



## Nigeria's macro headwinds trigger bank recapitalisation

April 2024







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# Executive Summary

*"To arrive at the \$1trn economy destination, we believe that we must address the capital adequacy of our banks that will provide the fuel for the journey"-  
President Bola Ahmed Tinubu*

The Central Bank of Nigeria (CBN) has released new guidelines on the minimum capital requirement for banks operating in Nigeria. This ranges from NGN50bn to NGN500bn depending on the type of license held by the bank. In total, approximately NGN4.14trn is expected to be raised between now and March 31, 2026.

## **Inflation, high interest rates and forex imbalances erode banks' capital buffers**

The upward review of the capital base is an essential action required to boost capital adequacy needs of the Nigerian financial system, which have been significantly impacted by macroeconomic challenges such as high inflation and interest rates, currency volatility and forex illiquidity. In the last two years, Nigeria's inflation rate has spiked to an almost 30-year high of 31.7%, while the local currency has lost at least 60% of its value. As a result, banks' total capital base (limited to share capital and share premium) that was valued at USD5bn using an exchange rate of NGN460/USD) in 2022 is now worth a paltry USD1.8bn (using an exchange rate of NGN1258/USD), when adjusted for the exchange rate differential.

## **Rationale for upward revision of minimum capital base**

The upward revision will ensure that Nigerian banks have the capacity to take on bigger risks and stay afloat amid both domestic and external shocks. It also means increased liquidity positions of banks, which will help broaden their loss-bearing capabilities. With the proposed recapitalisation exercise, the prospect of a reduction in the number of banks is high. However, this reduction will create room for an even stronger banking sector that can drive a USD1trn economy by 2030. It will also deepen the capital market, as banks currently account for over 10% of total market capitalization. The CBN has identified three options that banks can adopt to raise the additional capital gap, which is aggregated at NGN4.14trn.

These options include:

1. Injection of fresh equity capital either by private placement, rights issue and/or offer for subscription,
2. Mergers and acquisition, and/or
3. Upgrade/downgrade of license authorisation.

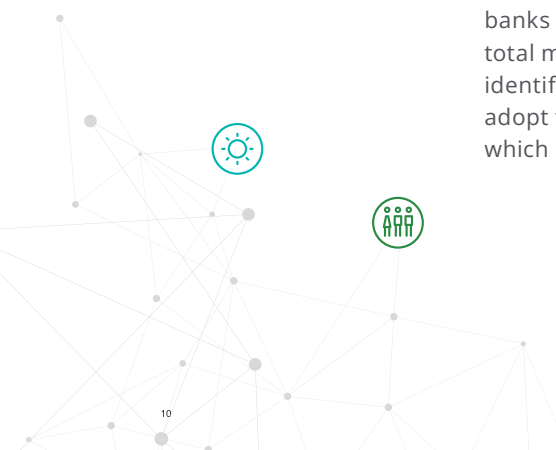
There are other possible options that banks could consider, such as dividend capitalization. However, this is subject to the CBN's approval.

## **Implications and what to expect**

The proposed recapitalisation will impact the financial industry and economy as a whole. Some of these implications include but are not limited to:

- Increased market liquidity
- Deeper capital markets
- Inflow of foreign investments
- Dilution of voting power
- Changes in company valuation
- Economies of scale, cost savings and improved efficiency within the banking sector
- Increased tax revenue for the government in the long run due to economies of scale

In all, the exercise is a requisite development needed to deepen banks' ability to absorb domestic and external shocks at a time of severe macroeconomic headwinds.



# 1.0 Brief history on bank recapitalisation in Nigeria



In the last seven decades, the CBN has undertaken 10 recapitalisation exercises, with the last one conducted in 2004. The recapitalisation exercise was critical to address the issues from the banking crisis of the 1990s, make the system more effective and strengthen the growth potential of the industry and the wider Nigerian economy. At the time, investigations by the CBN using the Capital adequacy, Management capabilities, Earnings sufficiency,

Liquidity position, and Sensitivity (CAMELS) to market risk parameters showed a deterioration in banks' overall performance, and this necessitated the recapitalisation exercise in 2004. The exercise saw the number of deposit money banks reduce from 89 to 24, as banks had to increase their minimum capital base to NGN25bn from NGN2bn. In addition, in 2004 NGN25bn was worth USD187mn, now this is approximately USD20mn.

Year	Commercial Banks (NGN)	Merchant Banks (NGN)
1969	1,500,000	-
1979	2,000,000	-
1988	5,000,000	3,000,000
1988	10,000,000	6,000,000
1989	20,000,000	12,000,000

Year	Commercial Banks (NGN)	Merchant Banks (NGN)
1990	50,000,000	40,000,000
1997	500,000,000	500,000,000
2001	2,000,000,000	2,000,000,000
2004	25,000,000,000	25,000,000,000
2024	500,000,000,000	50,000,000,000

Table 1

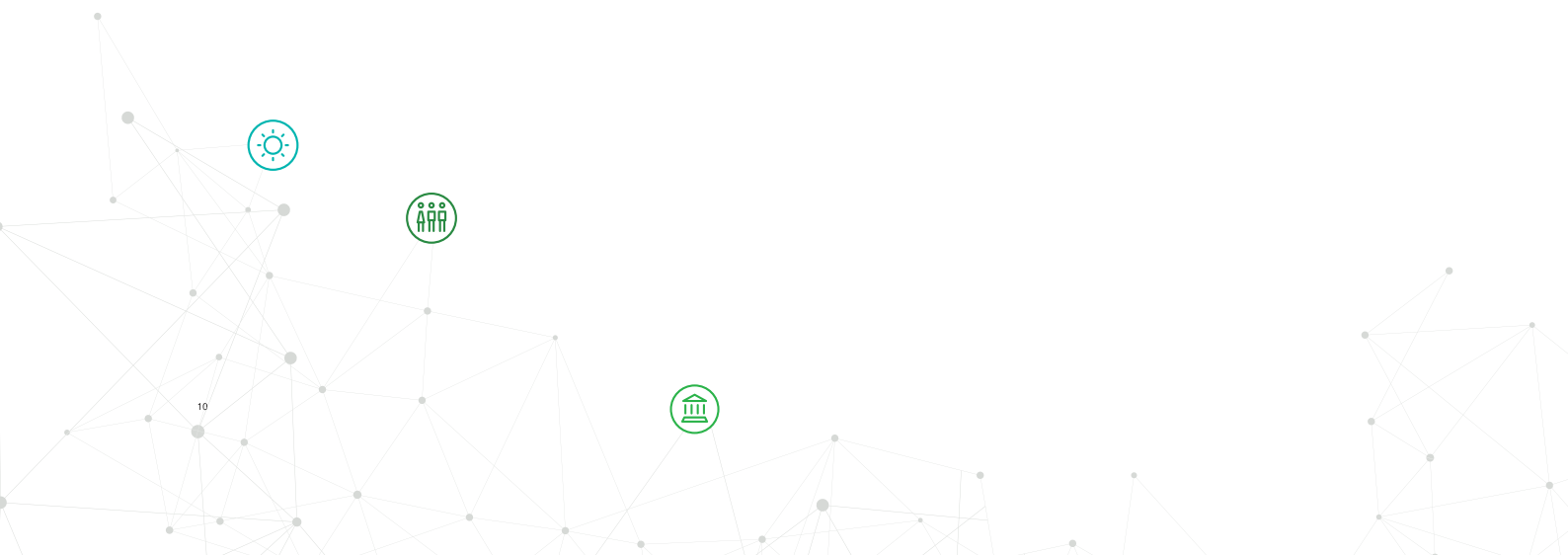
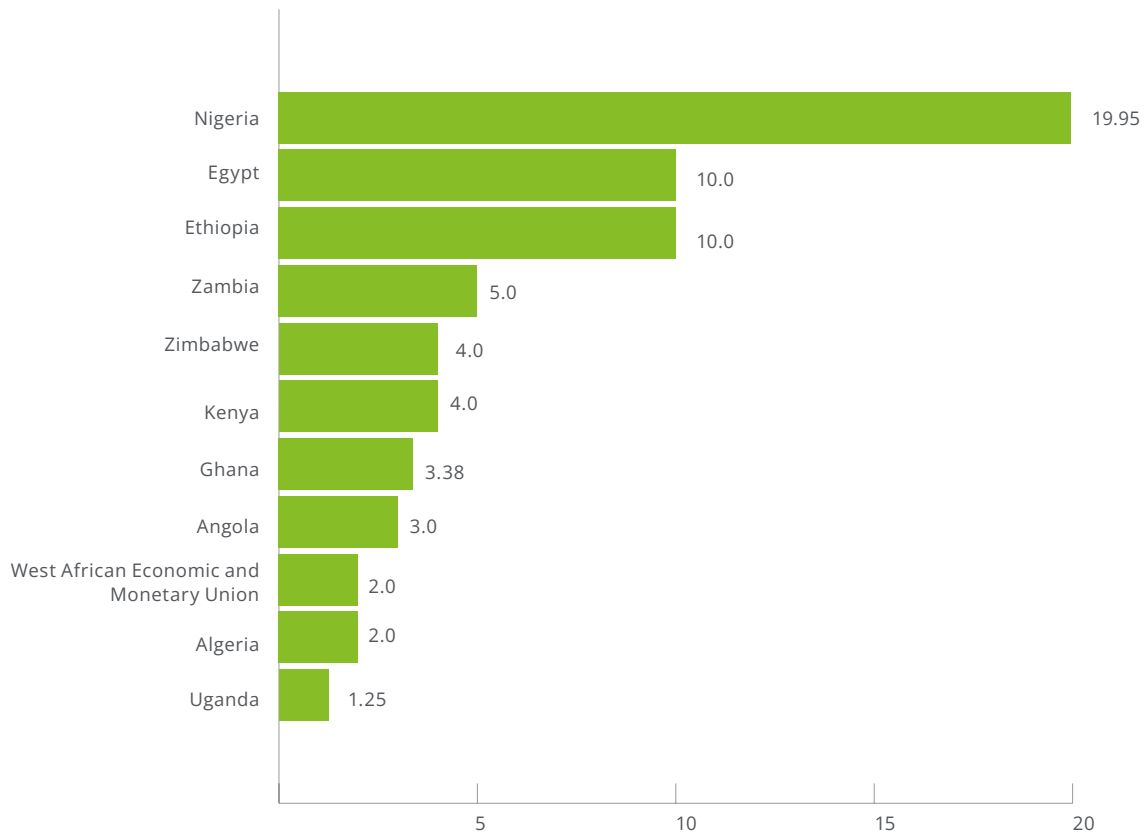
The CBN is not alone in its bid to build financial resilience and stability of banks. Regulatory bodies across Africa's leading economies are actively implementing similar reforms. Some of the recent recapitalisation measures set by the various monetary authorities are shown in the table below:

Name of the Regulator	Country	Recapitalisation	Multiplier (x)	Country GDP (USD'bn)	Year of Review
Banque d'Algérie	Algeria	Capital requirement moved from 10 bn dinars (USD74.6mn) to 20 bn dinars (USD149mn)	2.00	195	2018
Banco Nacional de Angola	Angola	2.5 bn Angolan kwanzas (USD3mn) to 7.5 bn kwanzas (USD9mn)	3.00	106	2019
Central Bank of Kenya	Kenya	Recapitalisation requirements became 1 bn shillings (USD6mn)	N/A	113.4	2024
Banque Central Des Etats De L'Afrique d'Ioutest (Regulation Body for 7 member countries: Benin, Burkina Faso, Côte d'Ivoire, Guinea-Bissau, Mali, Niger, Senegal, Togo)	West African Economic and Monetary Union	10 bn CFA (USD16.84mn) to 20 bn CFA (USD33.67mn)	2.00	759.73	2023
National Bank of Ethiopia	Ethiopia	500 mn birr (USD8.84mn) to 5 bn birr (USD88.4mn)	10.00	126.8	2021
Bank of Ghana	Ghana	120 mn cedis (USD10.01mn) to 400 mn cedis (USD33.88mn)	3.38	74	2017
Bank of Uganda	Uganda	Recapitalisation for commercial banks moved to 120 bn Ugandan shillings (USD315.7mn) by 31st December 2022 and 150 bn (USD394mn) by June 2024	1.25	45.57	2024
Reserve Bank Zimbabwe	Zimbabwe	USD25mn to USD100mn	4.00	27.37	2018



Name of the Regulator	Country	Recapitalisation	Multiplier (≈)	Country GDP	Year of Review
Bank of Zambia	Zambia	Increased from 12 mn Zambian kwacha (USD0.465mn) to 104 mn (USD4.03mn) for locally owned banks and 520 mn (USD20.15mn) for foreign owned banks. The revision came into effect on 30th January 2012.	5.00	29.16	2012
Bank of Egypt	Egypt	500 mn Egyptian pounds (USD16.1mn) to 5 bn Egyptian pounds (USD161mn)	10.00	476	2019

### Current minimum capital base of African banks (multiplier effect)

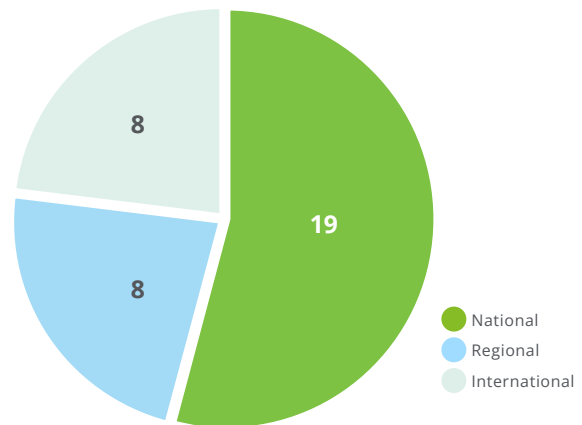


# 1.1 Financial industry structure

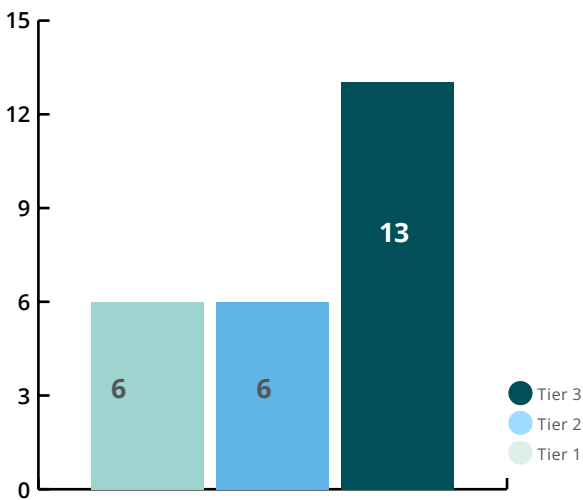


Nigeria's financial system plays a critical role in driving economic growth and development. The industry comprises of three: banks, non-bank financial institutions (NBFIs) and regulatory bodies. The banking group comprises of commercial banks (known also as deposit money banks), merchant banks, and non-interest banks. All 35 operational banks in Nigeria fall under one of these categories.

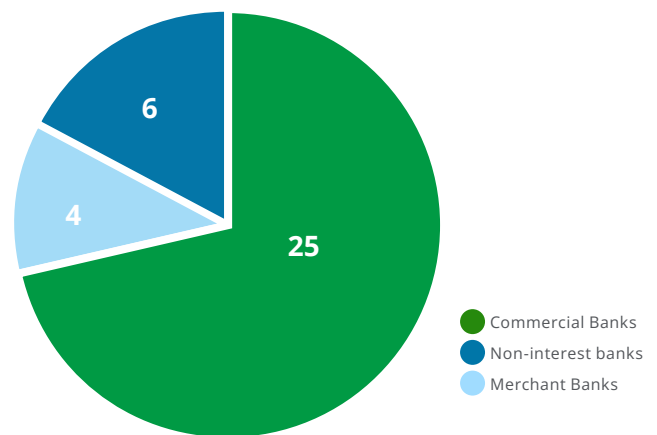
Nigerian banks by authorisation



Nigerian commercial banks by tier



Nigerian banks by type





## 2.0 Options available to banks (including other alternatives)

Capitalisation is a pivotal reform measure in the banking sector of any country's economy because a bank with a strong capital base can net losses that arise from non-performing liabilities. The increase in capitalisation from NGN25 bn to NGN500 bn by the CBN will prevent insolvency of banks and future possibilities of financial distress and capital insolvency. The CBN has set the timeline for all banks to comply with the new capital requirement at 24 months with effective date from April 1, 2024. Banks are expected to be in compliance by March 31, 2026.

The options available as proposed by the CBN in its circular are below:

### **Injection of fresh equity capital through private placements, rights issue and/offer for subscription**

With the new capital requirements, the CBN expects banks to seek new investors or ask existing shareholders to purchase new stocks. While this option could lead to an increase in banks' liquidity, it could also lead to a potential increase in the cost of capital due to higher cost of equity capital relative to debt.

Given the additional capital requirements, banks may turn to foreign portfolio investors. An influx of foreign capital would boost the country's forex liquidity, potentially boosting the stability of the local currency. Tier 1 banks, with their established reputations, are likely to raise the required capital within the stipulated time frame, while Tier 2 banks will need to foster a more concerted effort with this option.

### **Mergers and acquisitions (M&A)**

This entails an amalgamation of the assets and liabilities of banks (merger) or acquisition of sufficient shares in another bank to trigger a take-over (strategic acquisition) which would ultimately result in a merger. While M&A is a strategic tool which improves the operational efficiency and stability of banks, it may not necessarily help to achieve the overall objective for capital raising, due to the exclusion of other components of shareholders fund from the qualifying capital and debt raising (leveraged recapitalisation).

M&As should be viewed from the lens of a pre and post-acquisition impact on the operations of banks. Tier 2 banks and other smaller banks are likely to consider this option alongside the injection of capital. However, the question is "who will merge with whom?". The bigger banks may be looking at strategic acquisitions that would provide expansion benefits and operational synergies. Due to the technicalities required in the M&A process, some of the banks with a rich M&A history may better navigate process hurdles and scale common hurdles like agreeing on the valuation. However, banks with limited or no history in M&As will require the services of the right M&A advisers.

# ₦25bn to ₦500bn

will prevent insolvency of banks and future possibilities of financial distress and capital insolvency.

## Tier 1 banks

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## Tier 2 banks

will need to foster a more concerted effort with this option



### **Upgrade or downgrade of license authorisation**

The last option prescribed by the CBN is the upgrade or downgrade of license authorisation. It is imperative to understand that the downgrade of a bank's license implies a reduction in the number of branches, which could involve assets stripping. However, we note that a robust online banking system may limit the impact of a reduction in the number of branches. We understand that Tier 1 banks may not consider this option. However, some national banks could consider the option of a downgrade, as most of them have already met or have a minimal gap to meet the capital requirement of a regional bank. Alternatively, such banks could consider an upgrade, using M&A to comply.

### **Other alternatives available to banks but subject to CBN approval**

#### **Dividend recapitalisation – Use of retained earnings**

Although the CBN is definitive on the acceptable options banks can utilize to raise capital, the exclusion of the retained earnings is a front burner issue. Some pundits have reasoned that if the objective of the CBN is to increase paid-up capital, then utilization of the portion of retained earnings that was earmarked for dividend payment should be ringfenced for capital raise. This will mean that banks will have to compel or sway shareholders to forfeit dividend payments for additional investment in the bank. The merit of this option is that banks can fully utilize the amount of dividend bound cash for conversion into paid up capital as against rights issue post payment of dividend.

In a high interest rate environment, it may be very challenging for banks to convince investors to invest in shares when they can fully exercise their right after dividend is paid. The banks argue that this approach would meet the required capital gap halfway. Ultimately, most banks are going to be considering a combination of options to raise capital. From the CBN's perspective, the use of retained earnings do not meet the overall objective of paid-up capital.

It also creates room for a possible inclusion of unrealised accounting gains except the apex bank provides clear guidelines to determine the exact components and limit capitalisation to realised components of retained earnings backed up by cash.

#### **Debt capital**

Debt capital is another option to consider to build alternate tier 1 and tier 2 capital (subject to the compliance of the regulatory set limits). The funds raised can be deployed to embark on an M&A. However, one of the limitations of debt capital as a form of funding is the cost relative to the returns.

## 3.0 Implications of an increase in capital buffers



### 3.1 Macroeconomic impact

#### Increased liquidity

An increase in the capital buffers of banks implies an injection of additional liquidity into the system. The total level of broad money supply in the financial system is NGN95.56trn as of February 2024. This is a 20.58% growth from December 2023 (NGN79.25trn). We expect a further increase in liquidity by the end of the recapitalisation exercise. While this should lead to lower lending rates in the medium to long term, it could also pose demand pull inflationary concerns, which would require a monetary policy response.

#### Increased economic activity, job creation

Financial institutions are the second fastest growing sub sector of the Nigerian economy, with a growth rate of 28.86% in 2023. However, the industry's contribution to GDP is less than 5%<sup>4</sup>. With the influx of investments both from domestic and international players, and the resultant growth in business activities, we expect an uptick in the sub sector's contribution to GDP. An expansion in business implies more jobs are created. Financial and insurance sector, of which banks are a subset, accounts for a meagre 1.5% of total employment in Nigeria<sup>5</sup>.

#### Deeper pockets, bigger transactions, increased foreign investment

A stronger capital base suggests increased market depth. In addition, banks will be able to embark on bigger ticket transactions, which will attract more foreign investments. The level of foreign portfolio investments (FPIs) into Nigeria has declined from a peak of USD16.37bn in 2019 to a record low of USD1.15bn in 2023 due to weak investor sentiment about the Nigerian economy and policy environment. FPIs account for the largest share of capital inflows by investment type into Nigeria. Foreign Direct Investments (FDIs) have also mirrored the trend of FPIs, falling to as low as USD377mn in 2023 from USD2.23bn in 2014<sup>3</sup>. An increase in investment will spur an accretion in external reserves and provide the CBN with more buffers to support the local currency. Banks will also be able to underwrite higher levels of credit and thereby generate more income.

3. National Bureau of Statistics

4. National Bureau of Statistics

5. World Bank report- Nigeria in Times of COVID-19: Laying Foundations for a Strong Recovery



## 3.2 Specific implications and considerations

### 3.2.1 A bird's eye view of implications from a financial perspective

Given the pivotal role that recapitalisation plays in the Nigerian banking industry, alternative options assessment requires a systematic approach – with a clear view of attendant implications for each path. The below table shows a summary of each option's risk versus potential.

	Dilutive impact	Growth prospects	Process timelines and cost
<b>Fresh capital raise</b>	Historically, rights issues have not been proportionally taken up by shareholders, hence we expect a dilutive impact of a rights issue or IPO/secondary issue.	Medium to high growth option. The new fund strengthens the capital base which helps the bank take on larger transactions towards overall economic development.	Typically shorter than an M&A option which can be concluded within a year.
<b>Mergers and acquisition</b>	Usually result in a dilutive impact where the business combination necessitates the acquisition of one entity by another, or a merger of 'unequals'.	Medium to high, depending on the extent to which synergies are leveraged, as well as the value accretion/ erosion impact of post integration issues.	Similar to an equity capital raise. This may require lengthy planning and execution timelines, as well as significant regulatory and advisory costs for the process.
<b>License downgrade or upgrade</b>	<ul style="list-style-type: none"> <li>A bank will experience a dilutive impact on its equity where:               <ul style="list-style-type: none"> <li>There is compliance within the license and an upgrade via an M&amp;A process.</li> <li>There is non-compliance within the license even after a downgrade.</li> </ul> </li> <li>A bank will experience a non-dilutive impact on its equity where:               <ul style="list-style-type: none"> <li>There is compliance within the license and a downgrade.</li> <li>There is non-compliance and a downgrade.</li> </ul> </li> </ul>	We do not expect any bank to plan for negative growth. Growth is expected within the licensing regime a bank opts for.	Will require upfront planning (management and board) and internal simulations to determine the best option. Thereafter, the necessary CBN processes and approvals will be engaged.

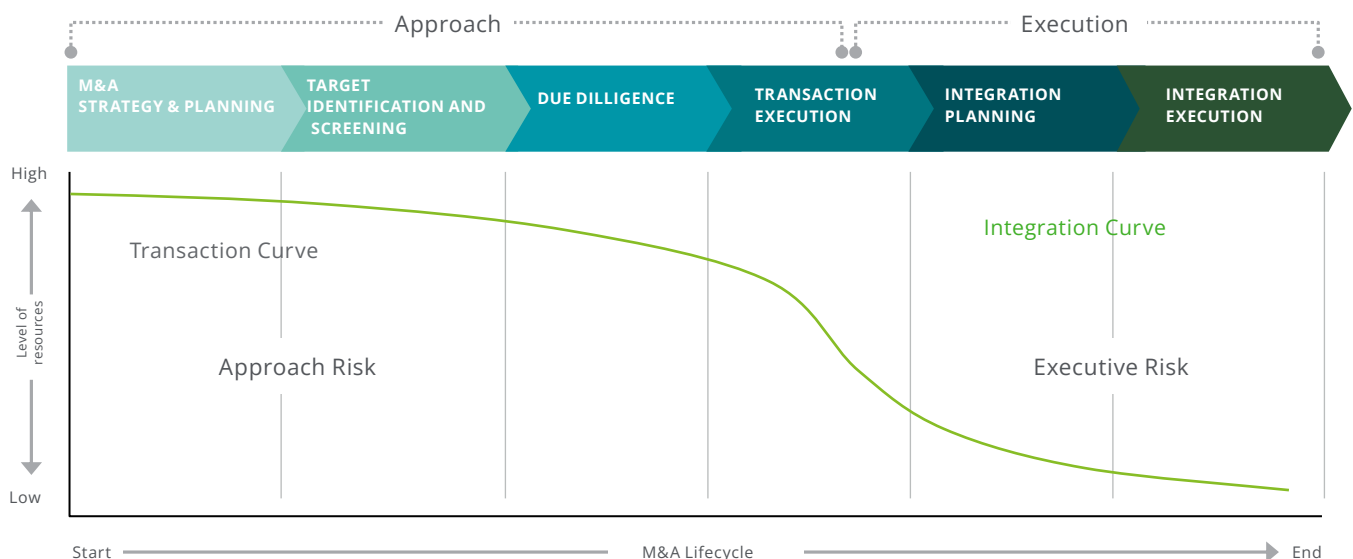




# Thematic approach for a merger & acquisition process

The success of any M&A process is determined by several factors such as the commitment and willingness of the process participants to get the deal done, the potential value to be received by the respective parties, the experience and competence of transaction advisers – financial, legal and technical, and the process of obtaining the requisite approvals and consent from the regulatory bodies. The development of an end to end M&A approach is therefore crucial as this supports a 360° view of the above listed factors - envisaging the potential issues and framing potential solutions before they crystalize.

## Deloitte's view of how to approach M&A transactions



### M&A Strategy & Planning

This phase sets the tone for the entire deal process and typically involves the following:

- Development of the overall transaction objective – In essence, coming up with the “why” and attempting to answer - what “the bank” seeks to gain from the entire process.
- Aligning the potential M&A process with the bank's long-term objectives – Where do we intend to be in the next 10 – 20 years and how can this process support the achievement of our goal?
- Mapping out the potential implications to all respective stakeholders of the bank – shareholders (returns and dilution), customers (service delivery and reach), employees (retainership and redundancies), etc.
- Engaging the right transaction advisers to support with the following:
  - » Evaluating the financial and valuation implications of the process
  - » Developing potential transaction structuring options
  - » Evaluating all potential legal, tax and regulatory considerations
  - » An M&A roadmap
  - » Documentation support (information memorandums, prospectus, financial models, valuation benchmarks, NDAs, shareholder agreements and other regulatory and deal specific documents)
  - » End-end process management

### Target Identification and Screening

After mapping out the M&A strategy, the next phase involves identification of potential targets or partners, and this will cover the following:

- Develop a criterion to support the sourcing and screening of potential target banks based on the long-term strategic goals of the bank. Considerations may include:
  - » Strategic alignment
  - » Size and growth of loan book and deposit base
  - » Geographical presence and reach
  - » Market positioning
  - » Operational alignment with emphasis on organizational structure, technological infrastructure
- Work with the advisers to identify potential targets that meet the agreed criteria, thereafter, screen and engage these targets.
- Evaluate the potential synergies and additional value that can be derived from the deal.

### Due Diligence

The due diligence process involves a thorough review of the bank's historical, current and forecast performance/ position in order to give a true view of sustainable core returns.

For transaction purposes, a comprehensive due diligence process will cover financial, tax, operational, IT, legal and HR aspects of the bank.

Specific focus areas for financial due diligence will include (but not limited to):

- **Historical Asset Review:** Coverage will include accuracy of balances, classification and impairment of financial assets, liquidity profiles of the investment securities portfolio and status & nature of pledged financial assets.
- **Historical Liabilities Review:** Coverage will include nature and completeness of deposit & other liabilities, as well as off balance sheet items.
- **Loan and Advances – Credit review:** Coverage will include a good understanding of the loan portfolio, impairment model, authorisation limits, segment breakdown, security status and pipeline overview.
- **Quality of Earnings:** Coverage will include analysis of gross earnings and costs, as well as adjustments for all non-core and non-recurrent items.

### Transaction Execution

In this phase, all parties involved in the process with support from their advisers work towards:

- Attaining a consensus on:
  - » The final valuation, and associated consideration of the deal – (shares, cash, etc.)
  - » All associated legal and transition documentation

- Obtaining all required board and shareholder approvals
- Facilitate the end – end regulatory approval processes at the CBN and SEC.

### Integration (Planning and Execution)

Post receipt of all regulatory and board approvals, the transaction component of the process is completed.

Therefore, this phase will focus on post-merger integration, and will cover the following:

#### 1. Start with the end in mind:

- i. Clearly articulate the strategic rationale, value drivers, integration principles and define what success looks like
- ii. Ensure alignment on the vision, strategic rationale and value drivers for the deal
- iii. Define the 'North star' operating model for the merged business before Day 1 to a sufficient level to set the overall direction

#### 2. Pursue value creation throughout:

- i. Place value creation at the heart of the program, thereby focusing change where it drives benefit
- ii. Ensure clear accountability and ownership of value creation initiatives and incentivize for success
- iii. Determine an integration prioritization framework to achieve high impact quick-wins and aid decision making

#### 3. Inspire the people behind the vision

- i. Bring teams together to sequence functional integration, clarify required pace and develop an overall roadmap
- ii. Retain and engage employees by minimizing the period of business and cultural disruption
- iii. Define the cultural vision and identify culture carriers in both organizations to bridge gaps and bring it to life

#### 4. Provide outstanding leadership and execute flawlessly

- i. The integration must be sponsored by the - executives of both banks and implemented through an accountable integration director and respective workstream leaders
- ii. Programme governance must facilitate robust and rapid decision making and issue resolution
- iii. Establish robust programme management disciplines that accelerate and enable execution

### Typical challenges faced during post-merger integrations



**Conclusion:** The recapitalisation drive of the CBN has made it crucial for banks to review their strategic plans and reshape their view of long-term growth. The above thematic guide gives banks who are opting for the M&A option a high-level view of the typical process and the applicable considerations.



### 3.2.2 Risk, capital and accounting considerations

Just as Basel III mandates higher capital requirements, regulators also believe having higher capital levels make a bank more resilient, increase its loss absorbing capacity and reduce insolvency risk. However, there are also some effects of recapitalisation on the banks risk and capital management.

The recapitalisation exercise has risk and capital implications on one hand and accounting implications on the other, as banks navigate the details required to comply with any of the options highlighted by the apex bank.

M&A between banks typically focuses on consolidating businesses, not directly increasing the acquirer's paid-up capital during a recapitalisation.

It is noteworthy to mention that the proposed recapitalisation will impact capital planning and key risk metrics prescribed by the banking regulator. The array of options to be adopted by banks could have varying effects on the regulatory capital and risk metrics. It is most likely that at the initial phase post recapitalisation, many risk and capital ratios would immediately become very impressive, substantially exceeding the minimum regulatory thresholds. Post recapitalisation, the

litmus test of how banks have efficiently deployed available capital will result in a different league status of banks especially in terms of the risk metrics and future capital ratios. This is even more relevant for banks that will comply via M&A.

Acquiring banks should carefully consider the assets, liabilities, off balance sheet items and risk weighted assets of target banks that can negatively affect the various regulatory capital metrics. The scenarios of the pre and post recapitalisation risk and capital status must be key considerations in decision making including assessing how the various capital metrics will be affected under mildly stressed scenarios.

From an accounting perspective, there are significant reporting requirements that will be triggered irrespective of the options considered by banks to meet the CBN directive. Business combination in line with IFRS 3, treatment of capital raise cost under IAS 32, IFRS 7 on disclosure of financial instruments, IAS 33 earnings per share and even in the unlikely scenario of a downgrade to regional or national bank – non-current assets held for sale and discontinued options are but a few of the accounting standards that will be triggered. Banks must consider these ahead and model the resulting impact on the books including disclosures. Below are the specific risk, capital and accounting considerations for each of the approved options by the CBN.





### A. Mergers & Acquisition

M&A can contribute to a successful recapitalisation in some ways such as providing economies of scale. i.e., merging can lead to cost savings and improved efficiency, potentially freeing up resources for the acquirer to raise additional capital through retained earnings; enhanced market position – attraction to new investors, making it easier to raise capital through new share offerings; diversification of the acquirer's loan portfolio and customer base, potentially improving its overall financial health and risk profile, which can be beneficial during recapitalisation.

M&A between banks typically focuses on consolidating businesses, not directly increasing the acquirer's paid-up capital during a recapitalisation. However, to address the underlying objective of enhancing paid up capital or keeping it within the minimum threshold for the capitalisation groups just like the other options, merger arrangement must involve the issue of new acquirer shares as the acquisition currency. With proper pricing, the net assets of the acquiree may be substantially reflected in the newly issued shares thereby boosting the paid-up capital in a manner that achieves the recapitalisation objective.

### Risk and Capital Implication

To analyse the risk and capital implication of M&A, it is important to consider a few critical ratios such as leverage, liquidity, and capital adequacy. Leverage ratio aims to prevent excessive risk-taking by banks, promote a more stable financial system and is a function of a bank's Tier 1 capital to its total exposures. Mergers may not necessarily improve the leverage ratios but are a function of the post-merger exposures measure which in this case is the unknown element in the ratio. Since the constituents of consolidated qualifying assets are what make up the exposure measure, there is the possibility of an actual decreased leverage ratio post-merger if the acquiree bank is valued less than the net exposure that is to be transferred to the surviving bank.

A bank's ability to meet short term target is measured by the liquidity coverage ratio. They typically compare a bank's liquid assets. Where there is a merger/acquisition, the liquidity coverage ratio for the bank will depend on the quality of the assets of the respective banks, the respective net outflows that will occur on account of the asset/liability position of the banks. Liquidity coverage ratios for banks that recapitalise through mergers/acquisition may likely improve and meet minimum requirements. However, there are other factors that need to be considered by merging banks with these capital ratios in mind at the merger phase.

The capital adequacy ratio (CAR), (a key metric used to ensure that banks maintain sufficient capital reserves to absorb potential financial losses) of most banks are currently above minimum threshold so in a merger arrangement, substantial dilution of CAR is not envisaged. It is however important to

consider the current credit and market portfolio of the target bank as key impact factors in post-merger CAR.

### Accounting Implication

The critical standard here is IFRS 3 Business Combinations. Other accompanying standards such as IFRS 13 and IAS 36 are also relevant in view of the specific measurements of assets and liabilities. The acquisition method of accounting is what will be used even if both banks are relatively of similar size. Consequently, there must be an acquirer and an acquiree Purchase price/purchase method, Goodwill or Bargain purchase, which are the three accounting terms that can change the dynamics in terms of resulting position of post-merger from a recapitalisation perspective. Also, there is IAS 33 Earning per share Impact in calculating the weighted average number of shares of outstanding (the denominator for the earning per share calculation) during the period in which the acquisition occurs and the resulting possible dilution or synergetic upgrade of EPS.

### B. Injection of fresh equity capital

The option of injecting fresh capital through vehicles like IPO, rights issue or private placement will generally improve liquidity, leverage, and capital adequacy ratios of banks. Banks can also use this fresh capital to expand its assets and change the composition of its risk portfolios. As positive as this may sound, rebuilding capital positions essentially by attracting fresh investment is more than a simple re-stocking exercise. To attract new capital, or to be able to retain earnings without losing the confidence of investors, banks will need to be seen as investable businesses both locally and internationally. There is a possibility of unintended effects on profitability in terms of return to equity. The management of the bank may need more time to find qualified borrowers or may decide to reduce leverage, both of which could lessen risk and hence lower expected profitability.

The point to note here is the practical challenge banks may face in raising new capital amidst severe economic challenges. Interest rates are at record high levels. Credit impairment is looming, real sector capacity to produce is stifled and foreign exchange net flow deficit is not encouraging. The economic picture by its variables and metrics alone gives less confidence around the timing of recapitalisation via fresh capital injection from the public. What this means is that the combination of a recapitalisation imperative (to maintain buffers) and weak prospective economic performance makes the challenge all the harder, and even more urgent despite having two years for this exercise.

Foreign portfolio investors are a suitable direction for banks in search of fresh capital. With the depreciated naira, foreign investment inflows will help to ease dollar illiquidity and

boost external reserves accretion. Another good option (if not for regulatory blockade) is the pension funds. With the mammoth cash in pension funds, meeting these capital requirements by some of the most profitable and stable banks (by risk and performance ratios) would have been an easier ride. This is a topical issue for the relevant regulators to look at, as part of plans to unlock real value in pension funds. Issuance of preference shares and other similar financial instruments with identical contractual features as ordinary shares, such as non-redeemable instruments with term structure that runs into perpetuity, in essence meets the CBN recapitalisation programme objective. However, it does not meet the specific definition for minimum capital as specified by the CBN since additional tier 1 is excluded.

### Risk and Capital Implication

As indicated earlier, banks will have elevated leverage ratios (regulatory CBN ratio) alongside improvements in capital adequacy ratios (CARs) and liquidity coverage ratios (LCRs). This strong position will precede the redeployment of the additional capital raised towards the expansion of the banking and trading books. The risk and capital implication largely depend on how the bank strategically plans the equity injection and how the bank utilises the recapitalisation in either increasing its asset portfolio or decreasing leverage.

Capital from the fresh issue is not a free commodity, it comes with its own cost that must be covered by the bank. The management must design a credible pathway to demonstrate economic viability of the bank in generating capital returns that exceed capital cost.

There is also a possible impact on the overall banking in form of system risk. As long as recapitalisation lowers leverage, the balance sheet effect will cause a lower systemic risk. However, the reduced profitability that comes from deleveraging or inability to get qualified borrowers may raise systemic risk due to negative signalling that could arise from low return on equity.

### Accounting Implication

Earnings Per Share EPS (IAS 33): Where equity increase is purely from capital market events as against organic generation of equity, the profit after tax will gradually grow towards current capital levels, hence there will be a decrease in the earning per share.

Where a bank decides to raise capital through an IPO, such banks are subject to increased disclosure and filing requirements. These statements will need to be transparent and clearly reflect the impact of the IPO on the bank's financial position.

Share Issuance Cost: Banks will incur costs associated with the IPO process, such as underwriting fees, legal fees, and marketing expenses. These costs are typically treated as

deduction to equity in line IAS 32 on presentation of financial instruments to the extent that they are incremental costs directly attributable to issuing equity.

### C. Upgrade or Downgrade of License Authorisation

Downgrading or upgrading a banking license can be a strategic option but likely the road to be least travelled. It is a complex decision requiring careful analysis of the bank's financial health, future goals, and risk tolerance.

**Downgrading a license:** Downgrading allows the bank to focus on the core business where they have comparative advantage. This potentially reduces operational costs, improves risk and capital ratios, and simplifies their business model. The freed-up resources can then be channeled towards strengthening their base and gives the bank time to gradually target the higher capital base category within its own pace at a future date. Downgrading has its own limitations. The bank might lose access to certain products or services it previously offered under a higher license and the value that comes from diversification. Additionally, downgrading might be perceived negatively by some customers and associated with reduced financial strength. A downgrade in banking license indicates a strategic shift by the bank. If the bank decides to discontinue its operations under that license, it may trigger classification as "held for sale" under IFRS 5 (Non-current asset held for sale). IFRS 5 requires detailed disclosures for assets classified as held for sale. The bank would need to disclose the classification, the measurement basis used, and any impairment losses recognised.

**Upgrading a License:** Upgrading to a license with a higher capital threshold allows the bank to expand its operations. This can be attractive for banks that already have sufficient capital or can raise it easily. Upgrading unlocks access to a larger customer base and potentially more complex financial products and services, leading to increased profitability. Upgrading requires a strong capital base and the operational capacity to handle a larger and more complex business. Not all banks with sufficient capital may be well-positioned for an immediate upgrade.



### 3.2.3 Tax considerations for bank recapitalisation

Apart from commercial and strategic long-term objectives, it is worthy to note that there are tax implications for whichever choice a bank makes to comply with the recapitalisation mandate of the CBN. Therefore, banks are required to consider tax risks and opportunities of the different recapitalisation options available to them. This is necessary to ensure tax efficiency and optimisation.

Some tax considerations for the options available to banks include:

#### 1. Injection of fresh equity capital through private placements, rights issue and/or offer for subscription:

This option attracts minimal tax implications given its simplicity. Tax consideration would be whether the private placements, rights issue/offer for subscription will create any tax exposure for the bank or existing shareholders or prospective investors.

There is no transfer or capital gains tax on issuance of shares. However, where the share capital of a bank is increased as a result of the rights issue and/or offer for subscription, stamp duties would be applicable at an ad valorem rate of 0.75% on the value of the increased share capital of the bank.

*Generally, all transaction costs involved in the capital raise will be non-deductible as they are considered capital in nature. However, banks may make a special case for deductibility of these costs relying on the "accord and satisfaction" principle relied upon in Shell v FBIR. This is on the premise that the increase in capital was mandated by the CBN and these costs were wholly, reasonably, necessarily and exclusively incurred in maintaining its licence for income generation.*

#### 2. Merger and acquisition:

Under this option, a bank may consider acquiring the shares of another bank (up to 33.3% of the bank to force a take-over) and thereafter merge with the acquired bank. It is also possible to adopt an outright merger without initial acquisition of shares. Regardless of the structure of the merger, it is important to note that there are tax consequences as well as opportunities that can be harnessed. Some of the relevant implications are set out below:

##### 2.1 Capital Gains Tax (CGT)

1. Share transfer - Capital gain from the sale of shares of a company is taxable under the Capital Gains Tax Act (CGTA). Section 30 (2) of the CGTA imposes CGT at 10% on any capital gain made by a person on disposal of shares in any Nigerian company except any of the following conditions is met:
  - a. where the disposal proceeds are less than NGN100mn in any 12 consecutive months, or
  - b. where the sale proceeds are reinvested in shares of a Nigerian company within the same year of assessment, or
  - c. where the shares are transferred between an approved Borrower and Lender in a regulated Securities Lending Transaction.





## Transfer of assets

# 10%

Any gain realized on the disposal of an asset is subject to CGT at 10%.

## Transaction Taxes

# 7.5%

### Other Transaction Taxes

The transferee will also be required to pay value added tax (VAT) at 7.5% and stamp duty at 1.5% of the value of assets transferred.

## Tax incentives

Banks seeking to merge can take advantage of the tax incentives in the CITA, Value Added Tax Act, Stamp Duty Act and CGTA, provided they meet certain conditions

### Section 19 CITA

# 19 CITA

In line with section 19 CITA, dividend paid out of the retained earnings of a company is exempted from excess dividend tax

Based on the above, any acquisition which does not fall within any of the exceptions above triggers CGT. In this regard, the strategic acquisitions may be conducted in tranches below NGN100mn threshold to eliminate the CGT impact. This is in view of the provision of CGT (albeit theoretical) that seems to suggest that a sale of an asset is voidable until applicable CGT has been settled.

For mergers, this provision may not be triggered as shareholders of the submerged bank obtain shares in the resultant entity, thus considered investment in another Nigerian entity.

2. Transfer of assets – Any gain realized on the disposal of an asset is subject to CGT at 10%. Mergers typically involve transfer of assets and liabilities, thus the transferor may be obliged to pay CGT at 10% on gain arising from the disposal of the asset. There is, however, room to enjoy relevant incentives in this regard.

2.2 Companies Income Tax (CIT) Similarly, based on the Companies Income Tax Act (CITA), there could be CIT implications for the transferor depending on the value at which the assets are transferred vis-a-vis the tax written down value (TWDV) of the assets transferred. This may or may not result in a deductible allowance or a taxable charge.

2.3 Other Transaction Taxes The transferee will also be required to pay value added tax (VAT) at 7.5% and stamp duty at 1.5% of the value of assets transferred.

**NOTE:** Banks seeking to merge can take advantage of the tax incentives in the CITA, Value Added Tax Act, Stamp Duty Act and CGTA, provided they meet certain conditions. Some of these incentives include: deeming assets transferred as a result of the merger as transferred at TWDV and exemption of such assets from CGT and stamp duties.

One of the key conditions for enjoying the tax incentives above is that the merging entities must be related companies with

one of the companies controlling the other or both being controlled by some other persons or being members of the same group of companies. Also, this relationship must have been in place for a consecutive period of 365 days prior to the date of merger. Consequently, banks wishing to take advantage of the above incentives will have to expedite the acquisition process to meet the 365-day common control threshold, while also considering the timeline for the recapitalisation as directed by the CBN. The merging banks will also be required to obtain the approval of the Federal Inland Revenue Service before the merger/acquisition is concluded, in line with section 29 (12) of CITA.

Finally, another key consideration for banks seeking to merge is the potential loss of some tax assets such as accumulated capital allowances, unrelieved tax losses and unutilised withholding tax (WHT) credits of the merging entities. This is because the position on whether these assets can be utilised by the surviving/emerging entity, post-merger, is not clear in CITA. Consequently, this gives room for the tax authority to exercise discretion. Nonetheless, banks would have to examine the potential risk of losing tax assets in determining the recapitalisation option to adopt.

3. Capitalisation of undistributed profits

Although, the CBN has excluded retained earnings from what should constitute capital to the banks, in meeting the new minimum capital thresholds, it is essential for banks to consider the tax implications of this option should the CBN revisit its position on the use of retained earnings.

In line with section 9(3)(a) of CITA, any distributions from retained earnings, including bonus issues, are deemed as dividend distribution to existing shareholders. Therefore, this will attract all tax consequences applicable to dividend distribution. Dividends are subject to WHT deduction at 10% except where the recipient is resident in a treaty country in which the DTA8 specifies a reduced WHT



rate. Also, in line with section 19 CITA, dividend paid out of the retained earnings of a company is exempted from excess dividend tax provided that such retained earnings have been previously subjected to tax.

Furthermore, where the bonus issue results in an increase in the share capital of a company, stamp duties would be payable at 0.75% of the value of the increase.

#### 4. Downgrade of license

As noted earlier, banks also have the option of downgrading their current license which may result in the reduction in the number of branches and personnel. In this instance, banks would have to note the tax implications of selling off some of the assets in those branches, such as CIT, CGT and VAT exposures. Also, the reduction of staff may create CGT or personal income tax (PIT) implications for the affected employees. Some state governments, (e.g., Lagos State Internal Revenue Service), have appointed the employer as agent of collection of CGT applicable on compensation for loss of employment. The Personal Income Tax Act (PITA) also requires an employer to deduct pay-as-you-earn (PAYE) tax and remit to the relevant tax authorities. Therefore, it is important for banks to ensure that appropriate tax deductions are made and remitted to relevant tax authorities to avoid tax exposures as well as penalty and interest charges applicable to non-compliance.

### Regulatory considerations of the proposed options

Considering that the banking industry is a highly regulated industry, any option chosen by the banks would involve regulatory approvals, notifications and processes to comply with the extant rules. We have provided below a high-level consideration of the regulatory impact of each of the options below:

#### 1. Injection of fresh equity capital through private placements, rights issue and/or offer for subscription

The injection of fresh equity capital through private placements, rights issue and/or offer for subscription would require a written consent of the Governor of the Central Bank of Nigeria. This is required to be sought and obtained before any restructuring can be done by a bank. Additionally, all securities must be registered with the SEC. Notification will be given to the Corporate Affairs Commission (CAC) upon completion of the procedure.

#### 2. Mergers and acquisitions

In addition to the due diligence and transaction execution



noted above, there are relevant regulatory approvals required for a merger and acquisition. A written consent of the CBN Governor must be obtained before any bank can enter into an agreement or arrangement of merger and acquisition. There is also need to obtain the approval of the Federal Competition and Consumer Protection Commission. As part of the consideration the employees of both banks must be informed of the proposed merger.

In line with section 7 of the BOFIA Act 2020, the prior review and approval of the SEC is also required for every merger or acquisition in line with Rule 423 of the SEC rules 2013. An order of the Federal High Court will be obtained to sanction the scheme of Merger and acquisition.

There would also be notification to CAC, States Inland Board Revenue, Land Registries, Financial Reporting Council etc. There may also be contractual approvals/notification required – ranging from lenders to bondholders among others.

#### 3. Capitalisation of undistributed profits

An application must be made to register the bonus issue with SEC within one month of the passage of the resolution by the company's shareholders in line with Rule 279(4)(b) SEC rules 2013.

### 3.2.4 Workforce/talent implications of the options

Each of the options have different implications for the workforce and talent management of the banks. Some of the key implications are:

- **Mergers:** These can lead to rationalization of staff, as the merged entity may seek to eliminate duplication of roles, functions and branches. This can result in layoffs, redeployment, retraining or early retirement of some employees. It can also create cultural clashes, as the employees of the different banks may have different values, norms and practices. This can affect the morale, motivation and performance of the staff. However, on the bright side, such mergers can also create opportunities for career advancement, as the merged entity may offer more diverse and challenging roles, as well as better remuneration and benefits.
- **Acquisitions:** These can also lead to rationalization of staff, as the acquiring bank may seek to integrate the operations of the target bank and optimize its resources. This can result in layoffs, redeployment, retraining or early retirement of some employees, especially those of the target bank. Acquisitions can also create power struggles, as the employees of the target bank may feel threatened or marginalized by the employees of the acquiring bank. This can affect trust, cooperation, and communication among the staff. From a positive standpoint, some acquisitions can create opportunities for learning, as the employees of the target bank may benefit from the expertise, technology and best practices of the acquiring bank.
- **Injection of fresh capital:** Injection of fresh capital can have a positive impact on the workforce and talent management of the bank, as it can enable the bank to invest in human capital development, such as training, coaching, mentoring and career development. This can enhance the skills, competencies and capabilities of the staff, as well as their engagement and retention. Injection of fresh capital can also create new roles and responsibilities, as the bank may seek to expand its products, services, and markets. This can offer more opportunities for growth and innovation for the staff.
- **Downgrading:** Downgrading may have a negative impact on the workforce and talent management of the bank, as it can limit the career prospects, exposure and recognition of the staff. Downgrading can also reduce the attractiveness and competitiveness of the bank as an employer, as it may offer lower salaries, incentives and benefits, as well as less challenging and rewarding work. This can affect the morale, motivation and performance of the staff, as well as their turnover and loyalty.
- **Upgrading:** Upgrading a bank's operational status, from regional to national or national to international, has significant implications for its workforce and talent strategy. It will require hiring specialists to drive the business. Expanding into new markets necessitates a workforce capable of navigating cultural and language differences. It will also require managing the demands of a geographically dispersed team and this will require new thinking with respect to evolving a winning talent management strategy.

#### Strategies for dealing with workforce implications

In responding to the above workforce implications, banks should consider the following:

- i. **Transparent Communication:** Implementing a transparent communication strategy, offering retraining programs, and ensuring a fair and equitable integration process.
- ii. **Employee Engagement:** Engaging with the workforce early on about potential changes and their implications is crucial for maintaining trust and morale.
- iii. **Effective Change Management:** Implementing effective change management strategies to mitigate the risks associated with acquisitions, such as power struggles and loss of trust among staff. Where downgrading is involved, provide support and guidance to employees during the process of downgrading to maintain employee morale, motivation, and performance.
- iv. **Retention Strategy:** Uncertainty may prompt valuable employees to leave. It is therefore important to develop a compelling employee value proposition to attract and retain top talent, especially during the process of merging, acquiring, or upgrading the bank's operational status.
- v. **Employee Development:** Intentionally invest in your workforce development to enhance their skills, competencies, and capabilities to take up new challenges, roles and responsibilities.
- vi. **Holistic Approach:** By adopting a holistic approach that considers both strategic and human capital implications, banks can turn regulatory compliance into a strategic advantage.

### Conclusion

The CBN's regulation on capital base is a significant challenge for Nigerian banks, as it requires them to make strategic decisions that will affect their future direction and performance. The banks need to carefully weigh the pros and cons, as well as the workforce and talent implication of each option, to choose the best option that will enable them meet the requirement and achieve their goals. Drawing lessons from past consolidations, banks can avoid pitfalls and emerge stronger, more resilient, and better equipped to serve their customers in the evolving financial landscape.

## 3.2.5 Practical steps for Boards & Management to adopt



Asking the right questions is a hallmark for holding the right conversations that produce constructive results. Boards and Management of banks should:

- **Review the current capital base of the business.**
- **Engage with relevant stakeholders** to review options to be considered (rights issue, investment, mergers & acquisitions, or raise additional funds)
- **Run scenarios of the respective options for recapitalisation** and the implication for the respective stakeholders
- **Review the implications (pros and cons) of each scenario for recapitalisation.**
- **Set timelines.** Based on the scenarios, agree timelines, and monitor implications
- **Request for support from experts** to assess plans for recapitalisation.

The timeline set by the CBN for the submission of the plan for recapitalisation makes it quite urgent for Boards and the Management of banks to be nimble in responding to the requirement while also investing time and resources to ensure thorough appreciation of the consequences of decisions to be made and the plans to be designed.

According to the CBN circular, banks have a timeframe of 24 months to comply but must submit their implementation plan to the CBN not later than 30 April 2024. Hence, this new capital requirement regime is a call for Boards and Management of banks to revisit their corporate strategy in designing the way forward for their respective institutions.

It is paramount for these Boards and Management to ask the right questions and define SMART action plans to address the compliance requirements under this new regime.

# 4.0 Risks, opportunities, way forward

A revitalized and well-capitalised financial services industry can significantly boost the economy by facilitating enhanced financial intermediation. However, the CBN's guidance remains crucial to ensure these new investments are directed towards strategic sectors identified by the government as essential for fostering economic development.

With increased paid-up share capital and an increased buffer, international investors and stakeholders particularly credit rating agencies could have a different outlook on the financial services industry. This does not mean that credit ratings for banks will immediately become more favourable, however improved capitalisation strengthens the case for positive ratings of banks. With improved ratings, Nigerian banks can approach international debt/equity markets and raise more capital for business expansion.

The commercial banks in Nigeria can also choose to take on more risk, with particular focus on trading and treasury activities. This is because banks will now have a capital buffer that can withstand expected and unexpected losses. However, this should be done in line with the bank's risk strategy and regulatory guidance. For the Nigerian banks with international licence, this presents an opportunity to expand into regions that are assessed to be profitable. While there will be large scale opportunities for financial intermediation, there are concerns that the regulator will need to address. The regulator might need to rethink its position on single obligor limits. This will ensure that lenders

do not just direct the funds raised to specific customers alone and that funds are directed strategically into specific sectors of the economy.

Key next steps for banks

1. Detailed impact assessment of the different recapitalisation options
2. Develop credible business and capital building strategies that can be discussed with the regulators and investors.
3. Prepare for new levels of frequent and intense supervisory scrutiny which we expect will be sustained for the foreseeable future, with a particular focus on risk and governance.
4. Set up a team internally and / or engage experts on the subject matter to support with the development of an implementation plan that will clearly indicate the chosen option(s) for meeting the new capital requirements and various activities involved with the timelines.

"Banks are to the economy what the heart is to the human body. They cycle necessary capital through the whole, and they are barely noticed until pressure, necessity, or crises" -

*Hendrith Vanlon Smith Jr.*





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