REGULATORY UPDATE:
CBN'S REDUCTION OF LDR BY 15%: IMPLICATIONS FOR BANKS AND THE ECONOMY

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INTRODUCTION

On 18th April, 2024, the Central Bank of Nigeria ("CBN") issued a circular **("the Circular") (BSD/DIR/PUB/LAB/017/005)** to review regulatory measures aimed at improving lending to the real sector of the economy. The circular directed all Deposit Money Banks (DMBs) to reduce their loan-to-deposit ratio (LDR) from 65% to 50%, effective immediately. This represents a 15% decrease from the previous LDR rate.

The loan-to-deposit ratio assesses a bank's liquidity by comparing its total loans to its total deposits for the same period. To calculate the loan-to-deposit ratio, you divide a bank's total loan amount by the total amount of deposits for the same period.

The purport of this directive is to ensure that the ratio of the use of funds for loaning by banks to customers' deposits are balanced, such that loans are not advanced to the detriment of customers' deposits whenever such is called for by the customers. This directive aligns with the CBN's decision to tighten its monetary policy, demonstrating a commitment to refining its regulatory framework in response to evolving economic conditions, fostering lending to the real sector of the Nigerian economy and ensuring the stability of the banks.

IMPLICATION FOR BANKS

Under the new policy, banks such as DMBs and merchant banks must maintain 45% and 14% respectively of their total deposits with the CBN as Cash Reserve Ratio (CRR), while also ensuring they maintain a minimum 50% percentage of their total deposits as loans to customers.

Further, the performance of banks in meeting the minimum LDR will be evaluated by averaging their daily loan-to-deposit ratios over a specified period. To comply with the new regulatory requirements, banks will need to make significant adjustments to their strategies and operations.

It is worth noting that this directive will entrench prudence in the lending practices by the banks, ensure they reassess their lending practices and refocus their lending target, particularly to the real sector of the economy. This may involve revising credit policies, targeting specific industries for lending, strengthening credit assessment processes, implementing stricter loan monitoring mechanisms, and enhancing collection strategies.

Operationally, banks will need to enhance their risk management frameworks to mitigate potential increases in loan defaults as they will experience more liquidity because of deposits made available. This is because of the 15% cut-back on the LDR.

This extra liquidity could be used for:

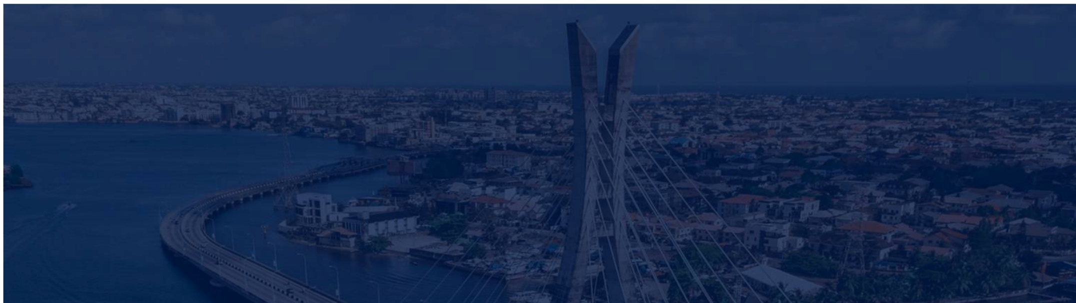
Cash Reserve Ratio (CRR) compliance: with the increase in the CRR by CBN to 45%, this extra liquidity by the banks can be utilized towards meeting the revised CRR requirement by the CBN.

Investments: the excess liquidity can also be utilized by banks to buy derivatives, and mutual funds, invest in government securities, treasury bills, etc. These investments have the potential to diversify the bank's portfolio and offer additional revenue streams.

IMPACT ON THE ECONOMY

The reduction in the LDR will encourage prudence in spending the available capital. However, access to credit becomes tighter for businesses as a result of these prudent measures. Also, interest rates on loans might increase due to an increase in the cost of capital and as part of the bank's measures to make a profit from the loans that they make. These will increase the cost of carrying on businesses, the cost of final goods and services on consumers, and inevitably slow down economic growth.

However, it is important to note that the LDR reduction is a shift towards a more contractionary monetary policy. This is because it allows banks to hold on to more cash reserves, potentially reducing the money supply in circulation. This is aimed at controlling inflation but might also slow down economic growth. While this may lead to short-term economic slowdown, the goal is to maintain price stability and sustainable economic expansion in the long run.



CONCLUSION

The CBN's LDR reduction is a calculated move to bolster the Nigerian economy in the long run. By allowing banks to hold more reserves, the CBN aims for a tighter monetary policy to control inflation. The CBN continues to closely monitor the economy and the impact of its policies and will adjust its approach as it deems fit to achieve its goals.

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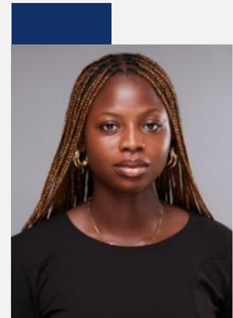

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