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## The implementation of Basie II: issues, challenges and implications for Nigeria.

O. K. Ibedu  
*Central Bank of Nigeria*

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# The Implementation of Basle II: Issues, Challenges and Implications for Nigeria

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*O. K. Ibedu\**

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## I. Introduction

The significant development of Basle II throughout the world has meant that financial institutions and insurance companies must manage and measure risk in new ways. This paper is intended to provide the participants at the Executive Seminar with a firm foundation of the state of Basle II Accord principles and provide the tools and techniques to grapple with its implementation.

This paper is divided into eight parts. Following this introduction, Part 2 discusses the necessity for a capital accord, the emergence of Basle I and the Basle II Accord. Part 3 discusses in brief the concept of Risk Management and the integrated risk management structure. Part 4 discusses the intention of the new accord, its pillars and the entire structure. Basle II implementation and the necessary condition for implementing the Accord and the scope of implementation are discussed in part 5 and 6, respectively, while part 7 dwells on the obstacles to a successful implementation and other challenges. Part 8 concludes the paper.

## II. Why an Accord?

Some thirty years ago, the banking world was very different as most organisations borrowed money from banks. The borrowed funds were recorded on-balance sheets and

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*\*Mr. O. K. Ibedu is a Deputy Director in the Banking Supervision Department of the Central Bank of Nigeria. The views expressed in the paper are entirely those of the author and should not in any way be ascribed to the CBN or its management.*

typically priced at a spread over funds - hence market risk-free. That era was characterised by the following: credit risk was the main component of risk controlled on a case-by-case basis by limiting the principal amount. Operational risks were only considered a part of business while liquidity was the main regulatory constraint requiring banks to hold a fraction of their assets in liquid form. Moreover, the level of equity capital was not a constraint as banks could lower their capital as much as they liked.

In today's world, however, organisations are increasingly using capital markets to raise money directly but are looking up to banks to provide risk management solutions. In addition, banking has become much more competitive and dynamic as some banking institutions structurally changed and became experts, not only in capital intermediation but also in risk intermediation. Furthermore, the banking world has recorded massive risks in off-balance sheet activities through derivatives and has also taken huge market risks to enhance profits.

In the early 1980's, with the rise of totally unregulated derivatives market, the regulators realised that they had lost control. In 1985, the Bank of England and the Federal Reserve Bank of New York published a paper which recommended the introduction of new banking regulations. This formed the foundation for the first Basle Accord in 1988. Before the First Accord, there was no international consistency of regulation. Individual risk profiles were ignored while risk was considered on size or business. Only balance sheet (BS) activities were regulated, typically liquidity, despite the rapid growth in off-balance sheet items.

### **Objectives of the First Accord**

The intention of the first Accord was to increase the capital ratios which were perceived to be too low. It was also intended to harmonise capital requirements across G-10 countries, although many other countries complied. It was also meant to include both on- and off-balance sheet activities. Off-balance sheet activities then were growing out of

proportion and could not be accounted for because of the emergence of derivatives products. The first accord initially considered only credit risk as that was deemed to be a larger and more important source of risk. Market risk amendment was subsequently introduced in 1996 to cover trading exposures only. The accord was deemed to be broadly successful as bank's capital was significantly raised across the globe.

In mid-1990's, there were increasing complaints about the Accord which included that credit model was a black box and was not permitting internal models, Credit model was very risk insensitive, for instance 0.0 per cent risk weighting was allocated for Organisation for Economic Cooperation and Development (OECD) government, 20.0 per cent weighting for all OECD banks, 100.0 per cent for all corporate. Further complaints were that risk mitigation was extremely primitive and limited and that the precise role of the capital charge was unclear as banks that had developed a probabilistic concept of Economic Capital (EC) in contrast to the Regulatory Capital (RC) charge laid down by the Accord found out that in many instances RC was (a lot) higher than EC. This led to regulatory "arbitrage" such as:

- Securitisation → removal of credit risk → freeing up RC
- Inter-bank activity → due to the mismatch in the RC
- Taking on market risk.

Note that this was unregulated during early 1990s.

G30 (group of 30) global investment banks made 20 recommendations for good practice for derivative dealing and end-users in their report issued in 1994 titled "Industry Guidelines for Good Operations Practice". The Group made 20 recommendations for good practice for derivative dealing and end-users. In particular it required defined risk management covering senior management responsibilities, scope and authorisation of trading, systems and controls, product valuation and adequate disclosure. The recommendations became good standard practice in all major institutions and formed the basis for a new accord.

In June 1999, it was decided to replace the Accord with the objectives of maintaining at least the current level of capital in the system, enhancing competitive equality, containing probabilistic approaches to capital adequacy that is appropriately sensitive to the degree of risk involved in a bank's position and activity, emphasising the responsibility of directors and senior management and focusing on internationally active banks. The final version of the Accord was published on 26th June, 2004. This was revised substantially in November 2005 and, it is likely to evolve further.

### **III. Overview of Risk Management**

Traditionally, risk management was perceived as a control centre placing constraints on revenue generation but reacting after the event, a reporting centre with no operational responsibilities organised by region or legal entity and staffed by relatively low-skilled people. The modern view of risk management shows that there is a link between return, risk and capital. A transaction exposes a bank to risk. It requires capital to cover this risk and must ensure an adequate return on this capital. Otherwise, the value is ultimately destroyed. Risk management is evolving from the reactive reporting of risk to the proactive pricing of risk.

#### **Integrated Risk management**

Banks like all businesses have to take risks to make money. Therefore, risk taking is an essential part of business. If return is a reward for risk taking, every level should consider the trade-off between risk and return in all transactions

Portfolio Management → Active Risk Return

For risk management to work in a strategic fashion, it has to be perceived to be adding value, by providing inputs into the major decision making within the bank pricing, performance measurement, compensation.

Risk Adjusted Return on Capital (RAROC) → Use of economic capital

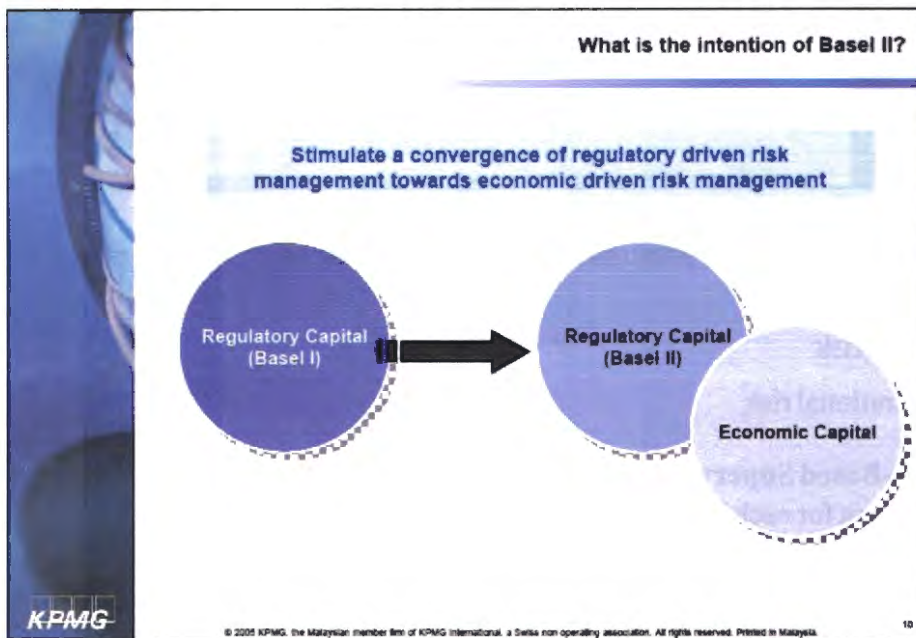
Risk analysis → VaR, Stress Tests, Scenarios

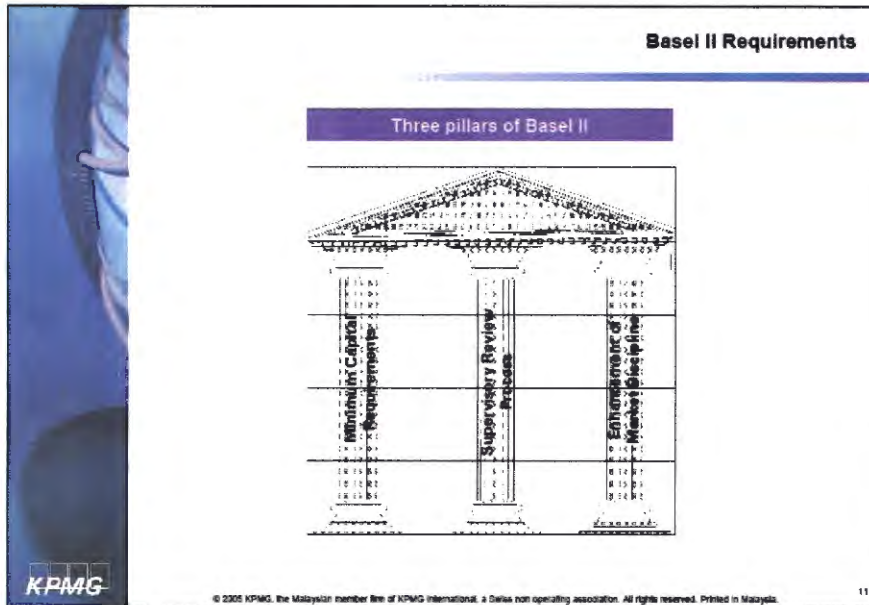
Control Management → Identify, monitor, avoid.

Pricing of the transactions must include adequate risk premium so that correct pricing becomes a strategic weapon. Risk management must be proactive, driven by the centre to ensure consistency and staffed by skilled people who see this as a career.

#### IV. Intention of Basel II

The New Accord is risk sensitive ensuring that capital matches the risks, applies across all activities of the bank and across all risks categories and has a clear understanding about the role of capital.





### Structure of the New Accord

#### **Pillar 1: Capital Structure - Minimum Capital Requirement**

- Market risk
- Credit risk
- Operational risk

#### **Pillar 2: Risk-Based Supervision - Supervisory Review Process**

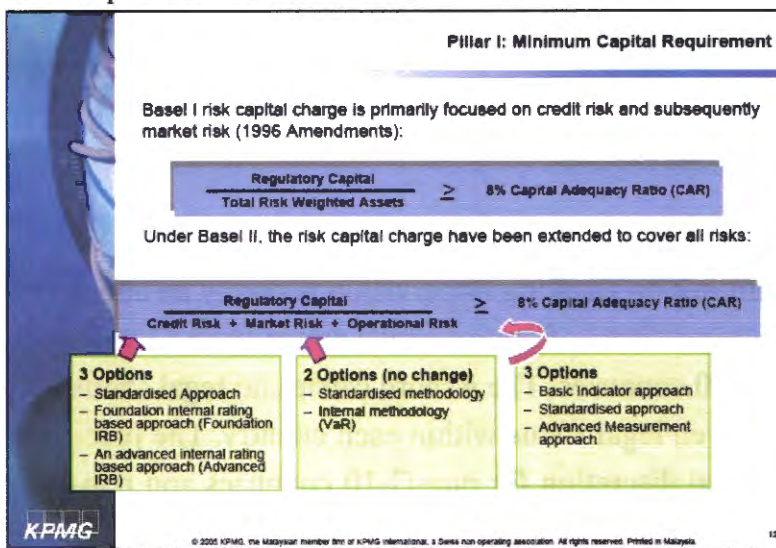
- Different for each Bank.
- Review process.
- IRR in the banking book

#### **Pillar 3: Market Disclosure - Enhancement of market discipline.**

- Impose market discipline
- Capital
- Levels of risk

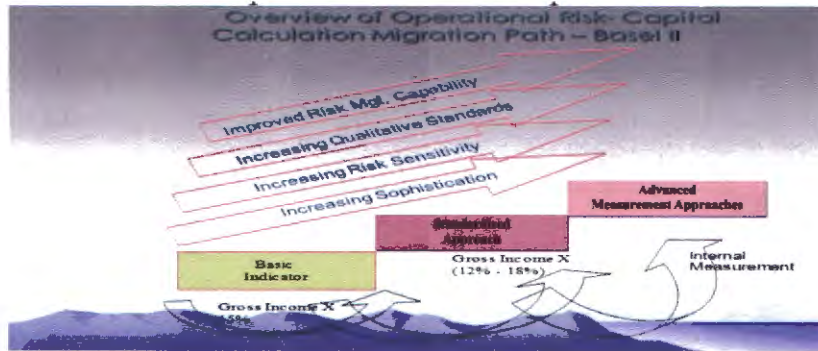
**Important**

The pillars are mutually reinforcing. Regulators cannot rely just on pillar 1 to control banks but must also fully implement Pillars 2 and 3. This may cause the supervisors difficulties due to required skills.



Basic Indicator Approach	Standardized Approach	Advanced Measurement Approaches (AMA)
<ul style="list-style-type: none"> <li>✓ Intended for banks having relatively less significant exposure to operational risk</li> <li>✓ Calculated at firm level</li> <li>✓ Capital against risk = specified % of the bank's average annual gross income over the preceding 3 years</li> <li>✓ Risk mitigation effect of insurance not allowed</li> </ul>	<ul style="list-style-type: none"> <li>➤ Intended for banks having relatively less significant exposure to operational risk</li> <li>➤ Calculated for each of the 8 designated business lines</li> <li>➤ Capital against risk = specified % of the bank's average annual gross income over the preceding 3 years</li> <li>➤ Risk mitigation effect of insurance not allowed</li> <li>➤ Intended as entry point for internationally active banks.</li> </ul>	<ul style="list-style-type: none"> <li>➤ Intended for internationally active banks having significant exposure to operational risk</li> <li>❖ Total assets &gt; \$10billion</li> <li>❖ Total foreign exposure &gt; \$10 billion</li> <li>➤ Rigorous quantitative methodology</li> <li>➤ The methodology developed by the bank must be pre-approved by the regulators.</li> </ul>





## V. Implementation of the Accord

The Basel Committee on Banking Supervision is purely an advisory committee. Its members are supervisors of central banks drawn from 13 countries originally established by G-10 countries. The Accord carries no legal status; therefore, the Accord is to be given legal status within each country. The precise detail of the Accord is a national discretion for non-G-10 countries and non-internationally active banks in G-10 countries.

### Pillar 2: Supervisory Review

The key premise of pillar II is that supervisors should ensure that banks hold adequate capital. Pillar II emphasises four basic principles:

- Banks must develop their own internal processes, based on evolving best practice.
  - Supervisors must conduct regular review to ensure adequate capital.
  - If review fails, supervisors should increase capital charge. This may require additional legal powers to be able to do this; that is in jurisdictions where such statutes are non-existent.
  - Supervisors should demand early remedial action to ensure adequate capital.

Pillar II is to some degree in conflict with Pillar I as Pillar I is based on formulaic prescription, while Pillar II is based on principles. Pillar II is intended to

encourage development and use of better risk management (in contrast to measurement) practices. Risk-based supervision places considerable responsibility on supervisors but the accord is becoming de-facto standard globally. Supervisors should, therefore, brace-up to the challenges, otherwise the broad lack of supervisory skills are likely to push onus back unto Pillar I.

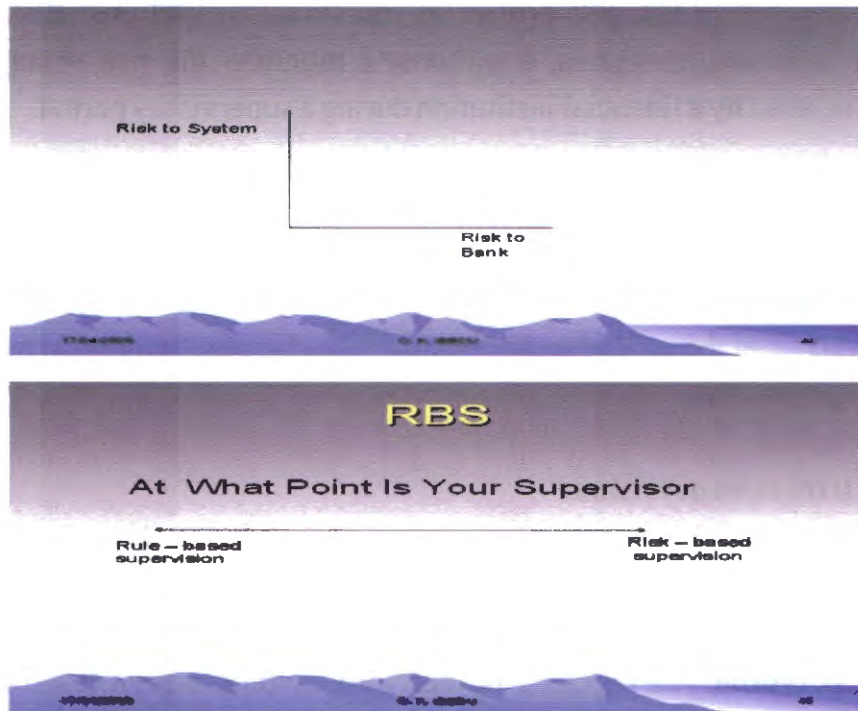
### **Risk Based Supervision**

Risk based supervision is the key to Pillar II.

#### **Which Risk?**

Risk to System is the risk to the entire banking system.

Risk to Bank is the risk to an individual bank.



Risk-based supervision (RBS) is an object-based supervisory approach concerned with translating economic and other information into potential risk factor for a bank. It focuses on the quality of risk management systems and the recognition of systematic risks to the banking system. RBS is a framework with which banks are assessed regarding the probability and impact of risk as opposed to the intuitive assessment by the traditional approach. In contrast to the traditional form of supervision which is biased in favour of risk avoidance. Risk-based supervision treats risk mitigating and offsetting as valid approaches to risk management.

A risk-focused supervision process provides flexible and responsive supervision to foster consistency, coordination and communication among supervisors. It relies on the risk assessment as well as the development of a supervisory plan and procedures tailored to the risk profile of individual institutions. Risk based supervision identifies, measures, controls and monitors the risk management process put in place by a financial institution during a supervisory period.

### **Objectives of RBS**

The main objective of RBS is to sharpen supervision focus on: the activities or institutions that pose the greatest risk to banks and financial institutions or the financial system and the assessment of management process to identify, measure, monitor and control risks.

### **Benefits of RBS to Supervision**

The main benefit of this approach to supervision includes: The allocation of supervisory resources according to perceived risk that is, focussing resources on the banks highest risk or devoting more supervisory efforts to those banks that have high-risk profile. The regulator is, therefore, enabled to prioritise the use of available resources. The supervisor is better placed to decide on the intensity of future supervision and the amount of supervisory actions in accordance with the

perceived risk profile of the bank. Supervisory attention will also focus on banks whose failure could precipitate systematic crises.

### **Unresolved Pillar 2 Issues**

#### **Home Vs host government is the most pressing**

Where there is a difference in implementation between home and host supervision especially in some advanced methods of operational risk, some international banks would like approval in one jurisdiction accepted (with minimum review) in another as total regulatory capital is likely to be less than the sum across jurisdictions. Some methods of apportionment have been suggested but as capital is not freely transferable apportionment need to be conservative.

#### **Materiality thresholds should be consistent.**

There was a regulatory disagreement on Interest Rate Risk (IRR) arising from banking (Non-Trading) book, which was not marked-to-market and allocated a capital charge under Pillar I, but included under Pillar II. Bank for International Settlement consultative forum have addressed this in its review of Market Risk framework due to go live November 2008.

#### **Preconditions before Implementing the Accord**

Jurisdictions implementing Basle II should have a well-developed infrastructure including enforceable contract law, enforceable and reliable accounting standards and independent audit, efficient and independent judiciary, secure and efficient mechanism for the settlement of financial transactions. They should also have well defined rules governing the operations of the financial markets such as strong corporate governance rules, adequate flows of information to market participants that are accurate, meaningful, transparent and timely, appropriate financial incentives to reward well-managed institutions, investors are not insulated from the consequences of their decisions, no hidden guarantees especially by government, and need to balance systemic protection and business risk taking.

Risk-based Supervision lies at the heart of the new Accord. There are three basic concepts to be noted:

- Assessment of the risk of each institution to the overall system.
- Principle-based supervisory process instead of rule-based. This allows firms the incentive to manage themselves better and in return, suffer less supervisory intervention.
- Most of the supervisory resources should be devoted to those institutions that represent the greatest risk, recognising a supervisor has scarce resources.

### **The Main Accord - Specific Issues**

Irrespective of the regulatory capital regime, supervisors have a core mandate of strengthening the safety and soundness of the banking system and the protection of the depositor. They will have a number of competing priorities which will require legal backing to fortify the supervisory infrastructure. The following questions are relevant in this respect. First, does the supervisory authority have the legal authority required under the Accord? Many countries, including EU, have had to introduce new laws to strengthen their regulatory framework before implementation of the Accord. Second, does the supervisor possess current resources/skills? Third, do the supervisory skills require enhancement and over what framework? Fourth, what is the current disclosure regime particularly to Pillar III?, and what is the status of accounting and, in particular, provisioning, especially in the context of International Financial Reporting Standard?

### **VI. The Scope of Implementation**

Countries implementing the Accord need to make important decisions regarding:

1. Which banks are to be subject to the Accord in terms of?
  - Size
  - Complexity

- International presence
- Risk profile

## 2. Which methods will be permitted?

Most developing countries are adopting IRB (Internal Risk Based approach) for credit risk and Standardised approach for Operational Risk. There are a wide range of national discretions but this need to be set in the local context.

## 3. What is the implementation timetable?

Select a single date for implementation of the simple method as this may make the supervision easier and permit migration to more advanced approaches. It is important to involve the banks in the creation of the local Accord for the reasons that assessing the current bank practices and general readiness can be achieved through both bilateral and industry discussions by way of structured supervisory visits, horizontal reviews that is looking at specific practice across a range of banks, thus, enabling the drafting of supervisory guidelines which is consistent with pillar II. An early version of the local Accord may be necessary to enable the introduction of local Quality Implementation standards (QISs), thus, enabling banks to assess the impact of implementation and to provide benchmarking feedback. The implementation team should be encouraging the structured collections of data and request implementation timetables from the banks. Some of the discussion should include the sharing of bank data. A well-developed approval process should emphasise the need for internal in-depth assessment as well as decide upon the length of parallel running before switch-over.

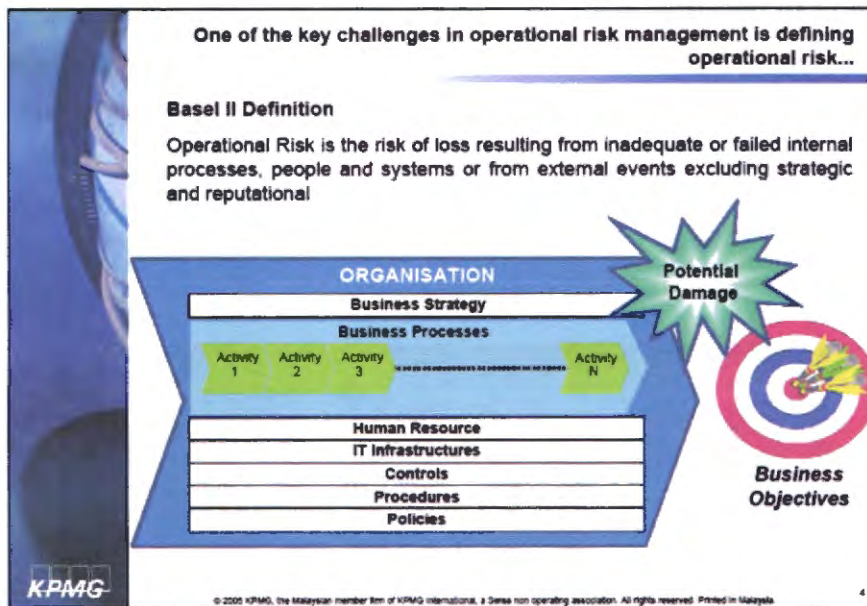
## **VII. Obstacles to a Successful Implementation**

Several obstacles have been identified to be inimical to the successful implementation of Basle II. The major obstacle is the impact on staffing and skills. **Staffing and skills** determine successful implementation of Pillar II. There is also the need to create a consensus among banks. Whilst the implementation can be

imposed by the Regulator, the uncertainties in the Accord are better resolved by the whole industry. There is also the need to create a realistic timetable both for the data collection and for the banks approval process. The resolutions of home-host supervisory issues could also be an impediment to the implementation of the Accord. Other impediments include pragmatism and co-operation from the supervisors across jurisdictions; their preparedness to share supervisory information **including** the mutual development of a supervisory framework for a specific bank?

### **Other Challenges**

The Accord, which explicitly requires capital for credit risk, does not have an explicit capital charge for operational risk. Nevertheless, the Basel Committee recognized when developing the Accord that banks incurred risks other than credit risk, including operational risk, and thus calibrated the Accord so that the 8.0 per cent minimum capital requirement included a buffer for such risks. More recently (based on the development of a more credit risk-sensitive capital framework) a view has been canvassed that operational risk was significant and increasing in the banking industry and recognition that a number of sophisticated banks were allocating significant amounts of internal capital to operational risk. Therefore, the Basel Committee proposed an explicit regulatory capital charge for operational risk in the revised Basel Capital Accord. A major challenge in operational management is in defining operational risk.



As can be seen above, operational risk occurs in all facets of the business. The knowledge of the business is required to be able to distinguish between business risk and operational risk.

A far greater challenge is the organizational and cultural issues which tend to conflict with the management of operational risk.

## The realms of risk

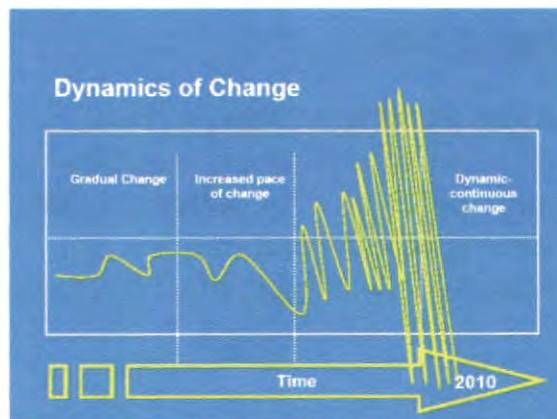
In managing Operational Risk, organisational and cultural issues ultimately pose greater challenges than the evolving technical hurdles that Operational Risk Managers must overcome



Factors external to the organization could impact on the way operational risk is measured and managed. In the event of hyper-competition, some operational risk issues could be compromised. The nine external factors stated below could affect operational management and measurement. The occurrence of any of the stated event will alter the normal operation of the bank and may be difficult to capture as an operation event.



Operational risk management and measurement could seriously be challenged during periods of dynamic continuous change either in regulatory policies or in the operations of the entity



### **Market Risk Challenges**

The dearth of knowledge in treasury operations and market risk is a big challenge in implementing market risk which has relied on advanced measuring approach using value at risk (VaR) for most jurisdictions. Inappropriate use of VaR has been a major discourse lately and several measures have been exposed to make VaR effective in the proposed changes to the Basle II market risk framework. Some of the changes include the decision to capture not only defaults but a wider range of incremental risks in the incremental risk capital charge. The improvements in the Basel II Framework concerning internal value-at-risk models will in particular require banks to justify any factors used in pricing which are left out in the calculation of VaR. They will also be required to use hypothetical back-testing at least for validation, to update monthly market data and to be in a position to update it in a more timely fashion if deemed necessary. They should work co-operatively to ensure an efficient approval process and the use of an internal model will be conditional upon the explicit approval of the bank's supervisory authority. The home and host country supervisory authorities of banks that carry out material trading activities in multiple jurisdictions should work co-operatively to ensure an efficient approval process.

### **IMF and World Bank: Consideration for Sub-Saharan African Countries**

There is a serious consideration by the IMF and the World Bank for Sub-Saharan African countries intending to adopt Basel II. Such countries were required to look inwards at their internal processes and to avoid "adoption at all costs approach". Their priority should be to ensure financial sector safety and soundness by ensuring compliance with Basle I, Basel core principles, International Financial Reporting Standards, e.t.c. Thus, Financial Sector Assessment Programmes (FSAP's) and Article 4 assessments will not negatively score non-adoption of BII for such countries but once they have decided to adopt BII will score the quality of adoption plans and implementation. The risk of

adoption will involve negative assessments, rating downgrades, limited access to international finance, limit to foreign investments e.t.c.

<b>STATE OF READINESS – NIGERIA</b>	
<b>Relevant Areas</b>	<b>State of Readiness</b>
Legal	
Corporate Law	Up to standard
Insolvency Law	Up to standard
Banking law	Up to standard
Accounting	IFRS compliant
Auditing	International standards
compliant	
Supervision	BCP and BI compliant
Corporate Governance	Best Practice?
Risk management	Best Practice?
Payment System	Basel Compliant?
Disclosures	IFRS Compliant

### VIII. Conclusion

The new accord has been broadly welcomed by financial community, particularly the increased sensitivity and the permitted use of advanced models. There are concerns about the vagueness of the operational risk and there are also concerns about the homogeneity of regulation. Its implementation requires structured approach. What is required for the regulatory authorities in Nigeria is to strengthen the Basle II committee with a clear mandate and timelines. It is gladdening to note that most deposit money banks have taken their Basle II compliance levels higher. The challenges can be surmounted through concerted effort on the part of stakeholders in banking and finance industry through the creation of standards. The industry is gradually and continually embracing the Basle II tenets, therefore, full implementation and cut-over will not pose serious problems.

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**Key:**

- IFRS - International Financial Reporting Standards
- BCP - Basel core Principle
- BI - Basle I
- QIS Quality Implementation Standards.