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From Culture to Crisis: Documentation Gaps and Financial Stability



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From Culture to Crisis: Documentation Gaps and Financial Stability

In today's fast-evolving financial ecosystem, credit risk remains one of the most significant concerns for banks and financial institutions globally. In Nigeria, the issue is particularly critical given the high levels of Non-Performing Loans (NPLs) and the regulatory push towards recapitalisation. Credit risk, simply put, refers to the potential that a borrower may fail to meet their obligations in accordance with agreed terms. It is the risk of default when a borrower does not pay back the interest or principal on time and it affects everything from a bank's profitability to its solvency and reputation.

The importance of mitigating credit risk in loan agreements cannot be overstated. If not properly addressed, the implications of unchecked credit risk could ripple across a financial institution's operations and even the broader economy. The primary objective in mitigating this risk is to ensure that banks are not overly exposed to borrowers who may default. This includes understanding the creditworthiness of borrowers, anticipating external factors such as economic downturns, and ensuring robust legal documentation that supports enforcement when things go wrong.

Several factors influence credit risk. A borrower's creditworthiness is paramount and this includes their financial history, repayment capacity, and reputation. However, credit risk is also impacted by macroeconomic conditions, industry trends, regulatory changes, and even political instability. For example, lending to a company in the construction sector during a period of rising inflation and declining consumer spending may pose higher risks than lending to a utility company in a more stable environment. Hence, beyond assessing the borrower, lenders must understand the sector and overall market conditions in which the borrower operates.

Unfortunately, many Nigerian loan agreements do not go far enough in addressing these risks. Based on a review of loan agreements from several Nigerian banks, it is evident that critical clauses designed to manage and mitigate credit risk are often missing or inadequately drafted. Many agreements lack comprehensive representations and warranties from the borrower concerning solvency, litigation status, or even the accuracy of financial statements. Key protective provisions, such as covenants to monitor financial performance and trigger early intervention, are often skeletal or non-existent. Even enforcement clauses, which would empower the bank to act swiftly in case of default, are poorly structured or overly discretionary, leaving room for ambiguity and legal disputes.

This stands in stark contrast to the practices in more developed jurisdictions where credit risk is addressed both operationally and through well-drafted legal documentation. For instance, under the Loan Market Association (LMA) standards commonly adopted in the



UK and across Europe, loan agreements typically contain detailed representations and warranties, financial covenants, reporting obligations, and defined events of default. These provisions are specifically structured to ensure early identification of credit deterioration and allow lenders to take action before default occurs. Additionally, mechanisms such as material adverse change clauses, cross-default provisions, and defined cure periods are standard tools that give banks flexibility in managing loan exposures.

Moreover, these developed jurisdictions often require regular financial reporting from borrowers, including quarterly management accounts, updates on litigation or regulatory issues, and compliance certificates. These requirements ensure that banks maintain visibility over the borrower's financial health throughout the loan tenure. When compared to the lax standards in Nigeria, the gap becomes not only evident but concerning.

The lack of attention to credit risk mitigation in Nigerian loan documentation is puzzling, especially in light of the Basel III regulations, which provide clear directives on how banks should manage and measure risk-weighted assets. Basel III emphasizes the importance of capital adequacy and requires banks to maintain higher levels of capital against riskier loans. It also encourages stress testing and robust risk management frameworks. If Nigerian banks are to comply meaningfully with these regulations, their documentation must reflect these principles by building in credit risk protection clauses that meet global standards.

Why then are Nigerian loan agreements falling short? Part of the issue stems from a lack of integration between legal and risk teams within the banks. Loan documentation is often treated as a routine administrative process rather than a strategic risk management tool. Moreover, some banks continue to rely on outdated templates that have not been reviewed or updated for years. Others simply adopt LMA-style documentation in form but not in substance, omitting or simplifying critical clauses that are vital for credit risk protection.

It may also be worth considering whether the slow pace of judicial resolution in commercial disputes has inadvertently contributed to weak documentation practices within the financial sector. Where banks and lenders perceive that the courts are unlikely to resolve credit-related disputes expeditiously, there may be no incentive to prepare documents that comprehensively cover credit risk. Such documents are erroneously perceived as needlessly lengthy and consumer-unfriendly. The market appears to be naively opposed to such documents. Accordingly, a culture is created where risk is traded for extremely short documents, many of which contain clauses that are unenforceable. Again, this is downplayed because enforceability is seen as uncertain or unduly delayed.

There is also a cultural element at play. In some instances, aggressive competition for market share pushes banks to approve loans under pressure, with documentation taking a backseat. Borrowers may also resist stringent terms, and in the absence of a strong legal and risk-driven negotiation stance, banks end up compromising on protections.



Regulatory oversight is also critical. Poor documentation not only exposes individual lenders to loss but can ultimately place depositors' funds at risk. When such risks are multiplied across institutions, the cumulative effect can threaten financial stability and give rise to systemic failure. This highlights the broader public interest in ensuring that credit documentation adequately covers foreseeable risks.

To bridge this gap and position Nigerian banks to compete internationally, a fundamental shift is required. First, loan documentation must be reviewed through a credit risk lens. Legal teams should collaborate closely with credit and risk departments to draft contracts that reflect the realities of the borrower's business and the inherent risks. Second, banks should adopt and adapt global standards such as the LMA templates not just cosmetically, but substantively, ensuring all key provisions are present and tailored to local legal and commercial realities.

Training and capacity building are also critical. Legal advisers, credit officers, and relationship managers must understand not just the legal language of the loan agreement, but the commercial and regulatory implications of each clause. Institutions like the Chartered Institute of Bankers of Nigeria (CIBN) and the Nigerian Bar Association (NBA) can play a role here by introducing certification and training programs focused on credit risk documentation.

Finally, regulators such as the CBN can encourage better practices by requiring banks to demonstrate that their documentation aligns with risk-based capital standards. This could include checks on the presence of key clauses in large credit exposures or periodic audits of documentation standards.

In conclusion, the risk of borrower default cannot be eliminated entirely, but it can and must be mitigated through strong legal and commercial safeguards. In the Nigerian context, where NPLs remain a challenge and the economy is in constant flux, mitigating credit risk through better loan documentation is not optional—it is essential. The road to global competitiveness and financial stability starts with smarter lending, and that begins with smarter contracts.



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