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INTERNATIONAL CONVERGENCE IN SUPERVISION AND REGULATION

O. I. Imala*

INTRODUCTION

The presentation is made within the context of this year's seminar theme of "Second West African Monetary Zone: Implications for Monetary and Fiscal Policy Management".

The financial system in any economy plays an important role in promoting economic growth and development by improving the efficiency of resource moblilisation, pooling savings and allocating these savings to investment outlets. It provides liquidity and capital to firms in their production processes and facilitates a reliable payment system, thus providing a veritable platform for an effective monetary policy management. For the system to achieve the above objectives, it must be developed through the collaborative efforts of the government, the monetary authorities, the operators and the general public. The monetary authorities must therefore improve on their supervisory processes and pursue policies and standards that would enhance the safety, soundness and efficiency of the financial system.

Banks, as the major operators in the system, provide the institutional mechanism for financial intermediation in the system by managing the financial assets and liabilities of other economic units. They mobilise deposits, provide credits and in the process create money, offer professional advice to investors and act as agents of the government in the implementation of various monetary and macroeconomic polices.

Given the overall importance of banks in the economy, their supervision and regulation become imperative in order to ensure a stable and healthy financial system. Supervision entails, not only the enforcement of rules and regulations, but also some judgment regarding the quality of financial institutions' assets, capital adequacy and management, while regulation involves the body of specific rules governing expected behaviours that limit or control the activities and business operations of financial institutions. Oftentimes, these concepts are used interchangeably because of their very close relationship.

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Banking Supervision, as part of public infrastructure, has the major role of ensuring financial sector stability and sustainable economic growth and development. Sound economic policy management requires a robust, efficient and sound financial sector. Supervisors must therefore ensure that banks and other financial institutions are operated in a safe and sound manner that would guarantee sustainable economic growth. Instability in the banking sector could lead to bank failures, loss of public confidence as well as adverse macroeconomic environment with negative impact on real incomes, employment and output.

Banks' capital is only a small part of their sources of funds, the major source of their funding being deposits. Hence, depositors need protection, primarily because they do not have the means to determine the extent of risks taken by banks in the use of their money. The supervisory and regulatory framework must therefore ensure that banks operate within prescribed prudential limits and standards, in a safe manner and uphold high standards of professional conduct that would sustain continuing confidence in the banking system.

Due to the growing volume of international trade, financial institutions have adopted more effective and efficient ways to facilitate and finance cross borders transactions and at the same time manage the related risks. The resultant close linkage between financial markets has in turn necessitated, among others, the development of financial derivatives, strong support for reducing counterparty credit risk and a growing need to clarify laws and regulations regarding cross-border financial contracts. Banking Supervisors worldwide, have consequently realized/recognized the need to harmonise laws, regulations, codes and standards in order to promote economic growth and international financial stability.

To fully address the topic of this session, the remaining part of this paper is divided into six sections. Section two deals with the driving force behind international convergence in supervision and regulation. Section three highlights areas of common interest to supervisors and regulators as well as the international agencies that have come into existence to address them. Section four focuses on the major international standards and codes that have been agreed upon and are being implemented by the different regulatory/supervisory jurisdictions worldwide. Section five discusses the emergence of regional groupings, with emphasis on the African continent, and the key areas for the achievement of harmonization in supervision and regulation.

Finally, section six presents the Nigerian experience in the implementation of internationally adopted standards and codes, while section seven concludes the presentation.

CONVERGENCE FACTORS

In the last few decades, financial markets and institutions the world over, have become larger, more complex and more tightly integrated. These developments have been propelled by a number of driving forces, including the following.

The first is deregulation and liberalization. Deregulation involves the relaxation of controls usually designed to override market forces. Countries are rapidly shifting towards market forces and private enterprises in the management of economies and these have manifested in the steady retreat of the state from administrative and quantitative controls. Deregulation contributed to the increasingly intense competition and the blurring of traditional distinctions between different types of financial institutions. On the other hand, liberalisation entails the removal of impediments to world-wide expansion of trade in goods and services, flows of capital and foreign investment. Liberalization has also led to the tremendous growth in the number and variety of financial institutions, the volume and complexity of operations, as well as the number of products and services offered due to the increased competitiveness in financial intermediation.

The increasing awareness of the potential advantages of opening national financial markets to international competition has led to globalisation, a process of integrating national economies into a global market place in which all nations can freely participate. The process also involves the creation of harmonized trade policies, rules and practices across the globe. Globalistion is increasingly fuelled by international financial institutions and regional groupings, which promote similar policies across the world.

A third major force is technology. Rapid technological changes in Information Technology [IT], communication and transport has given rise to new products and services, methods of management and organization of production. Similarly, innovations in technology has provided a fresh stimulus for capital, enterprise and skills to move across national frontiers. It has clearly transformed transactions processing, encouraged some forms of specialisation and consolidation and made possible an entirely new and much cheaper means

of delivering financial services. Additionally, it has facilitated the development of new financial instruments and investment strategies and radically changed trading mechanisms. Furthermore, technology has made it easier for both financial institutions and their regulators to measure, monitor and manage risks.

Within the framework of these driving forces, the global financial market has been subjected to increasing volatility and vulnerability such that there have been currency, banking and financial crisis in some regions. Thus, the need for fair, sound, stable and consistent policies, standards, procedures and practices have become imperative. Indeed, the global growth of financial markets and institutions had provided the impetus for cooperation, coordination and harmonization among different countries' supervisory and regulatory systems, and consequently various international agencies have been established to address areas of common interest.

AREAS OF COMMON INTEREST AND INTERNATIONAL AGENCIES

There are essentially two reasons that necessitate most international efforts to coordinate banking issues: First, to maintain a healthy, responsive, and financially strong banking and financial system which will facilitate the growing needs of domestic economies. Second, to build and maintain adequate legal and regulatory structures that will permit institutions to compete safely on an equal and non-discriminatory basis, both domestically and internationally.

The promotion of sound risk management has become of common interest and to the extent that regulatory and supervisory authorities continue to build on "best" or "sound" banking practices in designing rules and regulations, working towards such a common end will be achieved.

Apart from risk management, other areas of common interest in banking supervision and regulation include issues relating to accounting standards, auditing practices, corporate governance, information dissemination, transparency, cross-border securities transactions and insurance. These areas have continued to be addressed by relevant standard setting agencies across the globe.

The agencies established to address these common areas of interest include the

International Accounting Standards Board [IASB], International Federation of Accountants [IFAC], Organisation for Economic Cooperation and Development [OECD], International Monetary Fund [IMF], the World Bank, United Nations Commission on International Trade Law [UNCITRAL], International Bar Association [IBA], International Association of Insurance Supervisors [IAIS], Committee on Payments and Settlements Systems [CPSS], and International Organisation of Securities Commissions [IOSCO].

These international agencies have produced standards and codes along the areas of common interest to supervisory and regulatory authorities world-wide. However, in implementing the standards and codes, supervisors are never unmindful of their environment and the structure of the financial institutions in their jurisdication. Such consideration should however not impair their oversight responsibilities because in the global market, weak or ineffective supervision in either large/ developed or small/developing countries can have adverse and far reaching consequences. It is therefore important for supervisors to relate and cooperate with their counterparts in other countries in implementing the agreed standards for the safety and soundness of their financial institutions and the global financial system.

INTERNATIONAL STANDARDS AND CODES

International financial standards have been developed to help financial authorities fashion prudent policies, increase transparency and improve institutional and market infrastructure. These, in turn, are expected to reinforce the stability of the international financial system. It is, therefore, in the overall self-interest of any country not only to adopt these standards but also to adhere to them as much as possible. The basic responsibility for ensuring the implementation and monitoring of the standards rest with the relevant financial sector supervisory/regulatory agencies in each country. In the light of the Asian crisis, the need for fundamental changes in the international financial architecture has acquired greater urgency. Many proposals have been made for strengthening the international financial system. These proposals broadly focused on the indicators of financial vulnerability, the development of sound international codes, standards and best practices, the introduction of pre-emptive measures and safety nets, and the designing of a framework for crisis management.

As part of the effort to strengthen financial systems and improve coordination among the agencies responsible for them, the Financial Stability Forum [FSF] was established in April 1999. Its mandate was to promote international financial stability by improving the

functioning of markets and thereby reducing systemic risk through information exchange and international cooperation in the supervision and surveillance of financial markets. The FSF has drawn together various standard setting bodies, which were constituted by means of cooperation among central banks, international financial institutions, national authorities and international supervisory and regulatory bodies.

The FSF has produced a compendium of standards, which serve as a common reference. Currently, there are 69 standards in the compendium. A set of 12 standards have been highlighted by the FSF as key, for sound financial systems and deserving of consideration for priority implementation. These 12 key standards which are organized under three broad headings are accepted as representing minimum requirements for good practice as listed hereunder.

A. Macro-economic Policy and Data Transparency:

1. Code of Good Practices on Transparency in Monetary and Financial Policies;

2. Code of Good Practices on Fiscal Transparency; and

3. Special Data Dissemination Standard.

B. Institutional and Market Infrastructure:

4. Principles and Guidelines for Effective Insolvency and Creditor Rights Systems;

5. Principles of Corporate Governance;

6. International Accounting Standards;

7. International Standards on Auditing;

8. Core Principles for Systematically Important Payment Systems; and

9. The Forty Recommendations of the Financial Action Task Force on Money Laundering

C *Financial Regulation and Supervision:*

10. Core Principles for Effective Banking Supervision;

11. Objectives and Principles of Securities Regulation and Disclosure Standards to Facilitate Cross-Border Offerings and Initial Listings by Multinational Issuers; and

12. Insurance Supervisory Principles

Perhaps, we should focus on one of the standards that is most relevant to banking supervision. The Core Principles for Effective Banking Supervision was developed by the Basle Committee on Banking Supervision, to provide the international financial community with benchmarks against which the effectiveness of bank supervisory regimes can be assessed. The need for strengthening the supervision of banks has been stressed as a major priority since it is now widely recognized that weaknesses in banking systems have been the cause of financial crises in many countries over the last decade. Thus, the Core Principles which have been endorsed and are being implemented by a vast majority of countries, have become the most important global standard for prudential regulation and supervision.

The Basle Core Principles comprise 25 basic principles which are regarded as minimum standards that need to be in place for any supervisory system to be effective. They relate to 7 main areas of supervision namely: pre-condition for effective banking supervision, licensing and structure; prudential regulations and requirements; methods of on going supervision; information requirement; formal powers of supervisors; and cross-border banking. The Basle Committee continues to take the lead in coordinating banking supervisory policies and practices globally.

Another area the Basle Committee has also excelled so much is on the setting of capital standards. Recognising that adequate capital is essential for fostering the safety and soundness of banks, the Committee issued the first Capital Accord in 1988. Since then, it

has continued to develop and refine the standard in an effort to keep pace with banking practices and to maintain adequate levels of bank capital throughout the world. From the start, it was observed that the 1988 Accord was not perfect in several respects. Although the Accord incorporated some differentiations in credit risk, it was limited. Moreover, it did not explicitly address interest rate risk, market risk, operational risk, and other risks that could be significant in some banks. In order to address the initial and inherent imperfections, the Committee in 1996, reviewed the 1988 accord to incorporate market risks in the determination of the adequacy of banks' capital. It also recently issued the New Capital Accord that is more comprehensive and risk sensitive in approach and consists of three mutually reinforcing pillars.

Pillar I is the minimum capital standard which essentially is the existing Accord with some additional requirements. Pillar II is supervisory oversight of capital adequacy at individual banks while Pillar III is market discipline, involving adequate public disclosures by banks. The addition of Pillars II and III emphasises the importance of ongoing review by supervisors of the capital adequacy at individual banks and the critical role of market discipline in controlling risk- taking by banks.

The Committee expects the implementation of the New Accord to commence by the end of 2006. This is to allow time for necessary amendments to the legislative framework and for effecting any changes that might be necessary in the various countries' processes, procedures and information systems. Also, time is required to build up the required data bank for the extensive statistical records that most aspects of the new package would require. Supervisors and operators would also require time for training.

The several interrelated standards and codes represent the collaborative efforts of developed countries and emerging economies, international institutions, public and private sector regulators and market participants.

In addition, the current initiative provides for assessment methodologies involving external assessment and incentives for internal assessment of the degree of compliance of a country with the key standards and codes.

Furthermore, the entire exercise is undertaken on the premise that its implementation would not only help to promote sound financial systems within the different countries but

would ensure smooth integration into the global market, thereby contributing to financial stability in the global system.

The adoption and implementation of international standards and codes are also fostered by regional groupings in order to optimally derive the inherent benefits and also move towards a better assimilation into the global financial market.

REGIONAL GROUPINGS

The globalisation of financial markets engendered the establishment of regional economic groupings to foster trade, investment and competition. Similarly, in recognition of systemic problems that may endanger the stability of the banking systems and other challenges to financial markets globally, regional efforts to harmonise, among others, banking legislation, regulation and supervision, became necessary.

The goal of regional convergence in Africa is being championed by sub-regional organizations like the Economic Community of West African States [ECOWAS] whose objectives include the creation of a Customs Union, full economic and monetary integration and the harmonization of economic, industrial and agricultural policies of member countries. Of recent, ECOWAS had intensified efforts towards the formation of a monetary union. It is argued that the formation of such a union could engender or hasten the process of macroeconomic stability. Also, such an arrangement would lead to improved economic performance, rapid technological progress and stronger bargaining power at the global level. In addition, it will encourage the mobilisation and improved management of human and financial resources. I believe that other papers presented in this seminar will exhaustively deal with developments and issues relevant to the establishment of a second monetary zone. What is worth emphasizing here is that the arrangement would be of immense benefit to member countries through the elimination of currency inconvertibility, reduction in speculative capital flows, centralization of monetary policy, and coordination of macroeconomic policies, among others.

The formation of sub-regional economic groups also facilitated and necessitated the establishment of sub-regional supervisory groupings. In Africa, the prominent ones include the East and Southern African Banking Supervisors Forum [ESAF] and the Committee of West and Central African Banking Supervisors.

In 1993, the Eastern and Southern African Banking Supervisors Forum [ESAF] was formed to:

[i] Work towards the development of a harmonized system of supervision of the member countries' financial institutions;

[ii] Enhance the implementation of the guidelines of the Basle Committee on Banking Supervision;

[iii] Share training resources and regionalize the training of banking supervisors; and

[iv] Develop mechanisms for reviewing the progress made by each member country in adopting the Basle Committee guidelines.

Central to the establishment of the ESAF is the development of a collaborative approach to supervision of banks in the region, and the enhancement of safety and soundness within the region.

A year later, in April 1994, the Committee of West and Central African Banking Supervisors was formed with the following objectives, to:

[i] provide a forum for regular contact, co-operation and exchange of information among members on national supervisory arrangements, including the techniques for cross-border supervision.

[ii] improve the techniques and quality of supervision of banking institutions in accordance with international standards as embodied in the Basle Concordat and its supplement.

[iii] evolve minimum standards for addressing the peculiar supervisory difficulties that such regional co-operation entails.

[iv] work closely with the Basle Committee as well as collaborate with other regional groups in Africa for the formation of a continental group of Supervisors.

With the above objectives in mind, the Committee of West and Central African Banking Supervisors had been meeting annually. Since its inception, the sub-regional group has made some impact on capacity building by organizing training for junior/middle level supervisors and seminars for heads of Banking Supervision within the sub-region. In addition, deliberations on the implementation of the Basle Committee Core Principles for Effective Banking Supervision have been going on.

The key areas which are essential for the achievement of the harmonization of banking supervision through sub-regional groupings include the strengthening of legal frameworks for banking business and banking supervision, licensing processes, effective problem resolution, prudential standards, core principles for banking supervision, and international accounting/reporting and public disclosure standards by banking institutions.

Others are the adoption of minimum standards on cross-border supervisory co-operation, the establishment of uniform anti-money laundering measures, the sharing of resources for capacity building, and improved communication amongst banking supervisors.

THE NIGERIAN EXPERIENCE

In the West African Sub-region, Nigeria has always been in the fore front in the attempt to comply with international standards in the three broad areas of standards identified earlier on. Thus, in the area of macroeconomic policy and data transparency, the IMF code of transparency in monetary policy, supervision and payment systems have all been adopted. Nigeria has also opted for the IMF financial sector assessment programme.

Furthermore, in the area of transparency in the formulation of policies, the current practice in Nigeria is the stakeholder approach, where the views of the relevant sectors of the financial services industry are sought and incorporated into monetary policy. This is done through fora like the Monetary Policy Forum and the Bankers' Committee. The dissemination of information is also done through various publications of the CBN and self-regulatory organizations.

Nigeria, in the mid- 1990s, witnessed a generalised distress in the financial system and during the period 34 banks were liquidated. After emerging from the crisis, there was the need to evolve a new approach to distress management. A contingency plan based on the Toronto Leadership Centre model was developed. The plan is essentially a proactive plan of action for the prevention and containment of distress in the financial sector. It is composed of five components including the thresholds for supervisory intervention and guidelines for banks in drawing up their own contingency plans.

A deposit insurance scheme has been in place since 1988 with the establishment of the Nigeria Deposit Insurance Corporation. In addition, in the last one decade, the

minimum capital requirement has been increased three times to put the banks in a good position to compete in the global and regional markets and to absorb the increasing risks they have to take.

Corporate governance is another area where the CBN has taken some concrete steps. Circulars have been issued on pre-qualification requirements for appointments to top management positions in banks. Other aspects of corporate governance are being considered. In these and other cases, the best practices are always considered.

The Nigerian Accounting Standards Board sets accounting standards called the Statement of Accounting Standards. The CBN, through its supervisory framework, has ensured that banks comply with these standards which are in line with international accounting standards.

Although Nigeria was recently classified by the Financial Action Task Force as a non-cooperative territory in the global fight against money laundering, concerted efforts have been made in that direction by the CBN, the Government and other stakeholders.

Nigeria was first assessed for compliance with the Basle Core Principles in 1999 by the IMF/World Bank. In the assessment, the country was adjudged to have fully fulfilled 9 of the principles, 11 partially fulfilled and 5 unfulfilled. The rest of the principles were considered as not relevant to the Nigerian situation as at the time of the assessment. A self-assessment carried out thereafter did not agree entirely with the assessment of the IMF/ World Bank team, mainly because of subsequent developments which greatly enhanced the level of compliance. A second assessment by the IMF was carried out under the Financial Sector Assessment Programme [FSAP] in 2001/02. This new assessment was based on the core principles methodology, which has been adopted by the Basel Committee. Under the programme, the capital and insurance markets regulation was also assessed for compliance with the principles of securities regulation and insurance core principles, respectively.

All these efforts geared towards compliance with international standards and codes are based on the premise that their implementation would promote a sound financial system, strengthen financial regulation and supervision, enhance transparency, facilitate institutional development and reduce vulnerabilities, thereby contributing to global financial stability.

CONCULSION

The impact of liberalization, technological innovations and globalisation led to expansions of financial markets with new and increasingly more complex activities. With these developments, rigorous, harmonized and coordinated supervisory and regulatory approach has become necessary in order to ensure international financial stability.

The implementation of international standards and codes is an important aspect of our collective efforts to make domestic and international financial systems less susceptible to crisis and its disruptive tendencies. Regulatory and supervisory agencies have a major role to play in ensuring the effective implementation of these standards and international best practices in their jurisdictions so as to achieve the benefits derivable from them. Although there are some constraints, the CBN, as the apex supervisory and regulatory institution in the Nigerian financial system, will not relent in its efforts in implementing international standards and codes for the sustenance of macroeconomic growth and development, through effective monetary and financial policy management as well as effective supervision. The nurturing of efficient, well-managed and responsible financial institutions in accordance with sound practices will continue to be our main focus.

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