership Functions:** The corporate governance framework should protect and facilitate the exercise of shareholders' rights.
3. The Equitable Treatment of Shareholders: The corporate governance framework should ensure the equitable treatment of all shareholders, including minority and foreign shareholders. All shareholders should have the opportunity to obtain eff ective redress for violation of their rights.
4. The Role of Stakeholders in Corporate Governance: The corporate governance framework should recognise the rights of stakeholders established by law or through mutual agreements and encourage active co-operation between corporations and stakeholders in creating wealth, jobs, and the sustainability of financially sound enterprises.
5. Disclosure and Transparency: The corporate governance framework should ensure that timely and accurate disclosure is made on all material matters regarding the corporation, including the financial situation, performance, ownership, and governance of the company.
6. The Responsibilities of the Board: The corporate governance framework should ensure the strategic guidance of the company, the eff ective monitoring of management by the board, and the board's accountability to the company and the shareholders.

For more information see www.oecd.org

Figure 1: Modern corporations are disciplined by internal and external factors



1. Reputational agents refer to private sector agents, self-regulating bodies, the media, and civic society that reduce information asymmetry, improve the monitoring of firms, and shed light on opportunistic behaviour.

Source: The World Bank

Figure 1 presents a good overview of the classic corporate structure. Viewed from another perspective, corporate governance is not simply a principal-agent problem, but it is a part of market structure and societies within which companies operate. In that sense, much of corporate governance is about corporate discipline.

The chart in Figure 1 illustrates corporate governance from yet another perspective. Looking at both sides of the chart, one can identify the depth of different agents in the framework of corporate governance. On the one side, corporate governance demands the participation of private actors, including auditors, accountants, and credit rating agencies. But on the other side, it involves the functions of government, securities regulators, capital market authorities, and the like. The framework presented in Figure 1 better describes the corporate governance dilemma that developing countries face, because it recognizes the major issues in emerging markets, such as the abuse of minority shareholders, rather than simply dealing with the enforcement of the principle agent requirement.

Another major area of concern in emerging markets has been the relationship between sources of debt, principally the banking system, and the corporate governance framework. In the Asian financial crisis, for example, as well as in Brazil, Russian, and other countries' financial crises, the underlying quality of the assets against which bank loans were made was murky. It was not transparent to the banking system, and, as a result, the banks ended up assuming a greater degree of risk than would have otherwise been the case. In this sense, a higher standard of transparency and disclosure is of great importance to various sources of debt around the world in order to improve the underlying quality and stability of the banking system. Also of concern in emerging markets is the area of privatization – the transfer of ownership of assets from the state sector through a corporatization process into ownership by the private sector. The Russian case is the one that comes to mind most often because the privatization was opaque and state assets in many instances were sold well below their market value.

Corporate governance risk stemming from these major areas – abuse of minority shareholders, lending from the banking system, and privatization – is of tremendous importance to individual transactions, but, to a higher degree, it can be seen as a systemic risk to emerging markets.

Box 2. New York Stock Exchange Provision on Codes of Ethics.

Commentary: No code of business conducts and ethics can replace the thoughtful behavior of an ethical director, officer, and employee. However, such a code can focus on the board and management on areas of ethical risk and provide guidance to personnel to help them recognize and deal with ethical issues, provide mechanisms to report unethical conduct, and help to foster a culture of honesty and accountability.

Each code of business conduct and ethics must require that any waiver of the code for executive officers or directors may be made only by the board or a board committee and must be promptly disclosed to shareholders. This disclosure requirement should inhibit casual and perhaps questionable waivers and should help ensure that, when warranted, a waiver is accompanied by appropriate controls designed to protect the listed company.

Each code of business conduct and ethics must also contain compliance standards and procedures that will facilitate the effective operation of the code.

Each company should determine its own policies, but all listed companies should address the most important topics including the following:

• **Conflicts of interest.** A "conflict of interest" occurs when an individual's private interest interferes in any way or even appears to interfere with the interests of the corporation as a whole. A conflict situation can arise when an employee, officer, or director takes actions or has interests that may make it difficult to perform his or he company work objectively and effectively. Conflicts of interest also arise when an employee, officer, or director or a member of his or her family receives improper personal benefits as a result of his or her position in the company. Loans to or guarantees of obligations of such persons are a special concern. The listed company should have a policy prohibiting such conflicts of interest and providing a mean for employees, officers, and directors to communicate potential conflicts to the listed company.

• **Corporate opportunities.** Employees, officers, and directors should be prohibited from (a) taking for themselves personally opportunities that are discovered through the use of corporate property, information, or position; (b) using corporate property, information, or position for personal gain; and (c) competing with the company. Employees, officers, and directors owe a duty to the company to advance its legitimate business interests when the opportunity to do so arises.

• **Confidentiality.** Employees, officers, and directors should maintain the confidentiality of information entrusted to them by the listed company or its customers except when disclosure is authorized or legally mandated. Confidential information includes all nonpublic information that may be of use to competitors or harmful to the company or its customers if disclosed.

• **Fair dealing.** Each employee, officer, or director should endeavor to deal fairly with the company's customers, suppliers, competitors, and employees. None should take unfair advantage of anyone through manipulation, concealment, abuse of privileged information, misrepresentation of material facts, or any other unfair dealing practice. Listed companies may write their codes in a manner that does not alter existing legal rights and obligations of companies and their employees, such as 'at will' employment arrangements.

• **Protection and proper use of company assets.** All employees, officers, and directors should protect the company's assets and ensure their efficient use. Theft, carelessness, and waste have a direct impact on the listed company's profitability. All company assets should be used for legitimate purposes.

• Compliance with laws, rules, and regulations (**including insider trading laws).** The listed company should proactively promote compliance with laws, rules, and regulations, including insider trading laws. Insider trading is both unethical and illegal and should be dealt with decisively.

• Encouraging the reporting of any illegal or unethical **behavior.** The listed company should proactively promote ethical behavior. The company should encourage employees to talk to supervisors, managers, or other appropriate personnel when in doubt about the best course of action in a particular situation. Additionally, employees should report violations of laws, rules, and regulations or the code of business conduct to appropriate personnel. To encourage employees to report such violations, the listed company must ensure that employees know that the company will not allow retaliation for reports made in good faith."

Source: Securities and Exchange Commission: NYSE Rulemaking, April 2003. http://www.sec.gov/rules/sro/34-47672.htm

From Corporate Governance to Business Ethics

The relationship between ethics codes and corporate governance has surged to the fore. When one looks at the World Bank chart in Figure 1, ethics, although not directly listed, is an unstated assumption that runs through many pieces of it. In fact, the New York Stock Exchange (NYSE) in the U.S. recently released new corporate governance rules, which include a section with very specific requirements for a code of ethics. These rules, therefore, place the ethics principles at the heart of its corporate governance provisions. Specifically, Section 10 declares that "listed companies must adopt and disclose a code of business conduct and ethics for directors, officers, and em-

ployees, and promptly disclose any waivers of the code for directors or executive officers."

This was done in response to Enron and other major corporations, where the board of directors waived a very substantially developed code of ethics and was at the center of the financial meltdown that occurred in the Enron crisis. What happened in Enron illustrated what may be one of the determining factors in all codes, not just the ones on ethics – simply having a code is not enough. It is just as important to enforce that code in day-to-day operations. The NYSE provision (see Box 2), in that regard, focuses on both aspects of an ethics code – definition and implementation.

These NYSE provisions have been further developed in filings by the Securities and Exchange Commission (SEC) and other regulatory bodies. These requirements from the NYSE should be seen as the beginning of a trend, and individual companies might want to take a look at their own standards of ethics and their relationship to corporate governance and compare them to the above listed NYSE requirements.

One of the more contentious elements in today's environment that results from these standards is the adoption of a whistleblower's policy, which requires boards of directors to establish what is known as a "safe channel" for employees to report violations of the ethics codes, law, or other regulations directly to a member of the audit committee of the board, bypassing management channels. Implementation of whistleblower standards can spur many debates as to the best strategy for such a policy. Nevertheless, the trend is clearly in that direction. Whether development banks and other multinational firms adopt the NYSE listing requirements or find some other way to satisfy the growing demand for ethics is, of course, an individual choice.

Ethics

From the time of the earliest civilizations, public authorities, philosophers, and business leaders have been concerned with ethics. This section will attempt to put into some historical context the concept of ethics and ethical codes. One challenge for those in the business community, particularly those operating in a multicultural or multinational environment, has been to find a source or standard that can anchor an ethics code, independent of national culture or national issues.

To put these kinds of considerations into context, it's useful to take a step back and look at the historical development of the concept. The term ethics comes from the Greek *ethikos*, which has several meanings.

First, ethics can be thought of as dealing with what is good and bad, with moral duty and obligation.

Second, ethics can be seen as a particular set of moral principles or values. In some settings, these ethical standards are unique to a particular culture, while in others, they might be part of the common cultural heritage of all nations, such as the U.N. Charter.

Third, ethics can be thought of as the principles of conduct governing an individual or a group. That is, a professional ethics standard such as business ethics, banking ethics, more recently accounting or advertising ethics. Fourth, ethics is also traditionally a branch of philosophy, and is related to the development of the ideas of a market economy.

Many of the original philosophers of markets, such as Adam Smith and David Hume, were quite concerned with establishing an ethical foundation or a moral code to govern commerce. The feeling that these philosophers shared and the legacy that they have left, is that in order to guarantee the orderly transactions within a market system, some standard, some objective utilitarian standard of behavior, needs to be established in order to ensure that markets could perpetuate over time. In a sense, this is a reversal of the traditional Latin or Roman concept of *caveat emptor*, or buyer beware.

When one establishes this type of ethical code, the goal is to establish the grounds for fair dealing between buyer and seller, borrower and lender, investor and corporation2. Over the centuries, philosophers and leaders have attempted to set out both ethical values and general guides for codes of conduct. They generally took great care to try to establish some independent or objective standard from which these codes could be derived.

The first recorded comprehensive ethical guide was the *Code of Hammurabi* developed in 1780 B.C.E. Running to some 282 directives, the Code became the foundation for the Kingdom of Babylon. Although many of the provisions in the Code, such as those regulating slavery, will be seen as unethical by modern standards, the code did establish a set of rules making commerce and civilization possible. As such, it is often referred to throughout the Middle East.

Other ancient civilizations developed codes or principles of their own, including the "Analects of Confucius" (500 B.C.), the "Ten Commandants" of Moses, and the *Koran*. Each of the civilizations where these principles were developed sought to establish codes of conduct and principles to ensure that societies could be held together. From the time of the ancient Greeks through the Enlightenment,

philosophers, scholars, and others have attempted to create ethical systems, based on general principles, to guide behavior.

The works of philosophers such as Aristotle and Immanuel Kant are cited in American business schools today. Articles published in business schools3 give future business leaders grounding in the moral dilemmas that philosophers have taken on over the centuries, by packaging it in a practical guide so that business leaders begin to think about ethics as a set of principles and guidelines for behavior rather than a set of simply rigid rules. The business world is beginning to recognize one of the key challenges facing business in a multicultural world – to develop ethical guidelines that are meaningful to employees from a wide variety of cultural and geographical backgrounds.

Business Ethics

Given the new mandates on business, such as the one from the NYSE described above, firms find themselves pressed to develop strong codes of ethics to guide the behavior of board members, managers, and employees. As will be discussed later, multinational corporations are also being required to set standards for those in their supply chains – in some cases setting higher standards than the laws of the countries in which they do business. There are many different factors that companies, especially financial companies, need to take into account when developing their own code of ethics as part of a general corporate governance guideline.

As noted earlier, in this sense, business ethics is an attempt to set out a standard by which all of the employees of a firm can know what is expected. But it is also an attempt to encourage employees, managers, and board members to think about and make decisions through the prism of some shared set of values. What then are the sources from which these values can be derived?

Laws and regulations of the countries in which companies operate constitute one of these sources.

However, it is important to recognize that companies are no longer simply limited to national law. A set of international conventions, such as the anti-bribery convention of the OECD, have to be taken into account. National laws in many countries are seeking to harmonize with these international standards.

In the area of corporate governance, there are the OECD guidelines on corporate governance, and many countries are beginning to require corporate governance codes as a condition of doing business. For example, in Russia, the federal securities regulator requires Russian companies to adopt a code of corporate governance that is consistent with its code of corporate governance or to explain why they have not done so. The NYSE is another example, and other exchanges are beginning to consider its same standard.

Another area that is driving the development of corporate governance and business ethics codes is the notion of social responsibility or corporate citizenship, which is the preferred term in the business community.

Corporate citizenship involves building a decision making system that takes into the account not only internal operating procedures, but also the impact of corporate behavior on its stakeholders – employees, investors, and communities.

One starting point to consider in developing initiatives to strengthen business ethics is the difference between bright lines and values. This is a relatively new distinction. Bright lines are those standards that attempt to set out specific and very finite rules which companies and individuals cannot break. The sources or guidance on these bright line rules can start with, for example, the OECD Anti-Bribery Convention, which can be translated into national laws and rules on anti-bribery standard.

Companies could take a considerable amount of time to develop these bright line standards or to try to identify them themselves. Fortunately, Transparency International (TI), working with major corporations, has developed its own set of bright line standards called the TI Business Principles (see Box 3), applicable to companies of various sizes, industries, and geographical locations. Similarly, the

Box 3. Transparency International's "Business Principles for Countering Bribery."

The Business Principles

• The enterprise shall prohibit bribery in any form whether direct or indirect

• The enterprise shall commit to implementation of a Programme to counter bribery

Aims

Provide a framework for good business practices and risk management strategies for countering bribery. Assist enterprises to:

a) eliminate bribery;

b) demonstrate their commitment to countering bribery;

c) make a positive contribution to improving business standards of integrity, transparency and accountability wherever they operate.

Development of a Programme for Countering Bribery

• An enterprise should develop a Programme reflecting its size, business sector, potential risks and locations of operation, which should, clearly and in reasonable detail, articulate values, policies and procedures to be used to prevent bribery from occurring in all activities under its effective control.

• The Programme should be consistent with all laws relevant to countering bribery in all the jurisdictions in which the enterprise operates, particularly laws that are directly relevant to specific business practices.

• The enterprise should develop the Programme in consultation with employees, trade unions or other employee representative bodies.

• The enterprise should ensure that it is informed of all matters material to the effective development of the Programme by communicating with relevant interested parties.

Scope of the Programme

• Bribes
• Facilitation Payments
• Political Contributions
• Gifts, Hospitality, and Expenses
• Charitable Contributions and Sponsorships

Programme Implementation Requirements

• Organization and Responsibilities
• Raising Concerns and Seeking Guidance
• Business Relationships
• Communication
• Human Resources
• Internal Control and Audit
• Training
• Monitoring and Review

International Chamber of Commerce (ICC) has also developed a set of rules of conduct to combat extortion and bribery (see Box 4).

Although bright line rules, such as those offered by TI or ICC, are often very specific, every individual company still needs to develop accountability practices to ensure that employees are indeed following these rules. TI, for example, has also developed a handbook to help companies develop an entire internal practice to enforce such initiatives. Sarbanes-Oxley, the famous U.S. corporate governance law, also requires documentation standards of accountability for handling funds and assets in Section 404.

In terms of general guidelines for behavior, there are a number of different sources for business ethics programs. Historically, one of the more prominent is that developed by Reverend Leon Sullivan, which began with the anti-Apartheid movement in South Africa and has since evolved into a global set of principles (GlobalSullivanPrinciples.org) Reverend Sullivan's principles have been adapted and expanded by the United Nations' Global Compact into 10 principles (see Box 5). The U.N. Global compact is an unprecedented effort to coalesce the business community around common principles and contribute to global development through good business practices and business leadership.

The 10 principles in the U.N. Global Compact go considerably beyond the bright line rules and deal with the larger issue of values. Another similar set of principles was developed by the Caux Round Table, an organization where business leaders from different countries came up with a set of general principles for business behavior (see Box 6). There is another set of guidelines developed by the OECD: the OECD Multinational Corporation Guidelines. They go even further, attempting to encourage or mandate corporate behavior in a variety of areas, ranging from the environment to contributions to society and providing leadership in developing a nation. The OECD Guidelines can be found at www.oecd.org.

The principles cited above, whether the Caux Round Table's or the 10 principles of the U.N. Global Compact, and others go considerably beyond the bright line rules. In this sense, they revert back to the concept of ethics as a code to guide proper behavior, as a code to guide decision-making. And they have tended to bring out and to merge into corporate citizenship concerns.

Building codes of conduct

Codes of corporate ethics, codes of corporate conduct, and codes of corporate governance overlap in many ways. Many different organizations offer guidance and advice on what should be contained within a code of corporate conduct or a code of ethics. In that regard, the most encompassing list, perhaps, comes from the Ethics Resource Center located in Washington, D.C. (www.ethics.org), which provides guidance on the issues companies should address within their code of corporate ethics (see Box 7).

When one looks at the various codes and sources of corporate ethics, it is easy to see that the core elements contain a number of provisions which try to capture three core areas. The first deals with existing laws and regulations, the second one deals with building good business relations, and the third one addresses key concerns of society and improves corporate citizenship.

Corporate citizenship starts with a corporate code of ethics. A code of corporate ethics outlines the values and beliefs of an organization and ties them to an organization's mission and objectives. A good code not only describes an operational process and regulates the behavior of managers and employees, but it also sets long-term goals, communicates the company's values to the outside stakeholders, and motivates employees giving them pride in working for the right cause.

The value of a code of ethics is that it is more than simply a statement of a company's moral beliefs. A well-written code is a true commitment to responsible business practices in that it outlines specific procedures to handle ethical failures. Codes of ethics today address a variety of issues including work environment, gender relations, discrimination, communications and reporting, gift giving, product safety, employee management relationships, involvement in the political sphere, financial practices, corruption, and responsible advertising.

As business ethics have evolved and the scope of business issues has expanded in the past several decades, so have the codes. Originally seen as a set of policies designed to manage daily issues in the workplace, ethics codes have grown into extensive documents that address a variety of issues and serve as corporate complements to the extensive regulatory and societal pressures on business to behave in an ethical manner. A code of ethics needs to define the purpose of an organization. Doing that is important because it allows a firm to communicate its mission and objectives as well as core values to its employees, customers, suppliers, and other stakeholders. Clearly defining organizational values helps create a corporate image that stakeholders can easily relate to and allows potential employees and shareholders to have a realistic view of a corporate identity.

To be effective, codes of ethics should be more than just a document on a shelf. They need to be created in a way that ethical behavior is encouraged and that employees take pride in making ethical decisions. Codes of ethics should provide guidance into relationships between stakeholders and corporate decision-making. More importantly, employees at any level of an organization must strive to uphold the standards put forth by the code of ethics and the top management should exemplify those standards, as codes of ethics are of a little benefit if the leadership ignores them.

Supply-Chain Codes

One of the greatest benefits of corporate citizenship is that it can rationalize and improve a company's relations with its supply chains overseas regarding the quality of the products, labor practices, and the environmental impact of their activities. The growth of supply chain codes is most evident in supply chains involving consumer goods in emerging markets with weak regulatory environments selling to consumers in developed markets. In countries where labor laws are less stringent than international norms, the codes have the effect of creating higher labor standards and serve as a self-governing mechanism for the enforcement of laws governing working conditions and production standards.

Supply Chain codes fall into several broad categories4:

Buyer Codes

Major companies such as Wal-Mart and Target use these codes in their supply chain as a prerequisite for purchasing consideration. The system is such that the buyer pays for internal monitors and independent auditors to review the supplier factories. Suppliers then must pay for any infrastructure upgrades or other improve-

Box 4. Rules of Conduct to Combat Extortion and Bribery

Transactions.

• **Article 1: Extortion.** No one may, directly or indirectly, demand or accept a bribe.

• **Article 2: Bribery and "Kickbacks."** No enterprise may, directly or indirectly, offer or give a bribe and any demands for such a bribe must be rejected. Enterprises should not (i) kick back any portion of a contract payment to employees of the other contracting party, or (ii) utilize other techniques, such as subcontracts, purchase orders or consulting agreements, to channel payments to government officials, to employees of the other contracting party, their relatives or business associates.

• **Article 3: Agents.** Enterprises should take measures reasonably within their power to ensure: that any payment made to any agent represents no more than an appropriate remuneration for legitimate services rendered by such agent; that no part of any such payment is passed on by the agent as a bribe or otherwise in contravention of these Rules of Conduct; and that they maintain a record of the names and terms of employment of all agents who are retained by them in connection with transactions with public bodies or State enterprises. This record should be available for inspection by auditors and, upon specific request, by appropriate, duly-authorised governmental authorities under conditions of confidentiality.

• **Article 4: Financial Recording and Auditing.** All financial transactions must be properly and fairly recorded in appropriate books of account available for inspection by boards of directors, if applicable, or a corresponding body, as well as auditors. There must be no "off the books" or secret accounts, nor may any documents be issued which do not properly and fairly record the transactions to which they relate. Enterprises should take all necessary measures to establish independent systems of auditing in order to bring to light any transactions which contravene the present Rules of Conduct. Appropriate corrective action must then be taken.

• **Article 5: Responsibilities of Enterprises.** The board of directors or other body with ultimate responsibility for the enterprise should: take reasonable steps, including the establishment and maintenance of proper systems of control aimed at preventing any payments being made by or on behalf of the enterprise which contravene these Rules of Conduct; periodically review compliance with these Rules of Conduct and establish procedures for obtaining appropriate reports for the purposes of such review; and take appropriate action against any director or employee contravening these Rules of Conduct.

• **Article 6: Political Contributions.** Contributions to political parties or committees or to individual politicians may only be made in accordance with the applicable law, and all requirements for public disclosure of such contributions shall be fully complied with. All such contributions must be reported to senior corporate management.

• **Article 7: Company Codes.** These Rules of Conduct being of a general nature, enterprises should, where appropriate, draw up their own codes consistent with the ICC Rules and apply them to the particular circumstances in which their business is carried out. Such codes may usefully include examples and should enjoin employees or agents who find themselves subjected to any form of extortion or bribery immediately to report the same to senior corporate management. Companies should develop clear policies, guidelines, and training programmes for implementing and enforcing the provisions of their codes.

For more information see International Chamber of Commerce http://www.iccwbo.org/home/extortion_bribery/rules.asp

ments necessary to meet the code standards. The factories' labor standards are also taken into consideration. Once suppliers are selected, they are continuously monitored to make sure they are maintaining that standard.

For buyers, the benefits of these codes are that they protect their brand from bad publicity and other civil attacks and higher quality goods often result from the upgrades to the quality of the infrastructure and the labor force.

Agent codes

Doing business abroad often requires the use of agents to facilitate everything from customs and shipping permission to finding business partners and arranging introductions with the proper authorities or business leaders. Corporations, governments, and non-governmental organizations working with or through intermediaries abroad know this can be an area of risk as they are held responsible either legally or in the court of public opinion for the activities of these agents. Shielding companies from this risk is increasingly expensive as it involves a great amount of due diligence on the part of the organizations researching the background of the agent and verifying the soundness of their business practices. At the same time, intermediaries seeking to do business with large international companies can find the approval process to be laborious and slow, creating extra costs to doing business and causing opportunities to be missed.

Transparent Agents and Contracting Entities (TRACE), an international organization that addresses the void in working with intermediaries abroad, seeks to meet the needs of both parties in this process while creating a more ethical business environment. Principals are better protected and intermediaries are better served by this inde-

pendent, non-partisan organization that undertakes preliminary vetting of agents, consultants, and subcontractors.

The process is simple. First, agents apply for membership with TRACE. They are then subjected to an extensive due diligence review, including a lengthy questionnaire, three business references, a financial reference, and a media search. Candidates are also required to have or adopt a code of conduct addressing bribes, kickbacks, and conflicts of interest and agree to annual ethics training provided by TRACE or by approved lawyers in their country. Once their files are completed, they are made available to a large number of corporations – avoiding the need to replicate packages for each company. The requirements are the same for every requesting company or organization, resolving the "best practices" concern that others are undertaking more extensive due diligence.

TRACE members' companies benefit by avoiding the timely documentation gathering process in support of an intermediary. Instead of months to vet a candidate, information is available upon request and updated annually. The process can be done in a day. TRACE is funded by member fees to cover the screening process and corporations pay an annual fee or a per-report fee to have access to the due diligence voluntarily submitted by the members. Governments and non-governmental organizations pay only the cost of copying and postage for each report requested.

Factory certification schemes

Factories seek certification to prove that they have been proactive in addressing labor and infrastructure standards. The factory pays for the certification process, annual audits and any needed upgrades or actions required to remain certified. CERES Principles, the chemical industry's Responsible Care ISO 14001 is an example of such a process. These standards and certifications are typically sought out as a marketing and communication tool for factories to demonstrate their high level of standards and systems. Certification allows some factories to receive higher fees for their services as certification eliminates much of the risk for the buyer to work with them and often satisfies buyer codes, eliminating the buyer's oversight costs.

Other benefits to suppliers to certification or participation in buyers' codes would be more competitive contract bidding, higher productivity, innovation and quality, and declining employee turnover as health and quality of life issues improve for them. Examples include SA 8000 (labor), ISO 14001 (environment), and WRAP (labor). There are many others.

Other types of codes

The Base Code of the Ethical Trading Initiative (ETI), and codes from the OECD and other groups all serve as guidelines for companies and countries on appropriate standards. These codes typically do not have any monitoring or auditing programs, and their purpose is to provide guidance and best practices. Most codes cover ten points and represent principles corresponding to the International Labor Organization's Core Conventions including: forced labor, child labor, freedom of association, and collective bargaining, discrimination, health and safety,

Box 5. The U.N. Global Compact

The vision of the Global Compact is outlined in its ten principles. Companies that sign on to the Global Compact agree to uphold these principles in their operations in any country around the world.

Human Rights

Principle 1: Businesses should support and respect the protection of internationally proclaimed human rights; and

Principle 2: make sure that they are not complicit in human rights abuses.

Labor Standards

Principle 3: Businesses should uphold the freedom of association and the effective recognition of the right to collective bargaining;

Principle 4: the elimination of all forms of forced and compulsory labor;

Principle 5: the effective abolition of child labor; and

Principle 6: the elimination of discrimination in respect of employment and occupation.

Environment

Principle 7: Businesses should support a precautionary approach to environmental challenges;

Principle 8: undertake initiatives to promote greater environmental responsibility; and

Principle 9: encourage the development and diffusion of environmentally friendly technologies

Anti-Corruption

Principle 10: Businesses should work against all forms of corruption, including extortion and bribery.

For more information, please visit www.unglobalcompact.org

wages and hours of work. Key challenges for the codes are that they can produce inefficiencies and confusion for suppliers as each buyer has his own code of conduct and audit procedures. This confusion produces a barrier to entry for suppliers as it is unclear how to demonstrate high standards and compliance. The audit systems can vary from company to company and be very uneven in their rigor and application.

This overlap and repetition can produce unnecessary burdens on both buyers and suppliers as buyers cover the cost of monitoring and suppliers have to allocate time and resources to ascertain and comply with a myriad of codes. A convergence of codes and procedures is needed to truly realize the benefits of the codes and certification programs.

Business Ethics and Anti-Corruption

Over the past several decades we've witnessed profound changes in the way business operates in countries around the world. One of the more notable areas is the business community's treatment of corruption-related issues. The private sector has become one of the leaders in global efforts to curb corruption, developing landmark and far-reaching transparency and accountability standards as well as mechanisms to enforce them. While ethical codes play an important role in driving transparency and accountability reforms, other initiatives that extend beyond internal rules have also made their mark in combating corruption.

As noted earlier, one of the sources from which ethical values can be derived is laws and regulations of countries in which companies operate. At the same time, quality of laws and regulations (as well as their enforcement) has a direct bearing on the levels of corruption in a particular country. The World Bank's Doing Business survey of more than 100 countries, for example, clearly showed that heavy business regulation and procedural complexities in the judiciary are associated with higher levels of corruption. The Heritage Foundation/*Wall Street Journal* annual Index of Economic Freedom also illustrates well that higher degrees of economic freedom are correlated with lower corruption. What one can derive from looking at the Doing Business survey and the Index of Economic Freedom is that corruption is directly related to the enabling environment issues. In that sense, efforts to establish the rule of law, strengthen the protection of private property rights, and improve the quality of regulations become crucial in anti-corruption reform. Such efforts are also crucial in improving ethical standards.

For example, the Colombian Confederation of Chambers of Commerce (Confecámaras) in the late 1990s recognized that on paper Colombia had a sophisticated set of norms and instruments for detecting, controlling, and punishing corrupt practices. However, these mechanisms were often not applied, partly because of fear of political backlash from entrenched, corrupt politicians. Confecámaras therefore attempted to put forth measures that would ensure application of anti-corruption initiatives on the supply-side of the equation – the private sector.

Box 6. The Caux Round Table Principles for Business.

1. The Responsibilities of Businesses: Beyond Shareholders toward Stakeholders
2. The Economic and Social Impact of Business: Toward Innovation, Justice and World Community
3. Business Behavior: Beyond the Letter of Law Toward a Spirit of Trust
4. Respect for Rules
5. Support for Multilateral Trade
6. Respect for the Environment
7. Avoidance of Illicit Operations

For more on the principles see The Caux Round Table http://www.cauxroundtable.org/principles.html

Confecámaras worked with local businesses to establish clear rules and codes of conduct in procurement processes and to demonstrate the benefits of compliance. With input from business leaders, Confecámaras developed local codes of conduct, which over 1,000 businessmen voluntarily signed in the first year alone. To ensure transparency in public procurement, Confecámaras also proposed the development of integrity pacts. In the first year, 12 integrity pacts were signed between local businesses and governments and the total value of the contracts that were signed under integrity pact requirements with the Manizales city mayor amounted to $1,039,200. In January 2005, 16 governors and 78 mayors delivered on their electoral promises and signed official agreements in public, committing themselves to a transparent relationship with the local business community.

Specific Industry Standards: Banking

Going beyond the general concerns of developing a code of corporate ethics, development finance institutions, of course, have two related areas of concern. The first area of concern deals with developing banking ethics standards to guide their own lending practices. The second

one deals with their role in promoting standards for individual interests in individual industries. In the area of banking codes, there is a wealth of sources. Perhaps the most interesting is the Swiss banking system, which has developed as one of the market leaders for banking sources. The Swiss banking system and the Federal Banking Commission, the Swiss regulatory authority, require binding codes of conduct that define good industry practices or, to put it in more modern terms, ethical management. They have a number of guidelines on their web site (http://www.swissbanking.org/). The following are the main areas where codes of conduct, guidelines, or agreements are available:

1. Agreement on due diligence
2. Agreement on depositor protection
3. A code of conduct for security traders
4. Guidelines for management of country risk
5. Guidelines for risk management
6. Guidelines on portfolio management agreements
7. Guidelines for the treatment of dominant Assets

When looking at all of these codes in the banking area, one observer, Fouad Shaker, General Secretary of the Union of Arab Banks, presented a list of what he felt would be the 13 principles necessary to create a good code of banking ethics5. Dr. Shaker's list contains, in one form or another, elements put forth by the Swiss banking regulators:

1. Integrity and fairness
2. Confidentiality
3. Professionalism
4. Compliance with directives
5. Monitoring procedures
6. Sound implementation
7. Transparency of transactions
8. Good customer service
9. Promotion of banking services (advertising)
10. Transactions giving right to suspicion
11. Collecting and keeping customer information
12. Handling customer complaints
13. Interbank regulations and rotations with other parties

Another good source to compare corporate governance and banking codes is the Canadian Bankers Association, which also developed a wide range of separate provisions that can be found on its website, www.cba.ca. In the more narrow interests of securities and exchange and foreign exchange dealers, the ACI, the financial markets association has developed its own extensive code of good conduct or code of ethics, which can be found on its website, www.aciforex.com.

Developing an Ethics Program: The Role of the Board- As noted in the NYSE listing requirements, it is very important for corporations and banks to develop their own ethics program. Simply adopting a code of ethics or a code of corporate governance with a companion code of ethics is not sufficient. In fact, the Conference Board conducted a recent study of business ethics around the world and the role of boards of directors in carrying out board oversight of ethics programs6. The Conference Board identified the following elements as being representative of the role of the board and of ethics programs in a cross-section of countries:

- Codes of conduct
- Communication of standards through training
- Methods to encourage employees to report possible violations to management
- Enforcement mechanisms through investigation and discipline
- Oversight and review to achieve ongoing improvement

The development of the federal sentencing guidelines by the U.S. Sentencing Commission several years ago is one element in encouraging such an encompassing program to be adopted by American corporations. These sentencing guidelines, which can be found at www.ussc.gov, are intended to guide a company in dealing with employees who have engaged in bribery or broken a law. Doing so is important especially for the management, because the company as a whole can be punished for violations. The sentencing guidelines, in that regards, were intended to give courts some direction in terms of when to consider the company itself responsible for the action of its employees7. The guidelines are:

1. Establishing ethics and compliance standards and procedures
2. Assessing high-level persons to oversee ethics and compliance
3. Taking due care in the delegation of substantial discretionary authorities to individuals
4. Effectively communicating standards and proce-

dures to all employees and agents through training and also through printed and electronic materials

5. Monitoring and auditing the operation of the ethics and compliance program and establishing a retribution-free means, (e.g., a help line) for employees to obtain information about standards and procedures and to report possible wrong doing

6. Consistently enforcing discipline of employee violations

7. Responding promptly to any wrongdoing and remedying any program deficiencies8

These guidelines from the Federal Sentencing Commission have been one of the drivers behind the development of ethics programs in the U.S. Moreover, as noted in the ethics resource list provided earlier, and in the elements identified by the Conference Board, they have also spread worldwide. In fact, the Conference Board carried out a survey of companies across the world and found that not only were these elements quite common, but in many countries the program was actually established by board resolution.

In the United States, 66 percent of American companies established the ethics program as the result of the action of the board of directors, while in Japan, 96 percent took a similar stance.

Similarly, one of the key things that boards of directors must do in the wake of the U.S. Federal Sentencing Guidelines and the broader trends internationally is to develop ways of monitoring compliance and ensuring that these ethics codes are not simply a standard put on the company's web site, but not communicated and implemented throughout the company. One of the ways to do that is by carrying out program audits9.

In U.S. companies, some 45 percent have carried out program audits (a number which can be expected to increase given recent trends). In contrast, in Japan, 64 percent of such companies have carried out program audits. The number is event higher at 67 percent in India, and in Western Europe, where it is over 75 percent.

Complementing program audits is the concept of directors' ethics training. The same Conference Board survey found that directors' ethics training is becoming quite common throughout the world, from a low of 42 percent in Western Europe to a high of 94 percent in Japan. Many multinational companies are now routinely putting on ethics trainings programs for their directors. The subjects covered include:

- Fiduciary duties
- Corporate opportunities
- Principal regulations governing company business
- Personal liability
- Corporate law
- Stock exchange regulations
- Insider trading

Box 7. Common Ethics Code Provisions (by the Ethics Resource Center.)

Employment Practices
- Workplace Harassment
- Equal Opportunity
- Diversity
- Fair Treatment of Staff
- Work-Family Balance
- Discrimination
- Illegal Drugs and Alcohol
- Use of Organization Property

Employee, Client and Vendor Information
- Maintaining Records and Information
- Privacy and Confidentiality
- Disclosure of Information

Public Information/Communications
- Advertising and Marketing
- Development and Fundraising
- Clarity of Information
- Access to Information
- Transparency of Information

Conflicts of Interest
- Gifts and Gratuities
- Political Activity
- Outside Employment
- Family Members

Relationships with Vendors
- Procurement
- Negotiating Contracts

Environmental Issues
- Commitment to the Environment
- Employee Health and Safety

Ethical Management Practices
- Accuracy of books and records and expense reports
- Proper use of organizational assets
- Protecting proprietary information

Employment Practices
- Proper Exercise of Authority
- Employee Volunteer Activities Conflicts of Interest
- Disclosure of Financial Interests

Political Involvement
- Political Activities

For more information see Ethics Resource Center at http://www.ethics.org/common_provisions.html

- Business secrets
- The employee training program10

The role of the board of directors, therefore, is seen as central to establishing and maintaining a corporate ethics program, and by corollary is a central feature in the overall subject of corporate governance guidelines and codes. This trend can be expected to continue, driven both by national legislation, international conventions, and the expectations of investors.[11]

Conclusion

Debates in coming years will center on the relative roles of business, government, and NGOs in establishing codes of conduct and in reporting requirements as well as individual industry standards. In each of these areas, non-governmental organizations, such as Transparency International and Social Accountability International, are leading the way12. These NGOs have worked cooperatively with business and in some cases have presented their demands to business. In either case, the triangle of business, government, and NGOs will continue to be the dominant forum for debates and discussion of the proper role of business in society.

From the point of view of the business community, the major issue to consider is the central importance of corporate governance and business ethics in maintaining a market economy. As noted earlier, Adam Smith, David Hume, and other philosophers and early economists were very much concerned with the role of ethics and the role of business behavior in ensuring that transactions could be conducted not only in regional, but also in the multinational setting.

In one sense, one can look at ethics as the solution to one of the central problems of development. The problem is moving from a "cash and carry" or barter economy to an economy where transactions can be conducted over time and distance. One of the findings of the new institutional economics13 is that in countries and in firms with low standards of ethics, with low standards of legal regulation, and with low enforcement, the costs of contracting become very high. Business ethics, therefore, are central to ensuring that contracts are adhered to, thereby holding down the costs of doing business and improving the flow of capital to emerging markets. On another note, business should be mindful, as should NGOs, that too much pressure is not put onto the multinational corporations in terms of enforcing through corporate codes or supplier-vendor relationships laws and regulations, which are actually the concerns of national government. For example, the emerging trend to hold business accountable for human rights violations in developing countries is worrisome. In some cases, it may deter multinationals and other sources of investment from investing in an emerging market. We have to find a way to meet high ethical standards and, at the same time, ensure that the reputational and collateral risks assumed by corporations do not inhibit the further development of the emerging markets.

(* John D. Sullivan has been Executive Director of CIPE since 1991)

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[11]International Corporate Governance Network. http://www.icgn.org

[12]SAI-SA8000 has become the code of conduct of labor standards for supply chain management considerations.

[12]SAI-SA8000 has become the code of conduct of labor standards for supply chain management considerations.

[13]A branch of economics that looks at the importance of property rights, legal structures, contracts, and other institutions as key elements of a market economy. For more, please see CIPE Feature Service article "Local Knowledge and Institutional Reform" by Douglass North, Nobel Prize-winning economist.
Http://www.cipe.org/publications/fs/articles/Douglass_North.htm

The Global Economy in 2005: Prospects for 2006

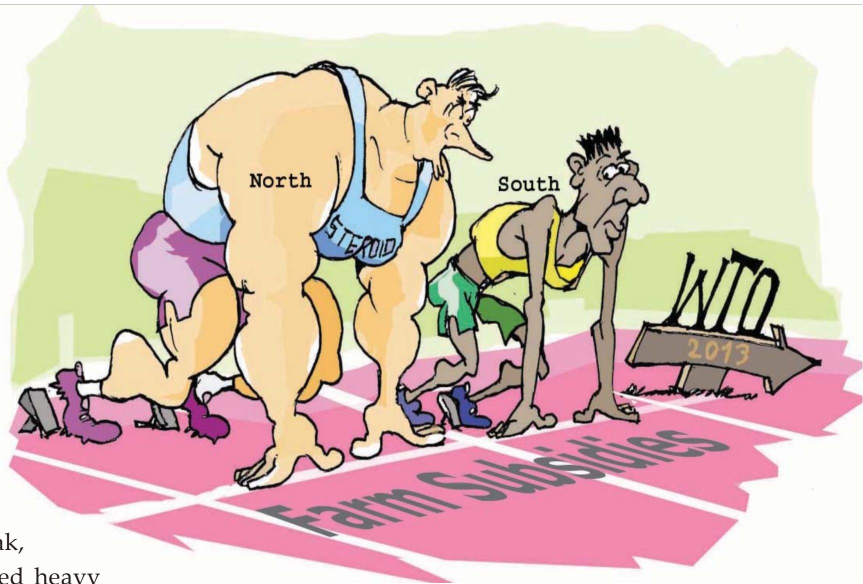
*By Eunice Sampson

Considering the pessimism that characterized most forecasts before now, the global economy with at least 3.2% growth in 2005 did not turn out as bad as feared. Most countries, especially developing economies and economies in transition, witnessed remarkable growth.

Even for 2006, the growth prospects look brighter; ranging from the earlier predictions of 2.0-2.5%, to about 3.2%-3.5%. For major economies like the United States where a near economic gloom had been predicted in 2006, the picture is no longer so bleak. Having grown by 3.5% in 2005, the US is set to achieve a fifth consecutive year of economic expansion in 2006 that would be almost as good as the 2005 pace.

The US dollar after 3 years of consistent decline, appreciated against the major currencies in 2005; 14.6% against the Euro; 15.2% against the yen; 12.6% against a basket of the world's six main currencies. The dollar appreciation was influenced by interest rate hikes and the repatriation of profits of most US subsidiary companies abroad. Interestingly, in most economies, inflation rate was tamed despite the high cost of crude oil.

Gross Domestic Product (GDP)



Developed economies led by the United States grew by 2.4% in 2005, substantially lower than the 3.2% growth recorded in 2004. Developed economies would have done better than this but for the series of hurricanes and the hike in the price of crude oil, which distorted their growth prospects. The United Nations estimated a 3.2% real GDP growth for the global economy in 2005 while IMF estimated 4.3%; both were a far cry from the 5.1% growth in 2004.

Industrial production was also weak, while most developed countries suffered heavy current account deficits, especially the United States which in 2005 was short by over $700bn.

Growth outlook in Europe was also slow, even though the gap was not as wide as that of the United States since the former experienced slow growth even in 2004. Europe grew by 1.2% in 2005 with the eurozone once again being the worst hit at 1.1% growth.

Europe has been projected to grow at an average of 5% in 2006 and 2007 owing to expected increase in demand and market share, as well as high oil prices, which for many European countries, is a positive trend.

In Japan, GDP grew by an estimated 2.3% in 2005, spurred by high domestic demand and rising household incomes. With a growth projection of 1.4%-2.5% this year, the Japanese economy is showing signs of breaking out of the stagnation that has gripped it since the burst of the share market bubble in the early1990s.

According to UN calculations, the developing economies and economies in transition grew by 5.7% and 6.0%, respectively in 2005; while the highest level of growth was achieved by the least developed economies, which grew by 6.8%.

In Asia, the East Asian region grew 7.8%, slower than the 8.3% achieved in the preceding year. China and India continue to experience high economic growth, at 9% and 8% respectively. Growth in China is forecast to drop to 7.6% and 7.4% respectively in 2006 and 2007, while India is projected to grow 7.2% and 6.5%, respectively over the two-year period. For both countries, it is getting more certain that they are on a path of sustainable growth.

In line with the rapid economic growth begun since 2001, the African continent grew by 5.1%, in 2005, about the same level of 2004, and far above the world average of 3.3%.

The oil windfall enjoyed by many African exporters helped expand GDP in that continent last year; but not much productivity was achieved in the manufacturing sector. Sub-Saharan crude oil exporters like Nigeria, Angola, Chad, Sudan and Mauritania grew 7% in 2005 (Angola and Chad actually grew double digit). The growth prospects for oil producing African countries are greater this year; especially in Nigeria and Mauritania where new oil wells are expected to come on stream.

Few sub-Saharan countries, including Cote d'Ivoire, Zimbabwe and Seychelles suffered decline in growth in 2005 following major setbacks in their economic mainstay. Minus (-) 4% growth is estimated for Zimbabwe; Cote d'Ivoire, a cash-crop-dependent economy which has been

Top 10 Global Economies by GDP (PPP) - US $ Trillion

	2003 ($US Billion)		**2005** ($US Trillion)
USA	11,012,.6	USA	12,370.0
Japan	4,360.8	China	8,158.2
Germany	2,085.5	Japan	3,867.6
France	1,521.6	India	3,678.1
China	1,416.8	Germany	2,446.4
Italy	1,243.2	UK	1,867.1
Mexico	637.2	France	1,816.0
South Korea	576.0	Italy	1,645.0
India	568.0	Brazil	1,580.4
Brazil	479.0	Russia	1,535.3

Source: CIA, ***World Development Indicators 2005, World Bank***

bedeviled with socio-political crises since 2002, slipped in growth to -3.8%. For the three African countries, the prospects for recovery this year and next is very dim.

Despite the relatively strong growth in 2005 at 5.2%, Nigeria experienced slowing growth that year compared to its 2004 performance of about 5.5%. But thanks to the increased oil and gas revenues boosted by higher prices, the country once again enjoyed current account surplus of $24.3bn in 2005. From its 2.4% growth level in 2004, South Africa's GDP grew by 4.5% in 2005 driven by domestic demand and enhanced export activities.

Real GDP Growth: 2003 - 2005; *Projections for 2006

	2003	2004	2005	*2006
World	2.6	4.0	3.2	3.3
Developed Economies	1.9	3.2	2.4	2.5
Economies in transition	7.1	7.7	6.0	5.9
Developing Economies	4.9	6.6	5.7	5.6
Least Developed economies	6.5	6.7	6.8	6.6
Africa	4.4	5.1	5.1	5.5
North Africa	4.6	4.8	5.1	5.7
Sub-Saharan Africa (excluding Nigeria & South Africa)	3.2	5.6	5.3	5.3
South Africa	2.0	2.4	4.5	-
Nigeria	10.3	5.5	5.2	4.8

**2006 figure is projection*
*Source: **UN/DESA; CIA; 2006***

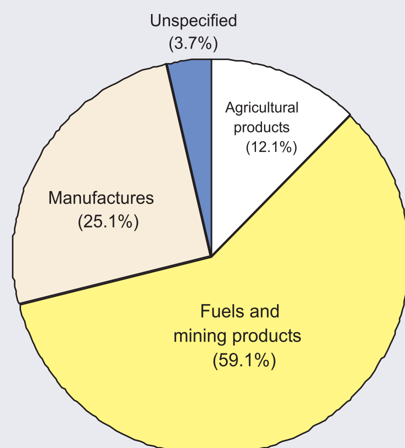
The persistent recession in the manufacturing sector of most Sub-Sahara African economies is a growing cause for concern. Despite the AGOA advantage, the value of Sub-Saharan textile and apparel exports to the United States dropped by 11% last year. This resulted in a rise in unemployment level in these countries. Nigeria's textile industry especially suffered great losses in 2005, owing to smuggling activities and the inconsistencies in the re-introduction of the export grant policy. Between 2004 and 2005, at least 30,000 jobs have been shed in Nigeria owing to crises in the industry.

Some of the key constraints to global growth in 2005 included higher oil prices, resource-sector capacity constraints, tightening monetary policy in the United States and, in some countries, the maturation of the investment cycle following a year of very fast growth. Rising short-term interest rates and natural disasters, especially the series of hurricanes, slowed growth in the United States, from over 4.0% in 2004 to 3.5% last year.

World Trade

World trade slowed significantly in 2005, from its 9% growth level in 2004 to about 6.5%. This is attributed to lower economic output worsened by high energy cost. The developing countries like China, India and the oil exporting economies, led the world in growth in trade value and volume last year. China for example grew its merchandise export volume by 24%. Much of the trade deficits were suffered by the developed economies, especially the United States and Europe. The IMF calculates that, at an average crude oil price of $59 per barrel in the next 5 years, the oil exporters would enjoy an annul average current account surplus of $470bn. Traditionally, agricultural products and natural resources/ mining products were the dominant exports of African countries in 2005; Africa's export of commercial services remains minimal.

Product structure of Africa's merchandise exports, 2004 & 2005



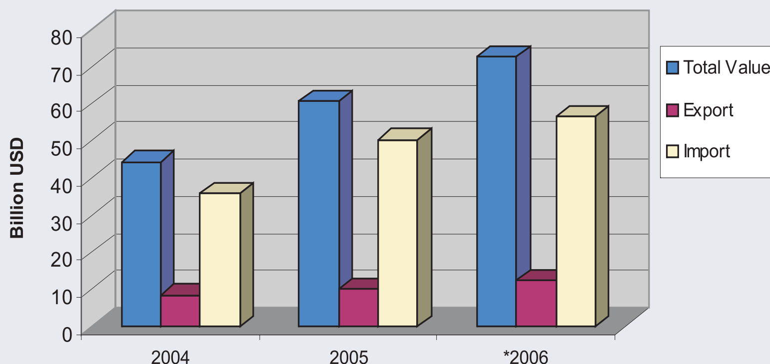
Source: WTO, 2006

According to reports released by AGOA in February, two-way total trade (exports plus imports) between the United States and sub-Saharan Africa increased 37% to over $60.6 billion in 2005, up from $44.4bn in 2004. U.S total exports to Africa rose 22% to $10.3 billion, up from $8.6bn the previous year; and U.S. total imports (AGOA and non-AGOA) from Africa increased by 40% to $50.3bn, up from $35.9bn in 2004. Like in the previous years, rise in trade volume and value between the US and Africa was driven predominantly by increased sales of oil field equipment and parts, aircraft, wheat, vehicles, and electrical machinery. But only few African countries accounted for the high volume, especially Nigeria and South Africa. Over 50% of US import from Africa comes from Nigeria (predominantly oil); while US export to Africa is dominated by

South Africa. As in the previous year, petroleum products accounted for over 70% of US trade relationship with Sub Saharan Africa.

US crude oil import from Sub-Saharan Africa was valued at $26.1bn in 2004, and over $30bn in 2005. Other major US imports from the continent include apparel, platinum, diamond, cocoa, etc.

While the US remains the leading importer from Africa, China maintains its position as the major supplier to the continent, reaping exports value of $7.5bn in 2003 and over $10bn in 2005.



Source: AGOA; 2006 is Research & EIG projection

Despite its relatively stable economic growth, the rising profile of the US current account deficit is a source of worry to economists worldwide, even as it once again widened last year from its $666bn position in 2004 to over $700bn. The United States is in trade deficit with most regions of the world.

Crude Oil

In 2005, the all-important place of crude oil in the global economy was once again emphasized. The average crude oil price for the year was about $58 per barrel, far higher than the 2004 average of about $50 per barrel. Global crude oil demand was an average of 83.2 million barrels per day last year, while supply was 84.3 million leaving a surplus of 1.1 million. This impacted OPEC's decision not to raise production despite high crude prices. The cartel and other analysts saw the price hike as, not due to supply shortage but mostly to refining problems and speculative supply worries.

The economic slowdown among the oil-importing countries (excluding China and India) was sharper, from 5.6% in 2004 to 4.3%. Even for the oil exporting countries (most of which are developing economies) the fall in refining and production capacities for most of 2005 and the series of internal crises led to a fall in growth, from 6.6% in 2004 to 5.7% despite the persistent rise in crude oil proceeds.

Global oil supply is likely to be slightly negative against demand in 2006. In the first two months of 2006 supply has been unstable as major oil producing economies like Nigeria and Iran are faced with internal and external wrangling. While the former battles insurgency in its oil producing Niger Delta area, the latter battles the developed economies over nuclear ambition. Nigerian authorities are already raising fears that the economy might not be able to fund its N1.9 trillion (about $15bn) budget for 2006, as oil revenue might fall short of projections due to disruptions to production and the closure of oil wells. If the crises persist, oil prices might hover between $58 and $60 per barrel throughout the year.

Foreign Direct Investment

Global foreign direct investment (FDI) inflows rose by 29%, from its $612bn in 2004 to US$897bn. Developed countries attracted about 75% of the total, with a flow of $573bn, a 38% rise from the 2004 level. The huge investment in developed economies last year was a significant recovery from the 4-year slump experienced since 2001.

A breakdown of the estimated $274 billion FDI flow to the developing economies show that Sub-Saharan Africa moved from its $20bn position in 2004 to $29 billion in 2005, but still less than 4% of global FDI flow that year. The rise in Africa's FDI was accounted for mostly by the oil producing countries.

Globally, mergers and acquisitions was the dominant source of FDI. M&A activities rose by 40% last year to a high of $2.9trillion. The European economies were the major beneficiaries, especially the UK which received an inflow of $219bn in 2005. For the first time in almost 30 years, UK topped global FDI inflow, spurred mostly by the $100 billion merger of Shell Transport and Trading Company Plc and Royal Dutch Petroleum Company into Royal Dutch Shell. The US was the second highest recipient with a flow of $106 billion, its best in a long time.

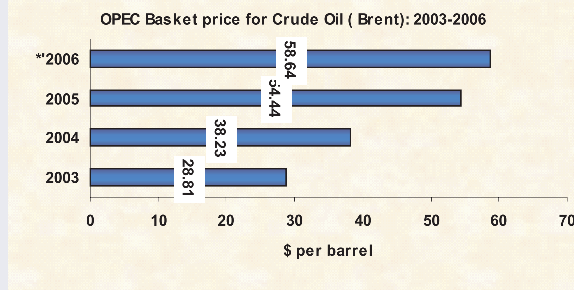
In Asia, Japan's FDI flow was once again moderate at $9.4bn. China for the first time in almost a decade experienced a negative FDI flow, from $60.6bn in 2004 to $60.3bn, down by -0.5%. National and international investments slowed in China last year as the country made efforts to cool down the economy to a sustainable growth level. All regions of the world experienced improvement in their FDI flow in 2005.

In Africa, South Africa maintains its position as the largest recipient of FDI flow. South Africa in 2005 received 30% of the total FDI flow from the United States to Africa while Nigeria was the next biggest beneficiary with 15%. At a paltry $12bn in 2004 and an estimated $15bn last year, the continent attracts less than 1% of total US FDI flow.

Ten Yearly Average Crude Oil Prices (1946-2006) U.S. Average (in $/per barrel)

Year	Ave Nominal Price	Ave Annual Inflation Adj. Price
1946	$1.63	$16.18
1956	$2.94	$21.30
1966	$3.10	$18.80
1976	$13.10	$45.31
1986	$14.44	$25.92
1996	$20.46	$25.66
1997	$18.64	$22.86
1998	$11.91	$14.38
1999	$16.56	$19.52
2000	$27.39	$31.29
2001	$23.00	$25.57
2002	$22.81	$24.94
2003	$27.69	$29.63
2004	$37.66	$39.21
2005	$50.04	$50.38
2006	$52.15	*$55.53

*Secondary source: inflationdata.com; *2006 is projection*



Source: OPEC; 2006 is projection

FDI Inflow by Region and Selected Economies: 2003-2005 (Billions of dollars)

	2003	2004	2005	2005 Growth Rate (%)	2006 Projection
World	637.8	695.0	896.7	29	950.4
Developed Economies	441.7	414.7	573.2	38	572.2
Europe	358.9	258.2	449.2	74	506.7
European Union (25)	340.1	259.1	445.3	72	446.4
EU (15)	327.6	231.4	407.7	76	371.2
United Kingdom	27.4	77.6	219.1	182	359.0
United States	56.8	95.9	106.0	11	103.2
Japan	6.3	7.8	9.4	21	12.1
Developing Economies	172.1	243.1	273.5	13	306.4
Africa	17.2	18.7	28.9	55	32.6
Latin America & the Caribbean	48.0	68.9	72.0	5	78.1
Brazil	10.1	18.2	15.5	-15	18.4
Chile	4.4	7.6	7.0	-8	7.9
Mexico	12.8	17.9	17.2	-4	16.9
Asia & Oceania	106.9	155.5	127.7	11	134.8
West Asia	11.9	17.6	26.5	51	35.2
South, East & South-East Asia	94.7	137.8	146.2	6	153.3
China	53.5	60.6	60.3	-0.54	71.9
Hong Kong, China	13.6	34.0	39.7	17	41.6
India	4.3	5.3	6.0	12	6.6
Singapore	9.3	16.1	15.9	-1	16.2
South East Europe & the CIS	24.0	37.2	49.9	34	58.3
Russian Federation	8.0	12.5	26.1	109	28.7

Source: UNCTAD; 2006 is Research & EIG Estimate

Socio Economic Developments

Unemployment – The ILO report for 2005 shows that global labour productivity (measured as output per worker) grew by 2.6%, down from 3.0% growth in 2004. The drop is associated with the slower growth in global GDP level last year. The ILO has calculated that "*For each 1-percentage-point reduction in the global GDP growth rate, net employment growth will be between 9 and ten million fewer around the world*".

In 2005, global unemployment rate stood at 6.3%, unchanged from the previous year and 0.3% percentage points higher than a decade earlier. A total of 191.8 million people were unemployed around the world in 2005, up by 2.2 million from the 2004 level.

Latin America and the Caribbean suffered the highest growth in unemployment with the number of the unemployed rising by over 1million, taking the unemployment rate between 2004 and 2005 to 7.7%.

The Central and Eastern Europe (non-EU) and CIS region also witnessed a year-over-year increase in its unemployment rate, which stood at 9.7%, up from 9.5% in 2004. The Asian region's unemployment rates remained unchanged in 2005: East Asia's unemployment rate stood at 3.8%, the lowest in the world. South Asia's unemployment rate stayed at 4.7% and South-East Asia and the Pacific's unemployment rate was 6.1%.

The most remarkable improvement in employment was recorded in the Developed Economies. The United States unemployment rate dropped to 4.7% in January

World Oil Supply/Demand Balance (Mb/d)

	2005	Q1 2006	Q2 2006	Q3 2006	Q4 2006	2006
Total World Demand	83.2	85.5	83.6	84.2	86.1	84.8
OPEC Crude production	29.9	29.1	29.1	29.3	29.5	29.3
Total Supply	84.3	83.0	83.7	84.5	84.0	84.1
Balance	1.1	-1.5	0.1	0.3	-2.1	-0.8

Source: OPEC; 2006 is projection

2006 while 2 million jobs were created last year, an average of 166,000 per month. Unemployment rate also declined in the EU zone.

The Middle East and North Africa remains the region with the highest unemployment rate in the world at 13.2%. Sub-Saharan Africa's rate stood at 9.7%, down from 9.9% in 2004. Further improvement is expected this year to about 9.4%.

Natural Disasters – The series of natural disasters in 2005, especially the hurricanes, had negative impact on the growth of the global economy, compounded by the carry-over of the impact of the Asian tsunami and earthquake disaster of 26 December 2004.

The disasters among other immediate impact, led to the destruction of oil facilities especially at the Gulf of Mexico, and took oil prices to the $70 per barrel highs in August 2005. On October 8, 2005, over 71,000 lives were lost to an earthquake that struck Pakistan, India and other parts of South Asia. Over 3 million people were rendered homeless.

In Africa, Niger Republic was on the news much of 2005 following the acute famine and hunger in the land which was triggered by droughts. Over 4 million lives, (mostly children and women) were declared at risk. The food crises prompted relief efforts from countries and groups round the world.

In his 2005 Economic Report, the US President, George W. Bush described the impact of natural disasters on the US economy in 2005 thus:

"In addition to the tragic loss of life and the massive destruction of personal property, the two major hurricanes (Katrina on August 29 and Rita on September 24) damaged the productive capacity of the American economy".

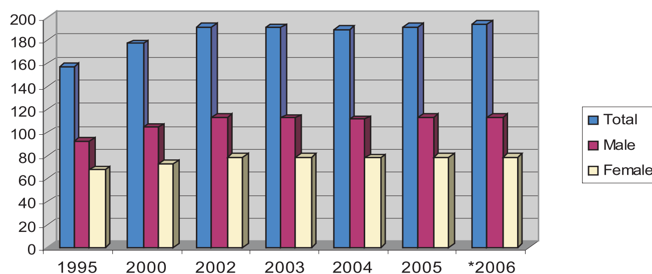
Conclusion

After about 3.2% growth in 2005, the global economy is expected to expand by about 3.3%-3.5% this year. The U.S. will remain the dominant global economic growth engine, supported by the European Union and Japan - the trio, which have for decades accounted for more than 70% of world production factor.

But other economies are now better positioned to contribute more to global growth than before; breaking the US monopoly. Massive economic transformation in China and India have propelled them ahead of the UK and Germany as the biggest economies in 2005, and they would henceforth have stronger influence on global economic growth prospects more than before.

For most economies, inflation, interest rates and employment would be major growth factors in 2006. Other potential hazards to economic growth could include the continued surge in oil prices, a fall in the housing market (especially for the United States and Europe) and the possibility of major financial upsets such as corporate bankruptcy and a possible repeat of the natural disasters that negatively impacted global economic growth prospects in 2004 and 2005.

(* Eunice Sampson is an Assistant Editor, Zenith Economic Quarterly.)



*Source: ILO; *2006 is estimate*

Global Unemployment Position (%): 2004-2006

	1995	2004	2005	2006 (Projection)	Employment to population ratio (2005 %)
World	6.0	6.3	6.3	6.0	61.4
Developed Economies & European Union	7.8	7.1	6.7	6.6	56.4
Central & Eastern Europe (non EU) and CIS	9.4	9.5	9.7	9.4	52.1
East Asia	3.7	3.7	3.8	3.8	71.7
South East Asia & the Pacific	3.9	6.2	6.1	5.9	65.8
South Asia	4.0	4.7	4.7	4.5	57.2
Latin America & the Caribbean	7.6	7.4	7.7	7.7	60.9
Middle East & North Africa	14.3	13.1	13.2	13.4	46.4
Sub Saharan Africa	9.2	9.9	9.7	9.4	66.7

Source: ILO, 2006

ZEQ DATABANK

Macroeconomic Environment

Nigeria's macroeconomic environment, by the last quarter of the year 2005, exhibited strong recovery features although the inflationary trend remained on the high side. There was significant reversal in the decline in the industrial sector as well as a strong showing in growth potential in terms of spread and size of growth.

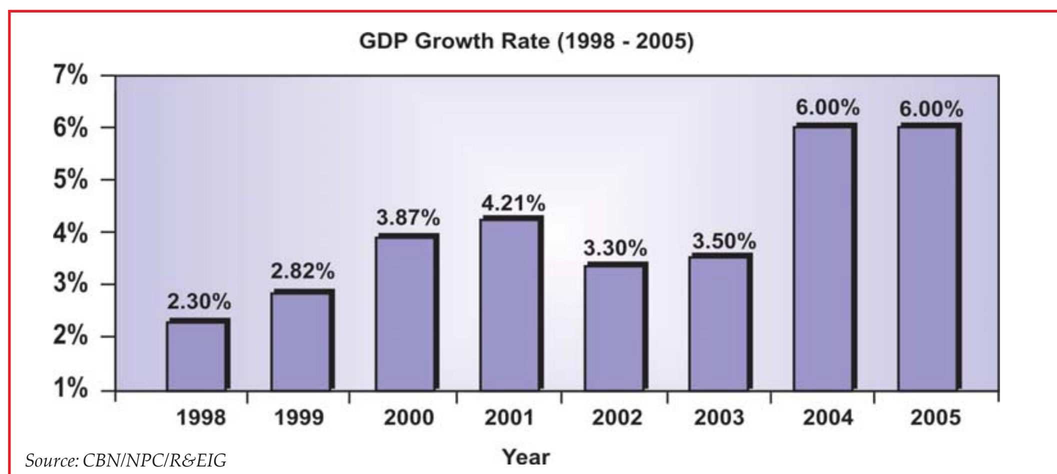
The macroeconomic environment benefited immensely from the successful implementation of the first phase of the Paris Debt Club exit scheme, the continued strong showing in the prices of crude oil and improved fiscal management especially in terms of the sterilization of the 'excess crude proceeds'. Overall, the economy is in a recovery mode, indicating that the wide range of reforms, if sustained would lead to significant growth rates in the coming years. The only challenge has been the question of a successful national population census and general elections in 2006 and 2007 respectively.

The expectation is that with the adherence to the debt exit scheme, especially if and when the second tranche in the first quarter of 2006 is met, external credit guarantee agencies would be favourably disposed to Nigeria, her credit risk rating would improve significantly (as was the case in Poland years ago) and foreign direct investments especially into the non-oil sector would also improve.

One thing is certain: the overall prospects are brighter than three years ago and government remains determined to pursue the economic reforms and fiscal restraint that has helped to achieve significant excess crude oil proceeds sterilization and improved public expenditure management.

Gross Domestic Product (GDP)

The projection is that the primary (extractive) sectors– Agriculture, mining, Oil and Gas would remain the largest contributors to the growth in GDP in 2005 and beyond. Given the all-year round showing in the prices of crude oil, the projected GDP growth rate of 6% would be met if not exceeded. Although oil accounts for over 85% of federal government revenue, it accounts for less than 25% of GDP. Agriculture, which contributes over 40%, and has been growing at an average rate of 7%p.a. over the past three years, would remain the major source of GDP growth. The GDP is estimated to be over $75.0bn at end of year 2005.

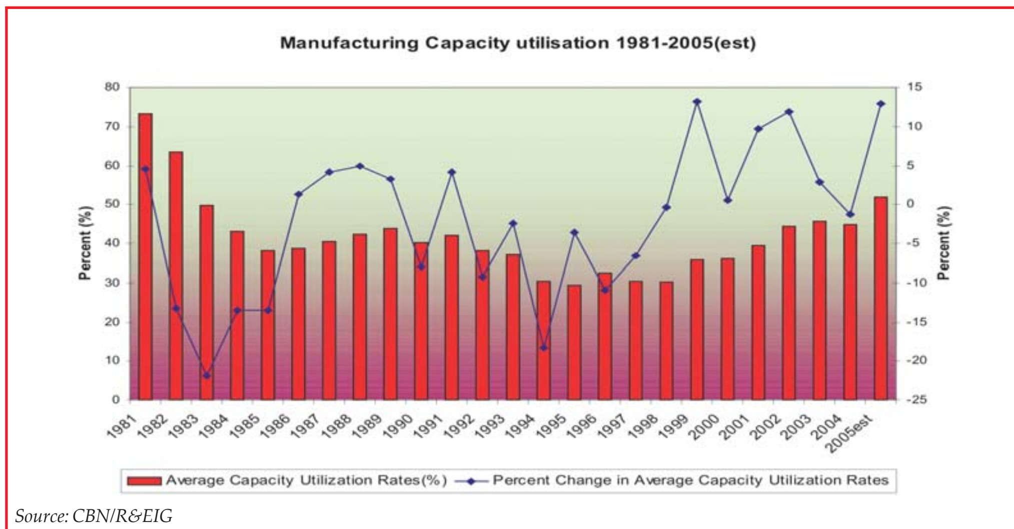


Source: CBN/NPC/R&EIG

This is consistent with the pattern over the last three years. Hopefully the reversal in decline of the industrial sector as a whole would lead to a meaningful rate of contribution from the manufacturing sector. (With capacity utilization projected to be about 52%).

Manufacturing Capacity Utilization

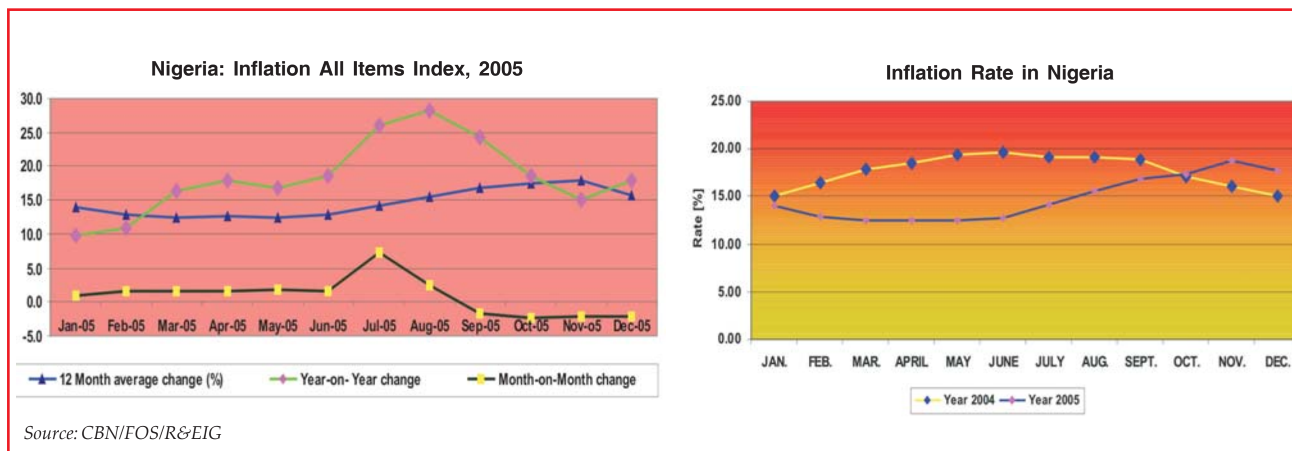
The generally low interest rate and seeming adequacy in the supply of foreign exchange to the manufacturing sector have impacted positively on the level of capacity utilization. The limited impact is traceable to the poor, though improving, state of infrastructure services. Dramatic improvements are expected in the course of the new year as ongoing power generation and transmission line projects are completed.



Source: CBN/R&EIG

Inflation Rate

Although official inflation figures show a decline in year-on-year rate between third quarter 2005 and the first few weeks of the last quarter, inflation has remained relatively on the high side. CBN's withdrawals of government funds from the banking system, the general food price volatility and the M2 growth rate (23% already as against the projected 15% for 2005) have contributed to this trend.

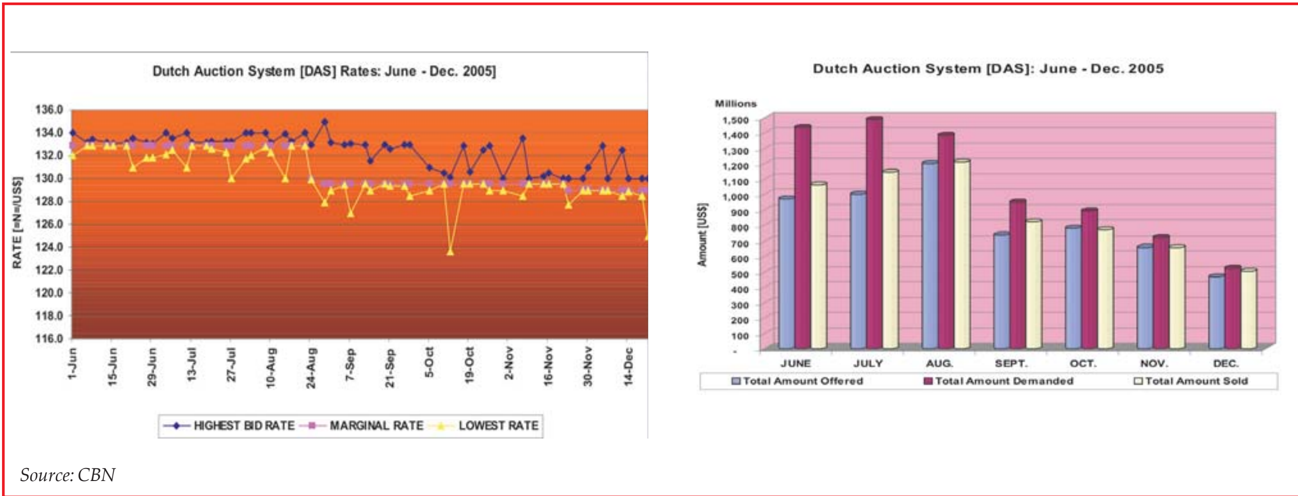


Source: CBN/FOS/R&EIG

The sustained high crude oil prices and the recent increases in the pump prices of petroleum products have impacted the level of inflation and therefore the projected single digit inflation rate at year end is not realistic. However, a lower double digit –about 18%, is projected by year end.

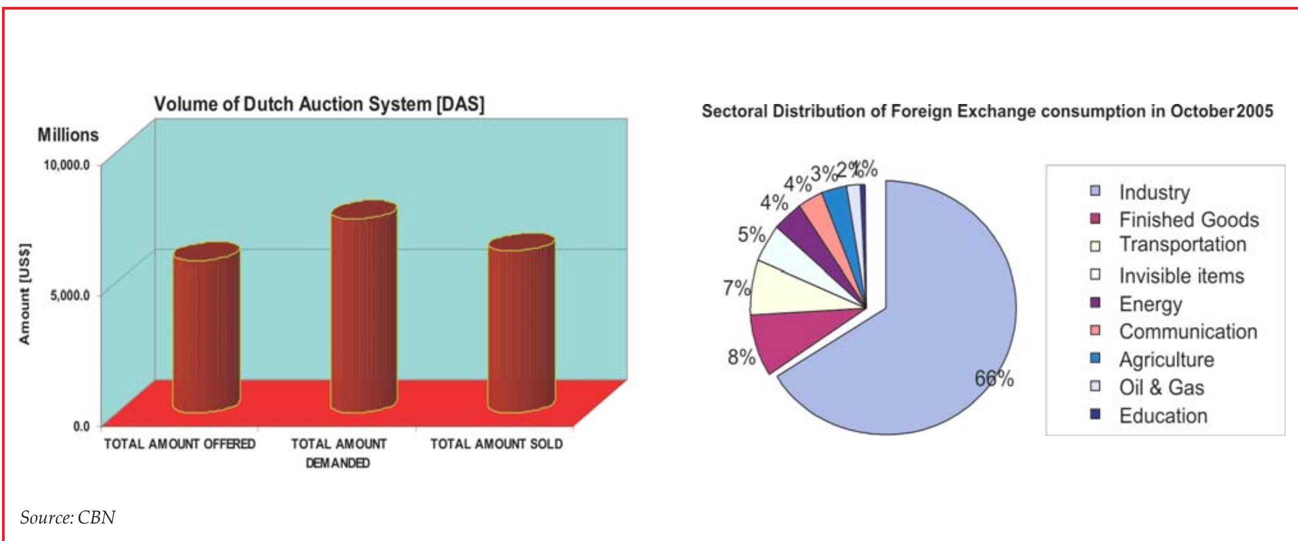
Foreign Exchange Market

The foreign exchange market continues to experience CBN special intervention which has been significant in shoring up the value of the naira against major currencies. With the wholesale dealership arrangement expected to take effect before the end of the first quarter in 2006, the stability in the foreign exchange market seem assured over time, (given the prices of crude oil and government's determination to exit the Paris Debt Club as evidenced by the recent payment of the first installment of about US$7.0bn.). The exchange rate has remained stable at aboutN129.0 to US$1.00.



Source: CBN

As would be expected, transactions in the DAS generally declined as the year comes to a close as indicated by the amount demanded, supplied and bought-same level as with 2004 is expected at year end ($9.43bn as at Nov, 2005, compared with $9.56bn for 2004 for same period).



Source: CBN

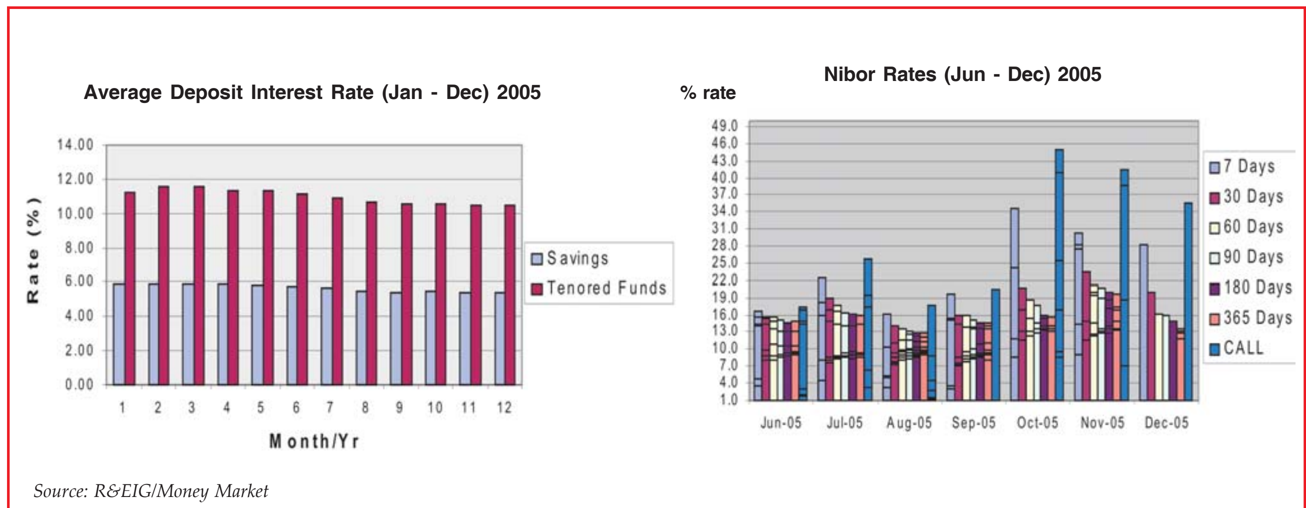
Expectedly, the manufacturing sector accounted for over 60% of the foreign exchange consumption in the economy during the period and indeed for the whole year.

Interest Rate

The withdrawal of government funds led to a strong spike in inter-bank interest rate moderated by the now well known pattern of disbursements of statutory allocations from the federation account. Treasury bills rates have generally fallen to an all time low especially with the introduction of non-rediscountable bills. CBN has continued to focus on bringing down interest rates.

Source: R&EIG/Money Market

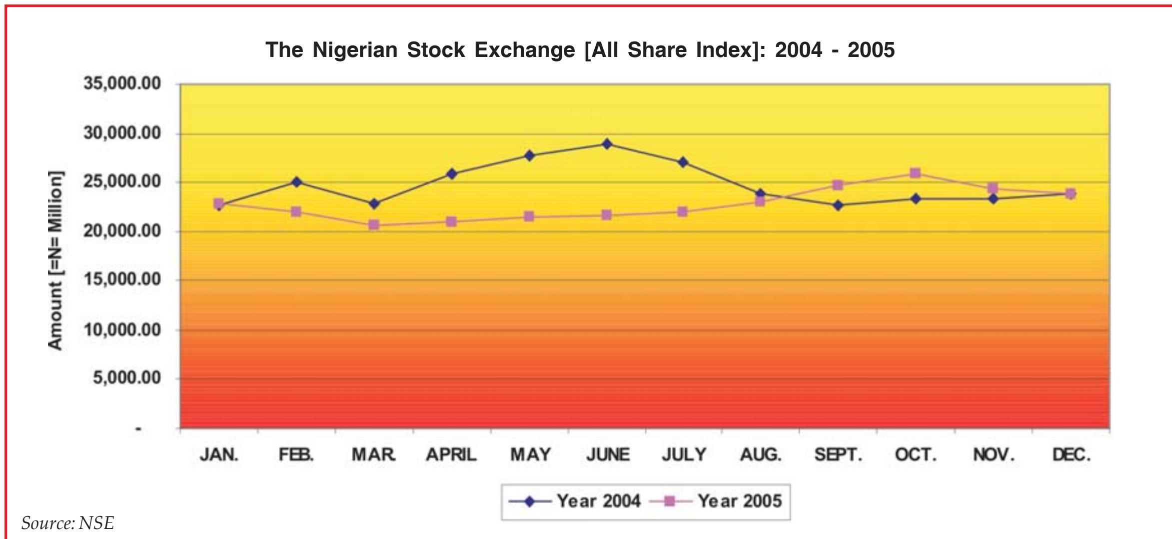
Though average lending rates went down, mostly large borrowers/corporates benefited from the downward trend. Tenored funds continued to show very good trends especially towards the later part of the last quarter, 2005.



Source: R&EIG/Money Market

Capital Market

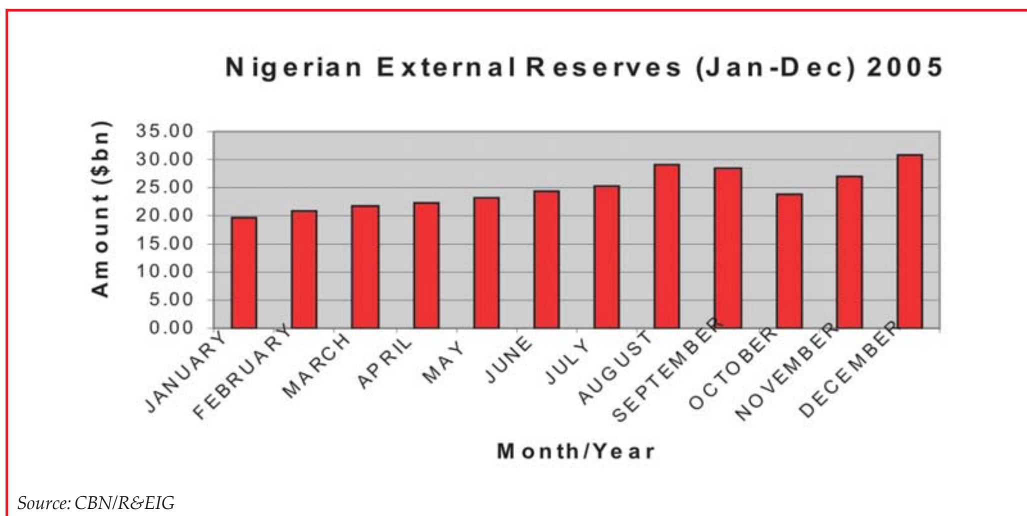
The market has remained significantly busy due in part to sharp rises in market rates which in turn led to dumping of some stocks. Total market capitalization has declined to N4.2tn by mid-quarter, but is expected to close the year marginally higher. Banking, petroleum marketing and food, beverages and tobacco sectors have continued to record declining growth in earnings.



Source: NSE

External Reserves

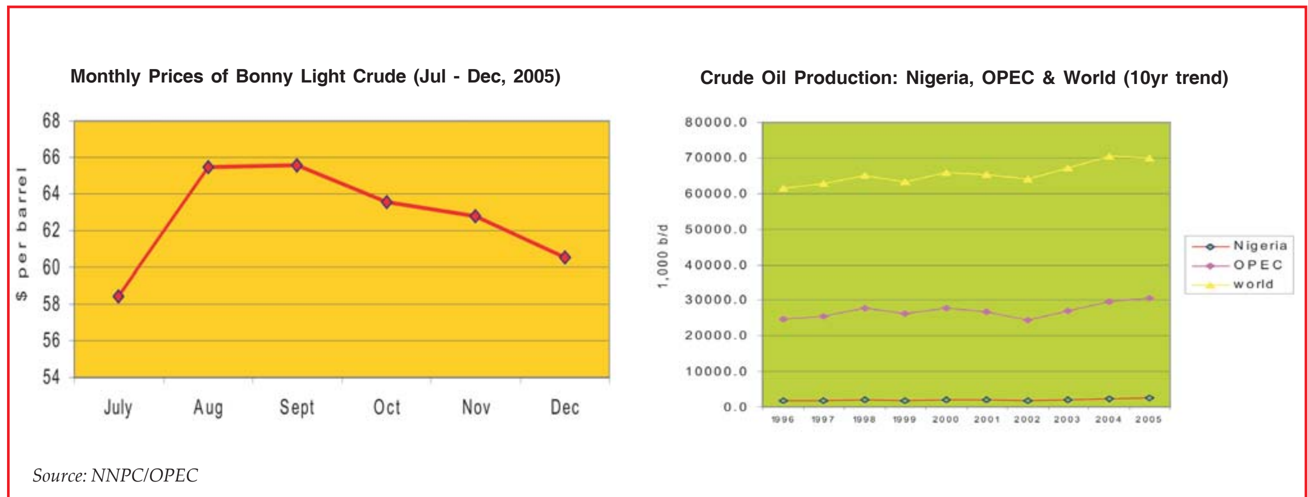
Nigeria's external reserves continue to grow due to prudent fiscal management and the consistently high price of crude oil. It is estimated that total export revenue would surpass previous year's by as much as 48%. At US$34.6bn at September ending, external reserves was already almost twice the figure for the same period in 2004. The figure for 2005 year end is estimated at US$30.1bn. It is imperative to note that the historical pattern of budgetary expansion-contraction in line with changes in the price of crude oil has been jettisoned.



Source: CBN/R&EIG

Oil and gas Sector

Oil production has remained fairly stable, in spite of threats of disruption due to unfulfilled expectations during the recent constitutional talks. It has averaged about 2.45mbpd, some 2% above the average for 2004, thus far. Indications are that this trend would be sustained for the rest of the quarter, and perhaps into the New Year. Estimated export revenue is in the region of $46.0bn. So far marginal changes in price have been witnessed in the months of October and November. The trend would be maintained into the New Year. The price level has helped to keep various government reform efforts on course, especially the Paris Club Debt exit scheme and the concerted effort at improving power generation through massive one-off investment to the tune of about US$2.5bn.



Source: NNPC/OPEC