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## Examining the effect of bail-out on the large port-folio wipe out as a result of liquidity and lack of investors' confidence in the present condition of the Nigerian capital market

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### Abstract

The effect of bailout on the large portfolio wipe out cannot be over emphasized. The effect can be said to be positive in that the trend of liquidation hovering over the Nigerian capital market as well as lack of investors' confidence can be said to be effectively solved. The banks experienced some form of liquidation due to the corruption going on in the banking sector. It has also tended to affect the confidence level of investors in that they are now thus scared of losing their money for investing. They are also discouraged by the fact that the system of granting credit facilities such as loans as well as the fact that it is virtually impossible for small investors to get loans due to too much collateral which they obviously cannot meet.

**Keywords:** Bailout, Portfolio Management, Nigerian Capital Market, Liquidity Management, Nigerian Wonder Market, Portfolio wipe out, Noncompliance and Central Bank of Nigeria

### Introduction

The policies of bailout on large portfolios especially when they are in financial crisis is an age-long practice whereby government or wealthy corporations and individuals come together to pour in huge amount of money on a weaker corporation(s) which is either facing financial liquidity or has lost confidence of previous investors. Moreover, this practice has numerous effects. These effects are either positive or negative. The bailout as embarked upon by the central bank can be thus said to be very drastic, an action which of course led to drastic effects. In other words, it was done in earnest to save the banks from total collapse after the general bank overhauling thereof. Therefore, the banks were placed back on track by the Central Bank Nigeria (CBN) thereby boosting their capital base. However, the commercial bank that benefited from these bailout funds given them by the Central Bank such as Intercontinental Bank, Fin Bank, Oceanic Bank etc. were closely monitored to ensure that the new MD, CEOs and their various boards effectively and judiciously utilize these funds since the former ones as the likes of Erastus Akingbola, Cecilia Ibru, Okey Nwosu etc. were removed in the most unpalatable manner due to their corrupt practices characterized by flagrant mismanagement of funds of the bank. In addition, this act which has become a common practice all over the world was applied on the Nigerian Capital Market which experienced some financial crisis as a result of functional loans granted to some corrupt business minded political figures. The financial bailout from the Central Bank of Nigeria (CBN) into the above commercial banks mentioned, I received a text message from the Managing Director (MD) of Oceanic Bank by name Mr. John Aboh on October 2009 assuring me that the #100 billion injected into their bank by the Central Bank of Nigeria (CBN) have boosted their confidence not to disappoint and kill the confidence I

(their investor) have in them.

### Literature Review

The objective of a bank is to make profit from its operation and also to meet the demands of its customers. In order to meet this dual objective, the bank must define a way to see that these objectives of liquidity and profitability did not suffer. Let us look at liquidity management.

### Liquidity Management

Liquidity management is the maintenance of adequate liquidity. Liquidity is a very important index in commercial banks management because adequate liquidity implies two (2) things:

- a. That the bank in question can satisfy its safety need which means that it will not run out of cash.
- b. It means also that the bank can simultaneously satisfy its profitability needs.

### Problem of Liquidity

The basic problem in liquidity management is to have sufficient fund to satisfy customers' withdrawal needs. Another issue is also the protection of the customer as well as the bank itself, as we can see what happened to banks and customers during the distress banking period. Also, liquidity management is concerned with the ability to satisfy the credit need of the customers. Also, other problems associated with liquidity management are as follows:

1. Loss of profitability
2. Increase in cost of security
3. Mismanagement of fund
4. Increase in fraud and theft
5. Loss of public confidence and investors' confidence
6. Inability to seize profitable opportunities

7. Forced sales of assets
8. Involuntary borrowing
9. Noncompliance with statutory requirements

### Theories of Liquidity Management

Various schools of thought exist on how best a bank should manage its affairs to ensure that adequate liquidity is maintained. Below are the theories or doctrines:

1. Commercial loan theory
2. Stability theory
3. The anticipated income theory
4. Liquid asset theory

Generally speaking, investors all over the world are risk averse and, in most cases, try to choose investment that will give them best results giving the prevailing risks. The question now is what is portfolio?

Portfolio is a collection of investments real and/or financial. It is a group of investments. The more diversified the portfolio is more likely to earn the same return in the market. A portfolio is a collection of securities held by a single investor. As popular adage says that one should not carry all his eggs in one basket, which means that if one has ten eggs and wish to cross a slippery gutter, to diversify (i.e. reduce the risk of all the eggs in the basket breaking at once in case of a fall) risk of breakage, it is best to cross with the eggs one at a time over the slippery gutter. In investment terms, it simply means that one diversifies (reduces) risks by not investing in just one stock (i.e. shares or debentures of one firm) but in as many stocks of different firms as are possible considering the risk involved.

For proper understanding of what portfolio is, we are to look at the meaning of risk.

Risk can be defined as uncertainty about future outcomes. Interestingly, the greater the range of possible outcomes of an event, the greater the risk. And as we have discussed earlier investors prefer less risk to more risk venture and will only increase their risk-taking position if a premium for risk is involved.

### What is Portfolio Management

Portfolio management is the act of practice or making investment decision in order to make the largest possible return. Portfolio management takes two (2) basic forms. They are:

1. Active, and
  2. Passive
1. Active Management involves using technical, fundamental or some other analysis to make trades on a fair regular basis. It involves buying an index, an exchange traded form or some investment vehicles with securities which the investor does not directly choose. For example; one may buy and exchange traded form that holds all the stocks on the S and P (Standard and Poor's) 500.

### The Nigerian Capital Market

The capital market is the market for long term funds. Those who need long term capital for project of long-term gestation

to be repaid after five (5) years, ten (10) years, or more go to the capital market to source such funds (Anyanwaokoro, 1999).

### The Reasons for the Establishment of the Nigerian Capital Market

The Nigerian Capital Market was established for the following reasons:

1. Provision of opportunities for borrowing and lending for long term purposes for Nigerians.
2. Mobilization of long-term capital for the economic development of the country.
3. Provision of investment opportunities for foreign businessmen and Nigeria businessmen to invest their fund.
4. Provision of facilities for quotation and marketing of shares and stocks.
5. Creation of opportunities for proper conduct and regulation of activities in the market.

### What Then is Bailout?

Bailout simply means to rescue somebody or a corporate body from financial difficulties. It is also a process of injecting funds into the banking system, in order to help banks that are on the verge of liquidating from winding or folding up.

### The Causes of the Nigerian Capital Market Meltdown Are as Follows

1. A global phenomenon.
2. Pull-out of various foreign investors.
3. Lack of infrastructure and high production costs.
4. Impact of commercial banks.
5. Avalanche of private placement offers.
6. Banks short-term orientation imposed on long-term capital market.
7. Inability of the Federal Government to plot a bailout option.
8. Structural deficiencies of the Nigerian Stock Market.
9. Regulating inconsistencies and pronouncements.
10. Pressure from banks.

### Consequences of the Market Meltdown

The meltdown of the Nigerian capital market characterized by the crash of the market capitalization from a record high of #13.5 trillion in early 2008 to less than #4.5 trillion in the corresponding period of 2009 has manifested the under listed cost and consequences.

1. Loss of confidence in the Nigeria economy, as many investors prefer to convert their naira to foreign currencies, especially the dollar and hold them through their domiciliary accounts. This has in part led to worsening exchange rate against the naira.
2. Mega losses by investors in the capital market whose total losses are not below 2/3 or of their investment before the meltdown. In other words, investor now have less than one third of the value of their investments before the free-for-all fall.
3. Trillions of naira - what remains of the capitalization - tied down in unsalable stocks. Most of the securities are

- on serious offer - an indication that there are no willing buyers to check litany investor who wishes to do so. Here investor not only contend with their losses to date, they also contend with a supply glut that they seem trapped with the remaining securities in their sad possession.
4. Over exposure of investors and stock broking firms to banks before the meltdown, banks engaged in lending frenzy through margin account. Borrowers were required to contribute 30% to while the banks contributed 70 and the entire 100% was used for stock speculation. Currently, the market meltdown has wiped out the investors 30% contribution while. Half of the banks 70% have also been wiped out. Notwithstanding these scenarios, the bank are still calculating interest and on daily basis and posting to the debit of the borrowers account investors and stock broking firms, thus to sting perpetual liabilities on the borrowers which only divine intervention can save these borrower from the hangman - the banks.
  5. The market meltdown has also led to credit crunch in the economy as banks do not have enough to lend to the productive sector leading to high interest rate. Given that interest rate - cost of fund to manufacture is a very significant component of cost of production, thus translates to high prices of goods and services, leading to inflation.
  6. The meltdown has also led to the loss of confidence of banks and other lenders on shares as collateral for loan facilities. Shares which were before now readily accepted by banks as collateral are now shunned by them. The few of them that dare to touch them for this purpose only do so with a hundred-meter pole, at ridiculous discounts as some of them seek up to 300% cover.
  7. The market meltdown has led to loss of depositors' funds with the banks. It is estimated that banks are exposed to the capital excess of #1 trillion through loss in the value of securities for which margin facilities were granted investors in Nigeria. This has significantly increased the quantum of banks non-performing assets - Toxic assets.
  8. The market meltdown has also induced massive withdrawal of foreign investors from Nigerian financial system, damping the remaining source of hope for possible market recovery.
  9. Loss of value of pension Asset. Following the passage of the Pension Reform Act, 2004, pension assets are now privately managed. Under the Act, every employer, whether in the private or in the public sector is obligated to deduct 7 1/2% of every employees/emolument, then added another 7 1/2% totaling 15%. This is remitted on monthly basis to a pension asset custodian under the superintendent of a pension fund administrator. The PFAs manage the pension assets by investing in a variety of instruments including equities. The PFAs also maintain retirement savings account for employees showing the deductions remitted on that I behalf a well as the profits or losses arising from the investors. It is estimated that more than #2 trillion of pension assets has gone down the drain casting and gratuities.
  10. Inability of stock broking firms to settle their clients for securities sold. With the current meltdown, many stock broking firms cannot discharge their obligation to their clients. Proceed of shares sold by these stock brokers for their clients are greedily seized by the banks to whom the stock broking firms are owing billions of naira through margin accounts. Incoming credits or debts arising from sale of securities or purchase of securities can only be settled through the appointed settlement banks. This gives the banks the opportunities to absorb any incoming credits to service huge margin facilities granted to stock brokers. Thus, many stock broking firms rejects sale order as they know that the banks will seize the credits, leading them to contend with their clients.
  11. Loss of confidence in the regulatory bodies. There appears to be a loss of confidence on the regulatory bodies of the Nigerian Stock Exchange as well as the Securities and Exchange Commission whose regulatory impotence has been largely blamed for the present woes of the capital market and whose principal officers appear to have exhausted all they know and all they can offer to change the fortunes of the market. Many market analysts believe that they ought to have thrown in the towel instead of trying to stay put and superintend the "funeral mass" of the market they have nothing again to offer.
  12. On a positive note, the Nigerian Capital Market meltdown has compelled investment diversification to their assets especially real estate and government bonds. Investors now scamper for safety rather than high returns at the expense of possible huge or near total losses which equity investment symbolizes - where the investor either enjoys too much or suffers too much.

### **Recommendation**

#### **How to Bailout Nigerian Capital Market**

No more bulls on the Nigerian Capital Market. The bears are having a field day. It is not surprising after a series of missteps from the Securities and Exchange Commission (SEC) and the Nigerian Stock Exchange (NSE). It is now becoming obvious that both regulatory organizations are clueless on tackling the bearish stalemate in the market. In fact, the initial attempt that led to the ill-advised one percent downward fix of price movement on stocks can largely be blamed for the current state of the market. The fix artificially stopped the market from bottoming out and led to a loss of confidence in the market that is becoming difficult to restore. The Exchange fortunately after much criticism saw the folly of the fix and removed it. This saw the market plunge, and then rise. But the rise was short-lived as the bears have returned seemingly stronger. In the last one week, we have seen the bears take complete hold of the market once more as less stock appear on the gainers chart. It has been the opposite when it comes to stocks losing ground. However, despite the fix of one percent drop, several stocks are on the losing side. Most stocks are currently on offer on the floor of the Exchange. Hard strapped investors are waiting for weeks and months to be able to make a sale. Even stocks like First bank Plc. that were as good as money in the market, now take weeks to sell and even then in little lots.

The question on the lip of investors is how we turn around this

market? Several players in the market are calling for a bail out considering this is the trend in leading global markets experiencing similar market meltdown. What has not been agreed on is how to achieve this bailout in the Nigerian Stock Market. The NSE has been in the forefront of a plan to make list banks put down a #100 billion each in a bid to rise about #600 billion to save the market. This plan has many loopholes. First, the market has lost over three trillion naira in the current meltdown and so a #600 billion lifeline will just be a drop in the ocean. Besides it will be highly risky to expose 40 to 50 percent of the bank's capital base to a highly volatile capital market. A market meltdown subsequently could send these institutions down just the same way it is happening in America right now.

There are better ways to restore confidence in the market. The government can then intervene in the market in a market friendly way. This can be done by floating a "reverse bond". It is called a reverse bond because instead of the usual bond where the government pays interest on the bonds and borrow money from individual and financial institutions, individuals holding the government reverse bond will have to pay interest to the government instead. This is how it will work. The government issues these reverse bonds with tenure of not less than three (3) years to individuals only. Institutional investors should be exempted. The reverse bond should attract the usual commercial interest rate say an average of 15 to 20 percent depending on the tenure. Individuals with margin facilities from banks can now exchange their short-term bank loans for the long term government bonds, paying the same interest rate to the government that they were paying to the bank. The impact is that it will reduce the immense placed on retail investors to sell their shares in a bid to cut their losses and pay off their loans. The sell side pressure on the exchange will almost be eliminated with this initiative. Then to boost the buy side of the market, the reverse bond should also be made available to all retail investors interested in buying shares. That is the government can buy three years bonds from the banks for onward sale to retail investors willing to invest in the capital market. This will automatically make available long-term funds for investors in the market commercial rates. With this strategy, the government will make money while restoring liquidity and confidence in the market without taking out of element of risk which is a key part of any functional and efficient capital market in any part of the world. It will also help to reposition the market as a place for long term investments and set long term yield curve for capital market investment. The bonds will mature in three (3) years or more during which hopeful confidence would have been restored in the market. Investors holding the government bonds can now redeem the bonds from the government.

#### **After bailout. What next?**

Current travails of the Nigerian Stock Market (NSM) did not arise from the ongoing global financial and economic meltdown. It derived principally from excessive greed and the negative activities of some crooked professional who especially over the last three (3) years were allowed to manipulate the Nigerian Stock Market (NSM) into a Nigerian Wonder Market (NWM).

#### **Effect of Bailout in Nigerian Capital Market**

1. The banking - sector problems experienced in recent months with fierce competition for liabilities, high interbank rates, and declining rates of private - sector credit extension - have further constrained broad money growth (for further details, see OTG Nigeria, 17th July, 2009, 'Step 2. Interbank guarantees'). According to the CBN's 2009 Monthly April 2009. Broad money, M2, fell by 3.1% m/m. Given the stresses seen in the banking sector since then, broad money may have contracted even further. Oil output has only started to recover recently with the announcement of an amnesty for Niger Delta militants. Whether this will be sufficient to offset banking - sector influence is doubtful, at least in the near term.
2. We also expect a decline in the velocity of money, deepening the potential concretionary impact on normal output. Many of the reform put in place to accelerate the banking - sector clean-up have been aimed at reducing the high cost of bank funding which had been a key constraint on private sector credit growth (see OTG Nigeria, 20th July, 2009, Sanusi's game of chess). Yet in order to accelerate the clean-up of the system, it was at time necessary to put in place directives that - in the short term at least - may have contributed to a further tightening of liquidity. The CBN directive of late July 2009, which requires commercial paper (CP) and bankers' acceptance (Bas) to be brought back onto banks' balance sheets, is one such example.
3. This regulatory measure was prompted by concerns over suspected abuse of CP and Bas. These include the suspicion that certain banks were repackaging troubled assets as CP and Bas in order to sell them on to other institutions. In some instances, underlying transactions for the CP and Bas were thought to be non-existent. There was also evidence of the frequent rollover of such paper beyond the permitted tenors. Given the regulators' belief that CP and Bas were being used to mask the extent of troubled banks suspended the sell down of CP and Bas as off-balance sheet instruments. There is little doubt that this directive, announced at the end of July accelerated the 'self-selection' process already underway among troubled institutions, making it clearer which banks were suffering severe liquidity distress. This may well have been worth the cost, as it allowed the CBN to initiate a more rapid of the banking sector.
4. With the greatest risks to Nigeria's banking system now largely identified, ring-fenced, and subject to recapitalization, and with the change of management at the troubled banks. It is debatable whether the directive suspending the use of CP and Bas as off-balance sheet items needs to remain in place much longer. The formal investigation by special examiner into all banks in Nigeria is due for completion by mid-September. With adequate provisioning in place for the identified problem assets, the CP market may be allowed to resume sooner than expected. However, the decline in the velocity of money - in part a consequence of financial sector distress, and in part necessitated by the very reforms aimed at ending that distress - will likely intensify the drag on nominal output

resulting from failing money supply. From this perspective, corrective action - any measure to boost liquidity - may not necessarily be a bad thing.

5. The capital injection into the rescued banks - now estimated USD 2.6bn - will achieve this to some extent. However, it is likely to be offset by the greater amount of provisioning expected across the sector. The five banks that received the capital injection are expected to see increased provisioning of NGN 530bn, more than offsetting the NGN 400bn initially injected. Sector - wide, the number will be even higher. Even taking into account increased money supply to accommodate the banking - sector recapitalization in the short term, broad money growth is likely to continue to disappoint. Fears of an inflationary surge would therefore be misplaced. If anything, expectations of further measures to boost liquidity at the CBN's MPC meeting on 1st September may well start to intensify.
6. What are the likely fiscal costs of the banking - sector clean-up? The short-term solution has been to inject Tier 2 capital into the rescued institutions. Given the economic context, we do not see high risks to price stability in time; the hope is that the injection of new equity capital into the previously troubled institutions, perhaps by foreign or domestic investors, will allow the authorities to recover the cost of the rescue package.
7. A key question is the extent to which further capital injections may be required. There has been press speculation that the rescued institutions are likely to need more than the NGN 400bn already announced by the authorities as an initial Tier 2 capital injection. It is worth noting that this amount was already considerably higher than NGN 204.94bn thought necessary to bring the five institutions to the regulatory minimum capital adequacy ratio of 10%, once satisfactory levels of provision had been put in place.
8. The controversial public naming of the largest debtors of the five institutions, and the involvement of Nigeria's Economic and Financial Crimes Commission (EFCC) in the recovery of the bad debts, are also key factors. The recovery of at least a portion of the rescued institutions' NPLs is already underway, although given the difficult economic and financial backdrop, only a fraction of the NPLs discovered by banks examiners are likely to be recovered. It would be misguided to expect that this alone will make a vast difference to the status quo, but given the one - week repayment deadline imposed by the EFCC, clarity on this issue is likely to come sooner rather than later. For more insights on corporate performance, see (Nwokwu, Dharmadasa, & Rathnasingha, 2018; Nwokwu, Atapattu, & Azeez, 2019; Nwokwu, 2018; Nwokwu, Rathnasingha & Pradeep, 2019).

## Conclusion

In conclusion, although it is difficult to say with any certainty, it appears improbable that the authorities will have to make further substantial capital injections into the system. While the risks to price stability from further money creation are not great, the authorities may well wish to explore other options to

further support the sector. The option of a 'bad bank' purchasing troubled assets has been mooted, as has the possibility for further loans to financial institutions, should they become necessary, in time, the idea of long term bond issuance to meet the resolution costs of the financial - sector clean-up may gain traction, although this can probably be delayed for some time. Nigeria also has the option of using a proportion of its FX reserves (which has fallen to USD 44bn but are finally rising again) for future financing needs, although this is unlikely to be a preferred option. For the moment, the authorities appear to have seized on the least costly option to finance the bank bailout - and that is appropriate to current economic conditions. Although clarity of the cost of the banking sector clean-up will only emerge after some time, S & P's rating downgrade based on supposed constraints to fiscal flexibility appears somewhat premature in our view.

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