The Regulatory Challenges of Cross-Border Banking in an Era of Post Banking Consolidation in Nigeria.

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I. Introduction

There is no gainsaying that banks play a central role in any economy. In simple terms, they accept deposits and provide credit to people and businesses. They also provide channels for the efficient transfer of funds; act as trustees and render custodian services to the public. Through their intermediation function, they provide a platform for the implementation of monetary policy. This oils the machinery of development.

Given the critical roles played by the banks and other financial institutions in economic development, the importance of banks' soundness and more broadly, financial sector soundness for good economic performance cannot be over-emphasised. One of the challenges of supervision, therefore, is to ensure that banking and financial systems, domestic and international, are and indeed, safe and remain sound. Given the macroeconomic fallout and other negative externalities of banking system problems, efforts to keep national and international financial systems safe and sound are very much part of the mandate of the Central Bank of Nigeria (CBN).

II. Banking Reforms in Nigeria.

Reforms have been a feature of the Nigerian banking industry. They have been introduced either in response to challenges posed by developments within the economy or those from outside the economy such as the imminence of systemic distress, deregulation, liberalization and globalization. Thus, the 2004 banking sector reforms were part of the broader on-going national economic reforms christened National Economic Empowerment and Development Strategy (NEEDS) designed to realize Nigeria's vision of becoming the

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largest African economy and a key player in world economy by the end of the first half of the 21st century.

The reforms intended to be a survival strategy to stem the imminent distress in the sector and a growth and development strategy to ensure the soundness, stability, efficiency and reliability of the sector

It should be recalled that the Nigeria banking reforms which focused on consolidation and recapitalization was prompted by some structural and operational weaknesses, which included: low capital base; a large number of small banks with relatively few branches; the dominance of a few banks; poor rating of a number of banks; weak corporate governance; insolvency; over-dependence on public sector deposits, and foreign exchange trading; neglect of small and medium scale savers; and lack of capacity to support the real sector of the economy.

Thus handicapped, the Nigerian banking industry as at end-June 2004 was not in a position to meet the nation's ideal of a strong, competitive and reliable banking system. It, therefore, required urgent and fundamental restructuring and refocusing, which was provided by the reforms in the sector. The reforms resulted, among other things, in the increase in the minimum the required capital for banks to ₦25 billion, resulting in bigger, somewhat stronger and certainly more sophisticated banks.

In the last three or so years, we have seen the emergence of some big cross-border banks with major activities in several countries. And this financial integration is accelerating. This development, in my opinion, is positive for the economy. It stimulates competition and product development across countries. It also means that the banks can profit from economies of scale and scope. The spread of cross-border banking has reached different levels in different parts of the world. As the integration of financial markets picks up speed, the subject of supervision and crisis management of internationally active banks have gained importance and has presented the Nigerian regulators with serious cross-border regulatory challenges, which this paper aims to discuss.

III. Cross-Border Supervision Challenges.

III.1 Cross-border Instability

Cross-border banking instability could spread through some "contagion links" such as those transmitted through the on-going global financial crisis. Such crisis could take root in an international bank with a branch structure (one legal entity headquartered in a home country) versus a subsidiary structure (different legal entities in most countries). For example, problems in a parent bank in one country might lead to curbs on its lending activity. In a branch structure, these curbs might be system-wide, causing the problem to spread to other countries, whereas with a subsidiary structure, the lending curbs would be chiefly confined to the parent, reducing potential contagion.

III.2 Supervision across-borders.

The basic desire to ensure cross-border financial stability and attain the level playing field between countries led to the first effort to coordinate supervision, in line with the Basel I Accord of 1975. While the accord was an important step in terms of coordination and communication, persistent gaps fueled additional agreements through the years, eventually leading to today's Basel II principles. There has been significant convergence in the core principles and the challenge is to hammer out and organize actual rules that would permeate regional borders. The overall challenge that cross-border supervision and regulation face is the difficulty in information sharing, particularly if a bank concentrates certain functions in a certain country.

III.3 Government Safety Nets.

A key issue in cross-border banking regulation has to do with who takes responsibility when transnational banks run into trouble. What country or entity should provide liquidity in a time of crisis in other words, who should function as a lender-of-last resort (LOLR)? Also, where can depositors turn to when international banks fail? While this is still an issue in the sub-region, in Europe, the basic operational framework of monetary policy already provides an effective automatic LOLR structure.

Issues of cross-border deposit insurance could pose a serious challenge to regulation. When an international bank runs into trouble, the patchwork of national insolvency laws is ill-

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equipped to restructure the institution and continue critical payments in a reasonable time frame. Various deposit insurance programmes differ in the types of accounts that are covered, maximum limits of coverage, funding mechanisms, government guarantees and payment speed. Perhaps most importantly, the flexibility of the laws varies, meaning that regulators often by-pass the system during a crisis and bail out the institution with government funds. This creates issues of moral hazard with potentially significant economic costs.

III.4 Insolvency Resolution.

Although the causes of cross-border banking and financial crises are not yet fully known, the negative effects are clear. Liquidity problems, settlement and clearing issues, and disruptions to hedge contracts are only a few of the difficulties that could result from these situations. Focusing on bankruptcy laws for example, the longer the bankruptcy process, the longer the depositors have to wait for access to funds, and potentially the deeper the crisis. This state of affairs is compounded in cross-border scenarios in which bankruptcy laws differ between countries. The issue of lack of coherence in bank insolvency regimes across the borders is, therefore, a major source of challenge for regulation.

III.5 Early Intervention.

We are advocates of "prompt corrective action"(PCA), a system adopted in the U.S. that is designed to minimize deposit insurance losses by mandating early supervisory intervention at troubled banks. Lawmakers and regulators must accept a few key concepts in order for PCA to be effective. For one, limits must be placed on supervisors' discretion; unless they are required to act early, supervisors may wait out problems and hope they correct themselves. Also, it must be accepted that banks will be closed even at positive levels of regulatory capital. Some institutional requirements for effective PCA include: supervisory independence, but with accountability; adequate supervisory powers, such as the ability to withdraw licenses; sound resolution procedures that inspire confidence; and reasonable, timely financial information. With these measures in place, PCA can help minimize the economic and financial costs of the bank insolvency. However, most countries in the sub-region have a long way to go to meet the conditions necessary for an effective PCA strategy domestically, let alone in cross-border situations.

III.6 Crisis Prevention.

The current cross-border supervisory framework multinational banks with national harmonization with persistent national differences would likely run into trouble in a crisis. In order to prevent contagion, there might have to be a significantly greater harmonization of laws and regulations. Unfortunately, while the desire exists, the political will to pursue this goal is rather limited.

III.7 National Interests.

Another challenge is that decisions and actions by national authorities are likely to have considerable implications for the financial stability in foreign economies. This is, of course, particularly true in cases where foreign operations are run through branches, meaning that they are subject to foreign supervision.

III.8 e-Banking

The popularity of accessing banking services through the internet and mobile phones is rising. The key issue for banking supervisors is how to ensure effective supervision of operations both in their own market (as host supervisor) when services are provided from abroad, and in foreign markets when a bank is licensed in the home jurisdiction. Both issues are not new, given the continuously rising importance of cross-border transactions, but can take on even more significance in the case of e-banking. A new, or considerably more pronounced challenge with which supervisors are faced, arises from reliance on technology for the delivery of e-banking services and products.

III.9 Corporate Governance

The failure of corporate governance has been identified as one of the major reasons for bank failures in Nigeria. It is a fundamental cause of banking problems and manifests in poor management and more broadly, weak internal governance by owners and managers. These weaknesses are frequently brought to light by adverse macroeconomic developments which have negative impact on all banks, but tend to affect poorly managed ones most heavily. Many governments, Nigeria inclusive, are concerned about protecting the central role of the banking system and guarding against the negative externalities associated with bank failures, especially when such failures are widespread.

The CBN, mindful of the havoc that poor governance has brought on the banking system over the years, introduced various types of safeguards to foster proper internal governance, compensate for failure in market discipline, and help protect the banking system in the event of adverse macroeconomic shocks. It was in this regard that it issued a Code of Corporate Governance to the banking industry in March 2006, the implementation of which is being closely monitored. Also, the entire framework of prudential regulation and supervisory practices is designed to ensure that sound corporate governance practices are the building blocks upon which our banks and other financial institutions are run.

III.10 Supervision of Financial Conglomerates

It is my belief that the reforms that have been embarked upon in the Nigerian banking industry are well documented in the literature and do not need recounting for an audience of this nature. Suffice to say, however, that the Nigeria banking reforms which centred on consolidation and recapitalization resulted in the increase in banks' capital and a concomitant increase in size and complexity of operations. The increasing complexity of the organizational structures that are being supervised, that is, conglomerates that deal with all types of financial and non-financial operations often not just within one country, but around the globe, is one of the primary challenges facing supervision today. Meeting this challenge will require enormous efforts to harmonize regulations and practices among supervisors of different categories of financial institutions, both nationally and internationally. Many such efforts are already underway, and some headway had been made. For instance, the reinvigoration of the Financial Services Regulation Co-ordination Committee (FSRCC), an umbrella body for all financial services regulatory agencies in the country, the signing of Memorandum of Understanding (MOUs) with some jurisdictions, adoption of consolidated supervision and the planned adoption of International Financial Reporting Standards (IFRS) by December 31, 2010 are efforts being made by the CBN to address this challenge.

A closely related subject is the legal framework under which these institutions will operate and thrive. The regulation of financial conglomerates will require a body of local laws covering the activities of business groups that act in different sector of the financial system which may include banking, securities and pensions. In this regard, the review of the

governing laws, which are not elaborate enough and limit the conduct of comprehensive and consolidated supervision of the entities as well as the groups, is a challenge that is yet to be surmounted.

III.11 Capacity Building

For bank supervisors to effectively carry out their responsibilities and deliver on their mandate, they must of necessity keep pace with the growing complexities of banking activities. The way to achieve this is through training and retraining of supervisory staff. The rapid rate of innovation in the global financial system has challenged the capacity of regulators to cope with developments in the system the world-over. In Nigeria, there are two major institutes that are responsible for the provision of training at all levels for the banking industry. The first is the Chartered Institute of Bankers of Nigeria, which is statutorily charged with the regulation of banking education in the country and the Financial Institutions Training Centre, which provides mainly high-level training for the industry in the form of short courses. WAIFEM has also made some remarkable impact in this area. The capacity of these institutions to adequately cope with the requirement of the industry is limited in view of the developments in the industry post consolidation. The issue of capacity building should also involve the development of the technical and professional skills of not only the supervisors, but the operators as well.

III.12 Disclosure

Distinguished ladies and gentlemen, you will agree with me that the current disclosure requirements do not provide adequate information to allow market participants access pieces of information on risk exposures, risk assessment processes, capital, and the capital adequacy of banks. Banks need to make disclosures that reflect their risk profile as market dynamics change because of their responsibilities to various market stakeholders. The absence of such disclosure requirements has made it possible for banks to exhibit significant discretion on the information they choose to disclose, thereby making it difficult for market participants to analyze their actual risk profiles. This attempt on the part of banks, which in some, if not all cases, is deliberate, makes it difficult to assess and compare the risk profile of banks.

Market participants are also slow to respond to pieces of available information on banks, possibly because they do not understand the information or they fail to appropriately decipher it. In essence, market response to appropriately reward or punish banks that fail to identify and monitor their risk profiles has not been encouraging. The CBN, mindful of this lapse, has adopted the International Financial Reporting Standard with banks expected to fully comply by December 2010. Also, the planned implementation of the third Pillar of Basel II Accord would provide a platform through which market participants can assess banks' risk and performance. Thus, the recent engagement of consultants by the CBN to prepare a comprehensive framework on "Additional Disclosure" by banks in Nigeria is timely and should be seen as a welcome development.

III.13 Data Integrity

Lack of accurate data undermines not only internal governance in banks, but also market discipline and official oversight. Increasing the availability of reliable information is a challenge that supervision has struggled to surmount in Nigeria. This problem is, however, not localized as it exists even in the international financial arena. It is generally agreed that increasing the availability of reliable information and data will require a truly massive international effort to improve accounting and auditing standards and especially to get common rules and practices on loan classification and provisioning. In Nigeria, efforts such as the introduction of the electronic Financial Analysis System,(e-FASS), a platform for an online rendition of statutory returns to the CBN by banks and other financial institutions, the resident examiners programme, the adoption of common accounting year end by December 31, 2009 and the deadline of December 31, 2010 set for the adoption of IFRS by Nigerian banks, as earlier mentioned, are intended to address this challenge.

III.14 Implementation of Basel II

As the risks faced by internationally active banks (some Nigerian banks are now active in several countries), become complex, the 1988 Basel I became inadequate in measuring the risks faced by these banks. The failure of Basel I to appropriately capture and measure the risks led to the introduction of Basel II by the Bank for International Settlement (BIS).

Basel II aims at improving flexibility and risk sensitivity in capital adequacy measurement with the objective of promoting safety and soundness, competitive equality, and a

comprehensive approach to addressing risk. Although, the CBN has made some efforts at implementing the Accord by holding several awareness seminars, workshops and training programmes for both its staff and the industry in general, the framework for implementation, which was developed in 2005 still remained unimplemented.

The implementation of the Basel II would assist banks in the development of efficient and comprehensive risk management systems and risk identification, monitoring, reporting to banks management and internal control system. The issue of data gathering and technical expertise has, however, remained a challenge for supervisors and practitioners alike to surmount. Added to this is the problem of absence of competent rating agencies whose role in this process is critical.

III.15 Managing the Aftermath of the Global Financial Crisis

As mentioned at the beginning of my presentation, some of the challenges that we face as supervisors today are a consequence of recent developments in the financial system, both locally and internationally. The causes of the global financial crisis that ravaged most, if not all, economies of the world from 2008 are well documented and do not need to be recounted to a distinguished audience of this nature. However, it would be inappropriate for me to end this presentation without a mention of this issue especially in the light of recent happenings in our domestic financial system.

The effects of the global financial crisis, which led to the collapse of many banks and other financial institutions in the world and even rendered an entire nation bankrupt are still being felt today. In Nigeria, the banking system appeared to have weathered the storm due to a number of factors, such as, the partial integration of our financial system into the International Financial System, the relatively simple nature of financial products and the strong capitalization and liquidity of Nigerian banks. However, while the system in general absorbed and survived the effects of the crisis, the effects were more strenuous on some banks than others. Some banks, mainly due to huge concentrations in their exposure to certain sectors (Capital Market and Oil and Gas being the prominent ones), and due to a general weakness in risk management and corporate governance, continued to display signs of failure. An audit of the banks was, therefore, carried out to ascertain the true financial

conditions of the institutions, the report of the audit, which is also well documented in the press, formed the basis of the decision to remove the Management Teams of ten banks that were found to be negligent in their responsibilities. New management teams were, therefore, put in place in their stead and the CBN injected a total sum of about N620 billion into the ten banks in form of Tier 2 Capital which is to be repaid from proceeds of their recapitalization. This is to ensure the absorption of the immediate shock that was bound to result from these actions.

IV. Conclusion

During the last decade, the banking sector has increasingly become cross-border and we should welcome this rather new form of financial integration as it enhances competition and stimulates economic growth. This development also raises challenges for the regulatory community. Our answer to these challenges should not be increased protectionism. Instead, we need to find new forms for cooperation and supervision that allow the benefits from integration to be realized.