

LENDER OF LAST RESORT IN THE NIGERIAN BANKING INDUSTRY: A REGULATORY OR MORAL HAZARD INSTRUMENT?

By

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ABSTRACT

Lender of last resort is a Central Bank function under which the central bank lends money to illiquid but solvent banks that are experiencing temporary liquidity problems. Such banks are constrained to approach the central bank because other borrowing avenues are no longer available to them. In Nigeria the Banks and Other Financial Institutions Act 2020 and the Nigerian Deposit Insurance Corporation Act 2023, make provisions for this type of liquidity intervention. The facility has some globally recognized conditions attached to it in order to avoid or minimize moral hazard which is very closely linked to it. The objective of this article is to examine how lender of last resort operates in Nigeria and to find out whether it is an instrument to regulate the banking sector or whether it encourages moral hazard in the sector. The doctrinal approach was used in this research. Foreign and local statutes on the subject were examined. The paper finds that in Nigeria all the safety nets that make lender of last resort functional in a positive manner are not statutorily enshrined. The responsible authorities have, in the circumstances, used the facility in a manner that aggravates moral hazard in the banking industry. The article consequently recommends the amendment of the relevant statutes to align with global best practices. The amendments should incorporate directives on the operation of lender of last resort, create some accountability provisions and streamline the number of agencies that are authorized to perform the function to only one agency.

Keywords: Lender of Last Resort, Insolvency, Illiquidity, Moral Hazard, Regulation

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1. Introduction

A commercial bank occasionally experiences liquidity distress even though it has enough assets to meet its legitimate obligations. Such a bank is usually described as a solvent but illiquid bank. Sometimes the bank is not in a position to meet its obligations because its assets have depreciated to a point where it has more liabilities than assets. Such a bank is considered insolvent. The Central Bank of Nigeria (CBN) is generally empowered to grant a variety of loans to sundry authorities including commercial banks under some statutorily prescribed conditions. For commercial banks, the CBN can grant temporary advances if they are recognized by the Banks and Other Financial Institutions Act (BOFIA) 2020. Such banks or institutions must be participants in bank clearing and the loans or advances are expected to be used to cushion temporary debit balances on their accounts. The advances are also expected to attract interests and other terms as determined by the CBN.¹ In crises situations, the illiquidity can be so acute that other avenues for borrowing become unavailable, forcing commercial banks to rely on the CBN. This form of lending to commercial banks by the CBN is what is generally referred to as Lender of Last Resort (LOLR). The lender of last resort package is one of the measures that the Central Bank of Nigeria employs to tide illiquid banks over their temporary liquidity challenges. Liquidity assistance to commercial banks is also provided by the CBN because it is banker to other banks.² The CBN generally cooperates with commercial banks in terms of promoting and maintaining financial services to members of the public in addition to ensuring high standards of conduct and management throughout the banking industry. It is also responsible for the introduction of policies that are consistent with the Central Bank of Nigeria Act (CBNA) towards the national interest.³ Under this provision, the Bank grants loans and other accommodation facilities at an interest rate and under terms determined by the CBN to any bank which may be having liquidity problems. This is the core essence of the lender of last resort function of the CBN.⁴ When a bank becomes insolvent, the recovery measures can be more severe, ranging from withdrawal of operating license⁵ to the liquidation of the bank by

¹ CBNA 2007 s29(1)(c)

² CBNA 2007 s41

³ CBNA 2007 s42(1)(a)-(c)

⁴ CBNA 2007 s42(2)

⁵ See BOFIA 2020 s12 and its many subsections

the Nigerian Deposit Insurance Corporation (NDIC)⁶ to the creation of a bridge bank to take over the operations of the insolvent bank.⁷

The lender of last resort function of central banks is firmly rooted in the global historical development of central banks. It is also one of the main pillars of the traditional function of central banks which is the maintenance of monetary and financial stability in a country.⁸ This was the verdict of the Court of Appeal in *CBN v Ukpong*⁹ where the court observed that ‘the purpose of establishing the Central Bank of Nigeria, generally, is for the overall control and administration of the monetary and banking policies of the Federal Government’.¹⁰ Central Banks traditionally, carry out this responsibility through four main avenues. a) They regulate the management of the payments system in order to ensure a seamless transfer of funds from one point to any other point in the economy. b) Commercial banks fund their activities through demandable liabilities namely, deposits. This makes them prone to liquidity crises. Central banks ameliorate these crises through their lender of last resort functions. c) The public sector is always cash strapped while the private sector is always overflowing with cash. Central banks smoothen the economic interaction between the public and private sector by smoothing cash flows. d) Lastly, the monetization of public and private debt is not always flawless and can in fact engender extreme price volatility. Central banks traditionally intervene to stabilize the value of monetary instruments. This is what is commonly known as monetary policy.¹¹ While these functions look separate, there is considerable overlapping in their practical performance. However, in this article the main focus is on the lender of last resort function of central banks. The discussion will therefore be limited to that function. Maturities in banking liabilities is very fast and transformation in the quality of banking assets is unpredictable. This makes banking business rather unstable. Deposits, which are demandable assets are usually reinvested into loans which by their nature, have peculiar individual characteristics and are also long-term liabilities. This creates a liquidity crises-prone business environment for banks.¹² Central banks with their privileged position, have the capacity to create

⁶ See BOFIA 2020 s12(2) and (3)

⁷ See NDICA 2023 s54 and its subsections

⁸ J Guttentag and R Herring, ‘The Lender of Last Resort Function in an International Context’ [1983](5)(151) *Essays in International Finance* (International Finance Section, Department of Economics, Princeton University, Princeton, New Jersey) 4-5

⁹ [2007]All FWLR (Pt. 357) 954 at 967

¹⁰ *CBN v Ukpong* (supra)

¹¹ S Ugolini, ‘The Historical Evolution of Central Banking’ in S Battilossi, Y Cassis and K Yago (eds) *Handbook of the History of Money and Currency* (Springer Nature, 2018) 978-981

¹² *Ibid*

liquidity by extending loans to counterparties in the banking arena and are uniquely positioned within the payment system to do so.¹³ Because central banks enjoy a monopoly in this business of crises-time lending, they also enjoy a lot of power including the power to impose some conditions otherwise called regulatory standards, ostensibly aimed at minimizing unreasonable risk-taking by counterparties in the banking business.¹⁴

Some of the key characteristics of a lender of last resort are that it provides emergency funds to reflate liquidity in banks that are going through a temporally liquidity crisis particularly when they face an abnormal and unexpected increase in demand for liquidity.¹⁵ In its initial conception, it was expected to provide such liquidity on certain terms. a) The aim was to protect the aggregate money stock, and not individual institutions, b) Insolvent institutions were generally allowed to fail without benefitting from the facility, c) The lender of last resort accommodated only sound institutions, d) Central banks offering lender of last resort services charged penalty rates for those services, e) The advances or loans were made on good collateral, and f) These conditions were preannounced well in advance of any crisis so that the market would know exactly what to expect.¹⁶ This was the classical or Thornton-Bagehot concept developed by Thornton and Bagehot for the Bank of England. The concept worked so well for the Bank of England that England was virtually free of banking crises from 1866 up to the closing years of the twentieth century.¹⁷

The mere presence of a lender of last resort and its assured commitment to provide liquidity assures the public that they can always access their funds and is therefore capable of preventing panics and bank runs that could quickly destabilize even sound banks. This in turn has the effect of helping to maintain overall financial stability and prevent systemic risks. The drawback in the lender of last resort concept is that it introduces ‘Moral Hazard’¹⁸ in the banking system by encouraging commercial banks to take on more risks in the secure knowledge that they can rely on the central bank to provide emergency support in times of liquidity crises.¹⁹ This concern was first raised by

¹³ Ibid

¹⁴ Ibid

¹⁵ B Fitz-Gibbon and M Gizycki ‘A History of Last-Resort Lending and Other Support for Troubled Financial Institutions in Australia’ [2001](10) *Research Discussion Paper 2001-07* 4 Also found on <https://www.rba.gov.au/publications/rdp/2001/pdf/rdp2001-07.pdf>

¹⁶ TM Hunzphmy, ‘Lender of Last Resort: The Concept in History’ [1989](March/April) *Economic Review, Federal Reserve Bank of Richmond* 8

¹⁷ Ibid (n16)

¹⁸ Moral Hazard is a situation where banks take unreasonable risks with customers funds because they are sure that when things go wrong, the Central Bank will always bail them out.

¹⁹ B Fitz-Gibbon and M Gizycki (n15) 2

Thornton.²⁰ When properly utilized it provides a critical lifeline when banks lose access to normal market funding as a result of widespread panic caused by financial crises. This stems market disruptions. For the public and the broader economy, lender of last resort helps to prevent the collapse of financial institutions by supporting the general financial system through financial injection during crises.²¹

2. Regulatory Properties of the Lender of Last Resort Function

When properly operated, lender of last resort is expected to regulate the conduct of commercial banks or other institutions receiving liquidity assistance from the central bank. Liquidity injection into illiquid but solvent banks is expected to stabilize the entire banking system and not just the individual banks receiving assistance. Towards this end, the process requires careful planning and execution to avoid it degenerating into gross moral hazard. Some of the guiding principles that assist lender of last resort regulate the conduct of financial institutions are discussed below.

2.1 Eligibility Rules (Qualifications to Benefit from Lender of Last Resort Facility)

The first thing a central bank should do when faced with a decision concerning the provision of emergency liquidity is to determine which bank or financial institution is eligible to benefit from the facility. The first qualification for such a bank is to be a regulated financial institution under BOFIA. This is part of the eligibility rules regime. The Banks and Other Financial Institutions Act (BOFIA) is very clear on this. It provides that the CBN can: ‘...grant temporary advances to banks within the meaning of Banks and Other Financial Institutions Act which participate in bank clearing in respect of temporary debit balances on their accounts at such rate of interest and under such terms as the Bank may from time to time determine’.²² Financial institutions that fall outside this category are not qualified to benefit. This reinforces the link between emergency support and the regulation of banks.

Although the CBN under the provisions of BOFIA has a lot of discretion in providing emergency liquidity to banks, some universally recognized pre-conditions for such provision are discernible. For instance, as a general rule, legislation and supporting regulations as well as circulars, or policy statements should clearly spell out the conditions for accessing emergency liquidity, which

²⁰ TM Hunzphmy (n16) 8

²¹European Central Bank, ‘What is a Lender of Last Resort?’ <<https://www.ecb.europa.eu/ecb-and-you/explainers/tell-me-more/html/what-is-a-lender-of-last-resort.en.html>> Accessed on 2/09/25

²² BOFIA 2020 s29(c)

conditions should be very clear to market participants.²³ This would typically include the central bank's right to refuse to lend, including circumstances that could warrant exceptions to the rules. A major consideration on the part of the central bank to extend emergency liquidity lending to a bank is whether the failure of such an institution would destabilize the monetary and financial systems. Additionally, eligibility requirements would include whether the institution is solvent; whether it has adequate collateral of acceptable quality; and whether it is prepared to take appropriate remedial action to deal with its liquidity problems.²⁴

2.2 Collateral Requirements for Beneficiaries

Another regulatory feature of lender of last resort is the requirement for collateral. It is incumbent on banks to pledge high-quality and acceptable collateral in order to access emergency liquidity. This is intended to discourage insolvent or reckless institutions from taking advantage of the facility. The requirement is also a regulatory safeguard. Although some experts have questioned the wisdom in demanding high-quality collateral from an institution that is already reduced to the single liquidity option of lender of last resort, it is mostly argued that the central bank should not lend against assets it cannot understand, value or manage if the bank, for any reason, goes into bankruptcy or a formal resolution.²⁵ Collateral management is seen as a core central bank function and a central bank cannot afford to be sloppy on this under any circumstances.²⁶ In terms of the regulatory importance of the requirement for high-end collateral in lending to illiquid institutions, the Bank for International Settlements (BIS) observes that:

It is also about surveillance of valuation practices in the market and of the infrastructure for clearing and settling the instruments eligible in central bank operations. If the supervision of critical market infrastructure did not already exist, central bankers in their role as LOLR, and thus as contingent holders of assets, would need to invent it (as, in fact, they largely did in many countries)...As public authorities, this gives central banks wider responsibilities to society. What they do to protect themselves as actual or contingent lenders gives them information that can and, I believe, should be used for wider macro prudential purposes. Just as many central banks got into the prudential supervision of banks through managing their counterparty

²³ D He, 'Emergency Liquidity Support Facilities' [2002](9) *International Monetary Fund (IMF)* 118-119 <<https://www.elibrary.imf.org/display/book/9781589060432/ch005.xml>> assessed on 2/09/25

²⁴ Ibid (n23)

²⁵ P Tucker, 'The Lender of Last Resort and Modern Central Banking: Principles and Reconstruction' 26 BIS Papers No 79 <https://www.bis.org/publ/bppdf/bispap79b_rh.pdf> assessed on 2/09/25

²⁶ Ibid (n25) 26

risks, so the control of their collateral risks makes them a de facto monitor of the state of the underlying asset markets.²⁷

2.3 Penalty Pricing of Liquidity Assistance

Lender of last resort lending is expected to be provided at a penalty interest rate that is above market levels. The objective is to discourage routine reliance on central bank liquidity by commercial banks in their operations. It also reinforces prudent liquidity management by banks. Bagehot, one of the originators of the lender of last resort concept as early as 1873, observed that, if the window is exercised too leniently, banks may come to expect liquidity support from the central bank as a matter of course.²⁸ In fact, extending liquidity support to illiquid banks on terms more favourable than the open money market offers, will make it something other than lender of last resort. That is why lending has to be at high rates relative to the pre-crisis rate. This will ration access to liquidity and minimize the problem of moral hazard in addition to being a fair price to pay for the protection of a failing bank and to cover the central bank's risk exposure.²⁹ When other stringent conditionality like restrictions on dividend payment or new business or liquidity restoration, are combined with a penalty interest rate, they constitute a serious disincentive for the borrower to frivolously approach lender of last resort, except in grave liquidity circumstances.³⁰

In essence, lender of last resort (LOLR) encourages commercial banks to manage liquidity properly by making emergency loans available at penalty rates. This creates a deterrence, making it expensive for banks to rely on the central bank for their liquidity needs. This pushes them to maintain their own strong liquidity reserves and sound management practices. The LOLR's commitment to providing loans at a premium rate serves as a backstop, calming panic and preventing systemic collapse, while also penalizing overuse. Banks are thus encouraged to keep adequate levels of cash or easily convertible assets to meet their obligations. Lending at a penalty rate also helps the central bank distinguish between truly illiquid but solvent banks (who need emergency help) and potentially unsound banks (whose difficulties stem from deeper problems).

²⁷ Ibid (n25) 26

²⁸ X Freixas and Others, 'Lender of Last Resort: A Review of the Literature' [1999](11) *Financial Stability Review* 159-160 <<https://scispace.com/pdf/lender-of-last-resort-a-review-of-the-literature-404k6zy100.pdf>> Assessed on 3/09/25

²⁹ Ibid (n28) 159

³⁰ EP Davis, 'Liquidity, Financial Crises and the Lender of Last Resort – How Much of a Departure is the Sub-prime Crisis?' [2008] *Reserve Bank of Australia Annual Conference – 2008* <<https://www.rba.gov.au/publications/confs/2008/davis.html>> Assessed on 3/09/25

2.4 Solvency Test

In principle, central banks lend only to illiquid but solvent institutions. This requirement prevents LOLR from being used to prop up insolvent banks and enforces a regulatory distinction between liquidity support and bailouts. The terms ‘liquidity’ and ‘solvency’ have been used repeatedly in this article. This is because they form the foundation of a central bank’s decision whether to provide lender of last resort facility to an institution or not, but what is ‘solvency’ and what is ‘illiquidity’?

A financial institution is said to be insolvent when its assets are less than its liabilities. This could be balance sheet insolvency or cash flow insolvency. As a going concern, the value of a bank’s assets should always be higher than its liabilities. The bank should not owe more than it owns and should have enough resources to meet its obligations. When this does not happen, the bank is insolvent. When a bank is illiquid on the other hand, it means its assets are still in excess of its liabilities but it does not have enough cash or liquid assets on hand to meet its short-term obligations like deposit withdrawals or interbank payments.³¹ This could happen as a result of mismatch between assets and liabilities or temporary payment difficulty and not insolvency. How the various scenarios develop is a technical issue that is outside the scope of this article. These two liquidity concepts are important to the lender of last resort because they do not exist in a vacuum but are essentially influenced by the financial soundness of other financial institutions.³²

As a regulatory measure, liquidity requirement has a lot of benefits for banking regulation. The direct benefits include reduced cases of bank failures with the attendant costs; reduced chances of systemic crises due to liquidity instability; less sensitivity of credit supply to intrinsic liquidity conditions in banks; and lower moral hazard in the banking system because the central bank will become the lender of last resort rather than the first call for temporary loans.³³ The indirect benefits include the fact that liquidity regulation is likely to minimize bank credit contraction as a result of liquidity shocks especially in banking crises situations; it helps to reduce the proportion of wholesale funding of banks or increase the share of stable funding; it results into increase in Net

³¹M Brunnermeier and Others, ‘The Fundamental Principles of Financial Regulation’ [2009](6) *International Center for Monetary and Banking Studies* (Centre for Economic Policy Research (CEPR) 53-56 Great Sutton Street London EC1V 0DG UK) 13-14 <<https://www.princeton.edu/~markus/research/papers/Geneva11.pdf>> assessed on 3/09/25

³² Ibid (n31)

³³ Bank for International Settlements, ‘Literature Review on Integration of Regulatory Capital and Liquidity Instruments’ [2016](3) *Basel Committee on Banking Supervision* (Working Paper No 30) 26 <<https://www.bis.org/bcbs/publ/wp30.pdf>> assessed on 03/09/25

Interest Income (NII), as a result of lower funding costs caused by a perceived reduced risk profile and lower probability of default; it brings about lower use of central bank funding; and it directly decreases the incidence of asset fire-sales.³⁴

2.5 Supervisory Oversight

Institutions receiving lender of last resort funds typically face enhanced regulatory scrutiny, such as reporting obligations, restrictions on dividends, or management changes. The facility thus becomes a regulatory lever to impose corrective action. In addition to monetary policy, (interest rates setting and unconventional policy), one of the major objectives of providing emergency liquidity by the Central bank through lender of last resort function is to minimize deviations from set inflation targets (monetary policy) and to mitigate potential losses that usually result from bank failures. These steps affect price stability by impacting aggregate demand. They also, induce changes in the behaviour of banks and in the process, support the smooth functioning of the financial sector.³⁵

Extending lender of last resort to an illiquid bank is usually accompanied by increased supervisory intrusion and conditionality. The International Monetary Fund (IMF) strongly advocates that the supervisor should enhance supervisory oversight and adopt early intervention measures as required. Prompt corrective measures should follow any breach of the measures. Examples of such conditionality include asset sales; a bar on distribution of profits and payment of bonuses; changing management; and other strategies aimed at addressing governance and risk management failures.³⁶

In addition, the central bank and other regulatory bodies should engage at least, on a daily basis, with the bank to ascertain if there are any unanticipated liquidity strains or any additional warnings of bank fragility and receive daily or intra-daily liquidity updates. The central bank could also restrain the entity from straying away from any agreed funding plan. Administrative measures such as a say on increases in staff salaries and forbidding the paying of dividends to shareholders could be imposed. The institution should be mandated to use the liquidity provided only for its

³⁴ Ibid (n33)

³⁵ M Ampudia and Others, 'The Architecture of Supervision' *European Central Bank Discussion Paper Series* (No 9) 6 <<https://www.ecb.europa.eu/pub/pdf/scpdps/ecb.dp9~f09c2b9fae.en.pdf>> assessed on 04/09/25

³⁶ M Dobler, 'The Lender of Last Resort Function after the Global Financial Crisis' [2016] *International Monetary Fund WP/16/10 IMF Working Paper* (Monetary and Capital Markets Department) 30-31 <<https://www.imf.org/external/pubs/ft/wp/2016/wp1610.pdf>> assessed on 04/09/25

core business. The recipient institution is not expected to engage in non-core activities without the approval of the central bank.³⁷

From the above, it is clear that banks receiving lender of last resort assistance face, or are expected to face more direct and intense supervision because the provision of LOLR implies the bank is in distress, and central banks need to ensure financial stability and prevent future crises. This increased oversight aims to control the bank's risky behavior, assess its solvency, and monitor its activities to justify the central bank's intervention and avoid moral hazard. This stands to reason because a bank needing LOLR funds has exhausted other borrowing options and is in a precarious financial state. This situation inherently requires closer monitoring to understand the causes of distress and prevent systemic collapse. Again, the primary goal of LOLR is to ensure the overall stability of the financial system. Increased supervision of assisted banks helps the central bank control potential risks and prevent widespread contagion from the failing institution.

Other reasons for the increased surveillance of banks receiving lender of last resort include the fact that without stricter oversight, banks might take excessive risks, knowing they can rely on the central bank to bail them out. Supervision acts as a check against this 'moral hazard,' reducing the incentive for banks to engage in overly risky practices. Added to the above, the central bank may not have full information about a troubled bank's financial health. Enhanced supervision helps bridge this information gap, allowing the central bank to understand the bank's true condition and determine the extent of eligibility for aid. Lastly, the 'stigma' associated with using LOLR can deter banks from seeking help. However, if a bank does seek it, the process requires significant information sharing, which naturally leads to greater transparency and oversight from the central bank and other regulators.

2.6 Providing LOLR on Conditionality

Emergency liquidity support to struggling banks can be made conditional on compliance with prudential standards, restructuring plans, or recapitalization. This ties LOLR to broader financial stability regulation. One of the most frequently used conditionalities is lending to banks against securities as collateral. This provides much needed liquidity for banks and at the same time mitigates fire selling in illiquid securities markets. It offers banks a cheaper source of liquidity than is available from securities sales thereby circumventing fire-sale price depression.³⁸ Some

³⁷ Ibid (n36)

³⁸ N Garvin, Emergency liquidity Injections [2024](1)(89)(Pt.A) *International Review of Economics and Finance* 1496-1513

other conditionality have already been discussed in the paper such as collateral requirements which must be of high-quality, unencumbered assets as collateral for the liquidity received; solvency requirement, which makes only institutions deemed solvent eligible to benefit, though this is often difficult to assess accurately during a panic; repayment terms and interest rates, which often specify the short-term nature of the funding, with clear repayment terms and prevailing interest rates; and information and readiness, which prescribes that banks may be required to provide detailed information about their assets or participate in readiness exercises. There are other equally important conditionality that can be imposed depending on individual circumstances.

In the end however, the judgment of the central bank along with the supervisory authority and the ministry of finance as to whether the failure of the troubled institution will devastate the stability of the financial and monetary system, if it is left to fail due to denial of liquidity assistance, is important in the provision of lender of last resort.³⁹ It is suggested that conditionality for accessing lender of last resort facilities should be pre-documented in statutes with detailed requirements from the institutions seeking same. This will bring orderliness, predictability and certainty for both the central bank and the troubled institution.⁴⁰

As a banking regulatory measure, providing emergency liquidity to illiquid banks under strict conditions regulates the banking sector by preventing systemic collapse, mitigating moral hazard, and encouraging responsible liquidity management. Conditionality ensures assistance is a last resort for solvent banks in crisis, deterring excessive risk-taking and maintaining lender of last resort credibility. Conditionality mitigates moral hazard by making it clear that assistance is not a guarantee of bailouts. When banks know they must meet strict conditions, they are less likely to take excessive liquidity risks. It promotes responsible liquidity management by requiring banks to have collateral in place or to demonstrate preparedness for liquidity stress, which encourages them to hold sufficient high-quality liquid assets and conduct regular readiness exercises.

Other ways in which rule-based conditional lending regulates banks is that it enhances lender of last resort credibility by strengthening the central bank's position as a credible lender of last resort, protecting it from political pressure and enhancing financial stability. It also encourages ex-ante preparedness by incentivizing banks to pre-arrange the assets needed to receive emergency

³⁹D He, (n23) 13

⁴⁰ RS Delston and A Campbell, 'Emergency Liquidity Financing by Central Banks: Systemic Protection or Bank Bailout?' Being a Presentation at the IMF Legal Department and IMF Institute Seminar on Current Developments in Monetary and Finance Law, May 7-17, 2002 p 4

support, ensuring a more effective response when a crisis hits. It incentivizes banks to remain solvent in view of the fact that while liquidity assistance addresses short-term cash flow, conditionality can also include an assessment of the bank's solvency, ensuring that only fundamentally viable institutions receive aid. Last but very importantly, it improves market functioning by addressing liquidity shortfalls. Through this, it helps markets function normally, restoring confidence and preventing a credit crunch where banks stop lending to each other.

2.7 Systemic Stability Mandate

The central bank's lender of last resort function is embedded in its regulatory duty to safeguard the financial system. One of the statutory duties of the central bank of Nigeria is to ensure monetary and financial stability.⁴¹ Lender of last resort is one of the means through which the CBN accomplishes this responsibility. It regulates market expectations by signaling that liquidity shocks will not collapse solvent banks, thereby reducing panic and contagion. It also helps to prevent bank failures and ensures that the banking system continues to function smoothly. This way the entire economy is saved from a downward spiral of bank failures and general economic stability.⁴² Tucker in defending the lender of last resort facility observes that 'money can be created by the central bank at will - at the stroke of a pen, as used to be said - so long as there is confidence in the stability of its value relative to goods and services (the goal of price stability)'.⁴³ The lender of last resort function is a fundamental factor in financial crises resolution by the central bank. It is used essentially to restore confidence in the stability of markets. This, the central bank does through its ability and obligation to maintain the smooth functioning of money markets, through the provision of liquidity when it is needed.⁴⁴

In the end, the regulatory features of lender of last resort are about rules (eligibility, collateral, solvency), discipline (penalty rates, conditionality), and supervision (oversight of assisted banks). These features are designed to limit moral hazard and integrate lender of last resort into the broader regulatory framework for financial stability. As clear as the regulatory features of lender of last resort are, when improperly handled, the facility could very easily retrogress into a conveyor of moral hazard or in fact, the creator of moral hazard.

⁴¹ CBNA s4(2)(a)

⁴² J Ponce and M Rennert, 'Systemic Banks and the Lender of Last Resort' <<https://www.sciencedirect.com/science/article/abs/pii/S0378426614000107>> assessed on 04/09/25

⁴³ P Tucker (n25) 12

⁴⁴ GJ Schinasi, 'The Role of Central Banks in Ensuring Financial Stability' [2005](12) <<https://www.elibrary.imf.org/display/book/9781589064409/ch007.xml>> accessed on 04/09/25

3. Ways in Which Lender of Last Resort Degenerate into Moral Hazard

The lender of last resort function of a central bank - where it provides emergency liquidity to banks or financial institutions in distress - has moral hazard features because it can encourage excessive risk-taking by financial institutions. Moral hazard manifests in several ways under the lender of last resort lending window to commercial banks.

3.1 Excessive Risk-Taking by Banks

Banks may take on riskier investments or lending practices if they expect that the central bank will rescue them in a crisis. Knowing that ‘losses will be socialized, but profits privatized’ encourages reckless behavior. Lender of last resort can easily provide an incentive for increased risk taking if the rate of interest is not punitive. In other words, ‘when the LOLR does not charge penalty rates, the bank chooses the same level of risk and a smaller liquidity buffer than in the absence of an LOLR. Moreover, the equilibrium choice of risk is increase in the penalty rate.’⁴⁵ Generally, critics of the lender of last resort window argue that it incentivizes banks to indulge in excessive risk taking with customers’ money when they are sure that the central bank will bail them out when things go wrong. This actually happened in the US when giant financial organizations like American International Group and Bear Stearns were bailed out during the 2007-2009 global financial crisis.⁴⁶

This excessive risk-taking behaviour is not found only in banks because a lender of last resort facility acts as insurance for both banks and their depositors. Its availability reduces the cost of risk-taking and consequently, reduces the incentive for banks to properly manage their own liquidity and for depositors to monitor banks' activities and take preemptive action at signs of liquidity challenges. The result is a more fragile banking system. A lender of last resort has the ability to minimize the prevalence of bank runs but it can also be responsible for a banking environment that runs become more severe when they do occur.⁴⁷

In practical terms, the availability of lender of last resort pushes banks to assume that, if they face a liquidity crisis, the central Bank will step in to provide funds, acting as a backstop against their own mismanagement. This reduces the pressure for banks to maintain sufficient

⁴⁵ R Repullo ‘Liquidity, Risk Taking, and the Lender of Last Resort’ [2005](9) *International Journal of Central Banking* 48 <<https://www.ijcb.org/journal/ijcb05q3a2.pdf>> accessed on 05/09/25

⁴⁶ A Hayes, E Estevez and V Velasquez, ‘Lender of Last Resort: Function and Examples [2024](9) <<https://www.investopedia.com/terms/l/lenderoflastresort.asp>> accessed on 03/09/25

⁴⁷ B Fitz-Gibbon and M Gizycki, (n15) 4

liquidity or to make robust provisions for potential losses. It also stimulates banks to take on more risk during upswings in the economic cycle, contributing to instability, especially when banks realize that weak institutions may be saved rather than liquidated.

3.2 Weakened Market Discipline

The availability of lender of last resort emboldens depositors, creditors, and investors to pay less attention to the financial health of banks on the assumption that the central bank will bail them out when things go wrong. This reduces the pressure on banks to operate prudently. The point has already been made that lack of adequate diligence could arise from managers of financial institutions who believe and know that they would receive liquidity by way of loans from the lender of last resort when a crisis occurs just as investors in those institutions would act with less care in the secure knowledge that the lender of last resort will make funds available to the institution in a crisis situation.⁴⁸ This challenge is accentuated by the fact that the lender of last resort is not likely to be able to distinguish perfectly between warranted and unwarranted crises. To add to the problem, a presumption of market indiscipline is created by the presence of the too big to fail doctrine and deposit insurance. Under such circumstances the lender of last resort is able to take measures that only attempt to minimize moral hazard in both managers of financial institutions and investors.⁴⁹

One of the originators of the concept of lender of last resort, Bagehot warned against overconfidence in the lender of last resort as against the need to strengthen individual banks. He believed strongly that the central bank, was not intended to substitute market discipline because the basic backbone of the banking system should not be the availability of lender of last resort facility but the soundness and resources of individual banks.⁵⁰ In other words, lender of last resort should not supplant market discipline. It is generally agreed that the availability of a lender of last resort could weaken market discipline.

⁴⁸ S Fischer, 'On the Need for an International Lender of Last Resort,' being a paper presented at the joint luncheon of the American Economic Association and the American Finance Association New York, January 3, 1999, <<https://www.imf.org/en/News/Articles/2015/09/28/04/53/sp010399>> accessed on 04/09/25

⁴⁹ Ibid (n48)

⁵⁰ TM Humphrey, 'The Classical Concept of the Lender of Last Resort [1975] *Economic Review* January to February 8 <https://www.richmondfed.org/~media/richmondfedorg/publications/research/economic_review/1975/pdf/er610101.pdf> accessed on 04/09/25

Certain factors instill discipline in the market in the absence of lender of last resort. Such factors include creditor pressure. In a competitive market, creditors will not wait until their claims can no longer be covered. If they expect a bank to become insolvent, they will withdraw their funds or refuse to lend more, forcing the bank to correct its deficiencies or exit the market. Shareholder discipline is one of the factors. Shareholders, guided by signals from creditors, auditors, and analysts, will also exert discipline by selling their shares or driving down the bank's value, leading to oversight of management and potential changes in ownership. Another factor is competition. In a competitive banking environment, individual banks are more dispensable, increasing exit pressure on underperforming or risky banks.

3.3 Zombie Banks Survival

LOLR support can, in some cases, keep insolvent or weak institutions alive, instead of letting them fail, which may prolong systemic weaknesses and misallocate resources. The presence of lender of last resort has the potential to create 'walking dead' banks. Banks that are practically dead but are kept on life support through the injection of emergency liquidity by the central bank. In Nigeria this happened between 2008 and 2010 when banks that were insolvent were propped up through liquidity injections until this became unsustainable.

Initially, measures like the easing of Monetary Policy Rates (MPR), Cash Reserve Ration (CRR) and Liquidity Ratio (LR) were employed. When that failed to resolve the crisis, restructuring margin loans, allowing additional instruments to access liquidity through the CBN discount window, and allowing banks to borrow up to 360 days and a stop on liquidity mop-up were used. Through these and various other lender of last resort measures insolvent banks were kept alive till the CBN decided to take a decisive action on the banking crisis by conducting a special audit of all banks in conjunction with the NDIC to determine those that were on life support (insolvent) and those that only required a temporary liquidity injection.⁵¹

The general idea of LOLR is to support viable banks and give them breathing space to restore normal functioning and maintain confidence in the banking industry. In a crisis situation, it may not be very easy to differentiate between an insolvent and an illiquid bank. This could lead the Central Bank to extend emergency liquidity to an insolvent bank thereby keeping a dead bank

⁵¹SL. Sanusi, 'Global Financial Meltdown and the Reforms in the Nigerian Banking Sector' Being the Full Text of a Public Lecture Delivered at the Convocation Square, Abubakar Tafawa Balewa University, Bauchi, Friday, December 10, 2010 also available in Vol. 2 No.1 of CBN Journal of Applied Statistics 99-100

on life support. Central banks need to exercise extreme caution in their decision making in this regard.⁵² This creates the situation known as ‘adverse selection’. It simply means that the banks most likely to seek LOLR assistance may be those with the worst risk profiles. If central banks cannot distinguish between illiquid-but-solvent banks and insolvent ones, they risk supporting bad institutions.

3.4 Too-Big-to-Fail Problem

Large financial institutions may believe they are guaranteed LOLR support due to their systemic importance. This expectation fosters more aggressive strategies, knowing their failure would be unacceptable. Firms that are considered too big to fail generate serious moral hazard and, in the process, exacerbate lender of last resort operations. Creditors are likely to demand less compensation for risks than they normally would. They would also not invest adequately in monitoring risk-taking in the firm. All of these weaken market discipline.⁵³

In the words of Dudley,

My remarks are going to focus on what is called the “too big to fail” problem....this problem arises when the failure of a large, complex financial institution threatens to cause such significant disruption to the financial system and the economy that these potential costs are judged as too severe to bear, leading to government intervention to prevent the failure. As a result, the firm, by being too big to fail, gains an implicit guarantee at the taxpayers’ expense that it does not have to pay for. I think there is broad agreement that such a regime is unacceptable in several respects.⁵⁴

Lender of last resort liquidity to too large to fail institutions creates moral hazard challenges by encouraging such institutions to engage in risky behavior, in the secure knowledge that they will receive government assistance if things go wrong. This arrangement undermines competition and puts smaller banks at a disadvantage because they do not enjoy similar safety nets.⁵⁵

3.5 Contagion of Expectations

If one bank is rescued, others may assume they will also receive support in future crises, reducing their incentive to maintain sound liquidity management. In a financial crisis, the survival of at least

⁵² M Dobler and Others, (n36)

⁵³ H Naqvi, ‘Banking Crises and the Lender of Last Resort: How Crucial is the Role of Information?’ [2015](5)(54) *Journal of banking and Finance* 20-29

⁵⁴ WC Dudley, ‘Ending Too Big to Fail’ Being Remarks at the Global Economic Policy Forum, New York City on November 7, 2013

⁵⁵ R Kalso, “Too Big to Fail” theory’ [2025] <<https://www.ebsco.com/research-starters/economics/too-big-fail-theory>> accessed on 04/09/25

some banks is essential for economic stability. So, while lender of last resort intervention in the banking system, especially in crisis situations, cannot be overlooked, its availability engenders rents for banks. Rent seeking in this manner has the potential to distort banks' motivation to assemble sufficient liquidity ex-ante. Instead, they gamble for lender of last resort support.⁵⁶

In a crisis situation, liquidity assistance may end up in the hands of insolvent institutions, imposing direct costs on the central bank and fiscal authorities.⁵⁷ When offered to insolvent banks, lender of last resort removes the pressure on regulators to close failing banks unhesitatingly. The continued operation of negative net worth banks causes major costs.⁵⁸ Some banks exploit this predictable rescue to pursue private benefits, or 'rents,' from riskier activities, rather than focusing on responsible liquidity management.

This behaviour is easily transmitted to other banks. When one bank receives support, other banks observe this. They may then adjust their own behavior, becoming more aggressive in their risk-taking, or lobbying for similar support, creating a broader culture of reliance on the central bank rather than on sound financial management. The dilemma here is that, to ensure systemic stability, the LOLR must provide support, but this very support can undermine the discipline needed for long-term stability and foster the very risky behavior it aims to prevent. The moral hazard features of LOLR arise because the safety net encourages banks to underprice risk, reduce self-insurance, weaken market discipline, and rely on bailouts - all of which can worsen financial instability if not carefully managed.

4. Nigeria is Not on the Same Page with More Advanced Economies on Lender of Last Resort

How lender of last resort operates in a given jurisdiction depends entirely on the statutory foundations on which the facility operates. The legal provisions anchoring lender of last resort and how they are interpreted determines whether it is a bank regulatory tool or whether it is primed to create moral hazard in the banking system. Respect for rule of law generally, is another subordinate factor. In this section the article will examine the legal basis for the operation of lender of last resort in Nigeria and how well it has served the Nigerian banking system.

⁵⁶ L Ratnowski, 'Bank Liquidity Regulation and the Lender of Last Resort' [2009](10) *Journal of Financial Intermediation* 541-558

⁵⁷ EP Davis, 'Liquidity, Financial Crises and the Lender of Last Resort – How Much of a Departure is the Sub-prime Crisis?' 117 <<https://www.rba.gov.au/publications/confs/2008/pdf/davis.pdf>> accessed on 6/09/25

⁵⁸ Ibid (n57)

4.1 The Legal Basis for Lender of Last Resort in Nigeria

The provisions of the CBNA that authorize the CBN to conduct lender of last resort operations have already been identified. Looking at lender of last resort from a generic perspective, there are other laws and organizations that perform similar functions. This is particularly so if it is agreed that the ultimate objective of lender of last resort is to save a financial institution from certain failure. It wouldn't matter at what stage in its ill health such lifesaving liquidity is supplied in order to keep it alive. If this is the case then other organizations can be considered as lenders of last resort in the Nigerian banking system. The bottom-line here is the supply of emergency liquidity to a dying financial institution.

The Nigerian Deposit Insurance Corporation Act (NDICA), authorizes the NDIC to give '...assistance to insured institutions in the interest of depositors, in case of imminent or actual financial or technical difficulties particularly where suspension of payments is threatened, to avoid damage to public confidence in the banking system.'⁵⁹ This is clearly a lender of last resort function. The Asset Management Corporation of Nigeria (AMCON) also performs the function of reflating the liquidity of banks. This responsibility comes out quite clearly from a community reading of sections 24-47 of the Act establishing AMCON.⁶⁰

One common characteristic of all these statutory provisions is that they do not prescribe any methodology or set any minimum requirements or standards for the exercise of the generous discretion granted the agencies to conduct lender of. last resort functions. The agencies have absolute discretion to handle issues as they deem fit. Such wide discretion, without a guide or accountability provisions is highly prone to abuse and misuse. Unfortunately, this is the background from which lender of last resort functions were conducted in Nigeria during the 2007-2009 Global Financial Crisis and since then.

Other jurisdictions operated from a different legal background. For instance, in the United States (US) the Federal Reserve Bank of the US, known as The Fed, provides lender of last resort functions under section 10B of the Federal Reserve Act.⁶¹ Section 10B of that Act gives detailed directives on how lender of last resort is to be provided by The Fed. For instance,

The Fed can make short-term loans; the loans must be secured by high-quality collateral; and various procedural requirements and limits must be respected,

⁵⁹ NDICA 2023 s4(b)

⁶⁰ AMCONA 2010 (as amended) s24-47

⁶¹ Federal Reserve Act 1913 s10B

especially if the bank is undercapitalized. The Fed charges a penalty of fifty basis points above the federal funds rate for banks in “generally sound financial condition,” and an additional fifty basis points for weaker banks.⁶²

Some of the instructions contained in the actual Act include limitations on advances; viability exceptions; extension of period; delegation of authority to issue certificate of viability; extended advances; advances to critically undercapitalized depository institutions; liability for increased loss; and many other directives. In spite of the detailed provisions of section 10B, the US Congress found it necessary to pass the Emergency Economic Stabilization Act, 2008 on October 3 of that year to enable the Fed handle the global financial crisis of 2007-2009 effectively. The Act authorized the sum of 475 billion USD to enable the Department of Treasury purchase or guarantee troubled assets and other financial assets held by the Secretary of the Treasury.⁶³

It is to be noted that in Nigeria, the statutory provisions for conducting lender of last resort are quite fluid and widely discretionary. It was on the basis of those provisions that the Central Bank of Nigeria expended the sum of N620 Billion to rescue nine (9) Nigerian banks which, in the words of the then Central Bank of Nigeria Governor, ‘were “technically” insolvent with significant negative asset value’.⁶⁴ The CBN went a step further and guaranteed interbank placements. The coinage, ‘technically insolvent’ will take some vigorous explaining to understand even among central bank governors. Globally, banks in crisis are known to be either illiquid or insolvent and lender of last resort facilities are extended to only illiquid banks and never to insolvent ones. It is not revealed whether the other safety nets that should be considered in providing emergency liquidity to illiquid banks were observed in this case. The presumption is that since the banks were insolvent anyway, they were not capable of meeting those other conditions like high-end collateral, high interest rate and other conditions. These conditions were presumably disregarded. In other words, those failing or dying banks were resuscitated with free public funds.

In the US, the US Congress went further to enact the Dodd-Frank Act⁶⁵ to plug most of the loopholes that became evident in the management of the 2007-2009 Global Financial Crisis. The Federal Reserve Act 1913 was also amended to remove observed lapses. In Nigeria, the pre-crisis CBN Act of 2007 under which the CBN handled lender of last resort during the crisis has not only

⁶²EA Posner, ‘What Legal Authority Does the Fed Need During a Financial Crisis?’ [2017] *University of Chicago Law School Journal Articles Faculty Scholarship, Minnesota Law Review* 1541

⁶³ See the OMB Report Under the Emergency Economic Stabilization Act, Section 202, dated November 8, 2011

⁶⁴ SL Sanusi (n51) 100

⁶⁵ Dodd-Frank Wall Street Reform and Consumer Protection Act, 2010

remained intact but no legislative effort has been made to remove challenges encountered by the CBN, the Federal Ministry of Finance and the NDIC in managing the crisis. The NDIC Act of 2006 was amended in 2023 and BOFIA 2004 was replaced by BOFIA 2020 but the provisions dealing with lender of last resort in both statutes have remained the same. Maybe there were no such challenges experienced under the statutes mentioned. The danger is that in the event of another crisis, the responsible authorities will most likely still extend lender of last resort facilities to 'technically insolvent' financial institutions, against all known global best practices. Under the same legal regime, it is most likely that the CBN has continued the same practice of injecting emergency liquidity into insolvent banks since the end of the global crisis. The use of lender of last resort during the global financial crisis of 2007-2009 by the CBN, the Federal Ministry of Finance and the NDIC appeared to create or encourage moral hazard, rather than create an opportunity to further regulate the commercial banking sector as discussed above.

5. Conclusion

While lender of last resort can be a great tool for regulating the business practices of commercial banks, in Nigeria it appears to promote moral hazard in banking instead. If the fundamental principles underlying the operation of lender of last resort are diligently followed by the central bank, the facility can regulate the conduct of business in commercial banks and put them on their toes in terms of banking best practices. If, however, the time-tested principles under which the facility operates are abandoned by the central bank, the potentially positive regulatory impact of lender of last resort can become a grand avenue for moral hazard in the banking sector to the detriment of the general financial system and the economy.

In Nigeria such safety nets were not strictly observed in the disbursement of lender of last resort during the global financial crisis of 2007-2009, thereby raising concerns about the effectiveness of the facility on the conduct of commercial banks in the country. They are most probably ignored till today. One of the reasons for this apparent failure is the fact that the legal basis on which the facility was utilised to bail out banks is originally faulty. Wide discretionary powers are given to the CBN and NDIC in this respect without corresponding accountability provisions. The statutory provisions do not provide any directives on how the facility should be operated. This has complicated the situation by implicitly permitting the CBN and NDIC to experiment and even abuse the system as was seen during the global financial crisis of 2007-2009. Since the end of the global crisis, there is

no evidence that anything has changed in that direction. Banks that have benefited from lender of last resort since then are not likely to have been subjected to the globally accepted best practices.

6. Findings

The paper made the following findings:

- a. The Statutory provisions upon which lender of last resort operates in Nigeria do not provide modalities that should be followed by the providers of the facility. Such modalities usually encompass global best practices as enunciated by the originators of the concept of lender of last resort.
- b. While the providers of lender of last resort have very wide discretionary powers given to them by the relevant statutes, there are no complementary accountability provisions to moderate the exercise of those discretionary powers.
- c. There are too many institutions involved in the provision of lender of last resort. This could give rise to overlapping actions when a situation arises that requires the injection of temporary liquidity into some financial institutions in a crisis situation.

7. Recommendations

It is recommended that the provisions of the CBNA and the NDICA that authorise the CBN, NDIC and Federal Ministry of Finance to carry out lender of last resort functions should be amended in the following areas:

- a. The provisions should be expanded to provide modalities on how lender of last resort should be conducted in the Nigerian banking system. Such modalities should take into account global best practices in the areas of eligibility of institutions that can benefit from lender of last resort; the interest rate at which lender of last resort can be accessed by illiquid financial institutions; the aim of lender of last resort should be stated as being to protect the aggregate money stock, and not individual institutions; insolvent institutions should generally be allowed to fail without benefitting from the lender of last resort function of the central bank; the lender of last resort should accommodate only sound institutions; the advances or loans should be made on good collateral; the conditions for accessing lender of last resort should be pre-announced well in advance of any crisis so that the market would know exactly what to expect.
- b. The CBN should incur some responsibility in its operation of lender of last resort if these conditions are not strictly followed. It is known that the CBN is independent in its operations but the Federal Ministry of Finance is consulted in most cases when the CBN has to take such major decisions. The

Ministry should be aware if something is going wrong and the President's powers to fire the Governor, Deputy Governors and Directors under the CBNA⁶⁶ should be activated.

- c. One institution should be responsible for the provision of lender of last resort facilities in order to simplify surveillance. A situation where multiple organizations are legally empowered to conduct lender of last resort functions is a recipe for confusion and abuse of the facility.

⁶⁶ CBNA 2007 s11