

## AFRICA RISK CONSULTING

### Nigeria Monthly Briefing August 2016

#### Nigeria Summary 3 August 2016

*The Central Bank of Nigeria (CBN) removes senior management of Skye Bank Plc after it breaches cash and liquidity thresholds. The banking sector's exposure to the oil sector has resulted in increasing non-performing loans, echoing the conditions that preceded the 2009 crisis. The federal government meets only 55% of its budgeted revenue target for the first quarter of 2016, as budget minister Udoma Udo Udoma makes an early start on the 2017 budget process. The CBN raises the benchmark lending rate 200 basis points to 14%. President Muhammadu Buhari (2015-present) appoints a new Nigeria National Petroleum Corp (NNPC) board, with junior petroleum minister Emmanuel Ibe Kachikwu the new NNPC chairman.*

#### CBN intervenes in Skye Bank over cash and liquidity concerns

The **Central Bank of Nigeria (CBN)** on 5 July removed the senior management of **Lagos-based Skye Bank Plc** over breach of cash and liquidity thresholds.<sup>1</sup> **Nigeria's** banking sector faces increased risks due its exposure to the struggling oil sector, while slower growth makes it harder to extend credit without increased exposure to non-performing loans. The CBN acquired the authority to remove banking sector executives following Nigeria's 2009 banking crisis. The context is similar to that which preceded the 2009 banking crisis when non-performing loans increased due to low oil prices and the global financial crisis. However, Skye Bank faced significant internal issues:

*"Skye Bank had major corporate governance issues, compliance was poor, insider-related credits were over the top and non-performing loans were alarming. The sack of the board was imminent."<sup>2</sup>*

The CBN acted after Skye Bank breached the thresholds designed to absorb losses on bad debts.<sup>3</sup> The CBN said the breaches had lasted "quite a while".<sup>4</sup> Skye Bank CEO **Timothy Oguntayo** and chairman **Olatunde Ayeni** were amongst the executives who were forced to resign.<sup>5</sup> **Adetokunbo Mukhail Abiru** is the new CEO and **Alhaji Ahmad** the new chairman.<sup>6</sup> In March, Skye Bank failed to report annual earnings for 2015.<sup>7</sup> This was after it used short-term funding in June of that year to acquire **Mainstreet Bank Ltd**.<sup>8</sup> Skye Bank's market value has declined 86% since 2011 to \$46m, and its shares have decreased 40% in 2016.<sup>9</sup>

The 2009 crisis badly damaged perceptions of the Nigerian banking sector and confidence is yet to recover, increasing the risk of contagion. Since the intervention, the CBN has publically said that Skye Bank remains healthy and that depositor funds are not at risk.<sup>10</sup> Skye Bank is Nigeria's eighth biggest lender by assets. Analysts warn that the prospects for a rights issue to inject capital into Skye Bank

<sup>1</sup> Premium Times, 7 Jul 2016.

<sup>2</sup> Source, economist, Lagos

<sup>3</sup> Premium Times, 7 Jul 2016.

<sup>4</sup> Premium Times, 7 Jul 2016.

<sup>5</sup> Premium Times, 7 Jul 2016.

<sup>6</sup> Premium Times, 7 Jul 2016.

<sup>7</sup> Premium Times, 7 Jul 2016.

<sup>8</sup> Premium Times, 7 Jul 2016.

<sup>9</sup> Premium Times, 7 Jul 2016.

<sup>10</sup> This Day, 11 Jul 2016.

remain low as previous recapitalisation efforts have proved unsuccessful.<sup>11</sup> The CBN has said it will support Skye Bank until the new management can secure additional financing and has since extended both loans and depositor guarantees, increasing the attractiveness of Skye Bank to a potential merger or acquisition.

*"There is nothing good or bad about mergers and acquisitions on their own. The question is whether it will amount to creating value or not. A good mergers and acquisitions strategy can prevent regulatory risk. A situation where the central bank will take action on a bank and there will be panic and everybody begins to run helter-skelter to withdraw their money is not good for a bank. If the fundamentals of a bank are beginning to get challenged, it is better a discussion is held with another bank and it is acquired. What creates a problem is regulatory risk."<sup>12</sup>*

The banking sector's exposure to the oil sector has resulted in broader concerns about its stability and profit. Five Nigeria-based banks have this year issued profit warnings: **First Bank of Nigeria Plc (FBN), Diamond Bank Plc, First City Monument Bank Ltd, Ecobank Nigeria Plc** and Skye.<sup>13</sup> The banking sector extended approximately \$10 billion to domestic oil companies in the two years to mid-2014 as they looked to acquire assets from divesting international oil companies.<sup>14</sup> The majority of this credit was in the form of badly collateralised and unhedged syndicated loans.<sup>15</sup> Even with the recent increase in oil prices, producers are struggling to repay their debts, due in part to increased **Niger Delta** militancy. Upstream oil and gas and services currently account for approximately 28% of the commercial banking sector's loan book.<sup>16</sup> The oil and gas sector accounts for 47% of the loan book of FBN, putting upward pressure on its non-performing loan ratio and profits.<sup>17</sup> As well as the oil sector, local companies borrowed in dollars to acquire power assets during the government's 2013 privatisation programme and are struggling to meet their repayment obligations. Non-performing loans are expected to reach 12.5% of total lending in 2016, compared to the CBN target of 5%.<sup>18</sup>

*"The ongoing economic crisis and spate of non-performing loans will affect their profitability initially and eventually it is going to affect their liquidity and solvency. Because of the squeeze in profitability, there will be a natural consolidation and a shake-out."<sup>19</sup>*

The government in August 2015 instructed all government ministries, departments and agencies to use a Treasury Single Account at the CBN for all government receipts and spending rather than commercial bank accounts. Until the decree, government deposits had provided a source of liquidity for commercial banks. The directive resulted in a decrease in liquidity estimated at 1.2 trillion naira (N) (\$6.2 billion), approximately 10% of total deposits.<sup>20</sup>

*"Skye Bank is only the first victim of the Federal Government's Treasury Single Account (TSA) policy – it might not be the last. The bank had operated largely on government deposits, not on private funds and the managers had mismanaged the bank by allowing non-performing loans to escalate."<sup>21</sup>*

Additionally, CBN capital controls have encouraged businesses to turn to the parallel market rather than curbing a significant formal banking sector revenue stream. The CBN's removal of the currency peg in June and subsequent fall in currency (see *ARC Briefing Nigeria June 2016*) will prove beneficial to the banking sector as it encourages economic growth and increases supplies of foreign exchange.

<sup>11</sup> Premium Times, 7 Jul 2016.

<sup>12</sup> Source, economist, Lagos

<sup>13</sup> Punch, 18 Apr 2016.

<sup>14</sup> Financial Times, 21 Apr 2016.

<sup>15</sup> Financial Times, 21 Apr 2016.

<sup>16</sup> Financial Times, 21 Apr 2016.

<sup>17</sup> Financial Times, 21 Apr 2016.

<sup>18</sup> Reuters, 1 Aug 2016.

<sup>19</sup> Source, financial analyst, Lagos

<sup>20</sup> Reuters, 17 Sept 2015.

<sup>21</sup> Source, public affairs commentator, Lagos

However, it will increase pressure on the naira-denominated capital adequacy ratios of banks that have a high proportion of loans in foreign currencies. Nearly half of the commercial banking sector's loan books are denominated in dollars.<sup>22</sup>

*"There is concern around the evolution of banks' capital adequacy if the naira continues to weaken; as the naira weakens, foreign exchange loans are likely to be problematic."*<sup>23</sup>

On 27 July, a CBN circular instructed banks to provide evidence they had sufficient buffers against their dollar loans.<sup>24</sup> Some banks have themselves borrowed heavily in dollars and these loans are now more expensive to service. Lagos-based **Guaranty Trust Bank Plc** has an estimated \$1.6 billion in dollar-denominated debt, and FBN \$915m.<sup>25</sup>

### Government misses revenue target by 55%

Budget minister **Udoma Udo Udoma** announced on 14 July that the federal government had only met 55% of its budgeted revenue target for the first quarter of 2016.<sup>26</sup> The shortfall suggests that the \$30.8 billion budget signed in May is overly ambitious. Udoma blamed the underperformance of the **Nigerian Customs Service** and the **Federal Inland Revenue Service (FIRS)** for the shortfall.<sup>27</sup> This contributed to the decline in crude oil export income due to the resumption of militancy in the Niger Delta. The government had hoped that increases in non-oil revenue would offset the drop in oil sector receipts. Udoma's figures did not disaggregate between oil and non-oil sector revenue.

The failure to meet the government revenue target negatively impacted planned expenditure outlays. Udoma told the senate appropriation committee that:

- Of the total N871 billion (\$2.95 billion) budgeted for government expenditure in the first quarter, the government had released 50%;
- Of the total N52 billion (\$176m) budgeted for overheads, the government had released 25%;
- Of the total N235 billion (\$796m) budgeted for capital projects, the government had released 15%.<sup>28</sup>

CBN figures show that government revenue decreased to N384.9 billion (\$1.2 billion) in May, down 1.6% from April.<sup>29</sup> This was 53% below the government budget estimate of N814.9 billion (\$2.55 billion).<sup>30</sup> Non-oil sector revenue failed to meet the provisional budget estimate by 45%, and decreased 2.7% from April.<sup>31</sup> Nevertheless, the **Federation Account Allocation Committee (FAAC)** paid out N550 billion (\$1.69 billion) to the three tiers of government in July.<sup>32</sup> This was the highest distribution since June 2015. It will reduce pressure on state governments to meet their recurrent spending obligations and on the federal government to bail them out. The FAAC distribution compares to N254 billion (\$759.3m) in June.<sup>33</sup> The distribution exceeded for the first time this year the budgeted monthly average of N477 billion (\$1.49 billion).<sup>34</sup>

Udoma acknowledged that the government has not yet approved a single new capital project under its fiscal stimulus package due to ongoing procurement processes.<sup>35</sup> This raises questions about the feasibility of government efforts to stimulate growth in the near future through infrastructure

<sup>22</sup> Reuters, 1 Aug 2016.

<sup>23</sup> Source, banking executive, UK

<sup>24</sup> www.cbn.gov.ng

<sup>25</sup> Reuters, 1 Aug 2016.

<sup>26</sup> Vanguard, 15 Jul 2016.

<sup>27</sup> Vanguard, 15 Jul 2016.

<sup>28</sup> Vanguard, 15 Jul 2016.

<sup>29</sup> www.cbn.gov.ng

<sup>30</sup> www.cbn.gov.ng

<sup>31</sup> www.cbn.gov.ng

<sup>32</sup> Daily Post, 28 Jul 2016.

<sup>33</sup> Daily Post, 28 Jul 2016.

<sup>34</sup> Daily Post, 28 Jul 2016.

<sup>35</sup> Vanguard, 15 Jul 2016.

spending and economic diversification. The **International Monetary Fund (IMF)** on 19 July warned that the Nigerian economy will contract 1.8% in 2016.<sup>36</sup> The projection is further indication that Nigeria will imminently enter recession. The IMF growth forecast is a downward revision from the 2.3% it projected in April.<sup>37</sup> The IMF additionally revised downwards its growth estimate for 2017 from 3.5% to 1.1%, suggesting it has little confidence that the government's fiscal stimulus package will accelerate growth from the third quarter as Udoma had previously stated.<sup>38</sup>

Udoma started the 2017 budget process on 25 July.<sup>39</sup> The government is keen to avoid a repeat of the delays to the 2016 budget that raised questions about its public finance management. Udoma pledged to introduce the 2017 budget to the national assembly by October.<sup>40</sup> Udoma presented details of the **2017 – 2019 Medium Term Expenditure Framework** that will contain the key assumptions underpinning the 2017 budget.<sup>41</sup> The framework includes conservative estimates for the average oil price. The framework projects that oil will increase from \$38.0 per barrel in 2016 to \$42.5 per barrel in 2017, and to \$50.0 per barrel by 2019.<sup>42</sup> The framework is more ambitious with regard to output. It projects that output will increase from 2.2 million barrels per day (bpd) in 2017 to 2.4 million bpd in 2019 on the back of quick improvements in Niger Delta security.<sup>43</sup> The current budget assumes oil production of 2.2 million bpd and an average price of \$38. Output levels since January are approximately 1.5 million bpd.<sup>44</sup>

The framework also projects “*significant*”<sup>45</sup> improvements in non-oil revenue collection. Udoma said the government expects VAT receipts to increase 42% in 2017.<sup>46</sup> Udoma did not clarify whether this is based on higher compliance rates or an increase of the current 5% levy. The FIRS on 21 July reported collection rates of approximately 90% for the second quarter and 73% for the first and second quarters combined.<sup>47</sup> The FIRS statement was probably a response to Udoma's criticism the previous week of domestic revenue collection efforts.

The 2017 – 2019 Medium Term Expenditure Framework is predicated on a steady naira rate of 290 to the dollar.<sup>48</sup> The naira decreased 9.5% on 22 July to reach a record low of 330 to the dollar, following the CBN's apparent unwillingness to intervene directly in the market amid limited liquidity.<sup>49</sup>

### **CBN increases benchmark lending rate to 14%**

The CBN on 26 July raised its benchmark lending rate 200 basis points to 14%.<sup>50</sup> The CBN is prioritising shoring up the naira rather than encouraging growth. The rate increase was larger than expected.<sup>51</sup> The CBN monetary policy committee noted that foreign investor sentiment remains “*lukewarm*” and that the new flexible foreign exchange market had not resulted in new capital inflows.<sup>52</sup> The CBN hopes that the tightening will increase liquidity in the foreign exchange market.<sup>53</sup> The CBN also noted significant inflationary pressures. **National Bureau of Statistics (NBS)** data

<sup>36</sup> Reuters, 19 Jul 2016.

<sup>37</sup> Reuters, 19 Jul 2016.

<sup>38</sup> Reuters, 19 Jul 2016.

<sup>39</sup> This Day, 25 Jul 2016.

<sup>40</sup> This Day, 25 Jul 2016.

<sup>41</sup> This Day, 25 Jul 2016.

<sup>42</sup> This Day, 25 Jul 2016.

<sup>43</sup> This Day, 25 Jul 2016.

<sup>44</sup> Reuters, 25 Jul 2016.

<sup>45</sup> Reuters, 25 Jul 2016.

<sup>46</sup> This Day, 25 Jul 2016.

<sup>47</sup> Pulse, 21 Jul 2016.

<sup>48</sup> Reuters, 25 Jul 2016.

<sup>49</sup> Reuters, 22 Jul 2016.

<sup>50</sup> Vanguard, 27 Jul 2016.

<sup>51</sup> Premium Times, 27 Jul 2016.

<sup>52</sup> Premium Times, 27 Jul 2016.

<sup>53</sup> Premium Times, 27 Jul 2016.

show that consumer price inflation reached 16.5% year-on-year in June.<sup>54</sup> The June inflation level compares to 15.6% year-on-year in May. On a month-to-month basis, the largest increases were in transport, electricity and liquid fuels due to continued foreign exchange shortages.<sup>55</sup> Core inflation (all items excluding agricultural produce) reached 16.1% year-on-year in June compared to 15.1% in May.<sup>56</sup> Domestic power shortfalls and high transport prices combined with persistent exchange rate pressures and currency depreciation will continue to drive inflation over the next few months.<sup>57</sup>

### Government appoints new NNPC board

President **Muhammadu Buhari** (2015-present) on 5 July restructured the management of the **Nigeria National Petroleum Corp (NNPC)**.<sup>58</sup> Immediate challenges including ongoing outages and increased Niger Delta militancy had distracted government efforts to address the structural challenges facing the NNPC. Junior petroleum minister **Emmanuel Ibe Kachikwu** is the new NNPC chairman.<sup>59</sup> Kachikwu was formerly NNPC managing director.<sup>60</sup> Kachikwu's successor as managing director is **Maikanti Baru**.<sup>61</sup> Baru was most recently NNPC group managing director, and was formerly NNPC exploration and production executive director, and NNPC chief technical negotiator on the **West African Gas Pipeline**. Baru is a former director of **Hyson Nigeria Ltd**, an oil marketing joint venture between NNPC and oil trader **Vitol SA**, and executive director of the **Nigerian Gas Co**.<sup>62</sup> The new board also includes Buhari's chief of staff **Alhaji Abba Kyari**.<sup>63</sup> Kyari is the only government official with regular access to Buhari.

*"Buhari does not trust people. He does not see people. But Kyari does not see people either and therefore there is very little interaction between the president, the federal government, the bureaucracy and the states."*<sup>64</sup>

Kyari is an influential advisor to Buhari, especially on economic matters.<sup>65</sup> Kyari has a long-standing friendship with Buhari dating back to the 1970s.<sup>66</sup> Kyari has a reputation as a respected intellectual and reformist.<sup>67</sup> The new board also includes finance ministry permanent secretary **Mahmoud Isa-Dutse**, a director of **Access Bank Plc** and **Northern Nigeria Flour Mills Plc**; former **Mobil Oil Nigeria Plc** executive director **Pius Akinyelure**; and former **Joint Development Authority** chairman **Tajuddeen Umar**.<sup>68</sup>

### Implications

Despite the problems at Skye Bank, corporate governance in the banking sector has generally improved since Nigeria's 2009 banking crisis. Profits and capital buffers remain broadly positive. The banking sector's trajectory is also encouraging. A recovery in economic growth will support asset growth while profits will increase as a result of increasingly efficient banking operations and an improved regulatory environment.

The budget revenue figures reiterate the risk of Nigeria entering recession for the first time since 1984. The government is struggling to increase fiscal revenue. Investing in infrastructure and

<sup>54</sup> Premium Times, 21 Jul 2016.

<sup>55</sup> Premium Times, 21 Jul 2016.

<sup>56</sup> Premium Times, 21 Jul 2016.

<sup>57</sup> Premium Times, 22 Jul 2016.

<sup>58</sup> Premium Times, 5 Jul 2016.

<sup>59</sup> Premium Times, 5 Jul 2016.

<sup>60</sup> Premium Times, 5 Jul 2016.

<sup>61</sup> Premium Times, 5 Jul 2016.

<sup>62</sup> Premium Times, 5 Jul 2016.

<sup>63</sup> Premium Times, 5 Jul 2016.

<sup>64</sup> Source, within presidential office, Abuja

<sup>65</sup> Africa Confidential, 1 May 2015.

<sup>66</sup> Africa Confidential, 1 May 2015.

<sup>67</sup> Africa Confidential, 1 May 2015.

<sup>68</sup> Premium Times, 5 Jul 2016.

encouraging economic diversification will take time and continued political will. The release of the contradictory FIRS figures indicates that political infighting over responsibility for slow progress is increasing which will, in turn, slow progress further.

The CBN rate increase will offer more support to the naira. However, investor concerns about economic growth through the rest of the year will counteract the ability of the rate increase to improve hard currency supplies. The rate increase will also increase the ratio of non-performing loans that commercial banks face.

The appointment of the new NNPC board is indicative of Buhari's continued commitment to reforming the oil sector. Nevertheless, it will have little impact on legislative delays or insecurity in the Niger Delta, the main bottleneck to increased production.

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