**Credit Risk Mitigation: The Capital Game Nigerian Banks Must Master**

Banking, at its core, is a business of trust. A bank opens its doors each morning with one simple promise: to lend money and get it back. That promise, however, is anything but simple. Every loan issued is a bet on the future, a wager that the borrower will repay, the economy will hold steady, and the institution will remain solvent. And in a world where uncertainty is constant, banks must do more than hope. They must protect themselves.

This is where the real business of banking begins. Beyond the marble floors and digital apps, banks are engaged in a daily balancing act. They must lend enough to stay profitable, but not so much that they risk collapse. They must assess risk, price it, and manage it. And above all, they must hold enough capital to absorb the shocks that inevitably come.

Capital is the cushion that keeps banks alive when loans go bad. Regulators around the world require banks to maintain a minimum level of capital relative to the riskiness of their assets. This is known as the **Capital Adequacy Ratio (CAR)**, and it is calculated using a framework called **Risk Weighted Assets (RWA)**. The higher the risk of a loan, the more capital the bank must hold against it. A loan to a government might require no capital at all. A loan to a small business might require full coverage.

In line with the Federal Government's ambition to build a ₦1 trillion economy, the Central Bank has raised the minimum capital requirement for banks, a bold move designed to empower financial institutions to underwrite big-ticket transactions and drive economic expansion. Yet capital alone cannot guarantee stability or growth. Without the right tools, banks may remain risk-averse, limiting their ability to support sectors like agriculture, manufacturing, and infrastructure.

Capital, however, is not free. It comes at a cost not just in terms of raising it, but in holding it. This is known as the **Carrying Cost of Capital**. When a bank sets aside capital to back a risky loan, that capital is essentially frozen. It cannot be used to fund other loans, invest in growth, or generate returns. The more capital a bank is required to hold, the less agile and profitable it becomes. For Nigerian banks, which often operate in high-risk environments with limited access to cheap funding, this cost is especially burdensome. It creates a drag on performance and forces banks to make hard choices between growth and compliance.

So how do banks resolve this tension? How do they lend boldly without breaching regulatory limits? The answer lies in a set of tools known as **Credit Risk Mitigation (CRM)** techniques. These are strategies that reduce the riskiness of a loan, allowing banks to hold less capital against it. When properly applied, CRM techniques transform risky exposures into safer ones, freeing up capital and enhancing profitability.

Globally, banks use CRM techniques as part of their core strategy. In Nigeria, however, adoption has been uneven. Collateral is often taken but not perfected. Guarantees are informal or unenforceable. Credit insurance is underutilized. As a result, many Nigerian banks carry more capital than necessary, limiting their ability to grow and compete.

This reluctance is not just a technical issue, it is an economic one. In the last recapitalisation exercise, banks successfully raised capital (from ₦2 billion to ₦25 billion), but much of it remained concentrated in balance sheets rather than being deployed into the real economy. Without effective

CRM tools, banks were hesitant to take on high-risk or long-tenor exposures, stalling the flow of credit to productive sectors. CRM is not a luxury. It is a necessity. It allows banks to lend more, earn more, and still remain within regulatory bounds. It improves risk-adjusted returns and positions Nigerian banks to compete globally.

In an economy grappling with inflationary pressures, currency volatility, and constrained fiscal space, Nigerian banks face a paradox: the need to expand credit to stimulate growth while managing heightened risk. CRM techniques offer a way out of this bind. They allow banks to lend into uncertainty with confidence, transforming capital into a developmental lever not just a regulatory buffer.

To understand how CRM works, consider the mechanics of the Basel framework. Under Basel II and III, banks calculate their capital requirements based on the risk weights assigned to their assets. A loan to a highly rated sovereign may carry a risk weight of zero, requiring no capital. A loan to a small business may carry a risk weight of 100 percent, requiring full capital backing. However, if that small business loan is secured by eligible collateral or guaranteed by a credible third party, the risk weight can be reduced. This reduction translates directly into lower capital requirements.

Let us explore four powerful CRM tools that Nigerian banks must adopt more aggressively.

1. **Collateralization**

This is the most direct and widely used form of risk mitigation. By securing a loan with tangible assets such as real estate, inventory, or receivables, banks reduce the probability of loss. If the borrower defaults, the bank can seize the collateral and recover its funds. Under Basel rules, eligible collateral can reduce the risk weight of a loan, thereby lowering the capital charge. However, while mortgages are traditionally viewed as secured exposures, the Central Bank of Nigeria's (CBN) Revised Guidance Notes on Credit Risk Capital Requirement takes a conservative stance. Both residential and commercial mortgages can still carry high risk weights, especially when certain conditions are not met.

For residential mortgages, the guidance notes specify that a lower risk weight such as 35 percent is only applicable if the loan is fully secured by the property, the bank holds a first legal charge, and the borrower has a verifiable income stream. The property must be owner-occupied or rented, and the loan must be performing. If any of these criteria are missing, the exposure is treated as high-risk and assigned a standard 100 percent risk weight, similar to unsecured credit.

Commercial mortgages face even stricter treatment. Unless the property is income-generating and leased to third parties, and the bank has enforceable legal rights over the asset, the exposure typically carries a 100 percent risk weight. This reflects the CBN's cautious view of Nigeria's real estate market, where title disputes, valuation inconsistencies, and slow foreclosure processes pose significant recovery risks. This regulatory conservatism, while prudent, creates a capital burden for banks. Loans that are technically secured still require full capital backing, limiting the bank's ability to optimize its balance sheet. However, this challenge can be mitigated and international jurisdictions offer useful models.

In more developed markets, residential mortgages often benefit from lower risk weights due to robust legal frameworks, reliable property registries, and efficient foreclosure systems. For example, under the Basel framework, banks in the EU or UK can apply a 35 percent risk weight to qualifying residential mortgages, provided the loan-to-value ratio is reasonable and the property is legally secured. Commercial mortgages may also receive preferential treatment if the property generates stable income and is professionally managed.

To move in this direction, Nigerian banks must strengthen their mortgage origination and documentation processes. This includes ensuring clean title registration, accurate property valuation, and enforceable legal claims. Collaborating with credit bureaus, property registries, and legal professionals can help build the infrastructure needed to support lower risk weights. Additionally, banks can explore mortgage insurance or credit guarantees (discussed below) to further reduce exposure and unlock capital relief.

Ultimately, the goal is not just to lend against property, but to lend against property in a way that regulators recognise as truly secure. By aligning local practices with international standards, Nigerian banks can reduce their RWA, lower their capital requirements, and expand access to housing and commercial finance—all while maintaining prudential safety.

2. **Guarantees and Third-Party Credit Protection**

A guarantee from a credible third party, such as a parent company, government agency, or multilateral institution, can significantly reduce the risk of a loan. Under Basel II, guarantees from eligible guarantors can substitute the risk weight of the borrower with that of the guarantor. This is a powerful mechanism. Imagine replacing the risk weight of a struggling SME with that of the Bank of Industry or Afreximbank. The capital savings are substantial. But to unlock this benefit, banks must structure guarantees properly, ensure legal enforceability, and document them in line with regulatory expectations. This requires collaboration between credit officers, legal teams, and risk managers.

3. **Credit Insurance and Derivatives**

Though still nascent in Nigeria, these instruments are powerful tools for transferring risk. When a bank insures a loan against default, the insurer absorbs the risk, and the bank can reduce its RWA accordingly. Credit default swaps, though more complex, offer similar benefits. Platforms like Fiducia and Capsa are beginning to offer structured credit protection in supply chain finance. Nigerian banks must engage these platforms not just as lenders, but as strategic partners in risk transfer. This will require regulatory clarity, product innovation, and market education.

4**. Securitisation**

This technique involves pooling a portfolio of loans such as mortgages, auto loans, or SME credit and converting them into asset-backed securities that are sold to investors. By doing so, the bank effectively transfers the credit risk to third parties and removes the securitised assets from its balance sheet. Under Basel II and III, properly structured securitisation transactions can significantly reduce a bank's RWA, leading to lower capital requirements.

A notable example is the Nigeria Mortgage Refinance Company (NMRC), which pioneered a mortgage-backed bond issuance by purchasing standardized residential mortgage loans from participating lenders. Though not a traditional SPV-based securitisation, NMRC's model injected liquidity into the system, demonstrated investor appetite, and laid the groundwork for future securitisation frameworks. This transaction showed how structured refinancing can unlock long-term funding and support housing. As the financial system matures and regulatory frameworks evolve, banks can begin to explore securitisation as a strategic tool for risk transfer and capital optimisation. It also opens up new funding channels, diversifies investor exposure, and deepens the capital markets.

Beyond these tools, banks must also invest in systems and processes that support effective credit risk mitigation. This includes robust credit scoring models, automated documentation, real-time monitoring, and integrated risk management frameworks. It also includes training for staff, engagement with regulators, and collaboration with industry platforms.

The benefits are clear. By reducing the riskiness of their assets, banks can reduce their capital requirements. This frees up capital for growth, investment, and innovation. It improves return on equity and shareholder value. It enhances resilience in the face of economic shocks. And it aligns Nigerian banks with international best practices.

More importantly, it enables banks to lend confidently into the real economy—supporting SMEs, infrastructure, and emerging sectors that are critical to Nigeria's ₦1 trillion economic ambition. In a macro environment marked by inflation, currency volatility, and fiscal constraints, credit risk mitigation becomes not just a financial tool, but a national imperative.

In conclusion, credit risk mitigation is the art of turning risk into opportunity. It is the strategic lever that allows banks to lend boldly, grow sustainably, and compete globally. For Nigerian banks, mastering this art is no longer optional—it is the key to unlocking capital that fuels real economic transformation. The capital game is changing, and those who learn to play it well will shape the future of finance.