

# RECONCILING BANKING REGULATION AND THE 'SYSTEMICALLY IMPORTANT BANKS' SYNDROME: DECONSTRUCTING THE LEGAL CONSTRAINTS FROM A NIGERIAN PERSPECTIVE

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## ABSTRACT

Banks occupy a central position in the financial architecture of any economy due to their financial intermediation roles and as facilitators of the national payments system. However, because of the peculiarly risky nature of their business, banks do fail. Among other outcomes, this can have grave repercussions for various stakeholders, especially depositors. To overcome these challenges and ensure that the banking system remains efficient, transparent, strong and stable, banking regulators apply various administrative and statutory measures. A major influential factor in seeking to keep distressed banks afloat is the 'systemically important banks' syndrome that nudges regulators to expend public funds in bailing out large insolvent banks because of their strategic position in the financial system and the potentially traumatic systemic implications of their failure and liquidation. The foremost tool in the pursuit of this objective is the now globally acknowledged failure-resolution policy of bank bailout. Here, regulators are unduly influenced by the 'too big to fail' phenomenon; they therefore reason that some banks are too big and are therefore too systematically important to be allowed to fail, hence the deployment of public funds to bail them out when they are in distress. This article considers the dilemma of banking regulators in pursuing the protection of depositors, on the one hand, and seeking to keep big distressed banks afloat at the expense of public resources, on the other. This objective is particularly pursued from the perspectives of the Nigerian jurisdiction. The article advances the view that the 'systemically important banks' syndrome may not be the most effective means of driving banking regulation because of the question of moral hazard involved. It proffers alternative measures for attaining the crucial outcome of effective banking regulation.

## INTRODUCTION

Banking institutions are usually prone to failure because they take business risks that sometimes go awry.<sup>1</sup> This may result from faulty credit risk management, insider abuse, fraud and such related problems.<sup>2</sup> When these challenges become endemic, the affected banks suffer illiquidity and, subsequently, insolvency.<sup>3</sup> An insolvent bank becomes distressed and in such a dire state faces certain challenges often associated with critically ill financial institutions, including bank runs and liquidation.<sup>4</sup> Banking regulation aims to prevent or contain these challenges that plague banks. Apart from the insolvency-resolution and safety-net objectives, other purposes of regulation are to maintain financial stability in the economy and sustain depositors' confidence in the banking system.<sup>5</sup> However, in carrying out their statutory functions, banking regulators are faced with some challenges that militate against effective monitoring and supervision. Regulatory measures seek to tame these challenges in order to ensure that the banking system is not only effective but also strong. A banking system that is strong, efficient and transparent becomes attractive to a greater number of the members of the populace and encourages the cultivation of the banking habit. This is apart from the fact that banks become resilient to the identified challenges that lead to failure. Such a desirable

- 1 In the past decade, a number of banks in several countries have failed for many reasons, including excessively risky transactions and poor management of toxic assets. The problem climaxed in the global financial crisis (GFC) of 2007–2008. This had devastating consequences for many economies. See NE Ojukwu-Ogba, 'Banking Regulation in Nigeria and the Lessons of the Global Financial Crisis' (2013) *Nigerian Institute of Advanced Legal Studies Journal of Business Law* 38 at 39.
- 2 A banking crisis can have a ripple effect on all other sectors of an economy. See DM Driesen, 'Legal Theory Lessons from the Financial Crisis' (2014) *The Journal of Corporation Law* 55 at 68. See also R Baxter, 'The Global Economic Crisis and Its Impact on South Africa and the Country's Mining Industry' <<https://www.resbank.co.za/Lists/News%20Publications/Attachments/51/Roger+Baxter.pdf>> accessed 8 December 2016.
- 3 For example, in Nigeria, between January 1994 and January 2006, the Nigeria Deposit Insurance Corporation (NDIC) liquidated forty-five banks. These do not include the seven banks whose operating licences were revoked but whose owners challenged the action of the NDIC in court. Bank failure is an event that cannot be completely prevented as long as banks take business risks. See 'Nigeria Deposit Insurance Corporation – Closed Financial Institutions' <<http://www.ndic.org.ng/closed-financial-institutions.html>> accessed 8 December 2016. In the United States, 547 banks were liquidated between 2000 and 2015 (see Table 1). Most of them were absorbed by stronger, more resilient banks in arrangements often overseen by the regulator in order to prevent systemic financial crisis. See 'Federal Deposit Insurance Corporation – Analysis of Failed Banks' <<http://www.fdic.gov/bank/individual/failedbanklist>> accessed 7 December 2016.
- 4 When a bank faces persistent illiquidity, it becomes incapable of fulfilling one of the most basic obligations to its customers: honouring their mandates validly drawn. At this point, a crisis of confidence develops which precipitates spontaneous panic by the bank's depositors. When the depositors of a bank simultaneously converge on their bank to withdraw money, it could result in bank runs, which may push the bank into more serious illiquidity, even when it may ordinarily have been able to navigate its way through the initial illiquidity in the absence of a run. This development worsens its solvency state and may lead in quick succession to distress.
- 5 GA Ogunleye, *Perspectives on the Nigerian Financial Safety-net* (NDIC Press, 2010) 19.

state of affairs in the banking system is brought about through effective regulation that emphasises the strategic macroeconomic position that financial institutions occupy in the wider economy.

Influenced by this reasoning, state regulators of banks go out of their way to protect banks that exhibit certain unique qualities.<sup>6</sup> Regulators do this in order to prevent big banks that exhibit characteristics such as a substantial depositor base and an extensive branch network from failing and being liquidated. This is premised on their fear of the collateral effect of such failure on the banking sector, the wider financial system and the economy generally. This reasoning is encapsulated in what is now termed the ‘too-big-to-fail’ (TBTF) syndrome. When regulation of the banking system is influenced by this myth, regulators consider some banks as being too systemically important or strategic to be allowed to fail and will therefore use taxpayers’ funds to bail out such banks when they become distressed and face imminent liquidation.

This article considers the pull of the TBTF syndrome on the pursuit of the objective of effectively regulating banks, with particular reference to the Nigerian jurisdiction. The article finds as a fact that the syndrome is a major problem that could stunt the advancement of banking regulation and consume state resources, especially in jurisdictions where there is substantial reliance on the policy. It is also found that, despite claims to the contrary, the Central Bank of Nigeria (CBN)<sup>7</sup> and the Nigeria Deposit Insurance Corporation (NDIC),<sup>8</sup> as state regulators of the banking system, aided by the Asset Management Corporation of Nigeria (AMCON),<sup>9</sup> are still heavily influenced by the TBTF myth in their implementation of policies and statutory provisions pertaining to banking regulation in Nigeria.<sup>10</sup> The pull of the myth on the regulatory mechanism

6 These attributes would include size, depositor base and spread of the affected bank. See MS Sriram, V Chaturvedi and A Neti ‘Too Big to Fail versus too Small to be Counted’ (2001) 62 BIS Working Paper 93 at 118.

7 The Apex Bank is a creation of s 1(1) of the Central Bank of Nigeria Act 2007 (CBN Act 2007) ch C4 Laws of the Federation of Nigeria 2011.

8 See s 1(1) of the Nigeria Deposit Insurance Corporation Act 2006 (NDIC Act 2006) ch N102 Laws of the Federation of Nigeria 2011.

9 Section 1(1) of the Asset Management Corporation of Nigeria Act 2010 (AMCON Act 2010) as amended by the AMCON (Amendment) Act 2015.

10 In a way, it could be said that the South African banking regulatory landscape exhibits traces of the influence of the TBTF model. The establishment, monitoring and supervisory roles of the South African Reserve Bank are enshrined in ss 10(1)(a)–(v) and 10A(1)–(12) of the South African Reserve Bank Act 90 of 1989, as amended by the South African Reserve Bank Act 57 of 2000. The processes that informed the intervention, rescue and rebranding of the failed South African financial institution, African Bank Investments Limited, by the Reserve Bank, is symptomatic of this influence. See R Bonorchis, ‘African Bank Failure Prompts Regulator to review Supervision’ *Bloomberg* (London, 2015) <<https://www.bloomberg.com/news/articles/2015-05-26/african-bank-s-failure-prompts-regulator-to-review-supervision>> accessed 3 January 2017. See also R Brand and N Khanyile, ‘African Bank Contagion sweeps from Lenders to Sovereign’ *Bloomberg* (London, 2014) <<https://www.bloomberg.com/news/articles/2014-08-21/african-bank-contagion-sweeps-from-lenders-to-sovereign>> accessed 3 January 2017; L Donnelly, ‘African Bank: The Rot stops Here’ *Mail &*

is a major challenge that the regulators should contain if the desired level of effective banking regulation and financial stability is not to become a mirage but a reality. Finally, the article offers recommendations that could aid the attainment of effective regulation.

## CAN BANKS REALLY BECOME SYSTEMICALLY TOO IMPORTANT?

The systemic importance of banks in the economy is universally acknowledged because they are considered to be catalysts that enable any given economy to function smoothly. This is due to their intermediation roles and the fact that they provide the appropriate platform for effective implementation of the payments system.<sup>11</sup> Therefore the state, through banking regulators, pays more attention to the banking industry than they do to other sectors of the economy.<sup>12</sup> This position is understandable. The potentially dire implications of banks failing and depositors losing their money are factors that fuel the inevitable imperative of ensuring that banks remain strong, efficient and transparent in business.<sup>13</sup> The corollary of this fact is that the bigger a bank is, the more systemically important it could be considered to be within the banking system due to the likely impact of its failure and liquidation on its customers and other stakeholders such as shareholders and employees. This is apart from the potential contagion effect of such failure on other financial institutions in the sector.<sup>14</sup> A big bank would normally have a large depositor

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*Guardian* (Johannesburg, 2014) <<http://mg.co.za/article/2014-09-04-african-bank-the-rot-stops-here>> accessed 3 January 2017.

- 11 Almost all payment channels are routed through banks, especially in a cashless and effectively regulated financial system. The platform presented by these financial institutions facilitates payments through cheques and other negotiable instruments as well as online and offline transfers. A dysfunctional banking system presents a major problem in the smooth operation of the payments system and could be disruptive of the economy. See OP Egbo, 'Universal Basis of Bank Failure – the Nigeria Case' (2010) *Developing Country Studies* 119 at 120; B Ebong, 'The Banking Industry and the Nigerian Economy Post-consolidation' (2005) *Union Digest* 1 at 2; JW Head, 'Lessons from the Asian Financial Crisis: The Role of the IMF and the United States' (1998) *Kansas Journal of Law & Public Policy* 70 at 71.
- 12 In the literature on the controversy regarding the necessity or otherwise of regulating banks, the crux of the argument has remained that banks are simply not capable of regulating themselves and if not closely monitored and supervised, will jeopardise not only the interests of the banking public but also the economy at large when failed banks are liquidated. See EB Nyantakyi and M Sy, 'The Banking System in Africa: Main Facts and Challenges' (2015) *Africa Economic Brief* 1 at 2; F Allen and E Carletti, 'What is the Rationale for Regulating Banks?' (2007) *Banking and Finance Monitor* 40 at 45 <<http://www.finance.wharton.upenn.edu/allenf/download/Vita/banking%20finance%20monitor%20article.pdf>> accessed 8 December 2016.
- 13 HA Garten, 'Regulatory Growing Pains: A Perspective on Bank Regulation in a Deregulatory Age' (1989) *Fordham Law Review* 501 at 503.
- 14 A major distress in the banking sector might precipitate widespread fear among depositors and this could trigger bank runs. If not contained quickly, the problem becomes contagious on other banks and could then quickly degenerate into a system-wide situation. See G Reint, M Lo Duca and J Vesala,

base and an expansive network of branches in all corners of the country. Most times, banks in that class also establish international businesses through the operation of foreign branches or international subsidiaries. These foreign operations become inextricably connected to the parent bank.<sup>15</sup> The insolvency and liquidation of banks in this class are events that are certain to cause panic in the financial system, particularly because the consequences of such failure would affect a wide spectrum of the banking public. This has been the case in Nigeria in several instances, especially during banking crises.<sup>16</sup> Accordingly, it can be said that when banks grow too big, they become systemically too important. While conceding that a bank can become systemically important, though, the key question for the purposes of this article is whether a bank can be properly considered to be too systemically important? Our view is that if banks are monitored and supervised prudently, the moral hazard<sup>17</sup> of TBTF will be eliminated and banks as such need not be considered too systemically important to warrant the commitment of state resources to bailing them out, even when they might have been reckless in their operations.<sup>18</sup>

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‘Cross-border Bank Contagion in Europe’ (2009) *International Journal of Central Banking* 97 at 98.

- 15 Many banks registered under Nigerian municipal law are active players in other economies within the West African subregion, including Benin Republic, Ghana, the Gambia and Sierra Leone. Also, some of them operate branches or subsidiaries in the United Kingdom and the United States. The banks in this category include Access Bank, Diamond Bank, Ecobank and Guaranty Trust Bank. Others are First Bank, Union Bank, United Bank for Africa and Zenith Bank. Some South African banks also have strong operations in Nigeria and other African countries, eg Standard Bank and ABSA. The complex web of the operations of banks in this class of mega financial institutions makes them systematically important to the economy, hence they may be deemed too big or too important and strategic to be allowed to become distressed should they face insolvency.
- 16 In Nigeria, the former Bank of Credit and Commerce International (BCCI), Intercontinental Bank, Oceanic Bank and the bridge banks, namely, Mainstreet Bank, Keystone Bank and Enterprise Bank (which arose out of the ashes of the erstwhile Afribank, Platinum-Habib Bank and Spring Bank) are typical examples of banks that had a reputation for being strong but eventually went into liquidation thanks to complex operational crises.
- 17 The moral hazard involved in such a situation is that banks develop the propensity to engage in more daring risks when the TBTF policy is in place because of the impression that there is a guarantee of bailout or packaged business rescue if the bank runs into insolvency and is likely to face failure and liquidation—provided that they have grown up to the size that they are considered too systemically important. See P Cartwright and A Campbell, ‘Co-insurance and Moral Hazard: Some Reflections on Deposit Protection in the UK and USA’ (2003) *Journal of Banking Regulation* 9 at 20; B Ely, ‘Regulatory Moral Hazard: The Real Moral Hazard in Federal Deposit Insurance’ (1999) *The Independent Review* 241 at 242; G Richardson, ‘Deposit Insurance and Moral Hazard: Capital, Risk, Malfeasance, and Management’ (2007) *Econ Journal Watch* 296 at 302.
- 18 It costs substantial sums to rescue and repackage a distressed bank. Proactive preventive monitoring and supervision measures remains preferable in regulating financial institutions in order to avoid, as much as is possible, the wastage that may become inevitable when state resources will be required to bail out banks that have already fallen into distress. See B Komolafe, ‘Afribank & Co: AMCON Acquires Bridge Banks, Injects N679bn’ *Vanguard* (Lagos, 2011) 1. In South Africa, it was reported that US\$940 million had been committed to the rescue of the failed African Bank a few years previously. See D Dolan, ‘South African Central Bank to Oversee \$940 million Abil Rescue’ *Reuters* (London, 10 August 2014) 1 <<http://www.uk-reuters.com/article/uk-safrica-african-bank->

## THE IMPERATIVE OF BANKING REGULATION

The desirability of institutionalising a mechanism for effective regulation of banks is borne out of the inevitable imperative of entrenching stable, transparent and strong banking and monetary policies that keep the economy stable, while protecting the interest of bank depositors.<sup>19</sup> These policies, and the regulatory processes that they create, ensure the effective operation of banks and other financial institutions in such a manner that they do not in any way destabilise the financial system or the nation's economy generally—in addition to avoiding a collateral loss of deposits by customers when banks are liquidated.<sup>20</sup> A free market system for banking business, devoid of any form of state intervention by way of monitoring and supervision, could be an incentive for excessive risk-taking, fraud and gross insider abuse by the operators of the banks, especially since banks are generally known to be incapable of self-regulation.<sup>21</sup> Even in the face of regulatory regimes, bank officials have sometimes been found to exhibit certain unethical and criminal tendencies that could lead to their banks' demise.<sup>22</sup>

The experience of Nigerian depositors in 1998, when twenty-six commercial and merchant banks were liquidated in one fell swoop, is clear testimony to the kind of

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inv-dUKKBN0GAOR320140810> accessed 3 January 2017.

- 19 JA Aremu, 'Lessons of Financial Sector Regulatory Reforms and Challenges of Real Sector Financing: A Regional Perspective' (2010) *Economic and Financial Review* 127 at 129; CE Blair, F Carns and RM Kushmeider, 'Instituting a Deposit Insurance System: Why? How?' (2006) *Journal of Banking Regulation* 1 at 4.
- 20 Even in jurisdictions that have instituted the explicit deposit guarantee scheme, the possibility of depositors losing their money is not eliminated because in most of these jurisdictions, deposit insurance has a stated maximum insured deposit payable to depositors of insured failed banks. High-volume depositors may therefore lose money because their deposits exceed the maximum sum payable as insured deposit provided for by statute. In this case, they would be entitled to the maximum insured deposit only.
- 21 MD Bordo and A Schwartz, 'The Performance and Stability of Banking Systems under "Self-regulation": Theory and Evidence' (1995) *Cato Journal* 453 at 455.
- 22 U Chiezey and AJC Onu, 'Impact of Fraud and Fraudulent Practices on the Performance of Banks in Nigeria' (2013) *British Journal of Arts and Social Sciences* 12 at 28; Egbo (n 11) 120; Y Alli and E Ikhile, 'Cecilia Ibru jailed 18 months ... forfeits N190bn' *The Nation* (Lagos, 9 October 2010) 1; B Madukwe and M Nwopoke, 'EFCC re-arraigns Ebong, ex-Union Bank MD, others' *Vanguard* (Lagos, 16 November 2012) 1. In South Africa, even in the face of concerted efforts by the South African Reserve Bank to ensure the effective monitoring and supervision of banks within its jurisdictional influence, the embarrassing event of the 'Regal Bank affair' nevertheless occurred. In this case, an entrepreneur (Jeffery Levenstein) through high-level financial manipulation and gross abuse of office, caused Regal Bank, and by implication the South African financial system, serious problems, which eventually resulted in the demise of the bank and his trial and conviction for criminal conduct. See *Levenstein v The State* [2013] ZASCA 147; 2013 (4) All SA 528 (SCA), where the South African Supreme Court of Appeal affirmed the conviction and committal to prison of Levenstein for the series of actions leading up to the failure and liquidation of Regal Bank. See also T Beamish, 'Failed Bank CEO jailed for Eight Years' (Moneyweb, 1 October 2013) <<http://www.moneyweb.co.za/archive/failed-bank-ceo-failed-for-eight-years>> accessed 18 December 2015.

fate that could befall depositors of failed banks.<sup>23</sup> In the light of such experience, it is only right that banking regulators should develop both failure-prevention and failure-containment programmes through proactive measures to guard against their recurrence. This should be so against the background of the fact that financial institutions, especially banks, are critical to the operation and sustainability of any stable economy.<sup>24</sup> That being the case, banks in particular and the financial sector in general are understandably subject to much closer supervision than other sectors of the economy.<sup>25</sup> This is done in order to prevent the total collapse of the economy as bank failures have the potential to have wide-ranging, external negative impacts on a wide spectrum of other groups, sectors and interests in any given jurisdiction: bank depositors, other banks, businesses, public utilities and the economy.<sup>26</sup> That informs the general consensus that one of the fundamental objectives of banking regulation is the prevention of financial crises; or, at least, where there are crises, their containment by way of the mitigation of their harsh effects in such a manner that the economy is constantly kept stable while at the same time the confidence of depositors is maintained. According to Singh and LaBrosse,

[p]ublic confidence plays an important role in sustaining financial system stability. In normal times the regulation and supervision of banks, the promotion and use of standards of sound business and financial practice, central bank actions, explicit deposit protection and an effective bank closure mechanism all help to reduce the adverse consequences of a financial crisis emanating from bank failures. It is understood that banks, like other firms, will fail and the likelihood of this happening is higher when risks in a particular banking concern are not managed appropriately, bubbles in certain markets burst or financial markets are very fragile due to either domestic or foreign reasons.<sup>27</sup>

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- 23 On 16 January 1998, the NDIC liquidated twenty-six commercial and merchant banks in one single operation that has been seen as unprecedented in the annals of banking in Nigeria. See ‘Nigeria Deposit Insurance Corporation – Closed Financial Institutions’ (nd) <<http://www.ndic.org.ng/closed-financial-institutions.html>> accessed 12 December 2016.
- 24 See ‘Banking Supervision and Regulation’ Volume 1: 2nd Report of Session 2008–2009, House of Lords Select Committee on Economic Affairs (June 2009) 10 <<https://www.publications.parliament.uk/pa/ld200809/ldselect/ldeconaf/101/101i.pdf>> accessed 7 March 2017.
- 25 The spontaneity and speed with which the GFC of 2007/2008 spread across several economies all over the world demonstrated the imperative of such proactive measures. See S Claessens and L Kodres, ‘The Regulatory Responses to the Global Financial Crisis: Some Uncomfortable Questions’ (2014) IMF Working Paper 2 <<https://www.imf.org/external/pubs/ft/wp/2014/wp1446.pdf>> accessed 12 December 2016.
- 26 NE Gunay and G Gunay, ‘Potential Insolvency, Prudential Regulation and Supervision in Emerging Market Banking Systems: The Case of Turkey’ (2007) *International Journal of Liability and Scientific Enquiry* 161 at 168; OO Mbutor and DJ Yilkudi, ‘The Recent Financial Crisis and the Special Financing Interventions by the Central Bank of Nigeria: Implications for the Real Sector of the Nigerian Economy’ (2011) *The Bullion* 44 at 45.
- 27 D Singh and JR LaBrosse, ‘Developing a Framework for Effective Financial Crisis Management’ (2011) *OECD Journal of Financial Market Trends* 1 at 4.

Financial regulation will be more effective where it addresses both the internal and the external effects of bank failures. Therefore, the failure of any particular bank is arrested to avoid such failure spreading to other financial institutions or even resulting in the total collapse of a country's financial system.<sup>28</sup> In most economies, the task of regulating the nation's banking system is given to the country's central bank, by whatever name it is called.<sup>29</sup> Such a financial regulatory authority, though not absolutely independent of the control of the central government, is usually given a wide range of autonomy and a high concentration of powers to carry out its assigned responsibilities in view of the important and strategic roles it plays in the economy.<sup>30</sup> Commenting on the role of regulation, Wood noted:

Regulation involves the concentration of legislative, executive and judicial powers in one entity. The regulator is often legislator, police, jury and judge, subject to safeguards. Administrative law is the fourth estate of government. Regulation is a form of state intervention acting through semi-independent agencies.<sup>31</sup>

Wood's definition could be said to best encapsulate the important role of the regulator. The objective behind the concentration of legislative, executive and judicial powers in the hands of one agency is to guarantee, as much as is practicable, that the regulator is insulated from unnecessary political interference that could sometimes paralyse its operations. However, Wood examined the issue in the light of an ideal setting but failed to consider situations where financial regulators could abuse their powers or become instruments for political witch-hunts.<sup>32</sup>

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28 The recent events in Greece and in Malta as well as the earlier banking crisis in Iceland are typical examples of economies where problems in the banking sector eventually spiralled into a national financial crisis. On the crisis in Iceland and how it was tackled, see E Gunnarsson, 'The Icelandic Regulatory Responses to the Financial Crisis' (2011) *European Business Organization Law Review* 1 at 39. See also B Eichengreen, 'Greek Debt Crisis: Lessons in Hindsight' *The Guardian* (London, 14 June 2013) 1 <<http://www.theguardian.com>> accessed 3 September 2014; S Perry, 'Cypriot Bank brings Claim over Greek Financial Crisis' (2014) *Global Arbitration Review* 1 <<http://www.globalarbitrationreview.com/news/article>> (accessed 3 September 2014).

29 For example, in the United Kingdom, the state agency playing the central banking role is the Bank of England, in the United States the Federal Reserve Board, in South Africa the South African Reserve Bank, in India the Reserve Bank of India, in Ghana the Bank of Ghana and in Canada the Royal Bank of Canada.

30 RG King, 'Central Banking in an Open Economy' (2012) *International Journal of Central Banking* 167 at 168.

31 P Wood, *Law and Practice of International Finance* (Sweet & Maxwell, 2011) 323.

32 In Nigeria, in the years following the reintroduction of democratic rule, a section of the populace believed that certain perceived political opponents of the central government, including Jim Nwobodo, had running battles with certain agencies of the Federal Government. For example, in the case of Savannah Bank (previously one of the big banks in Nigeria) in which Nwobodo had just acquired controlling equity, the bank was hounded out of operation. Despite a series of court actions, culminating in the bank's winning a suit against Nigeria's banking regulator (the CBN) in the Supreme Court, the commercial bank has been unable to re-commence operations due to the fatal blow and adverse publicity occasioned by the event. See *Savannah Bank of Nigeria v Central Bank*



## INFLUENCE OF THE TBTF SYNDROME ON BANKING REGULATION

Because of the important position that banks as drivers of the economy, operators of the payments system and financial intermediaries occupy, governments naturally treat their sustained effectiveness with considerable seriousness.<sup>33</sup> As has been noted above, the banking sector is given much more attention and is monitored more closely than any other sector of the economy because of its systemic importance not only to the economy but also to depositors.<sup>34</sup> In times of financial crisis, the frenzy of regulatory attention given to banking institutions is unprecedented because of the potential of loss of deposits, the negative effect on the business environment and price instability. An innocuous report about the solvency level of one or two banks could precipitate a chain reaction that sets off unmanageable bank runs.<sup>35</sup> Unchecked bank runs may ultimately lead to a major nationwide banking crisis.<sup>36</sup> State regulators are particularly concerned because of the dire implications of a systemic financial crisis for the economy at large owing to the particular crisis of confidence it is uniquely capable of creating.<sup>37</sup> This fear underpins regulators' reliance on the TBTF myth. On this issue, Busch observed:

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*of Nigeria* [2009] All FWLR (Part 481) 939; *Savannah Bank of Nigeria v Nigeria Deposit Insurance Corporation* [2004] 11 NWLR (Part 883) 60. See also B Adeyemi and AO Olowu, 'Corporate Governance: Has the Nigerian Banking Sector Learnt Any Lesson?' (2013) *International Journal of Business and Social Research* 49 at 56.

- 33 At the base of considerations for the special attention given to banks by regulators is simply deposit protection and the maintenance of financial stability. See N Kleftouri, 'Meeting the Rationale of Deposit Protection System' (2014) *Journal of Financial Regulation and Compliance* 300 at 317.
- 34 A Milne and G Wood, 'Shattered on the Rock? British Financial Stability from 1866 to 2007' (2009) *Journal of Banking Regulation* 89 at 92. Also see P Wood, 'The Future of International Banking and Financial Law and Lawyers' (2014) *Singapore Journal of Legal Studies* 355 at 361.
- 35 While institutional crisis affecting only one or two banks may easily be managed and contained by regulators, a systemic crisis affects the entire banking system; and if not properly managed, it could result in economic crisis, as was the case with Greece and Malta. See H Zhu, 'Bank Runs, Welfare and Policy Implications' (2005) *Journal of Financial Stability* 279 at 301; F Pantazis, 'The Greek Financial Crisis and the Voluntary Conferral of Jurisdiction to the ECJ in the Light of State Immunity' (2013) *Vienna Journal of International and Constitutional Law* 521 at 522; R Kulms, 'Private Creditors and Sovereign Default: From Argentina to Greece' (2012) *Belgrade Law Review* 65 at 67.
- 36 GG Kaufman, 'Bank Runs, Causes, Benefits and Costs' (1988) *Cato Journal* 559 at 560; DW Diamond and PH Dybvig, 'Bank Runs and Deposit Insurance and Liquidity' (2000) *Federal Reserve Bank of Minneapolis Quarterly Review* 14 at 15; PP Swire, 'Bank Insolvency Law, Now that it Matters Again' (1992) *Duke Law Journal* 469 at 472.
- 37 ER Carrasco and S Williams, 'Emerging Economies After the Global Financial Crisis: The Case of Brazil' (2012) *Northwestern Journal of International Law and Business* 82 at 109. Here, the two authors argued that the ability of banks in emerging market economies to wade through the GFC and thereby avert the then looming crisis of confidence between them and their customers was largely due to the fact that these banks were not deeply involved in international financial transactions and were therefore relatively insulated from the contagion effect of the crisis.

The banking sector plays a special role in the economy. The reason for this is twofold: the banking sector makes credit available to all the other sectors in the economy and to consumers; a well-functioning banking sector is thus a vital prerequisite for a well-functioning economy as a whole. Yet, at the same time, it is particularly vulnerable, for the failure of a bank can have distinctly different consequences from the failure of a business in another sector of the economy and threaten the viability of the whole banking sector (bank run). States have therefore traditionally subjected the banking system to specific regulation.<sup>38</sup>

Influenced by this line of reasoning, regulatory authorities go out of their way to bail out distressed and failing banks using taxpayers' money.<sup>39</sup> For some, the principle behind the justification of the state to save these institutions is represented by the TBTF syndrome.<sup>40</sup> In this respect, Zhou noted:

During financial crises, authorities have an incentive to prevent the failure of a financial institution because such a failure would pose a significant risk to the financial system, and consequently to the broader economy. A bailout is usually supported by the argument that a financial firm is 'too big to fail': that is, larger banks exhibit higher systemic importance.<sup>41</sup>

The overpowering influence of the policy will sway the state or the specific regulator to seek means of funding the rescue of a failing institution rather than allowing it to go into liquidation under the debt-resolution process of the deposit insurer, where that

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38 A Busch, 'Divergence or Convergence? State Regulation of the Banking System in Western Europe and the United States' (2002) Paper delivered at the Workshop on Theories of Regulation at Nuffield College, Oxford, 25–26 May 2002 <<http://www.ox.ac.uk/politics/papers>> accessed 21 July 2014. See also M Labonte, 'Systemically Important or "Too Big to Fail" Financial Institutions', Congressional Research Service Report submitted to the US Congress on 30 June 2015 <<https://www.fas.org/sgp/crs/misc/R42150.pdf>> accessed 12 December 2015.

39 This has led to varying shades of opinion on the plausibility or otherwise of committing state funds to saving distressed banks, since these banks are private profit-making ventures. At the peak of the banking crisis in Nigeria in the 1980s and 1990s, the state implemented measures to bail out distressed banks. Some of these measures included lending more, through the CBN, to enable the troubled financial institutions weather the storm of distress. In some cases, the government acquired controlling equity in these banks. The situation was even worse in the case of the former government-owned banks—African Continental Bank, National Bank of Nigeria, Cooperative & Commerce Bank and Bank of the North—as they became drainpipes for public funds in efforts to salvage their solvency. Even the establishment of NDIC is a reflection of that line of thinking. See MJ Roe, 'Structural Corporate Degradation due to Too-Big-to-Fail Finance' (2014) *University of Pennsylvania Law Review* 1419 at 1423. Also see H Gonzalez, 'Towards Deposit Insurance Reform' (1991) *Washington University Law Review* 665 at 668; K Habu, 'Deposit Insurance Scheme: Pillar for Financial Safety-net' *ThisDay* (Lagos, 19 May 2013) 1; IADI, 'Charting a Course through a Global Crisis' *International Association of Deposit Insurers 2008/2009 Annual Report*; KH Chu, 'Deposit Insurance and Banking Stability' (2011) *Cato Journal* 99 at 106; DL Dick, 'Confronting the Certainty Imperative in Corporate Finance Jurisprudence' (2011) *Utah Law Review* 1461 at 1467.

40 I Moosa, 'The Myth of Too Big to Fail' (2010) *Journal of Banking Regulation* 319 at 320.

41 C Zhou, 'Are Banks Too Big to Fail? Measuring Systemic Importance of Financial Institutions' (2010) *International Journal of Central Banking* 205 at 223.

system exists.<sup>42</sup> However, this fear need not be acted upon if an effective and prudent monitoring and supervision system is in place. In cases where the state has instituted a deposit insurance scheme, especially under the explicit deposit guarantee model, the dictates of the law relating to deposit insurance will be pre-eminent. This is because the relevant statute would have made detailed provisions for the aggregation of deposit insurance funds, rates and means of premium payments by banks and the insured deposit payable to depositors of failed banks and other financial institutions.<sup>43</sup>

Before the institution of the explicit deposit insurance scheme in Nigeria, the country operated the implicit deposit insurance model.<sup>44</sup> Under the implicit model, heavier reliance was placed on the TBTF policy, a system that concentrated all efforts on rescuing distressed banks at taxpayers' expense. Such bailout programmes are usually speculative as there is no guarantee that the failing bank would survive the process of insolvency, even with state intervention.<sup>45</sup> Even in the face of these efforts at bailing out distressed banks, the failure and liquidation rate in Nigeria was still relatively high and mostly involved smaller banks, simply because they were in the category of institutions that were more unlikely to benefit from the application of the TBTF principle.<sup>46</sup>

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42 Apart from effectuating a system that refunds deposits to depositors of failed banks, institutionalising a deposit guarantee mechanism makes it possible to implement a proactive policy to check effectively failures before they occur. This is possible because the agency established under the system also monitors and supervises banks to check for operational lapses that could lead to illiquidity or insolvency. For example, ss 27, 30, 32 and 37 of the NDIC Act 2006 give the state deposit insurer monitoring and supervisory powers to play interventionist and pre-emptive roles that could prevent banks from failing and going into liquidation.

43 The NDIC Act 2006 makes detailed provision for these issues. See, eg, ss 2, 17 and 20 of the NDIC Act (as amended).

44 On the other hand, some other jurisdictions, such as South Africa, operate an implicit deposit guarantee system. Here, there is no distinct state deposit insurer to handle failure resolution in the financial sector. Rather, the state financial regulator (the South African Reserve Bank, for example) intervenes at public expense to bail out a distressed bank whenever that occurs. Except for the deposit insurance arrangement in respect of deposits with South African cooperative financial institutions under the Cooperative Banks Act, the process towards instituting an explicit deposit insurance scheme has not reached fruition. See P Gordhan, 'A Safer Financial Sector to serve South Africa better' (National Treasury Policy Document, 2011) <<http://www.treasury.gov.za/twinpeaks/20131211%20...to%20serve%20South%20Africa%20better.pdf>> accessed 15 December 2016.

45 Examples of this situation abound in Nigeria, including National Bank of Nigeria, African Continental Bank, Mercantile Bank and Pan African Bank, owned by the Western States, the Eastern States, Cross River State and Rivers State respectively. The phenomenon of government pumping colossal sums into bank bailout programmes is commonplace. See OI Kuye, OJK Ogundele and A Otiike-Obaro, 'Government Bailout of Distressed Banks in Nigeria: A Justifiable Strategy?' (2013) *International Journal of Business and Social Science* 174 at 180.

46 Of the forty-eight banks liquidated in Nigeria in the past two decades, almost all were small banks that lacked nationwide or even region-wide spread: see Nigeria Deposit Insurance Corporation, 'NDIC Annual Report 2009' <<http://www.ndic.gov.ng>>. Therefore, it was easier for the CBN and NDIC, as regulators, to liquidate them quickly before they contaminated other 'healthy' financial institutions. This may not be the case with bigger banks with nationwide branch networks and substantial depositor base. To liquidate banks in this second category would be complex and expensive and could have dire

## CONTAINING THE TBTF SYNDROME

The regulation of the banking system in Nigeria, which is the position at present, appears to be heavily weighed down by the influence of the TBTF syndrome.<sup>47</sup> But the danger of reliance on the TBTF myth is that banks could, perhaps even unwittingly, begin to treat it as an incentive to take greater business risks, pursue inordinately rapid expansion in their operation, not only in size but also in capital outlay, so as to grow large rapidly. In addition, the smaller banks could feel encouraged to pursue policies that would catapult them into the league of big banks as this would effectively provide them with insulation against liquidation. The obvious rationale is to become big enough to be considered too big to fail or systemically too important. At that level, even in the face of obvious distress, banks in that class stand to benefit from the protection offered by the TBTF policy.<sup>48</sup>

After consolidation, the banks that emerged in the Nigerian banking sector became too big and sometimes too complex, coming to be known as the ‘mega banks’. It is, however, yet to be determined whether they are really ‘mega’, given that some of them have since experienced liquidity challenges.<sup>49</sup> And when a few of these mega banks

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implications for the banking sector and the wider economy.

- 47 This assertion that the TBTF is the overwhelming influence in banking regulation is founded on the emphasis of the state regulator, the CBN, places on categorising some licensed banks as ‘systemically important banks’ that must not be allowed to fail but must be rescued any time they experience illiquidity or insolvency. See CBN circular with reference number BSD/DIR/COB/LAB/07/026 (5 September 2015) on the framework for the regulation and supervision of domestic systemically important banks (SIBs) in Nigeria <<https://www.cbn.gov.ng/out/bsd/Approved%20Supervisory%20framework%20.pdf>> accessed 3 January 2017. See also B Udo, ‘Exclusive: CBN Moves to Insulate Eight Top Nigerian Banks from Distress’ *Premium Times* (Abuja, 19 September 2013) <<http://www.premiumtimesng.com/business/144950-exclusive-cbn-moves-insulate-eight-top-nigerian-banks-distress.html>> accessed 3 January 2017. Nevertheless, the fundamental objective of monitoring and supervising banks pursued by the CBN is no doubt to ensure, inter alia, that those banks which could be considered too big and hence systemically important are especially insulated from failure in line with global best practice. The enhanced regulation of these banks is influenced by the Basel Accords (Basel 1, Basel 2 and Basel 3). These rules serve as guidelines for national bank regulators in the performance of their monitoring and supervisory responsibilities over banks domestically. They emphasise such factors as capital adequacy, good governance and prudence. For further insight into the Basel Accords and the work of the BCBS, visit the BIS site <[www.bis.org](http://www.bis.org)>.
- 48 B Gadanez, K Tsatsaronis and Y Altunbas, ‘Spoilt and Lazy: The Impact of State Support on Bank Behaviour in the International Loan Market’ (2012) *International Journal of Central Banking* 121 at 163.
- 49 After the consolidation programme carried out by the CBN, which ended on 31 December 2005, twenty-five fully recapitalised banks emerged, often referred to as the ‘mega’ banks. Since then, five of these ‘mega’ banks have experienced distress and some of them had to be rescued by the CBN and repackaged under the bridge banking arrangement. These bridge banks have had their assets and certain liabilities acquired by new banking institutions. The erstwhile Intercontinental Bank and Oceanic Bank were rescued under the P&A arrangement through which the CBN rescued the distressed banks. It did so by injecting state funds into them to revive them and then entered into an

did become distressed, it was difficult for the CBN and the NDIC to liquidate them.<sup>50</sup> In particular, when the erstwhile Afribank, PHB and Spring Bank ran into operational and solvency problems, the two regulators explored the possibility and means of bailing them out rather than use the liquidation option. The upshot was that the three banks underwent the so-called ‘bridge banking’ arrangement<sup>51</sup> and by the end of the rescue exercise it had cost Nigerian taxpayers almost 700 billion Naira to repackage them.<sup>52</sup> The implication of the action of the regulators in this case is that, contrary to the government’s avowed determination to privatise all its interests in business, especially banks, it has made a U-turn to invest, albeit temporarily, in these private businesses.<sup>53</sup> The injection of public funds into the rescue of banks by the CBN and the NDIC is symptomatic of the influence of the TBTF phenomenon.<sup>54</sup>

To get around the challenges of the TBTF syndrome in Nigeria, regulators would need to adopt and implement a more equitable and pragmatic model of bank licensing, which could be accommodated by amending the provisions of sections 2, 3 and 5 of the Banks and Other Financial Institution Act (the BOFI Act).<sup>55</sup> This is attainable by categorising banks into state, regional and national/international banks. The CBN has already taken steps in that direction but needs to ensure its full implementation and strict application.<sup>56</sup> The smallest banks in terms of strength would be licensed to operate as

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arrangement for their takeover by stronger and more resilient banks.

- 50 Despite the obvious likelihood of its contagion implications for the banking industry at large if the distress was allowed to continue, that reluctance to liquidate the banks experiencing gross illiquidity was largely influenced by the TBTF policy.
- 51 A bridge bank is a temporary holding financial institution that is set up by the financial regulator to acquire and hold the assets and liabilities of a distressed bank that has benefitted from the regulator’s rescue programme pending the ailing financial institution’s takeover (acquisition) from the regulator by another stronger and more resilient bank.
- 52 See Komolafe (n 18). According to the prevailing foreign exchange rate in November 2011, when the transaction occurred, this would have translated into about US\$4.4 billion or R1.4 trillion. These rates were before the downward slide of the Naira in the foreign exchange market.
- 53 In 1986 the Federal Government of Nigeria established the Technical Committee on Privatisation and Commercialisation (TCPC), which oversaw the government’s divestment of all its equity interests in all banks and many other companies. The banking sector in particular saw 100 per cent government divestment of its equity interests. The TCPC is today the Bureau for Public Enterprises (BPE).
- 54 The injection of money from the state purse to rescue banks implies the inclination of banking regulators towards the TBTF principles. This measure has been relied upon by the CBN at intervals. See, for example, Omoh Gabriel, ‘Analysis: The 8 Rescued Banks run Similar Risk’ *Vanguard* (Lagos, 9 August 2011) <<http://www.vanguardng.com/2011/08/analysis-the-8-rescued-banks-run-similar-risk/>>; Central Bank of Nigeria, ‘Public Statement on the Recapitalisation of Eight Banks’ <<https://www.cbn.gov.ng/out/2011/pressrelease/...pdf>> accessed 17 August 2017.
- 55 See CBN’s Regulation on the Scope of Banking Activities and Other Ancillary Matters (No 3) 2010, which repealed the Guidelines for the Practice of Universal Banking in Nigeria; and the Central Bank of Nigeria Scope, Conditions and Minimum Standards for Commercial Banks Regulations (2010) <<https://www.cbn.gov.ng>> accessed 3 May 2017.
- 56 The reversal, in 2010, of the universal banking model that hitherto was in practice following the implementation of the programme of consolidation of banks was a positive step to ensure that

single-branch or limited-branch network banks. This category of banks may be restricted to operate within a particular geographical area or within a specified city or state (and certainly not beyond it). The regional banks, with medium-level capitalisation strength, would be licensed to operate within a region. This category of banks may operate a network of branches within the region they have been licensed to operate in. The third category would be the more highly capitalised banks that may be licensed to operate as national or international banks. The banks in this class may have a network of branches all over the country and may also operate offshore international branches. Only banks in the third category may be deemed to be systemically important and strategic. The implication is that when local, state-based and regional banks, having a smaller network of branches or operating a single branch, encounter illiquidity and become incapable of fulfilling their obligations on deposit liabilities, the problem may be quickly resolved through immediate liquidation. In this way, the TBTF principle becomes irrelevant and the likelihood of systemic bank runs and contagion effects is prevented.

## COMPARING THE INFLUENCE OF THE TBTF SYNDROME IN THE UNITED STATES AND NIGERIA

In the United States, TBTF is not emphasised because in the model of banking operated in that jurisdiction there is a clear categorisation of banks into units, state and national/international banks. As the table below reveals, it has been both easy and convenient for the banking regulatory system in the United States to seamlessly liquidate terminally distressed banks without upsetting the banking system or causing bank runs. This is because most of the affected banks were unit and state banks whose operations are rather restricted. Their liquidation, if they experience intractable insolvency, would not exert the kinds of effect that may flow from the failure of big banks affected by the TBTF syndrome.

**Table 1:** Failed/liquidated banks in the United States from October 2000 to November 2014

| Start date | End date   | Number of banks affected |
|------------|------------|--------------------------|
| 13/10/2000 | 31/12/2000 | 2                        |
| 02/02/2001 | 31/12/2001 | 4                        |
| 11/01/2002 | 31/12/2002 | 11                       |

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the categorisation of banks was realistic and effective. The CBN, through the instrumentality of the Regulation on the Scope of Banking Activities and Other Ancillary Matters (No 3) 2010 and the Central Bank of Nigeria scope, conditions and Minimum Standards for Commercial Banks Regulations 2010, developed and implemented a set of guidelines whereby the regulator licensed banks either international/national banks (that could be globally active) or regional and local banks, which are licensed to operate within stated regions or state/locality.

|            |            |     |
|------------|------------|-----|
| 07/02/2003 | 31/12/2003 | 3   |
| 14/02/2004 | 31/12/2004 | 4   |
| 01/01/2005 | 31/12/2005 | 0   |
| 01/01/2006 | 31/12/2006 | 0   |
| 02/02/2007 | 31/12/2007 | 3   |
| 25/01/2008 | 31/12/2008 | 25  |
| 16/01/2009 | 31/12/2009 | 140 |
| 08/01/2010 | 31/12/2010 | 158 |
| 07/01/2011 | 31/12/2011 | 95  |
| 20/01/2012 | 14/12/2012 | 51  |
| 11/01/2013 | 31/12/2013 | 25  |
| 17/01/2014 | 07/11/2014 | 18  |
|            | Total      | 564 |

Source: Federal Deposit Insurance Corporation: Analysis of failed banks (January 2000—16 May 2014)<sup>57</sup>

An analysis of the above table reveals certain basic facts regarding the regulation of banks in the United States. Between the year 2000 and the first eleven months of 2014, 564 banks failed, were liquidated and their assets and liabilities acquired by other, more viable banks under the purchase and assumption (P&A) principle.<sup>58</sup> The truth is that P&As cost the government a great deal of money in reconstruction or initial intervention before they are sold, although this can be recouped when the affected bank's assets are sold. Also, between 2000 and 2005, only twenty-eight banks failed. In 2005 and 2006, no bank failed because that was the peak of the boom period, fuelled by the securitisation of risk assets.<sup>59</sup> However, when the bubble of the US mortgage sector burst in 2007 and

57 Federal Deposit Insurance Corporation Report <<https://www.fdic.gov/bank/individual/failed/banklist>> accessed 7 December 2016.

58 The P&A system enables the regulator to closely supervise the purchase of a distressed bank by another stronger and solvent bank, thereby preventing an outright liquidation of the distressed bank. The acquiring bank thereby inherits the assets and liabilities of the distressed bank, including its deposit liabilities.

59 The global financial crisis actually started in the United States as a domestic mortgage debt crisis but was worsened by the securitisation of the mortgage debts into capital assets, which banks bought into when the practice went global and subsequently met with a crisis of confidence among globally active banks. See LH Meyer, 'The Challenges of Global Financial Institutions Supervision' (2000) BIS Review 1 at 2; CC Soludo, 'Global Financial and Economic Crisis: How Vulnerable is Nigeria?' (2009) Paper presented to the House of Representatives Committee on Banking at the National Assembly, Abuja, 21 January 2009. See also E Gilbert, E Calitz and S du Plessis, 'Prudential Regulation, Its International Background and the Performance of the Banks – a Critical Review of the South African Environment since 1970' (2009) South African Journal of Economic History 43.

climaxed in 2008, there was a very steep rise in the number of failures. Three banks failed in 2007 and twenty-five banks in 2008: when the global financial crisis hit the US and international banking scenes, the effect was devastating. This reflected in the failure of an enormous number of banks in the United States in 2009 (140) and 2010 (158).<sup>60</sup> The situation started tipping off again when the rescue measures put in place by the regulators started yielding positive dividends: ninety-five banks failed in 2011 and fifty-one in 2012. Remarkably, only twenty-five failed in 2013 and eighteen in the first eleven months of 2014.

If banking regulators in the United States were able to manage the failure and liquidation of 469 banks between 2008 and 2012, and continue to allow distressed banks to go into liquidation,<sup>61</sup> there is no reason why the banking regulators in Nigeria should not allow the collapse of highly distressed banks so that the remaining ones can continue untainted and the contagion effects eliminated or drastically reduced.<sup>62</sup> That way, the colossal sums applied to bailing out banks in Nigeria since the effects of the global financial crisis hit the Nigerian banking system in 2009 would have been saved and deployed to other critical sectors of the economy. In Nigeria, the amount of taxpayers' money that went into bailing out the three bridge banks is compelling evidence that reliance on the TBTF principle is not good for the Nigerian economy.<sup>63</sup> That policy may even have the unintended consequence of becoming a disincentive to the growth of the banking sector through the onset of the 'moral hazard' problem. When banks feel that becoming big guarantees bailout when distressed, by virtue of belonging to the TBTF class, their management might be tacitly encouraged to undertake greater business risks in order to attain rapid growth in size. Such a situation could be exacerbated by the possible implications of a lax regime of monitoring and supervision that does not put the management of these banks to task when they contravene statutory and administrative procedures for commercial banking operations.

The banking regulators in Nigeria should therefore increase their use of the pertinent monitoring and supervisory machinery. The banking models may, however, not really be the major problem with the Nigerian banking system; the fundamental challenges

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60 See Table 1 above.

61 There were 6 984 commercial banks operating in the United States as at 31 December 2008. That number had plummeted to 6 036 banks by 31 December 2012. The dynamism of the number of operational banks could be a stark reflection of the fluidity of the regulatory policy on the liquidation of banks in the United States. Significantly, as at 31 March 2008, before the climax of the global financial crisis, there were 7 135 commercial banks operating in the United States. This position could easily be observed from a close analysis of the statistics issued by the United States Federal Reserve. See the chart on the analysis of banks operating in the United States at <[https://www.ycharts.com/indicators/us\\_number\\_of\\_commercial\\_banks](https://www.ycharts.com/indicators/us_number_of_commercial_banks)> accessed 5 May 2017.

62 G Reint, M Lo Duca and J Vesala, 'Cross-border Bank Contagion in Europe' (2009) *International Journal of Central Banking* 97 at 99.

63 The CBN (through the AMCON) spent 679 billion Naira to rescue and recapitalize the bridge banks. That made it attractive to new investors to acquire the assets and liabilities of these distressed banks that had benefitted from the regulator's reconstruction package. See Komolafe (n 18).



may depend more on the imperative of cultivating the political will to enforce laws and regulations on the banking sector and to strictly punish infringement of rules governing banking operations. When, in many instances, infractions by bank directors and managers go unpunished, largely ignored or treated with levity, other operators may be encouraged to become more brazen in their breach of the rules of engagement in the banking sector.<sup>64</sup> There is also the matter of demonstrating consistency in the regulation of banks so as not to scare away prospective investors.

## IS THE TBTF PRINCIPLE APPROPRIATE FOR NIGERIA?

While the TBTF might have its usefulness, the disadvantages are too weighty to be ignored. When regulators emphasise the principle or make it the focal point of consideration in deciding whether or not to rescue a distressed bank, they tacitly put pressure on banking institutions to grow big in order to benefit from the insulation effect of TBTF and avoid possible liquidation. In pursuing this objective of ‘big is beautiful’, banks develop the tendency to take unnecessarily and progressively greater business risks. This could be by way of being reckless in their credit risk management system or pursuing other high-risk operational methods.<sup>65</sup> Effective checks on excessive business risk-taking is one aspect of banking regulation that the CBN and NDIC should strengthen. Where reckless risk-taking by banks is detected, the result is bound to engender systemic stability. This objective would best be attained by monitoring and supervision of banks, both online and offline. Such a regulatory mechanism would drastically reduce the incidence of bank distress that creates the necessity for rescue measures. It would also eliminate the moral hazard problem on the part of a government that claims to divest entirely from banking enterprises in order to allow them to run their businesses, only for it to recant by injecting taxpayers’ money into distressed financial institutions.

In relative terms, the institution of explicit deposit insurance schemes effectively insulates government from that dilemma, all things being equal.<sup>66</sup> One way to achieve such objective effectively is by making the implementation of premium payments by banks reflect the level of their exposure to credit risk, which would force reckless banks to pay higher deposit insurance premiums. This is possible and in fact workable. Another major step towards realising the objective of effective banking regulation without

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64 The state has nevertheless shown its readiness to punish financial crimes, especially insider infractions in the banking industry. In a radical move that was novel in the annals of Nigerian banking regulation, beginning from 2010, erstwhile directors of banks were prosecuted for a range of offences, including white-collar crimes (such as granting unsecured and unauthorised credit facilities and contraventions of securities regulations and extant banking regulations) as well as blue-collar crimes of stealing, obtaining (financial gain or advantage) under false pretences, foreign exchange round-tripping and related financial crimes. See Egbo (n 11) 120; Alli and Ikhile (n 22); Madukwe and Nwopoke (n 22).

65 L Laeven, ‘Bank Risk and Deposit Insurance’ (2002) World Bank Economic Review 109 at 110.

66 Chu (n 39) 100.

necessarily relying on the TBTF syndrome is to eliminate the unnecessary business risks associated with the moral hazard angle in banking.<sup>67</sup> Related to the imperative of de-emphasising the TBTF policy is the need for stricter enforcement of the rules governing equity holdings in banks to discourage insider abuse.<sup>68</sup> Chu has noted that in an extensive study by the World Bank it was observed that banks with concentrated ownership tend to take the greatest business risks whereas those with segregated ownership undertake a relatively lower level of operational risks.<sup>69</sup> Of course, when power is concentrated in the hands of one person, the likelihood of abuse becomes much greater.

The cases of the erstwhile Intercontinental Bank and Oceanic Bank provide good credence to the finding of the World Bank study as restated by Chu.<sup>70</sup> In these instances, a few persons held excessive controlling equity stakes in the banks, either as individuals or as close family bloc equity holdings. This, in retrospect, did not help sustain the future of those institutions. Although the banks faced certain liquidation, they underwent reconstruction and subsequently were taken over by Access Bank and Ecobank Transnational respectively under the P&A arrangement which the CBN and NDIC had designed and started implementing in 2006.<sup>71</sup>

Finally, in response to the question whether or not the TBTF is appropriate for Nigeria, it may be necessary to tackle the question from the perspective of the extant legal and institutional frameworks for effective deposit guarantee in both the United States and Nigeria and of the broader implications of the global financial crisis and its aftermath.

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67 The moral hazard involved in such a situation is that banks develop the propensity to engage in more daring risks when the TBTF policy is in place because of the impression that there is guarantee of bailout or packaged business rescue if the bank becomes insolvent and is likely to face failure and liquidation.

68 Situations where ‘family banks’ are licensed should be generally discouraged. Banks should be listed on a stock exchange. If they are not, the equity holding policy should not accommodate a monopoly in the ownership structure so as to prevent a situation in which an individual or a closed group of shareholders can hijack or monopolise decision-making in the bank.

69 Chu (n 39) 99.

70 These cases where the affected banks are rescued by the regulator with public funds are well documented in the literature. The affected banks were large financial institutions and major operators in the Nigerian banking sector until they ran into serious problems, which resulted in their being bought out by other banks. However, before their takeover by other commercial banks, the CBN had already committed state resources to their rescue and repackaging. See Komolafe (n 18); BI Hassan, ‘Deepening Deposit Insurance in Nigeria’ *Sunday Trust* (Lagos, 11 November 2012) 1.

71 The P&A model is a mechanism employed by regulators to resolve terminal insolvency problems in banks rather than allow them to go into liquidation. This option is adopted so as to sustain the confidence of the banking public in the system and to save depositors from the effects of bank liquidation. The P&A option is preferred because liquidation as an alternative may generate panic, which could result in bank runs, with potentially devastating consequences for the economy. See Habu (n 39); JA Afolabi, ‘Mergers and Acquisitions in the Nigerian Banking System: Issues and Challenges’ paper presented at the workshop for the Business Editors and Finance Correspondents Association of Nigeria at the Manpower Development Institute, Dutse, Jigawa State on 28–29 November 2011, 3 <<http://www.ndic.gov.ng/files/challenges>> accessed 25 November 2016.

On the face of it, it may be submitted that TBTF is no longer useful or appropriate in the light of the elaborate statutory and institutional mechanisms put in place to drive effective banking regulation. The greater powers given to the Apex Bank under the CBN Act 2007,<sup>72</sup> and the higher regulatory responsibilities placed on the NDIC under the NDIC Act 2006,<sup>73</sup> are sufficient to render the TBTF principle inappropriate. In addition, the creation of AMCON in Nigeria as a financial debt-redemption vehicle<sup>74</sup> should be sufficient to achieve the objectives of effective regulation, especially in relation to toxic asset redemption. If these state agencies were able to develop the political will effectively to enforce what the statutes on banking regulation in Nigeria provide for, in addition to more conscientious online and offline monitoring and supervision of banks, the TBTF would be rendered completely redundant.

However, probably on grounds of public policy, the CBN and NDIC in Nigeria continue to implement measures that place heavy reliance on the TBTF principle.<sup>75</sup> The statutory safeguards provided under the NDIC Act to monitor banks and guard against systemic instability is comprehensive enough to ensure that banks are stable, safe and strong.<sup>76</sup> These agencies do not need to import and rely on any principle that is not contemplated by the statutes on banking regulation. In particular, the deposit insurer should simply apply the relevant statutory provisions strictly and the desired public policy objectives will be realised. When banks subscribe to a deposit insurance scheme, they effectively submit themselves to greater scrutiny, so they should accordingly be subjected to that strict scrutiny. The problem, it appears, may lie in the political influence of banks and their promoters and the subtle blackmail they exert on the public through instilling fear in the government, as Moosa pointed out, of the possibility of their collapse if not bailed out.<sup>77</sup> Concerning the TBTF and the attraction of state-sponsored bank bailouts, Moosa has noted:

Financial institutions and their bosses have become so influential and politically connected that they have been capable of pushing governments for more and more deregulation while demanding (and obtaining) taxpayers' money when things go wrong. ... One reason why TBTF

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72 The supervisory powers of the CBN have been enhanced through the new CBN Act 2007. See, for example, s 1 of the Act.

73 The greater power of the NDIC to monitor and supervise insured banks is necessary in order to realise the effectiveness of the deposit guarantee safety-net mechanism in the Nigerian banking sector.

74 AMCON's role as an agency for sterilising banks' risk-asset portfolios is novel and commendable. If properly implemented, the objectives behind the creation of AMCON will go a long way to promoting financial stability and greater depositor confidence in the Nigerian banking system.

75 The overwhelming evidence of this position, which strongly buttresses this assertion that the systemically important banks qualify to be categorised as TBTF banks, is the CBN circular which clearly indicated that the TBTF principle is the basis of the Apex Bank's official policy on banking supervision and monitoring. See CBN's circular (n 48); see also Udo (n 48).

76 Except that, in the case of South Africa, there is the necessity to create a distinct deposit insurer in order to adopt an explicit deposit insurance mechanism and depart from the implicit deposit guarantee system that is currently in place under that country's system of financial regulation.

77 Moosa (n 40) 326.

is an almost exclusive privilege of the financial sector is that financial institutions can and do flex their political muscles, in addition to the image that portrays the financial sector as something special in the economy.<sup>78</sup>

The financial sector of the Nigerian economy is still prone to banking crises, as events in the sector have often proved in the past several years.<sup>79</sup> This situation is also a noticeable trend in many other economies, especially emerging ones.<sup>80</sup> Of this situation and the manner in which the banks utilise it, Moosa has observed:

Unfortunately, not even the global financial crisis has changed anything. Financiers are still defiant, expecting bailouts and bonuses despite the damage they inflicted on middle-class Planet Earth. They claim victimisation by the society and refuse to admit responsibility for the crisis, blaming it on macroeconomic factors. Big financial institutions, it seems, have only gained political strength since the crisis began, exploiting fear of systemic failure to strike favourable deals with government. Bank of America obtained its second bailout package (in January 2009) after warning the US government that it might not be able to go through with the acquisition of Merrill Lynch, a prospect that Treasury did not want to consider.<sup>81</sup>

Even in the face of the much-touted position that the government in Nigeria has not only completely divested from banks but in fact would no longer pump taxpayers' money into saving any bank that runs into trouble, the current realities do not reflect that position. For example, since its establishment, AMCON's mode of operation has reflected an overpowering influence of the TBTF principle. This is exemplified by the fact that the agency pumped almost 700 billion Naira into reconstructing the three bridge banks.<sup>82</sup>

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78 Moosa (n 40) 326.

79 Apart from the 2009 banking crisis in Nigeria that was eventually contained by the CBN, the adverse situation still remains prevalent, only it is being managed. See O Abioye, 'Economic Crisis: Five Banks' Profits drop by N54 bn' *Punch* (Lagos, 18 April 2016) 1; R Bonorchis, 'Nigerian Banking Industry seen in "Full Blown" Credit Crisis' *Bloomberg* (London, 10 October 2016) <<https://www.bloomberg.com/news/articles/2016-10-10/nigerian-banking-industry-seen-in-full-blown-financial-crisis>> accessed 2 January 2017; EM Egboro, 'The 2008/2009 Banking Crisis in Nigeria: The Hidden Trigger of the Financial Crisis' (2016) *British Journal of Economics, Management and Trade* 1 at 2.

80 T Wallace and SP Chan, 'Why Italy's Banking Crisis will shake the Eurozone to its Core' *The Telegraph* (London, 13 July 2016) <<http://www.telegraph.co.uk/business/2016/07/16/why-italys-banking-crisis-will-shake-the-eurozone-to-its-core/>> accessed 30 December 2016; see also 'Explaining Greece's Debt Crisis' *New York Times* (New York, 17 June 2016) <<http://www.nytimes.com/interactive/2016/business/international/greece-debt-crisis-eurozone.html>> accessed 30 December 2016; M Santa, 'Analysis: Malta unlikely to follow Cyprus into Crisis' *Reuters* (London, 13 May 2013) 1 <<http://www.reuters.com/article/us-eurozone-malta-analysis>> accessed 30 December 2016.

81 Moosa (n 18) 327. See also JB Hall, 'Bank Bailout Mark II: Will it work?' (2009) *Journal of Banking Regulation* 215 at 216.

82 Komolafe (n 18); Hassan (n 65). The irony of the entire saga is that the three banks that have been converted into bridge banks were among the original 25 'mega' banks that emerged out of the consolidation programme carried out in 2005.

Ironically, CBN, through Tunde Lemo (its Deputy Governor of Operations until 11 January 2014), restated the government's regulatory position on TBTF:

Some of the banks, given their size, are significantly important and because if anything happens to them, it might cause a systemic problem, the Central Bank in line with global best practice, has agreed to step up supervision of those banks that are significantly important, but no bank in Nigeria is 'too big to fail.' The banks that are significantly important in terms of their sizes require closer supervision and that is what we are doing. SIBs<sup>83</sup> are visited more frequently by the regulators.<sup>84</sup>

However, contrary to the policy position clearly expressed in the above statement by a principal officer of Nigeria's bank regulator, the contemporary actions of Nigeria's banking regulators continues to show that they are, in fact, of the view that TBTF is indispensable to effective regulation in the contemporary banking system. As stated above, our submission is that the current regulatory reliance on the TBTF principle in practice is both implausible and unnecessary. Support for this argument can be found in the fact that it leads to colossal waste of state resources and encourages banks to undertake unnecessary business risks in order to grow bigger. The rescue operations for banks likely to face imminent distress should rather be proactive through effective monitoring and supervision. In that way, the regulators will be able to detect institutional operational challenges in banks before they deteriorate. Doing so would potentially engender public confidence in the banking regulators as being capable of introducing shock-absorbing measures to cushion the possible impact of any financial crisis on the banking system.

Apparently, Nigerian banking regulators were successful in arresting the emerging crisis that resulted in the creation of the bridge banks.<sup>85</sup> This is evident in the fact that core investors have either acquired the banks concerned or are on the verge of doing so, therefore stabilising the country's financial system.<sup>86</sup> However, that step may not be the most cost-effective measure, considering what is committed in executing it.

As has been noted above, a progressive regulatory regime of levying deposit insurance premiums on banks, effective online and offline monitoring and supervision

83 By SIBs the commentator meant strategically important banks.

84 K Aderinokun, O Chima and E Abiodun, 'Eight Systemically Important Banks to raise Liquidity Ratio to 35%' *ThisDay* (Lagos, 14 November 2013) 1.

85 The bridge banks have eventually been acquired by new investors after their rescue and recapitalisation by the CBN. The underlining issue remains that state resources were expended in the initial reconstruction, which ensured that the distressed banks, before their reconstruction, did not undergo liquidation. See U Onyeka, 'Bridge Banks Acquisition: Overcoming Challenges of Process Integration' *National Mirror* (Lagos, 20 January 2015) <<http://www.nationalmirroronline.net/new/bridge-banks>> accessed 30 December 2016; C Agabi, 'That Marriage between Heritage, Enterprise Banks' (*Daily Trust* 31 August 2015) <<http://www.dailytrust.com.ng/news/business/that-marriage-between-heritage-enterprise-banks/108721.html>> accessed 30 December 2016.

86 O Abioye, 'AMCON to sell Enterprise, Mainstreet Banks October' *Punch* (Lagos, 26 February 2014) 1; T Opeaitan, 'Sale of Bridge Banks under Threat' *Daily Independent* (Lagos, 6 October 2014) 1.

as well as prudential regulation would ensure that banks consistently operate in a manner that is most transparent, efficient and ethical. This is the key to attaining effective regulation that leads to strong banks and financial stability in the Nigerian economy. More specifically, the NDIC Act is, in its current form, comprehensive enough to accommodate measures that can ensure the existence of an efficient, adequate and progressive deposit safety-net programme at every material point in time.<sup>87</sup> Where measures aimed at the effective regulation of banks fail to achieve positive results, the strategic functional roles of the NDIC and AMCON as failure-resolution agencies can be promptly activated to arrest financial distress and restore confidence in the Nigerian banking system.<sup>88</sup>

## CONCLUSION

This article has critically examined banking regulation in relation to the influence of the TBTF syndrome in Nigeria. It is indisputable that banks are incapable of self-regulation, hence the necessity for effective banking regulation by the state.<sup>89</sup> In the face of this reality, it is obvious that the TBTF syndrome, often employed by regulators, has a debilitating negative effect on attaining the objective of putting in place effective regulation which engenders a banking environment capable of growing strong, efficient and transparent banking institutions that could be globally active and competitive, while being resilient to adverse operational challenges. It has been shown that the TBTF policy is still heavily relied upon by the regulators of banks in Nigeria despite its negative implications and its propensity for breeding systemic moral hazard. It is submitted that the syndrome and its many challenges can be safely spurned by simply instituting or strengthening the deposit guarantee system to self-finance bank liquidations and ensure that banks are resilient to the challenges that threaten the survival of their operations. The article has also proffered suggestions that could aid the attainment of effective monitoring and supervision of banks while dispensing with unnecessary reliance on the TBTF myth. Movement away from the syndrome has the potential to free up state resources that are otherwise applied in bailing out distressed banks considered to be too large and systemically important. For a developing country such as Nigeria, it is

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87 See ss 15–22 of the NDIC Act.

88 Sections 37–44 of the NDIC Act and ss 25, 48, 51 and 52 of the AMCON Act. On the quest for effective bank failure resolution measures, also see GL Schiavo, ‘The Development of a New Bank Resolution Regime in Europe: Fit for Purpose?’ (2014) *Journal of International Banking Law and Regulation* 689–704.

89 ST Omarova, ‘Rethinking the Future of Self-regulation in the Financial Industry’ (2010) *Brooklyn Journal of International Law* 665 at 667; Bordo and Schwartz (n 21) 460. See also M Thoma, ‘Why Self-regulation of the Financial System won’t work’ (*CBS MoneyWatch*, 17 April 2009) <<http://www.cbsnews.com/news/why-self-regulation-of-the-fiancial-system-won't-work/>> accessed 3 January 2017.

more plausible to deploy such resources to strengthening other productive and essential sectors of the economy.

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