Regulation and Supervision of Financial Institutions - the Nigerian Experience

Samuel A. Oni
Central Bank of Nigeria

Regulation and Supervision of Financial Institutions-The Nigerian Experience

*Samuel A. Oni**

I. Introduction

The financial system in any economy serves as a catalyst for growth and development. Financial institutions (FIs) are able to perform this critical role through financial intermediation, provision of an efficient payments system and facilitating the implementation of monetary policies. It is not surprising, therefore, that governments globally strive to evolve an efficient and stable financial system for efficient intermediation, and maintenance of public confidence.

In recognition of the financial services industry's role in economic growth and development, regulation and supervision of FIs has long been established due to market imperfections and widespread failure of the market system to recognise social costs. There is also the tendency for market participants to take undue risks that had often resulted in unexpected losses and consequent impairment of the solvency of financial institutions. In addition, excessive risk appetite can also threaten the stability of the financial system and its continued capacity to support the real sector of the economy.

In Nigeria, the financial system comprises the regulatory and supervisory authorities, the money and the capital markets operators, and the infrastructure that facilitate the efficient and effective financial intermediation and payments services in the economy. The financial institutions include deposit money banks, microfinance banks, primary mortgage banks, development banks, Islamic banks, finance companies, bureau de change, securities & brokerage firms, fund managers and private equity firms, insurance companies and insurance brokerage firms and pension fund administrators and custodians sub-sectors. In the past five decades of independence, the Nigerian financial system had passed through various phases of developments, sometimes accompanied by far reaching reforms in terms of regulatory architecture, ownership, structure, scope and depth of market.

This paper focuses on the Nigerian experience, with regulation and supervision of financial institutions and is structured into nine sections. Following the introduction, section two discusses the reasons for FIs regulation and supervision, while section three dwells on the meaning and general principles of banking regulation. Section four

---

Samuel A. Oni is the former Director of Banking Supervision Department of the Central Bank of Nigeria. The usual disclaimer applies.

gives an overview of the legal basis of supervision and the supervisory framework for Nigeria, while section five addresses the structure, organisation and methodology of FIs supervision with particular reference to the Central Bank of Nigeria (CBN). Section six highlights CBN's experience in the regulation and supervision of FIs. In section seven the recent CBN initiatives at strengthening the regulatory architecture are presented. Section eight highlights the resolution mechanisms for distressed and failed banks and section nine offers some recommendations and concludes the paper.

II. Meaning and General Principles of Bank Regulation

Bank regulations are government controls (exercised by a central bank or a regulatory authority) subjecting banks to certain requirements, restrictions and guidelines.

Regulations create transparency between banking institutions and the persons with whom they conduct business. Given the interconnectedness of the banking industry and the reliance that the national and indeed, the global economy place on banks, regulatory agencies maintain control over the operations of these institutions. Supporters of such regulation often hinged their arguments on the "too big to fail" notion. This holds that many financial institutions (particularly investment banks with a commercial arm) have too much control over the economy, to fail without enormous consequences. This is the premise for government bailouts, in which financial assistance by the government is provided to banks that appeared to be on the brink of collapse. The belief is that without this aid, the crippled banks would create rippling effects throughout the economy.

II.1 General Principles of Bank Regulation:

Banking regulation is guided by the following principles:

Minimum Requirements: Banking regulations can vary widely across nations and jurisdictions. Generally, regulatory requirements are imposed on banks in order to promote the objectives of the regulator. Often, these requirements are closely tied to the level of risk exposure for a certain sector of the bank. The most important minimum requirement is maintaining minimum capital adequacy ratios.

Supervisory Review: Banks are required to be issued with a license by the regulator in order to carry on business as a bank, and the regulator conducts supervisory oversight on the licensed banks for compliance with the requirements and responds to breaches of the requirements through obtaining undertakings from the bank, giving directives, imposing penalties or revoking the bank license.

Market Discipline: The regulator requires banks to publicly disclose financial and other information so that depositors and creditors can use this information to assess the level of their risks and to make investment decisions. Regulators can also use market pricing information as an indicator of the banks financial health.

II.2 Instruments for Bank Regulation:

Capital Requirement: the capital requirement sets a framework on how banks must handle their capital in relation to their assets. In 1988, the Bank for International Settlements (BIS) Basel Committee on Banking Supervision decided to introduce a capital measurement system commonly referred to as the Basel Capital Accords. The latest capital adequacy framework is commonly known as Basel III which is more risk sensitive than the original one but also a lot more complex.

Reserve Requirement: the reserve requirements sets the minimum reserves each bank must hold to (demand) deposits and banknotes. The purpose of minimum reserve ratios is liquidity rather than safety. In Nigeria, for instance, banks are required to maintain a cash reserve requirement and a retention of Net open position of the bank's shareholders funds.

Corporate Governance: corporate governance requirements are intended to encourage banks to be well managed, and is an indirect way of achieving other objectives.

Financial Reporting and Disclosure Requirements: Among the most important regulations that are placed on banks is the requirement for full disclosure of their financials. The CBN and Securities and Exchange Commission (SEC) require banks to prepare annual financial statements according to the International Financial Reporting Standard (IFRS), have them audited, filed and published.

Credit Rating Requirement: Banks may be required to obtain and maintain a current credit rating from an approved credit rating agency and disclose it to investors. These ratings are designed to provide comfort for prospective clients or investors regarding the relative risk that one assumes when engaging in business with the bank.

Large Exposure Restrictions: Banks are usually restricted from having imprudently large exposures to individual counterparties or groups of connected counterparties. Such limitation may be expressed as a proportion of the bank's assets or equity and different limits may apply based on security held and / or the credit rating of the counterparty. Restricting disproportionate exposure to high-risk investment prevents banks from placing their capital at an unnecessary risk.

Activity and Affiliation Restrictions: A recent case is the repeal of the universal banking model in Nigeria, which requires banks to divest from non-banking firms or activities, prompting some banks to establish a non-operating Holding Company.

III. Why do we regulate banks and other financial institutions?

Regulation and supervision of banks remain an integral part of the mechanism for ensuring safe and sound banking practices. FIs regulation and supervision is required for three primary objectives:

promote soundness and stability of the financial system;
ensure protection of consumers of financial services; and
reduce financial crimes (anti-money laundering/counter financing terrorism)

III.1 Safety, soundness and stability of the financial system

Regulation and supervision of FIs are intended to assure the financial well-being of individual FIs and financial stability for the economy. As financial intermediaries, the operations of FIs involve very high inherent risks, while the collapse of an FI could trigger multiple runs on other FIs with systemic consequences. Banks trade in money and credit and so are susceptible to various risks which require that they be effectively supervised to adhere to good corporate governance practices.

III.2 Protect consumers of financial products and services

Regulation and supervision assist the government in ensuring that consumers of financial products and services are protected from predatory fees and charges, especially small depositors who rely on the financial system to save. It also attempts to ring-fence customers' short-term deposits from being applied to high risk activities by FIs as only capital and long-term loans are suitable for such purposes. In addition, the provision of safety net through deposit insurance guarantees ensures that the payment of minimum amount to depositors in the event of failure of an FI is enforced.

III.3 Combat financial crimes

Fis regulation is also designed to combat money laundering and financing of terrorist activities. An effective regulatory framework and supervisory practices will detect money laundering and terrorist financing activities and assist in the tracking and prosecution of offenders.

In addition, to the primary objectives enumerated above, bank regulation and supervision seeks to:

i. Promote financial inclusion and check undue concentration of economic power by providing incentives to specialized FIs such as MFBs to lend to the active poor.
ii. Enhance healthy competition in the financial system by creating level playing fields for operators;
iii. Ensure effective implementation of government's monetary and credit policies;
iv. Credit allocation – to direct credit to favoured sectors.

IV. Legal Basis of Financial Institutions Regulation and Supervision in Nigeria

As a starting point, some background on the Central Bank of Nigeria's supervisory authority may be helpful. The powers to regulate bank and other financial institutions in Nigeria are as stipulated in the Central Bank of Nigeria (CBN) Act 2007 and the Banks and Other Financial Institutions (BOFI) Act 1991, as amended. Section 2(d) of the CBN Act 2007 vested on the CBN the statutory responsibility of promoting a sound financial system in Nigeria. Also, Section 33(1) (a) (b) empowers the Bank to require certain information from and issue guidelines to FIs on matters relating to their activities and the economy, while Section 42(1)(b) mandates the Bank to ensure high standards of conduct and management throughout the banking system.

Section 30 of the BOFI Act requires the Governor of the CBN to appoint an officer of the Bank known as Director of Banking Supervision or by such other title as the Governor may specify who shall have the power to carry out supervisory oversight on banks and other financial institutions. Sections 31-34 further empowers the Bank to conduct both routine and special examination of banks and to either impose sanctions for contraventions or take remedial actions on banks in grave financial conditions.

At the apex of the regulatory and supervisory framework for the Nigerian financial system is the Central Bank of Nigeria (CBN). The Nigerian Deposit Insurance Corporation (NDIC) however, exercises shared responsibility with the Central Bank of Nigeria for the supervision of insured banks. Active co-operation exists between these two agencies on the focus and modality for regulating and supervising insured banks. This is exemplified in the coordinated formulation of supervisory strategies and surveillance on the activities of the insured banks, elimination of supervisory overlap, establishment of a credible data management and information sharing system. Other regulatory/supervisory agencies in the Nigerian financial system include:

Securities and Exchange Commission (SEC)

The SEC derives its power to regulate all quoted companies, including FIs, and other capital market operators from the Investment and Securities Act (ISA) 2007.

National Insurance Commission (NAICOM)

The Insurance Act 2003 vested the responsibility to regulate and supervise insurance businesses on NAICOM. Section 4(1) of the Act states that "subject to the provisions of the Act, no insurer shall commence business in Nigeria unless the insurer is registered by NAICOM". Also, NAICOM Act 2007 empowers it to license and supervise the operations of all classes of insurance business in Nigeria.

National Pension Commission (PenCom)

PenCom is charged, under the Pension Reform Act 2004 as amended, to regulate and supervise the operations of Pension Fund Custodian (PFC), Pension Fund Administrators (PFA) and any other operators in the pension sub-sector.

Nigeria Deposit Insurance Corporation (NDIC)
DIC Act 2006 vested it with supervisory powers and responsibilities over deposit taking Financial Institutions (FIs) in addition to the deposit insurance and orderly liquidation of failed Fis.

Financial Services Regulation Coordinating Committee (FSRCC)
The CBN Act 1994 and 2007 as amended provided for the creation of the FSRCC to coordinate and harmonise the activities of the various regulators and supervisors in the financial system with a view to minimising regulatory arbitrage. The Committee is chaired by the Governor of the CBN.

Economic and Financial Crimes Commission (EFCC)
The Nigeria Financial Intelligence Unit of the EFCC is charged with the mandate of receiving, collating and analysing currency transaction reports (CTRs) and suspicious transactions reports (STRs) from FIs with a view to checkmating money laundering and countering financing of terrorism.

V. Structure, Organisation and Methodology of Supervision in the Central Bank of Nigeria (CBN)

V.1 Structure and Organisation of Supervision

The supervision of banks and OFIs has traditionally been segregated into on-site and off-site activities, which ensure regular contact with the management of the institutions. This categorisation is consistent with the Basel Core Principle No. 20 on effective banking supervision.

From 1992 to 2005, the CBN operated separate departments for on-site and off-site supervision functions. The on-site examination and surveillance was domiciled in the Bank Examination Department, while Banking Supervision Department was responsible for policy development, collation and review of statutory returns and approval of requests of regulatory nature from the banks and discount houses. The mandatory returns include: monthly balance sheet and profit and loss accounts, sector by sector breakdown of credit portfolio including insider related facilities, schedule of non-performing loans, breakdown of other assets and other liabilities. Others include: prudential ratios, particularly capital adequacy and liquidity ratios computation and key financial performance indicators. Regulatory approval requests include board and top management staff appointments, branch expansion and rationalisation, annual and half-year financial statements, mergers and acquisitions, and recapitalisation.

Following the enactment of the Banks and Other Financial Institutions Act (BOFIA), 1991, as amended, the regulation and supervision of other financial institutions including microfinance banks (MFBs), primary mortgage banks (PMBs), development financial banks (DFBs), finance companies (FCs) and bureau de change (BDCs) were brought within the powers of the CBN. Consequently, the Bank created the Other Financial Institutions Supervision Department (OFISD) formerly Other Financial Institutions Department (OFID) in 1993 to carry out the on-site and off-site regulation and supervision of Other Financial Institutions (OFIs).

In 2005, Banking Supervision and Bank Examination Departments were merged into Banking Supervision Department. This was to foster better coordination of on-site and off-site supervisory activities and speed up the monitoring and enforcement of on-site supervisory recommendations. The merger was also consistent with the practice in several other jurisdictions, including the USA, UK, India, Malaysia and Canada.

Consequently, examiners were trained to handle both on-site and off-site examination functions. Some off-site examiners were often deployed to participate in on-site examinations, while the off-site continuous review of mandatory returns from banks was transferred to the on-site examination division which was situated in Lagos for administrative purposes.

However, while the Banking Supervision Department retained its power to grant routine approvals to banks, other off-site functions including licensing, policy development and regulation, macro-prudential analysis and surveillance, financial consumer protection and anti-money laundering/counter terrorism financing were transferred to a new department named Financial Policy and Regulation Department (FPRD) created in March 2010. In furtherance of its reforms to strengthen regulation and supervision and protect consumers of financial services, the CBN carved out an independent Consumer Protection Department (CPD) from the FPRD in April 2012.

V.2 Supervisory Methodology: Risk-Based versus Compliance Supervision

The supervisory authorities recently migrated from the compliance-based supervision to a risk-based supervision (RBS) approach in 2009/2010. This enables supervisors to focus attention on high risks areas that could threaten the achievement of supervisory objectives and to devise an appropriate risk mitigation programme for supervised institutions. The on-site process involves on-site examination of significant activities and the inherent risks; the existence and effectiveness of management control functions designed to mitigate the identified risks; and the availability of capital/earnings to absorb unexpected losses. The off-site aspect reviews and analyses the financial conditions of banks using prudential reports, statutory returns and other relevant information.

The RBS on-site examination procedures are used to evaluate the adequacy of the bank's policies and procedures, and the adequacy of its internal controls. It also reviews the work performed by internal and external auditors, the performance and activities of management and the board of directors. Furthermore, the process documents the basis of an FI's risk rating, the examiners' comments and overall conclusion regarding the condition of the bank and the quality of its management.
The implementation of RBS is expected to help solve the problems associated with transaction and compliance-based supervision technique, found to be largely reactive, narrow in scope and uniformly applied to all supervised institutions irrespective of size or complexity of operations.

V.3 Macro-Prudential Regulation/Supervision

The term macro-prudential regulation characterizes the approach to financial regulation aimed to mitigate the risk of the financial system as a whole (or systemic risk). In the aftermath of the late – 2000s financial crisis, there has been a growing consensus among policy makers and economic researchers about the need to re-orientate the regulatory framework towards a macro-prudential perspective.

A fundamental lesson from the crisis was that effective supervision at the individual bank level, while necessary, was not sufficient to safeguard the soundness of the financial system. Thus, the need for regulators, supervisors and central bankers to supplement strong micro-prudential regulation with a macro-prudential overlay became evident. This was to effectively monitor and address the build-up of risks arising from excess liquidity, leverage risk-taking and systemic concentrations that have the potential to cause financial instability.

Therefore, macro-prudential regulation aims at reducing the risk and the macroeconomic costs of financial instability. It is recognised as a necessary ingredient to fill the gap between macroeconomic policy and the traditional micro prudential regulation of financial institutions.

More so, given that the risk of distress to the financial system was not simply the sum of the risks of its individual components, but the impact of the collective behaviour of economic agents on aggregate risk needs to be accounted for explicitly. While it may be individually appropriate for banks to take more risks during benign economic times, e.g. by increasing lending, when this behaviour becomes widespread, the overall leverage of the banking sector may create the potential for financial instability.

The comprehensive approach to macro-prudential regulation and supervision followed three aspects:

1. Recognising the separate treatment of micro – prudential and macro – prudential issues i.e. identification of concentration risk.

2. Bringing together the major international institutions and key national authorities involved in financial sector stability i.e. consolidation on group basis (community referred to as consolidated supervision).
3. Integrating emerging markets more in this process i.e. feedback loop between financial sector and the real sector.

Furthermore, macro and micro–prudential perspectives differ in terms of their objectives and understanding on the nature of risk. Traditional micro-prudential regulation seeks to enhance the safety and soundness of individual financial institutions as opposed to the macro-prudential view which focuses on welfare of the financial system as a whole. Also, risk is considered as exogenous under the micro-prudential perspective in the sense of assuming that any potential shock triggering a financial crisis has its origin beyond the behaviour of the financial system. The macro-prudential approach on the other hand, recognises that risk factors may configure endogenously i.e. as a systemic phenomenon. In line with this reasoning, macro-prudential policy addresses the inter-connectedness of individual financial institutions and markets as well as their common exposure to economic risk factors. It also focuses on the pro-cyclical behaviour of the financial system in the effort to foster its stability.

Macro and Micro Prudential Perspectives Compared

	Macro prudential	**Micro prudential**
Proximate Objectives	Limit financial system – wide distress	Limit distress of individual institutions
Ultimate Objectives	Avoid Output (GDP) Costs	Consumer (Investor/ depositor) protection
Characterisation of risk	Seen as dependent on collective behaviour (endogenous)	Seen as independent of individual agents' behaviour (exogenous)
Correlations and common exposures across institutions	Important	Irrelevant
Calibration of prudential controls	In terms of system – wide risk: top – down	In terms of risk of individual institutions: bottom-up.

In view of the above, close adherence to micro-prudential rules (which leads to common behaviour by financial firms) ultimately, result in build-up of systemic risks. A central element of on-going reforms across jurisdictions is the requirement that financial regulatory authorities adopt the macro-prudential supervisory approach, with explicit considerations to threats to the stability of financial systems as a whole. Therefore, macro-prudential regulation succinctly put, requires that policies be focused on the entire financial system; consider aggregate risk as endogenous to the behaviour of individual financial institutions; and be used to limit distress in the financial systems in order to avoid the enormous costs associated with financial instability.

The CBN had attempted to establish policies that would minimise some of the factors that contribute to macro-economic instability, particularly, limiting the build-up of financial imbalances and their effects on the economy. Also, they must identify and address the issues of common exposures, risk concentrations, linkages and interdependencies that are principal sources of contagion that may jeopardise the functioning of the financial systems.

The increased emphasis on the macro-prudential approach has been attributed to the rapid expansion of credit during economic upswings and the withdrawal of same in periods of downturns as well as the highly interconnected nature of the financial system. This underscores the new thinking that a macro-prudential policy should be focused on identifying systemically important financial institutions, on the basis of well thought out criteria, and imposing capital surcharges and stricter liquidity requirements on them.

Notable amongst the developments at the international level in this direction is the Basel III framework, which contemplates the accumulation of a countercyclical capital buffer during periods of systemic risk build-up, while it is released when the risks materialise thus, serving as a stabiliser during both the expansion and contraction phases of the financial cycle. Other provisions of the Basel III framework that help in dampening pro-cyclicality include: additional minimum leverage ratio and new liquidity standards that help to check the build-up of financial imbalances during the expansion phase of the financial cycle. Other areas in this respect is the adoption of a framework for systemically important financial institutions (SIFIs) and the adoption of expected loss provisioning regimes, an idea that is being championed by the International Accounting Standards Board (IASB). The Basel Committee on Banking Supervision (BCBS) is also collaborating with IASB to issue guidance that will include principles for supervisory review processes to reinforce robust provisioning practices in ways that would mitigate pro-cyclicality.

VI. Experience with Regulated/Supervised Financial Institutions in Nigeria

VI.1 General Issues

VI.1.1 Poor Risk Management Practices by Banks

The dearth of robust and effective risk management framework and practices had been a common denominator for most banks in Nigeria, with subsidiaries of foreign banks the only exception. Both off-site and on-site examination procedures and reports had often indicated the inadequacy of the risk management framework in FIs and dearth of human capacity in the area of credit appraisal and administration, market, liquidity, operational and regulatory risks.

VI.1.2 Poor or Weak Corporate Governance

Poor corporate governance has been a regular feature in most FIs off-site and on-site supervisory reports as well as that of special examinations and investigations carried out over the past decade. Poor governance, which could be as a result of board failure to exercise its oversight function or collusion by board members and principal shareholders, which have become manifest as insider non-performing loans and diversion of FI's assets.

VI.1.3 Data Integrity

A major challenge that confronts FI supervisors is the rendition of false, inaccurate and/or leading returns by FIs, which makes the outcome of surveillance unreliable for the purposes of decision making. False or inaccurate returns often defeats the purposes for which they were collated and could delay early detection of unsoundness and the initiation of appropriate remedial actions.

VI.1.4 Late rendition and late review of banks returns

Late rendition and analysis of returns were also part of the regular experiences with the regulated institutions. As a consequence the regulatory authorities were often precluded from taking timely and proactive decisions on affected FIs, which could endanger the financial system.

VI.1.5 Negative perception and attitude towards supervision

Perhaps, due to lack of appreciation of the purpose of supervision, there was general apathy towards implementation of supervisory advice and guidelines. Often, the Management of FIs adopt defensive posture towards examiners failing to engage supervisors on the merits and demerits of such recommendations. Hence, the FIs failed to conscientiously develop internal policies and procedures to address regulatory concerns.

VI.1.6 Low level of collaboration among regulators in the financial system

At the domestic level, despite the creation of FSRCC in 1994, there had been very limited interaction by way of information sharing and collaboration in on-site and off-site examinations between the CBN and securities, insurance and pension regulators. The gap resulted in regulatory/supervisory arbitrage which the operators exploited to the detriment of financial system stability. On the international scene, the situation was not different, until in 2010 with the creation of the College of Supervisors of the West African Monetary Zone to promote collaboration in bank supervision in the zone. Also, a number of MoUs have been entered into with the WAMZ member states and other countries including the China Banking Regulatory Commission on supervisory cooperation, information sharing and crisis management.

VI.1.7 Skill gap on the part of operators and regulators

Skill gaps in the financial services industry had been endemic and particularly worrisome in the banking sector resulting in constant poaching of staff among FIs. Poaching had two negative outcomes (i) promoting people above their technical and managerial capacities; and (ii) unhealthy compensation practices exacerbating put bank management's financial pressure. At the regulator side, considerable skill gaps in terms of information technology and product innovation had been noted as they often trail behind the operators.

Closely related to the skill gap, was the reluctance of banks and other financial institutions to invest in capacity building for their workforce. Due to the incessant movement of staff from one institution to another, most FIs preferred to poach from the limited pool of skilled manpower within the industry and sometimes resort to recruiting from abroad.

VI.1.8 Low examiners morale/fear of uncertainty

Partly, due to the low remuneration structure of the regulatory authorities compared to the regulated FIs, especially DMBs, the morale of bank examiners reached an alarming low in the 1990s and 2000s. The situation led to some incidences where bank supervisors were found to have compromised in the discharge of their duties. On the other hand, fear and uncertainty on the part of staff of FIs arising from unrealistic deposit targets, intimidation and long work hours set by Management adversely affected their psyche, emotional stability and commitment to the institutions. These factors impacted negatively on the effectiveness of supervision during these periods.

VI.1.9 Slow and/or inappropriate regulatory response

Slow response to examination findings and sometimes unintended outcomes of regulatory actions were observed in the past as regulatory bodies attempt to balance between regulatory imperatives and economic and political realities. For instance, while handing over undercapitalized banks to NDIC for possible turnaround might seem expedient and supported by extant laws, the reality is that taking such actions will trigger a run on the bank and could create undue panic in the banking system.

VI.1.10 Managing Unrealistic High Stakeholders Expectations

One of the critical factors that shaped the risk behaviour of FIs in Nigeria during the past two decades have been heightened stakeholders expectaions. The shareholders, board and management as well as staff raised their expectations of FIs in terms of returns on investments, bonuses and emoluments, while government and society demanded for higher tax returns and better corporate social responsibility. This had implications for supervision as the banks and OFIs engage in high risk behavior and unethical practices to enhance their financial performance in order to sastisfy various stakeholders' expectation.

VI.1.11 Basel 2 Accord implementation

A major challenge encountered in the supervision of FIs was the absence of data on risk ratings of credit obligors and inadequate data on operational risks for the implementation of BASEL II.

VI.1.12 Asset Quality

Deteriorating asset quality was a permanent characteristic of FIs in Nigeria. This was not unconnected with weak credit policies and practices, insider abuses and unstable macroeconomic environment. Non-performing loans (NPLs) reached alarming levels in the late 1990s, sometimes in excess of 50 per cent of gross credits. This, led to the collapse of more than 30 banks in 1998 and several community banks and primary mortgage institutions and finance companies. Recently, in 2009, the NPL ratio of 10 banks, including the intervened banks averaged 54.2 per cent.

VI.1.13 Frauds and Forgeries

Frauds and forgeries constituted a major threat to banking regulation and supervision in Nigeria, especially from the early 1990s when the menace of advance fee fraud pervaded the financial system. The CBN requires banks and OFIs to put in place adequate internal control, including proper recruitment policies and practices to ensure that only fit and proper individuals are employed. In addition, FIs submit monthly/quarterly reports on frauds and forgeries to the CBN and NDIC for monitoring purposes. The experience in this regard is that banks often tended to conceal some frauds in order not to expose themselves to reputational risk, thus making the information of limited value for regulatory decision making. In spite of these measures, the number and value of reported frauds and forgeries in FIs had trended upwards.

VI.2 The 2009 Special Examination of Banks

Prior to the CBN-NDIC special joint examination of deposit money banks (DMBs), the CBN had adopted various palliative measures to minimise the pressure on DMBs arising from the global financial crisis and these included the reduction of the monetary policy rate (MPR) from 10.25 per cent to 9.75 per cent and later to 6.0 per cent in July 2009, reduction in Cash Reserve Requirement (CRR) from 4.0 per cent to 1.0 per cent, and reduction in Liquidity Ratio from 40.0 per cent to 30.0 per cent and later to 25.0 per cent. These measures did not, however, fully resolve the problems as there doubts as to the strength and resilience of the financial system. The situation was ascribed to several interdependent factors, key among which were macro-economic instability caused by large and sudden capital inflows, failures in corporate governance, lack of investor and consumer sophistication, inadequate disclosure and transparency, gaps in the regulatory framework and regulations, uneven supervision and enforcement, unstructured governance and weaknesses within the CBN as well as weaknesses in the business environment.

In recognition of the urgent need to restore public confidence in, and accord credibility to, the financial system, the CBN embarked on a special examination of the 24 DMBs which revealed substantial non-performing loans, poor corporate governance, capital inadequacy and illiquidity in some banks. It was against this background that the CBN moved decisively to strengthen and safeguard the integrity of the industry as well as restore financial stability. The actions taken by the CBN included:

- The replacement of the chief executives/executive directors of the banks identified as the source of instability in the industry,
- Injection of the sum of N620.0 billion ($4.13 billion) into the banks, and guaranteeing all foreign credits and correspondent banking commitments of some of the affected banks, in an effort to prevent a systemic crisis.

VII. Recent Efforts at Ensuring Effective FI Regulation and Supervision Some of the recent efforts aimed at effective FI regulation and supervision are highlighted below:

The establishment, on March 1, 2010, of a Financial Policy and Regulation Department, provides a policy research base for its financial stability function. The new Department articulates broad regulatory and supervisory policies as well as reviews, on a continuous basis, the existing policies in order to enhance the effectiveness of its regulatory and supervisory roles. The macro-prudential unit within the FPRD is the policy research and data analysis center for the co-ordination of the Bank's financial stability mandate. Other objectives of the unit include: (i) limiting distress in the entire financial system rather than distress in individual institutions; (ii) identifying the risks faced by the banking system collectively, rather than those faced by individual banks; and (iii) examination risks that may arise from contagion as a result of interaction of banks with other parts of the financial system rather than on a bank-by-bank basis.

In 2012, the CBN created a Consumer Protection Department to handle complaints from customers of banks and other FIs and serve as an anchor for a national financial literacy programme to educate and empower consumers of financial services.

TChampioned the establishment of the College of Supervisors of the West African Monetary Zone (WAMZ) made up of Nigeria, Ghana, The Gambia, Liberia, Sierra Leone and Guinea in 2010, to collaborate and share information on banks with cross border presence in the zone. Also, it signed MOUs with other jurisdictions where Nigerian banks were present or which have their banks' subsidiaries in Nigeria to strengthen cross border consolidated supervision.

Under the auspices of FSRCC, the CBN has been collaborating with the Securities and Exchange Commission (SEC), the Nigerian Stock Exchange (NSE), Nigeria Deposit Insurance Corporation and National Insurance Commission on inter-agency cooperation on the implementation of Consolidated Supervision for the banking sector. The FSRCC has assisted in the evaluation of banking groups as a whole, through stress-testing and other methods. Once risks which the operations of each of the component entities in portend to the group one identified, the relevant stakeholders are alerted to take proactive remedial actions before such risks crystallize. In collaboration with the Federal Ministry of Finance, an Asset Management Corporation of Nigeria (AMCON) was established. The AMCON Act 2010, which was signed into law on July 19, 2010, served as a veritable vehicle to free the banks from the weight of their non-performing assets. The Corporation played a key role in the recapitalisation of the rescued banks and the post-2010 special examination acceleration of the process of financial revitalisation of the banking sector where over N737billion and N1.4 trillion was injected as equity and financial accommodation into the three bridge banks and five merged/acquired banks, respectively. As at the end of September 2012, AMCON had acquired over N3.5 trillion eligible bank assets (EBAs) for a consideration of N2.2 billion.

The CBN approved a new banking model in 2010 with the following features and requirements:

- ✓ Classification of banks into Commercial, Merchant and Specialised categories;
- ✓ Classification of their operations into International, National and Regional;
- ✓ Banks' divestment from non-bank subsidiaries or transfer of such subsidiaries to Holding Companies by May 2012; and
- ✓ Banks with real estate subsidiaries to divest from such subsidiaries by June 2013.
- ✓ Part of the new banking model is the review of the licensing requirements for all categories of institutions under the regulatory and supervisory purview of the CBN. One of the objectives of the review was to ensure that banks maintain adequate capital relative to the scope and the level of risks in their operations.

The CBN has strengthened the implementation of the Code of Corporate Governance released in 2006 in various ways. The enforcement of the tenure limit for non-executive directors and external auditors of banks and the requirement for a performance appraisal of the board are cases in point. Also, tenure limit of a maximum of 10 years was prescribed for the MD/CEOs of banks, while former governors/deputy governors of the CBN and the MD/CEO and executive directors of NDIC were barred from taking up appointments in regulated institutions until after five years of their exit from office. A three years ban was imposed on ex- departmental directors of the CBN and NDIC. To further address the challenges of weak corporate governance, a new Approved Persons Regime for financial institutions in Nigeria was issued. The policy ensures that only credible persons of impeccable financial, personal and professional characters are allowed as major shareholders, directors and managers of banks.

In consultation with the Institute of Directors of Nigeria (IoD) and the Financial Institutions Training Centre (FITC), efforts have been intensified at educating directors of financial institutions in various areas to enhance their abilities to discharge their responsibilities as directors.

The Prudential Guidelines remains one of the supervisors' potent tools in credit review. However, that tool was considered non-supportive of the current supervisory framework in Nigeria, on account of its obsolescence. The CBN has consequently reviewed the Guidelines in May 2010 to take cognisance of the cash flow features of various sectors of the economy. Banks are expected to make dynamic provisions for loan losses, based on counter-cyclicality of performance as against the former guideline in which provisions were pro-cyclical.

The CBN has achieved compliance with most of the BASEL Core Principles and had also commenced the transition to BASEL II with the appointment of a Project consultant in 2011. Also, the IFRS was to be adopted in December 2012.

DMBs had been directed to adopt December 31 as a common accounting year- end and this has eliminated unhealthy accounting practices among banks, which tended to boost their financial performance at their different individual year-ends. To this end, banks as a requirement publish disclosure statements over and above that of other non-bank companies for the following reasons:

- ✓ To provide adequate information for the users of banks financial statements and reports, particularly high net-worth individual and corporate depositors and investors to assess and make informed decisions and judgments on the financial and operating conditions of the banks.
- ✓ Enable stakeholders to evaluate the risk management practices, the degree of board and management appetite for risk taking, adequacy of board oversight and understanding of the significant activities of the banks.

The CBN have been collaborating with the Nigerian Financial Reporting Council, international consultants and the World Bank on the implementation of the International Financial Reporting Standards for Nigerian banks by December 2012. This was consistent with the global best practice and growing agitation from informed stakeholders of banks, particularly international investors and financial analysts.

VIII. Resolution Mechanism for Distressed Financial Institutions

The provision of safety-net for FIs depositors became imperative to protect small, unsophisticated depositors and engender continued confidence in the financial system, following the liberalisation of banking and other financial institutions licensing requirements. It was anticipated that with the withdrawal of government explicit support for FIs following the emergence of private sector banks, there was need to provide explicit deposit insurance protection for banks depositors. The Nigeria Deposit Insurance Corporation (NDIC) was established in 1989 and provided limited coverage to only DMBs depositors until 2006 when it was extended to microfinance banks and primary mortgage banks. In addition, the NDIC had jurisdiction for distress resolution.

In 1998, the NDIC liquidated 33 commercial and merchant (DMBs), following the resolution of their operating licences by the CBN. Depositors were paid the prevailing maximum insured deposit of N50,000, while the net incomes generated from the assets of banks in liquidation were subsequently shared in respect of uninsured balances on pro-rata basis.

Though distress resolution options could be aggregated under a broad spectrum, their application would usually be driven by the financial condition and peculiarity of each institution and the banking system. The focus of a good resolution option would be to maintain public confidence and stability in the banking system; ensure fairness, equity, transparency and accountability; instil market discipline while discouraging moral hazards; achieve minimum disruption of banking services (both in the problem bank and the system at large); and be cost-effective.

In addition, the resolution threshold adopted should minimise the likelihood of having to 'bail out' uninsured depositors and creditors. This is because such bail-outs tend to undermine market discipline and encourage undesirable risk-taking. It is therefore, important to balance the conflicts inherent in these factors in order to adopt the most optimal strategy in the particular circumstance. For example, the desire to consider the least costly method might be outweighed by the need to maintain public confidence in the banking system. Another cardinal issue in restructuring an insolvent bank, by a government agency, is for the erstwhile shareholders to lose their investments, and managers to lose their jobs. This is to prevent a situation whereby you throw good money after bad money or allow monkey to watch over bananas, especially where the resolution strategy is aimed at rehabilitating the distressed bank. Some of the resolution strategies are highlighted below.

1. Pay-Off

This involves the payment of insured deposit up to the insurable limit to the depositors of the liquidated deposit money bank and other insured deposit taking institutions. The insurance limit is currently set at N500, 000 for DMBs, up from N50,000 in 2005. Microfinance and primary mortgage banks were brought under the deposit insurance coverage from 2006 with a ceiling of N200,000. The depositors of 103 MFBs liquidated in 2010 benefited from the insurance premium.

2. Insured Deposit Transfer

This involves the transfer of insured deposit of the failed bank to another bank or other banks, preferably within the same locality. The acquiring bank(s) will be given enough cash and/or riskless assets to cover the insured deposits transferred from the failed bank. Like in the pay-off, only insured deposits are fully covered and therefore, it is generally viewed as a variation of the pay-off option. The acquiring bank(s) may also purchase some or all the bad assets of the failed bank.

3. Bridge Bank

Under this option, the assets and liabilities of the failed bank are assumed by a new bank specifically set up for that purpose. The bridge bank would be operated for about two (2) years after which it would be sold to fresh investors. The shareholders of the failed bank would be given little or no monetary consideration since they would have lost their investments in the failed bank. The major advantage of this option is that it would permit continuity of banking services to all customers and fully protect all the depositors and creditors of the failed bank. This method was applied in August 2011 to resolve the distressed Afribank Nigeria Plc, Bank PHB Plc and Spring Bank Plc which metamorphosed into Mainstreet Bank Ltd, keystone Bank Ltd and Enterprise Bank Ltd following the revocation of the former's operating licences and takeover by the NDIC on August 5, 2012.

4. Purchase and Assumption (P&A)

This is akin to an acquisition by which a healthy institution offers to purchase the assets and assume the liabilities of a distressed bank. A failed bank could be split to make it attractive to banks that wish to enhance market penetration or establish new branches where the failed bank had branches. This option was used in the resolution of 11 of the 14 banks that failed in 2006 following their inability to meet the minimum regulatory capital of N25 billion for DMBs. The NDIC had not been able to obtain Final Court Order to wind-up two of the defunct banks (Fortune and Triumph), while one had its licence restored and would soon recommence banking operations as a commercial bank with regional authorization. It would be noted, however, that the CBN funded over 98 per cent of the entire costs of P & A transactions because of the peculiar circumstances under which the licenses of the failed banks were revoked.

A major advantage of P&A is that it ensure that all depositors are protected, thereby, giving added credibility to the deposit insurance scheme. Also, it ensures continuity in rendering banking services, thereby, engendering confidence in the banking system. The P & A arrangement has proven to be the most efficient and least cost resolution strategy for failed banks in Nigerian history.

5. Open Bank Assistance

Allowing a failed bank to continue to operate in the same name as a going concern is called open bank assistance. It could involve change in ownership and management of the bank, injection of fresh funds in the form of equity and/or loan capital; and re-organisation and overhauling of the bank including rationalisation of staff and branches. This option was adopted in resolving the legacy Bank of the North (now Unity Bank Plc).

The Regulatory Authorities in Nigeria have had to employ a combination of strategies available under this option to resolve many distressed banks in Nigeria, especially where pay-off option appeared to threaten the erosion of public confidence in the banking system.

IX. Recommendations on the Way Forward

To sustain and consolidate on the achievements recorded so far at ensuring financial stability by building sound, safe and resilient financial institutions and markets, the future regulatory and supervisory architecture should be centered on the following:

1. Establishment of Financial Stability Board (with or without legal responsibility) to monitor macroeconomic developments and manage systematic risks to financial stability. Its specific functions will include:

   Identification of systematic risks as the basis of monitoring and data collection process;

   Development of a common set of quantitative and qualitative indicators (Risk dashboard);

   Prioritisation of risks on the basis of an impact assessment and probability

analysis;
Issuance of risk warnings and proffer appropriate policy response or recommendation (for remedial measures of general or specific). Public disclosure may be decided on a case by case basis; and
Monitor the follow up to its recommendations and undertake stress testing.

The CBN should provide the leading role as the chair, while the governance structure should consist of the Board, Steering Committee, Secretariat and Advisory Technical Committee. Membership should include the CBN Governor, 2 Deputy Governors (DGs) (FSS & EP), NDIC, SEC, NAICOM, PENCOM, National Bureau of Statistics (NBS) and Ministry of Finance (MOF).

2. It is also essential to emphasize the critical role of liquidity in the attainment of financial stability as financial crisis is also often triggered by liquidity problems in the money market. Thus, it is necessary to identify sources of liquidity pressure in the markets, and which firms are under stress, to identify and respond proactively and effectively to liquidity problems;

3. Continue to evolve and deploy more robust and risk-sensitive supervisory framework in line with global best practice to proactively supervise the banks and their non-bank subsidiaries to nip-in-the-bud potential crisis;
4. Full and effective implementation of BASEL II and III, including liquidity management tools;

5. Creation of a Financial Soundness Technical Committee with membership from Banking Supervision Department, Financial Policy and Regulation Department, Monetary Policy Department, Research Department, Risk Management Department, Other Financial Institutions Department and Statistics with clearly defined mandate;

6. Ensure that compensation structure for the staff and management of regulatory institutions are at least at par with those of their peers in the regulated and/or supervised institutions;

7. Insist on continuous and compulsory capacity building for the regulators and operators at all levels, including the engagement and training of specialists in key supervisory areas;

8. Muster the political will to implement the prompt corrective action framework;

9. Split OFISD into two departments with one in charge of Microfinance Bank Supervision, while the other would supervise the other financial institutions. This would enable the CBN to focus more effort on MFBs, which have over time witnessed higher distress rate compared to others; and

10. Develop a broad-performance based compensation and incentive schemes for staff and executive management of FIs that will accord higher reward to long-term rather short-term performance measures. To this end, executive compensation could be structured in a manner that performance based bonuses will be in shares rather than cash payments. In addition, such shares should not be eligible for transfer/sale either privately or through Stock Exchange until a minimum of five years so that executives who take undue risks with the aim of reaping immediate benefits are put in check.

X. Conclusion

The CBN had been the lead in FI regulation and supervision in Nigeria over the past five decades with the overall goal of promoting financial stability and economic growth. The effective discharge of the regulatory and supervisory responsibilities had been hampered by both internal and external factors. The performance of the regulatory authorities had been a mixed-one, with periods of financial stability and rapid growth in FIs being interrupted by periods of financial crisis and collapse of several FIs and regulatory interventions.

Nevertheless, in spite of the aforementioned negative experiences, the CBN and the other regulatory agencies in the financial sector had recently undertaken significant initiatives and efforts aimed at further strengthening supervision, including the introduction of risk-based consolidated supervision, a robust corporate governance framework and macro-prudential regulation of FIs.

References

Abolo, M. E., (2012). "Financial Sectors Stability and Macro- prudential regulation in Nigeria", published by Business Day August.

Borio, C. (2003)." Towards a macro-prudential framework for financial supervision and regulation", *BIS working papers* No. 128 February.

Clement, P. (2010). "The term Macro-prudential Origins and Evolution", BIS Quarterly Review, March.

Lim, C., F. Columba, A. Costa, P. Kongsamut, A. Otani, M. Saiyid, T. Wezel, and X. Wu, (2011). "Macro-prudential Policy: What Instruments and How to use them", *IMF working paper* WP/ 11/238, October.

Miyoshi, T. (2009). "Enhancing sound Regulation and Strengthening Transparency – A case for Macro –Prudential Supervision, paper presented at the 10th IMF Seminar on Monetary and Financial Law, December 2009.

Oni, S. A., (2012). "Banking Sector Reforms-The Journey So Far", Paper presented at a seminar on the theme: *"Towards the Actualization of CBN Banking Reforms"* June.

Sanusi, S. L. (2010). "Nigeria's Banking Sector Reforms: challenges and Prospects", Paper delivered at the National Defence College, Abuja, "Macro-prudential measures and challenges for central banks". Published in SUNS No. 6929 May 25, 2010.