Special Remarks

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I am pleased to be in your midst this morning to make this Special Remark at the opening ceremony of the annual in-house Executive Seminar jointly organised by the Research and Human Resources Departments. Let me remind you that the purpose of this Seminar is for us, as Executives of the Bank, to share views on contemporary global economic issues relating to the financial services industry and in the process take advantage of the knowledge gained to chart the way forward in the country. The theme of this year's Seminar **"***Macro-Prudential Framework and Financial System Stability in Nigeria***"** could not have come at a more appropriate time, given our experiences with the recent crisis in the banking industry in particular, and the global financial crisis in general.

Distinguished ladies and gentlemen, let me state that this theme provides the opportunity for us, as Executives of the Bank, to engage in productive exchange of views and ideas on the subject, reflect on the increasing risks in our financial environment and articulate our views on how best such risks could be managed to ensure financial system stability in Nigeria. The theme is not only apt, but very timely, considering the importance of a strong financial services sector for economic growth, in particular and economic prosperity in general. I therefore commend the organisers of this Seminar for thinking along this line.

Prior to the global financial crisis of 2007 - 2009, the global banking landscape had gone through major changes, driven largely by technological development, deregulation and advances in information technology which increased competition in the industry. Global financial institutions had grown big both in size and scope and their organisational complexity had increased. The development generated a pro-cyclical willingness to take on additional risks and leverage, thus amplifying and propagating the boom and bust cycles. The vicious cycle of a collapse of confidence, asset fire sales, evaporation of liquidity, and deleveraging was the mirror image of the mortgage market crisis that preceded it. It is true that a more dynamic and sophisticated financial market has key benefits for sustainable economic development. However, the same can become a potential threat to domestic and global economic and financial stability, particularly when product innovations are not clearly understood by the market operators. Recent global experience shows that complex structures and products, increased integration and the growing size of financial institutions led to opaque bank balance sheets. There was clearly lack of a systemic approach to banking supervision and regulation. Indeed, the objective of financial stability was taken for granted simply because it was rational and desirable and was thought to be a by-product of proper/appropriate macroeconomic and regulatory policies.

However, the recent global financial crisis has called the above views to question such that it is now generally accepted that a separate macro-prudential objective relating to overall financial system stability has become imperative. In particular, one of the main lessons from the crisis was the need for monetary authorities and managers of the economy to pay more attention to identifying early warning signals and vulnerabilities not just in individual institutions but more importantly in the financial system as a whole. The fall out of the crisis also brought to the fore, the need to understand and track relationship between the risks and vulnerabilities and the general macroeconomic developments.

To avoid a repeat of the experiences of the crisis, it is essential to change the global landscape of supervision and regulation. Effective arrangements to take preventive action are, therefore, strongly desirable for all countries, emerging or advanced. This is what macro-prudential policy framework is intended to help supervisors and regulators achieve.

What is macro-prudential Policy framework all about? Is it separate from Micro-prudential Policy framework or is one a part of the other?

The term macro-prudential policy first appeared in the internal documents of the precursor of the Basel Committee in the late 1970s. The Bank for International Settlement started using it publicly by the mid-1980s. The underlying philosophy was that prudential supervisors should adopt a system-wide approach in the way they supervise, bearing in mind that the actions of individual firms can collectively generate systemic risk, even if those actions are individually rational and permissible. In this regard, supervisors should avoid focusing narrowly on the safety of individual institutions without regard to the implication of the individual actions on the wider system. It should be recognized that risk can build over time, and that the distribution of risk matters, particularly with respect to its implications for the overall financial system stability.

To this end, the objective of a macro-prudential approach is to limit the risk of episodes of financial distress with significant losses in terms of the real output for the economy as a whole, while that of micro-prudential approach is to limit the risk of episodes of financial distress at individual institutions, regardless of their impact on the overall economy. The macro-prudential policy within the overall financial system stability interacts seamlessly by feeding into and drawing from the processes of other national policies, particularly monetary and fiscal policies. In other words, macro-prudential policy framework facilitates not only the identification and monitoring, but also ensuring proper analyses of risks and vulnerabilities that relate to ensuring stability of the overall financial system. Macro-prudential policies differ from micro-prudential polices in that they are intended to protect the financial system as a whole and, by extension, the broader economy. They are aimed at countering the pro-cyclical nature of credit and leverage, leaning against the wind when systemic risk is accumulating. In addition, they seek to stem risks related to interconnections and spillovers in the financial system. The Basel Committee on Banking Supervision is playing a key role in designing this new regulatory regime as part of the Basel III initiative.

Ladies and gentlemen, you would agree with me that the philosophy behind macro-prudential policy is a desirable one. Key aspects of it are effective flow of information across the market operators and macroeconomic departments of monetary and fiscal authorities. This presupposes, therefore, that financial stability and the associated macro-prudential processes will ordinarily involve different institutions (especially regulatory) from different areas of the economy. Regular meetings among the representatives of these institutions to focus on risks and vulnerabilities and to highlight warning signs can be very valuable. A culture of coordination among these groups is very important in a crisis because, in many instances, a stress situation is first evident in liquidity strains visible to the central bank, and the first responses may be calls on central bank liquidity. The second element is effective bank supervision, including the capacity of supervisors to understand and query the risks that are being taken to ensure that they are being appropriately managed. In recent years, a great deal of effort has gone into upgrading the prudential requirements on banks through revisions to the Basel standards and other measures.

What are we going to be doing differently in the face of this new policy?

Macro-prudential policy tools are in fact the usual prudential tools that have long been used for ostensibly "Traditional Microprudential Supervision". What is 'new' is the motivation behind their use. As I have mentioned earlier, the build-up to the recent crisis resulted more from a micro-prudential than a macro-prudential failure. The easing in US mortgage lending standards, the growing reliance on short-term wholesale funding, the low risk weights attached to complex and highly leveraged structured securities were all things that dilegent micro-prudential supervisor could have- and – arguably should have – noticed and responded to. This could happen because many individual institutions are doing the same risky operations. Or it could happen because particular risks have become concentrated in few institutions. In the face of these developments, a more holistic (system-wide) perspective could, certainly, help supervisors see if risks are building up.

Without doubt, the role of macro-prudential policy frameworks is therefore to complement existing micro-prudential systems so as to identify and address emerging risks across the financial system as a whole. Designing such frameworks may encompass several aspects, including new institutional frameworks for coordination and decision making across supervisory agencies, frameworks for assessing systemic risk such as early warning systems and stress testing, and recognition that prudential regulations can also be actively used to help contain systemic risks. One major advantage of macro-prudential measures is that they can be targeted at specific risks. If potential bubbles are suspected, specific prudential actions such as debt to income limits can be taken to prevent consumer over-indebtedness or sector-dependent risk weights. At the very least, capital and liquidity buffers can be built to help shield the financial system from harm once the boom ends. Central banks around the world have adopted macro-prudential analysis as a method of detecting and evaluating the health, soundness and vulnerabilities in the financial system. It is also used in taking both preventive and resolution action in crisis management as well as identifying financial soundness indicators and methods used in analyzing them.

Does Nigeria really need a macro-prudential framework and what is in it for the nation's financial system?

Distinguished ladies and gentlemen, to answer these questions, I would simply say "Yes" to the first one. Today, a number of countries are reviewing their institutional frameworks for financial stability so as to support the development of a macro-prudential policy function and Nigeria cannot afford to be left behind.

The Nigerian banking sector had undergone series of reforms in the past 7-8 years with the aim of making the system more stable, safe, effective and resilient to shocks. The Bank introduced universal banking scheme in 2001 to create level-playing field for financial sector operators, encourage greater efficiency through economies of scale and foster competition by opening up various lines of business to banks. Before then, in 1991, the government promulgated the Bank and Other Financial Institutions Decree (No. 24) and the Central Bank of Nigeria Decree (No.25) which spelt out comprehensive guidelines for bank regulation, supervision and liquidation. The supervisory role of the CBN, aimed at promoting sound banking and financial system, was also statutorily expanded to cover non-bank financial institutions. Consequently, activities of all the regulatory and supervisory authorities in the Nigerian financial services sector were brought under the coordination of the Financial Sector Regulation and Coordinating Committee (FSRCC), under the chairmanship of the CBN. The monetary authorities also adopted the Code of Good Practices in Monetary and Financial Policies, the International Accounting and Auditing Standards and initiated a private sector-funded "lifeboat" facility accessible to all DMBs in temporary liquidity problem. Again, in line with international best practice, the CBN adopted the Core Principles of the Basel Committee on Banking Supervision, including the prudential guidelines for licensed banks to promote banking soundness and financial sector stability.

However, recent happenings in the global financial services space have indicated that whatever success may have been recorded from the reforms does not suggest that the banking sector is now immune from crisis in the future. This informed the need to further introduce new measures in the Nigerian financial landscape to guarantee continued safety, soundness and stability of the financial system. In this regard, the Central Bank of Nigeria is on the verge of putting in place the new macro-prudential policy framework with the objective of mitigating and minimizing systemic risk and ensuring coordination with monetary policy. As stated previously, the philosophy behind this new policy framework involves strong scenario planning, development and implementation of macro-prudential ratios.

Distinguished participants, let me state clearly that macro-prudential supervisory frameworks alone cannot guarantee an end to financial instability. A macro-prudential supervisor trying to prevent instability will have an incentive to severely limit the financial system's capability to innovate and to take risks. This will prevent the financial sector from fulfilling its resource allocation responsibilities. Furthermore, when incipient instability appears, the macro-prudential supervisor (and likely its government) will be under greater pressure to engage in bailouts to prevent or limit the instability. As important as the objectives of macro-prudential policy are, their effects around the world will be only as good as the quality of implementation and the quality of supervision that builds on them. It is all about how prudential supervisors should do their job and the perspectives of supervision. The policy tools are the tools of prudential regulation and supervision and so the process is as good as given but adequate attention should be accorded to the right attitude and motivation.

Before concluding my remarks, I will like to discuss some key issues that must be resolved before an effective policy regime for the containment of systemic risks can be established. First, we must understand the sources of systemic risks in the industry and design appropriate surveillance practices that would enable us detect threats to financial stability early enough. Second, we must develop a tool kit of supervisory policy instruments— macro-prudential policies—and guidelines on how and when to deploy them. And third, we must strive to avoid situations in which macro-prudential and monetary policies are working at cross-purposes, given that macro-prudential policies affect macroeconomic performance and that monetary policy may affect risk taking incentives. All of these issues raise complex questions of design and implementation.

To this effect, ladies and gentlemen, I would like to invite you to a productive debate- in which your input will be very important in coming up with valuable contributions that will help to ensure soundness of the financial system and at the same time mitigate any vulnerabilities to macroeconomic shocks.

Against this background, the organizers have carefully selected experts and seasoned professionals in the relevant fields as facilitators for this Seminar. I have no doubt in my mind that they will do justice to the issues at hand and by the end of their presentations, you will be better informed.

Once again, I urge you to make use of this opportunity by devoting maximum time and attention to all the deliveries and actively participate in all discussions.

I wish all of you a rewarding Seminar and fruitful deliberations.

Thank You.