Economic and Financial Review

Volume 46
Number 4 *Proceedings of the seminar on: "Financial sector developments: challenges for risk based supervision and effective monetary policy implementation", for CBN Executive Staff held at Hamdala Hotel,Kaduna, November 17-21, 2008.*

Article 8

12-1-2008

Supervising cross-border banks: matters arising.

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Supervising Cross-Border Banks: Matters Arising

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I. Introduction

An essential element of banking supervision is that supervisors supervise their banking groups on a consolidated basis, adequately monitoring and, as appropriate, applying prudential norms to <u>all</u> aspects of the business conducted by each group worldwide. Supervision of banking groups on a consolidated basis goes beyond accounting consolidation. It implies that there is a group-wide approach to supervision whereby <u>all risks</u> taken on by each banking group are taken into account <u>wherever</u> they are booked (i.e. in the bank or in a subsidiary; in Nigeria or elsewhere). Consolidated supervision requires that both <u>quantitative</u> and <u>qualitative</u> assessment of business groups that contain banks be conducted in order to identify and evaluate all the risks to which these banks are exposed (and their risk management capabilities). Consolidated supervision is not an alternative to the normal supervision of individual licensed banks but rather complements "solo" supervision. It is important to note that both accounting consolidation and consolidated supervision are key aspects in the supervision of banking groups.

The Origins, Standards and Codes

The Basel Committee on Banking Supervision (Basel Committee) has been actively promoting consolidated supervision as an important supervisory requirement virtually since its creation at the end of 1974. Over the years, the

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Basel Committee has issued much useful guidance to global supervisors on this important topic. Reflecting its importance, two of the Basel Core Principles for Effective Banking Supervision (Core Principles) are solely dedicated to consolidated supervision:

Principle 24: Consolidated Supervision

An essential element of banking supervision is that supervisors supervise the banking group on a consolidated basis, adequately monitoring and, as appropriate, applying prudential norms to all aspects of the business conducted by the group worldwide.

Principle 25: Home Host Relationships

Crossborder consolidated supervision requires cooperation and information exchange between home supervisors and the various other supervisors involved, primarily host banking supervisors. Banking supervisors must require the local operations of foreign banks to be conducted to the same standards as those required of domestic institutions.

To assess compliance with the Core Principles, there is a set of essential and additional assessment criteria for each Core Principle. The essential criteria are typically the only elements on which to gauge full compliance, while the additional criteria are best practices. (The focus of our efforts at CBN will be to achieve full compliance with the essential criteria relative to Core Principles # 24 and # 25).

The Joint Forum on Financial Conglomerates (Joint Forum) was established in early 1996 under the aegis of the Basle Committee, the International Organization of Securities Commissions (IOSCO) and the International Association of Insurance Supervisors (IAIS) to deal with issues common to the banking, securities and insurance sectors, including the regulation of financial conglomerates. The Joint Forum is comprised of an equal number of senior bank, insurance and securities supervisors representing each supervisory constituency. The Joint Forum has been particularly instructive on issues of consolidated supervision and financial conglomerates which is of specific relevance to Nigeria.

Notwithstanding the wealth of information and guidance available from various standard setters, implementation of consolidated supervision continues to be a challenge for many supervisors. In fact, the experience of the IMF and World Bank is that more than half of the countries assessed through their Financial Sector Assessment Program (FSAP) continue to show weak compliance with the Basel Core Principles on consolidated supervision.

II.0 Why is Consolidated Supervision Necessary? What are the Issues?

We are witnessing a very serious negative consequence of the globalization of the financial sector/markets as the shock waves of the "credit crunch" work their way through the system and around the world. It would appear that the linkages (and risks) between banks, financial markets, financial instruments, etc. were not fully appreciated even by the most "expert" of "experts". Although controversial, European leaders are calling for a rework of the rules of global finance, inter-alia, pressing for changes including global standards for regulation and banking, more standardization and transparency, an early warning system within the IMF for the world economy and a supervisory body for at least the world's 30 biggest banks. One thing remains clear and unchanged in this turmoil supervision is not effective unless all the risks of the entire banking group are identified and assessed! As Nigeria's banks and financial markets become more and more global in nature, the potential for exposure to the negative vagaries of foreign markets increases and the opportunities for contagion grow exponentially.

There are a number of "issues" related to consolidated supervision that we as supervisors need to be cognizant of. The CBN's approach to consolidated supervision must consider:

II.1 Capital Adequacy:

A primary objective of consolidated supervision is to assess capital adequacy on a group-wide basis and to identify situations of overstatement of capital. It is important to remember that only capital issued to external investors provides support to the banking group. The minimum risk-based capital requirement of 10 percent in Nigeria, for example, must be applied on a consolidated basis and not just to the bank. Assessments of group capital based on measures of solo capital is likely to overstate the external capital of group. Also, assessments of group capital should exclude intra-group holdings of regulatory capital

Measurement techniques must be designed to detect and provide for double gearing (where one entity holds regulatory capital issued by another in the same group and the issuer is allowed to count the capital in its own balance sheet. In this situation, the external capital is geared up twice; once by the parent bank and again by the dependent), or multiple gearing (where the dependent down streams regulatory capital to a third tier entity).

Measurement techniques must also detect and provide for excessive leverage which occurs where the parent issues debt and down streams the proceeds to the dependant as equity/regulatory capital. In this case, the effective leverage of the dependent may be greater than the leverage computed on a solo basis. The risk to the regulated entity crystallizes if the parent has difficulty in servicing the debt.

II.2 Contagion

Contagion occurs where a bank is affected by financial problems, such as insolvency or illiquidity, arising in another regulated or unregulated member of the banking group. Examples are intra-group transactions/exposures such as central management of short-term liquidity, guarantees, loans, commitments, management/service arrangements, purchase/sale of assets, transactions to shift third party related risks, etc. We need to be wary of other issues which may exist such as the transfer of capital from the bank in an attempt to rescue another group member from financial difficulties and/or where the bank has credit exposure to a group member whose ability to repay is questionable. Related party transactions between group members have historically had the real potential to be extremely problematic and must be controlled and scrutinized carefully by supervisors. Supervisory arbitrage is one of the most crucial things to guard against as supervisors. The banking group will tend to book transactions in the group member where the supervisory oversight is perhaps the weakest or the operating environment the most conducive and must be guarded against. Negative events involving a group member may also trigger a loss of confidence in the bank.

II.3 Autonomy

Autonomy may be an issue where a bank is a component of a larger business organization, such as a foreign bank subsidiary in Nigeria. A supervisory concern is the autonomy of those individuals responsible for the management and oversight of the bank. Supervisors need assurance that directors/managers can be held accountable for the sound operation of the bank, responding to supervisory mandates and compliance with legal/regulatory requirements. Directors/managers may lack the necessary authority vis à vis others within the group e.g. can they commit to take action as recommended by supervisors. Directors/managers may be compromised in their ability to make objective judgements regarding loans to connected parties or where a conflict of interest exists between customers of the bank and customers of other group members or other group members themselves.

II.4 Group Exposures

The concentration of credit risk exposure by a banking group to a group of associated persons has the potential to be extremely problematic. If these loans cannot be recovered, the financial condition of the lender(s) could be seriously affected. Large/connected exposures must be aggregated by the consolidated bank. It is important to limit the size of individual large credit exposures/connected lending. Without application of limits to banking groups, individual banks can circumvent the limits which apply to them by "syndicating" loans to subsidiaries and affiliates.

II.5 Transparency

The corporate organization of banking groups is often the consequence of legal provisions, capital adequacy requirements, tax laws and business decisions. Supervisors need to determine whether to specifically intervene to define forms of corporate structure or allow structures to be market-driven. It is clear that complex structures make effective supervision more difficult. Legal/managerial structures of a group may differ including matrix management where reporting lines are to a range of senior managers, in other group companies/countries. Supervisors must thoroughly analyse and identify lines of accountability and be comfortable with their understanding of the corporate and managerial structure. They must also prohibit/discourage structures where shareholder and management control/financial responsibility is not clear. Complex structures are often chosen to obscure operations or ownership so as to avoid effective supervision. Supervisors must be cognizant that the regulation of structure has the potential to be an impediment to competition or profitability.

II.6 Quality of Management

This is the risk arising from the business challenges inherent in forming and managing a banking group and their potential implications for directors' and managers' ability to perform their roles adequately. Directors/managers are increasingly challenged by forming and managing larger, more complex groups wide range of products/diverse geographic locations (integrating previously autonomous managements, merging different corporate cultures and managing new businesses e.g. insurance). Challenges may lead to financial difficulties. Supervisors need the authority to vet the suitability of those with the ability to exert direct or indirect control/influence over the bank and must assess/be comfortable with independence of bank's directors.

II.7 Access to Prudential Information

Effective supervision of banking groups relies on the supervisor's ability to obtain information as needed from not only the bank(s), but also from related non-bank companies in the group and from other primary supervisors. Supervisors need to see the "whole picture". Members of the banking group may be unwilling/unable to supply requested information which for a supervisor is a "red flag". Supervisors should not rely on the voluntary provision of information and must have the legal power to obtain information directly from non-bank group member. Supervisors must establish whether the provision of information is problematic <u>before</u> they allow their banks to establish abroad, or grant authorization to new banks with foreign ownership.

II.8 Moral Hazard

A supervisory concern of consolidated supervision is giving the impression that the activities of a whole banking group are being supervised, even if only informally. Problems may arise where management of non-bank group members believe that the supervisor will give them support in the event of financial difficulties in order to prevent their difficulties weakening depositor confidence in a related bank. Weakened market discipline could arise where business counterparties of non-bank group members may take greater risks in their dealings with such companies if they perceive the likelihood of official support for an entire banking group.

III.0 Critical Importance for Central Bank of Nigeria

The need for the CBN to develop its consolidated supervision capacity is enormous and growing by the day. The recent consolidation of the banking sector in Nigeria has resulted in fewer, however, much larger (and riskier) banks. The banks for the most part have, over the past couple of years, experienced explosive growth (domestically and internationally), fueled to a large extent by aggressive forays into the capital market. Competition for "size" and market opportunities is severe and escalating. We at CBN must keep pace.

With this growth and expansion into previously largely uncharted businesses and/or jurisdictions, comes significantly increased risk. Do the banks have the operational and risk management skills, systems capabilities, Board and management oversight competencies, etc. to manage the aggressive growth in size, complexity and inherent risks? Is the group's consolidated capital sufficient to support the entire banking group? Do we at CBN have effective oversight over the foreign and non-banking operations of our banks? Can we rely on the supervisory capabilities of the various host supervisors responsible for significant parts of the Nigerian banking groups? These and a number of similarly important questions must be answered if we are to ensure the safety and soundness of the Nigerian banking system. While we need to be sensitive to the tenents of Vision 2020 and the development of the Nigerian banking sector, we cannot allow development to take precedence over issues of safety and soundness.

In Nigeria, as elsewhere, corporate groups containing banks differ in terms of structure, activities and complexity. However, all have an inherent relationship between the parent and subsidiary companies and inter-company relationships which may allow one company to exercise significant influence over a second company, often without having control. The larger, more complex and more international the bank, the more challenging it is to supervise it. For that reason alone, we must temper our enthusiasm for growth until our supervisory processes and capabilities "catch up".

Complicating the landscape in Nigeria is the move towards financial conglomeratization, typically defined by the Basel Committee as a group of companies under common control whose main activities consist of providing services in at least two different financial sectors banking, securities or insurance. It has been reported in the financial press that no fewer than 15 insurers are either wholly owned by banks or subsidiaries or affiliates of the 24 banks. The business (and inherent risks) of insurance is very different from that of a bank and extremely complex. Securities firms, many of which are also owned by the banks, have been battered by the current bear market and exposure to margin lending. Adding to the complexity and the challenges of supervision in Nigeria are other subsidiaries such as microfinance banks, bureaux de change, primary mortgage institutions, discount houses and the like. Further complications exist as a consequence of allowing our banks to aggressively expand outside of Nigeria, some to jurisdictions where the quality of supervision is either not known or weak. Any negative events with any of these subsidiaries have a direct correlation to the consolidated risk and financial position of the parent bank in Nigeria and have the potential to bring it down. It makes no sense to conduct an exhaustive examination of the bank if we are to ignore the subsidiaries

IV.0 What Have We Accomplished So Far?

While much remains to be done, a significant amount of work has been completed in support of the CBN's journey towards full implementation of consolidated supervision.

Two of the more significant accomplishments are:

IV.1 The Supervisory Framework for Banks and Other Financial Institutions in Nigeria

Implementation of the *Framework* is an extremely challenging and long term exercise with the development of guidance/documentation and the capacity building of the BSD/OFID staff to continue for some time.

The objective of the *Framework* is to provide an effective process to assess the safety and soundness of banks and other financial institutions. This is achieved by evaluating their risk profile, financial condition, risk management practices and compliance with applicable laws and regulations.

Developing supervisory practices is a dynamic process. Consolidation, and the resultant rapid expansion/development of the banking and other financial institutions' sectors, necessitated a re-evaluation of the way that supervision is conducted in Nigeria. In response to this changing financial landscape, a more risk-based approach to supervision has been adopted, one that focuses on the identification of risk and an assessment of the management of that risk by regulated entities. Although effective risk management has always been central to safe and sound banking activities, it has assumed added importance. In addition to responding to the sector's post consolidation expansion both within and beyond Nigeria, in both financial and non-financial activities, there is need to comply fully with the Basel Core Principles on Supervision and to prepare an enabling environment for the eventual implementation of the Basel II Capital Accord.

The *Framework:*

- is a robust, proactive and sophisticated supervisory process, essentially based on the risk profiling of a bank;
- enables a better evaluation of risks through the separate assessment of inherent risks and risk management processes;

- is a dynamic, forward looking process, placing greater emphasis on the early identification of emerging risks and system-wide issues;
- is applied on a consolidated basis, using information from other regulators as appropriate. It includes an assessment of all material entities (subsidiaries, branches, or joint ventures) both in Nigeria and internationally;
- allows the supervisor to prioritize efforts and focus on significant risks by channeling resources to banks that have higher risk profiles. Work performed will be focused on clearly identified risks or areas of concern. Institutions that are well managed relative to their risks will generally require less supervision;
- includes the review of major risk management control functions such as Board and Senior Management Oversight, Internal Audit, Risk Management, Compliance and Financial Analysis. The *Framework* contemplates the use, where appropriate, of the institution's internal management and control functions; and
- contemplates reliance on external auditors for the fairness of the financial statements and their work will be used to modify the scope of reviews to minimize duplication of effort.

IV.2 Circular: Framework/Guidelines on Bank Expansion

A robust expansion approval regime for both national and international expansion has been developed and has been issued as a Circular to the banks. The new requirements apply to all expansion plans of the banks, whether domestic or international; banking and non-banking subsidiaries.

Any expansion approval regime must contain two basic elements. As Host Supervisor, CBN must be comfortable with the system of supervision and the quality and capabilities of the various Host Supervisors and whether we are prepared to rely on them; and whether the Home Bank has the people, systems, risk management processes, etc. sufficient to oversee and monitor such foreign operations. Each of these two basic preconditions will ordinarily take some time to assess.

Satisfactory Home-Host Supervisor relationships must be established and nurtured by CBN. CBN, while responsible for assessing the consolidated position/strength of banks in Nigeria does not directly supervise all of the bank's subsidiaries. It must therefore rely on other foreign and domestic supervisors for the information needed to perform consolidated supervision. Relationships (at the working levels) must be established and information exchanged on an on-going basis between regulatory agencies which share responsibility for various parts of the banking group. As a priority, the CBN must agree to a memoranda of understanding to exchange supervisory information with domestic supervisors such as NAICOM and SEC and with each country in which our banks want to expand to. The supervisor in each case must be communicated with and asked the types of questions that are contained in the foreign supervisor questionnaire which is part of the new Circular. Before Nigerian depositors and shareholders finance a bank's investments into a domestic or foreign subsidiary, CBN needs to assess the inherent risks, risk management capabilities, capital and a host of other issues, all on a consolidated basis. Should the requested approvals be granted, CBN will need to rely on these host supervisors and we must assure ourselves (before approvals are granted) of their capabilities and cooperation.