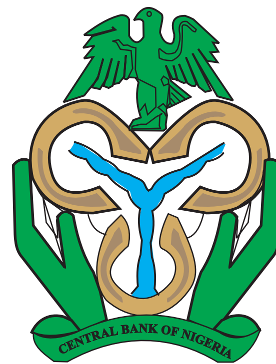
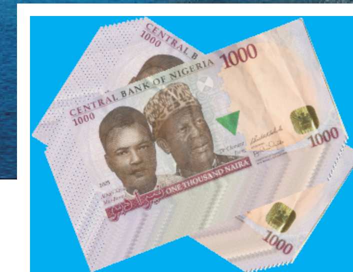


BULLION

PUBLICATION OF THE CENTRAL BANK OF NIGERIA

Volume 31, No. 2 July - September, 2007



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BULLION ISSN - 0331 - 7919

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CORPORATE GOVERNANCE IN NIGERIA: AN OVERVIEW

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1.0 INTRODUCTION

It is incontrovertible that corporate governance is one of the most critical issues in the business world today. There was a time when this topic would not have elicited much attention. But, with episodic failures of Johnson Matheys Bank (JMB), Bank of Credit and Commerce International (BCCI), Baring Brothers, Nomura Securities, Brex and Long-term Capital Management (LTCM) of the 80s' and 90s' and the more recent Enron and World Com debacles, corporate governance has taken a central stage in business discuss and any intellectual gathering on business management.

The rise in interest in the subject of corporate governance could be traced to the fact that there is now an increasingly clear separation of ownership from management, which has come to define modern corporations. This disconnection of ownership from management and the insulation of the owners from the day-to-day operations of the business have raised the need to install an appropriate framework for ensuring transparency and accountability in the management of the business venture.

Secondly the current wave of globalisation, which is blowing across the universe and the recent advances in information and telecommunication technologies have greatly facilitated business transactions across national boundaries. These developments, which have widened the geographical frontier of the market, have necessitated the development of international standards on best practices in the management of business for the benefit of all stakeholders. The existence of such standards would give comfort to investors, creditors and regulatory agencies on the conduct of corporations, their country of origin not withstanding.

The recent business failures cited above, demonstrate what happens when corporate governance fails. These failures also raise some fundamental questions, such as, the dependability of financial information, audit independence, the role of regulators, company management, the role of the board of directors, conflict of interest and, of course, the whole question of ethics and professionalism.

This paper seeks to address in the next sections, the definition of corporate governance and the salient principles of corporate governance. Thereafter, the challenges of corporate governance in Nigeria would be discussed. Finally it provides policy options needed to improve the level of corporate governance in Nigeria.

2.0 WHAT IS CORPORATE GOVERNANCE?

Governance could be conceptualised as the manner in which power is exercised in the management of economic and social resources for sustainable human development. It addresses the leadership role in the institutional framework.

According to Kwakwa and Nzekwu (2003), governance is a 'vital ingredient in the maintenance of the dynamic balance between the need for order and equality in society; promoting the efficient production and delivery of goods and services; ensuring accountability in the house of power and the protection of human rights and freedoms".

Governance is, therefore, concerned with the processes, systems, practices and procedures that govern institutions, the manner in which these rules and regulations are applied and followed, the relationships created by these rules and nature of the relationships.

Corporate governance, on the other hand, refers to the manner in which the power of a corporation is exercised in accounting for corporation's total portfolio of assets and resources with the objective of maintaining and increasing shareholder value and the satisfaction of other stakeholders while attaining the corporate mission (Kwakwa and Nzekwu, 2003).

In other words, corporate governance refers to the establishment of an appropriate legal, economic and institutional environment that allows companies to thrive as institutions for advancing long-term shareholders' value and maximum human centered development. The corporation has to achieve this while remaining conscious of its responsibilities to other stakeholders, the environment and the society at large.

Thus, corporate governance is also concerned with the creation of a balance between economic and social goals and between individual and communal goals. To achieve this, there is the need to encourage efficient use of resources, accountability in the use of power, and, the alignment of the interest of the various stakeholders, such as, individuals, corporations and the society.

David Smith (2002), President and CEO of the Canadian Institute of Chartered Accountants sees corporate governance as a "Culture that has a common understanding of the roles of management and the board" To him, "corporate governance is a culture of mutual respect that both parties have for each other's role". It is a culture of continuous open dialogue and communication. In rounding up his views on corporate governance, Smith noted that it is about people. "People doing not just what the rules say but about doing what is right".

Corporate governance is now widely accepted as being concerned with improved stakeholder performance. Viewed from this perspective, corporate governance is all about accountability, boards, disclosure, investor involvement and related issues. Research has shown that "firms with stronger shareholder rights had higher firm value, higher profits, higher sales growth, lower capital expenditure and fewer corporate acquisition" (McRitchie, 2001).

From the foregoing, it is apparent that no matter the angle from which corporate governance is viewed, there is always a common consensus that corporate governance is concerned with improving stakeholder value, and that governance and management should be mutually reinforcing in working towards the realization of that objective.

3.0 PRINCIPLES AND PILLARS OF CORPORATE GOVERNANCE

3.1 Principles of Corporate Governance

The Organisation for Economic Cooperation and Development (OECD) put forward a set of international principles of corporate governance. These principles were developed both in response to growing recognition of the importance of governance to enterprise performance and to the spate of recent corporate failures in Asia, America and other parts of the world.

The OECD principles are organized under five headings, namely:

- The rights of shareholders
- The equitable treatment of shareholders
- The role of stakeholders
- Disclosure and transparency; and
- The responsibilities of the board

We shall now expatiate on these principles hereunder:

3.1.1 The Rights of Shareholders

This principle deals with the rights of shareholders. It concerns the protection of shareholders' rights and the ability of shareholders to influence the behaviour of the corporation. The basic shareholders' rights include the right to:

- Secure methods of ownership registration;

- Convey or transfer share;
- Obtain relevant information on the corporation on a timely and regular basis;
- Participate and vote in general shareholder meetings;
- Elect members of the board; and
- Share in the profits of the corporation

Fredrick (1999) noted that while these rights are important to good corporate governance, it must be noted that extensive rights in and of themselves are not equivalent to good governance.

3.1.2 **Equitable Treatment of Shareholders**

This principle emphasizes that all shareholders, including foreign shareholders, should be treated fairly by controlling shareholders, boards and management. This principle calls for transparency with respect to the distribution of voting rights and the ways in which voting rights are exercised. The high points of the principle include:

- All shareholders of the same class should be treated equally.
- Insider trading and abusive self-dealing should be prohibited
- Members of the board and management should be required to disclose any materials interests in transactions or matters affecting the corporation.

3.1.3 **The Role of Stakeholders**

A good corporate governance framework should recognize the rights stakeholders has, as established by law. Such a framework should encourage active cooperation between corporations and stakeholders in creating wealth, jobs, and the sustainability of a sound enterprise. To achieve this, corporate governance should ensure that:

- The rights of stakeholders are protected by law
- The rights of the shareholders are respected;
- Stakeholders have the opportunity to redress any violation of their rights;
- Permit performance-enhancing mechanism for stakeholder participation
- Provides stakeholders with access to relevant information to enable them participate actively in the governance process

3.1.4 **Disclosure and Transparency**

This principle supports the development of high internationally recognized accounting standards. It stipulates that all the material matters regarding the governance and performance of the corporation be disclosed. It also underscores the importance of applying high quality standards of accounting, disclosure and auditing.

Disclosure should include, but not limited to, material information on:

- The financial and operating results of the company;
- Company objectives; · Major share ownership and voting rights;
- Members of the board and key executives and their remuneration; and
- Governance structure and policies Information should be prepared, audited and disclosed in accordance with high quality standards, while the channels for disseminating information should be fair, timely and cost-effective.

3.1.5 **The Responsibilities of the Board**

The traditional view of directors is that they serve primarily to monitor management. However, there is an emerging school of thought that directors can and should add value to the enterprise (Fredrick, 1999). The principle, which reflects the value-added approach, suggests that directors are responsible for the strategic guidance of the enterprise in addition to monitoring management.

Thus, the board has a definite function to perform to ensure the strategic guidance of the company, the effective monitoring of management by the board, and the board's accountability to the corporation and shareholders.

In doing this, board members should:

- Ensure the independence of the board;
- Act on a fully informed basis and in good faith, with due diligence and care, and in the best interest of all stakeholders;
- Treat all shareholders fairly, particularly in decisions that affect different shareholder groups; and
- Ensure compliance with applicable laws

3.2 **Pillars of Corporate Governance**

In all fields of human endeavour, good corporate governance is founded upon the attitudes and practices of the society. According to Kwakwa and Nzekwe (2003), these values centre on the:

- Accountability of power, based on the fundamental belief that power should be exercised to promote human well-being;
- Democratic values, which relate to the sharing of power, representation and participation;
- The sense of right and wrong;
- Efficient and effective use of resources;
- Protection of human rights and freedoms, and the maintenance of law and order and security of life and property;
- Recognition of the government as the only entity that can use force to maintain public order and national security; and
- Attitude towards the generation and accumulation of wealth by hardwork

The above attributes have been reduced to four pillars on which governance is framed. These pillars encompass;

- Effective body responsible for governance, separate and independent of management
- An approach to governance that recognizes and protects the rights of members and all stakeholders ·
- Institutions to be governed and managed in accordance with its mandate; and
- An enabling environment within which the institutions' human resources could contribute and bring to bear their full creative powers

The principles and pillars of corporate governance discussed above underscores the importance of the internal auditor. The principle of "Disclosure and Transparency" has direct bearing on the functions of the internal auditor. In the course of performing his or her duties, the internal auditor faces a number of challenges. These challenges are discussed below.

4.0 **CHALLENGES OF CORPORATE GOVERNANCE IN NIGERIA**

4.1 **Establishing the Codes**

There is a popular saying that where there is no law, there is no offence. For most institutions and professional bodies in Nigeria, it is either that there is no code of conduct or the codes are not being followed. Therefore, the first challenge in ensuring good corporate governance must start from taking appropriate steps to ensure that a code that will guide stakeholders is put in place.

4.2 **The Challenge of Enlightenment**

There is the need for mass enlightenment on corporate governance. In this part of the world, corporate governance is relatively a new concept and even some company directors are not fully aware of the onerous responsibilities of a director. Under the principles of corporate governance, we say that the rights of the shareholders must be protected. But the issue is how many shareholders know their rights?

In a situation where the shareholders and other stakeholders do no know their rights, how can they know when there is infringement on those rights? From the foregoing, the need for appropriate enlightenment of all stakeholders on corporate governance cannot be overemphasized.

4.3 **Emplacement of an Appropriate Institutional Framework**

One of the major challenges of corporate governance is the emplacement of an appropriate institutional framework for the realization of the objectives of good corporate governance.

In most corporations and business groups, there is no clearly defined institutional channel through which any party that is aggrieved could seek redress. It is common knowledge that those who have suffered one form of infringement or the other on their corporate governance rights do not want to go to court. And in the absence of any institutional arrangement to look into their case, the

affected parties either live with it or suffer deprivation in silence.

A good example of the need for an institutional framework to consider cases of infringement from both the corporate bodies and stakeholders, is the recently established Committee on Ethics and Professionalism of the Bankers Committee. Since the inception of that committee in 2001, a number of people who have grouses with some banks have presented their cases to the committee. Some of those cases have been disposed off by the committee, with the banks having to refund some money to the aggrieved parties.

In addition to installing an institutional framework, there is also the need to put in place a mechanism for the enforcement of the decision of the institutions. Where punishments are meted out by the institution, it has to be enforced. If such punishments or rewards cannot be enforced, it will not serve the desired purpose.

The issue of education comes to play here. The curriculum of our educational system needs to be modified to accommodate such topics as the rights of shareholders, corporate governance and related issues. If people are educated on the principles of corporate governance, it becomes easy for them to know when and where their right are infringed upon.

4.4 **Value and Orientation**

Corporate governance remains an ever-present challenge for emerging market countries, such as Nigeria. In these countries, businesses and regulators often contend with corruption and lack of transparency. This is sequel to the misplaced value system of our people, which encourages corruption. Corporate governance is all about transparency and accountability. A situation where the value system of the people is such that ill-gotten wealth is not questioned, corporate governance is threatened. For instance, a person who is made a Minister or Commissioner begins to receive congratulatory messages immediately from people who are anticipating one form of favour or the other from him or her.

Today, many companies still see the current drive for the enthronement of good corporate governance as a burden imposed on them by the regulatory authorities. There is a need for corporations to view good corporate governance as an issue of their enlightened self interest.

4.5 **Poverty Trap**

The prevailing vicious circle of poverty militates against the attainment of good corporate governance. Accountability and transparency cannot be easily realized where majority of the masses are wallowing in abject poverty. Such a high level of poverty makes people to compromise their moral values and do many things that are unethical and unprofessional.

4.6 **The Inefficiencies of Our Governance Bureaucracy**

The inefficiency of the government bureaucratic process is obviously a course for concern in the enthronement of good corporate governance in the country. A situation where the tax agencies, the Inland Revenue Office and related institutions encourage corporate bodies to engage in corruption is, to say the least, deplorable and must not be allowed to continue.

A corporate body may have a good intention to pay the correct value of tax or land rate and the agencies involved exaggerate figures and even discourage the corporate body from paying to government. Such a practice, which is rampant, is a big challenge to the attainment of transparency and accountability within the ambit of good corporate governance.

5.0 POLICY IMPLICATIONS AND RECOMMENDATIONS

The issue of corporate governance is an important one as it affects the rate of growth and the level of development in an economy. If good corporate governance is put in most of our corporations, the level of unemployment will be reduced, while productivity will increase. But for all these to be realized, the challenges discussed in section 4 have to be surmounted.

In order to attain good corporate governance in our environment, the following policy options are put forward:

- Each organisation and professional body should establish its code of conduct against which any infringement could be assessed.
- There is the need for each organization to pay attention to the enlightenment of its stakeholders. Staff and board members should be sent on training periodically to enhance the level of awareness on corporate governance.
- Every institution and professional body should install an institutional framework for the trial of those that have contravened the corporate governance rules. In addition, an apparatus for the enforcement of sanctions should be put in place to implement the verdict of the institutional apparatus mentioned above.
- The value system of our society should be re-examined. There is urgent need to intensify the campaign for ethical re-orientation in the entire country.
- Poverty we all know is a disease. The level of poverty in the country, exacerbated by high level of unemployment and underemployment calls for urgent attention. The poverty alleviation programme of the government needs to be reappraised to determine its effectiveness.
- There is an urgent need for a total war on corruption in the country. Though there seems to be some improvements in recent times, the rating of Nigeria on corruption is still very low. Conscious effort should, therefore, be made to remedy the situation. In this regard, the work of the EFCC and the ICPC should be supported by all.

6.0 **CONCLUSION**

The issue of corporate governance has come to stay as a veritable concept needed to achieve efficiency, increased productivity and growth in the economy. The key to wealth creation and the maintenance of a free society require that a broad based system of accountability be built into the corporate governance structure of corporations.

For Nigeria to achieve its aspiration of being one of the leading twenty nations of the world by the year 2020, a lot needs to be done to promote good corporate governance at

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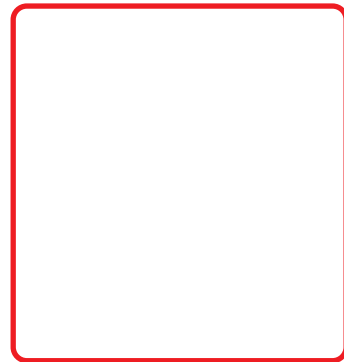
ISSUES IN CORPORATE GOVERNANCE IN THE BANKING SECTOR



BY

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I. INTRODUCTION

What is corporate Governance? Before I go into the meaning and definitions proffered by different people/organizations, I want us to ponder on the following remarks by Daniel Henninger The Wall Street Journal.

"When a company called Enron... ascends to the number seven spot on the Fortune 500 and then collapses in weeks into a smoking ruin, its stock worth pennies, its CEO, a confidante of presidents, more or less evaporated, there must be lessons in there somewhere."

The concern with good Corporate Governance emanated from the ripples and the challenges of the scandals associated with the collapse of ENRON Corporation, WorldCom, TYCO, Global Crossing & ADELPHIA in the USA and the recent accounting disclosures in Lever Brothers Nig (now Unilever) and Cadbury Nig Plc. The scandals revealed huge accounting fraud and corporate abuses.

Good Corporate Governance in the banking sector is vital because many banks are now global in terms of size of shareholders' funds, foreign investment inflow and lending activities. Good corporate governance is also in line with global best practices.

II. WHAT IS CORPORATE GOVERNANCE?

It is an internal system encompassing policies, processes and people, which serves the needs of shareholders and other stakeholders, by directing and controlling management

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activities with good business savvy, objectivity and integrity. Sound corporate governance is dependent on external market place commitment and legislation plus a healthy board culture that safeguards policies and processes. (Definition of Gabrielle O' Donovan).

Corporate governance refers to the processes by which all companies are directed and controlled. Corporate governance is also a system of structuring, operating and controlling a company, be it bank or non-bank, with a view towards attaining long term strategic goals to maximize shareholders wealth and satisfy other stakeholders (employees, depositors, suppliers other customers, and other stakeholders).

CORPORATE GOVERNANCE (ACCORDING TO THE Cadbury COMMITTEE OF UK) "IS A SET OF RULES THAT DEFINE THE RELATIONSHIP BETWEEN SHAREHOLDERS, MANAGERS, CREDITORS, THE GOVERNMENT, EMPLOYEES AND OTHER INTERNAL AND EXTERNAL STAKEHOLDERS IN RESPECT TO THEIR RIGHTS AND RESPONSIBILITIES, OR THE SYSTEM BY WHICH COMPANIES ARE DIRECTED AND CONTROLLED"

The objective of corporate Governance is;

- TO CREATE ADDED VALUE TO THE STAKEHOLDERS

OTHER DEFINITIONS OF CG.

- **WORLD BANK**

CG IS ABOUT PROMOTING CORPORATE FAIRNESS, TRANSPARENCY AND ACCOUNTABILITY (J.WOLFENSOHN, PRESIDENT OF WORLD BANK- FINANCIAL TIMES, JUNE 21, 1999).

· OECD

Corporate governance is the system by which business corporations are directed and controlled. The corporate governance structure specifies the distribution of rights and responsibilities among different participants in the corporation such as the board managers, shareholders and other stakeholders, and spells out the rules and procedures for making decisions on corporate affairs. By doing this, it also provides the structure through which the company objectives are set, and the means of attaining those objectives and monitoring performance.

III. PRINCIPLES OF CORPORATE GOVERNANCE

Key Elements
HONESTY
* TRUST
* TRANSPARENCY
* PERFORMANCE ORIENTATION
* INTEGRITY
* RESPONSIBILITY
* ACCOUNTABILITY
* MUTUAL RESPECT
* COMMITMENT TO THE ORGANIZATION

Commonly accepted principles of corporate governance include:

- Role and responsibilities of the board: The board needs a range of skills and understanding to be able to deal with various business issues and have the ability to review and challenge management performance.
- Disclosure and transparency: Organizations should clarify and make publicly known the roles and responsibilities of board and management to provide shareholders with a level of accountability.
- Right and equitable treatment of shareholders: Organizations should respect the rights of shareholders and help shareholders to exercise those rights.
- Integrity and ethical behaviour: Organizations should develop a code of conduct for their directors and executives that promotes ethical and responsible decision making.
- Interests of other stakeholders: Organizations should recognize that they have legal and other obligations to all legitimate stakeholders. They should fulfill such obligations particularly their civic duties.

IV. THE REGULATORY INFRASTRUCTURE FOR NIGERIAN BANKS

1. THE LEGAL FRAMEWORK

- The Central Bank of Nigeria Act 2007.
- Banks and other Financial Institutions Act, 1991 (As amended) [BOFIA].
- The Nigeria Deposit Insurance Corporation (NDIC) Act, 2006.
- The Companies and Allied Matters Act 1990 (CAMA).
- The Money Laundering Prohibition Act 2004.
- The Economic and Financial Crimes Commissions Act 2004 (EFCC).

2. THE INSTITUTIONS

- The Central Bank of Nigeria (CBN) is the apex regulatory body for the financial system, charged primarily with promoting sound monetary policy. Its primary duty necessitates that among other things, it takes charge of the oversight of the banks.
- The Securities and

Exchange Commission (SEC) provides oversight for the capital market.

- The Nigeria Deposit Insurance Corporation (NDIC) provides deposit insurance for bank deposits and also supervises the banks.
- The Nigerian Stock Exchange (NSE) oversees companies listed on the stock exchange (many banks included).
- The Economic and Financial Crimes Commission (EFCC). Its advent has helped to deal with the incidence of “419” and recalcitrant debtors of banks who have played a major role in the size of “non-performing” loans of banks.
- SROs Self Regulatory Organizations e.g. The Chartered Institute of Bankers of Nigeria (CIBN), the Institute of Chartered Accountants of Nigeria (ICAN), etc. These help to induce good corporate behaviour among their members and place sanctions on erring members.

3. THE FINANCIAL SYSTEM (2006)

- THE CBN
- THE NDIC
- THE SEC
- THE NSE
- Commodity Exchange (1)
- NAICOM (National Insurance Commission)
- NPC (National Pensions Commission)
- 25 BANKS
- 5 Discount Houses
- 750 Community Banks
- 7 MFBs (Micro Finance Banks)
- 112 Finance Companies
- 352 Bureaux De-Change
- 91 PMIs (Primary Mortgage Institutions)
- 5 Development Finance Institutions (DFIs)
- 103 Insurance Companies
- 581 Stock Brokers.

4. GOOD GOVERNANCE: THE APPLICABLE RULES/REGULATIONS

i. **BOFIA**

- A bank shall not without the prior approval of the CBN permit to be outstanding, unsecured advances, loans or credits of an aggregate amount in excess of N50,000.
- No person who has been a director of or directly concerned with the management of a bank which has been wound up by the Federal High Court shall without the express approval of the Governor of the Central Bank act or continue to act as a director or be directly concerned in the management of any bank.

ii. THE BASEL COMMITTEE RECOMMENDATIONS (2006)

- Board members should be qualified for their positions, have a clear understanding of their role in corporate governance and be able to exercise sound judgment about the affairs of the bank.
- The board of directors should approve and oversee the bank's strategic objectives and corporate values that are communicated throughout the banking organization.
- The board of directors should set and enforce clear lines of responsibility and accountability throughout the organization.
- The board and senior management should effectively utilize the work conducted by the internal audit function, external auditors and internal control functions.
- The board should ensure that there is appropriate oversight by senior management, consistent with board policy.
- The board should ensure that compensation policies and practices are consistent with the bank's corporate culture, long term objectives and strategy.
- The board and senior management should understand the bank's operational structure.
- The bank should be governed in a transparent manner.

Iii. C.G AND THE CBN

- Prospective board members should have first degrees or their equivalents with appreciable experience/exposure. Candidates with lower qualifications but with experience may also be considered.
- Mandatory completion of CBN's code of conduct forms, once the appointments have been approved.
- Directors or significant shareholders should not borrow more than 10% of the a bank's paid up capital without the prior approval of the CBN. The Maximum credit to all insiders should not exceed 60% of a bank's paid up capital.
- Chairmen of banks are prohibited from serving simultaneously as chairmen or members of board committees.
- No person is allowed to hold directorship in more than two banks.
- Disclosure of all insider-related party transactions of banks in their financial statements.

THE NEW CODE

- Apart from the foregoing, the CBN new code, is aimed at assisting boards of banks manage the challenges of balancing the conflicting interests of different stakeholders. Provisions of the new code that pertain to directors include:-
- The responsibilities of the Chairman of the board should be clearly separated from that of the MD/CEO. No one person should combine the post of Chairman with that of the Chief Executive Officer of any bank.
- No two members of the same extended family should occupy the position of Chairman and that of Chief Executive Officer or Executive Director of a bank at the same time.
- · There should be, as a minimum, the following board committees in a bank: Risk Management, Audit Committee, and Credit Committee.
- · The number of non-executive directors should be more than that of executive directors subject to a maximum board size of 20 directors.
- At least two non executive directors should be “independent directors”.
- A committee of non-executive directors should determine the remuneration of executive directors.
- Non-executive director's remuneration should be limited to sitting allowances and reimbursable travel and hotel expenses.
- Non executive directors should not remain on the board of a bank continuously for more than 3 terms of 4 years each i.e 12 years.
- Regular training and education of board members is important.
- There should be annual Board and Directors' review/appraisal by an outside Consultant. The review report is to be presented at the bank's AGM.
- Any director whose facility or that of his/her related interest remains non-performing for more than one year should cease to be on the board of the bank and could be blacklisted from sitting on the board of any other bank.
- The practice of anticipatory approvals by the Board Committees should be limited strictly to emergency cases only and ratified within one month at the next committee meeting.
- The Board Credit Committee should have neither the chairman of the Board nor the MD as its chairman.
- All insider credit applications pertaining to directors and top management staff (AGM and above) and parties related to them, irrespective of size should be sent for consideration/ approval to the Board Credit Committee

(BCC).

- Where directors and companies/entities/persons related to them are engaged as service providers or suppliers to banks, full disclosure of such interest should be made to the CBN.

- The Board Credit Committee should be composed of members knowledgeable in credit analysis.

5. **THE BANKING ENVIRONMENT**

(i) **CORPORATE GOVERNANCE: COMPLIANCE BY BANKS IN YEAR 2006**

- MOST BANKS COMPLIED WITH THE PROVISIONS OF CG.

- SOUNDNESS IN THE BANKING SECTOR (2006)
  - 10 Banks rated sound
  - 12 Banks rated satisfactory
  - 3 Banks rated marginal
  - No Bank was rated unsound (CAMEL RATING USED)

- Non Performing Loans in the banking industry averaged 8.7% (compared with 19.3% end December 2005 before the consolidation exercise).

(ii) **COMPLAINTS / PROBLEMS / ISSUES**

- Complaints by customers of banks on excess charges etc were dealt with. Also, the ethics and professionalism sub-committee of CIBN handled some complaints.

- Fraud / forgery
- Reported cases: 1193 cases in 2006 (involving N4.6 billion, US & 1.8M and £14,399). Lower in 2006 compared with 2005. 612 cases were successfully executed and actual losses to the banks totalled N2.6 billion, U$ 1.3M and £14,399.

(iii) **ARMED ROBBERY AND COSTS**

- The incidence of armed robbery of banks' money is on the increase.
- Banks have had to spend more money to make robbery attacks difficult and unsuccessful.

(iv) **DUBIOUS PRACTICES BY BORROWERS**

- Cloning of Certificates of Occupancy (with collusion of officials of state governments).
- Taking banks to courts as delay tactis, rather than paying up debts.
- Problems with collateral in some villages
- No one wants to buy his neighbour's house.
- Attitudinal Problems (The banks are rich)
- Loan diversion.

(v) ENVIRONMENT FACTORS

- High cost of doing business in Nigeria
- Frequent changes in government policies.

V. BENEFITS OF GOOD CORPORATE GOVERNANCE

- EASE OF RAISING CAPITAL.
- LOWER COST OF CAPITAL.
- IMPROVED BUSINESS PERFORMANCE.
- GOOD IMPACT ON SHARE PRICES OF CORPORATIONS.
- ACTIVE MONEY AND CAPITAL MARKETS.
- VALUE ADDED FOR STAKEHOLDERS.

VI. **ISSUES IN CORPORATE GOVERNANCE**

1. RISK APPETITE AND RISK MANAGEMENT

RISK APPETITE

- A BANK MUST CONVEY TO ITS MANAGEMENT STAFF ITS RISK APPETITE AND THE “NO GO” AREAS. THIS WOULD BE SPECIFIED IN ITS STRATEGIC PLAN, NOTING THE RISK RETURN PROFILE/TRADE-OFFS.

RISK MANAGEMENT

Strategic Risks
- Policy development
- Corporate Culture
- Organizational Structure
- Competition Risk
- Product Risk
  Unclear and/or unviable and/or badly implemented strategic plan.

Market ------
- Interest rate risk
- Liquidity Risk
- Investment Risk
- Foreign Exchange Rate

Credit -----
- Loan Monitoring
- Faulty Credit analysis
- Dubious Customers
- Loan Concentration
- Poor Skills

Operational -----
- People Risks — Ethics, Recruitment (Poor Quality Graduates in some cases)

Systems risks — control, Compliance

Environmental Risk
- Corruption (divertion of govt funds freeze on account, sanction on banks
- 419.
- Armed Robbery on Banks.
- Cloning of C of Os.
- The value system that places undue emphasis on money by all means.

2. **FINANCIAL DISCLOSURE**

- ROBUST FINANCIAL DISCLOSURE IS VITAL. THIS STRENGTHENS BANKING SYSTEM DISCIPLINE AND HELPS STAKEHOLDERS TO ASSESS THE BANKS.
- DETAILED INTERNAL AUDIT PROCECURES AND OVERSIGHT BY AUDIT COMMITTEE.

3. **CONFLICTS OF INTEREST**

- CARE TO BE TAKEN IN RELATED PARTIES' TRANSACTIONS AND BANK'S INTERESTS (eg doing business with major shareholders costing of services etc).
- ISSUES OF SHORT TERM PROFIT VIS-A-VIS LONG TERM STABILITY AND GROWTH (Conflicts of interest ruined ENRON).

4. **COMPETITIVENESS AND MARKET DISCIPLINE**

- BANKING SYSTEM SHOULD BE COMPETITIVE AND THERE SHOULD BE LEVEL PLAYING FIELD. REGULATORS SHOULD BE IMPARTIAL.

- OWNERSHIP (institutional, government etc) STRUCTURE SHOULD NOT UNDERMINE MARKET DISCIPLINE.

5. **EFFECTIVE IT GOVERNANCE. TO ENSURE SECURE USE OF TECHNOLOGY TO EXPAND AND PROTECT SHAREHOLDERS' VALUE AND TO IMPROVE SERVICE DELIVERY.**

- IT IS CRITICAL INPUT IN THE STRATEGIC PLAN AND IN OVERALL GOVERNANCE OF A BANK.
- TOP MANAGEMENT MUST BE READY TO ASSIST IN LEVERAGING IT TO INCREASE EFFICIENCY AND IN MANAGING IT RISKS.

6. **CAPACITY BUILDING**

- TRAINING VITAL FOR ALL:
  - THE BANKERS AND THE REGULATORS.
- TRAINING ON RISK MANAGEMENT AND ICT
  - RECRUITING SELECTED STAFF OF REPUTABLE INTERNATIONAL BANKING ORGANIZATIONS TO STRENGTHEN CORPORATE GOVERNANCE.

7. **COORDINATION AND EFFECTIVE SUPERVISION**

- FINANCIAL SECTOR INTERDEPENDENCE SUGGESTS COORDINATION OF GOVERNANCE PRACTICES.
- THE CBN THOUGH THE FINANCIAL SERVICES REGULATION COORDINATION COMMITTEE, FACILITATES THE COORDINATION OF ALL FINANCIAL INSTITUTIONS.

- CBN ARTICULATES STRATEGIES TO PROMOTE SOUNDNESS IN THE NIGERIAN FINANCIAL SYSTEM.
- EFFECTIVE SUPERVISION PROMOTES GOOD CG, AND HELPS IN DETECTING “EARLY WARNING SIGNALS”.

8. ADHERENCE TO INTERNATIONAL BEST PRACTICES

Particularly in:

- STRATEGIC PLAN & IMPLEMENTATION.
- RISK MANAGEMENT.
- PERFORMANCE EVALUATION.
- INTERNAL CONTROL SYSTEM.
- SUCCESSION PLANNING.

9. BALANCED SCORE CARD APPROACH

- (ALL ROUND IMPROVED PERFORMANCE) IN RECENT TIMES, WHAT IS CALLED A BALANCED SCORE CARD APPROACH WAS EVOLVED TO PRODUCE "A FRAMEWORK TO HELP ORGANIZATIONS ACHIEVE BETTER OPERATING RESULTS, SUPERIOR GOVERNANCE AND GREATER SHAREHOLDER VALUE.

This strategy helps to link financial results with the key drivers of the business including customers, employees and the internal processes.

- Enterprise Balanced Score card.
- Board Balanced Score card.
- Executive Balanced Score card.

10. PERFORMANCE MONITORING

- THE ABILITY OF ANY BOARD TO MONITOR A BANK'S EXECUTIVES IS DEPENDENT ON THE INFORMATION AT ITS DISPOSAL AND THE TIMELINESS OF SUCH INFORMATION.

11. REMUNERATION

- PERFORMANCE-BASED. SOME PORTION OF SALARY IS A FUNCTION OF INDIVIDUAL PERFORMANCE FOR THE TOP MANAGEMENT.
- CONTRIBUTION BY NON-EXECUTIVES SHOULD NOT BE SITTING ALLOWANCES ONLY, BEARING IN MIND THE RISKS THEY BEAR JOINTLY AND SEVERALLY (CBN ACT) AND NOTING THEIR CONTRIBUTION TO CG AS WELL AS THE NEED FOR THEM TO BE RELATIVELY INDEPENDENT.

12. ENABLING ENVIRONMENT

- A CONDUCIVE SOCIAL CLIMATE PROMOTES GOOD CG.
- A CORRUPT SOCIO-ECONOMIC ENVIRONMENT INHIBITS PERFORMANCE.

13. ELIMINATION OF CORPORATE ABUSES OR WEAKNESSES

- WINDOW DRESSING OF FINANCIAL REPORTS.
- EVERGREENING CREDITS.
- INSIDER LOANS/INSIDER ABUSES/RELATED PARTY TRANSACTIONS.
- ABSENCE OF CONTINGENCY PLANS.
- LOAN CONCENTRATION/POOR RISK MANAGEMENT.
- SINGLE OBLIGOR LIMIT VIOLATIONS.
- GOVERNMENT EQUITY STILL HIGH IN SOME BANKS.
- K.Y.C

VII. CONCLUSION

GOOD CORPORATE GOVERNANCE TRANSLATES INTO

- GOOD SERVICE DELIVERY.
- HIGH AND SUSTAINABLE PROFIT.
- COMPETENT AND HELPFUL STAFF.
- ROBUST RISK MANAGEMENT SYSTEMS AND REDUCED OVERALL RISKS.
- PROTECTION OF SHAREHOLDERS' RIGHTS, SUSTENANCE OF STAKEHOLDERS CONFIDENCE.
- EFFECTIVE SUCCESSION PLAN FOR TOP MANAGEMENT AND BOARD MEMBERS.

OTHER OBSERVATIONS

- TO SURVIVE AND GROW PROFITS ON A SUSTAINABLE BASIS, BANKS IN AND OUTSIDE NIGERIA MUST PRACTICE GOOD GOVERNANCE.
- THE LARGER MACRO-ECONOMY IN THE FORM OF A HEALTHY ENABLING ENVIRONMENT, IS CRUCIAL IN PROMOTING GOOD CG IN BANKS AND OTHER SECTOR.
- FOR NIGERIA AND OTHER DEVELOPING ECONOMIES, ESTABLISHING GOOD CG PRACTICES IS ESSENTIAL FOR SUSTAINING LONG-TERM GROWTH AND DEVELOPMENT, AS COUNTRIES TRANSFORM TO OPEN, MARKET-FRIENDLY DEMOCRATIC SYSTEMS.
- GOOD CG SYSTEMS ENHANCE MAXIMUM PRODUCTIVITY AND EFFICIENCY, MINIMIZE CORRUPTION AND ABUSE OF POWER AND PROMOTE A SYSTEM OF ACCOUNTABILITY AND TRANSPARENCY BOTH IN THE PUBLIC AND PRIVATE SECTORS.
- THE JUDICIARY AND REGULATORY BODIES AND THE LEGISLATURES PLAY A CRITICAL ROLE IN CORPORATE MANAGEMENT AND OVERSIGHT.
- GOOD CORPORATE GOVERNANCE IN BANKS IS OPTIMIZED ONLY IF THERE IS GOOD POLITICAL AND ECONOMIC GOVERNANCE IN THE OVERALL ECONOMY.
- ACCORDING TO THE REPORT "CORPORATE GOVERNANCE DEVELOPMENT": THE EXPERIENCES OF BRAZIL, CHILE, INDIA AND SOUTH AFRICA, "A COUNTRY CANNOT SIGNIFICANTLY CHANGE ONE WITHOUT SIMULTANEOUSLY INSTITUTING CHANGES IN THE OTHER.
- GOOD CORPORATE GOVERNANCE IS DESIRABLE AND IN ORDER TO HAVE OVERALL GOOD PERFORMANCE THROUGH HIGH AND SUSTAINABLE PROFIT AND HIGH RETURN ON SHAREHOLDERS' FUND. HOWEVER IT SHOULD BE NOTED THAT GOOD CORPORATE GOVERNANCE BY BANKS CAN NOT BE DONE IN ISOLATION. A CONDUCIVE MACRO-ECONOMIC ENVIRONMENT IS VITAL. THE GOVERNMENT AT FEDERAL, STATE AND LOCAL GOVERNMENT LEVELS MUST ATTACK THE PROBLEM OF ENDEMIC CORRUPTION WITH DESPATCH. EVOLVING A "CLEAN" SUB-SECTOR (THE BANKS) WITHIN A POLLUTED ENVIRONMENT OF CORRUPTION IS AN UPHILL TASK.

VIII. RECOMMENDATIONS

1. NEED FOR CAPACITY BUILDING AND SKILLS ACQUISITION

- THE REGULATORY AGENCIES AND THE BANKS SHOULD FOCUS ON CAPACITY BUILDING, TRAINING AND RE-TRAINING (TO REDUCE BANKS POACHING STAFF FROM EACH OTHER). THE AIM IS NOT JUST TO GET BIG OR BLOATED. THE ECONOMICS OF LARGE SCALE SHOULD REACH THE ENTIRE ECONOMY.
- (NOTE THE "CONQUER AND DIVIDE STRATEGY" that put ABN AMRO up for grabs by RBS, FORTIS and SANTANDER).
- BANKS REQUIRE GOOD STAFF TO BE ABLE TO COPE WITH THE CHALLENGES OF A BURGEONING MARKET.

2. REGULAR RETREAT FOR BOARD MEMBERS AND TOP MANAGEMENT STAFF

- THE BOARD MEMBERS AND TOP MANAGEMENT STAFF SHOULD GO FOR RETREAT REGULARLY (ONCE EVERY TWO YEARS), TO REVIEW, RE-DESIGN APPRAISE AND SET OUT BROAD POLICIES AND STRATEGIES. (A BOARD OUT OF SYNC WITH THE TIMES WILL BE GROSSLY INEFFECTIVE).

3. BANKING SKILLS/INSIGHT

- EACH BANK SHOULD DEVISE ITS OWN PROGRAMME TO EXPOSE BOARD AND TOP MANAGEMENT TO REQUISITE

INSIGHT/SKILLS/KNOW HOW, IN LINE WITH THE DYNAMICS OF THE FINANCIAL MARKETS.

4. THE INTRODUCTION OF "INDEPENDENT DIRECTORS" INTO BANKS SHOULD BE PUT ON HOLD. A DIRECTOR WHO HAS RELATIVELY NOTHING INVESTED IN AN INSTITUTION AND THEREFORE NOTHING TO LOSE MAY INVARIABLY ADOPT A POSTURE OF "WIFM OR ELSE".RECALL WHAT HAPPENED IN OTHER "SECTORS OF THE ECONOMY WHERE PEOPLE DEMAND TO BE "SETTLED".

5. SHAREHOLDERS, PARTICULARLY INVESTORS HAVE THEIR OWN ROLE TO PLAY. MANY COMPANIES THAT GREW AT THE RATE OF ENRON AND WORLDCOM CRASHED. (HIGH RISK/RETURN PROFILE).

6. AUDITORS HAVE TO BE INDEPENDENT IN EVERY FORM, TO BE ABLE TO WORK EFFECTIVELY.

7. BUSINESS JOURNALISTS MUST THEMSELVES BE TRAINED SO THEY CAN SENSITIZE THE INVESTING PUBLIC. (THE ERA OF WONDER BANKS MUST CEASE).

8. BANKS ARE VULNERABLE IN TERMS OF HEADY NEWS. NEED FOR BUSINESS JOURNALISTS TO EXERCISE CAUTION IN THE DISEMINATION OF INFORMATION ON BANKS.

FINALLY IN THE WORDS OF ALAN GREENSPAN (2002)"RULES CANNOT SUBSTITUTE FOR CHARACTER. IN VIRTUALLY ALL TRANSACTIONS, WHETHER WITH CUSTOMERS OR WITH COLLEAGUES, WE RELY ON THE WORDS OF THOSE WITH WHOM WE DO BUSINESS".

I believe strongly that good corporate governance hinges critically on a value system that is based on high ethical standards. With the recent retreat of Nigeria's 36 governors (October 2007), Nigeria may yet be moving in the desired direction of good corporate governance.

APPENDIX 1 KIVA: LOANS FOR THE POOR

KIVA (Means agreement in Swahili) KIVA is a US-based non-profit organization which acts as a retail micro-financier.

- Gives loans (not hand out) to poor people in Developing Countries.
- Does not require collateral. The loan is via the website of KIVA. Website launched in 2005 and enabled 90,000 people to lend up to US $10Million to 15,000 entrepreneurs.
- KIVA uses local micro finance institutions (it has 59 patners world wide) which assess whether or not, applicants are suitable for loans.
- Minuscule Default rate of @ 0.17% (countries include Kenya, Cambodia).
- A point to note by Nigerian banks and stakeholders in terms of credit analysis within the context of good corporate governance.

APPENDIX 2: ENRON

- ENRON was founded in 1985 through the merger of Houston Natural Gas and Internorth, a national gas company based in Omaha, Nebraska.
- Enron grew rapidly under the leadership of its Chairman Keneth LAY.
- ENRON became major energy and petrochemicals, commodities trader. It diversified into coal, shipping, steel and metals, pulp and paper and even credit derivatives.
- Peak profits moved to $1 billion.
- For six years ENRON was acclaimed in FORTUNE 500 as America's most innovative company.

EARLY WARNING SIGNALS

- Sudden resignation of ENRON Vice Chairman Clifford Baxter in May 2001.
- Sudden resignation of CEO Jeffery Skilling in August 2001. (Skilling was appointed only few months before the sudden resignation.

- Later ENRON announced it had to restate its earnings. The size was collossal.
- ENRON disclosed that its CFO, MR. FASTON was paid in excess of $30 million for the management of LJM1 and LJM2.
- ENRON'S ratings plunged.
- ENRON filed for bankruptcy protection on 2nd December 2001.
- ENRON had engaged in multiple partnership transactions through the use of what it called SPEs (Special purpose entities).
- Improper treatment of related party transactions contributed to ENRON'S collapse.
- Excessive Payments To Directors of ENRON
- Kenneth Lay (Chairman/CEO) $152.7 million.
- Mark fevert (CEO) $31.9 million.
- Jeffrey Skilling (CEO) $34.8 million.
- Clifford Barter (Vice Chairman) $16.2 million.
- Andrew Fastow (CFO) $4.2 million.
- (Payments were far in excess of what obtained in USA)
- Conflicts of Interest played a major role.
- Lack of Auditing Independence.
- ENRON HAD AN INDEPENDENT BOARD But there were many other "Financial ties.

APPENDIX 3: WORLDCOM

- WorldCom was a success story in the 1990s. Telecommunications giant WORLDCOM on Tuesday, 25th June 2002 disclosed that company officials misstated accounting figures to the tune of US $ 3.8 billion. The figure was later revised to a staggering US $ 7.1 billion.
- Scandal
- Monies that were actual expenses were booked as capital. This is in contrast to GAAP (Generally Accepted Accounting Principles).
- Company notified US SEC.
- WorldCom CFO SCOTT Sullivan and the Controller David Myers were relieved of their duties.
- Problem was discovered during a routine internal audit.
- Proper Accounting would have forced WorldCom to report loss in 2001.
- WorldCom's shares priced at $64.50 per share in 1999 tumbled to 15cents Thursday July 30 2002.
- In April 2002, WorldCom laid off 3,700 (6% of its workers).
- Arthur Andersen was the auditor of WorldCom during the critical period. They were replaced.
- Arthur Andersen said it had been kept in the dark.
- US SEC scrutinized WorldCom w.r.t loans to former CEO of WorldCom, Bernie Ebbers who quit in April 2002. The loans totalled US $402million.
- US SEC
- WorldCom executives accused of being co-conspirators in accounting scandal, particularly in

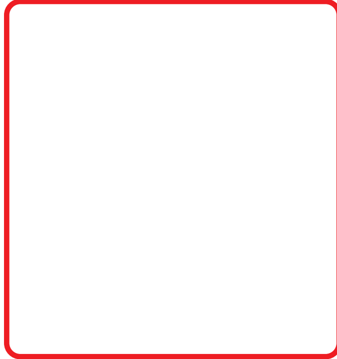
(1)Under reporting expenses.
(2)Overstating earnings.
(3)Defrauding investors.

- Former controller, David Myers pleaded guilty in September 2002.
- Ex Director of general accounting, Buford Yates also pleaded guilty in October 2002.
- Troy Normand, Director Legal Entity Accounting also pleaded guilty.
- WorldCom was involved in 17 mergers between 1994-1998.
- There should have been early warning signals on related party transactions.

APPENDIX 4: POLLYPECK

- Polly Peck transformed from a small English textile company to be in the category of Financial Times 100 share Index in 1989; when it had become a conglomerate (textile electronics etc).
- It collapsed in 1990 as a result of inability to collect huge debt from a subsidiary in Cyprus and from very weak internal control measures.
- Its auditor was fined a huge amount.
- Its Chairman and CEO ASIL NADIR who was charged with theft and false accounting fled to Cyprus.
- The firm was placed under bankruptcy.

PROMOTING GOOD CORPORATE GOVERNANCE: THE ROLE OF INDEPENDENT DIRECTORS



BY

O. I. IMALA,
DIRECTOR OF BANKING SUPERVISION
CENTRAL BANK OF NIGERIA, ABUJA

Introduction

A number of studies (e.g. by International Shareholder Services, jointly conducted with the Georgia State University, USA in 2004, Paul Gompers, Havard University, 2004) have shown a strong link between good corporate governance and profitability and investment performance. However, nothing brings more to the fore, the imperative for good corporate governance than the collapse of huge companies such as Enron.

CORPORATE GOVERNANCE

A number of definitions exist for the subject but, put simply, corporate governance is the system of internal controls and procedures by which individual companies are managed. It provides a framework that defines the rights, roles and responsibilities of different groups management, the Board, controlling shareholders within an organization. For example, the rights, roles and responsibilities of one of these different groups can be described as follows:

THE BOARD OF DIRECTORS

The Board of Directors is at the apex of every organization and the fiduciary relationship between owners and managers of organizations makes accountability very important. For large corporations, managers operate within the policies set by the Board of Directors and these policies are designed to improve shareholder value. The Board provides strategic direction for the company, sets policies and exercises oversight function over executive management. To perform its functions effectively, the Board must first be autonomous and act independently from the executive. Secondly, Board members must possess appropriate expertise relevant to the company's business. Thirdly, there is the need to have internal mechanisms to support the independent work of the Board, including the authority to hire outside consultants without management's intervention or approval. This, therefore, underscores the need for independent members on the Board.

Generally, a Board that is not predominantly independent is more likely to make decisions that unfairly or improperly benefit the interest of management. These decisions may also be detrimental to the long-term interests of shareholders and, for banking institutions, depositors.

In its role as the overall regulator of the banking system, and in recognition of the need to institute good corporate governance, the CBN had issued a code of corporate governance which, among other things, provides for the appointment of independent directors. This is aimed at making sure that Board members are able to make informed decisions about the bank's future, and act with care and competence.

INDEPENDENT DIRECTORS

There is no single universally accepted definition of independent directors. However, it would suffice to consider a director independent if he/she:

- Is not financially or otherwise dependent on a shareholder owning more than 5 per cent of the voting shares of the bank.
- Is not financially or otherwise dependent on the bank or its management.
- Is not financially or otherwise dependent on the bank's auditors, appraisers or consultants.
- Does not pursue personal political interest in his/her activities.
- Is not the representative of a government even if the government is a minority shareholder.

Independent directors play a key role in the decision making process of the board, which approves the overall strategy of the corporation and oversee the performance of management. This is because the independent directors are committed to acting in what they believe to be the best interest of the bank and its stakeholders. Furthermore, they bring to the bank, a wide range of experience, knowledge and judgment, as they draw their varied proficiencies in their respective areas of expertise, while preserving their allegiances only to the bank and its long term profitability. In many jurisdictions such as the United States and Japan, the Audit and Compensation Committee consists entirely of independent directors.

Ladies and Gentlemen, it might be asked, what financial contribution do the independent directors bring to the table? In other words, should we have people who had not contributed capital, or represent others that did, to take long term decisions for the institution? To this I would say yes and no. Yes, because the Board needs the dispassionate and independent opinion on issues by people who do not pay allegiance to any group of shareholders. Consequently, he/she will not so much act as the tie breaking vote but as a voice of reason in the Board room. Secondly, he/she is an industry expert who understands the market and knows the players in the industry as well as the competition. Therefore, he/she can bring a refreshing insight into the complicated business of decision making.

On the other hand, it is true that having independent directors on the Board does not guarantee that wrongdoing will not occur or that the independent directors will do their job independently. However, having them certainly does remove an obvious conflict-of-interest that might becloud objective decision making. Furthermore, it is only natural for the true owners of the bank, who bear the risk of their investment, to have direct say on how their company is run.

The question, therefore, is not whether or not to have independent directors on the Board, but how many. Unfortunately, there is no universally accepted proportion of independent directors to have on the Board. The number, quality, roles and responsibilities of independent directors will depend on the peculiarities of every jurisdiction. The code of corporate governance issued by the CBN recommends that at least two of the non-executive directors should be independent.

QUALIFICATIONS OF INDEPENDENT DIRECTORS

A person will qualify for appointment as an independent director if he or she:

- Qualifies for appointment under section 257(1) of CAMA, i.e. he/she is not:
  - ✮ An infant (under the age of 18 years);
  - ✮ A lunatic, or a person of unsound mind;
  - ✮ A person disqualified under section 253-258 of CAMA; or
  - ✮ A corporation other than its representative appointed to the board for a given term.
- Does not provide financial, legal or consulting services to the bank or any of its affiliates.
- Is not a current or former employee of the bank.
- Does not serve on the Board of a subsidiary of the bank.
- Does not have a leadership role in an institution supported by the bank.
- Is not a borrower from the bank or its subsidiaries/affiliates.
- Has sound knowledge of the operations of the bank, the relevant laws governing its operations and a minimum academic/professional qualification for the position as governed by CBN's circular on prequalification for appointment to the Boards of banks, in addition to a proven cognate experience.

TERMS AND APPOINTMENT OF INDEPENDENT DIRECTORS

Nominations for appointment as independent director should come from the bank's

Nominations/Selection Committee of the Board for the approval of the CBN. Also, remuneration for independent directors should be limited to sitting allowances only; otherwise the director might be swayed by the pecuniary considerations. Additionally, performance of independent directors should be evaluated by the external consultants hired by the Board to do so on its behalf. Finally, the tenure of independent directors should be for a term of four years and renewable only once.

CONCLUSION

A difficult period of under-developed banking system were witnessed in Nigeria characterized by:

- Disagreements between Board members and Management giving rise to Board squabbles.
- Ineffective Board oversight functions.
- Fraudulent and self-serving practices among members of the board, management and staff.
- Ignorance of, and non-compliance with rules, laws and regulations guiding banking business, etc.

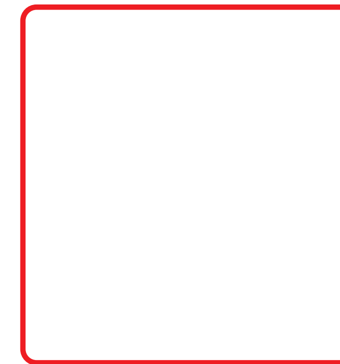
And yet, the promotion of public confidence through the enthronement of good corporate governance remains of utmost importance given the role of the banking industry in national development. It is therefore imperative to take another step towards strengthening our systems. It is my belief that the Board remains the starting point in this crusade and, therefore, appointing independent directors to the Board of the banks will bring strength, autonomy, professionalism, character, decorum, competence and effectiveness to the banks. Such appointment will support other measures put in place by the regulators to enthrone a safe, stable and sound banking system that will herald a growing, virile and structurally functional economy.

MINIMIZING RISK EXPOSURE IN NIGERIAN BANKS

BY

Lamido Sanusi

Executive Director, First Bank of Nigeria Plc, Nigeria



Quotes

§ "A risk is a risk they affect earnings potential, whether they come from fluctuations in commodity price, (equipment) fire, change in legislation, or adverse media coverage …. Ultimately, how you parcel your risks is how you see your company's core mission and the reasons investors invest in you to that extent, knowing your risks is knowing yourself".

-Bill Anderson, Director, Swiss Re New Markets

§ "Risk in itself is not bad. What is bad is risk that is mismanaged, misunderstood, mispriced or unintended"

.

- Suzanne Labarge, Chief Risk Officer Royal Bank of Canada.

Introduction

The past decade has seen dramatic losses in the banking industry. Firms that had been performing well suddenly announced large losses due to credit exposures that turned sour, interest rate positions taken, or other exposures that may or may not have been assumed to hedge balance sheet risk. In response to this, banks have almost universally embarked upon an upgrading of their risk management and control systems.

Up till a few months ago, we all thought the days of high losses due to poor risk management the types introduced by Barings, Allied Irish, etc -- were in the past. The recent sub-prime mortgage fiasco has been a jolting wake-up call. The sudden near-collapse of Black-Rock, and huge losses sustained by otherwise respected and reputable financial institutions underscore the need to guard against complacency. Already the CEOs of Merrill Lynch and CitiGroup have had to fall on their swords, and very possibly, many more heads will roll before this is over.

The last twenty years have also been particularly marked by substantial financial deregulation. Accompanying this deregulation has been a plethora of methodologies and technologies for managing the risks/rewards created by this deregulation.

Managing risk or minimizing risk exposure is increasingly becoming the single most important issue for both regulators and financial institutions.

The art and science of managing risk are more challenging than ever. Risk managers face a wide range of demands, from working with multiple variables to finding technology solutions that generate comprehensive risk analysis. Real-time access to accurate, updated market information is a critical component in the process. Added to this is the impact of so-called "Black Swan" events highly unpredictable, totally unanticipated occurrences with very high adverse impacts on organizations.

The markets have seen one debacle after another, each of which has brought its own set of lessons from some of which the markets have learned and from many of which the markets still need to learn!

But what is risk?

Risk is simply defined as the probability that outcomes vary from our expectations.

In other words, it is 'the threat or possibility that an action or event will adversely or beneficially affect an organisation's ability to achieve its objectives'.

In general, risk entails two essential components:

- Exposure; and
- Uncertainty.

Risk then is exposure to a proposition of which one is uncertain. Suppose a man leaps from an airplane without a parachute. If he is certain he will die, he faces no risk. Indeed, the risk he faces is that he may survive, and spend the rest of his life (which may be long) as an invalid.

Based on common usage, uncertainty is a state of not knowing whether a proposition

is true or false. Probability is often used as a metric of uncertainty

All organizations have expressed or implied objectives. Risk management will actively support the achievement of those objectives. It is not a process for avoiding risk: when used well it can actively allow an institution to take on activities that have a higher level of risk (and therefore could deliver a greater benefit), because the risks have been identified, are understood and are being well managed, and the residual risk is thereby lower. Risk management is not just negative (ensuring that bad things are less likely to happen) but also positive (making it more likely that good things will happen).

At this stage, I would like to talk in general about how risks are managed by financial institutions and why they, in fact, manage these risks. I will, thereafter, highlight the various risks faced by financial institutions.

II. RISK AS A CENTRAL INGREDIENT TO THE INDUSTRY'S FRANCHISE

Banks are in the risk business and taking risks responsibly can be said to be the business of bank management. Financial institutions that are run on the principle of avoiding all risks will be stagnant and will not adequately service the legitimate credit needs of the society. On the other hand, a bank that takes excessive risks is likely to run into mucky waters.

In the process of providing financial services, banks assume various kinds of financial risks. Market participants seek the services of these financial institutions because of their ability to provide market knowledge, transaction efficiency and funding capability. In performing these roles, they generally act as principal in the transaction. As such, they use their own balance sheet to facilitate the transaction and to absorb the risks associated with it.

2.1 What Kinds Of Risks Are Being Absorbed?

The risks contained in a bank's principal activities, i.e., those involving its own balance sheet and its basic business of lending and borrowing, are not all borne by the bank itself. In many instances the institution will eliminate or mitigate the financial risk associated with a transaction by proper business practices; in others, it will shift the risk to other parties through a combination of pricing and product design.

The banking industry recognizes, as I had earlier stated, that an institution need not engage in business in a manner that unnecessarily imposes risk upon it; nor should it absorb risk that can be efficiently transferred to other participants. Rather, it should only manage risks at the firm level that are more efficiently managed there than by the market itself or by their owners in their own portfolios. In short, it should accept only those risks that are uniquely a part of the bank's array of services.

It has often been argued that risks facing all financial institutions can be segmented into three separable types, from a management perspective. These are:

- risks that can be eliminated or avoided by simple business practices;
- risks that can be transferred to other participants; and
- risks that must be actively managed at the firm level.

In the first of these cases, the practice of risk avoidance involves actions to reduce the chances of idiosyncratic losses from standard banking activity by eliminating risks that are superfluous to the institution's business purpose.

Common risk avoidance practices here include at least three types of actions:

- The standardization of process, contracts and procedures to prevent inefficient or incorrect financial decisions;
- The construction of portfolios that benefit from diversification across borrowers and that reduce the effects of any one loss experience; and
- The implementation of incentive-compatible contracts with the institution's management to require that employees be held accountable.

In each case, the goal is to rid the firm of risks that are not essential to the financial service provided, or to absorb only an optimal quantity of a particular kind of risk.

There are also risks that can be eliminated, or at least substantially reduced through the technique of risk transfer. Markets exist for many of the

risks borne by the banking firm. Interest rate risk can be transferred by interest rate products. Borrowing terms can be altered to effect a change in their duration. Finally, the bank can buy or sell financial claims to diversify or concentrate the risks that result from servicing its client base, especially in developed financial markets.

To the extent that the financial risks of the assets created by the firm are understood by the market, these assets can be sold at their fair value. Unless the institution has a comparative advantage in managing the attendant risk and/or a desire for the embedded risk they contain, there is no reason for the bank to absorb such risks, rather than transfer them.

However, there are two classes of assets or activities where the risk inherent in the activity must and should be absorbed at the bank level. In these cases, good reasons exist for using firm resources to manage bank level risk.

The first of these includes financial assets or activities where the nature of the embedded risk may be complex and difficult to communicate to third parties. This is the case when the bank holds complex and proprietary assets that have thin, if not non- existent, secondary markets. It also applies, unfortunately, to many assets held by Nigerian Banks which are not easily marketable or transparent.

The second case includes proprietary positions that are accepted because of their risks, and their expected return. Here, risk positions that are central to the bank's business purpose are absorbed because they are the raison d'etre of the firm. Credit risk inherent in the lending activity is a clear case in point, as is market risk for the trading desk of banks active in certain markets. In all such circumstances, risk is absorbed and needs to be monitored and managed efficiently by the institution. Only then will the firm systematically achieve its financial performance goal.

2.3 Risks in Providing Banking Services

For the sector as a whole, the risks can be broken into six generic types: systematic market risk, credit risk, counterparty risk, liquidity risk, operational risk, and legal risks.

- Systematic risk is the risk of asset value change associated with systematic factors. It is sometimes referred to as market risk, which is in fact a somewhat imprecise term. By its nature, this risk can be hedged, but cannot be diversified completely away. In fact, systematic risk can be thought of as undiversifiable risk.

All investors assume this type of risk, whenever assets owned or claims issued can change in value as a result of broad economic factors. As such, systematic risk comes in many different forms. For the banking sector, however, two are of greatest concern, namely variations in the general level of interest rates and the relative value of currencies.

Because of the bank's dependence on these systematic factors, most try to estimate the impact of these particular systematic risks on performance, attempt to hedge against them and thus limit the sensitivity to variations in undiversifiable factors. Accordingly, most will track interest rate risk closely.

They measure and manage the firm's vulnerability to interest rate variation, even though they can not do so perfectly. At the same time, international banks with large currency positions closely monitor their foreign exchange risk and try to manage, as well as limit, their exposure to it.

- Credit risk arises from non-performance by a borrower. It may arise from either an inability or an unwillingness to perform in the pre-committed contracted manner. This can affect the lender holding the loan contract, as well as other lenders to the creditor. Therefore, the financial condition of the borrower as well as the current value of any underlying collateral is of considerable interest to its bank. The real risk from credit is the deviation of portfolio performance from its expected value.

*Being the text of a paper presented at the 11th Seminar for Finance Correspondents and Business Editors as organized by the CBN Governor's Office at Protea Hotel, Enugu, 8 10 November, 2007

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Accordingly, credit risk is diversifiable, but difficult to eliminate completely. This is because a portion of the default risk may, in fact, result from

systematic risk. In addition, the idiosyncratic nature of some portion of these losses remains a problem for creditors in spite of the beneficial effect of diversification on total uncertainty. This is particularly true for banks that lend in local markets and ones that take on highly illiquid assets. In such cases, the credit risk is not easily transferred, and accurate estimates of loss are difficult to obtain.

- Counterparty risk comes from non-performance of a trading partner. The non-performance may arise from counterparty's refusal to perform due to an adverse price movement caused by systematic factors, or from some other political or legal constraint that was not anticipated by the principals. Diversification is the major tool for controlling nonsystematic counterparty risk.
- Counterparty risk is a credit risk, but it is generally viewed as a more transient financial risk associated with trading than standard creditor default risk. In addition, a counterparty's failure to settle a trade can arise from other factors beyond a credit problem.
- Liquidity risk can best be described as the risk of a funding crisis. While some would include the need to plan for growth and unexpected expansion of credit, the risk here is seen more correctly as the potential for a funding crisis. Such a situation would inevitably be associated with an unexpected event, such as a large charge off, loss of confidence, or a crisis of national proportion such as a currency crisis.
- In any case, risk management here centers on liquidity facilities and portfolio structure. Recognizing liquidity risk leads the bank to recognize liquidity itself as an asset, and portfolio design in the face of illiquidity concerns as a challenge.

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- Operational risk is associated with the problems of accurately processing, settling, and taking or making delivery on trades in exchange for cash. It also arises in record keeping, processing system failures and compliance with various regulations. As such, individual operating problems are small probability events for well-run organizations but they expose a firm to outcomes that may be quite costly. In general, it is risk embedded in products, processes, people and systems, as well as resulting from external events such as power failures.

    - Legal risks are endemic in financial contracting and are separate from the legal ramifications of credit, counterparty, and operational risks. New statutes, tax legislation, court opinions and regulations can put formerly well-established transactions into contention even when all parties have previously performed adequately and are fully able to perform in the future. For example, environmental regulations have radically affected real estate values for older properties and imposed serious risks to lending institutions in this area.

A second type of legal risk arises from the activities of an institution's management or employees. Fraud, violations of regulations or laws, and other actions can lead to catastrophic loss, as recent examples in the thrift industry have demonstrated.

III. MINIMIZING RISK EXPOSURE

I have already indicated that risks cannot be completely eliminated; but they can be minimized through robust risk management practices.

And for this to happen, banks in Nigeria would need to focus on the following:

✓ Pay equal attention to quantifiable and unquantifiable risks Many financial institutions the world over are increasingly attuned to the dangers posed by less quantifiable risks, particularly with regard to their market value such as reputational risk. That awareness should stretch right to the top of the organization. Banks should always evaluate the reputational impact of business decisions.

✓ Identify, report and quantify all possible risks

Despite a growing awareness of unquantifiable risk, there remains a danger that some banks in Nigeria will take no action if they cannot find the numbers with which to measure a risk or set of risks. Banks need to identify and quantify all possible risks to minimize exposure.

✓ Let an awareness of risk pervade the enterprise Everything from performance to pricing and pay should be adjusted for risk. Too few institutions currently obey that imperative. Risk-adjusted performance/capital should be the norm in the industry.

✓ Make risk management everybody's responsibility In the past, financial institutions have tended to look outside their own walls when assessing risks. But issues of governance, culture and integrity are arguably more critical in protecting firms from unseen dangers and should be made the explicit responsibility of all members of staff.

✓ Risk managers should have teeth Everybody involved in monitoring risk of all kinds in the banking industry should have a genuine influence over decision-making. Independent risk assessments of a new product or transaction should be made before the CEO and senior management have approved it in principle

✓ Avoid products and businesses the enterprise does not understand If you don't understand the business, you cannot understand the risks facing it. A structured assessment of risk should be part of product development processes.

✓ Accept that uncertainty exists The greatest risks to a bank's market value are 'unknown' sources of risk. Workshops, scenario planning and cross-industry reviews are among the techniques that leading institutions are using to assess the potential impact of, and response to, these future sources of danger. Banks in Nigeria need to entrench these techniques in their systems.

✓ Good risk management delivers value Loss avoidance remains the staple means of demonstrating the value of risk management. Risk management should be managed at enterprise level.

✓ Define and enshrine your company's risk culture The enterprise's appetite for risk should be clearly and widely understood.
The institution's senior leadership should set a tone at the top that crates a behavioral and ethical benchmark for the entire organization. Given the inherent vagaries of human behaviour, however, process controls also need to be put in place to reinforce cultural norms and compensate for any lapses.

✓ Pay attention to regulatory proposals such as Basel II and SOA

✓ Capital strengthening to cushion the effects of unexpected losses

✓ Sound Corporate Governance Principles

Corporate governance relates to the manner in which the business of the organization is governed, including setting corporate objectives and an institution's risk profile, aligning corporate activities and behaviors with the expectation that the management will operate in a safe and sound manner, running day-to-day operations within an established risk profile, while protecting the interests of depositors and other stakeholders. It is defined by a set of relationships between the institution's management, its board, its shareholders, and other stakeholders.

The following key elements of sound corporate governance should be entrenched in Banks:

✓ A well-articulated corporate strategy against which the overall success and the contribution of individuals can be measured;

➲ Setting and enforcing clear assignment of responsibilities, decision-making authority and accountabilities that are appropriate for the bank's risk profile. Limits are critical e.g single obligor limits, dealing limits, position limits, expense approval limits. These should be set in line with pre-defined risk appetite.

✓ A strong financial risk management function (independent of business lines), adequate internal control systems (including

internal and external audit functions), and functional process design with the necessary checks and balances;

✓ Corporate values, codes of conduct and other standards of appropriate behaviour, and effective systems used to ensure compliance. This includes special monitoring of a bank's risk exposures where conflicts of interest are expected to appear (e.g., relationships with affiliated parties);

✓ Financial and managerial incentives to act in an appropriate manner offered to the board, management and employees, including compensation, promotion and penalties. (i.e., compensation should be consistent with the bank's objectives, performance, and ethical values);

➲ Transparency and appropriate information flows internally and to the public. The more information Banks are compelled to publish, the better they will mange risks.

IV. CONCLUDING REMARKS

Many banking risks arise from the common cause of mismatching. If banks had perfectly matched assets and liabilities (i.e. Identical maturities, interest rate conditions and currencies), then the only risk faced by a bank would be credit risk.

This sort of matching, however, would be virtually impossible, and in any event would severely limit the banks' profit opportunities.

Mismatching is an essential feature of banking business. As soon as maturities on assets exceed those of liabilities then liquidity risk arises. When interest rate terms on items on either side of the balance sheet differ, then interest rate risk arises. Sovereign risk appears if the international nature of each side of the balance sheet is not country-matched. Many of these risks are interrelated.

"Nothing endures but change", wrote the ancient Greek Philosopher Heraclitus more than two thousand years ago. In a world where change is the only constant, success depends on the depth of our awareness of the risks and rewards on the horizon and on the quality of our preparations to respond to them appropriately.

That is true not just in the banking industry, but certainly also in the formulation of public policies geared towards promoting more sustainable economic growth through greater financial stability.

"Why is it that so many of the important things are also the most boring"? asked Ashleigh Brilliant.

In my view, risk management is a management problem. The financial debacles that have occurred in history were not random events and they were not unfortunate draws from a known distribution of outcomes. They were all the result of failure of governance that grew out of the nature of the activities themselves and out of the nature of human beings. Preventing such debacles in the future would require improvement in governance mechanisms.

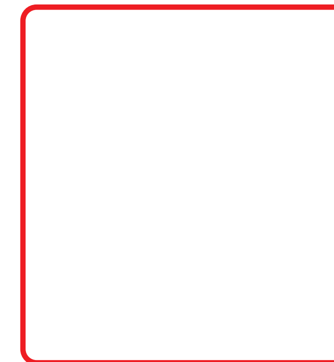
The experience of the last few years suggests that it has been operational risk that has been responsible for many of the largest debacles at financial institutions. Although I will not deal with the issue here, even many dramatic cases of credit losses were in essence, cases of operational risk. It is important to pay increasing attention to this category of risk.

It seems especially appropriate for me to mention that competition would increase at amazing rate in the banking industry in the years ahead. If we are to minimize exposure to risk, we need to play according to the rules. There is a high watermark burden on banks to entrench transparency and operate in an ethical manner. Banks are raising capital, and the pressure to deliver returns is increasing. Unfortunately, the great success of consolidation and the desire of regulators and operators alike have made banks forget the following words of Alan Greenspan one of the greatest Central Bankers of this century!

"It would be a mistake to conclude that the only way to succeed in banking is through ever-greater size and diversity. Indeed, better risk management may be the only truly necessary element of success in banking".

The tempo of risk-based supervision by the CBN must be sustained. Guidelines are being released, and meetings and consultations held. These must continue for the interest of the financial system.

THE ROLE OF THE MEDIA IN PROMOTING GOOD CORPORATE GOVERNANCE



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Introduction:

The role of the media in corporate governance or the intersection of media and corporate governance could be handled from multiple perspectives. The usual approach in this country has been to point to recent malfeasance of chief executives and then show how the media can help to straighten the identified ills in its historic function of a society watchdog.

More importantly, two basic assumptions are necessary:

(a) That the media is rationale (or responsible)

(b) That the media sees itself as a critical stakeholder in society and recognises its status as the fourth estate of the realm.

There are seven sections in this paper. In the first section, I will briefly state what Corporate Governance is all about. The second section will look at the media in its various roles, while the third section will attempt to establish the vital point of departure for this presentation. Next I will layout my understanding of the purpose of the modern corporation. The fifth section will discuss the purpose of the media from an economist's point of view. In the sixth section the intersection of the two purposes will be examined. And then my concluding remarks will follow.

Section One: What Is Corporate Governance?

Today, corporate governance attracts a good deal of public interest, because of its importance to the economic health of corporations, groups, countries, and society at large. But because it covers a large number of economic phenomena, it has become a subject with many definitions, with each definition reflecting an understanding of, and in the domain of an economic phenomenon being considered.

In general terms, however, corporate governance deals with the way corporate bodies utilise their funds to generate financial wealth for shareholders, and social wealth for the community in which they are located. This latter consideration is what has now become known as the Corporate Social Responsibility (CSR) of organisations.

A former President of the World Bank JAMES WOLFENSOHN once said that "corporate governance is about promoting corporate fairness, transparency, and accountability". I find this definition apt, as it captures the essence of the subject. This is so, because, generally, corporate governance refers to a set of processes, customs, policies, laws and institutions affecting the way a company or an entity is directed, managed, administered, or controlled, with the goal of ensuring best corporate, ethical, and business practices. It also involves the relationships among the many publics of a company, otherwise called the stakeholders, including the shareholders, management, board of directors, employees, suppliers/contractors, customers, banks, other lenders, regulators, and the (operating) environment/community of location of the company.

So, essentially, corporate governance deals with issues of accountability and fiduciary duty, in the main advocating the implementation of policies and mechanisms to ensure good behaviour and protect shareholders. There is also the perspective of economic efficiency, through which corporate governance should aim to optimise economic results with strong emphasis on shareholders welfare. Yet a

third consideration accommodates the interest of all stakeholders, which call for more attention and accountability to players other than the shareholders; like the employees and the environment/community, for examples. So, in short, corporate governance is about how an entity is managed or run.

Section Two: The Media

For the purpose of this presentation, we shall refer to all formal channels of mass communication as media. The media is an indispensable institution in every society. Structural Functionalism Theorists insist that society is made up of inter-connected parts, each of which play an indispensable role in the proper functioning and survival of the society. Given its basic function of information dissemination, the media becomes a crucial element of the social system. It ensures general diffusion of knowledge about life, thus influencing many aspects of the socio-cultural, political and economic patterns of the society. In this regard, the media affects public opinion, enriches it and helps to improve the fabric of society, especially in a democratic political system. The media also has a constitutional obligation, to hold government accountable and responsible, especially with respect to the Fundamental Objectives and Directive Principles of State Policy (Section 22, Constitution of the Federal Republic of Nigeria 1999).

Perhaps, we need to remind ourselves at this point that the traditional roles of the media include: To inform, to educate, to entertain, and is mandated by the constitution, to hold government and institutions accountable and responsible for good governance. All of these are to enhance the socio-cultural, economic, and political wellbeing of the people. In a sense therefore, the media is the watchdog of society. As the media impacts on (corporate) governance, public opinion, (political) agenda setting, its role as the watchdog the connecting bridge between government and its people, an agent of socialisation, and critical input provider to managerial decision-making deserve a little elucidation.

Public Opinion

Public opinion is the engine that keeps the wheels of society turning. Though some people are elected to conduct government affairs on behalf of the rest of the people, their actions are (or should be) moderated by the opinion of the same that put them into office. The average member of the society is affected by the social group and opinion leaders who reflect the opinion obtained largely from the media of mass communication. Thus, the divergent views and in-depth analyses presented by the media are of importance in the positions citizens take on critical issues about their immediate community, the larger society, as well as the government and country.

Political Agenda

This is similar to public opinion, but it indicates a wider scope. It includes all those matters people consider weighty and which also need to be considered by the government. In this respect, the media is regarded as a "market place" of political thought and ideas, which go into shaping government policies. It is also the institutions of society that informs the public about policies and decisions taken by their governments. Such thoughts, ideas or policies are put in the public domain to be further examined, discussed, scrutinised by the opposition, opinion leaders, communicators, analysts and the public in general. The media indeed, further publicise this interplay of opinion through deadpan reporting, interviews and panel discussions (in radio and television). Often, the public make decisions only after considering the different perspectives to issues. As a matter of fact, research has shown a very close relationship between the importance the public attaches to particular issues and the level of exposure or depth of coverage by the media of those issues.

The Watchdog

A crucial role of the media is to watch over the government and the society also, looking out for instances of malfunction and corruption. The public will have far less control over the affairs of parastatals, the city, state and national governments, without the probing questions of investigative reporters. Disclosures by the media have led to important investigations. Thus Carl Bernstein and Bob Woodward are widely acclaimed for revealing the

Watergate scandal that brought down President Richard Nixon of the United States. Reporters often uncover evidence of unethical and sometimes illegal conduct of officials, thus causing resignations or reprimands or sanctions of the officers affected. The discovery of the dumping of toxic waste in Koko in the then Bendel State, belongs here. So also the N628 million contract scandal involving the speaker and some principal officers of the Federal House of Representatives, otherwise called "Ettehgate".

As we talk about this, one area the media can help the CBN, for instance, is to monitor micro-finance institutions, to fish out those who operate illegally (in remote communities) or those who engage in "inappropriate" practices that are unwholesome, and which short-change stakeholders.

The Bridge

The media acts as a link, a bridge between the government and the people. The media provides several channels through which (political) leaders can express their views and also rally public support for their policies and programmes. In return, the people use the media to also ventilate their views and make their needs known to the leaders and the government.

Socialisation

Another important role of the media is to illuminate the social fabric and to influence the shape of its pattern. Various aspects of our habits, desires and relationships, both as individuals and as groups, are scrutinised by the media, thus helping in shaping social values. Just to illustrate: how we relate with one another (in private or official capacities), personal problems, our taste in popular music, movies, etc; ethnic tensions, sports, fashion, religions beliefs, and other aspects of life, are constantly the subject of reporting and discussion by the media. Often, too, the fear to stay out of media search light keep several corporate executives in check.

Input

Quality information, particularly appropriate business information also aid informed business decisions. Good information about prices, location and opportunities are always in demand. What stock is available, what dividend are companies paying, what are the regulatory authorities saying? Providing such critical information is why companies such as Bloomberg and Reuters reap millions of US dollars in profit every year.

Section Three: Point of Departure

Having defined corporate governance and examined the media, variously, the starting point of my arguments is that media and corporate managers share the same telos (purpose, end, or destiny). Both institutions are involved in the business of raising and sustaining the living standards of Nigerians or any society for that matter. The corporation does it by raising the level of production of goods and services. The media does it by showing the corporation where the markets are for its products and supplies and also putting them in check against misbehaviour. And both of their activities count as part of the Gross Domestic Product or national income.

To reiterate, we share the same end. The English word "end" has two meanings. It means destination or the last point. It also means goals and purpose. The media and the corporation are all moving towards enhanced quality of life through higher productivity, higher levels of income and economic development. If for some reason our purposes occasional "contradict," it is still in the national economic interest. As the iconoclastic economist, John Galbraith told us in its book, American Capitalism: The Theory of Countervailing Power, every capitalist economy needs a set of countervailing forces to make sure the market functions competitively.

Section Four: The Purpose of the Corporation in Society.

Milton Friedman, another top notch economist once famously stated (in Capitalism and Freedom) that the one and only social responsibility, the one and only purpose, of the firm is to increase profits. I will, to a certain degree, agree with him that corporate managers are to increase the wealth, market/enterprise value, and shareholder's fund of the firm. If the firm cannot fulfil this core function, there will be no profit to share or to fund social

projects. In a profession that believes in the virtues of division of labour and virtues of maximizing profit functions, this was a nice way of interpreting the purpose of the firm. But it is a long way from the 1970s when the Noble-Prize winning economist made this controversial view famous.

Today, I will like to add that the corporation also holds some responsibility towards its larger society, the environment or let us say to its network of stakeholders. Today, it is no longer completely against the profit motive of the firm's managers to expand their horizon. Executives now think about corporate social responsibility (CSR). Long gone are the days when the corporation saw itself as just converting raw materials into products for profits by manipulating production facilities, processes, and distribution networks. In the post-modern, globalized world investments of firms have gone beyond physical and product-specific facilities to branding. In many situations, branding has become the most valuable assets of the firm. The rise of image and reputation in the decision-making matrix of the firm has taught many a CEOs not to ignore potential damage to corporate names. Brand name is now part of the strategic corporate equity of the firm. So I will say the purpose of the firm is to increase profits in a socially responsible way. That is, in ways that support the building of better community (society) for all of its stakeholders. The firm, more than ever before, has to recognise the crucial society-wide interrelationships and interdependence that sustain and nurture its operation, profitability, and survival.

From this dual perspective of profitability and social responsible, we can define good corporate governance as the efficient practices, oversights, and directing-guidance that realize, raise, and sustain the profitability, the good name of a firm, and community (society) improvement. There are times when the firm may not be able to bring the profitability and CSR together effectively and efficiently. Nonetheless, the recognition of the tension of walking the fine balance between the two goals is necessary for ongoing viability of the modern corporation.

Section Five: The Purpose of the Media

Once again, permit me to think outside the usual box. In doing this I will like to go from the familiar to the unfamiliar. The purpose of the media is to provide information. What do you think is information? Information, in my lights, is any set of data, both qualitative and quantitative, that makes a difference. The information that the former speaker of the House of Representatives, Mrs. Patricia Etteh renovated her official residence with an inflated sum has made a difference in that chamber just the same way news about major developments in any crude oil producing country affect international price of oil.

The media in Nigeria has not always focused on this understanding of information. It is not just enough to fill the airwaves, the printed pages, or the ephemeral lattices of the internet with data, analyses, or opinions. To the business person, they become information when they can make a difference in his or her decision making. The person wants to know where he or she can buy low and sell dear; wants to know where the markets are for his or her products. It is information when it points to opportunities for profits or helps to protect the system such as will assist regulatory authorities to monitor the system. News becomes business information when it helps the manager or entrepreneur to recognise market trends. It is information when it tells him or her that a difference in the market or the political scene etc has occurred. Before any journalist puts pen to paper, he needs to ask how useful the information is. Who would need information and for what? Will it add value? Information to fill space is not better than hot air.

Dog bite man may be news to some people, especially if the canine bit your spouse. But it is news and information to the whole society when man bites dog. Something new and different, sometime out of the mundane, something that can make us revaluate our status as homo sapiens has happened. Many people miss the morale or lesson in the man-bite dog tale that is the staple of Journalism 101. As an economist who for over two decades has been looking into journalistic practice in this

country with the clear eyes of a trained economist, I see the anecdotal story as offering a definition of information relevant to market analysis.

The production and distribution of information is important for the functioning of any market. At the heart of neoclassical economic thinking about the competitive market process is the idea of free flowing information. Asymmetric information (this describes the situation when one party in a negotiation/bargain knows more about the product than the other party) is one of the causes of market failure, meaning the market is delivering non-optimal outcomes. It is the duty of the journalist to let the buyers and seller know about products and services in the market and level the playing field for economic transactions. The existence of asymmetric information is not good because it limits what the market can do and when it is removed by, for example, good reporting, it can lead to increases in GNP.

The 2002 Nobel Prize in Economic Science was awarded to George Akerlof for his famous paper called, “The Market for Lemons” which clarifies the connection between asymmetric information and market failure. This year the prize was awarded to three economists Leonid Hurwicz, Eric Maskin, and Roger Myerson for their idea about mechanism design. Their theory shows how the economic costs of asymmetric information can minimised. Once again, we see the most prestigious award in economics being awarded to the persons working to solve the problems relating to differences in the possession of crucial market information. Indeed, the fact that the Nobel Committee would give two prizes in five short years to economists who are working on how to solve the problems of asymmetric information reflects the importance of quality information in the modern world.

The profession of journalism has a great role to play in the dissemination of information for the proper functioning of the market. It was one of my favourite economists, Friedrich von Hayek who argued long ago that the crucial problem of the capitalist economy is not the allocation of resources which the Marxists and socialists thought could be done by planning. He said the main problem is the dispersion of information and as long as information is dispersed planning is not useful. He maintained that the market was better than planning offices when it came to ferreting and channelling of data and opinion for the proper functioning of economies.

Hayek, like all other economists, also noted that the market works best when information is shared. This year's Nobel Prize winners designed mechanism that can help people to share truthfully whatever private information they may have. Their theory has been put to work in auctioning radio spectrum and other forms of public auctions where information is not freely available as in a competitive market. In my many years of experience as a journalist in this country and in many parts of Africa, I have come to realise that there are many sources of private information that can be harnessed and made public to move African economies forward.

Nigerian corporations, and by implication the national economy, can do much better if we journalists can seek better efficient flow of information in the economy. But it is germane to add that we cannot do this effectively if corporations do not see the need to cooperate with journalists to inform the public and aid market operations. That corporations refuse to give information is not an excuse for not publishing the right news. It is the responsibility of the journalists to seek and secure the appropriate information. After all, journalism is like the work of intelligence agencies, but through civil means.

Section Six: Intersection of Corporate Governance and Media

Put differently, the role of the media is to help form, inform, and transform the enterprise value of firms. It does this by removing information asymmetry in the economy as much as possible, pointing to profitable opportunities, offering analyses and opinions that shape and reshape corporate strategies, offering feedbacks that help firms to manage their reputation, and working to transform the relationship between the firm and its public by being an alert watchdog for the interest of the

firm's stakeholders. What matters in all this is the production and distribution of data, analyses, and opinions that make a difference to executives, shareholders, environmentalists, community leaders, and all those whose lives are entangled one way or the other with the operations of the firm. When the media supports or aids corporate profitability and when it provides the kind of information that keeps firm awaken to their social responsibility to society, it is helping to evolve good corporate governance.

In sum, Corporate Governance + Information (Media) = Good Corporate Governance

Good Corporate Governance = Value (Profit + CSR)? =

higher GDP (better living standards)?.

(The upward arrow here is a symbol for increase.)

From the above two simple equations, is obvious that corporate governance plus appropriate information or what some may refer to effective media will necessarily produce good corporate governance. And good corporate governance would yield enhanced value. In other words, the corporations will make enough profit and therefore have enough funds to embark on Corporate Social Responsibilities (CSR) which leads to relative peace, progress and contributory development of society. It goes without saying that higher levels of profits plus good social responsibilities will in turn produce higher levels of GDP.

CONCLUSION

A story about how the Central Intelligence Agency trains its officers to recognise fake dollars indicate that they never showed a fake dollar to the trainees. Only the good ones were showed, repeatedly. The idea is that once a trainee knows sufficiently how the good one looks, he or she will immediately spot a fake one. If they were to present multiple fake dollars, one can spend a lifetime mastering them and still misrecognise the good one when it matters most. But when you know the good one you can instantly tell when one is not.

There are thousand and one ways the corporate governance has been mishandled or dwell so much on the role of the media in exposing or analyzing the instances of mismanagement. Rather, It has been exposed that there is only one correct way so as to recognise a good intersection of media and corporate management.

FOREIGN EXCHANGE RESERVES ACCUMULATION:

Implications for the Nigerian Economy

Magnus O. Abeng

Abstract

A country's demand for reserves is determined by a myriad of factors such as economic size, external vulnerability, export promotion, etc, depending on its development objective as reinforced by the prevailing economic management challenges. The paper noted Nigeria's appreciable foreign exchange reserves growth, which was observed to be in tandem with emerging market economies and global trends, and expressed an allusion for sustained reserve growth based on some economic fundamentals. It was also observed that Nigeria's reserves stock was quite above the international thresholds but, lagged far behind its contemporaries in the OPEC and Asian countries. The paper recommended, among others, the diversification of Nigeria's reserves away from the dollar; the deployment of the savings from debt relief for the resuscitation of dilapidated social, legal and economic infrastructure to enable an investment-friendly environment, (a precursor for poverty reduction and the meeting of MDGs); caution in contracting new debts; and the acceleration of capital market investment verification exercises by the CBN and Economic and Financial Crimes Commission (EFCC). The paper noted that continued intervention impact on the balance sheet, impair financial sector efficiency and creates risk for efficient financial intermediation.

Introduction

The Nigerian economy, in the past few years, recorded unprecedented achievements amidst very daunting and challenging environment. Principal amongst these are sustained growth in domestic output; positive current account balance; downward-trending inflation; stable exchange rate; low fiscal deficits and debt stock and a phenomenal growth in foreign exchange reserves position which rose from a paltry US$0.15 billion in 1970 to US$7.7 billion in 2002 and US$43.2 billion in 2006. These robust domestic economic performances were occasioned by macroeconomic fundamentals like internal reforms, complemented by favorable external conditions like the persistent and unprecedented rise in crude oil prices joined with drastic decline in external obligations like debt service.

The exceptional growth in Nigeria's Foreign Exchange Reserves (FER) position is not an isolated development but one that mirror global trends and the substantial reserves growth of developing and emerging economies, which account for the bulk of the world reserves, built to hedge against volatile capital movement as witnessed by the 1990s crises of the Asian countries. At the global level, for instance, Setser and Menegatti (2007) noted that after adjustments are made for valuation gains, global reserve growth stood at a whooping US$712 billion, with US$511 billion increase in dollar holdings in 2006. For developing countries, Rodrik (2006) observed that the net reserve holdings increased sharply from 6 per cent of GDP in 1995 to about 30 per cent in 2004. These developments consequently underscored the critical role of FER in the balance sheets of central bank and monetary policy operations, generating renewed and raging controversies among scholars and analysts in the process. Specifically, the crux of the arguments focused on key issues like the quantum or "optimum" reserves that should be held, the different uses these reserves should be put, the costs and benefits of holding large reserves portfolio, as well as the determination of the holding limits of countries' exposure to a sudden stop in private capital flows.

Reminiscent of every economic phenomenon, the development has earned the accolades of many as it equally drew severe criticisms from others who question the rationale for building reserves in the face of crippling domestic economic activities and high incidence of poverty. Husain (2002) categorized these critics into three broad groups. The first category consists of the "I don't accept" type which does not wish to be bothered with the facts: for them reserve accumulation is simply juggling with statistics and, in their opinion, reserves do not exist. The second group is that which consider foreign reserves to be "irrelevant" as this has not helped the conditions of the common man. To them, it is economically unjustifiable to build reserves in the midst of overwhelming poverty and deplorable state of economic and social infrastructure. They

typically view reserves as money in the bank which must be spent for the common good of all and not stocked somewhere in overseas accounts. According to Hussain (2002), this group of critics confuses the domestic budgetary resources with external resources and is not perhaps fully aware of the distinction between the fiscal and external accounts.

For the third and critically constructive group, while recognizing that reserves accumulation is indeed a necessary and plausible objective to pursue, they, however, attribute such achievement mainly to non-economic factors. In their view this is a one-off change which is unlikely to recur in the future. In other words, they express concern and skepticisms on the future sustainability of continued reserve growth. This paper is thus premised, on the suppositions expressed by the second and third groups of critics and is primarily focused on the contextual examination of the macroeconomic implications of the continuous build up of FER in the Nigeria economy, the disquiet of the second group. In this regard, the paper would explore the potential benefits, risks and the cost inference of prolonged accumulation of FER on the economy with a view to eliciting some relevant economic lessons for Nigeria. The concern of the third group of critics is left for further research.
The rest of the paper is structured as follows. Following the introduction is section two, which examined the theoretical issues vis-à-vis the raison d' état for reserves holding. The management of FER in Nigeria, an overview of reserves growth, the sources of such growth as well as the fundamentals for sustaining such growth pattern were considered in section three. Section four examined the level of achievement of reserve adequacy, measured against international benchmarks. The domestic implications of holding reserves on the economy were investigated in section five while section six proffers a way forward and conclude the paper.

2.0 Theoretical Issues

According to the IMF (1993), foreign exchange reserves consist of those "external assets that are readily available to and controlled by the monetary authorities for direct financing of payment imbalances, for indirectly regulating the magnitude of such imbalances through intervention in the exchange markets to affect the currency exchange rate, and/or for other purposes". Such external reserves, comprises of Gold, Nigeria's reserve position in the IMF and allocation of Special Drawing Rights (SDR) made to Nigeria by the IMF. Nigeria's reserves principally consist of the federation component (sterilized funds held in excess crude and PPT/Royalty accounts belonging to the three tiers of government); the federal government component (belonging to some government agencies like NNPC, PHCN, Ministry of defence, used for financing joint ventures, letters of credit, etc) and the CBN component (funds that have been monetized but held by the CBN and used in the conduct of its monetary policy). Prior to year 2005, the three components of reserves were lumped together without disaggregation. Hence this paper assumes FER in its totality without a breakdown into components, while in the review of the literature, the motive for holding reserves is used as a proxy for the theory for reserves accumulation since they are intrinsically linked and interchangeably used..

Though the management of foreign exchange reserves of a country is the exclusive responsibility of the central bank, the quantum of reserves to be held at any point in time is a function of several exogenous factors, depending on its development objective and the prevailing economic management challenges. According to Williams (2005) such factors range from the structure and vibrancy of the economy to the split between the traded and non-traded sectors, the level and rate of capital inflows and outflows, and the attractiveness of returns offered in other currencies. Aizenman and Marion (2003) attributed FER demand principally to two factors. The first being government's desire to "smooth consumption" (i.e.to spread out over time, the costs of shocks, such as sudden outflows of international capital, when it faces difficulty raising funds either through international capital markets or through domestic tax collection) and secondly for "loss aversion" (i.e. the tendency of people in the economy to be more sensitive to reductions in their consumption than to increases). In their view,

governments would choose to hold smaller reserve stocks if the populace is indifferent to reductions or increases in their consumption, while it will choose to hold a much larger stock if it believes the populace is loss-averse.

Hussain (2002) stated that reserves are demanded as a tool for exchange rate and monetary policy management. Adequate reserves, according to him, do not only ensure a realistic exchange rate, but also help maintain competitiveness of export goods. In addition, central bank's ability to intervene in the market with a view to influencing the exchange rate as well as boost the confidence in the currency is principally determined by the level of reserve stock. Countries thus hold FER to enable them intervene to reduce the volatility or better still maintain a target exchange rate.

Reserves affects the domestic money market balance and, by implication, domestic interest rate through the buying and selling of domestic currency at the inter-bank market. Reserves also provide funds in foreign currencies for servicing external debt and liabilities. Gradual accumulation of reserves through non-debt creating means to a sufficiently comfortable level avoids panic in the market and precludes the need for contracting additional debt for the country. A high level of reserves provides implicit guarantee to the creditors that the country would be able to meet its obligations as and when due. In the view of Williams (2005), reserves also permit central banks to limit the vulnerability of the country to external shocks, give confidence to the public and reassure credit rating agencies and international financial institutions about the soundness of the economy.

Another identified motive for the demand for FER is that it enables the monetary authority to function as the lender of last resort to banks with high levels of foreign currency liabilities. Reserves are held to meet the day to day transactions such as the purchase of goods and services or payment obligations to international organizations, respond to terms of trade shocks, fight deflation, support export-led growth and to smooth unpredictable and temporary imbalances in international payments.

Jeanne and Ranciere (2006) argue that holding reserves is costly, but without reserves, a sudden stop in capital flows would lead to sharp falls in consumption and output. Their model implies that the optimal level of reserves is a function of the probability of a sudden stop, the output loss in the event of a sudden stop, the level of private external debt to GDP (the roll-off of short-term private debt in their model triggers the fall in output), the term premium and the country's level of risk aversion. A high level of risk aversion, a high risk of a sudden stop and large expected output losses all increase the optimal level of reserves, while a rise in the term premium increases the cost of holding reserves and thus reduces desired holdings.

Since reserves are denominated in foreign currencies, the holding of FER therefore implies the financing of investment and development of other people's country by the home country. Simple logic would suggest that countries do not hold a dime of reserves more than necessary. Ironically, the opposite is the case for most economies, especially the emerging and developing ones, which accumulate FER much more than the specified thresholds, against all economic reasoning or justifications. According to Garton (2007) reserves accumulation incurs real cost in that it involves the "re-export" of capital inflows into foreign securities which entails a real resource transfer to foreigners when risk-adjusted returns on these assets are lower than the risk-adjusted costs of external borrowing. Rodrik (2006) noted that the idea of an excess of low yielding reserves in the developing world represents a radical departure from the problems that we have traditionally focused on in thinking about the international financial system. The IMF, on its part, had also expressed concern when developing nations are accumulating reserves to finance the United States.

Some countries keep reserves in order to undervalue their currencies with a view to maintaining external competitiveness, attract foreign direct investment and boost export growth. This is done by buying foreign currencies in the market, building FER at the same time. Meanwhile, in developing countries like Nigeria, intervention is often undertaken to mitigate the political and credit risk of steep

depreciation of the local currency. The open market operations, thus, take the form of selling, rather than buying foreign exchange, hence the level of foreign exchange reserves to support interventions is a much more important factor. In this perspective, a healthy FER position is a precondition for a steady exchange rate that would not only boost capital inflows but also ensure the achievement of overall macroeconomic stability. For the developed countries, the value of hard currencies is not influenced by the quantum of reserves but rather by economic fundamentals like corporate indicators and capital market movement.

Countries build up FER to take care of seasonal variations in capital inflows. Developing countries with seasonal exports, for instance, would need FER stock to finance imports during the off season periods, thus a stable level of reserves is a needed prerequisite. In the same vein, the execution of major capital intensive projects require adequate threshold of FER so as not to scuttle other national transactions, meet international obligations like debt service and maintain confidence in the economy. From the perspective of developing and emerging economies, higher reserves connote the ability of the country to redeem external debt, reduced risk of currency crises and an indication of the underlying potency of the economy.

Acharya (2002) summarizes the major objectives for holding FER into: a) enhancing capacity to intervene in foreign exchange markets; b) limiting external vulnerability by maintaining foreign currency liquidity to absorb shocks during times of crisis including national disasters or emergencies; c) providing confidence to the markets especially credit rating agencies that external obligations can always be met, thus reducing the overall cost at which foreign exchange resources are available to all the market participants; and e) incidentally adding to the comfort of the market participants, by demonstrating the backing of domestic currency by external assets. Thus the basic idea in the theory of the demand for FER is that a country chooses a level of FER to balance the macroeconomic adjustment costs incurred if reserves are exhausted (the precautionary motive) with the opportunity cost of holding reserves, (IMF, 2003). In order to further situate the argument for holding reserves, it is expedient to consider the channel through which such movements in reserves level affect the domestic economy the central bank and the balance of payment analytical balance sheet.

2.1 Foreign Reserves and the Balance of Payment Account

The central bank balance sheet provides useful insight to the understanding of the role of foreign exchange in monetary management. For the purpose of our discussion, we shall consider the monetary approach to balance of payment theory, which presents the balance of payment as a monetary phenomenon. This simplified model would expound our understanding of the movements and impacts. The principal proposition of this approach is that a country's external reserves position is determined by the interplay of the forces of money supply and money demand. The argument thus follows that given an equilibrium position; an increase in money demand will result in balance of payment surplus while an increase in money supply will give rise to a deficit. It, therefore, follows that disequilibrium in the money market would automatically translate to disequilibrium in the balance of payment position of the country. For analytical convenience, the model assumes a stable money supply function, a given level of output and the existence of purchasing power parity.

The demand for money function, which is dependent on price level, real income and interest rate, is stated as

$M^{d} = âP^{d}Y^{r}$ ………(1)

Where M^{d} and P^{d} represent demand for money balances and domestic prices, respectively, while Y^{r} is the real national income and $â$ measures the impact of money income ($P^{d}Y^{r}$) on the demand for money. From equation (1), it could be postulated that a rise in money income and price level would increase the demand for money since both the household and business entities would require larger cash balances to meet their transaction demands. However, an increase in interest rate adjusts portfolio investment in favour of high interest-bearing assets, thus dousing the demand for money

in the economy. Since our objective is to identify the balance of payment position of the economy, we would then specify the money supply function to enable us achieve that.

$M^{s} = mH$……….(2)

Where M^{s} represents money supply, H representing base money or high powered money and m is the money multiplier. Equation (2) thus depicts money supply as multiple (m) of the monetary base. Meanwhile the monetary base consist of two main components: the domestic component, which consist of domestic claims on government by the central bank, claims on deposit money banks, claims on private sector and the foreign component which comprised of net foreign assets and other assets net. Letting D to represent domestic component and R, the foreign component, would give:

$M^{s} = m(D + R)$…..(3)

Equation 3 specifies the relationship between money supply and the level of foreign exchange reserves of a country. Suppose m is held constant, it would imply that changes in money supply would only take place if there are changes in either or both the domestic and foreign components. This is expressed as:

$ÄM^{s} = m(ÄD + ÄR)$... (4)

Rearranging, we have

$ÄR = 1/m\, ÄM^{s}\; ÄD$… (5)

A necessary condition for equilibrium in the market requires that money supply equates money demand ($M^{d} = M^{s}$), consequently, from equation (1)

$ÄM^{d} = â(P^{d}ÄY^{r} + Y^{r}ÄP^{d})$..(6)

Setting $ÄM^{d} = ÄM^{s}$ will give us

$ÄR = â/m\,(P^{d}ÄY^{r} + Y^{r}ÄP^{d})\; ÄD$ ...(7)

Equation (7) specifies that changes in foreign reserves position, which is a reflection of the net position of the current and capital accounts in the balance of payment account, is a function of changes in the national income, the price level and the domestic component of base money. Leaning on our earlier assumptions of a given output level or full employment level in which case $ÄY = 0$ as Y is held constant and the purchasing power parity which ensures that $ÄP = 0$ at a fixed exchange rate, it could be deduced that a change in FER position (balance of payment surplus or deficit) can only be induced by changes in the domestic component of money supply. This simple exercise demonstrates that disequilibrium in the balance of payment account could be corrected by the effective control of base money or high powered money by the central bank through efficient management of domestic and foreign currency assets. The appropriate management of the monetary base is a necessary prerequisite for controlling inflationary pressure as well as moderate exchange rate movements in the economy. Consequently, in order to neutralize the impact, reserve purchases are often matched with domestic assets, an operation referred to as sterilization in reserve management.

3.0 Foreign Exchange Reserve Management in Nigeria

According to the IMF (2004) reserve management is a process that ensures that adequate official public sector foreign assets are readily available to and controlled by the authorities for meeting a defined range of objectives for a country. Such objectives should seek to ensure that: 1) adequate foreign exchange reserves are available for meeting a defined range of objectives; 2) liquidity, market and credit risks are controlled in a prudent manner; and 3) subject to liquidity and other risk constraints, reasonable earnings are generated over the medium to long-term on the funds invested. In the case of Nigeria, in addition to the above objectives, Nda (2006) enthused that safety (capital preservation) forms the overriding objective of reserve management. To that extent, the government invests its reserves only in government securities (treasury bills and bonds) and foreign banks with impeccable credit standing.

The statutory responsibility for the formulation and realization of the external sector policy objectives of the country is vested on the Central Bank of Nigeria by the Central Bank of Nigeria Decree No. 24 of 1991 which mandates the Bank to maintain an adequate level of external reserves to safeguard the international value of the country's currency; ensure external economic stability; maintain the reserves in specified external assets; and to use its best endeavour to maintain these assets at levels

it considers to be appropriate for the monetary system in Nigeria. In order to achieve these objectives, the government was constrained to be directly involved in the funding of the foreign exchange market given its external commitments and obligations, especially to debt service. Consequently, government FER management strategy hitherto revolved around "investment of reserve funds in secure, short term liquid assets in order to ensure prompt availability of funds when required; the rescheduling of the external debt in order to reduce the debt service burden and thereby conserve the reserves and the selection of only a few correspondents banks to operate documentary credits on an unconfirmed basis in order to enable Nigeria pay only when shipments are made".

However, the wind of globalization had significantly altered this reserve management strategy as the country, along with others, now position itself to take economic advantages prevalent in other economies by adopting more prudent high-yielding means of managing its reserves. Thus, consistent with emerging global best practices, the CBN in 2006, as part of its banking sector consolidation incentives, appointed global custodian for the management of its component of FER which hitherto was kept as deposits with foreign banks. The Bank thus named 14 foreign fund managers to partner with local banks in the management of the nation's reserves in line with government policies and guidelines. According to Nda (2006) the use of external fund managers was informed by the following benefits: 1) external managers could be used as yardstick for measuring the performance of internal managers; 2) external managers could be used to train internal staff through organizing seminars, conferences, attachment programmes, etc; 3) external managers could also provide internal staff with access to their research materials as well as provide them with market information; 4) since external managers are highly specialized and have deeper understanding of the global markets, they could enhance returns on the reserve portfolio; and 5) external managers could serve as fall back option in the event that some experienced internal staff leave the central bank.
Similarly, the new strategy is intended to enable prospective local banks to leverage on their partnership with external fund managers to equip themselves to play competitively at the international financial arena as well as sharpen their custody, asset management and other financial services skills. In order to ensure the success of the new strategy, the Bank has, in addition to the provision of other institutional infrastructure, increased the number of counterparties where the Bank funds are placed, with a view to spreading the attendant risk; entrenched the process of transparency and policy formulation based on IMF Guidelines for FER management; established the national investment fund to shield the economy from oil price uncertainty and volatility; established a dealing room with state of art and functional ICT equipment; the inauguration of an investment committee with the oversight function on reserve management in line with best practices; and the listing of the Bank as a member of the World Bank's Reserve Advisory and Management Program (RAMP). The Bank under the new reserve management framework also established the Strategic Asset Allocation to optimize the long term returns of reserves vis-à-vis the risk tolerance posture of the Bank.

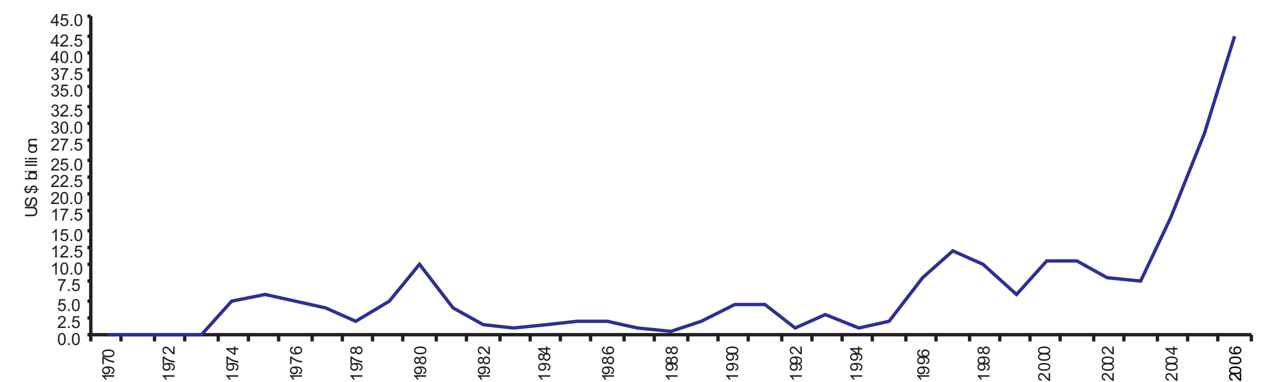
3.1 Trends in Foreign Exchange Reserve in Nigeria

The statutory mandate for managing Nigeria's foreign reserves is vested in Central Bank of Nigeria. The Bank hold the country's FER in major currencies including the US dollar, the euro, the Japanese yen, the British pound, the Swiss franc and those of other trading partners. However, Nda (2006) observed that over 90 per cent of Nigeria's FER is denominated in the US Dollar, mainly due to the fact that its crude oil receipts and other non-oil exports are invoiced in US Dollar while most of its obligations such as external debt service, foreign exchange intervention, as well as other service obligations are also denominated in US Dollar. Nigeria's reserves stock, which stood at a modest US$0.15 billion in 1970, rose to a significant US$43.0 billion in 2006, equivalent of 1.7 and 28.4 months of import cover, respectively. Prior to the oil windfall of 1974, reserves averaged US$0.25 billion or 1.9 months of import cover. Fortunes from the oil boom,

however, swung reserves position sharply to an average of US$5.2 billion or 8.24 months of import cover between 1974 and 1980, with the highest stock of US$9.97 billion recorded in 1980. This rise was attributed to the loans contracted in 1978, the increased oil revenue receipts of the last two years of the decade as well as the import austerity measures of 1979.
Sequel to the sharp decline in the international crude oil prices, exacerbated by the sustained rapid import expansion, foreign inputs requirements for import substitution industrialization strategy, the misaligned foreign exchange rate crises, the hamstringed domestic industrial production and poor performance of the non-oil exports, intense pressure was brought to bear on the reserves stock leading to a phenomenal depletion to US$0.072 billion or 1.8 months of import cover in 1988. Except for 1991 when reserves rose to a decade high of US$4.45 billion or 5.9 months of import cover, the stock of reserves hovered around an average of US$2.1 billion or 3.4 months of import cover between 1981 and 1995. The poor trend in reserves build up during this segment was attributed largely to weakening international oil prices, substantial increases in aggregate domestic demand pressures, external debt overhang and interest payment, deteriorating terms of trade, expansion in fiscal and monetary policies, overvaluation of the official naira exchange rate, excessive demand over supply for foreign exchange following substantial increase in domestic liquidity, compounded by the CBN undertaking to meet all genuine foreign exchange demand of the authorized dealers.

The level of international reserves, thereafter, maintained a sustained rise albeit with some fluctuation in 1999. Reserve stock rose from an average of US$3.21 billion or 4.1 months of import cover between 1989 and 1996 to a significant US$11.9 billion in 1997, representing an increase of about 271.6 per cent. Though it declined to US$5.9 billion in 1999, it however, recovered to US$10.7 billion in 2000 but fluctuated downward to US$7.7 billion or 7.4 months of import cover in 2002. Since then reserve position had risen astronomically to US$17.0 billion or 13.6 months of import cover and US$42.3 billion or 28.4 months of import cover in 2004 and 2006, respectively. This positive out-turn in the reserves position was accentuated by a conglomeration of factors including disciplined fiscal and monetary policy stance, high crude oil prices in the global oil market and the low debt service burden occasioned by the debt deal that tumbled Nigeria's debt stock from US$35.9 billion in 2004 to US$3.5 billion only in 2006.

Figure1: Nigeria's Foreign Exchange Reserves (US$ billion)



As earlier alluded, growth in Nigeria's foreign reserve position is consistent with the global and emerging markets trend. According to Valderrama (2005), total worldwide foreign reserves holdings reached US$3 trillion at the end of 2004, up from US$2.4 trillion in 2003, with the largest holders being Japan (US$834 billion) and China (US$615 billion). By 2006, the table had turned with China assuming the leadership position with a staggering US$1,184.3 billion while Japan reserve stock grew to US$875.0 billion. Hodges (2007) noted that Japan and China alone hold about 40 per cent of total world international reserves while the Asian countries cumulatively hold about 80 per cent of the world's official foreign exchange reserves.

3.2.1 Drivers of Nigerian Foreign Reserves

According to Soludo (2007), the main sources of rising FER in Nigeria includes inflows of oil revenues complemented by diaspora remittances, growing FDI and portfolio investments, capital inflows, banks' on-lending activities to foreign financial institutions, growing guarantees and grants, etc. The rising FER has been enabled by many factors other than external. Such factors include developments in the debt portfolio, which now stand at $3.5 billion, compared with $35.9 billion in 2004; developments in the financial markets, described as the fastest growing in Africa coupled with stable inflation and exchange rates that have stimulated capital inflow. The gradual sophistication of the financial market has also enabled the CBN to effectively undertake the necessary sterilization operations to keep money supply growth at a rate consistent with the growth objectives of the economy.

There is substantial evidence that high levels of reserves build up is sometimes accentuated by the political developments of the nation. Nigeria's enthronement of democratic governance, in no small way, filliped the country's reserves build up, having been returned to the community of global democratic economies. The prevailing political stability and friendly investment climate the country created has encouraged Nigerian in diaspora to remit monies home to families and for investment purposes. For instance, remittances grew to as much as US$4.0 billion in 2006, occupying the 29th position out of the 53 countries in Africa.

Another driver of FER increase is the growth in export earnings, increased tourism activities, the non-accommodating monetary stance and fiscal prudence. The inculcation of corporate governance in the conduct of government business, the Due Diligence process of awarding government contract and the war against corruption, all played significant respective roles in reserves growth.

A recent contributory factor is the ability of Nigerian enterprises, especially the financial institutions like banks, to raise debt and equity from foreign markets. The recapitalization of the banks empowered them to enter the international market and play competitively, a situation which hitherto was not possible. Consequently, GTBank, First Bank, Equitorial Trust International among others, have issued international bonds (second tier capital) as well as secured international funds. According to the CBN Governor "Nigeria currently boasts of having the first two companies in Southern Africa to successfully issue Eurobonds". Similarly, the reforms in the sector resulted in many more companies resorting to the capital market to transact business, a development that led to the inflow of Foreign Direct Investment (FDI) of about US$652 billion and £162,000 as at December 2006.

Overall, the prime place cannot be taken away from oil as the main driver of FER growth in Nigeria. Nigeria has recently experienced favourable international oil prices, reminiscent of the 1970s oil boom. Oil prices were in the neighborhood of US$80 and US$90 per barrel for most of 2007, with high prospects of striking the US$100 per barrel mark by end of the year. The favourable oil prices are hugely complemented by developments in our debt portfolio, the successful reforms in the financial sector and the deepening of the money and capital markets all of which offer the monetary authorities the operational tools necessary for effective management of the economy.

3.3 Risks in Foreign Exchange Reserve Management in Nigeria

The Bank, in carrying out its reserve management function, is indubitably exposed to various degrees of risks and financial hazards, depending on the strategy adopted. The IMF (2004) broadly categorized these risks into external market-based risks and operational risks,

which is not in any way exhaustible. Under the external market-based category are risks such as the liquidity risk which arises from government pledging its reserves as collateral for credit facility extended to either domestic or foreign entities, the failure of payment of which posses a risk to the Bank. More so, such pledged reserves are rendered illiquid for the duration of the facility. Credit risks are losses incurred from investments of reserves in instruments whose risk portfolios were not duly or professionally assessed. Another market-based risk is the currency risk arising from exchange rate movements leading to huge losses from the depreciation of the foreign currency in which reserves are held. Interest rate risk arises from increases in market yields that reduce the value of marketable investments below their acquisition costs.

From the operational risks block are control system failure risks which are associated with fraud, money laundering, or outright theft as a result of weak control procedures, inadequate skills, collusion among reserve managers, etc. Financial error risks are measurement risks arising largely from the reference of reserves to only one currency composition without including other foreign-currency-denominated assets and liabilities. Financial misstatement risk is one that arise from incorrect reporting of asset position such as the inclusion of funds lent to domestic or the foreign branches of domestic banks. Loss of potential income risk is the loss of significant revenue arising from the inability of the Bank to timely reinvest funds accumulating in clearing (nostro) accounts with foreign banks. This often arises from poor monitoring and settlement procedures. A refinancing risk is that which arise when the Bank experiences disruption in the rolling over of maturing loans.

4.0 Are Nigeria's Reserves Adequate?

Currently there are no internationally precise measurement benchmarks of what constitute optimal level of reserves; hence partial indicators are often employed in this regard. Historically, the literature has three basic indicators for assessing the optimum level of reserve for countries reserves/import ratio; reserves/money supply (M2) ratio and reserves/short-term external debt ratio.

4.1 Months of Import Cover

The most frequently used benchmark in determining the vulnerability of countries is the months of import cover. It measures a country's level of trade exposure, signifying the vulnerability or ability of country to continue to finance its imports, for a certain period of time, usually 3-4 months, should there be an unexpected decline in its exports or reserves. This indicator is especially relevant to low income countries that are vulnerable to current account shocks and with limited access to international capital markets. A country's holding of reserves, in this respect, are likely to increase or decrease depending on the country's average propensity to import, which is a measure of the economy's openness and vulnerability to external shocks and the size of international financial transactions that occur there. Prior to the promulgation of the Central Bank Decree No. 24 of 1991, the law required the CBN to hold at all times external reserves of not less than 25 per cent of its total demand liabilities. However, the bourgeoning level of imports made this target a daunting one to achieve. Currently, Nigeria along with several other countries has met this benchmark several times over, as depicted in figure 2 below.

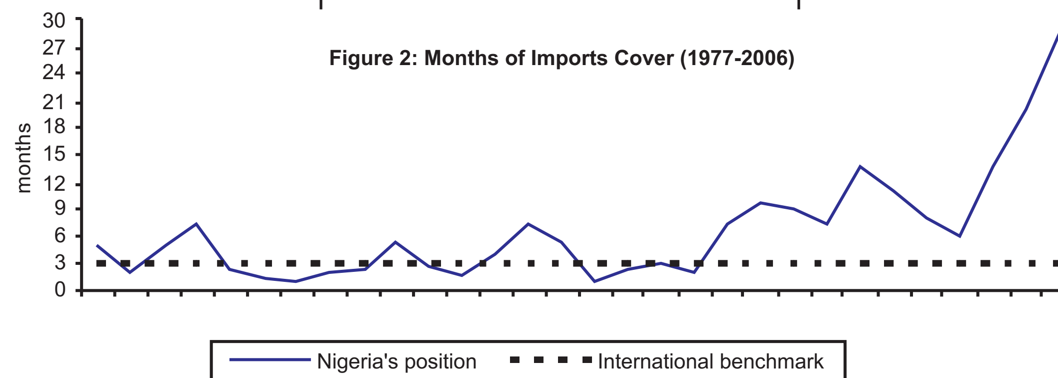


Figure 2: Months of Imports Cover (1977-2006)

The figure reveals that reserves holdings of Nigeria in the review period exceeded the IMF required threshold of 3 months and the WAMZ convergence criteria of 6 months of import cover for most of the period (63 per cent,) predominantly after 1995. This excess holding had resulted in great losses for, according to Rodrik, in 2004 alone, developing countries lost 1.0 per cent of their GDP by holding more reserves than the amount required covering three months of imports. The months of import cover for Nigeria, hovered around the average of 3.4 months between 1977 and 1995. Between 1996 and 2006, months of imports cover rose to an average of 12.3, comparatively higher than developing countries' reserves which fluctuated between 3 and 4 months of imports prior to 1990, but which now stood at over 8 months and against developed countries' reserve-import ratio, which still stands at 3 months import cover, (Rodrik, 2006).

This benchmark had been criticized and adjudged to have outlived its usefulness by many analysts, in that it concentrated only on external current account balance, prevalent in the pre-globalization era when capital movement was restricted. Given the quantum of unexpected capital flows some of the developing and emerging economies are now in receipt of, coupled with the liberalized capital accounts they are operating, there is the need for a shift of emphasis from the Fund's threshold of months of import cover to measuring the vulnerabilities of capital account. More so, for developing and emerging economies, this threshold is definitely inadequate and highly risky and hence the need to consider the interplay between reserves and other macroeconomic factors as public debts, banking system strength, and other country-specific factors in the determination of reserves adequacy.

4.2 Reserves-M2 Ratio

The reserves/M2 ratio measures the country's ability to cushion an unexpected outflow of capital, requiring reserves to be equal to between 5-20 per cent of the country's money supply (M2). This benchmark is essential for economies that need to shore up confidence in the value of local currency as well as reduce the incidence or risk of capital flight. Hence holdings are likely to increase with more volatility in a country's export receipts.

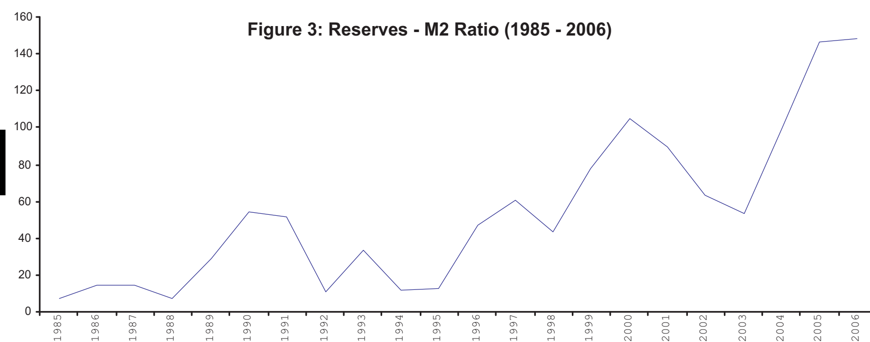


Figure 3: Reserves - M2 Ratio (1985 - 2006)

The reserves/m2 ratio for Nigeria trended in similitude as the import cover indicator. The 520 per cent equivalent of reserves to M2 benchmark hypothesized by Wijnholds and Kapteyn (2001) seemed to be an appropriate and acceptable buffer for the international community. On the average, the ratio hovered within the buffer (20 per cent) from 1985 to 1996 and thereafter achieved levels quite above the buffer zone. It could be inferred by this standard that Nigeria has equally held adequate reserves for the review period indicating the public confidence on the central bank's ability to convert domestic liquidity to foreign liquidity. The high ratio also implies that the rate of converting the domestic currency for the foreign is reduced, especially under the flexible exchange rate regime. This also offers a possible explanation for the low ratio witnessed for most of the period under fixed or managed exchange rate which was also characterized by capital flight.

4.3 Reserves Short-Term Debt Ratio

The third indicator, empirically favoured by Green and Torgerson (2007), Jeanne and Ranciere (2006), Garcia and Soto (2004), and many others, is the "Greenspan-Guidotti rule", which requires countries to hold reserves equivalent to 100 per cent cover of their short term external debt. This vulnerability benchmark measures the ratio of foreign reserves to short term external debt (amortization and interest payments) falling due within the next 12 months. The index measures the exposure of a country to capital account and currency crises. Figure 4 depicts the ratio from 1985 to 2006. It is shown that between 1985 and 1995 the ratio

hovered around one (1) indicating that reserve holding barely cover due debt service obligations by a 100 per cent. From 1996, however, one can confidently say that reserves holdings were adequate as the ratio exceeded the Grenspan-Guidotti threshold.

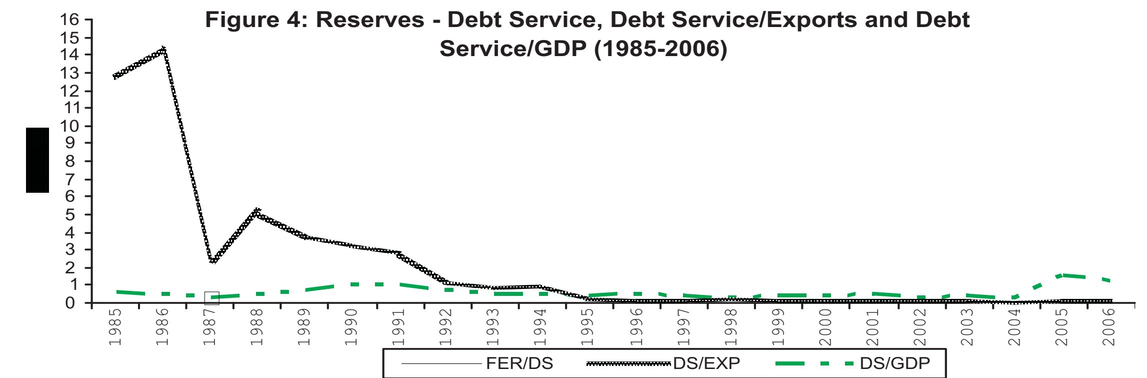


Figure 4: Reserves - Debt Service, Debt Service/Exports and Debt Service/GDP (1985-2006)

The debt service to export and debt service/GDP ratios are other relevant yardsticks for assessing vulnerability or reserves adequacy for a country. While the former is a pointer to the capability of the country to earn FER to finance imports, the latter is more related to economic growth than FER earnings. Even though high levels of growth do not imply high FER, Williams (2005), suggests that the structure of production must be geared towards export earnings in order for economic growth and FER accumulation to be in sinc. Prior to globalization, international institutions and rating agencies focused on government external debt but with the growth of private sector debt as a result of globalization, central banks would have to hold more reserves to meet FER demands of and the servicing of debts by the private sector.

Table1: Foreign Reserves Accumulation: Oil Exporting and Some Asian Countries (US$bn)

OPEC COUNTRIES	Stock at end-2005 ($US)	Stock at end – 2006 ($US)	Reserves per capita (2006) ($US)	Per cent of Total (2006)
Russia	182.2	303.0	2.12	37.72
Saudi Arabia	153.0	225.2	10.39	28.04
Libya	39.5	60.4	10.32	7.52
Algeria	56.3	76.4	2.33	9.51
Nigeria	28.3	42.3	0.32	5.27
Venezuela	23.9	28.2	1.05	3.51
Mexico	68.7	67.7	0.63	8.43
Total	**551.9**	**803.2**	**Av. 3.88**	**100.0**
SELECTED ASIAN COUNTRIES				
Japan	828.8	875.0		27.21
China	893.0	1184.3		36.82
Hong Kong	124.3	133.2		4.14
India	131.0	170.2		5.29
Indonesia	32.8	40.9		1.27
Malaysia	70.2	82.5		2.57
Philippines	15.5	23.0		0.72
Singapore	116.6	136.8		4.25
South Korea	210.4	239.0		7.43
Taiwan	253.3	266.2		8.28
Thailand	50.1	65.1		2.02
Total	**2,726**	**3,216.2**		**100**

Source: RGE Global Reserve Watch: Quarter 4, 2006 Update.

The table above is very instructive as per Nigeria's position both among the Oil Producing and Exporting Countries (OPEC) and some selected Asian countries. In terms of reserves build up among the OPEC countries, Nigeria's stock as at 2005 and 2006, were able to exceed only Venezuela but trail behind Algeria and Libya, African OPEC members. Russia topped the list followed by Saudi Arabia. Though Nigeria's growth during the period was impressive, quite above the OPEC average, its percentage proportion to the total OPEC reserve is minimal, as it recorded only 5.27 per cent, again, a little above Venezuela's 3.51 per cent but far below Russia's 37.72 per cent and 9.51 and 7.5 per cent for Algeria and Libya, respectively. In terms of reserves per capita, a benchmark that measures how much international reserves a nation has backed up for each of its citizens, Nigeria's position among the OPEC community is appallingly low in 2006. While Saudi Arabia and Libya led with US$10.39 and US$10.32, per citizen, respectively, Nigeria recorded the lowest per capita reserve of US$0.32, marginally below Mexico (US$0.63) and far below Algeria (US$2.33) and Russia (US$2.12). According to Hodges (2005) USA had (US$224.26); China (US$788); Germany (US$1,382); Japan (US$7,011) and Switzerland (US$8,689) reserves per person. Compared with the Asian countries, the story is replicated as Nigeria was marginally above Indonesia and Philippines as at end December 2006, indicating that though great strides have been recorded, Nigeria still has a long way to go.

From the foregoing assessments, the issue of considering Nigeria's reserve holding as adequate can not be conclusive, in that while going by the international thresholds, Nigeria could be adjudged to be holding adequate reserves to meet its economic objectives and reduce its vulnerability to financial crises, the same cannot be said when compared with its contemporaries as table 1 above reveals. This point to one fact: that Nigeria need to acquire more reserves to consolidate its position in the comity of contemporary nations.

But holding reserves beyond the required benchmarks, all things being equal, entails diminishing marginal benefits and rising marginal costs, as the marginal benefit of accumulating reserves is sure to decline at some point.

5.1 Implications of Foreign Exchange Reserves Accumulation

It was established in the preceding section that though Nigeria's external reserves growth exceeded the standard thresholds earmarked for adequacy, it was comparatively behind its contemporaries. This implies some macroeconomic implications for the domestic economy, particularly as the management of reserves involves both cost and benefits parameters. This section thus intends to reiterate some of the accruable benefits for holding FER which had been highlighted earlier on. The enormous benefits of FER accumulation to the country would better be appreciated with this hypothetical but true scenario. Let's assume for a moment that the reserve level is unsustainably low. What would be the domestic implication? The wheel of a myriad of economic activities such as exchange rate depreciation, rising interest rates (thus crowding out private investors and reducing productivity), increased prices of imported raw materials and production inputs that would snowball into higher prices and product scarcities would have been set in motion.

Given the state of our refineries and the consequent dependence on imported refined fuel, petroleum product prices would increase beyond the reach of ordinary citizen, transportation cost would increase, food prices too, industries would retrench and subsequently close down as industrial fuel price rises (rising unemployment), medical and other services cost would jump up in tandem as well as external and domestic debt service burden. In summary inadequate reserves would result in high inflation, unemployment, lull in business activities, capital flight, depreciating exchange rate, high interest rate and high money supply. The combined effects of these on the economy are better imagined than experienced. Reserves, therefore, afford the monetary authorities the prerequisite ammunition to defend its currency during crises periods, avoiding being

excommunicated from the international financial markets for fear of default either by the government or the private sector on foreign debt payments and obligations. The country is, thus, adjudged creditworthy to borrow or contract new debt for growth and development. The current inflow of FDI, the sharp rise in remittances, the rating of Nigeria as B+, the de-listing of Nigeria from Financial Action Task Force, the meeting of policy support instruments, and many others were strongly traced to the reserves growth.

Specifically, FER accumulation greatly enhances a sovereign state's credit rating occasioned by greater confidence in the foreign exchange market. An improved credit rating immensely helps the sustainability of external reserves positions. Strong growth in reserves is a pointer to the country's capacity to redeem all external obligations a they fall due, thus reducing the risk of currency speculation. Growing FER positions also highlight the underlying potential strength of economic fundamentals in the economy, and thus engender confidence in the economy.

Similarly, prior to the achievement of a robust position in reserves, it was the preference of exporters to keep their export earnings abroad to finance external obligations. This trend has, however, changed as not only has remittances by Nigerians in diaspora grown tremendously but huge foreign direct investment had flowed into Nigeria especially in the capital market segment of the economy. The choice to repatriate funds home is a testimonial of the confidence reposed by the international community in the economy, informed largely by the excellent performance of the reserve position of the country. The appointment of external fund managers to manage the country's reserves is an added source of confidence as these custodians do not only bring their professionalism and expertise to bear in the optimal management of the reserves but also ensures transparency in the country's reserve management strategy. FER accumulation engenders confidence in the country's currency, giving the central bank the window to intervene in the foreign exchange market in order to influence the exchange rate.

Another beneficial implication for holding reserves derives from the notion of shielding the economy from vulnerabilities of external shocks. The financial crises witnessed by the Asian countries in the late 1990s and early 2000s underscore the need for countries to hedge against sudden capital movement. Reserves accumulation thus enables countries to achieve financial independence such that capital flights do not severely distort internal economic development or better still result in subjecting the country to obnoxious credit conditions of the IMF and other international lending agencies.

Another advantage of FER growth is the reduced country risk or as a corollary a reduction in borrowing cost. The high credit rating of the country by rating agencies results in low borrowing cost at the international financial market as the country is no more seen as a high risk client.

Suffice to note that in spite of the huge identified benefits often associated with holding increasing reserves, reserves accumulation is an expensive policy with varying degrees of costs, most of which are difficult to express quantitatively. This section would explore cost factors such as sterilization cost, opportunity cost, balance sheet cost as well as other related cost components as they impact on the economy.

5.2 Sterilization Costs

Sterilization is a monetary management strategy, designed to insulate or prevent monetized external reserves from influencing domestic economy's banking system credit financing, government financing of increased expenditures, and the distortion in the movement of other macroeconomic indicators. It has two cost implications according to Green and Torgerson (2007). The first is the direct fiscal cost to the monetary authority and the second is the indirect systemic cost of preventing current account adjustment, with the direct cost being the most commonly considered. Fiscal cost, according to them, is the premium between what the CBN earns on international reserves investment and what it pays on the domestic debt issued to sterilize the effect of reserves on the economy, (see table 2). If the returns on

foreign reserves are less than government's borrowing rate, a fiscal cost is incurred. For countries like Nigeria with high domestic interest rate (20-26 per cent), such cost would supposedly be enormous. In addition, the economy may incur indirect systemic costs in its bid to stifle the monetary impact of reserves in that sterilization permits a central bank to manipulate the real exchange rate and consequently disrupt appropriate current account adjustment.

Table 2: Fiscal Cost Indicators

	2000	2001	2002	2003	2004	2005	2006
Foreign Exchange Reserves (₦ billion)	1,090.10	1,181.70	1,013.50	1,065.10	2,252.60	3,835.43	5,441.64
Interest on Reserves & Investments (₦ billion)	35.92	40.28	19.94	10.51	20.84	92.37	215.06
Domestic Debt Service (₦ billion)	108.49	155.4	170.64	200.00	203.64	150.45	166.8
Nominal Losses	72.57	115.12	150.7	189.49	182.8	50.08	-48.26
External Debt Service (₦ billion)	174.43	238.23	148.27	247.87	233.14	1,165.24	284.6

Sources: Annual Reports of the Central Bank of Nigeria and Debt Management Office

5.3 Interest Rate Cost

Liquidity mop up exercises that often accompany sterilization impinge on the money supply in the system, driving interest rate high. Hence, where sterilization debt outpaces the growth of money supply consistent with monetary policy objectives, a saturation point would be reached where it would require higher interest rate to persuade investors to hold more of domestic government debt. The higher interest rate, given the current high global mobility of capital, would induce more foreign inflows setting in motion another vicious cycle of sterilization, resulting in higher interest rate, and to more capital inflows. And the cycle continues. A point will be reached when either the exchange rate would be allowed to appreciate or money supply would grow, resulting ultimately in higher inflation, further crowding out of private sector investment and ultimately low national output.

5.4 Exchange Rate Cost

Many countries sterilize FER with a view to preventing an upward movement or appreciation of their real exchange rate which influences trade and capital flows. Sterilization gives a false sense of efficient resource allocation, thus misdirecting resources to inefficient sectors and regions. The effect is a distortion in resource allocation (over investment in some sectors to the detriment of others) and the mitigation of the formulation and implementation of necessary policy reforms. Expectations of eventual adjustment can attract speculative capital inflows and hence asset bubbles, although these flows also tend to lower domestic interest rates and, therefore, may lower direct fiscal costs, (Green and Torgerson, 2007). If on the other hand, capital does not flow in, domestic interest rate would rise, crowding out private investment in the process. The IMF (2006) noted that the prevention of real exchange rate appreciation has recently contributed to a global current account imbalance, one of the IMF's primary concerns for the world economic outlook.

5.5 Opportunity Cost.

According to Williams (2005), the opportunity cost of holding reserves is the foregone investment of resources, which have been used to purchase reserves rather than towards building domestic investment capital. In other words, the opportunity cost of holding reserves is the marginal productivity of domestic capital. Though, at least for now, there is no general consensus as to what indicators should be used in measuring the opportunity cost of reserves accumulation, Summers' (2006) ad hoc construct seemed to gain international acceptability. Having noted the enormous cost of developing countries' holding of reserves beyond what is necessary for financial stability, Summer, asserts that "if the wealth tied up in reserves were invested either domestically in infrastructure or in a fully diversified long-term way in global capital markets, 6 per cent would not be an ambitious estimate of what could be earned. The resulting gain would be close to US$100 billion a year". Applying this suppositions to emerging economies like Nigeria which are high short-term debtors characterized by low earnings on FER investment compared with their high cost of debt service, simple economic reasoning would suggest the settlement of debts rather than investing the reserves, an option Nigeria adopted in 2006.

Another related cost according to Summers (2006) is that reserve build up forms a substantial outflow of capital from the developing countries and emerging markets to the industrialized world, especially the United States, whose 75 per cent of net international borrowing is financed overwhelmingly by emerging markets and oil exporting countries' reserves. This is contrary to expectations that capital should flow the other way round. The real returns on these reserves are very low. If real exchange rates in emerging markets are likely to appreciate then domestic returns will be even lower and more risky. These three elements flow of capital from emerging markets to industrial countries, huge accumulation of reserves, and expected negative returns on reserves, constitute what might be called the capital flow paradox in the current world financial system, (Summers, 2006). In other words, Nigeria is, in essence, exporting the very resource it requires for the formation of the domestic capital.

5.6 Balance Sheet Risks

From the perspective of the developing countries, an economy with an appreciating exchange rate is very likely to incur enormous nominal losses in the value of their foreign assets, especially where the foreign assets form a major component of the monetary authority's balance sheet. These losses may net out over time by the central banks, depending on the maturity profile of its foreign assets, the speed of appreciation of the local currency and the positive interest margins. However, Green and Torgerson (2007) noted that leaving itself undercapitalized, could in time jeopardize the central bank's credibility and ability to target price stability, intermediate government foreign borrowing, act as lender of last resort or to maintain a domestic payments system. Even if the central bank is able to recapitalize from retained profits and is not directly affected by the losses, those retained profits represent revenue forgone by the treasury, they further argued.

Unrealized losses are incurred where the local currency appreciates or the foreign currency depreciates. Reserves in most of these countries are several times central bank capital (78 per cent in the case of Nigeria) so the magnitudes of such potential losses are enormous. Table 3 gives an illustration, assuming, for the purposes of approximation, that all currencies held by Nigeria in its basket of reserves exchange at the same rate. Nigeria's external reserve stood at US$28.3 billion in 2005 at the exchange rate of N130.29 to the dollar, giving a local nominal value of N3,684.2 billion. By 2006, Nigeria's exchange rate appreciated by 1.37 per cent to N128.27 over the dollar.

Table 3: Nominal Central Bank Balance Sheet Losses

	2005	2006	Nominal Losses 2005	Nominal Losses 2006
Foreign Exchange Reserves (US$ billion)	28.28	42.30		
Exchange Rate	130.29	128.27		
Foreign Exchange Reserves (₦billion)	3,684.48	5,425.56		
1.2 %	(3,640.26)	(5,360.46)	44.21	65.11
1.4 %	(3,632.90)	(5,349.61)	51.58	75.96
1.6%	(3,625.53)	(5,338.76)	58.95	86.81

Source: Author's computation

The table demonstrates the nominal losses that would be incurred under three scenarios: a 1.2, 1.4 and 1.6 per cent appreciation of the local currency over the dollar. At 1.37 per cent appreciation the nominal balance sheet loss of N75.96 billion or reduction to the domestic economy is incurred while a 1.6 per cent appreciation would attract a nominal loss of N86.81 billion. Considering some economic fundamentals like the reforms complemented by rising oil prices, there are possibilities that the naira would continue in its upward movement. This would imply significant losses. This result is in tandem with the findings of Mohanty and Turner (2006) which observed significant valuation losses in the face of appreciating local currency. They, however, quickly added that though such losses do not reduce central bank's ability to intervenes, nor do they reduce the purchasing power of its foreign currency reserves in terms of foreign goods but it might undermine central bank's credibility and independence.

5.7 Other Costs

Apart from the cost points identified above, there are several other cost components that are associated with reserves build up. One of such cost implications is the absence of simultaneity in the nature of assets being held and borrowed. While foreign assets are mostly held in government securities, domestic borrowing on the other hand is done from the private sector. Reserves holding countries have no direct access to borrow from the countries where their reserves are placed. Government domestic borrowing thus overcrowds private borrowing, driving interest rate up; dampening investment and reducing aggregate output of the economy.

Reserves holding are inextricably linked with foreign exchange rate management, at least for the developing and emerging economies. This introduces another strand of complexity in monetary policy formulation. The management of a matrix of policies to achieve both monetary and exchange rate objectives consistent with the overall economic growth objectives, would require a delicate balancing, as the pursuit of one might lead to unexpected gyrations or erosion in the outcomes of other macroeconomic variables. Rapid reserve accumulation may also complicate the formulation of monetary policy under flexible exchange rates.

6.0 Way Forward

Though reserves accumulation results in improved confidence, but the over accumulation of a country's FER in a single currency would tantamount to vulnerability and erosion of the very confidence it was meant to build. The current situation where over 90 per cent of Nigeria's FER are held in the US dollar points to an over exposure of the country to the gyration of the dollar, increasing the country's risk and vulnerability. Valderrama (2005) cites Dougherty (2005) and Koizumi (2005) as alluding to the apprehension clouding the global financial market as both South Korea and Japan are said to be considering diversifying their holdings of foreign reserves away from the dollar. Currently the Asian countries account for 80 per cent of total world reserves, 70 per cent of which is dollar-denominated. China and Japan (Asian countries) hold 40 per cent of world international reserves and constitute about 50 per cent of Asian proportion. If analysts' thought are true and these two governments sell some of their dollar-denominated assets, an excruciating pressure would be brought on the dollar. The consequences are obvious: further depreciation of the dollar and monumental nominal losses in the balance sheets of central banks that hold large proportions of their reserves in dollar, Nigeria inclusive.

The Nigerian monetary authority, therefore, need to critically reexamine the currency composition, portfolio management and duration or maturities of internationally invested securities. Adequate diversification of asset holdings across currencies is a prerequisite to mitigating or reducing risks. In addition, the country should hedge against the depreciation of one currency by holding reasonable amount of other hard currencies since the depreciation of one hard currency implies the appreciation of another hard currency. Nigeria should hold large reserves but reduce their level of exposures through currency diversification; especially as there are great apprehensions at the international circles about the implications of US enormous deficits payments on the global economy. The view of the international financial institutions is that the currency composition of the reserves should broadly reflect the composition of potential flows

rather than trade flows only (Williams, 2005).

The government must ensure a virile investment-friendly institutional and macroeconomic environment by enshrining transparency and good governance, liberal and competitive playing field devoid of business encumbrances, and improved legal framework that would ensure law and order are maintained and the safety of lives and property is guaranteed. It is only through such provisions that the much desired export and economic growth would be achieved. Hussain (2002) summed it all by stating that whether reserves will continue to accumulate in the future will depend on the record of the country in adhering to macroeconomic objectives, pursuing good economic management and implementing structural policies. Government should leverage on the improved credit rating and confidence in the economy to formulate sustainable external sector policies that would further woo investors. In the same vein, a comprehensive overhaul of necessary laws and regulations (like the land use Act) must be appropriately amended to boost development and FER growth.

As a corollary, the cost of doing business in the country strongly influences the level of reserves build up. According to the World Bank Group's (2007) “Doing Business Indicators”, Nigeria is ranked 12th in Sub-Saharan Africa far behind Kenya (6th) and Ghana (8th) and 108 among 174 countries covered in a survey with respect to the ease of doing business in the region. The report further indicated that prospective entrepreneurs go through 9 and 16 procedures taking an average of 43 days and 465 days to start a business and deal with licensing, respectively. The cost structures, delay in business registration, corruption, etc, reduces the profitability of businesses and the growth of its exports of goods and services, precursors for FER growth. In the West African sub region, Nigeria had lost many potentially viable investments to Ghana due to infrastructural inadequacies and cumbersome registration procedures.

Reserves could be used in the financing of growth-inducing projects. India, for instance, dedicated its reserves to financing infrastructures. In the case of Nigeria, bearing in mind that oil, the major FER earner, is an exhaustible or wasteful resource and whose prices are volatile and exogenously determined, investing FER in the other sectors of the economy would further ensure the continuous flow of reserves. The employment of reserves in the provision of social, cultural and economic infrastructure would boost productivity as well as diversify and expand the export base of the economy for sustainable growth. Thus, returns from such public investment would, by far, outweigh current earnings from international reserves, as long as they are allocated efficiently. It would also save the foreign earnings often dedicated to medical bills and the importation of other essentials by the country.

That Nigeria liquidated its external debt in 2006, is to say the least a no mean achievement. Prior to this time, enormous resources were committed to servicing external debt which highly depleted FER, thus always returning the country's current account balance to the deficit. Now that the economic space of the country had been expanded, (through huge savings from debt relief) such resources should be committed to projects that would lead to poverty reduction, the meeting of the Millennium Development Goals (MDGs) and other social safety nets that would impact positively on production. Such improved national output would impact positively on the export base, which is a precursor for FER growth. If the Financial System Strategy 2020 master plan and the NEEDS project are anything to go by, it is imperative that budgetary allocation to the social and economic sectors be increased substantially with a view to generating and stimulating the desired economic growth and development that would enlist Nigeria among the top 20 economies of the world by year 2020. A development plan without complimentary soft and hard infrastructure availability would tantamount to futility. Now that the reserves have reached a somewhat comfortable level of US$42.3 billion in 2006, with a stable, appreciating and converged exchange rate, stable and single inflation rate with reduced speculative activities as the markets are assured of the availability of the reserves, it is expedient that government explore avenues for more optimal utilization of subsequent reserves. The dilapidated economic and

social infrastructure should be resuscitated to induce private sector investment, stimulate productivity and economic growth. The government should facilitate economic growth by using reserves to import technology and capital goods and thus scale up production.

The Nigerian capital market has been variously acclaimed as one of the fastest growing in the whole of the continent, responding with speed to domestic and international opportunities. This is an indication that given the right economic environment, such rewards like low cost of funds and stable global capital from the market are potentially very high, more than 400 per cent, compared with other countries. However, the speed at which the CBN and EFCC are currently investigating foreign investments in Nigeria is counterproductive as it takes about six months or more for such investigations to be concluded, depriving genuine investors the opportunity of transacting businesses. Investigation time must be drastically reduced to allow genuine investors transact their businesses within the shortest possible time, taking advantage of the capital appreciation, which is the world standard the Nigerian capital market is aspiring to achieve. The long period of investigating foreign investors deter foreign investors from shipping their investments to the coast of Nigeria, thus reducing the inflow of FER especially in the face high mobility of capital in the global economy. Nigeria should not let the high credit rating achieved through debt relief be eroded by other institutional bottlenecks.

The achievement of surplus current account balance since 2003 is laudable, rising from 6.9 per cent to 24.5 per cent of GDP in 2003 and 2006, respectively. However, this may indicate a false strength of the external sector as the growth in FER had principally been accounted for by the rising oil prices and reduced debt service which do not represent any strength or rejuvenation in any economic fundamental. The growth in FER may thus hinder the undertaking of fundamental structural reforms that would engender growth and development. Government should thus pry beyond upward trend in reserve to articulate policies that would stimulate non-oil export that though had shown improvement, but still trail far behind import levels to sustain the FER growth peradventure the oil well cum revenue dries up.

The desire of government to smooth consumption in the face of poor internally generated revenue led to the building up of foreign exchange reserves. In order to release these resources for domestic application, there is the need for government to, not only harmonize its tax structure and mechanism but also expand and strengthen the tax base with the view to fully harnessing domestic resources as it has been shown that countries with sustainable domestic resources keep less FER and vice versa. Similarly, there is need for holistic fiscal reform especially in fast-tracking the passage of the Fiscal Responsibility Bill and the relevant amendment of the constitution to instill fiscal discipline, enthrone prudence and curb corruption. All these would eliminate the undue pressure often exerted by the various arms of government for the monetization of crude oil proceeds and other FER earned.

Conclusion

It had been established by the paper that countries hold reserves for various reasons, ranging from exchange rate management to smoothening of consumption, while factors as economic size, external vulnerability, export promotion, etc., determine the quantum of reserves held at any point in time. Nigeria's appreciable reserves growth, which is in tandem with emerging market and global trend, was noted as strong allusion was made to sustained reserve growth based on some economic fundamentals. It was also observed that Nigeria's reserves stock was quite above the international threshold benchmarks but, lagged far behind its contemporaries in the OPEC and Asian countries. The infused confidence occasioned by the high reserve growth, filliped by favourable international crude oil prices was noted. The paper recommended, among others, the diversification of Nigeria's reserves away from the dollar, resuscitation of dilapidated social and economic infrastructure to enable an investment-friendly environment, caution in contracting new debts, and the acceleration of investment verification exercises by the CBN and EFCC in the capital market. Though the current growth in FER accumulation is by all standards high, the cost implications such as the sterilization of monetized reserves seemed to be lower than the benefits at least for now. The exchange rate is fairly stable and the inflation rate is also trending downwards as domestic productive capacity is expanding. With the near liquidation of all external debt, government might now have enough economic space to attend to domestic debt "overhang", poverty reduction and the meeting of the MDGs goals, amongst others. Nigeria may well learn from the experience of the Asian crises and build reserves huge enough to cushion any risk from unpredictable capital outflow.

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