Zenith Economic Quarterly

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Financial Services Sector: The Unfolding Revolution

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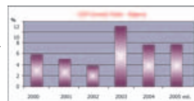

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Waiting for the next wave of revolutionary policies

The best is yet to come. We believe that by the time financial institutions in Nigeria become 'big players' in the oil and gas sector, thus helping to 'domesticate' the sector further, we would have less need for 'revolutionary policies'.

The Financial Services sector typically mirrors the state of health of an economy. Therefore when the sector is seen as experiencing a revolution, it is either responding to a stimulus from the economy generally or proactively spearheading a dramatic change.

Often, we are reminded that the Bretton Woods Institutions *facilitated* the recent revolutionary path of Africa's financial services sector by their insistence on the now infamous Structural Adjustment Programme (SAP) - that prescription of a 'cure-all' package of economic reforms intended to assist developing economies address trade and balance of payment inadequacies.

And as we evaluated trade and economic statistics on Africa and Nigeria in particular, we could not but agree that there have been epochs of revolutionary changes in Africa's financial landscape – institutional, processes, systems, people and technology.

With Africa's subscription to the Millennium Development Goals (MDGs) and the growing commitment (of Africa's leaders) to the NEPAD goals, a new wave of inter regional and continental realignment within financial sectors have begun to gain roots. The targets? - project specific areas under the NEPAD programme especially financing of infrastructural development and the enhancement of intra African investment (capital) flows.

In Nigeria, there have been epochs of revolutionary changes in the financial services sector, each redefining the rules of the game especially in some sub-sectors - recall the various SAP induced reforms that led to significant expansion in the number, depth and scope of operations in banking, finance, mortgage finance, insurance, rural/community banking, foreign exchange auction markets, etc.

Then the NEEDS induced reforms - the Bank recapitalization policy, the second recapitalization policy for the insurance companies, the payment systems overhaul - settlement banks, MICR cheques, automation, the Federal Government backed mortgage bond, and perhaps, a soon-to-be announced recapitalization for mortgage institutions in the country.

Since the 1985-1987 era of SAP, the policies of the last eighteen months have been most revolutionary in nature. After the banking and insurance sector consolidation, the financial services sector in Nigeria would have moved on to another level of sophistication in terms of information technology, product innovation, skills, capacities and service orientation.

The sheer magnitude of the impact of the various reform efforts on the financial services sector is what this edition of ZEQ is devoted to. Mr. Marcel Okeke's 'Periscope' reviews developments in the financial sector that qualifies it as experiencing a revolutionary trend. Dr. Boniface Chizea's piece focuses on the depth and implications of the July 6, 2004 Banking Sector recapitalization policy by the CBN as we gradually inch closer to the deadline of December 31, 2005, while Mr. Jim Ovia's article on internet banking and financial services mirrors the future direction, especially post recapitalization, of financial services delivery, highlighting the quintessentials (interplay) of IT in currency, cash management, financing and risk management across multiple time zones and culturally diverse societies globally.

The section by Mrs. Eunice Sampson reviews selected global financial developments that have resulted from technological innovation and impacted growth positively while the segment on 'facts and figures' puts in perspective the performance of the Nigeria economy; indicating what to expect at year end.

Nigeria, it would seem, is at the threshold of an economic revival of monumental proportion. Sustainability would be the basis of determining if this trend would *trickle down* adequately and translate into the basic, 'common man's view of economic development - job creation, food on the table, water to drink, good roads, affordable school, shelter, health facilities, constant power supply, etc.

With the level of political commitement to the Paris Club debt exit scheme and the need to secure the IMF's endorsement through the Policy Support Instrument (PSI), no doubt, more revolutionary reforms are expected.

Given the intensity of the anti-corruption and financial crimes wars, new pace of privatisation program, and the various legislative proposals at the National Assembly especially the proposed tax reforms, it is highly probable that a new wave of 'revolutionary policies' still lie ahead of us. It takes a careful reading of the NEEDS document and a proper gauge of the political will to confirm this.

With the level of political committement to the Paris Club debt exit scheme and the need to secure the IMF's endorsement through the Policy Support Instrument (PSI), no doubt, more revolutionary reforms are expected.

Chris 'E. Onyemenam

from our mailbox

I write to thank you for sending me once again your ZEQ. I find this publication very refreshing and a source of getting in touch with the wider picture of Nigeria's economic landscape. I congratulate you on the quality i.e. both intellectual input and production. I hope this publication will be a permanent contribution of your bank towards Nigeria's economic journey of growth and more importantly I will continue to be on your mailing list.

E. I. Ijewere,
Chairman, Best Foods (Global Nig. Ltd), Lagos.

I received a copy of the third edition of the Zenith Economic Quarterly, and would like to congratulate you on your continuing ability to produce work of high quality. I have found the journal extremely useful, well-researched and informative. I have no doubts that it will soon gain and build for itself a high level of recognition in the banking industry and the academia as well. Please keep up the good work.

Dr. Reuben Abati,
Chairman, Editorial Board,
The Guardian Newspapers, Lagos.

I am delighted by the quality of your publication, zenith Economic Quarterly, vol. 1. NO. 3. That is by any standard an excellent production both in content and packaging. I read the preceding edition but it would appear that every up-coming edition has something new to add. More grease to your elbows. It is however not surprising to me considering the names behind the publication and the stuff zenith Bank Plc is made of. It is my prayer that you will sustain the niche you have carved for yourself.

Alex C. Anameje,
Asst. Director, Research & Development, CIBN.

I wish to refer to your letter dated August 23,2005 and to acknowledge with thanks the receipt of the Zenith Economic Quarterly. (Nos.3). I look forward to future editions of the journal and do hope that you will retain me in your mailing list. Once again thank you so much for sending me this latest edition.

John D. Edozien,
former MD/CEO, Afribank Plc.

We acknowledge with deep appreciation, the receipt of one (1) copy of the above named journal, which was forwarded to Dr. Oladimeji Alo. The publication is definitely a good addition to our library collection and our clientele will find it of immense value. Many thanks for this kind gesture.

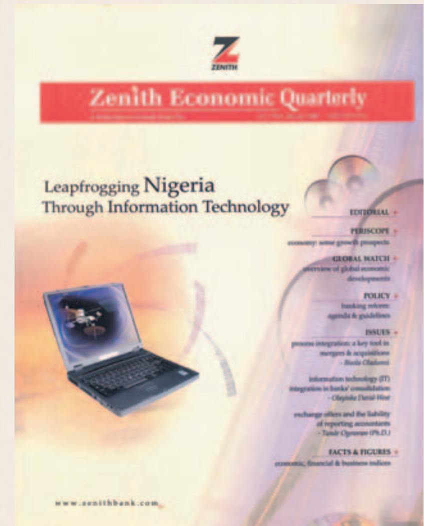
Mr. Tunji Ajiboye,
Head, Research Unit, FITC, Lagos.

Thank you for the complimentary copies of the first and second editions of your Zenith Economic Quarterly (ZEQ), sent to us for the enrichment of our library. We also want to congratulate you on the successful outing and quality of your journal, which makes it reader and research-friendly. We wish you success in your subsequent editions.

Juan Elegido, Dean,
Pan-African University

Thank you for the ZEQ journal. I must commend you on the excellent quality in production and content; I urge you to keep it up.

Foluso Phillips,
Managing Director/CEO, Phillips Consulting



This is to confirm receipt and thank you for your letter dated 23rd August 2005 together with copy of Zenith Economic Quarterly attached thereto. Once again, I must congratulate you and your team for a thorough job. Zenith magazine is highly informative and educative and of course a very good reading material. Thanks once again for having us in your mailing list.

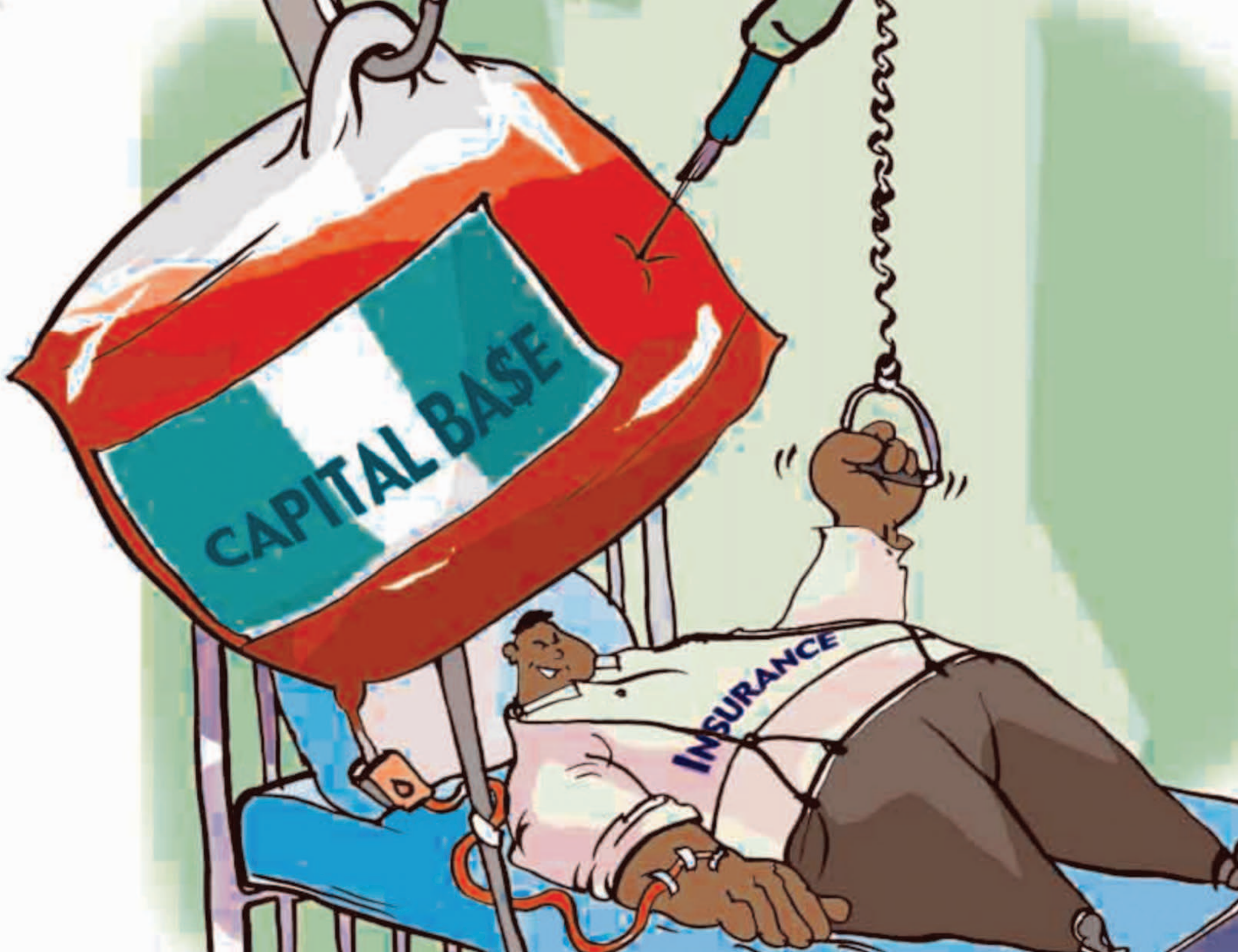
J. A. Ajayi
Managing Director/CEO, UAC of Nigeria Plc

This is to acknowledge the receipt of your magazine with profuse thanks. We want to assure you that, as with the previous editions this copy is going to be circulated among our staff and friends. Finally, while thanking you for keeping us in your mailing list, we look forward to receiving the future editions of the journal.

Dr. (Alh.) W. A. Kareem
Managing Director/CEO K-Marine Business Network Ltd

Thank you for the copy of your Zenith Economic Quarterly (ZEQ) No. 3, receipt of which I now acknowledge. Permit me to recognize this as another milestone from the Zenith brand house -
Congratulations for a job well done.

Chris Uwaje (FNC, FIAP),
Managing Director, Connect Technologies Ltd.


CAPITAL BA$E
INSURANCE

Developments in the financial services sector in the last two years have set in motion a series of events and activities of a revolutionary nature. So fundamental are these reforms that the Nigerian financial services landscape will never be the same again.

FINANCIAL SERVICES: Triggers of the *Revolution*

*** By Marcel Okeke**

In recent times, the word—*revolution*—has been severally used to characterize happenings in the Nigerian financial services industry in particular and many other parts of the globe. Specifically, the revolutionary touch of activities in the Nigerian financial landscape became manifest in the third quarter 2004, when the 13-point bank consolidation plan was unveiled. The dramatic effect of the agenda on all segments of the financial services sector in the past sixteen months or so remains unfathomable.

The frenetic and frenzied search for equity funds by operators in the banking sector, each pushing to meet/surpass the new minimum share capital of N25 billion as required by the Central Bank of Nigeria (CBN), by December 2005, has been impacting every fabric of the economy. As at end-September, 2005, about N235 billion had been raised by re-capitalising banks through private placements, offers for subscription and Initial Public Offerings from the

capital market. In fact, bank consolidation has come to epitomise an era of *reform-mania,* marked by reforms in virtually all aspects of the socio-economic life of the Nigerian polity. Thus, today, apart from the banking sector reform, there are other reforms in other sectors. These include the capital market, insurance industry, pensions, payments system, foreign exchange market, settlement/clearing system, bureaux de change, community banking, finance houses and mortgage institutions—all in the financial services sector.

Drivers of the *Revolution*

All these reforms sum up to and drive the *revolution* in the financial services industry—a *revolution* that is bound to see the number of operating banks shrink from the present 89 (nominally) to a range of 25 to 30 by this year-end. The era of 'mega banks' is here, with the big players in the industry getting bigger; mergers and acquisitions (M & A) or talks appertaining to them are the order of the day. Competition is being propped by the acquisition and use of the state-of-the-art information and communications technology (ICT) to drive service delivery. Already, more ICT-driven products and services (i.e. wider delivery channels- branches, ATMs, IT & Telecom supported channels) are being developed and turned into the market.

Re-capitalisation is the pivot around which the reforms revolve. Whether for the banks, the insurance companies or the capital market operators, quantum increase in capital base is the critical factor that drives the reforms. In the banking sector, the minimum capital or shareholders' fund was raised (for all banks) from N2billion to N25billion, with a time frame of 18 months, from July 2004 to December 2005. Similarly, the minimum paid-up share capital for insurance companies was raised several folds, although to varied levels in accordance with the classes of business underwritten by each sub-group in the industry. Thus, the minimum paid up capital for life assurance underwriters was raised from N150million to N2billion; for general business underwriters, the raise was from N200million to N3billion; composite insurers and reinsurance companies had a raise from N350million to N5billion and N10billion respectively.

Whether for the banks, the insurance companies or the capital market operators, quantum increase in capital base is the critical factor that drives the reforms.

The Insurance Sector

Like their counterparts in the banking sector however, the insurance companies are required to meet the new minimum capital within 18 months, from September 2005 to February 2007. The Finance Minister, Dr. (Mrs.) Ngozi Okonjo-Iweala who announced the new policy September 5, 2005, said the measure was "part of the continuing reform in the financial services sector, so that the sub-sector could add more value to the economy by being mobiliser of funds". She noted that: "in the past, lack of capacity had cost the nation a lot of premium loss", observing that "multinational companies and operators in the oil and gas sector prefer insuring their risks overseas with the attendant capital flight".

The last re-capitalisation exercise in the insurance industry came via the Reinsurance Act 2003. The Act placed in the hands of the National Insurance Commission (NAICOM), the power to withdraw the insurance certificate of any insurer who fails to re-capitalise to the new minimum levels by end-February, 2003. NAICOM was also further empowered by the Act to raise the minimum capitalisation of insurance companies from time to time as it deems fit. Therefore, the latest increase in the minimum paid-up capital of the insurance companies is in compliance with Section 9 of the Insurance Act, 2003. And as in the banking sector, the latest measure will unleash on the insurance industry, an era of consolidation involving a number of mergers and acquisitions as well as an assortment of hybrid new issues/ public offers in the capital market.

On its part, the Securities and Exchange Commission (SEC), the apex regulatory agency in the capital market, had in March 2004, announced new minimum paid-up capital for all operators in the market, "with a view to making them compete effectively in the local and international scenes". The deadline set by SEC had however been shifted from March 31, 2005 to December 31, 2005. Under the re-capitalisation policy, each broker/ dealer is to have a new minimum paid up capital of N70million, while each broker should have N40million.

In support of the bank consolidation, SEC granted a 50% reduction in fees payable by banks seeking to raise funds from the capital market. Thus, the fees became 1% of the nominal value of the shares of the banks involved. The new fees which became effective on August 15, 2005, will however, lapse on December 31, 2005. This measure implied the suspension of the provisions of Schedule 1 of the Commission's Rules and Regulations (as amended in 2003) relating to fees payable for mergers and acquisitions.

Community Banking Sector

The CBN has also embarked on the categorisation of community banks, with a view to increasing their minimum capital base to N10 million. Accordingly, community banks and other micro-credit institutions that want to operate across the country must have a minimum capital base of N100 million. Those that want to operate within a state must have a minimum capital base of N50 million, while those that want to operate within a local government must have a minimum capital base of N20 million. The minimum capital for those operating within a community is fixed at N10 million. Although the categorisation has been concluded, the implementation is expected to commence in the last quarter, 2005. Before the latest categorisation, the minimum capital base for a community bank was N5 million.

Since the era of universal banking and the abrogation of rural banking policy, community banking became the only tool for extending banking services to the rural areas. Reform in this sector was therefore inevitable. Indeed, some community banks, in a shift from the guidelines under which they were set up, were recently allowed to open some branches outside their immediate communities. Community banks were created to be (one branch) financial institutions, catering for the banking needs of their communities. The latest development which allowed a few of them to spread beyond their immediate communities, portends their emergence as 'regional banks' of sorts—thus, another plank of the 'revolution' in the financial services sector.

The CBN had in June last year, also brought the community banks and primary mortgage institutions under the purview of the Nigeria Deposit Insurance Corporation. In a circular to the affected institutions, the apex bank said that "the NDIC in consultation with the CBN is making arrangements to provide insurance cover to the deposits of licensed community banks and primary mortgage institutions". It further directed the affected deposit taking financial institutions "to oblige the corporation with their quarterly returns and any other information it may need to accomplish this task." This development has since brought further checks and controls to the activities of that subset of the financial sector whose modes of operation had been a source of worry to the regulatory/supervisory authorities.

Overview of a typical low income housing estate

Housing/Mortgage Sector

In the housing/mortgage sub-sector, four significant developments have taken place in the last two years, even as reforms in the industry are yet ongoing. First, the National Housing Fund (NHF) collections rose by 68% or N7.02 billion, from a cumulative sum of N10.36 billion at the end of 2002 to N17.383 billion as at July 2005. This is as a result of the widening of the contribution base in both the pub-

lic and private sectors (within the period, the number of state governments participating in the Fund increased from three to 18). Secondly, the problem of scarcity of long-term housing/mortgage funds is being addressed via a combination of measures, including the floating of N100billion housing bond by the Federal Government through the Federal Mortgage Bank of Nigeria, the issuance of FGN guaranteed mortgage bonds and comprehensive amendment of mortgage-related laws. The massive oversubscription of the Bond (over 150%) via intentions to underwrite, even before the actual floatation later this year, is a pointer to the long-standing needs and expectations of operators in the housing sector.

Thirdly, the primary mortgage institutions (PMIs) had last year, set up a committee on the "repositioning and re-capitalisation of PMIs" for the challenges of post-consolidation banking industry. In its report in March this year, the committee recommended among other things, a new minimum capital base of N1billion. And although the CBN is yet to officially implement the recommendation, some new entrants into the industry have taken off with the new capital.

The fourth development in the housing sector is the boom in the private sector participation through public-private-participation (PPP) initiatives.

The DMO initiative is to provide benchmark instruments for pricing other securities in the capital market, and to facilitate the development of the bond market in the country.

Pension Funds Sector

The pension fund sector has undergone far-reaching reforms, the pivot of which is the new Pension Reform Act (2004). The Act provides for a fully funded pension system for both the public and private sectors of the country. Unlike the arrangement in place before the Act, the new pension regime is a contributory one, under which employees would contribute 7.5% of their total emoluments to a Retirement Savings Account (RSA) and employers would also contribute a minimum of 7.5%.

The aggregation of the RSAs (that is, compulsory savings) amounts to a large pool of long-term funds in the country. The size of this pool is estimated at N300 billion with a projected growth rate of about 15% per annum. Thus, the new pension regime is bound to make a dramatic change in the Nigerian investment milieu that has for long been dominated only by short-term funds. Already, the apex regulator/supervisor of the new pension scheme, the Nigerian Pension Commission (PenCom) has granted approval/licenses to about 14 firms to operate as Pension Fund Administrators (PFAs). These PFAs are firms of professional fund managers.

Just as the new pension regime was taking shape, the Debt Management Office (DMO) on behalf of the Federal Government, commenced the conversion of the nation's local debt instruments (Treasury Bills, etc.) into long-term (tradable) instruments of two to three years tenor. The DMO initiative is to provide benchmark instruments for pricing other securities in the capital market, and to facilitate the development of the bond market in the country. The first tranch of the (2nd FGN) Bonds Series was issued on July 11, 2005, and there are seven

tranches (each with a value of N20 billion) to be issued before the year-end.

Further to this, the CBN, DMO and the capital market authorities are in a concerted effort to develop the bond market. In fact, in his remarks at the "2005 Nigerian Bond Market Technical Roundtable" in June, Governor of the CBN, Prof. Charles Soludo noted that the bond market would provide a viable investment avenue for long-term funds to be pooled together from the new pension scheme. He observed that the prospects for a viable bonds market in Nigeria that would enjoy national and international confidence were quite high.

veer.com

The Payments System

The payments and clearing systems have also been undergoing reforms. Although the Nigerian Payments System Committee was set up in 2002, it had to be re-constituted in May this year. On the occasion, the CBN Governor, Prof. Charles Soludo noted that the Nigerian Payments System required fundamental reforms, " particularly the need to migrate to electronic modes of payment". In this regard, the CBN had already issued guidelines on e-banking, and is establishing a system for large payments, which is expected to go live before the end of the year. On the other hand, several banks have been making a lot of strides in this direction.

Thus, new products, including shared-ATMs, have been introduced, while payment cards are being offered and switching services system has been put in place. Some electronic modes of payment through inter-branch funds transfers have also been introduced. On its part, the apex bank had on April 1, 2004, instituted a cheque clearing and settlement arrangement under which seven banks were qualified as "Settlement Banks", with the rest of the operators joining them on agency status. Some of the settlement bank/agency groupings that emerged from this development had since served as nuclei for M & A groups under the ongoing bank consolidation.

On its part, the apex bank had on April 1, 2004, instituted a cheque clearing and settlement arrangement under which seven banks were qualified as "Settlement Banks", with the rest of the operators joining them on agency status.

In its revolutionary activities in the banking industry, the CBN has also been applying the provisions of the Money Laundering Prohibition Act, 2004, and its concomitant—the "Know Your Customer"(KYC) policy/manual. They both deal with the reporting of 'unusual or suspicious' transactions to the appropriate authorities. Specifically, in compliance with Section 6(1-3) of the Act, all banks and other financial institutions must forward all Suspicious Transactions Reports (STR) and other related investigation reports to the Economic and Financial Crimes Commission (EFCC)/Nigeria Financial Intelligence Unit (NFIU). Banks' compliance with the legislation/policy is fast becoming a serious check on money laundering and economic/financial crimes generally.

Monetary Policy/Measures

In many respects, the tenacious pursuit by the CBN of its monetary policy objectives (2004/2005) constitutes a major fillip to the ongoing *revolution* in the financial services sector. These policy objectives are derived from the focus of the "Monetary and Exchange Rate Policies" in the National Economic Empowerment and Development Strategy (NEEDS). According to the NEEDS document, "monetary projections for the reform

period envisage lower public sector deficits as well as increasing the availability of funds for lending to the private sector".

Recognising that "banks need inducements to lend to the private sector, rather than trade in government instruments, conduct foreign exchange transactions, or finance short-term (commercial) activities", NEEDS stipulates that "providing credit to the private sector will be encouraged through a set of incentives". This would mean creating incentives that "alter the structure of banking from deposit-driven to credit giving".

In pursuit of these objectives (which are a fillip to the *revolution*), the CBN had, in the past few months, taken a number of measures. For instance, in the realm of exchange rate stability, the apex bank made its biggest single intervention since the deregulation of the foreign exchange market. It offered $500 million (on Monday, August 22, 2005) at a special Dutch Auction Session (DAS), and this immediately saw the Naira appreciating by N3.00 or 2.26% in the foreign exchange market. The Naira closed at N129.86:$1 as against N132.86:$1 that has ruled the market for a while. The appreciation (2.26 per cent) is the highest ever recorded by the Naira in a single day since DAS was re-introduced in 2000.

The CBN special intervention in the forex market is borne out of its policy of maintaining a foreign exchange rate band of plus/minus 3.0% during the course of the year. Furthermore, the measure is preparatory to the introduction of a wholesale Dutch Auction Forex Market that would make for the convergence of the DAS and the inter-bank exchange rates and eliminate rent-seeking behaviour of the authorised dealers.

Similarly, the apex bank has issued new foreign exchange guidelines which among others, allow foreigners to invest in Treasury Bills that have maturities of more than one year. Under the guidelines which became effective from September 1, 2005, all current investments by foreigners in TBs of a tenor less than one year will be allowed to run till their maturity, after which they are expected to be liquidated and the proceeds invested in TBs/Bonds with a tenor not less than one year.

Another radical measure by the apex bank has to do with transactions involving transfer of bills/funds and pledging of bills (excluding pledges made to NIBSS and CBN). In this regard, the apex bank said in a bid to recover cost of providing the services mentioned above, it is charging (from August 1, 2005) a commission of 0.01 percent on the face value of any transaction involving the above mentioned. Also, with effect from August 1, 2005, the CBN re-introduced a 1% commission charge on all foreign exchange sales to banks. Thus, each bank will be debited with the Naira equivalent of the foreign exchange sold, plus the 1% commission charge at the point of delivery of FX.

Withdrawal of public sector/parastatlas' funds from deposit money banks has also been part of the apex bank's measures that impacted on the industry. In fact, a number of public sector organisations, including the Nigerian National Petroleum Corporation (NNPC), now do banking transactions only with the CBN. The apex bank is applying the gradual withdrawal/re-injection of public sector deposits with commercial banks as a tool for liquidity management, and to encourage the banks to mobilise savings from traditional sources other than the public sector.

Investor protection and confidence-building in the Nigerian capital market have also received a boost through the activities of SEC

Investor protection and confidence-building in the Nigerian capital market have also received a boost through the activities of SEC, the Nigerian Stock Exchange and the Investment & Securities Tribunal (IST). The Automated Trading System (ATS) introduced by the NSE has now reduced the transaction cycle to transaction day plus three working days (T+3), while the Central Securities Clearing System (CSCS) recently launched a "phone-in" scheme that enables investors to enquire about their stock holdings. The IST which commenced its adjudication on disputes and controversies in the capital market in 2003 has, to date, settled cases worth over $2 billion, most of them in the last one year. All these have assisted in the building and sustaining of the confidence of both local and foreign investors—and has translated into improvements in foreign portfolio/direct investments—even as fresh equity injections in some of the re-capitalising banks. Thus, the capital market institutions/agencies, by their activities

and operations, are key agents of the *revolution* in the financial services sector.

Legislative Amendments

It is noteworthy that in the past two years or so, virtually all the regulatory and supervisory agencies in the financial services sector have been pushing for far-reaching amendments in their enabling laws, essentially to empower them in driving the *revolution*. The Chartered Institute of Bankers of Nigeria (CIBN), for instance, is working to bring under its purview and discipline, all practitioners in the banking industry. Its subsisting enabling legislation, Act 12 of 1990, failed to empower the Institute to control or discipline all (erring) bankers.

The CBN special intervention in the forex market is borne out of its policy of maintaining a foreign exchange rate band of plus/minus 3.0% during the course of the year.

In the same vein, the apex bank is seeking for the amendment of its CBN Act No.24 of 1991 as well as the Banks and Other Financial Institutions Act (BOFIA) of 1991. Other laws for review include the bankruptcy laws, Dud Cheque Acts and law of contract/property rights. In the past 20 months or so, the National Assembly has, on more than two occasions, called to question, the authority of the apex bank in enforcing some reform measures in the banking industry. At present, most of the needed amendments are at various stages of legislative deliberations.

Like the CIBN and the CBN, the Securities and Exchange Commission (SEC), has also embarked on the amendment of its enabling legislation, pursuant to Section 262 (4) of the Investments and Securities Act (ISA) No. 45 of 1999. A key plank of these amendments has to do with its operational rules and regulations, an 'exposure draft' of which was widely advertised for public inputs all through the third quarter, 2005. The Nigeria Deposit Insurance Corporation, on its part, has also proposed several amendments in its NDIC Act of 1988 as well as the Failed Banks Act—all with the aim of further driving the ongoing *revolution* in the financial services sector.

Some of the mortgage-related laws slated for amendments include: the FBN Act, Trustees Investment Act, Land Instrument Registration Act, the Conveyance Act and the Land Use Act—to facilitate easy transfer/assignment and foreclosure of mortgages. Already, an Inter-ministerial committee set up by the Federal Government on mortgage financing is also working out details of these amendments.

(*Marcel Okeke is the editor, Zenith Economic Quarterly.)

'Human beings, being creatures of habit will probably view anything that is new with caution and suspicion. The same applies to multimedia banking. People are cautious and often downright reluctant to depart from traditional brick and mortar banks to electronic click and avatar banks'

– P.Vijayan (Chief Internal Auditor,* Affin-ACF Finance, *Kuala Lumpur, Malaysia).

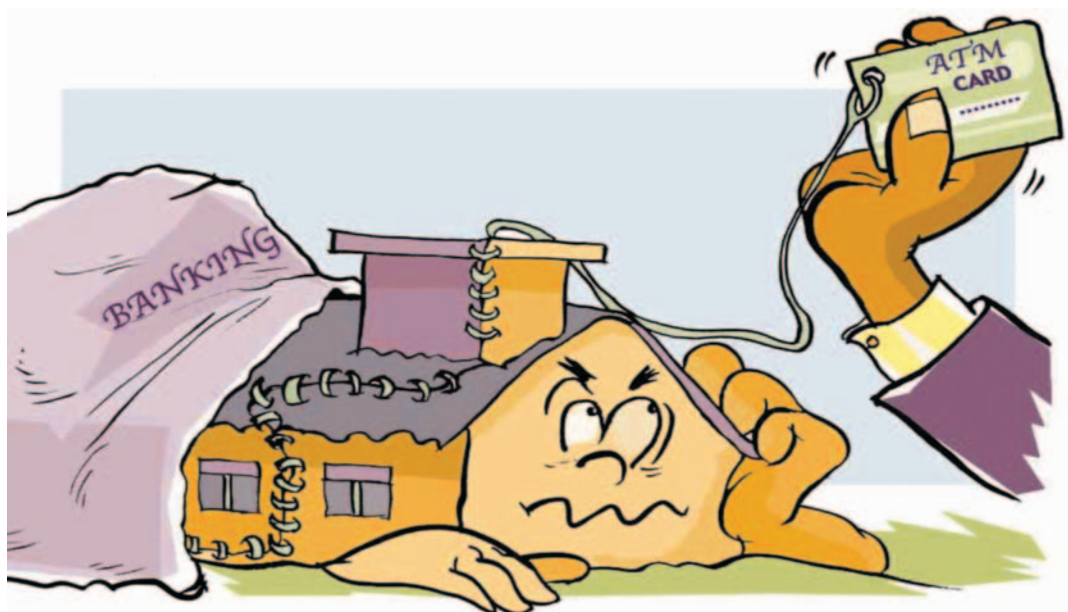
HOW INTERNET CAN DELIVER 21st Century Banking In Africa

*** By Jim Ovia**

The banking industry is an extremely information-intensive one, relying heavily on information collection, storage, transfer and processing; and the Internet has proven to be an incredibly powerful and efficient tool for handling these processes.

Trends In Electronic Banking

Today, many innovative banking channels are springing up – the Internet; ATMs; POSs; Kiosks; PC banking; or handheld computer (such as the personal digital assistant, PDA); mobile banking (SMS and IVR); TVs and so on – giving bank cus-



tomers more convenient options to choose from out of the widening array available.

Although the Internet has become highly fashionable, the developing countries of Asia and Africa are still struggling hard to catch up with their counterparts in the developed countries.

Whereas Internet banking was first introduced by Security First Network (USA) in 1995, it did not begin to gain acceptability in Africa and Asia until much later.

Today, modern banking institutions around the world resort to this technology in the provision of efficient, cost effective and convenient banking services to their customers.

In developed economies, especially North America and Europe, more 'Internet-only' banks have since emerged which do not offer the conventional "bricks-and-mortar" banking services through branches but solely operate electronically.

Internet is used in banking for two broad functions – to present information to customers and the general public on banking products and services; and to provide an interface through which customers can access their account and conduct banking transactions. Internet banking is therefore gradually gaining wide acceptance for two reasons - convenience and cost efficiency.

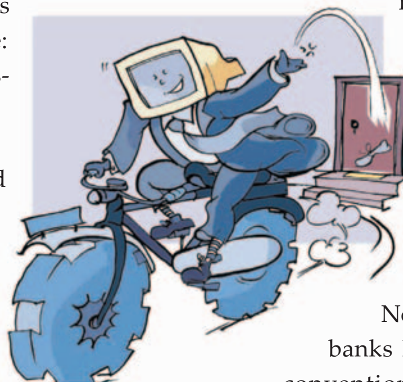
Currently, most Internet banking services are free, offered as added value. In the United States, a range of between $5-$8/month is charged. In the UK, most of the major banks offer Internet banking, but often without any charges. And in most African countries, fee-generating Internet banking services are quite rare – Internet banking is offered to customers free, and at best, for very minimal charges.

Internet Banking Products/Services

The process of using an internet-enabled personal computer to access and operate a bank account through a bank's website, with full authentication. While it cannot be seen how Internet banking can take over the conventional role played by the brick and mortar bank branches, it is becoming a major component of the business and marketing strategies of modern banking institutions.

Basic Internet banking products and services already existing include:

- Check account balances and transaction history
- Transfer funds between accounts
- Order foreign currency and traveler's cheques
- Apply for credit cards and loans online
- Post current interest rates
- Stop payment orders
- Receive and pay bills (without cheque writing, envelopes, or stamps; EBPP)
- Download information directly into personal finance software, etc.



Indeed, some banks now provide customized Internet banking services to meet the needs of specific customers.

At Zenith Bank, for example, Internet banking products and services include the Automated Direct Payment System (ADPS), which allows our customers make payments to their suppliers, vendors, staff, etc, through the Internet and other electronic media. Other Internet banking services we render include e-ticketing, embassy solutions, etc. On the average, our customers are charged about 0.1% of the value of the transaction that is less than N1m ($8000).

Nigeria just recently witnessed the emergence of its first ever complete internet shopping Mall called, shopforless, a website where customers can shop for their household and electronic needs and make payments via the internet through available switches, like NEFT, eTranzact and Interswitch. Also, the two largest switches in the country (Interswitch and CTL) earlier in the year merged their networks, making it easier for online payments and other transactions to be carried out in the country.

'Internet-Only' Banking

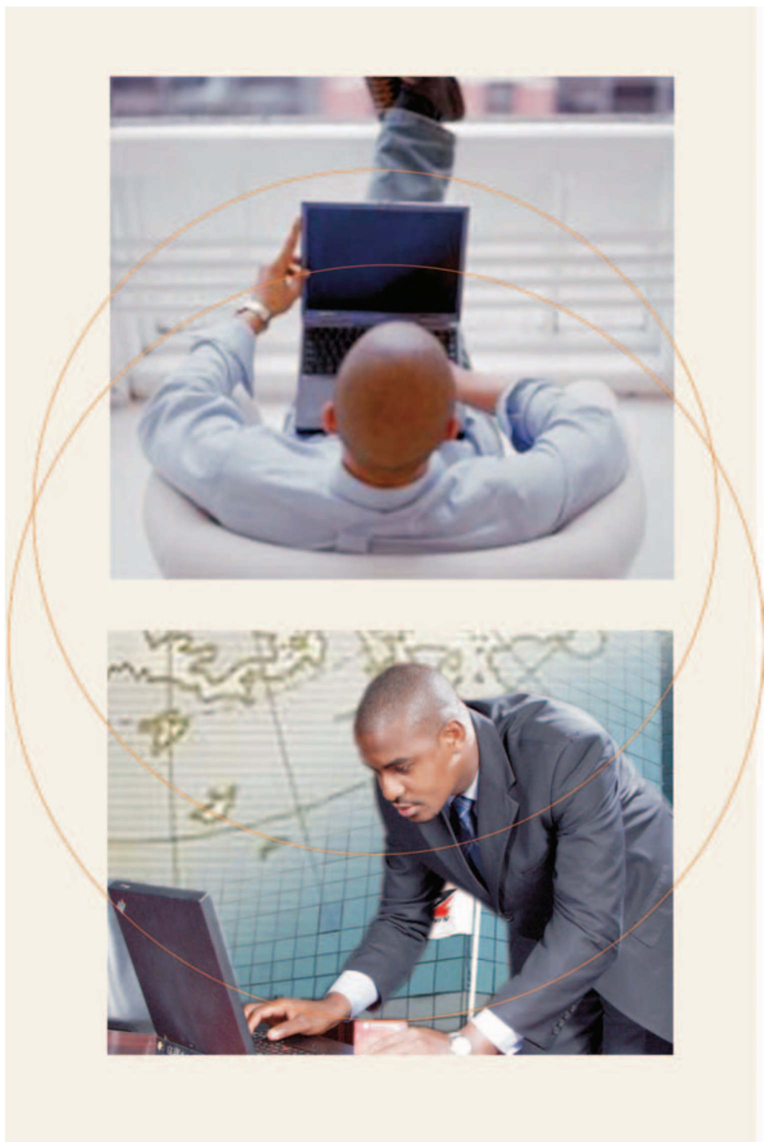
Security First Network Bank, SFNB, USA, is the first internet-only bank in the world, opening its doors to complete online banking business in 1995.

In developed economies, especially North America and Europe, more 'Internet-only' banks have since emerged which do not offer the conventional "bricks-and-mortar" banking services

through branches but solely operate electronically. Internet-only banks are known to offer higher interest rates and lower fees than traditional banks because they incur minimal overhead costs.

However, 'Internet only' banks have not been as successful as initially predicted. In the United States for example, 'Internet-only' banks shrunk from 60 to less than 20 within 3 years. Some of the major virtual banks in the global banking industry now include Abbey National (UK), ING Direct (USA), Cahoot (UK), Security First Network Bank (Canada) and Egg (UK).

As at today, there is no known 'internet-only' banks operating anywhere in the African continent. In our banking environment, the more feasible option now and in a long time to come, would be a combination of conventional and online banking methods.



AFRICAN INTERNET BANKING EXPERIENCE

The Internet is one of the most far-reaching innovations of the information age, impacting on all key areas of human life. Unfortunately, Africa has remained a slow adopter of this amazing business-enabler, with just 2% of the 900 million African populations currently using it.

Everett Rogers in his famous 'Diffusion and Adoption' research (1995) classified innovation adopters into five broad categories:

(1) Innovators - (first 2.5% of individuals in a social system to adopt an innovation)

(2) Early adopters - (next 13.5% of individuals in a social system to adopt an innovation)

(3) Early majority - (next 34% of individuals in a social system to adopt an innovation)

(4) Late majority - (next 34% of individuals in a social system to adopt an innovation)

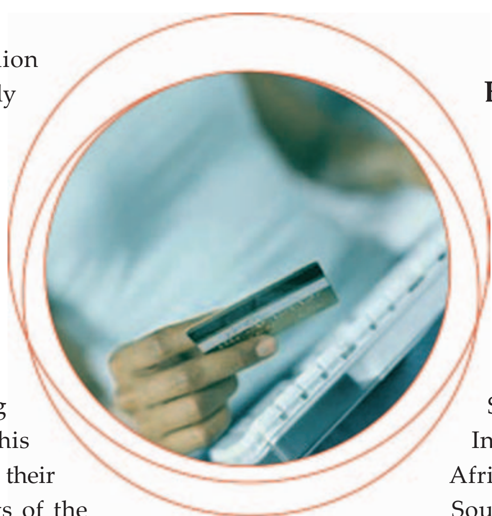
(5) Laggards - (last 16% of individuals in a social system to adopt an innovation)

While the developed countries of Europe and America have remained in the categories of the innovators and early adopters of this technology, using it to enhance their business and personal productivity, most African countries have, at best, fallen into the early and late majority category, or worse still, laggards.

Africa has in recent years improved its ratings in telecomunications growth. Unfortunalety, the continent has not been so lucky with the Internet. According to ITU's 2004 Telecommunications Indicator report, Africa scored the highest (65%) annual average mobile subscribers growth rate compared to the rest of the world; with Nigeria alone contributing at least 30% of the overall growth in Africa's telecoms spread in the last 2-3 years.

About 13,468,600 Africans (out of a 900m population) use the Internet currently (2005). But 30% of these users are in North and South Africa; 1 out of every 200 - 300 Africans use Internet. When you compare this with the world average of 1 user for every 15 people; North American/European average of 1 in every 2 people; Asia's online banking population of 173 million (Asia now accounts for 30% of global internet users and about 60% of total world population); or Singapore with 2.1m Internet users for a

total population of 4 million people; then you can rightly say that Africa has done poorly in Internet adoption.



But developments in the last three years have shown that while most businesses and individuals adopted the technology late, they are making frantic efforts to correct this mistake and catch up with their counterparts in other parts of the world.

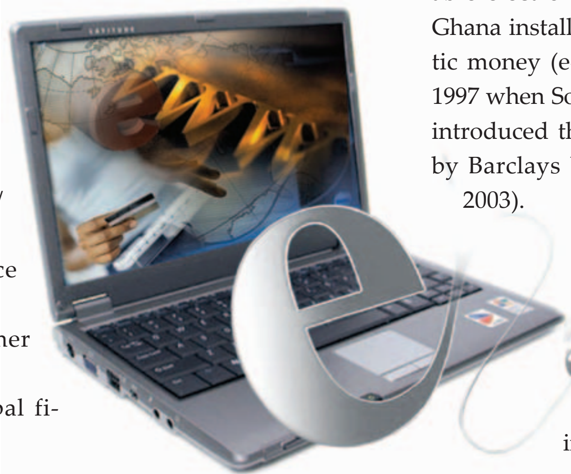
Currently, at least 50% of the over 800 banks in Africa offer one form of online banking service or the other.

Aside from banks, other financial services institutions like Stock exchanges, clearing houses, insurance, are digitizing their processes and introducing technologies that would enhance service delivery and simplify hitherto cumbersome manual processes. Today, it has reached a point where the neglect of technological tools in the discharge of financial services duties is the exception, rather than the norm.

Why Internet Banking?

While African banks have not started reaping the comparative cost advantage of using Internet for service delivery, the convenience it offers is making about 10% of African banks' customers and over 50% of banks to render internet banking services. Other reasons for adopting Internet banking include:

- Increased confidence on banking system, processes
- More depositors/ higher balance
- Increased revenue for banks & cost effectiveness
- Customers consume more products
- Banks spend less on service delivery/ maintenance
- Enhanced service delivery efficiency
- Enhanced customer loyalty/ satisfaction
- Harmonised global financial system



Examples from Selected African Countries:

South Africa:

The web was first directly accessible to the South African public in 1994. And the country has since grown in Internet usage ahead of other African countries. South Africa had 3,523,000 Internet users for a population of 47,556,900 as at 2004, meaning about 7.4% of South Africans use the Internet. Over 26% of Internet users in the entire continent are South Africans.

South Africa also has the largest population of Internet banking subscribers in the continent. A report released in 2004 by World Wide Worx (a leading South African ICT research firm) shows that the number of online bank accounts in South Africa has surpassed the one million mark at the end of 2003 and is growing annually (on the average) at the rate of 29%.

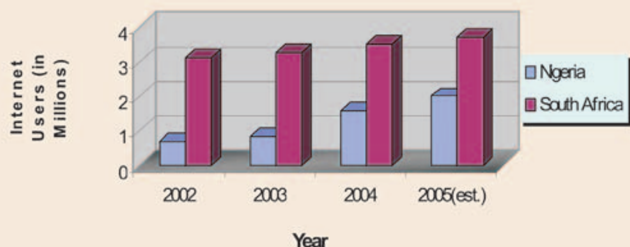
Egypt:

Egypt has the second largest population of Internet users in Africa, after South Africa. With a population of 69, 954,717 (2005), Egypt has 3,000,000 Internet users, with 22.3 % of all Africa's Internet users as Egyptians. However, less than 10% of Internet users in the country subscribe to Internet banking. But the country 's Internet penetration has been growing at an average of 100% per annum in the last five years, raising hope that its e-banking population might begin to increase by at least 20% every year.

Ghana:

In Ghana, a pioneer in telecom liberalization and deregulation in Africa, ATM has remained the more acceptable electronic banking channel since the Trust Bank of Ghana installed the first ATM in that country in 1995. Plastic money (e-purse) has been in use in Ghana since May 1997 when Social Security Bank, now Societe Generale SGB, introduced the product. Telephone banking was launched by Barclays Bank Ghana just two years ago (August 28, 2003).

But Ghana has not been as enthusiastic with Internet banking, or even in the use of the Internet for other purposes. With a 21 million population, Ghana has about 400,000 Internet users. Internet ranks lowest among the e-banking media preferred by Ghanaians, as shown



E-banking trends in Ghana

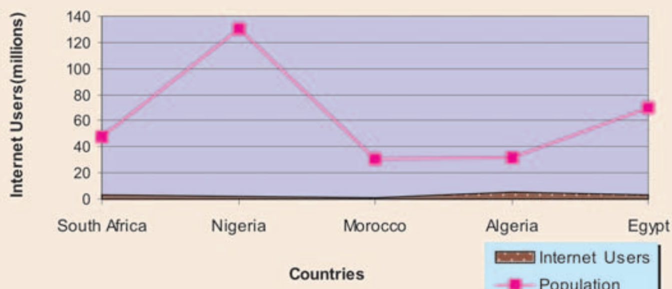
Electronic Delivery Channel	Frequency	%
ATMS	495	56.7
Telephone Banking	182	20.8
PC Banking	133	15.2
EFT/Pos	32	3.7
Others	31	3.6
Total	873	100

Source: "Technological Innovations & Banking in Ghana" by Joshua Abor, University of Ghana; 2004 (www.financialcertified.com)

in the table below. Major banks in the country (Ecobank ((Gh.), Standard Chartered Bank (Gh.) and Barclays Bank (Gh.)) started rendering Internet banking services in Ghana about 2 years ago.

Nigeria:

According to reports released in May by the National Space Research and Development Agency, just about 2% (about 2.4 million) of Nigeria's over 130 million population actively use the Internet.



The report puts internet access points in the country at 685,459, with offices having 530,968 of these, representing 77.4%; homes, 122,431 points, representing 18.9%; and cyber cafés accounting for the remaining 32,060 points, representing 4.7% of the total internet access points available in the country. The country's outbound international traffic is currently estimated at between 350-600 million minutes yearly; this is estimated to rise to about one billion minutes in the next three years.

In Nigeria, as in most African countries, each computer with an Internet or email connection usually supports a range of three to five users.

Nigeria has performed dismally in Internet usage generally; and so performance in Internet banking cannot be an exception. In fact, among the 5 top economies in the continent (South Africa, Egypt, Morocco, Algeria) Nigeria has the poorest Internet usage record, when compared with its huge population.

The rapid spread of the Internet in Nigeria would go a long way in boosting the rating of Africa in Internet usage. This is because of its huge population size, constituting about 20% of the continent's entire population. The recent revolution in the Nigerian telecoms sector has impacted greatly on Africa's new telecoms rating as one of the fastest growing telecoms market and the fastest growing in cellular telephony.

Constraints to Internet Growth:

Africa is rated as the slowest growing continent in internet pentration. The following are some of the major constraints to growth:

- Inadequate ICT Infrastructure
- Inadequate funding
- Absence of appropriate legal & regulatory framework
- High cost of bandwidth/telephone lines/internet access
- Severe inter-exchange congestion and slow Internet connectivity due to high international tariffs
- Unexpected system failure
- Complacence/illiteracy
- Security:

a) Cyber security (hacking, viruses/worms, etc)

b) Data integrity

c) Protection of customers' confidential information

d) Identity Theft = Internet fraud

Internet Banking: Reaping the Gains:

Worldwide, the banking industry is becoming so increasingly competitive that every bank is looking for distinct products and services, and also, unique service delivery media that would stand them out. This is where Internet banking becomes critical.

Some of the benefits of Internet banking include:

- **24/7/365 uninterruptible banking, anywhere, anytime**
- Harmonized banking standards (e.g. RTGS)
- Competitive edge
- Efficient, convenient service delivery
- Enlarged banking scope/ coverage; globalization
- Cost effectiveness, both for the bank and its customers:
  a) Cheapest way of providing banking services
  b) Reduces transaction costs/administrative overheads
  c) Proven to be about 12 times cheaper than through a branch
  d) Most banks offer customers up to 50% off charges for online

Internet banking is a major tool of financial globalization. As more bank customers adopt Internet banking, the speed at which national and international business deals are financially settled would be enhanced.

Most African economies are currently adopting reform measures aimed at placing them on the map of major global economic players. The spread of the Internet and e-banking would help financial institutions in these countries to achieve this goal.

Leapfrogging the Process:

For Internet banking to succeed in this continent, we must learn from the experiences of the early adopters in the developed economies. Actions that must be taken would include:

- Vigorous developments of ICT infrastructure:
  a) Public/private sector collaboration
  b) Special funds for African ICT development
- Addressing cyber security threats:
  a) Full proof authentication
  b) Firewalls, filtering routers, encryption, digital certification
  c) Customers' vigilance against fraudulent websites
- High Internet cost – local availability of infrastructure & increased competition will bring down current high cost
- Complete ICT industry deregulation
- Awareness creation/sensitization

Nigeria has performed dismally in Internet usage generally; and so performance in Internet banking cannot be an exception.

The society addressing these key issues, and the banking industry developing the passion and zeal for innovative service delivery and introducing highly practical and personalized internet banking products would encourage more patronage of online banking services in the continent.

INTERNET BANKING SCORECARD

The adoption of Internet banking by banks has grown at different rates in different countries. Even in the highly developed economies, Internet banking has not spread as rapidly as expected, considering its enormous advantages both for the banks and their customers.

Out of a world population of about 6.4 billion, world Internet users in 2004 stood at an estimated 700 million. This is not very encouraging. Worse still, out of the 700million internet users, internet banking users worldwide only grew from 1.0 million in 2000 to 6.5 million in 2005.This means that only about 11% of global Internet users actually subscribe to Internet banking services.

In Africa, less than 2% of the almost 900 million population uses the Internet. While telephone usage (especially cellular) has grown rapidly in the last four years in the continent, Internet penetration has not been so rapid. Africa's cellular market is the fastest growing in the world, growing by over 50% in 2002, almost 40% in 2003 and over 40% in 2004.

The Internet has proven itself an efficient and effective 'banking enabler'.

The banks of the future are those that would increasingly embrace and adopt the Internet and other banking enabling technologies to meet the challenges posed by competition, and in order to satisfy, and even exceed, the expectations of customers and investors. Banks that do not live up to customers' increasing demand for Internet banking will end up marginalized in the long run and lose out to more ICT compliant competitors.

The big question is: what will be the next corporate mistake by financial institutions? I suggest it will be a failure to recognize the power of the digital economy to make a deeper transformation of corporate and wholesale finance" – Dr. Patrick Dixon, Chairman, Global Change Ltd, UK

(* Jim Ovia is the MD/CEO, Zenith Bank Plc.)

Revised Guidelines for the Small and Medium Enterprises Equity Investment Scheme (SMEEIS)

1.0 Establishment Of The Scheme:

1.1 The Small and Medium Enterprises Equity Investment scheme is a voluntary initiative of the Bankers' Committee approved at its 246th Meeting held on 21st December, 1999.

1.2 The initiative was in response to the Federal Government's concerns and policy measures for the promotion of Small and Medium Enterprises (SMEs) as vehicles for rapid industrialisation, sustainable economic development, poverty alleviation and employment generation.

1.3 The Scheme requires all banks in Nigeria to set aside ten (10) percent of their Profit After Tax (PAT) for equity investment and promotion of small and medium enterprises.

2.0 Purpose Of The Scheme:

2.1 The 10% of the Profit After Tax (PAT) to be set aside annually shall be invested in small and medium enterprises as the banking industry's contribution to the Federal Government's efforts towards stimulating economic growth, developing local technology and generating employment.

2.2 The funding to be provided under the scheme shall be in the form of equity investment in eligible enterprises. This will reduce the burden of interest and other financial charges expected under normal bank lending, as well as provide financial, advisory, technical and managerial support from the banking industry.

3.0 Activities Covered By The Scheme:

3.1 Every legal business activity is covered with the exception of

(i) Trading/merchandising

(ii) Financial Services

4.0 Definition Of A Small And Medium Industry:

4.1 For the purpose of this scheme, a small and medium enterprise is defined as any enterprise with a maximum asset base of N500 million (excluding land and working capital), and with no lower or upper limit of staff. This is subject to review by the Bankers' Committee from time to time.

5.0 Eligibility For Funding:

5.1 To be eligible for equity funding under the Scheme, a prospective beneficiary shall:

(i) Register as a limited liability company with the Corporate Affairs Commission and comply with all relevant regulations of the Companies and Allied Matters A ct (1990) such as filing of annual returns, including audited financial statements;

(ii) Comply with all applicable tax laws and regulations and render regular returns to the appropriate authorities; and

(iii) Engage or propose to engage in any of the businesses as indicated in clause (3) above.

6.0 Modalities Of The Scheme:

6.1 Funds invested by participating banks shall be in the form of equity investment in eligible enterprises.

7.0 Definition Of Equity:

Equity is defined as ordinary and preference shares. However, Preference Shares under the Scheme shall be non-cumulative and shall bear zero coupon rate.

8.0 Limit Of Equity Ownership:

Upper limit of 40% equity funding by banks shall apply.

9.0 Maximum Amount Investible In Any Enterprise:

Maximum amount investible in any enterprise is N200 million.

10.0 Co-Investment By Different Banks:

Co-investment by different banks is allowed subject to the maximum limit of 40%.

11.0 Sectoral Allocation:

Real/Service Sector – 90% maximum; and Microfinance– 10% minimum

12.0 Deadline For Investing Funds:

The time limit to invest the funds set-aside shall be 12 months after the AGM of the bank.

13.0 Incentives/Sweeteners:
There shall be annual award in various categories to the best performing banks under the SMEEIS.

14.0 Sanctions And Penalties:
On expiry of period of grace, after the date of setting aside of the funds:-
14.1 The CBN shall debit the banks that have not invested and invest such funds in treasury bills for six(6) months after expiry of the deadline. The interest earned would be used to administer the scheme.
14.2 Thereafter, existing venture capital companies and banks could bid to manage and invest the funds through proposals made to the Bankers' Sub-Committee on the SMEEIS for final approval by the Bankers' Committee.

15.0 Continuity Of The Scheme:
The Scheme shall continue after the first five years but banks' contributions to SME reserves to thereafter reduce to 5% of Profit After TAX.

16.0 Mode Of Investments And Other Related Issues:
16.1 Equity under the scheme may be in the form of fresh cash injection and/or existing debts owed to participating bank.
16.2 A participating enterprise may obtain more funds by way of loans from banks in addition to equity investment under the scheme.
16.3 Eligible enterprises are free to approach any bank, including those they presently have relationship with, to seek funding under the scheme. Prospective beneficiaries should note that the banks may operate the scheme directly, through their wholly owned subsidiary venture capital companies or through venture capital companies floated by consortia of banks or through independent venture capital companies.
16.4 Prospective beneficiaries are advised to seek the opinion of third party consultants such as lawyers, accountants and valuers in determining the value to be placed on the assets and capital of their businesses in order to determine a fair price before or during negotiations with the banks.

17.0 Requirements By Beneficiaries:
17.1 Beneficiaries will be expected to:
(a) Ensure prudent utilisation of funds;
(b) Keep up-to-date records on the companies' activities under the Scheme;
(c) Make the companies books, records and structures available for inspection by the appropriate authorities (including banks and the CBN) when required;
(d) Comply with guidelines of the Scheme; and
(e) Provide monthly financial and operational reports to the investing banks before the 15th of the next succeeding month.
17.2 The recommendations of industrial associations, particularly Manufacturers Association of Nigeria (MAN); National Association of Chambers of Commerce, Industry, Mines and Agriculture (NACCIMA); National Association of Small and Medium Scale Enterprises (NASME); and National Association of Small Scale Industries (NASSI) will be mandatory for members of these associations. Membership of recognised NGOs engaged in entrepreneurial development and promotion of small and medium scale enterprises will also be an advantage.

18.0 Presidential Consultative Advisory Committee (PCC):
A PCC compris ing members from the following institutions shall be setup for the scheme:
(a) The Central Bank of Nigeria (Chairman)
(b) The Bankers' Committee;
(c) The Presidency;
(d) Federal Min istry of Finance;
(e) Federal Ministry of Industry ;
(f) Manufacturers Association of Nigeria (MAN);
(g) National Association of Chambers of Commerce, Industry, Mines and Agriculture (NACCIMA);
(h) National Association of Small Scale Industries (NASSI); and
(i) Development Finance Department of the CBN shall be the Secretariat of the Committee.

19.0 Bankers' Committee Sub-Committee On The SMEEIS :
19.1 There shall be a Standing Sub-Committee on the SMEEIS appointed by the Bankers' Committee to determine issues relating to the SMEEIS and report to it for final determination and approval. Ad-hoc Sub-Committees could also be appointed from time to time as the need arises to determine specific issues relating to the SMEEIS. Membership of the Bankers' Committee Sub-Committee on SMEEIS shall include:
(i) Bankers' Committee Representative - Chairman
(ii) The Central Bank of Nigeria - Member
(iii) Selected representatives of banks - Members

20.0 Secretariat For Bankers' Committee Sub-Committee On The SMEEIS:

20.1 There shall be a Secretariat for the Bankers' Committee Sub-Committee on the SMEEIS and PCC on the SMEEIS at the Development Finance Department of the Central Bank of Nigeria.

21.0 IDENTIFIED KEY STAKEHOLDERS:

The identified key stakeholders include:
(i) The Federal Government;
(ii) The Central Bank of Nigeria ;
(iii) The Bankers' Committee;
(iv) Individuals banks;
(v) Independent Fund Managers;
(vi) The Securities and Exchange Commission; and
(vii) Promoters of Small and Medium Industries.

22.0 RESPONSIBILTIES OF STAKEHOLDERS:

22.1 The Federal Government:

(i) Stable macro-economic environment;
(ii) Stable and reliable regulatory and legal framework;
(iii) Adequate Physical Infrastructure;
(iv) Prudent fiscal regime; and
(v) Capacity building. Specifically, the responsibility of the Government with respect to the implementation of the SMEEIS is to pass the enabling legislation to provide the following tax reforms and incentives:
• Make the bank's contribution to the Scheme enjoy 100% investment allowance;
• Reduce tax paid by SMEs to 10%;
• Provide 5 years tax holidays to the SMEs under the Scheme; and
• Exempt divested fund under the Scheme from capital gain tax.

22.2 The Central Bank Of Nigeria:

(i) Ensure sound financial system;
(ii) Liaise with the Federal Ministry of Finance to ensure that the required tax incentives are granted;
(iii) Monitor the implementation and gather statistics to quantify the impact of the scheme;
(iv) Articulate clear guidelines for the implementation of the Scheme;
(v) Liaise with the SEC to facilitate and simplify the registration of venture capital operators;
(vi) Ensure each bank's compliance with the guidelines of the Scheme and penalise erring banks in accordance with the penalty stipulated for non-compliance;
(vii) Capacity building;
(viii) Disseminate information on the scheme to SMEs and the larger public ;
(ix) Prepare annual progress report; and
(x) Provide data for the review of the Scheme after 5 years for the Bankers' Committee.

22.3 The Bankers' Committee:

(i) Obtain the co-operation of the major stakeholders ;
(ii) Disseminate information on the Scheme to SME promoters and the larger public ;
(iii) Oversee joint collaborative efforts under the scheme ;
(iv) Monitor the implementation of the Scheme;
(v) Capacity Building; and
(vi) Review the Scheme after five (5) years.

22.4 Individual Banks:

(i) Provide funding for equity investment in SMEs;
(ii) Comply with the guidelines of the Scheme;
(iii) Report on the activities of the Scheme on monthly basis to the Development Finance Department of the Central Bank of Nigeria ; and
(iv) Capacity building.

22.5 Independent Fund Managers:

(i) Manage equity investment in SMEs on behalf of the banks;
(ii) Report on the activities of the investment to the banks on a monthly basis ;
(iii) Provide strategic support to Small and Medium Enterprises to minimise the risk of the investments;
(iv) Exit the investment at the instance of the bank;
(v) Comply with the guidelines of the Scheme; and
(vi) Register with the SEC.

22.6 Promoters Of Small And Medium Scale Enterprises :

(i) Ensure prudent utilisation of funds;
(ii) Keep up-to-date records on project activities for inspection by the appropriate authorities when required; and
(iii) Comply with the guidelines of the Scheme.

22.7 The Securities And Exchange Commission (SEC):

(i) Facilitate and simplify registration of venture capital operators;
(ii) Provide enabling environment, specifically, the development of the capital market; and
(iii) Liaise with other arms of Government to ensure that SMEs have access to the market.

BANKERS' COMMITTEE
REVISED: APRIL, 2005

*By Eunice Sampson

Three or four decades ago, banking was a simple business. Consumers saved their money with, and received their financial services from banks. Banking services were straight and simple. When customers open savings account, they received passbook from the bank with which the account would be run; and when it is a current account, they received cheque books for the same purpose. In those days, you could, in few sentences, sum up what banking is all about. But all that has changed.

Before now, due to its fundamental economic importance, the financial services sector was stringently regulated by government, even in the most advanced economies. In the United States for example, before the advent of the Monetary Control Act of 1980, it was illegal for U.S. banks to invent as much new products, without obtaining due permission from the government. Government took interest in regulating insignificant banking details – how often withdrawals could be made, the minimum deposits, and even the interest rates on deposits. In today's banking, these details are left for banks, consumers

and market forces to determine.

One of the most far-reaching changes in the global banking sector has been brought about by the emergence of Information and Communication Technology (ICT).

Scott Cook in "The Future of Money in the Information Age" summed it up thus:

Fifty years ago, wealth was stored and transmitted physically through gold bars, stock certificates, bank notes, and coins. Large physical distribution networks were required to collect and distribute the means of exchange. Today, the financial services industry is digital. Wealth is no longer stored in physical means; it's stored as bits on mainframe disk drives and transferred electronically.

Today's global banking has changed; and technology is the key driver of the changes.

DEVELOPMENTS IN TECHNOLOGY-DRIVEN BANKING

Information and Communication Technology (ICT) has made it possible for service providers in developing economies and their customers, to enjoy a good semblance of the services enjoyed by their counterparts in the highly developed economies. ICT has become, not just an enabler, but also a leveler, in the dispensation of quality services in the global financial services sector. Even in developing economies, financial service providers spend a sizeable portion of their budget on ICT infrastructure. In Nigeria, for example, the banking industry is the highest ICT spender, even more than the oil and gas sector, which contributes over 70% of the country's GDP.

ICT tools have made it possible for financial institutions to achieve better contact with their customers and enhance brand loyalty. It has afforded banks the opportunities to impress customers with various innovative products and services, which encourages customers to keep 'coming back'.

A good example is the introduction of the Automatic Teller Machine (ATM). The ATM was first put to use in the United States in 1968. Since then, it has gained wide acceptance all over the world as an indispensable banking instrument.

Before ATMs, withdrawing funds, account inquiries, and transferring funds between accounts all required face-to-face interaction between the customer and a bank teller. But the machine has long filled that gap and made banking a convenient and efficient experience.

Today, only banking institutions that can compete using high technology facilities stand any chance of surviving. No other trend has impacted more on global banking revolution than technology; and it has also helped to accelerate the pace of other key change drivers.

> *In the global banking industry, massive consolidation activities have taken place in the last ten years.*

Among the far-reaching changes technology has brought about or accelerated in the global banking industry are:

- Consolidation
- The Birth of Virtual banking; the Revolution of Branch Banking
- Globalization and Increased transnational transactions
- Less man-hour; more technology-hour
- Increased Competition
- Improved (Customers') Services
- Increased Profitability

Let us examine each of these in greater details.

Technology Aided Transnational Transactions

Due to the increasing rate of consolidation, there has been a steady decline in the number of banking in-

stitutions in developed economies since the 1990s. From 1990 to 2002, at least 300 mergers took place annually in the United States, with a peak of 726 mergers in 1997. In this period, the number of financial institutions in the US shrunk by 38%. Since 2003 however, merger and acquisition has slowed in the banking industry as the emerging banks settle down to manage the challenges of their new intimidating size and structure.

Global banking consolidation has led to the emergence of banks whose sizes are more that the GDP of an average prosperous nation. For example, Citigroup, achieved a Tier One capital of $74.4bn in 2005, and post pre-tax profits of over $30bn. These are humongous figures that most developing countries cannot generate as revenue in one year.

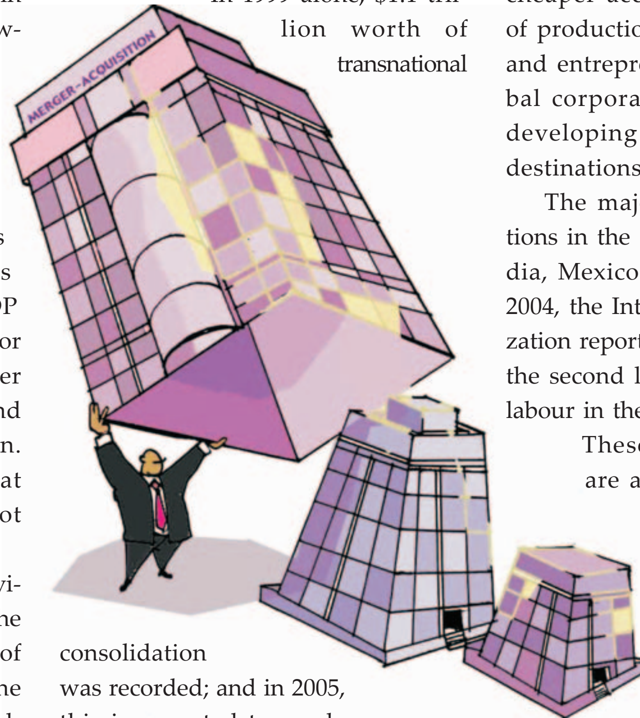
The concept of globalization envisions the economic integration of the whole globe through the removal of all forms of trade barriers, and the free flow of information and knowledge transfer. With technology, this vision is gradually becoming a reality.

Globalization technology has accelerated by shrinking communication barriers and removing the constraints of time and space. Technology could accurately be described as the principal driver of globalization.

Computerized financial transactions have become instantaneous in the provision of banking services; and communication between international companies, investors and customers has become more efficient and at lower costs. ICT advancements have contributed to the opening up of vast new markets in developing countries.

Technology and globalization are in turn creating a new banking environment, where financial transactions could be initiated at one point of the globe and concluded at another, at the speed of lightening.

Mergers across national boundaries have risen sharply this decade. In 1999 alone, $1.1 trillion worth of transnational consolidation was recorded; and in 2005, this is expected to reach over $3 trillion. This has been facilitated by the use of IT.



Global banks now realise that by expanding business presence and size onshore and offshore (by the use of IT) is one way they could remain in business, as bigger competitors seem ever poised to swallow up smaller ones. Size has always been an issue in the corporate world; but in this age of technology and globalization, it is a critical issue.

Even banks in developing economies are beginning to open branches abroad. For example, at least 3 Nigerian banks have opened branches outside Nigeria in the past few years; and many more are planning to follow suit.

The Central Bank of Nigeria recently disclosed that it had received more proposal from banks to open branches offshore this past two years than it had in the last three decades put together.

Transnational transaction has gone beyond access to a broader customers base and market size but also, cheaper access to the basic factors of production – land, labour, capital and entrepreneur. And so most global corporate institutions now see developing countries as attractive destinations.

The major outsourcing destinations in the developing world are India, Mexico and the Philippines. In 2004, the International Labor Organization reported that the Philippines is the second largest source of migrant labour in the world, after Mexico.

These developing countries are attractive for their skills, proficiency and affordability. In the Philippines for example, a publication by *The Banker* shows that labour costs one-fifth of US rates; there is a 94% literacy rate with about 400,000 new graduates annually; and they have good telecommunications and power infrastructure in place that meets global standards.

The Birth of Virtual Banking

While branch banking is still in vogue, virtual banking is growing in prominence.

Bank branches in Europe have grown by at least 10% since 1990. Also, a report published in 2004 by the US Federal Deposit Insurance Corporation shows that, between 1994 and 2003, US bank branches grew by 15%. In 1984, there were less than 42,000 branches in the US and by 2000 the number had increased to more than 64,000.

Branch transaction volumes in the US also remain high. The Internet has

so far not succeeded in taking over the business of the branch. . In fact, in Europe and the US, branches generate more than 50% of commercial banks' income.

But for branch banking, it is no longer business as usual. Technology is being used to restructure it, in ways that would reduce branch-operating costs and support multi-channel strategies.

Automation plays a major role in branch banking restructuring. This is why ICT expenditure in European banks is expected to increase by 6% in the next two years, rising by 8% by 2006, to E7.9bn ($9.1bn). Similarly, US banks will increase their spending from $3.5bn in 2002 to $4.4bn in 2006.

The challenge for banks is how to reduce branch network operating costs while supporting branches' changing role; and ICT is being deployed to achieve this.

The growing number of branches has however not stopped the steady growth of electronic banking. Some banks have gone completely virtual – the 'internet-only' banks (EGG, Security First Network, etc); most other banks combine branch and electronic banking services to achieve a 'click and mortar' strategy. The aim of most banks today is to provide the most convenient banking experience possible to their customers, whether electronically or through branches.

Branch banking seems ready to stay; but with fundamental changes to how it delivers services.

Today, it would be difficult to see any bank that does not render one form of e-banking service or the other, even banks in the most remote parts of the earth.

A major incentive for bank chiefs in the provision of electronic services is the huge cost saving it engenders. Each Internet transaction is estimated to cost just 10% of a branch-based transaction, as overheads from providing and maintaining staff and buildings are slashed.

Increased Profitability

Modern banking has moved away from the provision of basic services like taking deposits and granting loans to the provision of more sophisticated services. These IT-driven services have helped to increase the profitability of banks worldwide.

Information Technology, which is the basic tool deployed in the provision of these services has become more available and accessible in the last decade, imparting positively on commercial banking activities and resulting in dramatic productivity gains; less is now spent to provide more convenient services, and this has in turn greatly enhanced profit margins.

For example, ATMs have automated the teller processes and, to the extent that they were simply substituting a machine for a bank teller, costs per transaction has fallen significantly. *The Wall Street Journal* reported that a typical transaction by a teller costs between 90 cents and $2 per transaction, whereas the same transaction processed via an ATM costs only 40 cents.

Innovative Banking Services

To retain existing clients and expand their base of customers, banks now offer IT-driven, non-traditional services, such as mutual funds brokerage and stock portfolio management.

New generation of cashless transactions and electronic payments, whether by Internet, smart cards, telephone or dial-up bulletin boards and extranets are being introduced in a global market where the customer has become king more than ever before.

Customers can do all their banking transactions while sitting at home. This promises to change the face of banking forever.

However, as services improve, technology becomes both a source of business strength and threat to banks. The Internet for example, has become a great force for "disintermediation", threatening to

bring lenders and borrowers together, thereby cutting off the traditional role of banks. Unlike other items of manufacture, money can be stored and transmitted electronically; and once this trend becomes pervasive, it may well lead to the disintermediation" of the banking sector.

In many developed countries, Internet banks have drawn away deposits from traditional banks. Technological advances may well make online storing and payments so secure that people will turn to electronic-only banks. It will not be surprising if firms use the Internet for raising finance as well, without the assistance of banks, in the nearest future. Even in Nigeria, general post offices recently introduced funds transfer services while mobile phones are now also used to effect funds transfers, by-passing banks in the process.

The advantages to customers of managing their finances online are clear - an end to inconvenient trips to banking halls, no more standing in queues and banking is available 24 hours a day at the click of a mouse.

Increased Competition

Commercial banking is evolving into a highly competitive and technologically innovative industry. To better compete in a changing market, banks use technology to provide new services and attract customers.

The growing cases of consolidation have helped to intensify, rather than reduce competition. The era of monopolies is giving way for the emergence of banking giants. Hitherto small are joining forces to be able to compete fiercely with the traditional mega banks.

Currently, Visa International, MasterCard and a host of other e-payment service providers are moving en masse into the developing markets of Asia and Africa, to take advantage of economies that are advancing in technology banking and electronic transactions.

Global banking consolidation has led to the emergence of banks whose sizes are more that the GDP of an average prosperous nation.

And even the nature of competition in the banking industry is changing. Competition now goes beyond struggle for customer-base and market share between fellow banks. In the US and most developed economies for example, changes in banking laws permit financial institutions other than banks to offer banking services to their customers, electronically and otherwise. In highly advanced economies, ATM services are no longer provided by just banks, but also brokerage houses, credit organizations, etc. Customers now have more varieties to choose from; and the quest to satisfy them at all cost, is improving the face of global banking.

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Less Man-hour, More Technology-hour

The world of business and of banking has changed significantly. Firms increasingly want a one-stop shop for their financial needs. And it is only technology banking that can make this possible. Banks have been able to use technology to cut costs and offer new services, but usually at the expense of man-hour.

Citigroup (USA) in March announced plans to cut 1,400 jobs before the end of 2005; JP Morgan at the end of 2004 announced plans to shed about 5% of the 6,000 jobs at its investment banking operations in Europe; In January 2005, Deutsche Bank said it would shed hundreds of the 8,000 jobs in London, as part of a worldwide restructuring programme. The bank had in 2002 laid off 3,800 staff in its investment banking and asset management operations unit, to safe costs. This trend seems to have become commonplace in most banks worldwide, especially in developed economies where the act of technology banking has been perfected.

Technology facilities like the ATMs and POSs are dispensing the services carried out by humans in traditional banking. The proposed 'super ATM' for example, is expected to do even more than the current ATM does. With the aid of a smart card, the ATM will soon take the place of a customer service representative as well as a bank teller. A smart card-enabled ATM terminal will be capable not only of automatically cashing

cheques, but will facilitate bills payment, money wiring and purchases.

Technology driven banking services have been proven to be cheaper than manual banking. Banks are forever looking for ways to free resources for expansionary purposes and increased profitability; technology banking seems to offer them these privileges.

In recent years, the restructuring in the banking sector - moving towards postal, telephone and online banking - is estimated to have cost up to 200,000 jobs.

THE FUTURE OF GLOBAL TECHNOLOGY-DRIVEN BANKING

In the early 1980s, banks were just deposti money banks offering basic services and predicated on face-to-face contact with customers for any transaction to take place.

But today, technological innovations and the various IT products have changed the face of banking dramatically. Making use of multiple distribution channels and offering an ever-increasing variety of complex products are the hallmark of modern-day banking.

And these changes are likely not over yet.

Tomorrow, more changes are expected to take place in the industry, and technology would have an even bigger role to play in bringing about these changes, especially in terms of upgrades of existing technologies to provide even more sophisticated and convenient services than we have today.

A good example is the ATM. The original machine was a simple cash dispenser; today banks can install sophisticated ATMs that scan checks, give out cash to the last kobo, let customers apply for loans, and allow for face-to-face discussion with a service representative via video. Thus, what started as a way to automate the services of a bank teller eventually developed into a new and improved delivery system for bank products. Tomorrow, demand could lead to an even more far-reaching upgrade of the services the ATM can render to customers.

And in planning tomorrow's technology banking needs, a key issue would be security. This is one of the biggest flaws in today's banking tools, and tomorrow's technology would try to almost completely ensure a security-tight banking.

The sheer size of the merging institutions could become global economic threat and a source of intimidation to competition, democratic norms, labor standards, human rights, and environmental quality.

Huge reduction in bank branches, especially in Europe, is expected in future; online financial services activities will grow; competition will intensify and the struggle to remain key global players would be heightened. The big banks would continue to swallow up, or partner with the smaller banks to spread their products and services across the globe.

Electronic funds transfer is expected to become even more widely used in future, while written cheques would be significantly reduced, if not eliminated. More bank branches would be closed as electronic banking gains more ground.

Consolidation is expected to further change the outlook of global banking. However, consolidation would not be without its challenges – post merger problems like culture, products, and IT integration would have to be confronted. The titans would struggle hard, not only to remain on top, but also to try and ensure their competitors do not catch up with them. Mergers and acquisition would therefore become even more attractive nationally and across borders and more job cuts would occur.

Finally we can say with all certainty that technological innovation would play a vital role in tomorrow's global banking. What is 'innovative' banking today could become 'old school' in just a decade. Banks of the future must therefore create ample room for scalability to be able to adapt quickly and easily.

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

Competition In The Nigerian GSM Market: Present And Emerging Trends

* By Ik. Muo

Telecommunication plays an indispensable role in the economic development of any nation especially in this global, knowledge-based economy driven by ***information, intelligence and ideas.*** The internet-enabled by telecom- has facilitated fast, reliable and online transmission of data, information and images, leading to new ways of doing business, governamce and social interaction. Time is saved and optimized; decision making, research, new product development and corporate management become easier; information is easily acquired, stored, sorted, distributed and applied; individuals and organizations are empowered and global operations and competitiveness are all enhanced all thanks to advances in telecommunications. In Nigeria, even though telecom services were introduced by the ubiquitous *whiteman* in 1886, it was more than a hundred years later, precisely from 2001, that Nigeria and Nigerians actually witnessed the transforming impact of telecommunications. That year marked a watershed in our telecom industry with the introduction of the GSM [Global System of Mobile Communication] into the country .

Today, the number of telephone lines in Nigeria stands at about 16million [588,000 in 2000] with the teledensity at

9.2[.49 in 2000] making Nigeria the fastest growing telecom market in the world. The sector has also become the 3rd most vibrant sector in economy [next to oil and banking] and a significant source of Direct Foreign Investment inflow into the economy [about $8bn since 2000]. But as is usual in such circumstances, competition has intensified in the GSM segment of the industry, which is oligopolistic in nature. This paper examines competition in the Nigerian GSM market using Porters *5-Forces Framework* as the analytical tool.

It is divided into six parts**. Part One** is this introductory section; **Part Two** gives the historical background of the industry up to the advent of the GSM; P**art Three** briefly examines the analytical foundation for the study, [Porters 5-Forces Framework]; **Part Four** presents the current picture of the industry with an expose on the key players. **Part Five** critically examines the competitive trends in the industry and the likely future direction while the paper is concluded in **Part Six**.

HISTORICAL BACKGROUND

The pace of developments in the Nigerian Telecom Industry has moved from the ***sluggish phase*** [1886, when Telecom services were introduced to the establishment of NITEL in 1985]; the *moderate phase* [from 1985 to the establishment of the NCC in 1992.]; the *fast phase* [from 1992 to 2000 which witnessed deregulation agenda, the launching of National Policy on Telecommunications] and the *Supersonic phase* which commenced in 2001 and continues to the present day.

The Sluggish/ Moderate Phase(1886–1992).

The colonial adventurers introduced Telecom services in Nigeria in 1886 to facilitate the efficient coordination of their colonial estate [National Telecom Policy, 2001]. Telephones were mostly available to colonial civil servants and a few foreign businessmen. Available telephone lines increased to 18, 724 in 1960 and 200,000 in 1985 when the Telecom Division of P & T was merged with Nigerian External Telecommunications to establish Nigerian Telecommunications Ltd. [NITEL]. NITEL was an absolute monopoly and being Government owned, it exhibited the most negative aspects of a monopoly. Services were unreliable (all trunks were always busy) and expensive; waiting time was about 5years and only those who were well connected or willing to offer inducements could obtain NITEL services. Teledensity was about .33,one of the worst in the world; cell-phone usage was about .0001 with unmet demand of about 3,500,000 lines

Of course NITEL had [and still has] many problems to contend with including political instability, medlesomeness and policy summersaults. The most evident was the embarrassing CEO turnover. Mr. Adegbuji who retired on 1/3/03, was the 9th CEO and the first to voluntarily retire from that position within 18 years! [Okenwa, 2003, b3].

The staff were arrogant and had no regard for customers; complaints were ignored; large-scale corruption was the norm; telephone services were really "not for the poor'' and for the lucky few who had telephones, (mostly official lines), they were most of the time **" temporally out of order"**. The Billing system was inefficient and manipulated while customers were held hostage since they had no choice. NITEL cables defaced the environment with their untidy "cobwebs"; lines "went dead" anytime it rained, anytime there was an accident affecting the cables, anytime a container laden trailer passed by or anytime a nearby tree fell; customers went on ***pilgrimages*** to NITEL offices anytime their lines were faulty and had to ***pay homage,*** in addition to providing vehicles for NITEL staff and equipment before the faults were attended to and the major way of communicating with customers (e.g. to ask them to come and pick or pay their bills) was to **TOS[deliberately disconnect]** their lines.

Customers went on ***pilgrimages*** *to NITEL offices anytime their lines were faulty and had to* ***pay homage,*** *in addition to providing vehicles for NITEL staff and equipment.*

The Fast Phase(1992-2000)

This phase started with the establishment of a regulatory body,

the **Nigerian Communication Commission (N.C.C)** in 1992 and its formal inauguration in 1993. Empowered by the all embracing enabling legislation, spurred by the encouragement and support of the Government, challenged by the quantum leaps in ICT worldwide and the vistas opened by these developments and perhaps fired by personal vision and zeal to write their names in gold, the pioneer and current leadership of N.C.C took the Nigerian Telecomm Industry to hitherto unimaginable heights. **O.C. Iromantu** was "in charge" during the fast phase and laid the foundation for the supersonic phase currently being managed by **E.C.Ndukwe**.

The fast phase witnessed actual commencement of operations by the N.C.C and initiation of policies and procedures that led to the emergence of Private Telephone Operators. For the first time, fixed wireless telephone lines were introduced into the country. The licensing of **Multilinks, Intercellular, EMIS** and others for a ten-year period in the first instance, in 1996, marked the beginning of the revolution that has swept across the Telecom Industry and continues to the present day.[The first PTO, Muiti-Links commenced commercial operations on 8/12/97]. With new technologies that made cables obsolete, private sector efficiency, performance focused management and the rollout plans instituted by N.C.C, these new arrivals performed what could only be described as '**magic**' by Nigerians suffering from the iron grip and inefficiency of NITEL.

The number of landlines increased, waiting time was eliminated, technical and service quality improved with increased access and teledensity. But the lines were still expensive and beyond the reach of more than 95% of Nigerians [connection fee in 1997 was as high as N200,000.00; Aragba-Akpore,2003,41] and like NITEL, their presence was also felt in few centers. NITEL also made things difficult for these PTOs especially as regards the terms and cost of interconnectivity.

The next giant stride during this phase was the launching of the National Telecommunications Policy in October 1999, which was extensively reviewed and re-launched in 2001. The document encapsulated our National aspirations with regard to Telecom in the short, medium and long term. It has the overall aims of modernizing and expanding networks and services, enhancing economic and social development and ensuring global integration through the provision of efficient, affordable, reliable and readily available services.

Available telephone lines increased to 18, 724 in 1960 and 200,000 in 1985 when the Telecom Division of P & T was merged with Nigerian External Telecommunications to establish Nigerian Telecommunications Ltd. [NITEL].

The Supersonic Phase(2001-Present)

This phase commenced in 2001 with the grand entry of GSM telephones in Nigeria. This started with an auctioning process in January through which ECONET and MTN won the very expensive licenses ($285m) and launched their operations in August 2001. Eventually, NITEL commenced its own operations and within the first 18months of ***GSM mania***[August,2001-February,2003] lots of records and breakthroughs were achieved.

- About 2 million lines were rolled out, with MTN accounting for 1000000. This increased number of operational telephone lines in the country by about 300% and raised the cellular subscription level from 0.03 in 2001 [EMC, 2001,64] to about 1.5%.This made Nigeria the fastest growing telecom market in the whole world [Wazara, 2002,64]. This was made possible by the pent-up demand and the nature of mobile networks which were quick to install and less cumbersome. The introduction of pre-paid cards reduced operator risks and aided consumer budgeting. All this widened telephone demand, supply and usage.
- The teledensity in Nigeria rose to more than 2;Cell-phones ceased to be status symbols; several direct and indirect employments were created.

As at November,2002, MTN had a staff strength of 1000.It also had 160 Distribution Partners and 6000 Sub-Dealers who collectively employed about 20000 workers. This excluded the ubiquitous one-man card dealers and GSM call operators [Edozie,2002,32]

• It also generated substantial fresh investment - foreign and local; telephone prices were drastically reviewed while the tempo of competition in the industry also rose.

What would have been the second milestone in this phase was the NITEL privatization agenda, which has repeatedly failed to click. The BPE offered for sale, 51% stake in NITEL through an open tendering procedure. The bid was won by Investors International of London Ltd (IILL), which made the 10% initial deposit ($131m) but failed to pay the full bid amount despite an extension of the deadline. The BPE having learnt from the IILL mistakes decided to change its strategy and appointed Pentascope International as a **Managing Operator** for 3 years with effect from 18/3/2003, when the contract was signed. That arrangement was dogged with multidimensional controversies from the very beginning. It eventually collapsed and Pentascope was sacked with ignominy by the Nigerian government for incompetence and fraud while the then BPE boss came under fire for his alleged poor handling of the matter. Efforts are still on to privatize the octopus.

The licensing of 19 regional Fixed Wireless Access (FWA) providers in May 2002, marked the third major development in this Phase. Still using the bidding process, FWA providers were licensed to operate in specified areas as covered by their licenses. A major novelty of this licensing was that of various firms obtaining the same licenses at different costs depending on their bids. Some paid almost double the fees paid by others for the same license.

The last major development was the successful licensing of GLOBALCOM as the Second National Operator thereby breaking finally the monopoly status of NITEL. This four-in-one license, which went for $200m, allows GLOBALCOM (a corporate brother to CIL, which failed in the initial GSM bid) to set up its own Public Switch Telephone Network (PSTN)- National Carrier License; establish a gateway to carry international call traffic (International Gateway License);provide G.S.M services (Digital Mobile License)and provide Fixed Wireless Access Services (FWA license).

The NCC has been quite active and proactive in its regulatory duties, trying to raise the standards to global levels. In this regard, it has [1] Released the draft conditions for the allocation and utilization of Frequency Licenses and specifying the terms under which the licenses will be revoked. [Ajakaye,2003,41] [2] Introduced Quality of Service **[QOS]** Guidelines for the industry covering areas like customer satisfaction, waiting time, treatment of faults, call completion rates, complaints management and disconnection of prepaid customers [Ebhodaghe,2003,1]

AN OVERVIEW OF *PORTER'S FIVE-FORCES FRAMEWORK*

In a seminal article on ***How Competitive Forces Shape Strategy***, Porter [1999] argues that the state of competition in any industry depends on five basic forces, some of which go beyond the direct combatants and that those forces ultimately determine the profitability of the industry. This treatise forms the basis of the Five-Forces Framework. The five forces are:

Threat of Entry: New entrants bring in extra resources and capacity and heighten the *war* for market share. The seriousness of the threat is a function of entry barriers, which include economies of scale, product differentiation, capital requirements, cost disadvan-

tages independent of size, access to distribution channels and government policies. Likely reactions of existing operators and how these are perceived by the potential entrant are also a critical factor

Powerful Suppliers and Buyers: Powerful suppliers can squeeze margins by raising prices or reducing quality while buyers can also do so by forcing down prices, demanding higher quality or playing competitors against each other. A supplier group is powerful if it is oligopolistic, has a unique product with high switching cost, has no close substitutes and has the potential to integrate forward. A buyer group is very powerful if it buys in large volumes, the products are standardized, and it has the potential to integrate backwards, amongst others

Substitute Products: Substitute products diminish the potentials of an industry by limiting profits in normal times and reducing the windfall during boom seasons particularly those that improve their trade-off with the industry's products or produced by industries earning high profits

Jockeying For Position: Competitive rivalry takes the form of manipulating of the marketing variables[the Ps] and is intense where competitors are numerous, industry growth is slow, there is little differentiation or switching costs and fixed costs are high.

Depending on the structure of competition, Porter suggests that a company can position itself to use its capabilities for defence [matching its strengths and weaknesses to the structure]; take on the offensive by strategically influencing the balance of forces in its favour or anticipating trends in the structure and reacting proactively. In this third option, critical trends are those that affect the sources of competition, or introduce new forces.

Though the Five-Forces Framework has been a popular tool for analyzing industry competition and strategic brinkmanship, it has occasionally received some knocks. Grant [2002:89] for instance argues that its theoretical foundations are suspect; that industry structure is not static as the dynamic nature of competition itself transforms the industry structure and that there is no empirical evidence as to the importance of the environment in determining industry profitability. He also argues that complementary products and strategies, collaboration between competitors [*coopetition]* and network externalities are critical in shaping industry competition

THE GSM MARKET TODAY

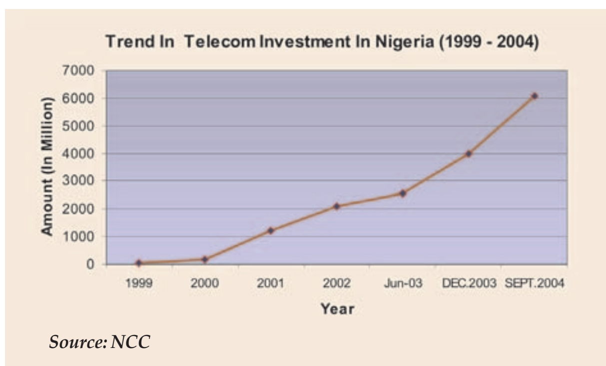
An Overview

The Nigerian GSM market today is dynamic, exciting, and innovative and as the experience of MTN has shown, it is also very profitable. As at June 2005 the number of lines has hit the 13.3million mark-5million new lines were connected in 2004 alone-[NCC;2005:74].This is estimated to exceed 16m by the end of July[Abang,2005:17]; Teledensity has risen to 9.2 and lines that were as costly as N200,000 three years ago are now literally free. Services are now available in all nooks and crannies of the country and the NCC boss has projected 80% coverage of the country by 2007; several value added services have been introduced and several customer baiting gymnastics are being continuously unveiled. Per second billing has now become commonplace; unit value of airtime has fallen to as low as N250;virtual recharging is readily available and the issue of disconnection for non-recharging is as good as forgotten. Quality is picking up and the advertising industry has never had it so good as all the players are smiling to their banks courtesy of *crazy* advertising, publicity, sponsorship and public relation budgets by the operators. Foreign Direct Investment inflow has also moved in significantly from that sector, rising cumulatively to above $8bn as at March 2005. But over all, the market is very competitive [Tooki,2005:17; Okenedo,2004:1b]. The market is growing at about 150% pa [against 65% for Africa and 33% for the world] with a mobile subscription rate of 92% against 62% for Africa and 51.2% for the world.

The Contenders: MTN

MTN has overrun the telecom landscape in Nigeria through aggressive expansion of coverage area and massive advertisement and brand enhancement techniques. MTN is present in 223 towns, 12000 communities and 36 states of the federation, the only network with such an extensive coverage and accounts for about 46% of the 13300000 lines in existence as at 30/6/05. It has occasionally ex-

hibited the arrogant streak of a dominant operator and has had to be called to order by the NCC on a few occasions. It was literally forced to adopt a per-second billing and today, having finished its 0803 code, it recently launched the 0806 series. Some of its star offerings include ***Pay As You Go***; *Booster* ***Card; Flexi, Business Time, Messenger***, enhanced data and fax, international roaming, Wireless Application Protocol, and directory enquiry. Its latest offering is the ***MTN Bizcom***, which creates networks within the network for corporate clients.



Source: NCC

GLOBACOM

Globacom is the youngest player in the GSM market but almost beat MTN in the NCC overall rating, has more subscribers than VMOBILE and has reshaped the nature of competition in the industry. While MTN was claiming that it needed many more years to go *per-second*, Globacom rolled out on a per-second platform; it also crashed the connection rates by offering lines for N1 from October 2004. In both instances, others had to follow its lead. Globacom is also embarking on aggressive network expansion, advertising and innovation and now has a little less than 4m of the 13.3m mobile lines in existence as at June. It offers ***glo-mms, mobile internet***, and ***glo mobile banking*** spread across its prepaid classic, ***premium*** and ***profit-max*** packages. It currently offers 15% airtime bonus on every recharge card.

VMOBILE

It is one of the ironies of the Nigerian GSM history that VMOBILE [formerly, ECONET] which switched on the first GSM network on 6/8/2001, has turned out to be the laggard in the industry. It has been beset with internecine board room squabbles which have both local and international dimensions; this created or worsened a cash flow crisis and both problems combined to make it impossible for VMOBILE to muster the will, the competence and the capability to hold its head high in the emerging, highly competitive but highly profitable industry. It lags behind Globacom in customer base and came last in the NCC –conducted network audit [see Table III]. Yet, VMOBILE is perceived as the most customer-friendly which, until recently, offered the longest validity days, toll-free customer care line and an enviable airtime bonus regime. Only recently the board approved a bid by VODACOM for majority stake in the firm at a rate of $8.9 per share plus extra injection of funds. [Famakinwa,2005:1]. It will be recalled that VODACOM made a dramatic entry and exit into ECONET last year. This may be the last chance for VMOBILE to make its mark in the GSM market

M-TEL: The First Shall Be The Last

M-tel an offshoot of **NITEL,** had everything going for it but has nothing to show for it. It did not fight for the license; it has a pedigree that is more than a century old and it has the federal might behind it. But that

Growth in Telephone Lines and Teledensity in Nigeria [1999-2005]

SERVICE CATEGORY	1999	2000	2001	2002	2003	2004*	JAN. 2005
FIXED							
NITEL	450172	497017	540662	555466	555466	524596	525000
PTOs	23144	56355	59659	146534	333068	515173	568925
SUB-TOTAL	473316	553374	600321	702000	888534	1039769	1093925
MOBILE	35000	35000	266461	1569050	3149472	8500000	9950000
TOTAL	508316	588374	866782	2271050	4038006	9539769	11043943
TELEDENSITY	.42	.49	.72	1.89	3.36	7.77	9.2

Source: NCC

Network Audit of Mobile Operators in Nigeria [2005]

S/N	TEST CATEGORY	MTN	GLOBACOM	MTEL	VMOBILE
1	Call set up success rate	**	****	***	*
2	Call success rate	**	****	***	*
3	Call retention rate	****	**	*	***
4	Call drop rate	***	**	*	****
5	Call handover	****	***	**	*
6	Voice quality to dnlink	***	****	**	*
7	Voice quality to uplink	***	****	**	*
8	Successful recharge	***	*	**	****
9	Successful balance	****	**	***	*
10	Billing inquiry rate	***	****	**	*
T0TAL POINTS.		31	30	21	19

Source: NCC/IT EDGE

may have become its albatross as it suffered the consequences of the one-step-forward-two-step-backwards privatization of NITEL, which created a lot of confusion and uncertainty. In fact, many people do not remember that there are 0804 series in the mobile family and as far as competition is concerned, M-tel is just a potential factor; it is not yet a factor

COMPETITIVE FORCES, STRATEGIES AND LIKELY TRENDS

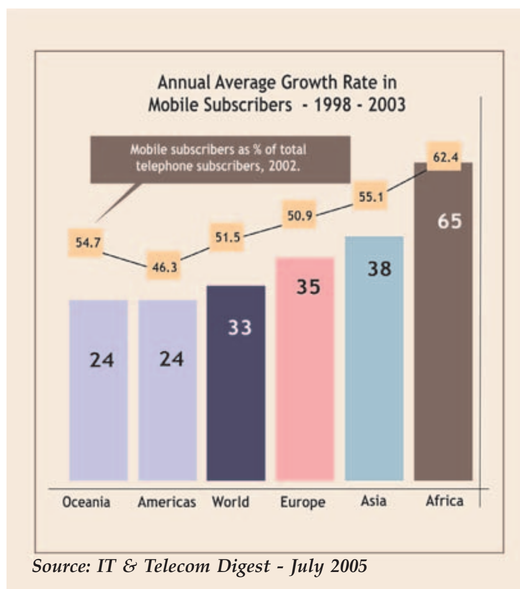
Preliminary Observations

What are the forces shaping industry competition in the Nigerian GSM market; how should the operators respond and what are the likely trends? Before going into this analysis, it is pertinent to recognize some realities on the ground.

In the first instance, it is clear that MTN is a dominant operator and that unless a miracle happens, its major competitor is Globacom. This situation will persist for a while since M-tel will take a long while to find its feet even if it is released from the clutches of government interference while VMOBILE will also take a long while to rediscover its rhythm even if its VODACOM deal goes through. And with the gap between MTN and Globacom in terms of coverage and facilities, MTN will continue to dominate the market for a long while

Secondly, we are still, relatively speaking, in a sellers market. Despite the quantum leaps, only about 10% of Nigerians willing and able to acquire the lines have them for now. That means that as long as companies are able to expand capacity and offer passable quality, they will continue to make sales.

Thirdly, the GSM market is oligopolistic and is even moving towards duopoly if M-tel and VMOBILE do not wake up. Oligopoly is an imperfect market situation in which there are few sellers. The *few* is not precisely defined but they are so dominant and visible that they are easily counted [Stonier& Hague, 1978:227; Umo, 1986:197]. The Nigeria GSM market is a pure oligopoly-few sellers offering undifferentiated products. The action of an operator in an oligoploistic situation has an immediate and direct impact on others and this leads to automatic reaction. There is thus a serious interdependence amongst oligopolists and each operator carefully weighs the possible reaction of others before taking any action.



Source: IT & Telecom Digest - July 2005

Applying The *Five Forces* To The Nigerian GSM Market

It is obvious that some of the 5-forces are not critical in the competitive structure of the industry, at least, for now. The threat of entry is relatively low despite the attractions of a large and expanding market .The NCC appears not to be in a hurry to license new operators and the government's major concern is to successfully privatize Nitel. Further more, the cost of entry and operation is acclaimed to be the highest in the world. The $285m license fee was 8 times what was paid for GSM 1 and 2 in the UK and 5 times more than what was paid for any license in any part of the world; it costs $ 205000 to construct a base station in Nigeria as against $ 85000 elsewhere; Nigeria is the only country where operators construct their own microwave backbone-and a 3500km backbone cost MTN,N15bn in 2003;as at 2002,ECONET and MTN were consuming about 600,000liters of diesel weekly and all their installations were 100% generator-powered [Wood, 2002:32; Muo,2002:12; Wazara, 2002: 66; Edozie, 2001 :19 ; Nwogbo , 2001:21]

The buyers are not organized enough to have any impact on operations and profitability. The Telecom Services Consumer Organisation of Nigeria [TESCON] has been inactive since its formation in 2001 while the GSM Subscribers Association of Nigeria seems to have gone on a long

break after its partially successful GSM boycott of last year. Of course, in a sellers market, buyers do not generally have much power especially when they are fragmented. The suppliers [Siemens, Alcatel, Erricson]are so busy competing among themselves that squeezing the Nigerian operators should not be top on their cards. And these are all global players with other more important *battles* to contend with elsewhere.

Substitute products are also far from being a serious variable in the structure of competition in the industry. P&T/NITEL was only able to roll out 200,000 line in its first hundred years of existence [1886-1986] and the entire land line availability has just increased from 553374 to 1093,925 between 2001 and 2005 as against the mobile lines which grew from 266461 to 13300000 within the same period. In fact the Private Telephone Operators[and there are more than 20 of them] are struggling to stay afloat in the face of the competitive onslaught from their GSM cousins. Indeed, non of the PTOs has a customer base of up to 100,000.Of course the GSM lines are still easier to acquire and operate. The other alternative, Thuraya Satellite Phones introduced into the country by ADNET in 2002 are so expensive to acquire and maintain [about N200,000 per line as at 2004] that they are really no substitutes for GSM lines.

The critical competitive factor that is operative in the industry is thus ***Jockeying For Positions***. The structure and nature of competition in the industry revolves around competitive rivalry between the operators each of which is trying to capture a large chunk of the fertile market. It should be noted that the tempo of this competitive wrangling heightened tremendously following the emergence of GLOBACOM.

Likely Changes In The Competitive Landscape

Competition in the short and medium term [we are all dead in the long run!] will continue to be intense. The structure and intensity of the competition will however be influenced by certain emerging developments.

1] The first of these factors is the development in the privatization of Nitel. The government plans to conclude the jinxed process by the last quarter of 2005.Already, 6 short listed bidders-Telekom/Vodacom Consortium, Huawei/Jacuz Consortium, Newtel, Celtel, Orascom and MTN[S/A]- are conducting due diligence on NITEL [Nkwocha,2005:21]. If the privatization were successfully concluded and a technically competent and financially robust core investor takes over NITEL, the competitive landscape would definitely change.

2] Secondly is what happens at V Mobile. If V Mobile settles its long-drawn boardroom crises and injects significant funds into its operations, it would then be in a position to fight back and attempt to live up to its historic mandate of being the first. This will also alter the competitive equation

3] The regulatory regime is also about to witness some fundamental changes. The ten-year licenses granted to the PTOs in 1996 and the 5-year exclusive license granted to the GSM operators in 2001 are due to expire next year[2006]. Plans are thus afoot to review the licensing regime through unified or mega-licensing. It does not necessarily mean that PTOs would automatically commence GSM services[many of them are even barely surviving] . But those who meet the eligibility criteria[including licens-

Part view of old NET building under refurbishment

ing obligations and fees, current scope of operations, status of interconnection payments and technical competence] may be so licensed. The NCC is also reported to be proposing to lift the ban on limited mobile services by permitting the use of other platforms like CDMA and the introduction of regional licenses [Eke,2005:60; Abang,2005:66; Badaru,2005:1]. In fact, the Minister of Communication had declared that ***"Unified Licensing is the next level in the growth of the telecom sector and indeed, the only way forward".*** Whichever shape the regulatory changes take, it will surely impact significantly on the competitive landscape.

4] In this era of consolidation, nothing precludes a local or cross-border merger or acquisition involving any of the telecom operators[mobile, fixed-wireless or National Carrier]. If some of the PTO promoters could swallow their pride and merge or allow fresh injection of capital, that would increase their technical capacity and ability to compete and that will also impact on the competitive landscape

Strategic Options

The Nigerian GSM industry is an emerging industry and an oligopoly. Emerging industries are new and fast-growing with consumer explosion and sales growth. Key problem is usually finance for expansion and keeping pace with technology and the strategic focus is to capture larger market share and achieve faster growth than competitors [Lynch,1999:552]. Oligopolies by their nature constrain competition since they cannot easily compete on prices and they divert attention to indirect price competition[Salvatore,1992:272].These two forces perhaps explain the modus operandi of our GSM companies. Even though lines are virtually free, the tariffs are still relatively high and the possibility of a price war is very remote. This is despite the fact that the demand of GSM services is elastic [Muo, 2002:14] and that a large number of customers would either hook on or increase their calls if prices were to be significantly reduced. Apart from top executives and business men, the few who are rich, and those whose calls are sponsored without limit by their organizations, other categories of customers [including business centers] would respond favourably to significant price reductions.

Quality is picking up and the advertising industry has never had it so good as all the players are smiling to their banks courtesy of crazy advertising, publicity, sponsorship and public relation budgets by the operators.

It is also noticed that the firms engage in indirect price competition as in promotions and seasonal discounts. ***Globacom second anniversary promo*** is worth N350m in prizes and this excludes the cost of promoting the promotion! And the ***V-Mobile Knockout Draw*** involves $300000 and 15 exotic cars. MTN only recently concluded its 4th anniversary offers. They have also increased validity days, offered free SMS messages and other non-price enticements to customers.

Now, where do we go from here in terms of competition? The above trend will obviously continue [non-price competition] but beyond that, here is what we may expect.

In terms of the three strategic options advocated by Porter [Positioning the company, influencing the structure and exploiting industry change], we expect that firms would try to exploit changes in the industry by anticipating changes in the underlying forces of competition and reacting proactively. This is necessary because the present scenario-few players, large market, limited substitutes and minimal threat of entry-will not last forever.

There is also need for greater Network expansion and coverage. As at today, only 10% of Nigerians are on the mobile network whereas up to 50m Nigerians can conveniently be ***on-line.*** Availability thus becomes a source of competitive superiority, which is what has kept MTN on top. V Mobile recently launched ***Operation ROSE [Rolling Out Service Everywhere]*** through which it intends to invest $2bn in 3000 base stations so as to be able to connect 10m customers by March 2007. Globacom is looking beyond the local scene and in addition to its ambitious expansion programme, has contracted Alcatel to construct a $150m submarine cable to connect it to all the continents to facilitate the easy transmission of voice and data.

But as customers get connected to the network, after the initial euphoria, their attention will move to technical quality and service delivery. Operators must therefore continue to provide innovative products and services, quality service and update their technology to meet the changing demands of the customers and the environment.

Of course aggressive advertising and promotion campaigns would continue as the operators try to capture the mind and purse of the consumers by positioning their organizations and

aggressively communicating the desired positioning to the people.

As time goes on, the operators may move from competition to coopetition-collaboration amongst competitors. One of the major complaints of the operators has been the high cost of providing telecom infrastructure in Nigeria. But there is no reason why they can not share facilities so as ***reduce costs, enhance collaboration and facilitate network expansion.*** The NCC is already promoting the idea and is in fact preparing a guideline on co-location of facilities while some facility managers are already proposing to build sites to lease to GSM operators. Even the operators themselves are already laying the foundation for collaboration. Recently, they sponsored a joint study on GSM JOINT FRAMEWORK FOR ACTION:NEEDS and it is from such developments that the spirit of ***coopetition*** develops.

CONCLUSION

The Nigerian GSM market is growing at a very fast pace and competition is very dynamic amongst the few operators. The threat of entry is almost non-existent because of government policy and high cost of entry/operation and the substitutes [land-lines] that are there are not up to the task. Internal wrangling is thus the main competitive factor which also affects profitability. But the market is still juicy for the operators because they are few and because the market is large and still expanding. The possibility of self-destructive price wars is low. Aggressive expansion, advertisement and product/service innovations [some of them cosmetic] will continue to be the main focus of strategic action. The competitive tempo will however change depending on the strategic refocusing of VMOBILE, the privatization of Nitel and the changes in the regulatory regime, which are expected in 2006.

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" The Nigerian Financial System has experienced a considerable expansion in size and in the variety of financial assets and institutions."

The Revolution
in the Financial Services Sector:
The Case of the Banking Industry

By Dr. Boniface Chizea

It is correct to observe that the banking industry had not witnessed what could be truly characterized as a revolution till the unfolding of the 13 point reform agenda by the current Governor of the Central Bank of Nigeria on July 6, 2004. The core of this revolution is the decision to recapitalize banks from the extant level of N2 billion to N25 billion with an 18 month deadline. This revolution which is still unfolding is seen in its true perspective when it is recalled that banks had to be granted an extension on the guideline to recapitalize to the tune of N2 billion. Banks were still battling with this limit when it was increased to what it is today.

But in order not to restrict this contribution to the on-going developments, we would attempt to look back into the past to capture what could pass as major sign posts in the evolution of banking practices in the country. We would therefore briefly discuss the commencement of indigenous banking in the county and the spate of wide scale failures which characterized the era, the attempt to indigenize the ownership and management of banks, the impact of the Structural Adjustment Programme on

the financial sector, the introduction of the National Economic Empowerment and Development Strategy (NEEDS) and the specific policy thrust and strategies articulated therein which could be rightly seen as the precursor to the on-going reform agenda for the banking industry. We would bring the paper to a conclusion by documenting the rationale, the thrust and the content of the on-going reform, its fallouts, challenges and opportunities. We would also speculate regarding what the banking system post consolidation would look like, particularly from the perspective of the management of foreign exchange and legislative challenges.

New CBN Head Office, Abuja.

Indigenous Banking

Prior to flag independence for the country in 1960 whatever semblance of banking that existed, like with most aspects of life, was dominated by expatriates. In fact banking at that time was little more than institutions established to facilitate the trading activities of dominant expatriate companies which operated with the primary aim of expropriating goods and services from the colonies to the metropolis. Available evidence corroborates the establishment of the First Bank in 1892. The African Banking Corporation followed suit. It was established 60 years later in 1952.

There was a period up to 1952 when there was no legislation guiding banking operations in the country. As a result of this lack of legislation, there was a boom in the establishment of indigenous banks in the period from 1947 to 1952. By the time the 1952 Banking Ordinance was promulgated owing to unregulated growth in the industry, all the indigenous banks had collapsed. The only surviving banks then were African Continental Bank, the Agbonmagbe Bank and the Merchant Bank. When we take into account the National Bank which was established in 1933, these represented the pool of indigenous banking which are still in operation. Three other expatriate banks complemented the totality of the number of banks in the country at this point in time.

Era of Indigenisation: 1970-6

The Enterprises Promotion Decree of 1972 was aimed at ensuring that Nigerians took charge of the commanding heights of the economy. It would be recalled that this Decree segregated businesses into three categories: wholly indigenous, 40 per cent and 60 per cent indigenous participation. With the benefit of hindsight, this is one of those programmes hallmarked by a singular and remarkable failure to achieve policy intention. It was undermined by all manner of practices perpetrated by unpatriotic Nigerians who were prepared to sell their souls for a mess of lucre. Some Nigerians colluded to negate the goal of policy by fronting for expatriate companies.

Though the indigenisation Decree initially excluded banking, some expatriate banking institutions reading the handwriting on the wall, proceeded of their volition to implement some measure of indigenization. By 1973, the Federal Government had acquired 40 per cent in the three biggest commercial banks in the country. Under the second phase of the indigenization exercise, the Federal Government in 1976 acquired an additional 20 per cent in these banks and 60 per cent in all foreign banks in the country. It is a matter for the records that some banks in protest terminated their operations and packed bag and baggage home. This should be contrasted with this era of total deregulation which has seen us come full circle to the situation whereby anybody can own anything in banking today even if the unfolding scenario had made it almost practically difficult for family or banks with dominant individuals to thrive.

The Structural Adjustment Programme

The Nigerian Financial System experienced a considerable expansion in size and in the variety of financial assets and institutions. Commercial banks have been and remain the

dominant intermediaries in the country with an asset size that approximates to about 85 per cent of the asset base of all financial institutions in the country. But the array of financial assets available to a majority of savers is limited to time, savings and current deposits with sub-optimal intermediation between ultimate savers and investors. The rest of the financial system comprises the regulatory/ supervisory authorities, banks and non-bank financial institutions.

Under the Structural Adjustment Programmes (SAP) which was introduced in July, 1986, a number of far reaching market related fundamental changes were introduced. These included:

(a) the credit allocation system which was quite complex was simplified, allowing more operational discretion to the financial institutions.

(b) the differential interest rates applied to some of the preferred sectors were eliminated.

(c) the level of interest rates was adjusted in 1986 to reflect a positive real yield on holding financial assets and the process of deregulation of interest rate structure was set in;

(d) the administration of official foreign exchange allocation was decentralized to the financial institutions and the allocation itself was allowed to be determined by the interplay of market forces, an active interbank foreign exchange market then became operational;

(e) the regulations governing the surrender and retention of foreign exchange earnings were liberalized and an exporter was allowed to retain and deposit 100 percent of foreign exchange earned with the bank of his choice and utilize it for any purpose he deemed fit.

Under the liberal environment fostered by SAP, banks were expected to pursue lending polices that would ensure that funds were made available for the high priority, growth inducing sectors of the economy especially agriculture and manufacturing. In addition banks were expected to extend more medium and long term loans to small businesses, undertake prospect financing and large scale leasing resulting in a more aggressive banking culture. And the abolishing of import licensing and exchange control provided the banks with new opportunities to play an important role in import trade financing.

Growth of The Banking Sector

	Number of banks in operation			Branches	
Year	Total	Commercial	Merchant	Commercial	Merchant
1985	40	28	12	1297	26
1986	41	29	12	1367	27
1987	50	34	16	1483	33
1988	66	42	24	1665	46
1989	81	47	34	1855	54
1990	106	58	48	1937	74
1991	119	65	54	2023	84
1992	120	66	54	2275	116
1993	120	66	54	2258	124
1994	116	65	51	2403	144
1995	115	64	51	2368	144
1996	115	64	51	2407	147
1997	155	64	51	2330	147
1998	89	51	38	2107	113
1999	90	57	33	2234	110
2000	90	90	34	2234	194
2001	90	90	-	3247	-
2002	90	90	-	3247	-
2003	89	89	-	3010	-
2004	89	89	-	3,367	-

Source: CBN

Financial Sector Distress

Financial distress is commonly used to describe two distinct but closely related states or conditions of business enterprise. These two states are illiquidity and insolvency. Illiquidity refers to a situation of cash flow crunch which often result in the suspension of payment to depositors and to a default on maturing obligations such as interbank placements. While insolvency refers to a situation when the sum of the asset is less than the totality of the liability as a result of unrevised erosion of capital.

The scale of distress in the financial sector was modest until 1989, after then the incidence of distress deepened and became more wide spread. The causes of distress included unhealthy competition arising from rapid expansion of banks and non-bank financial institutions, reducing deposit base, large stock of non-performing assets, volatility of interest rates especially in the interbank market, insider abuse and unprofessional conduct. Exogenous factors that impacted adversely the distress situation included such measures as

macro-economic instability, recession and policy induced shocks. Commencing from 1993, distress in the financial system spread to a wider circle of banks and non-bank financial institutions including Community Banks, Primary Mortgage Institutions and Finance Companies.

Some of the distress resolution options that were deployed included credit assistance by way of temporary accommodation by the regulatory authorities, the imposition of holding actions, assumption of control and management. And finally revocation of licences which is the last option exercised when all else failed. The distress syndrome did not entirely leave the banking system as there was a preponderance of so many marginally weak banks that corrupted the fundamentals of the market and which resulted in the revolution which is still unfolding in the banking industry.

The National Economic Empowerment and Development Strategy (NEEDS)

The NEEDS document on inauguration observed that over the past decade and a half, the financial sector had experienced substantial fluctuation in fortune. And that the financial sector is critical in the mobilization and effective allocation of savings, the pricing and trading of risks and the implementation of monetary and fiscal policies. There is therefore a strong case for ensuring the efficiency of the financial system and for dealing with the contradiction inherent in the fact that despite high profit levels reported over the years, the sector does not appear to be playing the catalytic role expected of it in real sector development. Other concerns were identified to include the following:

- The capital market remains shallow.
- The banking system is dependent on public sector funds as a significant source of deposits and foreign exchange trading.
- Some of the information submitted to the monetary authorities is not accurate.
- Fiscal and monetary policies are not harmonized.
- Bank loans and advances are not repaid promptly.

To build and foster a competitive and healthy financial system to support development and to avoid systemic distress, the thrust of policy under NEEDS includes:

- Deepen the financial system in terms of asset volume and instrument diversity.
- Drastically reduce and ultimately eliminate the financing of government deficits by the banking system in order to free up resources for lending to the private sector.
- Review capitalization of financial institutions in the system.
- Develop a structure of incentives to enable the financial system to play a developmental role by financing the real sector of the economy.

Some of the distress resolution measures deployed included credit assistance by way of temporary accommodation by the CBN.

The following strategies were earmarked for adoption under the NEEDS programme to revamp the financial sector:

- Embark on a comprehensive reform process aimed at substantially improving the financial infrastructure (legal codes, information systems).
- Restructure, strengthen, and rationalize the regulatory and supervisory framework in the financial sector.
- Address low capitalization, the poor governance practices of financial intermediaries that submit inaccurate information to the regulatory authorities, and the consequent costs to the financial system.
- In collaboration with banks and other financial institutions, work out a structured financing plan that ensures less expensive and more accessible credit to the real sector.
- Direct government policy towards financial deepening (establishing links between rural and urban, banking and nonbanking, and formal and informal financial systems) and financial product diversification (filling the missing middle for commercial financial services for small and medium-size enterprises with new services based on best-practice technologies for cash flow financing, leasing, and so forth.

It is correct to note that NEEDS was the precursor of the consolidation agenda that was foisted on the banking sector. Professor Charles Soludo who it would be recalled prepared the NEEDS document as Economic Adviser to the President was elevated with his appointment as the Governor of the Central Bank with the specific mandate to unleash the consolidation revolution.

Consolidation Programme

The Governor in his presentation was quite explicit regarding the rationale that informed this development. Structurally, the sector is highly con-

centrated as ten largest banks account for 50 per cent of the sector's assets/liabilities. Specifically as at end of March 2004, 62 banks were classified by the Central Bank as sound / satisfactory, 14 as marginal, 11 as unsound while 2 banks were more or less not operating. Some of the problems identified with banks particularly those characterized as unsound included:

a. Weak corporate governance, evidenced in high turnover in the Board and management staff, inaccurate reporting and non-compliance with regulatory requirements, falling ethics and de-marketing of other banks in the industry.

b. Late or non-publication of annual accounts that obviates the impact of market discipline in ensuring bank soundness.

c. Gross insider abuses resulting in huge non-performing insider related credits.

d. Insolvency, as evidenced by negative capital adequacy ratios and shareholders' funds that had been completely eroded by operating losses.

e. Weak capital base even for those banks that have met the minimum capital requirement.

f. Over-dependence on public sector deposits and neglect of small and medium class savers etc.

The Governor then posited that consolidation and strengthening of banks would ensure a diversified, strong and reliable banking sector able to play active developmental role and be a competent and competitive player in the African regional and global financial system. The requirements of the reform agenda were identified by the Governor to include:

1. The requirement that the minimum capitalisation for banks be now N25 billion with full compliance by end – December, 2005

2. Phased withdrawal of public sector funds from banks commencing from July, 2004.

3. Consolidation of banking institutions through mergers and acquisitions.

4. Adoption of zero tolerance in the regulatory framework especially in the area of data/information rendition /reporting.

5. Promotion of the enforcement of dormant laws especially those relating to issuance of dud cheques and the law relating to the vicarious liabilities of the Board members of banks in instances of liquidation etc.

The Great Debate

The debate that followed the reform agenda was quite fierce as individuals and groups dug into their trenches. Somehow there was this thinking that the Central Bank could be made to shift ground based on the strength of argument and emotion displayed. Bankers took up the gauntlet as the debate raged. They poohpoohed the comparisons made by the Governor with the situation in Malaysia, Singapore, South Africa as missing the point, as far as they were concerned it tantamounted to comparing oranges and apples. The National Assembly was lobbied to put pressure on the Executive for the decision to be rescinded. The bankers canvassed stratification of banks with minimum level of capitalization similarly aligned. The Bankers argued that there is nothing that says that the proposed mega banks cannot co-exist with small banks.

I do not suppose that there was any reaction that generated as much reaction as that published as paid announcement by Atedo Peterside, the Chief Executive Officer of Investment Banking and Trust Company. The issues raised in this advertorial were in my opinion largely answered by Basil Ezegbu of Risk Reefing and Publications in another advertorial. The points raised by Peterside in his publication included the following:

- Why did the CBN show preference for the Malaysian model arguing that he was sure that the Governor of the Malaysian Central Bank would not introduce this model in Nigeria giving the difference in environment. He recommended the Lebanon model which largely had to do with ensuring that enabling legislation was enacted to protect banks regarding disclosure of market sensitive customer information inevitable in mergers and acquisition discussions and the need to guide against other collateral damages such as adequate provisions for redundancy payments etc. The advertorial by Basil Ezegbu referred to earlier actually asked why we should not adopt a Nigerian model.
- No prior dialogue with stakehold-

ers to ensure more informed decision. Infact the reform could have been aborted if word was let out about it. Therefore such earth shaking developments are of necessity shrouded in secrecy. The Governor himself is aware and infact admits that he could not have been able to introduce the reform if he allowed the details to be debated and if he did not introduce it when he did at the very beginning of his tenure.

• What methodology was adopted in determining the proposed level of capitalisation? He argued that probably, average Returns on Investments should have been used. He also enquired regarding what informed the deadline. As Ezegbu rightly asked, which capital would the determination of the average returns be based? Is it capitalisation as in the case of quoted companies which is fluid, or as start-up capital or shareholders' fund? Regarding the deadline, the Governor did infact indicate that the norm in this regard is 12 months and therefore the Central Bank was really generous in this regard by giving 18 month deadline.

And in the arguments which were largely emotional, stakeholders forgot the fundamental rule guiding deadlines. You don't give a deadline and proceed to extend it immediately. Such a development could connote unseriousness or lack of adequate preparation. Deadlines are monitored and strategic flexibility maintained to extend the deadline in the light of results. We also recall Parkinson's Law that the job/ assignment would expand to occupy the time allotted to it. Therefore when you initiate such a fundamental and far-reaching programme, you want to complete it quickly. It is like surgery for malignant tumour. You do not delay it. And what is more, Nigeria has lost a lot of time and is lagging in so many areas that it cannot afford the luxury of delay. Like Ezegbu observed, since when however did we start enquiring regarding the methodology that underpinned such decisions.

We agree with the observation that withdrawal of public sector deposits would exacerbate the poor health of banks as diagnosed by the Central Bank. I recalled during the stakeholders consultation which I had earlier referred to that I had wondered aloud as part of my intervention that I did not understand the rationale behind the withdrawal of public sector funds particularly as it is often discussed in the context of high interest rates. I made the rather elementary observation that such a development would worsen the supply situation and therefore generate the opposite effect to that which is desired on interest rates. I also recalled that such moves were made in 1989 with disastrous consequences for the health of banks. Infact it signalled the on-set of bank distress which led to the withdrawal of the licence of many banks. The Central Bank as indicated under this reform agenda attempted a phased withdrawal which was reversed in the face of adverse consequences for the stability of the banking system. The Central Bank of course has not left anybody in any doubt about this policy thrust. It has not been abandoned; the CBN sees it as a veritable tool for liquidity management to be deployed when necessary.

The Central Bank as indicated under this reform agenda attempted a phased withdrawal which was reversed in the face of adverse consequences for the stability of the banking system.

The question was asked regarding what to do with banks with negative networth. Which banks would want to acquire or merge with such banks? It was proposed that a two tier approach should be adopted whereby the banks with negative networth are given a shorter period to recapitalise or be liquidated. Obviously, the Central Bank is in a dilemma regarding how to deal with this category of banks. If these banks are suddenly liquidated, the worry is about its systemic implications.

Peterside also makes the point that given the deluge of returns banks are required to make to the Central Bank, it is not possible for any individual to guarantee the accuracy of such returns. The point has been made time without number that there is the need to streamline the returns banks are required to render to the Central Bank. But no matter the extent of these returns somebody must be accountable for their accuracy. If the Chief Executive Officer's job is on the line on account of the accuracy of these returns, the hammer should also be dangling over the head of any one down the line who has responsibility for the returns. One has also had complaints to the effect that sometimes the way and manner these requests are made cannot but lead management that places lesser stock on integrity and the ethical content of

their conduct to falsify them. This brings to mind the way and manner sanctions are regarded by bank management. In the past, bank Chief Executive Officers would do everything possible to avoid the blot on their reputation which non-compliance to regulatory guidelines would attract. The Managing Director of Nigerian Deposit Insurance Corporation recently bemoaned the fact that banks now attach cheques representing penalty for making late returns while sending the returns.

The issue of inadequate institutional capacity was also highlighted using the experience of the delays at the courts, a situation that occasioned the call for special courts particularly for dealing with cases of recalcitrant bank debtors to buttress this point. One should in this respect only expect that those institutions, Securities and Exchange Commission, Nigerian Stock Exchange, The Central Bank would take note and be on the ready to upgrade and improve upon available institutional capacities that would be required in speedily concluding merger and acquisition transactions particularly as the existing legislation requires that all mergers and acquisitions must inevitably go through the law courts.

The point was made that Mergers and Acquisitions are usually commercial decisions which are voluntarily entered into after detailed cost-benefit considerations. Yes, that is the situation for usual commercial transactions. But this is a different situation. The authorities are dissatisfied with the performance of banks in particular areas and have thought out consolidation as a panacea. Just as the Central Bank, dissatisfied with the speed at which clearing was effected, decided to reduce the number of banks that go to the clearing House by designating settlement banks which would in turn clear for affiliated banks. Therefore if the regulatory authorities have taken a decision to reduce the number of marginal players that are really not doing financial intermediation, there are in my opinion, not many options to the matter, no matter how unpalatable it may be. It has been argued that moral suasion should have been tried well enough. Ignatius Imala, the Director of Banking Supervision at the Central Bank in a conversation confirmed that in the past one year he had discussions with the Board of many banks to point out to the Boards the precariousness of their situation urging them to seek banks to merge with to no avail. Most people would vouch for the fact that even during the tenure of the immediate past Governor that hints were dropped encouraging banks to look for merger and acquisition opportunities.

If the Chief Executive Officer's job is on the line on account of the accuracy of these returns, the hammer should also be dangling over the head of any one down the line who has responsibility for the returns.

Organized Private Sector

The organized private sector has, not surprisingly, supported the ongoing reformation of the banking system. The organized private sector castigates banks for not granting loan to the real sector of the economy and for the usurious level of interest rates. It has been asked if consolidation by itself would bring any welcome developments in this regard. Certainly the economies of scale which consolidation would facilitate coupled with rationalization of capacities which currently have proliferated, should result in an overall reduction in the cost of doing business which if passed on to customers would result to a reduction on the level of interest. The pressure to earn commensurate returns on relatively large shareholders' funds would challenge bank management to be aggressive and innovative in booking loans. It should be expected that the real sector would receive attention given the quantum of loanable funds which consolidated banks would possess. It is also argued that Small and Medium sized businesses would be neglected in the unfolding environment. I should not think so. Mega banks would inevitably have departments that would cater for the par-

ticular interest of SMEs. The OPS is not satisfied with banking in the dispensation being reformed and therefore at best would be giving the reforms at worst the benefit of the doubt and no wonder the support has been full and unqualified.

The manufacturers Association of Nigeria (MAN) following the meeting of its Executive Council supported the reform and particularly welcomed the new level of capitalization. It concluded that the policy is well intentioned and should bring about an improvement of the economy by making long-term loans readily available at affordable low interest rates. The then President of the Institute of Chartered Accountants of Nigeria (ICAN), Mrs Ibironke Osiyemi, on a courtesy call on the Governor of CBN observed that the new capital base if properly implemented would revive the economy, encourage healthy co-operation amongst banks, improve corporate governance and discourage one family bank ownership. She also requested that safety nets should be fashioned to cater for the inevitable casualties of the reform.

Similarly, Michael Makinde, President of the Nigerian Association of Small and Medium Scale Enterprises (NASME) noted that the new capital base would affect SMEs positively as it would challenge the banks to aggressively look for and embrace opportunities to offer advice, consultancy and book credit. Dr Faruk Umar of the Association for the advancement of the Nigerian Shareholders while supporting the new capital base called on the Central Bank to extend a five year tax holiday in support of the new level of capitalization to banks, ensure that the cost of effecting mergers and acquisition was reduced and that the incentives the Central Bank is offering under the scheme are well advertised. He does not agree with the request for the stratification of banks and would therefore wish to see community banks undertake responsibility for rural banking. It would now appear that stakeholders have come to the realization of the inevitability of the reform and have now come round to embrace it in the open even if a minority remains closet opponents of the reform agenda.

The Journey So Far

As the Governor of the Central Bank noted during a workshop on Mergers and Acquisitions, the time for debate is over, the implementation train is revving to leave the station. It would be disastrous for any bank to be left stranded at the station. Banks should gear up to embrace the challenges of consolidation which include decision on which of the technology to adopt, human resource upgrade, culture clashes, the fact that big size would not automatically mean greater efficiency; become internationally competitive particularly in the African region and access to offshore lines of credit to boost financing.

The breakout session at the workshop considered separately issues relating to incentives, constraints, Information Technology and legal consideration. Looking at the feedback from the sessions the group on constraints did not in my opinion highlight any worthwhile constraints. Most of the recommendations from this group sounded more like incentives. The group on I/T made a good case for compensation and assistance because a number of systems would be retrenched with enormous cost implications. The incentive group came up with a long wish list. It is discernible that the mindset that informed these recommendations is that which says you got us into all this, you must therefore be carrying the can. It is interesting as the prayer regarding the reduction in the scale of statutory fees would seem to be bringing answers. The Securities and Exchange Commission recently indicated its preparedness to slash fees payable on mergers and acquisitions to a minimum of 50 per cent which would be graduated up to 90 per cent depending on the volume of transactions. The Nigerian Stock Exchange has also pledged to reduce fees and protect quoted shares like it did by suspending trading on the shares of banks that announced their intention to merge to avoid dumping, as an indication of its support of the consolidation policy.

The newspapers became replete with announcements of banks holding extraordinary A.G.Ms to receive approvals for their plans to meet the new capitalization requirement. Most of the strategies under consideration are, mergers, acquisitions and recapitalisation. Some of the banks are exploring mergers with banks outside the shores of the country.

Mega banks would inevitably have departments that would cater for the particular interest of SMEs.

Post Consolidation Management of Foreign Exchange

At independence, the Nigerian Pound had parity with the Pound Sterling with easy convertibility which delayed the development of an active indigenous Foreign Exchange Market. By 1982, it became necessary to deploy a comprehensive range of exchange controls in response to an unprecedented softness of the oil market, a major and dominant source of the Nation's foreign exchange inflow. In no time, a vibrant and thriving parallel market emerged in response to the controls and bureaucracy which then (and probably still does) characterize the foreign exchange market. The Parallel Market Premium which emerged overtime was as a result of the disequilibrium in the official foreign exchange market resulting in malpractices which included under-invoicing of exports, over-invoicing of imports and round tripping. In fact in some extreme cases evidencing desperation to perpetrate flight of capital, containers were imported with thrash backed by fraudulently obtained documentation that was patently misleading regarding the content of such containers.

In September 1986 following an attempt to deregulate the management of foreign exchange, a Second-tier Foreign Exchange Market in which the rate was determined based on the forces of demand and supply was introduced under the Structural Adjustment Programme (SAP). At the first tier window, the exchange rate was fixed for the settlement of foreign debts and permissible government transactions. This situation encouraged rent-seeking behaviour and made many bankers overnight hard currency millionaires. To deepen the market in 1986, the Foreign Currency Domiciliary Account Scheme into which exporters could deposit and access export proceeds was introduced. And in 1989, bureaux de change was introduced to deal in privately sourced foreign exchange and to attempt to reform the parallel foreign exchange market. On July2, 1987 the first and second tier markets were merged into an enlarged Foreign Exchange Market (FEM). Various pricing methods which included the weighted average rate, marginal and the Dutch System for the allocation of foreign exchange to end users based on a priori determined pro-rata were at one time or the other experimented with. By 1994, a resort was made to formal pegging of the rate of exchange, the consolidation of all foreign exchange inflows at the Central Bank, the reaffirmation of the illegality of the parallel market and the discontinuation of the use of Open Accounts and Bills for Collection as a means for the payment of imports. Again in 1995, an attempt was made to liberalise the market arising from the distortions that were fostered by the extant approach to the allocation of foreign exchange, with the introduction of the Autonomous Foreign Exchange Market (AFEM) for the sale of foreign exchange to end users by the CBN through selected authorized dealers at market determined rates. In addition bureaux de change were once more accorded the status of authorized buyers and sellers of foreign exchange.

Some of the banks are exploring mergers with banks outside the shores of the country.

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Inevitably we have to migrate for the Retail DAS currently in operation to the wholesale DAS post consolidation. It would be wrong to attempt to micro managed banks that are capitalized to the tune of N25 billion. But we must recall that the wholesale approach was tried and discontinued in the past as it was riddled with malpractices. So the issue is what will change post consolidation. We would expect that the banks that would emerge post consolidation would adopt better ethical conduct by the mere fact of their size. It is easier to perpetrate illegal practices in family based organizations or those dominated by an individual whereby the organization would be run based on the ethics of the owner. Also it is common knowledge that what is sustainable is the adoption of practices that are legal and above board. We would

also expect that the automated process that should drive regulation and operations would mean that the scope for malpractices would be reduced. Indeed it is in order to observe that the wholesale DAS is a mid-course procedure. The destination for the effective management of foreign exchange in the country is an inter-bank market in which the Central Bank would just be another player denied of its dominance in the volume of foreign exchange in its possession and its role in fixing the rate. The CBN would now only be expected to intervene in the market to avoid wide swings which would undermine stability so sought after by economic agents. Therefore the challenge would be how to ensure stability in a market determined exchange regime. Obviously immediately after consolidation we would expect that the wholesale DAS would be single price based but at what rate would end users access foreign exchange? If we are going to deepen the market we must be prepared for a multi-price regime and exporters that earn foreign exchange should be free to sell it not necessarily to the CBN. The CBN would also have to prime its horns for risk based on-line, prudential monitoring and regulation.

The Prudential measures will include limits on net open positions (as a percentage of capital) to discourage hoarding which would facilitate speculative tendencies, on foreign currency lending (as a percentage of foreign currency liabilities) and bond issues related to the capital base. To deepen the market, deliberate attempts must be made to eliminate or phase out regulations that constrain market development, abolish the surrender requirements; reduce restrictions on inter-bank trading, relax restrictions on current account transactions and to some extent transactions on capital accounts. We would expect that as the market develops, all the banks that meet the consolidation requirement should be allowed to access the auction market. It would be difficult to come by a robust and acceptable rationale for the selection of banks. The banks on their own must be prepared to continue with screen based two way quote system for foreign exchange transactions.

Rating of Banks Using The "CAMEL" Parameters

	Number			
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

Source: CBN

One of the carrots dangled before the banks (post consolidation) is the management of the country's external reserves. As the Governor of the Central Bank observed at the Forum, successful consolidation is a necessary but not sufficient condition for participation. He assured that a committee would be empanelled to evolve the templates for participation in the management of foreign reserves which will include consideration for collaterals for pre-settlement exposure. Eventually a desired outcome is exchange rate unification which is typically dependent on the fostering of an environment that is arrived at after a wide agenda of trade and financial system reforms to remove economic distortions and inefficiencies to promote sustainable economic growth. It is expected that the consolidation project would foster this desired environment. And for success in this enterprise, to avoid the need for costly reversals we must be alert to the realization that speculation, arbitrage, hedging and portfolio switching are important elements for gauging the health and development of the foreign exchange market. It bears emphasizing that the imperatives of a shift in paradigm in the extant foreign exchange management practices anchored on market driven deregulation would per force be indispensable in the effective and efficient management of foreign exchange post consolidation.

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The End of The PROFITABILITY CYCLE In China

***By Joe Studwell**

It was good while it lasted. Indeed, it was unprecedented. The investment boom that began with a sudden and powerful surge of credit in China in 2002 brought with it three years of unparalleled profits for domestic and foreign companies operating in the local market. The profits were nothing by comparison with the money made from buying cheap manufactured goods in China and selling them at hefty mark-ups to end-users in rich countries — the real significance of China in the global economy — but still outstanding by the chimeric standards of "the Chinese market".

Sadly, data released in recent weeks confirm that the profit fest is past its peak. This will come as a surprise to people who put their faith in profitability numbers from Chinese corporates. Net income of larger local companies was up a heady 16 percent year-on-year in the first half of 2005, according to the National Bureau of Statistics (NBS). The data are not perfect, but they are unlikely to be a million miles from what is recorded in the accounts of the businesses concerned.

The problem is that at this stage of the economic cycle the

profit and loss accounts of big Chinese firms become increasingly detached from reality. With plenty of retained earnings on hand, continued access to under-priced credit and impotent shareholders, they react to softening demand not by cutting output and mothballing capacity, but by extending more generous payment terms to clients and by tolerating higher levels of payment receivables.

As a result, there is a period when reported earnings continue to rise even though a chunk of the money will never be collected. We are in that period now.

How do we know this? We know because we have separate data sets for the earnings of foreign-invested enterprises. Although foreigners as individuals suffer more than their share of fantasies about China, their companies react in a much more "normal" way to market forces - because they have a higher cost of capital and powerful and irascible shareholders.

The first clear indication that the party was over came with first-half 2005 NBS data that showed a 4 percent year-on-year drop in profits for all foreign-invested industrial enterprises. This was significant not for the size but the fact of the decrease - it was an inflection point after a long period of strongly rising earnings.

Moreover, the news was accompanied by figures that also showed a small drop in foreign direct investment (FDI). It may seem extraordinary that levels of utilized investment could track changes in earnings to within a matter of weeks, but in a globalised world - in which one year of world-wide FDI is equivalent to a decade's worth prior to the 1990s - the correlation has vastly increased.

It is an interesting aside to remember that in the mid-1990s, when the aggregate profits of multinational companies in China were zero, or less, China was heavily over-invested by foreigners. Today, the correlation between investment and returns is much closer. On a per capita basis China receives less than US$50 per person per year, compared with several hundred dollars per capita in higher-return domestic markets such as those of eastern European countries. At the start of this decade, many economists had forecast China would soon receive US$100bn a year in FDI. This has not happened because foreign investment levels have come in line with earnings.

Returning to the current state of affairs, the end of the present China profit cycle was confirmed by data released in Washington DC two weeks ago reflecting the earnings of overseas affiliates of American companies. These showed that earnings of US-controlled businesses in China ended a three-year period of strong growth in the last quarter of 2004 and went into decline in the first and second quarters of this year.

The scale of the year-on-year decline is around nine percent (it should be noted that the second quarter 2005 numbers are still provisional). The main reason why the

The profits were nothing by comparison with the money made from buying cheap manufactured goods in China and selling them at hefty mark-ups to end-users in rich countries.

drop is larger than that indicated in Chinese statistics is that US investments in China are somewhat — though not excessively — more weighted towards the domestic market than the average foreign investment, which is more likely to be export-oriented. The export economy, of course, is still in good shape.

What does the end of the profit cycle mean? As ever, it is benign or neutral for companies that make money from China without being significantly invested there, and negative for companies that are.

Traditionally export-oriented operations in China lose a little bit of pricing power as Chinese demand for their output — which has become significant in this latest cycle — falls off. However, being predominantly private, such firms will curtail production to protect margins. International traders of Chinese manufactures, from Wal-Mart down, gain even more pricing power for as long as rich-country consumers keep spending.

Global sellers of commodities that feed China's irrationally-large heavy industrial economy suffer no immediate effects. Chinese big business is not yet reacting to profit erosion by reducing output, which means it must import commodities that China does not have. As predicted in this column in July (see Winning at Chinese dominoes), the share prices of global mining companies like BHP Billiton and Rio Tinto have continued to be good investments, despite many forecasts of the opposite.

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The negative short-term impact of the end of the profit cycle is on those companies heavily invested in China's domestic market but with little revenue from exports or sales of essential goods into China. Indeed the more unhedged the exposure to the domestic market is, the worse the prognosis becomes, since we expect the presently modest rate of profit erosion to accelerate substantially in the next 12 months. If this proves to be the case, China investors will divide neatly into two camps - those who learned the lessons of the China gold rush in the early 1990s, and those who did not.

(* Joe Studwell is editor-in-chief of the China Economic Quarterly and author of the The China Dream.)

Corporate Governance: A New Risk Element in Corporate Finance

*By Amb. John Bohn

Investment is all about managing risks. It has been the root of traditional analysis to focus on numbers, ratios, and capital. But as investors evaluate an opportunity and banks look at loans, a new factor is being injected into the analysis – the risk that the numbers do not reflect the operating performance of the enterprise. So today, a whole new risk assessment industry has sprung up, focusing on the internal workings of the corporate structure. The is new industry is corporate governance.

While the numbers remain important, investors and bankers are increasingly focusing on how the various aspects of the corporation perform relative to its objectives and its shareholders. Whether one views this new trend as simply fashion or evolution, good corporate governance is of increasing importance for companies in developing countries as they compete for capital and investment. It is seen to help create more sustainable companies regardless of their size, geographic location, or industry.

With the increasing global integration of business, companies in developing countries face a new kind of scrutiny from the global community.

Corporate governance is about improving business performance and national competitiveness. At the end of the day, corporate governance is going to be a key driver in the effort to ensure that capital is managed responsibly. And it is key for the investors that provide the capital, the companies that have to manage it, and perhaps most im-

portantly, for the societies in which growth is an imperative.

Investment is all about managing risks. In the banking sector we have many examples from countries around the globe where careless bank lending has destroyed industries and put entire economies on the verge of collapse. The Asian banking crisis was less about structural issues than about sudden changes in risk perception multiplied by the global capacity for instant communication. The magnitude of that crisis and its aftershocks in countries around the globe demonstrates well the central role that risk perception plays in directing investment flows. When that perception changes, it forces capital to rethink its destination and recalibrate its targets.

In the banking sector, for example, the Basel II Framework plays an important role not only in helping banks manage risk but in communicating that risk. In focusing on risk management and bank supervision, Basel II recommendations guide banks in building an internal process to make sure that they are better prepared to deal with specific problems and increases the probability that the banking system understands the risks that it is undertaking. It has been the root of traditional analysis to focus on numbers, ratios, and capital. But as investors evaluate an opportunity and banks look at loans, a new factor is being injected into the analysis – the risk that the numbers do not reflect the operating performance of the enterprise.

This new industry is corporate governance, and with proper application it represents an exciting and important trend in business evolution.

One can argue, correctly, that such risk has always been present. Management has always been a factor in investment analysis to some degree. But today, a whole new risk assessment industry has sprung up, focusing on the internal workings of the corporate structure. There are several driving forces behind this movement. For example, there are enormous losses from the large scandals at Enron, Worldcom, and other companies in the United States. As a result, ambitious attorneys general see political opportunity in tearing apart corporate giants. Private attorneys are free to interpret mistakes in judgment as opportunities for shareholder lawsuits that strip millions from corporate value. As a result, CEOs and other directors face the reality of taking on new personal risks and a long shadow is cast over "the corporation" and its capacity to generate wealth in society.

With the increasing global integration of business, companies in developing countries, therefore, face a new kind of scrutiny from the global community. While the numbers remain important, investors and bankers are increasingly focused on how the various aspects of the corporation perform relative to its objectives and its shareholders. Is the board of directors competent, independent, engaged? Is management truly involved in the operations? Are the rights of all shareholders taken into account so as to encourage the flow of funds into those well performing

companies and to discipline poorly performing enterprises? Are decisions taken that are in the overall best interests of the corporation? Relying simply on the "hard" numbers without taking into account the environment within which these companies operate is no longer enough.

There are examples of corporate greed, lack of oversight, insider dealing, and collusion in both developed and developing countries. But the overflow from the recent collapses in the United States has poisoned the waters of corporate operations. Virtually every university and business school offers new courses designed to attack the problem.

Entire associations have sprung up to produce standards of conduct. The Organisation for Economic Cooperation and Development (OECD) spends millions of dollars every year to define it. The World Bank has incorporated it into its lending processes. Whole new disciplines have been created out of the wreckage of the accounting business, which devote their entire attention to it. No investor or lender today can make a responsible investment decision without attention to whether the operation of the corporation and the institutions that surround it are in accordance with fundamental expectations

This new industry is corporate governance, and with proper application it represents an exciting and important trend in business evolution. Corporate governance is, essentially, the process by which each of the various aspects of a corporation performs its assigned and expected role in the creation of value for the shareholders and, therefore, for society as a whole. From the internal perspective, it creates responsible and transparent companies that are better prepared to manage financial risks and can be easily held accountable for their actions. From the external perspective, it both facilitates and feeds off the development of key institutions that build healthy and stable business environments. Whether one views this new trend as simply fashion or evolution, good corporate governance is of increasing importance for companies in developing countries as they compete for capital and investment. It is seen to help create more sustainable companies regardless of their size, geographic location, or industry.

Discipline can be brought to bear by market pressure, which requires disclosure. Discipline can come about as a function of the internal governance of the company or the board; or discipline can result from a variety of external factors, stemming from private or regulatory agents.

To better understand the emerging role of corporate governance in managing risks, especially in developing countries, it is important to understand the big picture of corporate governance and the key differences (that many tend to overlook) between governance environments across different economies.

Why is good corporate governance relevant in emerging markets?

The movement got a big push in 2002, when the global consulting firm McKinsey & Company surveyed institutional investors around the world to determine just how important corporate governance process is to that key segment of the economy. What they found is that many institutional investors would be willing to pay a premium for a company with good corporate governance practices. In some countries, investors indicated that they are willing to pay a premium as high as 40% for a well-governed company. Not surprisingly, that premium is higher in countries where corporate governance practices are unsound and the relative value of a well-governed corporation is therefore greater for its shareholders. For example, the

premium is much higher in Russia and Egypt than in the UK.

A clear significance of this fact is that today corporate governance has a direct bearing on the cost of capital, and it has an immediate impact if it can be improved at the level of the firm, even if not at the country level. Conversely, if it is improved at the country level, it tends to drive through the firms. It is important to note that we are discussing behaviors that are valuable not because they are in some sense "moral" or "ethical," but because they relate directly to the actual cost of doing business and the cost of capital. Good corporate governance creates competitive and responsible companies and helps them harness capital flows. Such companies are better positioned to survive in today's rapidly globalizing economy, which means that they are also better positioned to provide jobs, create wealth, and invest in development of societies where they operate. And, incidentally, they attract the best partners and are better investment prospects.

Just as the benefits of good corporate governance are clear for companies, they should also be evident for governments. By instilling the key elements of transparency and responsibility, governments help create predictable and stable business environments. This, in turn, helps attract investors, creates a level playing field, and provides new business opportunities for citizens. All the global signs point out the dramatically increasing importance of good corporate governance in both private and national development.

Simply put, good corporate governance is an assurance mechanism – a mechanism that sends a signal to investors that their investments are not going to be channeled into the pockets of cronies or confiscated at will. It sends a signal to citizens that they can join the formal economy from the shadows of the informal sector and begin to create a bright sustainable economic future. Increasingly, the global community is insisting on adherence to good corporate governance standards as a condition for development funds, and the market is insisting on compliance as a condition of participation.

Good corporate governance helps build a foundation for development. The day-to-day practice has the effect that companies support the rule of law and demand efficient courts that uphold property rights. It requires from its participants accurate and timely financial records and that avenues of corruption be exposed. It demands that shareholders be given information so that they can make informed decisions.

It demonstrates the values of transparency, accountability, responsibility, and fairness not only in companies, but in societies as well.

The former governor of the Bank of Thailand addressed a CIPE conference held shortly after the Thai baht collapsed. He said that the Asian financial crisis showed that "even strong economies, when lacking transparent control, responsible corporate boards, and shareholders' rights, can collapse quite quickly as investors' confidence erodes." The Thai economy was, in fact, a very strong economy, but it lacked transparent con-

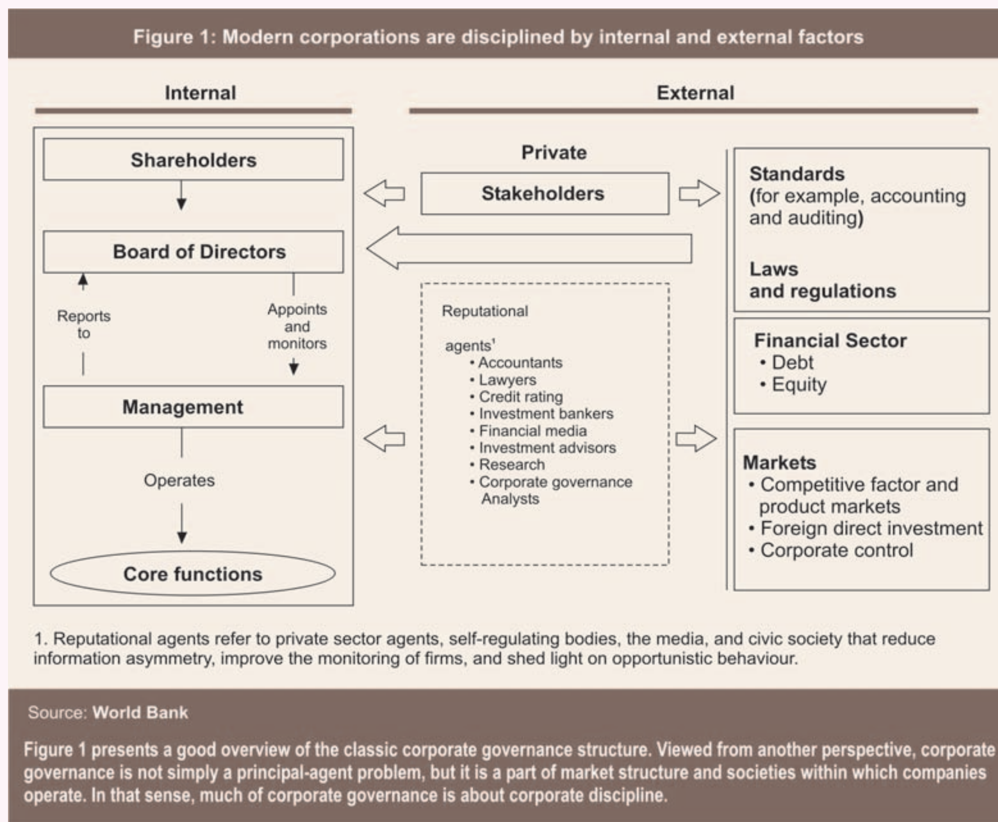

Figure 1: Modern corporations are disciplined by internal and external factors

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: **World Bank**

Figure 1 presents a good overview of the classic corporate governance 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.

trol and good corporate boards. When the Thai baht collapsed and exposed the weakness of that market, companies lost investor confidence quickly, resulting in the flight of capital out of the country. Interestingly, that flight was originally by domestic investors only, but foreign investors soon followed.

From the principal-agent problem to corporate discipline

At its core, corporate governance analysis addresses one central issue: "how to ensure that the parties in the corporate governance process are acting on behalf of their respective principals and not on their own behalf, or on the behalf of some subset of owners, say, the blockholders (i.e., those individuals or groups who own large blocks of stock) or family." One answer is to encourage accurate and timely disclosure so that all shareholders have the same information as the managers, the boards of directors, and other insiders with respect to benefiting from the corporation.

In the U.S., we have moved to a system of enforcement of rules as a way to ensure disclosure. Those rules are the Sarbanes-Oxley rules; the rules from the New York Stock Exchange; and the new rules coming out of our Securities and Exchange Commission. The current rules are a reaction to the corporate scandals that I mentioned earlier and in the judgment of many impose too great a burden and cost onhonest and smaller companies and thus may in the short run discourage growth. In our case the pendulum may have swung a bit too far.

The United Kingdom has taken a slightly different approach. The British have adopted, instead, a principles based system. They have assembled the initiatives that have been implemented in the United Kingdom over the last 20 to 30 years into the combined code, which has been released by the London exchanges. The differences between the U.S. and U.K. solutions have been discussed widely and will not be detailed here. Suffice it to say that they reflect different views on how best to achieve responsible corporate governance.

The lack of a triggering mechanism for legal enforcement was one of the reasons the Asian financial crisis was so difficult to address.

Corporations are disciplined by internal and external factors (see figure 1). Discipline can be brought to bear by market pressure, which requires disclosure. Discipline can come about as a function of the internal governance of the company or the board; or discipline can result from a variety of external factors, stemming from private or regulatory agents.

The left-hand side of the chart illustrates the traditional structure of corporate governance: shareholders to boards of directors; the monitoring and appointing functions of management and the board; and the management function of operations. All this makes up the internal, or governance, function.

The right-hand side shows the external structure. Under the private side, we have stakeholders and reputational agents.

Stakeholders include banks and other sources of debt capital and also includes unions, community groups, and others that have an economic stake in the company. The reputational agents are those that certify and transmit information to the markets, to the investors, and to the shareholders, such as accountants, lawyers, credit-rating agencies, investment bankers, the financial media, and, increasingly, corporate governance analysts. Several companies, such as Standard & Poor's, UBS Warburg, and some private groups in the Philippines are developing actual corporate governance ratings. These allow someone to know, within a range of accuracy, how well a company fulfills its core corporate governance functions, how good its disclosure is, and how trustworthy it is.

Also included under external factors are the regulators, i.e., the agents that set the standards. We can divide the regulatory factors into three categories: standards, including laws and regulations; the financial sector; and markets, which provide private standards.

Under standards, we turn to the current debate over how the

Erm, fireman, teacher, train driver, anything that offers plenty of time off via strike action?

international accounting principles should look, and how these principles can be harmonized across countries.

That is, how the laws and regulations can become universally accepted and acceptable, and whether they are the equivalent of the U.S. Sarbanes-Oxley rules or capital market authority rules as found in Egypt, for example.

As mentioned earlier, the financial sectors play a key role in corporate governance in the manner in which they provide debt and equity, increasingly after a hard look at corporate governance as a risk factor in making their decisions.

Competition in an economy or market can substitute for some degree of regulation. Markets that are heavily protected and segmented from the international competition are not going to have as much competitive pressure as very open markets, whether those open markets are the United States or the United Kingdom, or, increasingly, some emerging markets such as Russia.

One concept being increasingly discussed is that if a company is well governed, its risk should be lower, and the bank should have to hold back less capital and have fewer reserves than is otherwise necessary to provision against the loss of a loan to that company. In fact, this issue was raised recently in a review of the OECD principles and is an intriguing new area that continues to gain more attention.

Emerging markets – The need to build key institutions

In any discussion of corporate governance, the key distinction between emerging markets and developed markets is that in developed markets the issues revolve mostly around minority shareholders and the principal-agent problem. In emerging markets, however, the key issues are as likely to concern the degree to which these supporting institutions, on which corporate governance depends, are in place and the ways in which they can be strengthened.

Effective corporate governance systems depend upon a set of institutions – laws, regulations, contracts, and norms – that permit self-governing firms to be the central element of a competitive market economy. These institutions ensure that the internal corporate governance procedures adopted by the firms are enforced, and that management is responsible to owners (that is, shareholders) and to other stakeholders, whether they are the sources of debt, the community, or the employees. All of these stakeholders have to be considered.

Certain institutions are present where there is good corporate governance. The first institution is transparency or full disclosure of financial and key performance information.

In most emerging markets there is the tendency for blockholders to dominate companies. Blockholder dominance concerns groups of investors, e.g., family firms or other forms of blockholders, who have a privileged position in the company and who are able to generate highly advantageous cash flow for themselves or make decisions for the company that are advantageous to themselves but that may not be advantageous for the whole company. Often, minority shareholders with advantageous voting rights can act as blockholders as well.

Certain institutions are present where there is good corporate governance. The first institution is transparency or full disclosure of financial and key performance information.

Full disclosure is a responsibility of the board. However, enforcement of that responsibility is a function of the degree to which regulations are in place, either at the securities market level, the stock exchange level, or at the regulators' level, and the degree to which those regulations are enforced. It is also a function of a culture of corporate governance found in the country or the company.

The second necessary institution is a set of laws and regulations that deal with conflicts of interest involv-

ing boards of directors and managers, either through required disclosure or simply prohibition.

Bankruptcy procedures are the third key institution. An orderly process by which creditors, investors, and shareholders can re-align their interests and protect and enforce their expectations while freeing up unproductive resources is essential for parties that undertake the risks involved in any enterprise. The lack of a triggering mechanism for legal enforcement was one of the reasons the Asian financial crisis was so difficult to address.

Conclusion

A consensus on the importance of local institutions in building strong corporate governance is emerging among governments, the international financial community, and private investors. We saw this reflected in a recent OECD meeting in Paris in November of 2003. Experts from emerging markets all over the world – the Middle East, North Africa, Latin America, and Eastern Europe – came together to look at the OECD corporate governance principles and figure out a way to make them more relevant and applicable in developing countries. Several CIPE partners helped generate this drive to create corporate governance framework that takes into account the local realities of doing business. We saw it again in a CIPE conference in Jordan in February of this year where many Middle Eastern private sector representatives, the press, and governments gathered to affirm that good corporate governance based on both the international experience and fundamentals of local institutions is essential to the development of their countries.

Corporate governance as an element of risk ranking in investment and lending is growing in importance at an accelerating rate across the globe. It is affecting world lending institutions, private equity investors, as well as corporate planners and executives. There are now literally dozens of indices, codes of conduct, internal mission statements, and legal rules that influence capital and investment flows. They exist partly out of a reaction to recent events, but at their roots they rest on the evidence that good corporate governance reduces risk. It is particularly uplifting to see that many developing countries recognize the benefits of good corporate governance and work diligently to introduce their own sound governance standards.

Often, minority shareholders with advantageous voting rights can act as blockholders as well.

Moreover, the banking industry occupies a particularly key position in this evolution as increasingly it is using corporate governance evaluation as a risk-ranking tool. In many countries, banks can lead by example, both implementing good corporate governance within themselves and facilitating development and adoption of corporate governance in other companies. Corporate governance is not only about the mechanisms that comprise it, but it is also about the enforcement. In the broken institutional environment of many developing countries where implementation of rules and regulations is weak, banks have an opportunity to become an effective enforcement mechanism of good governance.

The ultimate reward, the objective of all this activity, is, of course, increased investment and growth, which produces wealth for societies and their citizens. Corporate governance is about improving business performance and national competitiveness. At the end of the day, corporate governance is going to be a key driver in the effort to ensure that capital is managed responsibly. And it is key for the investors that provide the capital, the companies that have to manage it, and perhaps most importantly, for the societies in which growth is an imperative.

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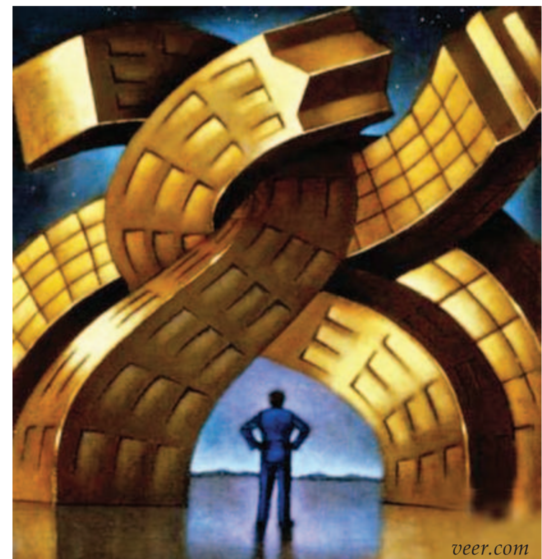
Mergers and Acquisitions (M&A) transactions, which are invariably expensive corporate finance ventures, can be wasteful if one party backs out after management time has been spent and substantial advisory fees have been paid by the other party. As the Nigerian banking consolidation exercise has amply demonstrated, neither reputational considerations nor a Memorandum of Understanding (MOU) can compel a party to remain on the negotiating table and see the deal to completion. One party can walk away from the negotiation process even at the twilight of completion notwithstanding that the other has spent considerable sums on advisory fees. This article shows how transactional lawyers can through the break fee clause enable a prospective acquirer recoup its wasted expenditure.

Deal Protection In M&A Transactions:

Reducing The Risk Of Wasted Professional Fees And Management Time

*** By Dr. Tunde Ogowewo**

There are three broad categories of advisers employed in M&A transactions: accountants, investment bankers and transactional lawyers. Whilst the use of accountants and investment bankers requires little explanation, the same is not necessarily the case with the transactional lawyer. This is because conceptually the transfer of assets (in an asset sale) or the transfer of shares (in a takeover bid) can be effected without the involvement of lawyers. With the exception of transactions that necessarily involve a trek to the court-house,1 where "practice of law" rules give lawyers a monopoly, the need for transactional lawyers in M&A transactions is at first glance hardly self-evident. In the UK, for instance, where the regulatory framework does not necessarily involve resort to the courts,2 an M&A transaction can conceivably be structured without the involvement of transaction lawyers. Yet there, as elsewhere, transactional lawyers are indispensable to such transactions. Why?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Transactional lawyers are used, first and foremost, because they add value to the deal. One way they do this is by lowering transaction costs through exploiting

regulatory arbitrage.3 So, in the UK for instance, although a scheme of arrangement under section 425 of the Companies Act 1985 and a takeover bid can each be used to effect a takeover or merger, the latter will lead to stamp duty liability, while the former will not. This is because the takeover bid necessarily involves a transfer of shares and this transfer results in stamp duty liability of 0.5% of the value of the consideration paid by the acquirer for the shares.4 The transactional lawyer in the UK can eliminate this cost by structuring the transaction as a scheme of arrangement in the form of a cancellation scheme.5 A cancellation scheme involves no transfer or conveyance of shares and therefore no liability to pay stamp duty arises. This example shows that by selecting one form of transaction over another, the transactional lawyer can ensure that the M&A deal is done at the lowest possible cost.

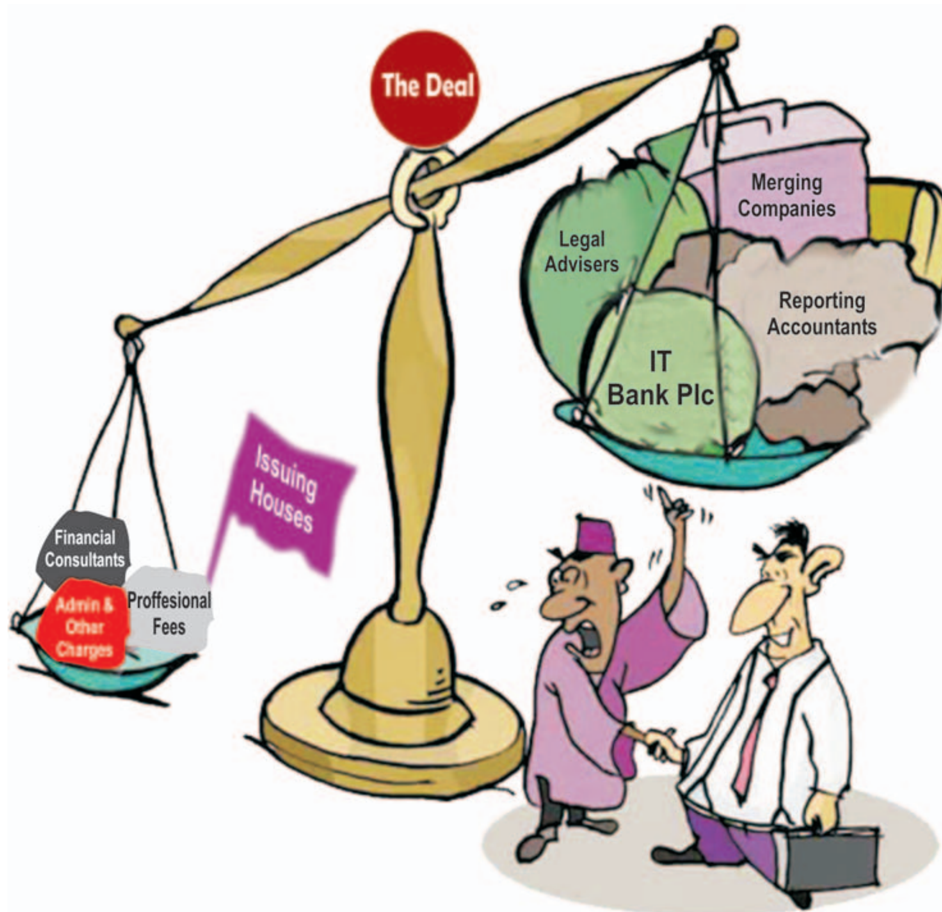
Transactional lawyers also add value to the deal by being able to reduce the cost of information asymmetries:6 a specie of non-regulatory costs. In a non-hostile M&A transaction, the target may supply the acquirer company with information about its business that contains untruths: outright lies may be told, the truth may be shaded or misleading information may be supplied. To reduce the risk of opportunistic withholding or manipulation of asymmetrically held information the transactional lawyer will conduct due diligence and exact from the target company disclosure in the form of representations, warranties and covenants.7 The reduction of information asymmetry between both parties leads to less uncertainty and less need to take costly precautions with the consequence that transaction costs will fall.8

Another important reason for the use of transactional lawyers is that they help to ensure deal protection. The prospective acquirer that is going to devote time, effort and resources to an M&A transaction needs to be assured that its investment in the entire process will not be wasted. From the prospective acquirer's perspective, there are substantial sunk costs involved in the process: search costs (costs incurred in identifying a suitable target), due diligence costs (costs incurred in investigating the target) and commitment costs (if the consideration for the purchase is to come from external funding sources). If the target decides to call off the deal or another suitor acquires the target, how can the frustrated party limit its financial loss? A transactional lawyer limits this loss by means of devices that ensure exclusivity with respect to a transaction that might well prove costly in terms of management time and advisory fees. The aim of this article is to identify an important deal protection device that can be used in the Nigerian M&A space. To provide context, a brief overview of other deal protection measures will first be provided.

Another important reason for the use of transactional lawyers is that they help to ensure deal protection. The prospective acquirer that is going to devote time, effort and resources to an M&A transaction needs to be assured that its investment in the entire process will not be wasted.

Deal Protection Measures

Memoranda of understanding (MOU) – also known as letters of intent or heads of agreement – are frequently signed to ensure some measure of deal protection. Such agreements are entered into at the beginning of the transaction, once preliminary terms have been agreed and before the commencement of due diligence and the drafting of the definitive agreements. The real value of an MOU is that it creates a moral obligation during the lengthy process of negotiating a full agreement and identifies the crucial points for agreement. It also provides the basis for a joint submission for regulatory clearance. However, the MOU does not give legal comfort in the sense that it does not legally compel the parties to conclude the deal on the terms stipulated in the document or even at all: the House of Lords in *Walford & ors v. Miles & anor*9 has held that agreements to negotiate in good faith, even with a time limit imposed for those negotiations, are not enforceable because they lack the necessary certainty. Neither do the agreements enable the prospective acquirer recover wasted advisory fees incurred where the target simply decides to walk away unless a clause to that effect exists in the agreement: a prospective acquirer who has incurred ₦20 million on advisory fees is not likely to be in a position to recover this sunk cost should the target company decide to terminate arrangements because another prospective acquirer



appears interested in it.

Although it is conceivable that an MOU could create a binding contractual obligation and provide the basis of an action against a competing bidder for tortuous interference with contract,10 it is highly unlikely that the standard MOU would create grounds for such an action, especially when there may be issues outstanding for negotiation and agreement. Recently, the Court of Appeal in England held in *Cable & Wireless plc and anor v. Valentine and ors*,11 that an agreement between the parties was void for uncertainty because it was an agreement to agree an essential term. However, if the negotiations were not conducted on a "subject to contract" basis,12 and where all essential terms were agreed, then the fact that the subsequent preparation of a formal written contract was envisaged would not prevent an MOU from creating a binding agreement.13 Furthermore, it is noteworthy that statements made in an MOU, or in connection with the negotiations to which they pertain, carry the potential to create liability for misrepresentation or negligent misstatement, where the MOU does not create a contract.

There are other exclusivity provisions that can be used to promote deal protection. A performance promise is one wherein the target's board agrees not to engage in certain types of conduct for a fixed period or prior to the shareholder vote.14 This gives the prospective acquirer a period of exclusivity in which to negotiate and complete the transaction. There are two types of such promises: a "best efforts clause" and a "no shop/no negotiation" clause. The former requires the parties to use their "best efforts" to consummate the transaction. This gives some measure of comfort to the prospective acquirer that the target will not back out of the transaction. The latter clause prohibits the target from soliciting a competing offer from any other prospective acquirer, although they allow the target to consider a bid if it is unsolicited. Here, negotiations are permitted. In contrast, a "no negotiation" covenant prohibits all such negotiations. Lockup options refer to agreements granting the prospective acquirer an option to buy the target's shares or assets (usually its crown jewels) and the option becomes exercisable upon the acquisition by some third party of a specified percentage of the target's outstanding shares. These exclusivity provisions can take the form of a stand alone agreement or may be one of the terms in the MOU.

Whilst the enforceability of exclusivity clauses in Nigeria will turn on an interplay of corporate law principles (mainly the fiduciary doctrine as codified in the Companies and Allied Matters Act 1990) and contract law, the enforceability of lock ups will turn on corporate law principles.

Deal Failure and the Break Fee Clause

Deal failure can be prohibitively expensive for the prospective acquirer, who has invested time and money in the negotiation process. The break fee clause (also known as the termination clause or inducement fee

clause) enables the prospective acquirer to recover its wasted expenditure on the process, such as advisory fees. The clause, in effect, allows prospective acquirers to share with the target the financial risks of the M&A transaction. A break fee is an arrangement entered into between a prospective acquirer and a target company whereby a fee is paid to the prospective acquirer if a specified event occurs which prevents the transaction from completing. A prospective acquirer who wishes to avoid the risk of wasted costs may therefore approach the target with an attractive offer price and refuse to announce the offer until its due diligence is complete but also refuse to commence due diligence until a satisfactory break fee agreement is in place.15 Although the negotiation of a break fee is secondary to that of the acquisition agreement, its commercial importance is obvious: it helps to ensure that a party to an M&A transaction does not leave the negotiating table or entertain a competing proposal and it obliges the target company to bear some or all of the professional and other advisory costs incurred in the negotiation and due diligence stages of a deal if it does not complete.16

The break fee clause has long been a feature of US M&A practice, but its use in the UK has become common in the last 6 years.17 The bid by WM Morrison Supermarkets for Safeway in 2003, which had a headline value of £3 billion, had a break fee of £30 million. Recent examples of break fees that were payable without legal challenge include the break fee of £8.5m that Debenhams had to pay to Permira because another bidder (Baroness) made a successful bid at a higher price to that of Permira; the break fee of £2.6 million that PizzaExpress had to pay to Venice Bidder following the success of a third party bid (Gondola Express); when the merger of Royal Caribbean Cruises and P&O Princess failed because the P&O board withdrew its recommendation of the merger and instead recommended Carnival Corporation, a break fee of US62.5 million became payable by P&O Princess to Royal Caribbean. In the UK, the practice is for break fees not to exceed 1% of the bid value.18 In the US, market practice limits the level of the fee to around 3%, although there are variations.19 It has been noted that the Delaware courts have approved break fees of up to 5% of the transaction value: one of the largest so far is the break fee of US$2.3 billion in the merger transaction between JP Morgan Chase & Co and Bank One Corporation announced on January 14, 2004.20

The real value of an MOU is that it creates a moral obligation during the lengthy process of negotiating a full agreement and identifies the crucial points for agreement. It also provides the basis for a joint submission for regulatory clearance.

Drafting a Break Fee Clause

The first consideration in using a break fee arrangement is its timing: when does one use it – before due diligence or after? The risk of wasted costs is eliminated if it is used before due diligence, but whether a target would agree to this would ultimately depend on how badly it needs the deal. The second consideration is the identification of the source of the break fee: this article has proceeded on the basis that the source of the break fee is the target company; whilst this is invariably the case, where the target company has a shareholder with a shareholding that is large enough to thwart the acquisition, it will make commercial sense for the prospective acquirer to seek its support. If, after the prospective acquirer has spent considerable sums on professional fees, the target shareholder decides not to support the transaction, the existence of a break fee agreement between the target shareholder and the prospective acquirer will have the effect of limiting the loss suffered by the latter. Concluding a break fee agreement with such a shareholder early in the day ultimately allows the prospective acquirer to recoup from the target shareholder its wasted costs.

The drafting of the break fee clause can be complex and it is best for the transactional lawyer to take specialist advice because of the minefields that exist in contract and company law. The key provisions will include the following: (i) the amount of the break fee; (ii) exclusivity (iii) payment triggers; and (iv) mutual fees. Each of these provisions present legal issues.

The Size of the Break Fee

The amount that the target company may become liable to pay and the circumstances when the break fee becomes payable may raise questions concerning whether the target directors have breached their duty of

loyalty and care to their company. The target board should therefore have reasonable grounds for believing that the arrangement is in the best interests of the company and is not for a collateral purpose. Furthermore, the target board will need to ensure that their directorial authority to engage in such a transaction is not abridged under the company's articles of association.

It is important to point out that the size of the break fee is not relevant to whether or not the amount payable is a penalty. Under the common law, a penalty is unenforceable: under the penalty doctrine, if a sum is payable on a breach of contract and the sum agreed exceeds a genuine pre-estimate of the loss which the innocent party would be likely to suffer as a result of the breach by the other party, the agreement will be unenforceable to the extent of the excess.21 In the case of a break fee, the arrangements for the payment of the fee are made pursuant to an agreement and on the happening of certain defined (trigger) events rather than as a result of a breach of contract.22 Therefore, the issue of a penalty will not ordinarily arise. However, the size of the break fee may be relevant to whether it involves unlawful financial assistance for the purchase of shares (a company law issue), even though no purchase occurred.23

Exclusivity

A prospective acquirer will ordinarily want the field to itself: it will therefore want its break fee arrangement to provide for an exclusivity period. If it is drafted as a positive undertaking to negotiate with the potential bidder, the clause will not be enforceable.24 Recall that an agreement to negotiate is void for uncertainty. For this reason, the exclusivity provision should be drafted as a negative undertaking by the target not to solicit offers from third parties during a specified period.

The exclusivity provision in the break fee clause will often specify an amount payable to the prospective acquirer by way of liquidated damages in the event that the undertaking is broken. Such a provision leads to the risk that it could be viewed as a penalty by the courts. Accordingly, the amount should be a genuine pre-estimate of the likely wasted costs that the prospective acquirer would incur as a result of the breach.

A prospective acquirer who wishes to avoid the risk of wasted costs may therefore approach the target with an attractive offer price and refuse to announce the offer until its due diligence is complete but also refuse to commence due diligence until a satisfactory break fee agreement is in place.

Payment Triggers

The trigger mechanism, which will depend on the strength of the negotiating position of the parties involved and the time when the break fee agreement is entered into, would usually include the failure of the target board to recommend the transaction to its shareholders (if a takeover bid is used)25 or to implement the transaction if a scheme of arrangement is used).26 The payment of the break fee could also be triggered if the offer lapses due to no fault on the part of the prospective acquirer or a third party transaction is successful27 or if the target company enters into an agreement to dispose of fixed assets worth a certain amount within a certain time.28 In drafting payment triggers, it is important to be aware of company law fiduciary principles that proscribe directorial fettering of discretion and the contract law doctrine on penalties. It is vital that the break fee arrangement does not infringe the company law rule in section 159 of the Companies and Allied Matters Act 1990 that prohibits unlawful financial assistance for the purchase of shares. The Court of Appeal in England has recently held in *Chaston v. SWP Group plc*29 that assistance which merely acted as an inducement to a share purchase transaction (such as a break fee arrangement) could breach the equivalent provision in the British Companies Act 1985.30 As a result of that case, it would seem that even if a proposed acquisition does not reach completion, payment of the break fee can constitute financial assistance. For this reason, it is advisable that the break fee arrangement is structured so as to avoid falling within the categories of unlawful financial assistance identified in section 159(1)31 of the Companies and Allied Matters Act, as it is conceivable – though not inevitable – that a Nigerian court may follow the *Chaston* decision. It remains to be said that where the source of

the break fee is the target's shareholders the question of unlawful financial assistance will not arise.

Mutual fees

This article has, in general, proceeded on the basis that the break fee is payable by the target to the prospective acquirer where the deal fails. Yet deal failure could arise because the prospective acquirer was the party that decided to walk away from the negotiating table. Since the target may have incurred its own professional fees in respect of the failed deal, there is no reason why the target should not want to protect itself from this risk by ensuring that the break fee agreement has a mutual effect. In a merger of equals, for instance, it is highly likely that both parties will insist on mutual break fee arrangements.

Conclusion

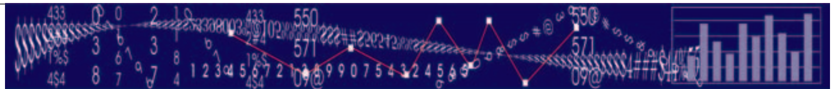
Though many courtships have been announced in the new regulation-created M&A space in the Nigerian banking sector, nearly as many have fizzled out, unsurprisingly because these courtships were mostly driven by regulatory pressure rather than by the identification of a strategic objective: they are akin to courtships involving putative lovers, without the spark of romance or (at least) a strategic objective, which seldom blossom into marriage. Substantial sunk costs have been incurred in these doomed courtships. If transactional lawyers are to add value to these deals, they ought to save their clients from the expense of these wasted costs. The break fee arrangement is one tool that they really should be using.

(* Dr. Tunde Ogowewo is a Barrister of the Middle Temple and member of the Nigerian Bar. Dr Ogowewo teaches M&A Law on the University of London's intercollegiate LLM programme at King's College London and does advisory work.)

Footnotes

1. Such as a scheme of arrangement.
2. If the transaction is structured as a takeover bid or reconstruction through a voluntary liquidation, the transaction may never reach the courts. A visit to the courthouse will be unavoidable, however, if the transaction is structured as a scheme of arrangement.
3. S.M. Bainbridge, Mergers and Acquisitions (Foundation Press: 2003), p.5.
4. Finance Act 1999, Schedule 13, paragraph 3.
5. For an example of a cancellation scheme, see Re BTR plc [2000] 1 BCLC 740. In that case, the judge described the scheme thus: "'The scheme, in the broadest terms, is designed to effect a merger between BTR and Siebe plc . . . The scheme provides for the cancellation of the scheme shares [this is done by a reduction in capital under s 135 of the Companies Act 1985], for the allotment to holders of scheme shares of new fully paid shares in Siebe on the basis of 0.533 of a new share for every one scheme share cancelled, and for the capitalisation of the reserve arising on the cancellation of the scheme shares in paying up new shares in BTR to be allotted credited as fully paid to Siebe or its nominees [the capitalisation occurs by transferring the amount standing in the reserve (created on the cancellation) to the company's share capital account – this is an accounting movement that has the effect of treating the new shares issued to offeror as paid for]". This can be contrasted with a transfer scheme – see Re Savoy Hotel [1981] Ch 351 for an example.
6. Note 3 above, at page 5.
7. Ibid.
8. Ibid.
9. [1992] AC 128.
10. See United Acquisition Corp. v. Banque Paribas, 631 F. Supp. 797 (S.D.N.Y. 1985).
11. [2005] All ER (D) 383.
12. Where the "subject to contract" formula is used in negotiations it creates a strong presumption that the parties did not intend to be bound. Only in "very strong and exceptional circumstances" will the courts displace the presumption. See Munton v. Greater London Council [1976] 2 All ER 815. The recent case, ProForce Recruit Ltd v. The Rugby Group Ltd [2005] EWHC 70, shows that the use of the formula "subject to contract" is not necessarily foolproof.
13. See GHI Ltd and anor v. ICTS (UK) Ltd [2000] All ER (D) 1111.
14. Note 3 above, at page 180ff. See also Gilson and Black, The Law and Finance of Corporate Acquisitions (Foundation Press: 1995), p.1020ff
15. Wippell and Knighton, "Inducement Fees: a US import takes root" (2004) 15 PLC (No.3) 31, 32
16. C. Pearson, "Break fees" PLC Practice Note.
17. Wippell and Knighton, at note 15, p.31.
18. Rule 21.2 of the Takeover Code implemented following the Takeover Panel's Statement of 1999/10 of July 16, 1999.
19. Note 15 above at p.34.
20. Ibid at p.36. The headline value of the deal was US$130 billion. So the break fee was 1.8% of the bid value.
21. Dunlop Pnematic Tyre Co. Ltd v. New Garage and Motor Co Ltd [1915] AC 79.
22. Saywell and Gamble, "The break fee: a useful negotiating tool" (1999) 10 PLC December 31, 36.
23. See text accompanying notes 29 and 31
24. Walford v. Miles [1992] 2 AC 128.
25. Part of trigger device in the bid by Venice Bidder for Pizza Express PLC (7 February 2003).
26. Part of trigger device in the bid by Silvestor UK Properties for Canary Wharf Group plc (5 December 2003).
27. Part of trigger device in the bid by Carnival Corporation for P&O Princess Cruises (8 January 2003).
28. Part of trigger device in the bid by Wm Morrison Supermarkets for Safeway (15 December 2003). Other trigger devices are that the shareholders of the target fail to pass the necessary resolutions required to effect the deal (such as the resolution necessary for a scheme of arrangement); or the board of the target negotiates with a third party in relation to an unsolicited offer.
29. [2003] 1 BCLC 675.
30. Section 151.
31. For instance, it is vital that the target does not give an indemnity to meet the prospective acquirer's costs. A fixed fee is therefore advised. Furthermore, a fee of more than 1% of the value of the offer might run the risk of it being viewed as resulting in a material reduction in the net assets of the target (a category of unlawful financial assistance in section 159(1)).

ZEQ DATABANK

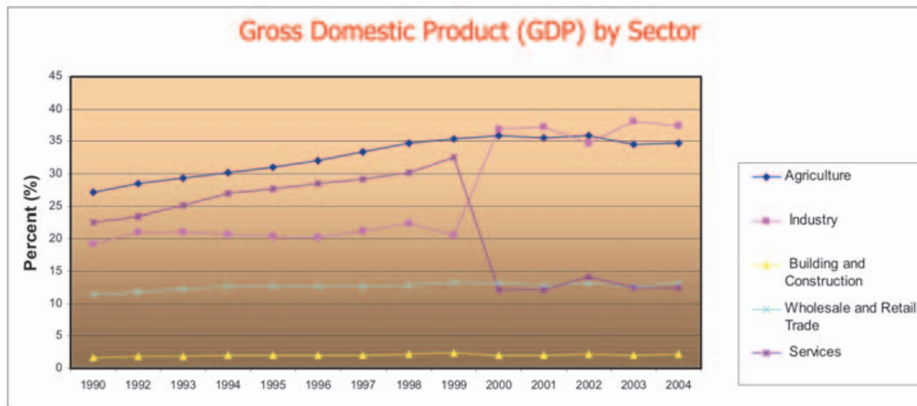


Macroeconomic Environment

Nigeria's business and economic environment though improving, remains a major source of concern to investors. Fortunately, the various sector reforms detailed in the NEEDS document have continued to receive attention and the expectation is that with time, these reforms would begin to reflect in improved trends in the significant macroeconomic indices.

Gross Domestic Product (GDP)

The NEEDS projected a GDP growth rate of 6% for 2005. From all indications this is quite realizable. Nigeria's GDP growth rate is expected, at year end, to have significantly benefited from the soaring crude oil prices. However Agriculture would remain a significant contributor to overall growth in GDP, especially as a good harvest is expected this year.

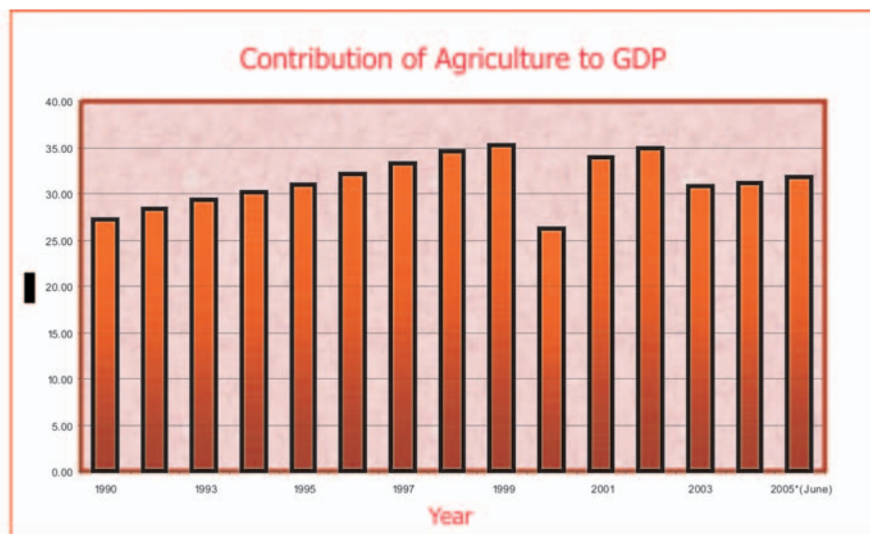


Source: CBN/NPC

In particular, expected good harvest in staple crops would significantly impact food price levels and ultimately lower inflation.

source: CBN/NPC/R&EIG

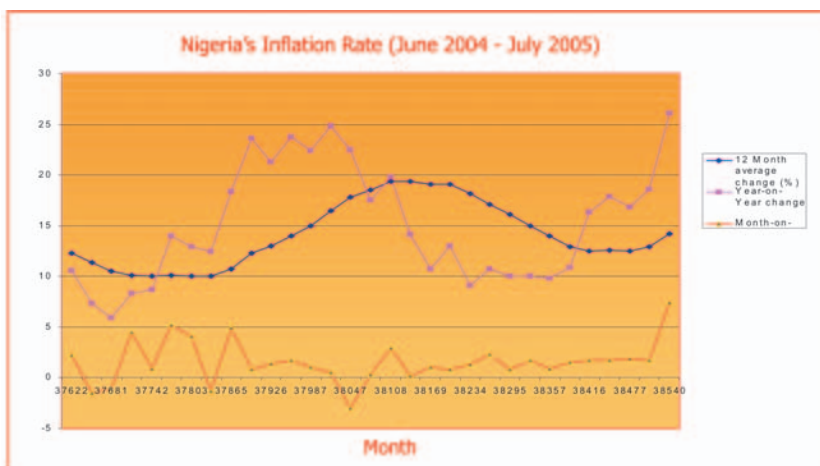
In the recent years agriculture has sustained a contribution rate of over 30%. It is likely to exceed 40%, end 2005.



source: CBN/NPC/R&EIG

Inflation Rate

Inflation, year on year, is projected to be as low as 9.5%, at year end (according to the NEEDS document). However recent developments in the economy suggest that this would be difficult to achieve. In view of the international crude oil market dynamics in recent times, the 30% increase in the pump price of petroleum products and the growing level of money in circulation (> N500.0bn), inflation rate is expected to remain higher than last year's figures by year end, except agricultural output more than compensates for this. Month on month average is estimated at 15.6% for the third quarter.

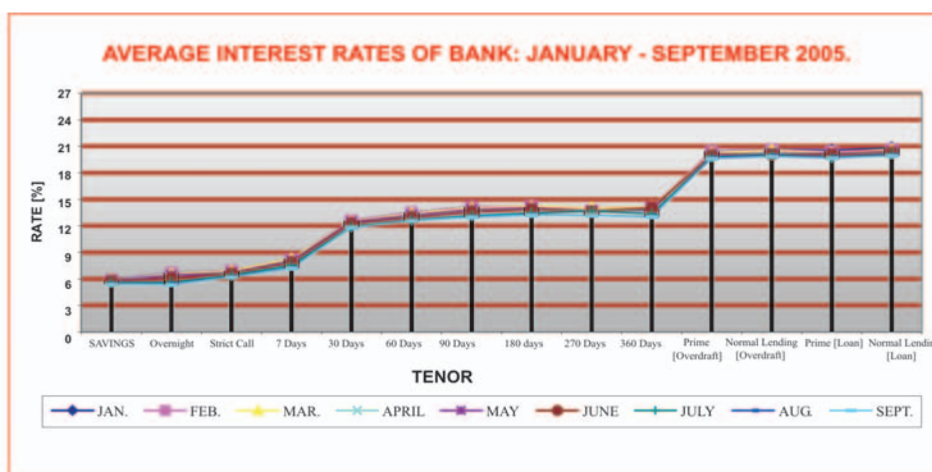


source: CBN/FOS/R&EIG

Interest rates

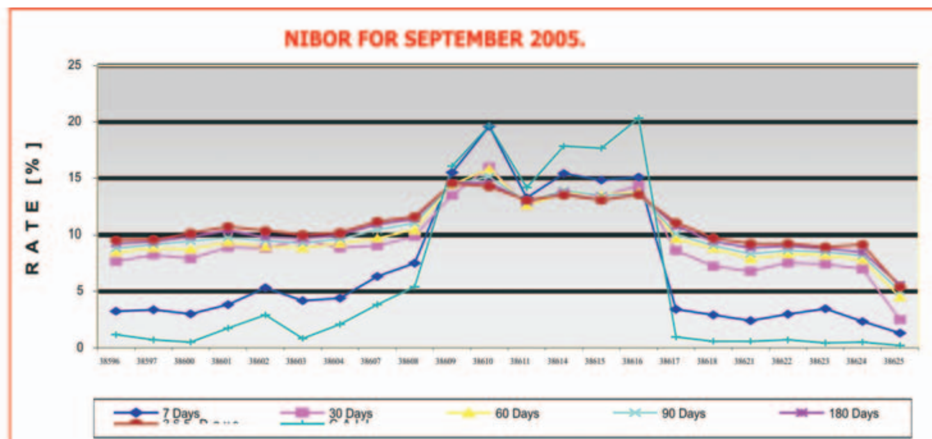
A typical pattern of interest rates began to emerge since the first quarter when the restructuring of government's debt instruments and the flurry of activities by Banks seeking to achieve the N25.0bn minimum recapitalization level combined with government's fiscal operations to 'force rates downward'.

The issuance of restructured debt instruments have since signalled the dawn of a new rates structure in the Nigerian money market and the various rates benchmarks have confirmed this new trend. However, in terms of lending rates the pattern has been a gradual rise from the beginning of the year except that the rise has been relatively low-to-stable (over various tenors) than it was last year. Average interest rates of Banks in the last quarter have remained relatively stable at about 18% – 21% per annum.

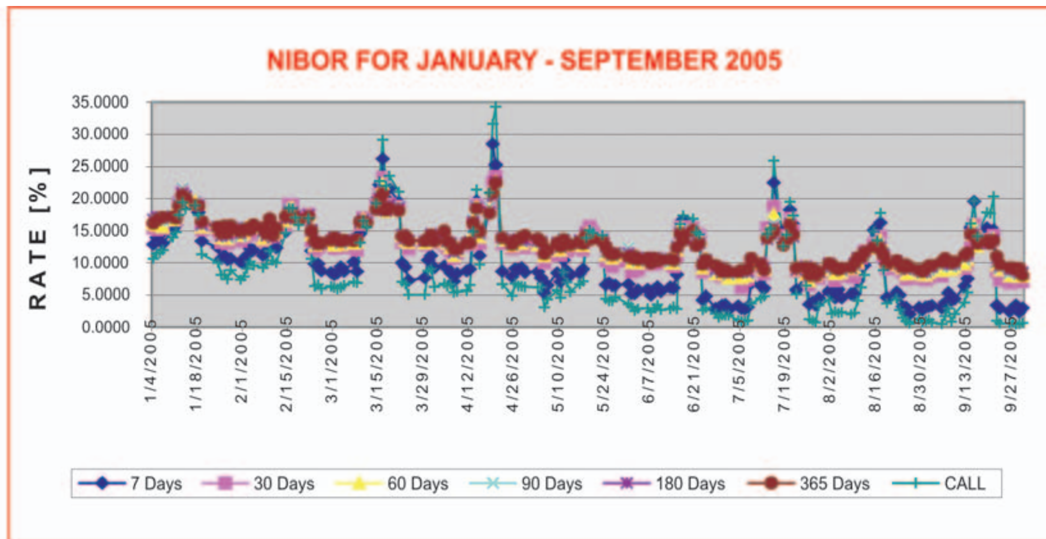


Source: R&EIG/Money Market

In terms of pricing of liabilities, the NIBOR benchmark showed a typical pattern all year to date. This is partly due to government's fiscal operations especially the usual release of statutory allocations at particular dates within each month as the NIBOR graph below shows. Clearly rates have been on the downward trend and are likely to remain so given the dearth of investment options and government's commitment to achieving a reduced interest rate regime.



Source: R&EIG/Money Market



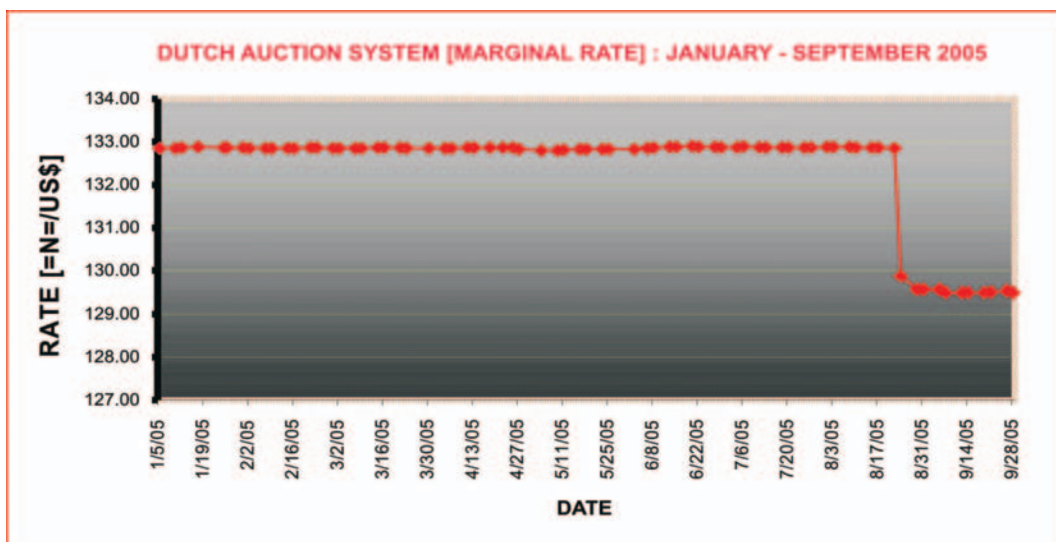
Source: Money Market

Foreign Exchange Market

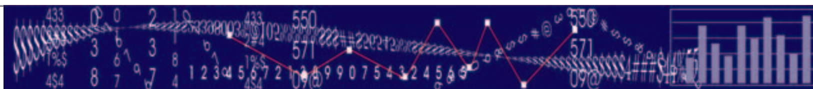
The foreign exchange market has witnessed significant policy shifts in the course of the year especially in the third quarter during which CBN specially intervened to sell huge volumes of US dollars to the real sector (there were three special offer sessions totaling about $1.0bn.

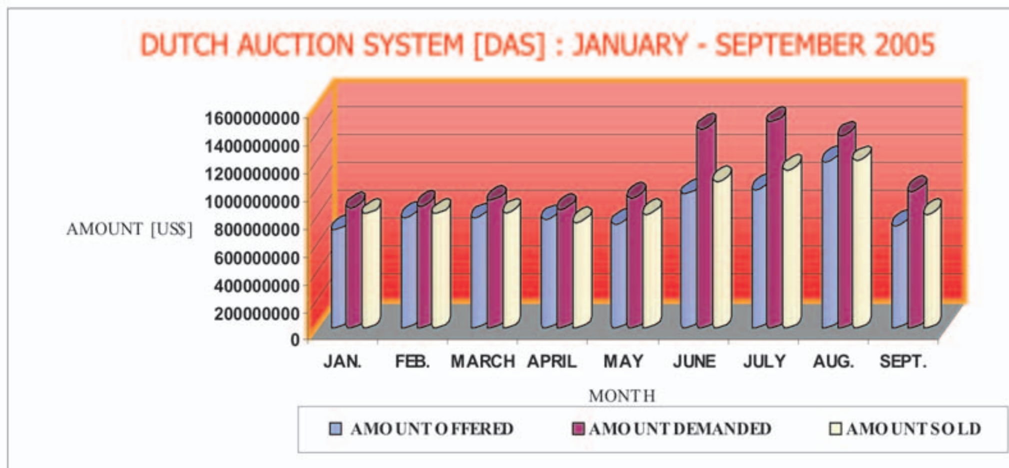
Increasingly, the number of banks participating in the DAS has continued to dwindle as the search for the recapitalization funds heightens. The DAS market has equally been very active with the CBN seeking to meet the demand for foreign exchange in an effort to achieve a stable exchange rate within the target +/- 3% margin set in the monetary policy circular No. 37, of 2005 and consistent with the NEEDS objective.

The exchange rate remained stable for the greater part of the year, appreciating in the third quarter. It is expected that the naira would finish the year stronger, gaining some 5%., over the US dollar.



Source: CBN





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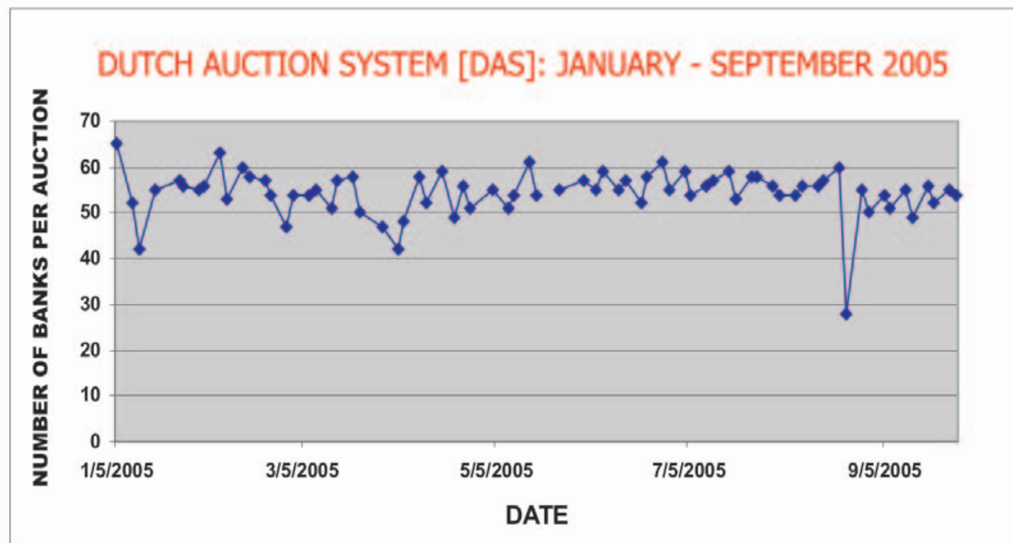
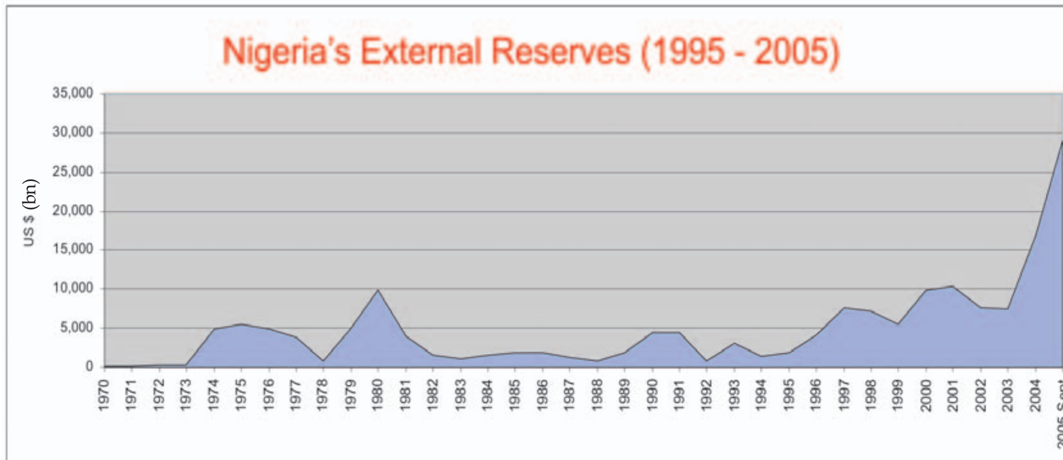


Source: CBN

External Reserves

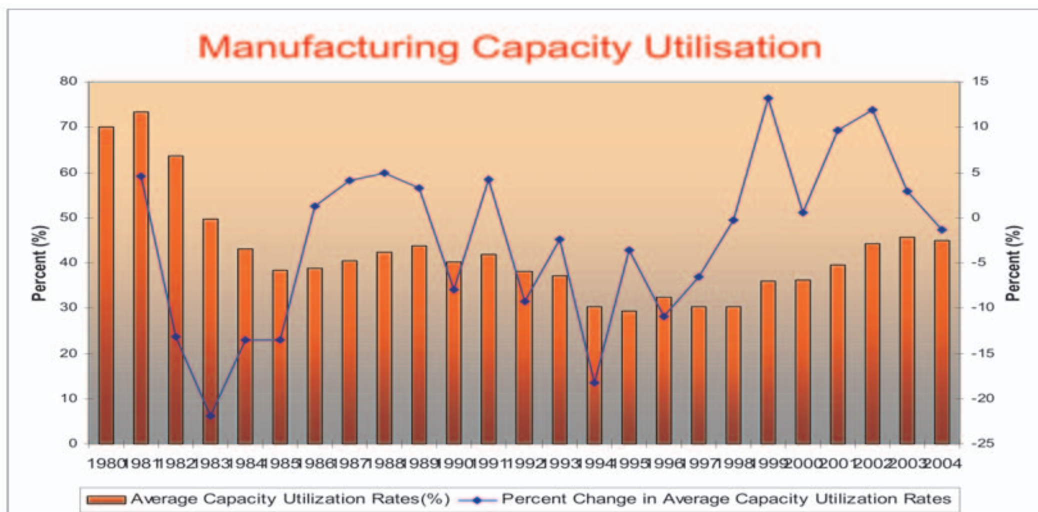
Nigeria's external reserves position has continued to improve since 1999. Recent developments in the crude oil market and improved fiscal operations have helped to grow the reserves from a $16bn mark in 2004 to above $29.0bn as at end of September, 2005. The prospect of implementing the Paris Club debt exit scheme is possible partly because of the improved external reserves position. Given the current trend in the crude oil market, external reserves, post Paris Club exit arrangement, is estimated to be above the $11.0bn mark.



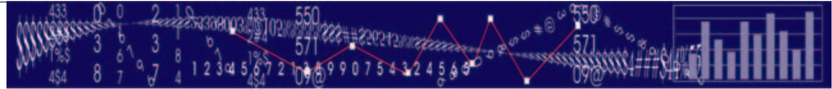
Source: CBN/R&EIG

Manufacturing Capacity Utilization

Nigerian firms remain largely uncompetitive due partly to the difficult operating environment caused mainly by the poor state of infrastructure. Available information shows that capacity utilization has remained above the 40% mark for the better part of the year. Third quarter 2005 estimates indicate a marginal improvement to 45%, up from 44.4% in first quarter. It is expected to improve significantly as the year comes to an end due to the stable foreign exchange market and the gradual improvement in the power sector, a major production constraint (Government has committed to spending some $2.5bn out of the huge external reserves to expanding power generation capacity).



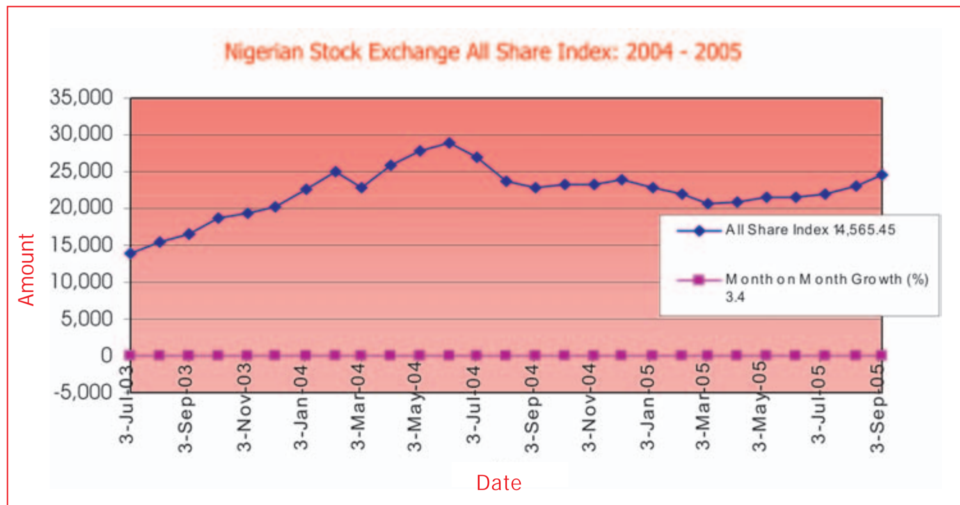
Source: CBN/R&EIG



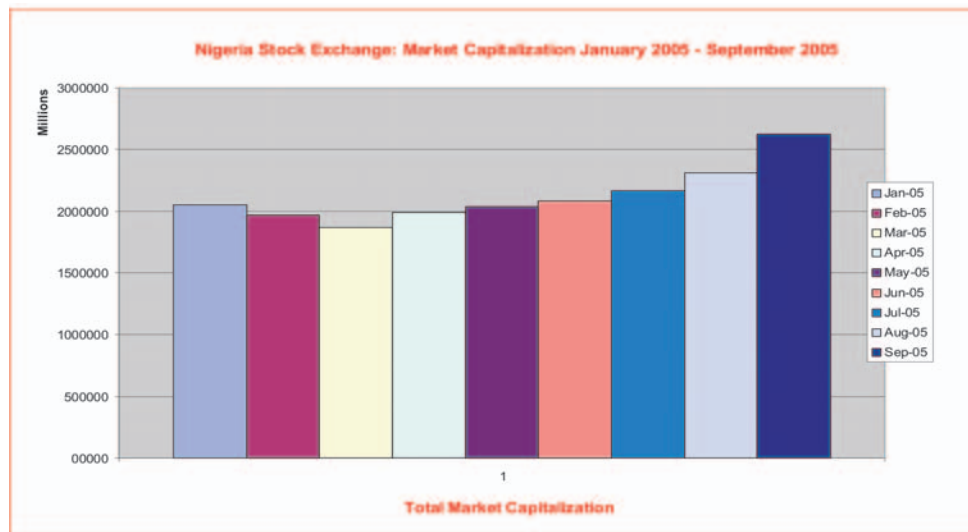
Capital Market

Capital market activities have remained significantly upbeat as Banks mainly begin to conclude their recapitalisation issues. The announcement by the SEC and the CBN that September 30, was the cut off date for raising funds from the stock market by banks, was followed by a Federal Ministry of Finance announcement that Insurance companies are required to recapitalize to the tune of N2.0bn, N3.0bn and N10.0bn respectively for life, non-life and reinsurance business by February, 2007.

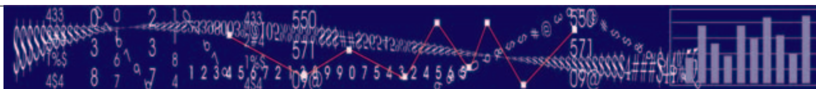
Unlike in 2004, the stock market expectedly had been busy all through 2005. It is however doubtful if the new recapitalization requirement in the insurance industry would lead to a similar flurry of activities from the last quarter, into 2006, given the fact that operators in the insurance industry (over 108 companies) are mostly small players who may not be able to meet the capital market terms and conditions for sourcing funds and the investor fatigue caused by the banking consolidation offerings. This remains to be seen especially as the major player NICON Insurance Plc would be privatized before the end of the year.



Source: NSE

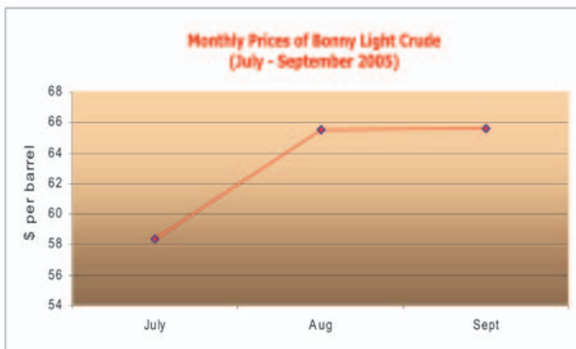


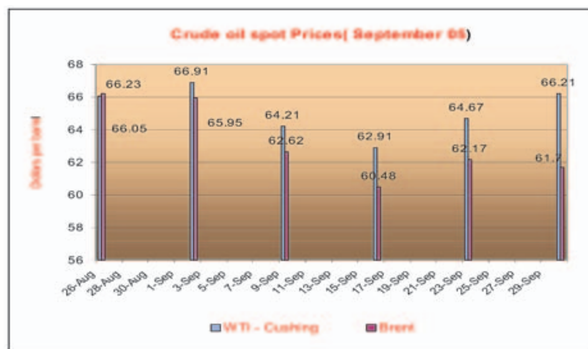
Source: NSE



Oil and Gas sector.

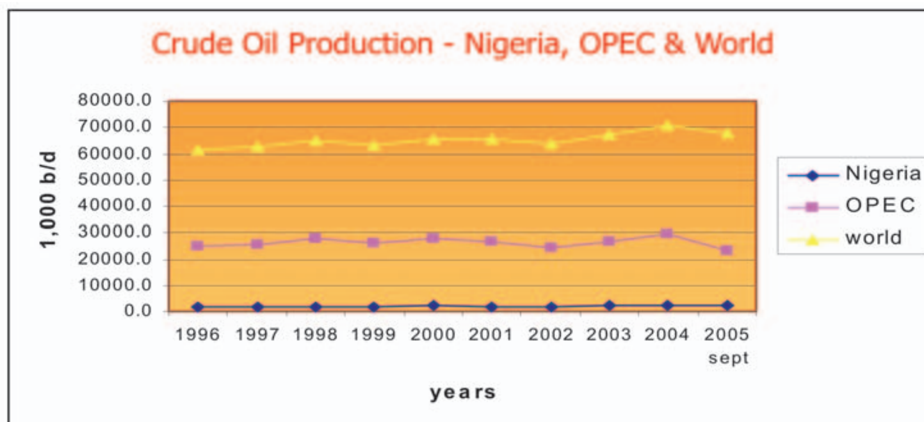
Nigeria's GDP growth in 2005 would be strongly influenced by the saoring price of crude oil which has remained significantly above the $63.50pb mark since the beginning of the third quarter of the year. The expectation is that the average price of Bonny Light, Nigeria's premium crude would be above the $58.0pb mark. - a significant level of $28.0 pb above the benchmark of $30.0 pb used in the 2005 Federal Government budget.





Source: NNPC/OPEC

In terms of production, Nigeria has managed to sustain production at the approved OPEC quota levels, due in part to the relative peace in the Nigeria Delta, in spite of recent political skirmishes. Nigeria's production in the quarter under review averaged about 2.45million b/d, over 80% was exported. This translates to higher crude oil revenues and accounts for the improved level of external reserves so far. Indeed at over an estimated $28.0bn, that is, over 16 times import cover, Nigeria's external reserves has grown remarkably and guarantees her ability to successfully conclude the Paris Club debt exit scheme. It is expected that the external reserves would be above the $11.0bn mark at year end.



Source: NNPC/OPEC