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Implication of Insider Lending on the Banking Sector Performance in Nigeria

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Abstract: *This paper investigates the impact of insider lending on the performance of Nigeria's banking sector. Insider lending and fraud, we discovered, have serious consequences not only for the banking sector, but for the entire financial system. These fraudulent activities expose the banking system to a variety of risks, including operational, credit, liquidity, reputation, and compliance risk. Insider lending has been linked to the high volume of toxic assets or bad and irrecoverable loans that endanger banks' corporate survival. This was a common occurrence in banking failures in the 1990s. However, we must remember that the primary responsibility for preventing and detecting any type of fraud, not just loan fraud, rests with the financial institution and the system of internal controls it has in place. An infrastructure should be in place to promote a system of controls that reduces the risk of fraud. Given the importance of the restrictions to bank regulators in preventing insider abuse, it is critical to understand and follow them. As a result, banks and insiders should carefully review any potential insider transaction and, if necessary, seek legal advice before proceeding.*

Key Words: *Insider lending ; Banking sector ; Nigeria.*

1. INTRODUCTION :

Lending on a short, medium, or long-term basis is one of the services provided by commercial banks to their customers. In other words, banks make loans and advances to individuals, businesses, and governments in order to enable them to engage in investment and development activities that will aid their growth in particular or contribute to the overall economic development of a country (Olokoyo, 2011). Poor lending policies, on the other hand, stand out as one of the leading causes of banking crises, particularly in countries with poor corporate governance and weak enforcement of regulations and laws. This paper focuses on the most common of these lending policies in Nigeria, namely lending to insiders. Nigeria is of particular interest because ownership connections between Nigerian borrowers and their banks appear to have facilitated insider lending. Nigeria also has a weak institutional framework and poor corporate governance (Laeven, 2001).

A bank can make loans to a variety of insiders, including major shareholders, subsidiaries, affiliated companies, directors, executive officers, and board members. When insiders receive loans with favourable terms, there is a risk of abuse. Such loans are not a major concern if the favourable conditions are due to the availability of more information and, as a result, less uncertainty on the borrower's part. However, if favourable terms are granted on insider loans in comparison to similar risky loans to outsiders, and if the bank has allocated a significant percentage of its loans to such activities, the bank's lending policy should concern both the regulator and its shareholders (Brownbridge, 1998).

Another potential issue with these loans is that insiders may have less incentive to repay a loan on time or at all than outsiders. Bank executives may simply roll over the bad debts of insiders with whom they have close ties in some cases. As a result, we define insider lending as lending to insider parties who are connected to the bank through ownership or control, on terms and volumes that are more favourable than would be economically justified. Insider lending is also known as connected lending because the favourable terms apply to parties who are linked by control or cash flow rights.

Insiders, in general, pose a significant threat to financial services companies due to their knowledge of and access to proprietary systems, as well as their ability to circumvent security measures legitimately. Insider fraud is committed by a malicious insider, who is a current or former employee, contractor, or other business partner who has or had authorised access to an organization's network, system, or data and purposefully exceeded or misused that access in a way that compromised the confidentiality, integrity, or availability of the organization's information or information systems (Carnegie Mellon University, 2012).

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2. OVERVIEW OF INSIDER LENDING IN THE NIGERIAN BANKING SECTOR :

According to Dunleavy, fraud poses a threat to specific organisations as well as the entire system (2003). The primary factor for many regional banks' subpar loans was insider lending. Insider loans were a factor in at least half of the aforementioned bank failures. Insider loans to politicians were a factor in the majority of Kenya's larger banks' bankruptcies, including Continental Bank, Trade Bank, and Pan African Bank (Mamman and Oluyemi, 1994) In 1995, insider loans that could not be recovered caused 65 percent of the four local banks in Nigeria to fail (NDIC, 1994, p. 48).

In 1995, a small bank in Uganda gave its directors and employees about 50% of its loan portfolio. (Manu, 1994). Numerous insider loans were made to businesses that couldn't make money right away (such hotels and retail malls), broke the bank's large-loan exposure restrictions, and were engaged in speculative endeavours like real estate development.

High insider lending in bank failures suggests moral hazard was a problem. There were many factors involved. Local banks were first owned and managed by politicians. Many failed banks, particularly in Kenya, were dependent on large-scale deposits from a select number of parastatals. The parastatals that made these deposits likely didn't decide on their safety based only on financial considerations because of political pressure. Deposits from parastatals reduced the need for public support. These banks weren't under any pressure from depositors to establish a solid reputation (Lewis and Stern, 1997).

Political connections also aided banks in obtaining licences and were employed to persuade regulators to spare banks from punishment when they broke the law. These elements reduced bank management restrictions.

Banks were compelled to lend to politicians in exchange for deposits, licences, and other favours because of their political connections. Key politicians received a number of insider loans from failed Kenyan banks.

Second, because initial capital requirements were low, the majority of failing banks had inadequate capital. The risks and incentives of insider lending were distorted since owners had nothing to lose if their bank failed. Bank owners might use the bank's deposits to fund high-risk ventures and earn significantly if they were successful while suffering only minor losses (Mamman and Oluyemi, 1994).

3. A FORM OF INSIDER LENDING :

Laeven (2001) provided an example of an insider lending model where a bank manager offered a borrower a loan at subsidised interest rates in exchange for a portion of the subsidy in the form of a bribe. For the sake of simplicity, we disregard the likelihood that relationship banking could benefit loans to insiders and the possibility that insiders may have weaker incentives than outsiders to return loans on time or at all. Every borrower is allowed to bribe in the model, but only the bank's shareholders—potential borrowers—have the authority to fire the manager. The bank manager has an incentive to favour shareholders because they will exercise this power if the bank management makes insider loans to borrowers other than the shareholders. A specific shareholder will have a better chance to obtain insider loans if he has a larger equity position in the bank because the power of a single shareholder increases with the number of voting rights that he possesses and with the amount of his investment in the bank's share capital. But it's not immediately clear why a shareholder would think it's in his best interest to pay off the bank manager for insider loans. The bank shareholder is forced to make a trade-off because the less expensive loan improves his personal project that the bank is funding, but it lowers the value of his stock position in the bank. If an insider lends money to a shareholder, he must gain more from the transaction than he spends.

3.1 Insider Loan Fraud Patterns

According to Dunleavy (2003), the following list, which is not exhaustive, demonstrates numerous instances of insider loan fraud that are frequently seen in financial institutions:

Loans tied to favours for friends and family, including non-monetary consideration; Fictitious loans; Manipulation in the sale and purchase of loan pools; OREO sold through preferentialism. Nominee loans4 and similar transactions that are designed to get around laws, regulations, and institutions' internal limits or internal policies. Conflicts-of-interest that go beyond laws governing insider interests.

The regulatory bodies may be able to punish the perpetrator, defend the financial system from the offender, and discourage similar offences by other insiders by pursuing civil enforcement action, according to Dunleavy's (2003) further argument. Regardless of whether an insider is being criminally prosecuted, the agencies may have the right to pursue specific enforcement measures against them. These potential responses can range from imposing civil monetary fines to requiring insiders to pay back damages or make amends, or even banning them from managing the activities of insured institutions.

3.2 Detection of Insider Loan Fraud

Identification of possible insider loan fraud requires a combination of experience and common sense. In most cases, more investigation is required if anything does not seem right or to make sense. In order to warn other examiners to search for like patterns or circumstances, it is crucial that you express your concerns to the examiner in charge as soon as possible.

Examiners should be aware of how simple it is to produce fake documents while analysing documentation from various sources. The original documents may not be accurately reproduced in photocopies. One or both of the documents may be fakes if there are discrepancies between what should be identical information in one document and another. In these circumstances, the examiner should invariably ask for the original documents.

3.2.1 Examining Online Loan Data

Financial institutions frequently offer regulators an electronic download of their loan data, which is largely used to decide the scope of the examination's loan review. When correctly reviewed, a lot of the data fields contain data that could serve as early warning signs of potential insider loan fraud. The data is frequently presented in a spreadsheet format, allowing auditors to do computations and data sorting (Khan, 2011).

3.2.2 Board reports and minutes

The substance and educational value of board level reports and minutes vary from institution to institution, according to De-Simone and Wu (2011). It is equally typical for certain institutions to keep thorough board minutes as it is for others to keep simple records. Management may be able to successfully hide signs of fraud by producing lengthy board packets replete with minute detail or by leaving out important details. In order to assess the correctness, sufficiency, and appropriateness of the material provided to the directorate, board reports should be thoroughly examined.

3.2.3 Conversations with Staff

Anomalies, anomalies, or suspicious conduct may be discovered through formal and informal interactions with personnel. Employees who are particularly circumspect in their responses to examiner queries might be concealing something. They can be seeking for an opportunity to share information with examiners since they have firsthand knowledge of dubious loan deals. Some workers might seek out examiners with well-known circumstances. Examiners should follow up on any information that other employees could accidentally provide during casual conversations (Dunleavy, 2003).

3.2.4 Analysis of Insider and Borrower Financial Statements

Financial statements of insiders and borrowers can be examined to find numerous interesting things. Statements with accumulated assets or obligations that exceed an insider's capacity to generate money might be a big evidence of questionable conduct. The financial statements of a borrower can also disclose insider borrowing or business connections with other institution clients. It is crucial that an institution conducts an internal analysis of insider financial statements as part of the standard credit granting process. In instance, if the financials are not audited, this would involve the verification of assets and liabilities. Lack of financial statement item verification can be a red flag that requires additional examiner evaluation (Leaven, 2001).

3.2.5 Review of Loan Files

In order to identify any irregularities, examiners should study loan files, committee minutes, and the financial institution's policies and procedures if there are any red flags. By providing a handy reference for determining policy compliance, a summary of the major policy parameters created by a member of the examination team can help file review examiners. Policy and process inconsistencies should invite closer examination. In conclusion, there are numerous possible grounds of suspicion for insider loan fraud, as well as a single source. Inconsistencies and facts that doesn't make sense should be questioned until the problems are fixed.

4. Effects Of Insider Activities On The Overall Performance Of The Bank :

While the majority of dangers are quantifiable, insider misuse has the potential to harm a bank's reputation far beyond any financial loss. Inappropriate insider activity can erode the public's trust in a bank. The financial health and long-term viability of a bank are directly correlated to the market's assessment of the insiders' integrity (Chege, 2014). In order to keep the public's trust, a bank needs to be known for its honesty, integrity, and high ethical standards in all of its dealings, particularly with insiders.

Reputation, credit, compliance, operational, and liquidity were the categories used by the Office of the Comptroller of Currency in Washington, DC, in its 2013 classification of the effects and risks most frequently connected with insider activity.

• Risk to Reputation

To safeguard the bank's reputation, the board, management, and staff must constantly uphold a high standard of honesty and integrity. The ability of the bank to conduct business in a secure and sound manner might be significantly hampered by actual or perceived insider misuse (Keister, 1997). Even if the bank and the insider do not conduct business together, when the bank is closely linked to an insider or a company owned by an insider, the bank may experience reputation risk or other harm if the insider or the insider's business encounters financial difficulties or receives unfavourable press. The trust of the bank's shareholders, clients, suppliers, and financial partners may be negatively impacted by any harm to the bank's reputation or any suggestion of insider misuse or fraud. The bank's client base might therefore decline, which would have a significant impact on the bank's profitability, capital, or franchise/enterprise value.

• Credit Danger

Banking rules and regulations allowing bank insiders to borrow from the bank, subject to certain limitations. However, the bank must make sure that loans to insiders are provided at arm's length, which means that the terms and conditions must be no less strict than those that apply to comparable loans that the bank extends to non-insiders at the same time. When insider policies are not properly or leniently enforced, insiders who might not otherwise qualify for credit may receive preferential treatment, which could increase the bank's credit risk. Additionally, insiders' pressure to loosen credit criteria for their associated interests might result in credit issues and possible losses. Giving insiders unfavourable terms, lending to untrustworthy insiders, or creating other conditions that encourage insider misuse enhance the risk of loss and legal and regulatory infractions (Davis, et al. 2006).

• Compliance Danger

Kilonzi (2012) claims that the bank's management and board are in charge of making sure the bank abides by the law, rules, recommended procedures, and ethical standards. If these conditions or safety and soundness standards are not met, the bank and its insiders may suffer severe repercussions, including enforcement action. An insider who, knowingly or unknowingly, violates any banking law or regulation, engages in a risky or unsound banking practise, or violates a fiduciary duty may be subject to civil money penalties, be barred from managing the affairs of any insured depository institution, and be required to make payments in the form of restitution, reimbursement, indemnification, or a loss-insurance guarantee.

• Risk Operational

According to Elyasiani and Goldberg (2004), one sort of operational risk is the absence of procedures to recognise potential conflicts of interest and insider fraud and abuse. The board of directors and management of a bank must make sure that the proper procedures and controls are in place to stop insiders from skirting board-established rules addressing conflicts of interest, stealing company opportunities, and breaking the law. Systems and control flaws might raise the possibility of operational risk from fraud and insider exploitation.

• Risk of Liquidity

Even false rumours that cast doubt on a bank's honesty or integrity can make it more difficult for it to secure funding from institutional investors, correspondent banks, and the general public. Even the perception of insider misconduct could result in the loss of funding sources, deposit withdrawals, and the need for the bank to sell assets before their time at unacceptable losses in order to retain liquidity (Fatimoh, 2012).

5. CONCLUSIONS :

In this essay, the impact of insider lending on Nigeria's banking industry performance is examined. We found that fraud and insider lending have significant effects on the banking industry as well as the whole financial system. Such fraudulent operations subject the banking system to operational, credit, liquidity, reputation, and compliance risk, among other forms of risks. Insider lending has been linked to the significant amount of toxic assets or bad and unrecoverable loans that endangers banks' ability to continue operating. This particular occurrence is typical of banking collapses in the 1990s. However, it is important to keep in mind that the financial institution and the internal control framework they construct bear the major responsibility for preventing and identifying all forms of fraud, not only loan fraud. An infrastructure should be in place to support a system of controls that reduces the risk of fraud. It is crucial to

understand and abide by the rules given their significance to bank authorities in preventing insider misuse. Therefore, before engaging in any transaction, banks and insiders should carefully analyse any prospective insider transaction and, if necessary, obtain legal counsel.

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