# Risk Exposure and Management in Cross-Border Banking

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## I. Introduction

Banks and banking are critical to the socio-economic well-being and stability of countries and the entire globe. This is because of their invaluable role in efficient fund intermediation which oils the wheel of economic development. Banks lend at higher maturities thereby facilitating capital projects; payments and transactions commerce, provides liquidity to markets, reduces the cost of capital and helps firms to manage risks like sudden swings in exchange rates. The Structural Adjustment Programme (SAP) of 1986 was the first major financial engineering that fundamentally altered the feature and fortunes of the Nigerian banking industry. It came along with a basket of measures that promoted deregulation, liberalization of licensing, establishment of other financial institutions and regulatory overhaul. The next major leap in the Nigerian banking industry was the consolidation programme of 2004 which raised the shareholders fund of banks to a minimum of ₦25bn when many banks were still below ₦2bn [Soludo, 2004]. When the transition period ended end-December 2005, Nigeria had 25 banks compared with 89 that had hitherto existed. In order to meet the ₦25bn hurdle, some merged; some were acquired and some stood alone. In other to meet the ₦100bn capital requirement for foreign reserve management and in line with an emerging riotous competitive tempo, some of the banks engaged in another round of capital raising from the capital market, a trend that got so worrisome that the CBN had to intervene.

Meanwhile, post-consolidation, banking era witnessed quantum leaps in the major performance indicators such as, assets, shareholders funds, profits and profitability and loans to various sectors of the economy. Nigerian banks even emerged on the global chart as being among the best 500 in the globe and the best 100 in Africa. With much capital at their disposal, the search for strategic superiority and the need to play the 'me-too' competitive

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game continued unabated. The banks embarked on massive expansion, first locally and then across our shores. Bank branches were opened in major cities with some of them having branches within one kilometer radius in commercial nerve centers like Lagos and Port-Harcourt. Before long, Nigerian banks became visible in the West African landscape and other parts of Africa and the globe. In most of these African countries, their preferred mode of entry was acquisition.

This local and international geographical diversification was also accompanied by product diversification and establishment of several subsidiaries. This is not a Nigerian affair and is in tandem with the findings of a previous study of Italian banks that the pressures of competition usually push banks to seek ways of widening their geographical reach and range of products so as to achieve economies of scale/scope and efficiency improvement [Chionsini, et al, 2003:1]. There is also a general tendency for banks to become riskier-post consolidation-because they choose to take on more risks or because loan monitoring is reduced or less effective [*G10*, 2001].

The global economic crises which took a heightened dimension with the collapse of Lehman Brothers on September 15, 2008 and from which the entire world is still battling to extricate itself as the curtain is drawn in 2009, brought in its wake, a basket of lessons for financial regulators. One of the key lessons was that it brought to the fore the problems inherent in cross-border banking. The complex and interlocking structures of institutions like Citibank [with 350,000 staff in 100 countries] and AIG [120,000 staff in 200 countries managing 74 million accounts] globalised their problems; the **too big to fail** syndrome took another dimension especially as they also became **too big to save** because of their size and structure; the contagion tendency was also very high and automatic (Muo, 2009).

Businesses operate under conditions of uncertainty; the uncertainty that expected outcomes may not materialize due to unforeseen exigencies. Consequently, every business and non-business organizations continually faces an array of risks. It may be operational or foreign exchange risks. Banks, as a peculiar type of business that deal in cash and have the singular ability to create credit, is fundamentally built on trust and confidence. In addition to risks facing every other business, banks have their own peculiar risks. Risks faced by other

businesses also take different dimensions in the banking industry. Thus, while liquidity and reputational risks affect every organization, in the banking industry, they may lead to runs and outright closure. By operating across borders, banks are also taking on extra risks; risks that arise purely due to the fact that they are operating at various geo-political entities with at least, different regulations. Thus, a cross border bank is contending with three types of risks: general business risks, banking risks, and risks that emerge from international banking operations.

The essence of this paper is to examine the concept and practice of cross-border banking; the risks inherent in the cross-border banking environment and to suggest ways of managing these risks [since risks by their nature cannot be eliminated]. The paper is divided into six parts. Following part one, which is the introductory section, is part two which dwells on conceptual clarifications. Part three reviews the risks assailing businesses and banks while part four discusses the risks inherent in cross-border banking. Part five discusses how to manage these risks and part six concludes the paper.

## I. Conceptual Clarifications

Decisions are taken under conditions of uncertainty and implemented in the future where unpredictability is the norm. Consequently, there are chances that expected outcomes may not materialize. Deviation from the expected is always a possibility but what matters is the extent of that possibility, which is probability. Risk exposure is the probability of loss arising from variations between expected and actual outcomes. A decision or transaction is deemed riskier if the probability of such losses is high, especially if such losses have life-threatening consequences for the organization. Organizations are exposed to risks for the mere fact of being in existence [even living itself is all about taking risks]; because of the philosophy of the management, the type of business they are engaged in and the environment in which they operate.

It is an established fact that there is a direct relationship between risk and reward in that riskier businesses are generally more beneficial. Organisations thus manage risks to decide which ones to take and which to avoid, and how to mitigate the risks inherent in their businesses including the ones they cannot anticipate. Risk management is the active process

of ensuring that the likelihood of risk crystallization is reduced to acceptable levels through the performance of structured processes. It is about processes of reducing the likelihood of an activity which will have negative outcomes on the business occurring through the use of certain tools and techniques (Adebonojo, 2009:16). Risk management is an attempt to minimize the probability of losses, create alternative plans of action and minimize the impact of these risks, which are a normal part of the business process. Effective risk management bring numerous benefits to the firm and its shareholders, the stakeholders and the society at large and the most obvious is that the business continues to exist to fulfill its economic and social roles in the society. Risks are thus quantified and managed within the context of a well coordinated risk management framework. Some of the common risk management tools include scenario building, sensitivity analysis, Monte Carlo simulation and option pricing which are offshoots of games and chaos theories and other advances in probability sciences.

However, risk management has not always been scientific. In the past years, decisions [and the implicit risks] were guided by superstition, blind faith, hunches and incantations (Bernstein, 1996:47). The elaborate apparatus of risk management facilitated by super-computers and mathematical models developed over the years, and have eventually metamorphosed into a culture that is threatening to 'become more complex and frequently so arcane as to constitute a new religion'. This quantification of risks has created some lethal dangers for businesses and the society, especially the arrogance of quantifying the unquantifiable and increasing-rather than minimizing-risks (as people are emboldened to take on more risks than they should because there are cork-sure solutions!) (Bernstein, 1996: 49). Thus, while risk management has become scientific, it is imperative to guard against being ensnared by figures, charts and models which are guides and mere means to an end.

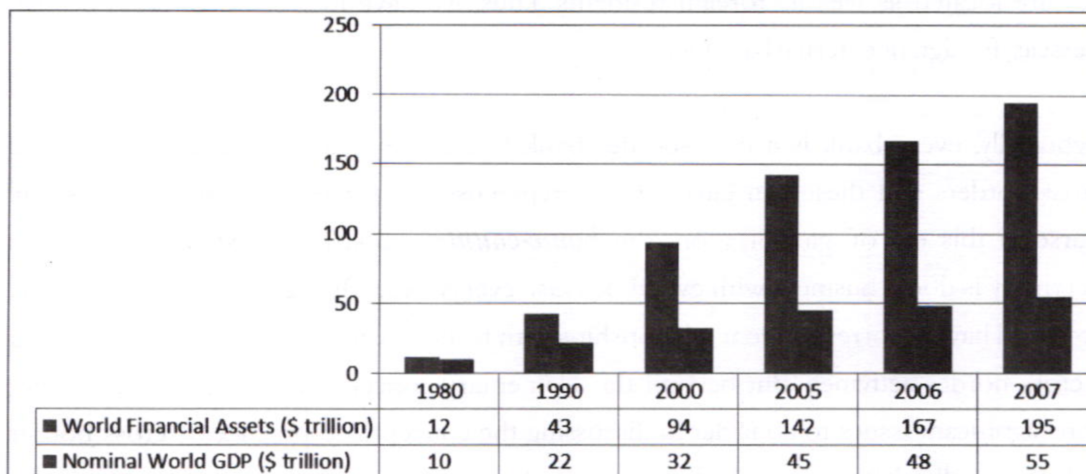
The concept of cross-border banking appears deceptively simple and straightforward. It is also intertwined with the concept of international and foreign banking. International banking may be defined as all banking transactions with non-residents and those with residents but in foreign currencies. The former are also described as cross-border or external transactions. International banking must be distinguished from overseas banking which consists of transactions of foreign banks with the residents of the country in which

they are located as well as foreign residents Thus, we have international, cross-border, overseas, foreign or external banking.

Technically, every bank is a cross-border bank because they are engaged in businesses across-borders and these can have adverse repercussions for their home countries. Of course in this era of globalization, the ***home-country*** concept is fast disappearing as everybody is doing business with everybody else everywhere. By merely opening letters of credit and having correspondent relationships with foreign banks, a bank is already engaged in cross-border activities. But beyond this elementary conceptualization, there are other more significant issues to consider in discussing the concept and practice of cross-border banking as well as how to manage the inherent risks.

First, with financial globalization facilitated mostly by developments in ICT, banks now operate widely across the globe even when their physical location is restricted and fixed. The value of world's financial assets rose from $12 trillion in 1980 [roughly equal to global GDP] to $195 trillion in 2007 (356 per cent of GDP). Thirty three per cent of holders of government bonds; 25 per cent of equities and 20 per cent of private debt securities are not from the countries where these securities are issued (Farrell, 2008:27) Even before then, global capital flows quadrupled between 1990 and 2000 to $7.3 trillion (Hausler, 2002:10). Banks that are into all sorts of financial intermediation and engineering are at the heart of this intimidating financial growth and flows and they did so without moving an inch from their locations. So, when Nigerian banks use ICT facilities to move products and funds across the globe, they are involved in cross-border transactions.

**Figure 1: Comparative Analysis of Global Financial Assets & GDP**




Source: Farrell ,D[2008] New Thinking For A New Financial Order; Harvard Business Review, September, p27

Second, Nigerian banks in the recent past have opened investment windows for foreign investors independent of whether they had established their branches outside the shores of Nigeria. Thus, in the past 5 years, there have been scores of foreign institutional investors who took direct stakes in Nigerian banks quoted in foreign stock exchanges and many of them floating Global Depository Receipts. This is another category of cross-border financial activity because the action of these foreign investors impact on the Nigerian financial environment.

Third, there are foreign banks which are operating in Nigeria, including Citibank, Standard Chartered and Stanbic - IBTC. In the short-run, more of them are likely to come in following the recent developments in the banking industry and the resultant windows of opportunity. In the long-run The FSS2020 strategy will attract more banks into the country. Aligned with the National Vision 20: 2020 agenda, it is targeted at transforming Nigeria into an International Financial Center [IFC] and the fastest and safest financial system among the emerging economies. It is also expected to transform Nigeria into a natural destination in West Africa for financial products and services and the ideal point for channeling investments to other parts of the continent [CBN, 2006,25]. The physical manifestation of that will be the Lekki Financial Corridor. London is the largest international financial center while others such as Hong Kong and Singapore are mainly regional centers. New York and Tokyo owe their importance chiefly to the size of their national economies. The size of

London in financial and securities transactions is out of all proportions to the size of the British economy. It also has the widest variety and number of international financial institutions [Rose, 1997; 388].

Fourth, there are Nigerian banks that have full-fledged physical presence overseas though they are mostly concentrated in West Africa [Table 1] and this has helped to consolidate their dominance of the West-African banking landscape [Table 2]. This trend has been described as the emergence of regional banking groups in Africa, which are mostly based in South Africa and Nigeria [Christensen et al, 2006]. Regional banks improve banking sector efficiency, allow banks to achieve economies of scale and risk diversification, promote competition, facilitate trade and enhance regional integration and the dynamism of the banking sector in the region. The banks also 'migrate' because they have excess liquidity, hold more reserves than they require and are in search of bankable businesses. Some also follow their customers abroad to offer banking services to them [Kohler, 2009:39].Unfortunately most of these banks are spreading to volatile high-risk environments exposed to terms of trade shocks [Gulde & Patillo, 2006:44]. Furthermore, while it is argued that geographical spread reduces risks since it involves diversification, it is also possible that the expanding bank may acquire a weak bank and thus inherit some 'trouble'. Its monitoring costs will also increase and both may offset the advantages of diversification [Amihud et al, 2002]. Also, diversification is not a guarantee against loss; it is just a guarantee against losing everything at once [Bernstein, 1996:51]. Regional banks also increase linkages among financial systems and, therefore, require adequate cross-border supervision, because financial sector problems that emerge in one of the countries in which those banks operate are quickly spread to other parts

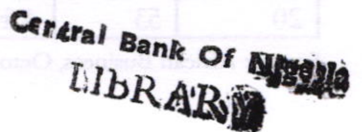

Central Bank Of Nigeria
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**Table 1: Spread of Nigerian Banks Overseas**

| S/N | Bank | Branches Within Africa | Branches Outside Africa | Total |
|---|---|---|---|---|
| 1 | Access | 6 | 1 | 7 |
| 2 | Diamond | 1 | 1 | 2 |
| 3 | FBN | 2 | 3 | 5 |
| 4 | GTB | 4 | 2 | 6 |
| 5 | Oceanic | 3 | 1 | 4 |
| 6 | UBN | 3 | 1 | 4 |
| 7 | UBA | 19 | 3 | 22 |
| 8 | Unity | 1 | | 1 |
| 9 | Zenith | 3 | 1 | 4 |
| 10 | FCMB | | 1 | 1 |
| | Total | 42 | 14 | **56** |

UBA plans to extend operations to 25 African countries by 2010.

Sources: several

**Table 2: West Africa's Top Twenty Banks**

| Regional Rank | African Rank | Bank | Date of Results | Country | Capital [$m] | Assets [$m] |
|---|---|---|---|---|---|---|
| 1 | 6 | Zenith Bank | June 08 | Nigeria | 2500 | 12800 |
| 2 | 8 | Oceanic Bank | Sept 07 | Nigeria | 1,777 | 8265 |
| 3 | 9 | Intercontinental | Feb 08 | Nigeria | 1.696 | 11781 |
| 4 | 11 | Access Bank | Feb 08 | Nigeria | 1431 | 10.055 |
| 5 | 12 | GTB | Feb 08 | Nigeria | 1382 | 6225 |
| 6 | 15 | UBA | Sept 07 | Nigeria | 1245 | 9479 |
| 7 | 16 | FCMB | April 08 | Nigeria | 1010 | 3567 |
| 8 | 17 | UBN | Feb 07 | Nigeria | 826 | 5460 |
| 9 | 17 | FBN | Feb 07 | Nigeria | 604 | 6855 |
| 10 | 23 | Ecobank Trans | Dec 07 | Togo | 514 | 6550 |
| 11 | 27 | Diamond | April 07 | Nigeria | 423 | 2506 |
| 12 | 36 | Stanbic IBTC | Dec 06 | Nigeria | 297 | 864 |
| 13 | 38 | Ecobank Nig | Dec 07 | Nigeria | 295 | 2640 |
| 14 | 40 | First Inland | April 07 | Nigeria | 292 | 1556 |
| 15 | 41 | Bank PHB | June 07 | Nigeria | 284 | 3001 |
| 16 | 42 | Spring Bank | Dec 05 | Nigeria | 267 | 1052 |
| 17 | 44 | Nig. Intl Bank | Dec 06 | Nigeria | 263 | 872 |
| 18 | 49 | Fidelity Bank | June 07 | Nigeria | 234 | 1706 |
| 19 | 50 | Skyebank | Sept 07 | Nigeria | 233 | 3563 |
| 20 | 53 | Afribank | March 09 | Nigeria | 221 | 1428 |

Source: African Business, October, 2008

Thus, the huge international financial flows by banks , which are mostly online and without anybody's consent and control, the involvement of foreign investors in our banks[through direct investment, listing, GDRs], the establishment of foreign banks in our shores, a tendency that will only become more pronounced and the dispersal of Nigerian banks across the globe in search of growth and competitive superiority, are all sources of risks and should be borne in mind when planning for cross-border risk exposure and management.

## III. An Overview of General Business and Banking Risks

### III.1 General Business Risks

Every business [and banking is a business] faces an array of risks in its efforts to create value. These risks are multidimensional and interconnected and they include; market, political, reputation/confidence, financial, ICT, information, succession, credit, operations, regulatory and change risks. We shall only dwell on some of these risks since most of them are common and are still part of the banking risks. Of course, the nature of banking will automatically change the nature and impact of these risks. *Succession risk* is the likelihood of an organization having a failed succession programme: having an unsuccessful successor, one who leaves before he has settled down or one rejected by the dominant stakeholders. *Change risks* include the probability that the change programme failed; that the organization collapsed in the process, that it gets into an endless change cycle or that its core value is destroyed in the change process [Muo, 2006]. In this knowledge economy where information moves at the touch of a button, information risks are also as threatening as the conventional ones[ Johnson,2005:4] and so are other newer forms of risks like political risks[Bach,2005:4] and project risks[De Reyck,2005:8]. But one of the most critical risks that is not much discussed is strategic risk. *Strategic risk* has been defined as an array of external events and trends that can devastate a company's growth trajectory and shareholder value [Slywotzky & Drzik; 2005:80]. Strategic risks take a variety of forms-new technology, shift in market or rapid shift in customer loyalty and businesses that successfully manage these risks become *risk-shapers*; they are both aggressive and prudent in pursuing new growths. Types of strategic risks and possible counter-measures are depicted in figure 3.

**Table 3: Types of Strategic Risks and Counter Measures**

| S/N | Strategic Risks & components | Counter Measures |
|---|---|---|
| 1 | **Industry**: margin squeeze, rising R&D/capital expenditure costs; overcapacity, commoditization, deregulation, increased power of suppliers, extreme business-cycle volatility | Shift in compete /Collaborate ratio |
| 2 | **Technology**: Shift in technology; patent expiration., process obsolescence | Double-bet |
| 3 | **Brand**: erosion or collapse | Redefine the scope of brand investment; reallocate brand investment |
| 4 | **Competitor**: emerging global rivals, gradual market share gainer, one-of-a-kind competitor | Create new, non-overlapping business design |
| 5 | **Customer**: customer priority shift, increasing customer power, over-reliance on few customers | Create and analyse proprietary information; conduct quick and cheap market experiments |
| 6 | **Project**: R/D or IT failure; business development failure and M/A failure | Engage in smart sequencing, develop excess options or employ stepping stone methods |
| 7 | **Stagnation**: flat or declining volume; volume-up, price down; weak pipeline | Generate demand-innovation |

Source: Extracted from Slywotzky & Drzik[2005] 'Countering The Biggest Risks of All'; ***Harvard Business Review***, April, pp78-88

Each business faces a unique mix of strategic risks depending on the industry, competitive position, sources of revenue and profits and brand strengths. A 6-step process for mitigating strategic risks involves:

1. Identifying the types of risk and assessing them on the bases of severity, probability, timing and changing probability over time;
2. Mapping these risks based on types and characteristics so as to see them at a glance;
3. Quantifying the risks so as to compare and aggregate them and link them to decisions on capital budgeting, pricing and risk transfer;
4. Identifying the potential upside of each risk-ascertaining what will likely happen if the risk is reversed;
5. Developing risk mitigation action plans; establishing multifunctional teams to outline risks, remediation plans and responsibilities; and
6. Adjusting capital decisions accordingly.

### III.2 Banking Risks

Banking is a particularly risky business especially as they have extended their services to all

aspects of the capital market. These risks are several and have been categorized differently by various scholars. Nnanna[2003:32] grouped them into four as financial risks [balance sheet structure, profitability, capital adequacy, credit, liquidity, market and currency]. Operational risks [internal/external fraud, employee practices and workplace safety, clients, products and business services, damage to physical assets; business disruption and system failures, execution, delivery and process management]. Business risks [macro policy, financial and legal infrastructure, regulatory compliance, reputational, fiduciary and country risks] and event risks [political, contagion, banking crises and other exogenous factors. Umoh(2003) classifies them as endogenous risks [those that are associated with the nature of the banking business] and exogenous risks [those that are external to the banking system] while Santomero [1997:3] categorises them into three as risks that can be eliminated or avoided by simple business practices; those that can be transferred to other participants and those that must be managed at the company level.

Banking risks are several and include systematic, credit, counter-party, legal, operational, interest, foreign exchange, reputational, liquidity, fraud, regulatory, confidence, IT, leadership, sovereign, industry and market risks. There is also the human resource risk which occurs when a bank does not have adequate human resources in terms of quantity and quality to pursue its mandate. In terms of which risks are more threatening, a risk prioritization exercise by Arthur Anderson in 2001 [recounted in Umoh2003] considered 17 banking risks and listed the first ten as: computer, human resources, credit default, regulatory, customer satisfaction, IT infrastructure, liquidity, industry and leadership risks in that order. Note that computer and human resources risks came before credit, fraud and liquidity risks! Some common bank risks are tabulated in Table 4.

Another category of risks which deserves special mention is those associated with e-banking. There are three levels of e-banking services. The first stage creates awareness about the banks offerings and attend to customers enquiries. The second allow customers to go beyond enquiries and submit instructions, order for cheque books and query their balances. The third and highest level is offered by fully transactional websites which allows for transfer of funds, payment of bills, purchase of securities etc. [Zarma, 2001:63]. Risks associated with internet banking and which are interlinked with other conventional banking risks-

include operational, business/strategic, technology infrastructure, security, access authentication, employee frauds, counterfeiting, reputational and legal.

**Table 4: Some Common Bank Risks**

| S/N | Type of Risk | Brief Description |
|---|---|---|
| 1 | Credit | Risk that a party to a loan agreement will not be able or willing to service the loan[interest/capital |
| 2 | Liquidity | Risk of bank having insufficient funds on hand to meet its current obligations |
| 3 | Interest | Risk of change in interest rate that will have adverse effect on banks income and/or expenses |
| 4 | Market[position] | Capital loss resulting from adverse market price movements related in investment in commodity, equity or debts |
| 5 | Currency structure | Risk of adverse exchange movements due to mismatch between foreign receivables and payables |
| 6 | Balance sheet structure | Risks resulting from the structure and composition of banks assets and liabilities and off-balance sheet positions |
| 7 | Income structure and profitability | Risk that a bank does not have enough income to cover its expenses and maintain capital adequacy |
| 8 | Solvency/capital adequacy | Risk of bank having insufficient capital to continue operations and non-compliance with regulatory capital standard |
| 9 | Country & Transfer | Risk arising from economic, social and political environment in the borrowers home country[country risk] and the risk present in loans that are not denominated in the borrowers local currency[transfer risks] |
| 10 | Legal | Risks that a bank's contract or claims will be unenforceable or that the court will impose judgments against it; risks of legal uncertainty due to lack of clarity of laws in localities in which the bank does business |
| 11 | Reputational | Risk that problems in a bank can cause customers, creditors and counterparties or markets to lose confidence |

Source: Nnanna; [2003] Today's Banking Risks & Current Regulatory & Supervisory Framework'. ***Bullion*** Vol.27, No.3, July/September; p30

Common approaches to measuring and managing these risks include:

- Standards setting and financial reporting - including underwriting standards, risk categorizations and standards of review, consistent evaluation/rating of exposures, external audits, regulatory reports and rating agencies.
- Position limits and rules - restricting risks to specified assets and standards and for

approved risks, limits of exposure to parties and different types of risks.

- Investment Guidelines and strategies - outlining strategies for concentrations and commitments to given areas, extent of desired asset-liability mismatch.
- Incentive schemes - aligning compensation to risks (Samtomero, 1997:8).

## IV. Risks Inherent in Cross-Border Banking

It has been argued earlier that technically, every bank is involved in cross-border activities and that this cross-border tendencies are heightened by fund movements and transactions through the internet, involvement of foreign investors in the Nigerian banking industry including those who bring in *restless* and *hot* money and the opening of off-shore subsidiaries by the banks. Most of these tendencies are also two-way affairs since, for instance, as we are opening banks off-shore, some foreign banks are also opening operations in Nigeria. Thus, even when we take the narrow view of cross-border banking [banks opening shops off-shore and vice versa] we must bear the broad concept in mind. Furthermore, the cross-border banks are also businesses and as such are susceptible to risks facing other businesses and banks. The only difference is that their cross-border operations have further compounded and complicated conventional risks while introducing novel ones. Thus, in this section, we shall be discussing risks that are specific to cross-border banking [narrow and broad view] as well as those that are made more complex by cross banking operations. It should also be noted that some of these risks affect a bank; some affect a group of banks and indeed the entire banking system [and consequently, the economy] while some will go beyond Nigeria to neighbouring countries.

### IV.1 Contagion Crises/Risks

The financial crises of 1994 [Mexico], 1997 [Asia] and 1998 [Russia] spread across the emerging markets and gave rise to the concern about international contagion risks. While the Argentine crises [2001] only affected Uruguay, the emergence of new forms of players [hedge funds, private equity funds and heavily loaded sovereign wealth funds] and instruments[index-based investing and exchange-traded funds, which facilitate investment in aggregate country/regional indices rather than individual stocks or even countries] ensured that the risks of contagion was forever present. 'The growth of cross-border banking has also played a role in increasing the potential for international transmission of

financial and other risks' [Mauro & Yafeh, 2007, 26]. The Margin/Lehman crises of 2008 reinforced that reality on a monumental scale. Within few days of the collapse of Lehman, the global financial industry was at a standstill and more than $400bn was withdrawn from money market funds across the world [Duyen et al, 2008:48]. In this as in other well known contagious crises, the financial institutions in advanced countries were responsible for transmitting the virus to banks in the periphery.

The fact remains that banks have long abandoned *narrow banking* and are now involved in all facets of the normal and esoteric financial activities [money and capital market]. They extend their tentacles in these spheres to all areas of operations. When there are problems at home or anywhere they operate, they *off-load* in areas that are apparently safe so as to solve the original problem. The fact that the whole international ensemble of banks does so simultaneously cause problems in the area that was hitherto safe and that is the contagion. Because our banks are now operating across the globe, any crises in any of the countries where they operate will readily and quickly affect Nigeria. Crises in countries where foreign banks operating in Nigeria have interests will also affect the country.

Contagion refers to the transmission of a shock affecting one bank or possibly a group of banks and how this shock is transmitted to other banks or banking sectors. It is thus a subset of the broader concept of a systemic crisis, which may be the result of a common shock affecting all banks simultaneously. Evidence of contagion exists and a pre-Lehman study of European banks between 1994 and 2003 indicates significant cross-border contagion which increased with the further integration of the European financial system occasioned by the introduction of Euro. Apart from the strong evidence of contagion, the study found one country pair with evidence of bi-lateral contagion, namely UK and Germany. This means that adverse shocks affecting German banks have an impact upon UK banks and vice versa. Second, aside from being exposed to contagion from the UK, German banks are also exposed to contagion from Spanish and Dutch banks. Third, Spanish banks tend to be particularly important for the banking systems in other countries, which may be somewhat surprising. In addition to German banks, also French, UK and Dutch banks have been exposed to contagion from the Spanish banking system. Fourth, Spanish banks themselves are exposed to contagion from Italian banks only [Gropp et al, 2006].

## IV.2 International Financial Centre (IFC) Risks

It is also important to stress that by being a destination of choice by foreign banks, a tendency that can only get stronger; the economy suffers what one may call an International Financial Center [IFC] risk in addition to contagion. London as a city and UK as a country suffered immensely from the recent global financial crisis. More financial jobs were lost per capita; the cost of bail out was high[as measured by public debts and budget deficits] the economic contraction was severe and the other economic consequences of *'The Great Contraction of 2008-2009* [Rogoff, 2009:12] were relatively more severe because of the concentration of banks and the pervasive influence of banking in the British economy. Indeed, the crisis placed Britain in a very precarious macroeconomic/financial position to the extent that the sovereign solvency of Britain was an issue of debate throughout the last quarter of 2008 and the first half of 2009.The financial services have grown in leaps and bounds to account for 30 per cent of UK economy and this situation seriously unbalanced the economy during the crisis. Britain experienced a rapid fall in house prices and high level of household indebtedness; the crisis damaged the financial sector and consequently, there was a severe credit crunch; it relies heavily on the financial sector for the supply of well-paying jobs; that sector has now contracted sharply and it also relied on that sector to finance a trade deficit, which stood at 6.4 per cent GDP in 2007 [Wolf, 2008:27]. This is mostly because these financial services are not products of British savings. London has become an offshore trading center for packaging attractive and complex financial products and while this is fine when things are going well, it goes awry when things are bad. The country is exposed to enormous overseas risks, more so as it borrows short and lends long [Eatwell, 2009:44].

## IV.3 Market Integrity Risks

Related to the above is the risk that market integrity may be compromised by financial crimes [like money laundering] and this is more likely when the supervisory and regulatory systems in the off-shore areas are weak and when data is inadequate or unreliable about their operations. Banks may take higher risks outside the shores of the country than they are allowed at home and with increasing integration of financial markets, problems of cross-border banks are quickly transferred to the parent banks at home thereby jeopardizing their health-especially when a significant proportion of their assets is held off-shore [Darbar et al, 2003:32].

### IV.4 Foreign Exchange/Currency Risks

Every bank is exposed to foreign exchange risks because it transacts foreign exchange deals for its clients and also on its own accounts. But for banks that are operating overseas, its investments in those offshore units are in foreign currencies and adverse movement in these currencies have severe consequences on the health of the offshore subsidiaries and of the banks themselves. It also affects the value of the returns from their operations and most of these holdings are not in global currencies. These risks will be more of *translation risks* [losses or gains that can result from restating the values of assets and liabilities /payables arising from investments abroad from one currency to another] than *transaction risks* [the risks that a country's currency may change in value to the banks disadvantage] when it has to pay or receive foreign currency at a future date in the process of import/export [Ball et al, 2002:649].

### IV.5 Political/Country Risks

Being in business in foreign countries, cross-border banks are exposed to an assortments of political risks because the political environment is different from the home country and also peculiar. These risks may be *macro* [affecting all foreign firms] and includes expropriation or being innocent victims in local strife or *micro* [affecting specific industries/firms] like when a bank's goals diverge from that of the government, nationalization or corruption [Eiteman et al, 1998]. Generally, these risks arise from instability of government, political mood of the country, policy orientation and attitude towards foreign investments [Stonehouse et al 2000:298]. Other associated risks include legal and regulatory. Apart from conforming to different and varying regulations across countries, the host country may introduce regulations that are generally difficult or particularly punitive towards foreign concerns. The government of Ghana has raised the bar on the capital base of banks operating in that country but gave different benchmarks and compliance dates for foreign banks-which are mostly Nigerian-owned. Of course, that is similar to an earlier policy that foreign traders need a minimum of $300,000 to be allowed to trade.

The extent of political/country risks is a function of the *'distance'* between the bank in question and the host country. This is however beyond geographical distanc*e and* actually measures the degree of incompatibility between the bank and its hosts. The Cultural,

Administrative, Geographical and Economic (CAGE) *framework* for measuring this distance considers the following:

- ✓ Cultural distance: this dimension measures differences in language, ethnicity, religion and social norms;
- ✓ Administrative and political distance: political, administrative and legal traditions. In this dimension, Togo is thus 'closer' to France than to Nigeria;
- ✓ Geographical distance: this dimension goes beyond physical distance to other geographical characteristics like size, sea access, transport infrastructure;
- ✓ Economic distance: this measures wealth distance and underscores the fact firms from different countries have different capabilities in serving certain group of customers. It is thus not just a matter of a wealthy market being preferable to a poor market [Johnson et al, 2008:308; Ghemawat, 2001:137].

### IV.6 Internet-Banking Related Risks and Issues

The internet does not recognize any boundary and that creates its own challenges and risks beyond the level of the individual banks. The internet even raises the fundamental question of what is a bank and what can be defined as banking services, under which supervisory jurisdiction specific internet services fall and which law is applicable at what time [Zarma, 2001:90]. It increases the speed of transfer and hence, fastens the speed of fraud, heightens liquidity crises as people can withdraw their money by the touch of the button, alters the velocity of money, makes it difficult to trace transactions [loss of audit trail] and to monitor the stock of money in domestic currency since some e-banking offer multi-currency facilities [Oluyemi, 2001:36].

#### Human Resources Risk

Umoh[2003] defines this as the risk that a bank may not have adequate human resources in terms of number, qualification and experience to pursue its mandate. It also includes losses due to errors of omission or commission by staff and outright theft, fraud and forgeries. This becomes a critical risk element in cross-border banking because the banks venturing outside has to work with and through people in distant lands at board, management and general staff level; people that are literally unknown and in an environment that has an established work culture and other cultural traits. There may not be enough people in the environment; the people may be there but lack the dynamism and orientation of the home

bank; the banking system and culture there may be so underdeveloped that both the customers and staff are poles apart from the foreign banks or they may have the impression that foreign interests should not be protected or should indeed be sabotaged as they are oppressors. Some of these variables may also be in opposite direction but the issue is that whenever a wide gulf exists between the home and host banking environment, human capital stock and culture, human resources risks become manifest.

### IV.8 Super Bank and Too-Big-To-Fail Risks

When banks expand both locally and across the border, their size increases; their systematic importance increases; they become 'super' banks and even lose the ability to effectively monitor their operations. This puts their entire operations and continued existence at risk especially when the expansion is aligned with product diversification and complex structures. The increasing size makes it imperative for the authorities to take desperate steps to prevent their failure, not for their own sake but because of the systematic [local, regional and global] impact of such failures. And because their size has grown, saving them when they run into bad weather becomes a problem. As in the case of Citi Bank and the UK big 4, they become *not just too big to fail but also too big[and difficult] to save!*

## V. Risk Management in Cross-border Banking

Cross-border banking has become an issue in Nigeria and whereas the exposure of banks and economy to attendant risks might have been insignificant a decade ago, it is now very significant and too critical to be ignored. The banks are exposed to the series of risks discussed above and a complication of the conventional risks due to their cross-border operations. These risks have to be identified, measured and managed. It is important to state *ab initio* that no organization is capable of anticipating and/or estimating all its risks or else, risk management would have been a straight forward affair. Like mathematicians, risk managers are perpetually searching for the unknown. But risk management is basically, the responsibility of the banks in question and the quality of bank management, especially the risk management process, are key in ensuring the safety and stability of both individual banks and the banking system [Nnanna, 2003:37]. The responsibility of the Central Bank as the overall regulator is to act as facilitators in the process of risk management and to strengthen the statutory framework on the basis of which risk management is undertaken.

Thus, the CBN has the responsibility to develop and enforce guidelines, design floors and ceilings and ensure that the banks do the right thing with regards to risk management. Already, the CBN has issued the guidelines for developing 'Risk Management Processes' and 'Guidelines for Developing Risk Management Framework for Individual Risk Elements in Banks'. In the discussions that follow, we shall dwell on steps that the CBN should take to protect the banks, the banking system and the economy from cross-border risks. It will also include some steps which the banks should take themselves; these are relevant because the CBN should ensure that these steps are taken in the interest of the economy. Some of the suggestions may also appear futuristic; they are more for tomorrow than for today but we have to prepare for tomorrow today and always remember that today is the tomorrow we thought was very far away yesterday!

### V.1 Cross-Border Risks and Basle Core Principles

Because concerns with cross-border banking are global and have been on for a long while, provisions were made on how to manage the supervisory challenges-including the risks- as part of the Basle Core Principles. The aspects that affect cross-border banking are:

- Banking supervisors must practice global consolidated supervision over internationally-active banking organizations, adequately monitoring and applying appropriate prudential norms to all aspects of businesses conducted by these banking organizations worldwide primarily at their foreign branches, joint ventures and subsidiaries;
- A key component of consolidated supervision is the establishment of contact and information exchange with the various other supervisors involved, primarily host supervisory authorities;
- Banking supervisors must require the local operations of foreign banks to be conducted to the same high standards as are required of domestic institutions and must have powers to share information needed by the home country supervisors of those banks for the purposes of carrying out consolidated supervision [Muse; 2006:24]

The CBN must thus put these provisions into effect; supervising the banks on a consolidated basis [product wise, risk wise and geographically] sign and/or update the

Memorandum of Understanding (MOU) with host supervisory authorities of foreign Nigerian banks [and this should include all players in the financial markets]; and ensure that such MOUs are in place before banks are licensed to operate offshore. It is good to subject foreign banks operating in Nigeria to our standards but where their home standards are higher, it may well be advisable to latch on the MOU so signed and have the knowledge of such supervisory information from home.

### V.2 Regional Supervisory Framework?

Most of the banks are operating in the West African sub-region. The possibility of having a regional supervisory arrangement within the ECOWAS framework should be considered. I am assuming the Nigeria Banking system is more developed than most of the banks in the neighbouring countries while some learns could be gleaned from these countries. Regularizing the supervisory framework ensures that banks are as much as technically and politically possible subjected to similar regulatory requirements. This will be a step above the MOUs and minimize the tendency to spread financial virus across-borders. Europe has established new ground rules to improve cross-border coordination between regulators and the 2005 capital requirements directives established minimum standards for banks operating in the EU. But it has not been effective whenever there were crises. The issue is that while their activities have regional impacts, the regulators operate from a national mindset and that is not optimal for an integrated market. Consequently, there have been arguments for the establishment of a single regulator for all cross-border banks across Europe [Munchau, 2007:23]. ECOWAS is very far away from the level of European integration but the lessons and concerns are useful and should be given serious attention. Such regional regulation will also help to prevent the *race to the regulatory bottom,* in which banks rush to establish branches in areas where regulatory standards are comparatively low

### V.3 Managing Contagion Risks

Part of the foregoing discussions on the practicalisation of the Basle Core Principles and the possibility of regional supervisory framework will help to minimize contagion risks. Other strategies for managing contagion risks at the global, regional and country levels include:

- Improved macroeconomic policies and debt management aimed at reducing vulnerability and softening the impact of contagious blows. This is self-insurance through the prudent accumulation of international reserves;
- Globally coordinated provision of liquidity during crises. Contagion at the global level resulting from market failures and externalities require global governance and coordination-which is what G20 has been doing;
- Pooling of regional reserves-within the appropriate framework- to provide a backstop in case of crises;
- Increasing surveillance and scrutiny of private financial market players;
- Effective consolidated supervision of all operations[insurance, banking, capital market] across industries and countries;
- Compliance with international supervisory standards by various supervisory regimes;
- Enhancement of information sharing and collaboration within sectors and across sectors;
- Outside/offsite supervision in collaboration with authorities[[Darbar et al, 2003:32]; and
- For foreign banks operating in Nigeria, efforts should be made to ensure that they are subjected to the highest level of regulation available and that any capital/liquidity shortfalls are borne by their corporate parents and home countries if it gets to that level. Restricting foreign bank entry or participation may not be an option as studies have shown that it will increase net interest margin and overhead cost and is positively associated with banking crises [Barth et al, 2001]. But if the foreign banks are engaged in riskier and complex operations, they should provide adequate capital as a regulatory buffer [and not as a protectionist tool as in the case of Ghana].

### V.4 Managing the Super Bank/Too Big to fail Risks

By operating across-borders, banks generally become bigger and eventually transform to *too big to fail [and save]*. When banks become too big to fail, there are systemic consequences:

- They become prone to moral hazards and too big to discipline effectively, supervise and wind down if need be;

- Any failure places a substantial strain on the system because it threatens other institutions and the entire financial system [Mishkin, 1999];
- Diversification can lead to monitoring difficulties if and when the bank lacks sufficient knowledge of the market it enters and if the home sector has a low downside risk, such diversification increases the overall insolvency risk [Winton, 1999]; and
- The too big to fail status also gives the institutions a highly market distorting special competitive advantage in pricing their debts and equities[Greenspan, 2009:33].

This risk can be mitigated via several means:

1. Closer monitoring of those banks;
2. Stress-testing the banks and measuring their sensitivity, cross-border related variables and imposing remedial actions;
3. Special capital requirements to meet the risks inherent in their operations;
4. Guarding against over-diversification [including product and local dimensions]. Most firms got into trouble in the past 12 months due to over diversification. AIG which went into credit insurance and Hypo Real Estate which strayed into the wholesale funds market are examples. Organisational Peter Principle occurred as they moved into areas they did not understand well and thus could not manage. This can be done to:
   a. Ensure that banks spread to areas where they are competent and where there are potentials for returns;
   b. Ensure that where offshore subsidiaries exist, they are properly managed; and
   c. Adopt the modular design option such that the subsidiaries are truly independent of their parents so that even if there were problems, they can bear the brunt without dragging their parents down.
5. Restricting and monitoring their level of leveraging so as to restrict the balance sheet size, propensity to expand and reckless risk-taking.

### V.5 Monitoring Host Economies and Advising Accordingly

Banks that wish to expand internationally should undertake feasibility and viability studies to ascertain the suitability of those countries for their investment. The CBN should also

have its own information on the economic health of those countries especially at the regional and sub-regional levels where most of these banks are concentrated for now. Published studies on the macroeconomic conditions of these countries abound [see table 5] but the CBN should have its own databank. Stress-testing and scenario building should be used to assess the changes in risk factors on the health of given banks, relative importance of some shocks [Hilbert & Jones, 2004:24] or even whether to approve the application for offshore licenses. The Reserve Bank of New Zealand conducted an internal stress-test and passed the outcome to its key banks to measure the impact on their capital [Gordon, 2004]. The CBN can apply such a method to proactively assess the impact of developments in the West Africa sub-region on our banks and the entire banking system.

**Table 5: Economic Outlook of Selected African Countries, 2008**

| S/N | Country | Short-Term Economic Risk | Global Rank | Long Term Economic Risk | Global Rank |
|---|---|---|---|---|---|
| 1 | Nigeria | 78.8 | 22 | 59.1 | 63 |
| 2 | Botswana | 74.4 | 41 | 58.2 | 46 |
| 3 | Morocco | 70.8 | 54 | 62.8 | 31 |
| 4 | Libya | 67.9 | 64 | 61.5 | 36 |
| 5 | Namibia | 66 | 67 | 72.3 | 12 |
| 6 | Algeria | 64.6 | 72 | 53.1 | 61 |
| 7 | Angola | 64.6 | 72 | 46.7 | 77 |
| 8 | Tunisia | 60.4 | 77 | 56.8 | 49 |
| 9 | Ivory Coast | 57.7 | 82 | 45.5 | 83 |
| 10 | S/Africa | 56.6 | 87 | 60.2 | 40 |
| 11 | Tanzania | 52.5 | 109 | 45.2 | 84 |
| 12 | Ghana | 43.5 | 119 | 48.8 | 73 |
| 13 | Kenya | 37.3 | 126 | 46.2 | 79 |
| 14 | DRC | 26 | 132 | 28.6 | 97 |
| 15 | Zimbabwe | 1 | 133 | 18.1 | 121 |

Source: Business Monitor International Economic Outlook Report, 2008

## V.6 The Gospel According to G20-Pittsburg, September 25, 2009

The Basle Principles, the problem of contagion, international collaboration and the "too big

to fail" issues were aptly captured by the G20 in its Pittsburg Summit in the proclamation on Addressing Cross-border Resolutions and Systematically Important Institutions by end-2010. It declared that:

*"Systematically important financial firms should develop internationally-consistent firm-specific contingency and resolution plans. Our authorities should establish crises management groups for major cross-border firms and a legal framework for crises intervention as well as improve information sharing in times of stress. We should develop resolution tools and framework for effective resolution of financial groups to help mitigate the disruption of failures and reduce moral hazards in future. Our prudential standards for systematically important institutions should be commensurate to the costs of their failure"*

This encapsulates the positions we have canvassed above and reiterates the primary roles of the banks themselves in the risk-management process. But the CBN as the regulator, just like other regulators, should ensure that the banks do the right thing on time. It is an unavoidable partnership.

### V.7 Doing the Right Things by the Banks

The banks must comply with the guidelines for risk management processes and framework for the management of individual risk elements as issued by the CBN. The risk management process for instance has three key elements:

- Risk management structure with board and senior management oversight;
- Systems and procedures for risk identification, measurement, monitoring and control; and
- Risk management framework review mechanism.

Each cross-border bank should abide by the guideline as it is relevant to the scope of its operations and regularly review same in line with emerging realities. No institution can perfectly estimate its risks but it must make efforts to approximate these risks, assess them, monitor them, mitigate them and make appropriate provisions. Capital adequacy is a critical aspect of this process but the capital just serves as a buffer; it does not prevent risks. What ameliorates the risks are the quality of the assets, the quality of the risk management processes and even the quality of proactive analysis undertaken before taking the risks. While the CBN sets benchmarks, it is for the bank to set up a robust *Internal Capital Adequacy Assessment Process [ICAAP]* which is an integral aspect of its risk management framework.

The ICAAP should identify the banks' risks, and ensure that they are assessed, monitored and controlled. The bank then decides those that it should manage and capitalize and those it should manage without capitalization. This will enable the bank to estimate its minimum capital adequacy ratio-independent of the minimum that the CBN has established [Blaauw, 2009:9]. It is then the responsibility of the CBN to review the bank's ICAAP results and methodologies, inputs and assumptions and quantify the capital add-ons required if the ICAAP is not adequate.

**Table 6: Risks Covered In A Typical Banks ICAAP**

| S/N | Risk Type | Capitalised & Managed | Managed & Not Capitalised |
|---|---|---|---|
| 1 | Country Risk | | # |
| 2 | Compliance risk | # | |
| 3 | Concentration risk | # | |
| 4 | Credit default risk | # | |
| 5 | Debt recovery risk | # | |
| 6 | Currency risk | # | |
| 7 | Investment risk | # | |
| 8 | Interest rate risk | # | |
| 9 | Liquidity risk | | # |
| 11 | Trading position risk | # | |
| 12 | Operational risk | # | |
| 13 | Reputational risk | | # |
| 14 | Pro-cyclical risk | | # |
| 15 | Environmental risk | # | |
| 16 | Technological risk | # | |

Source: Blauuw,A.J[2009] Nigeria Bank Sector Sustainability & ICAAP; BusinessDay, September 2nd,p9

Banks should also install risk management strategies for all types and quantum of risk they take and make sure that these strategies are updated. The CBN on its part should regularly review these measures and ensure that they are adequate for the banks exposures and peculiarities. Most of these risks are conventional and have tested techniques of measuring and managing. I will therefore not dwell on them. But we shall spare some thoughts for two of them that are unique: political and human resources risks arising from cross-border

operations.

We had earlier discussed *political/ country risks*. Strategies for managing them include:

- Investing in low-risk countries;
- Involving host-nationals in ownership and management;
- Complying with local policies; and
- Accurately reading/predicting the political mood [Muo 2002:27;]

For *human resources risks*, cross-border banks have the following options:

- Train the staff from the host country in the home environment;
- Take key people and as many as possible from home initially;
- Hire global staff;
- Institute legal barricades[guarantees];
- Hire people from host country who are used to the home environment;
- Learn about the people in the host environment; and
- Avoid ethnocentrism [judging everything from your own cultural mindset.

## VI. Conclusion

Nigerian banks have transformed from timid players engaged in ordinary international trade services for their clients through correspondent banks to vibrant and aggressive players in the cross-border market with branches in the triad economies of America, Europe and Asia. Their dominance of the sub-regional market is however more pronounced. As that is going on, more foreign banks are opening subsidiaries in Nigeria. This increasing scope of cross-border activities raises the quantum and type of risk exposures by the banks and the Nigerian economy. The most common ones are contagion, too big to fail tendency, currency/foreign exchange, political and country risks as well as other conventional risks which are complicated by cross-border operations.

The banks through their board and management are principally responsible for risk management but the CBN as the *regulator-in-chief* also has the responsibility to design frameworks and stipulate benchmarks which must be complied with. It should also review the risk management and mitigation efforts of the banks to ensure that they are doing the right things. On the cross-border risks, the key challenges are consolidated supervision

[product, risk and geographic], and moving beyond information exchange to mutually beneficial collaboration with host supervisors.

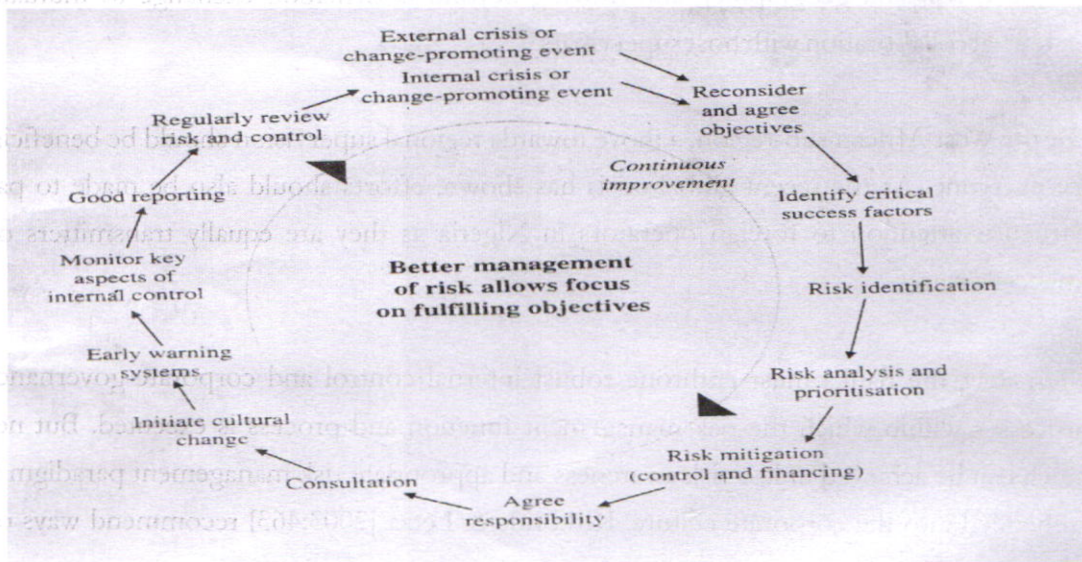
For the West African sub-region, a move towards regional supervision should be beneficial for everyone. As the recent global crisis has shown, efforts should also be made to pay particular attention to foreign operators in Nigeria as they are equally transmitters of financial viruses.

Ultimately, the banks must enthrone robust internal control and corporate-governance processes within which the risk management function and process is executed. But not much can be achieved unless risk awareness and appropriate risk management paradigm is embedded into the corporate culture. Kirkbride & Letza [2003:463] recommend ways of achieving this as:

- Adopt an open, proactive [holistic or ***collibrational***] risk management strategy. This strategy [Calibration] requires openness, communication, involvement and anticipation;
- Apply causal knowledge of systems failure to ex-ante failures thereby anticipating hazard eventuation;
- Adopt a no-fault approach to blame that avoids distortion of information and helps learning[***absolution];***
- Give proper weight to inherently unquantifiable qualitative factors in risk management;
- Apply accumulated knowledge of hazards and risks to design risk mitigation measures into the organization [***designism];***
- Believe that financial and non-financial risk related goals complement each other in good management;
- Realise broad participation in risk related discussions; and
- Believe that the regulatory process should concentrate on specifying industrial processes [***process specificationism]***

It is also imperative to link corporate governance, risk and control with corporate objectives; this is demonstrated in this model [Figure 2].

Figure 2: Linking Corporate Governance To Objectives




Source: Kirkbride,J & Letzaa,S [2003] 'Establishing The Boundaries of Regulation In Corporate Governance: Is UK Moving Towards A Process Of Collibration'. ***Business & Society Review,*** Winter, Vol. 104, No.4; p463

In this way, risk management becomes a part of the organizational culture and not something for the board and management or a process designed just to appease the CBN and its officials by always presenting a semblance of action when in effect, nothing is being genuinely done. *But there are two caveats.*

- Banks should not adopt a risk-avoidance culture neither should the CBN encourage such a tendency. They should always view risks as normal occurrences that should be managed, reduced, hedged or sold and strive to balance coping strategies which are defensive and focused on avoiding downside risks with an increasing mix of exploitation and exploration strategies, which embrace risks and make use of most of the opportunities it presents. [Weber and Kelly, 2005:2]. This involves seeing risks as sources of advantage and requires widening the bank's horizon beyond the immediate business environment.
- Risk management should also not become slave to the '***quants***', quantification and the supercomputers. We have been warned![ Bernstein, 1996:51]

*'As we sit and stare at the graphs and figures in the screen, we tend to forget that we are operating a gadget which mind is at rest. Computers exist to answer questions, not to ask them whenever we allow ourselves to ignore that truth, the computer becomes an ally rather than an enemy of our conceptual errors. Those who live by numbers may find that mathematically inspired techniques of modernism have sown seeds of destructive technology in which computers have become mere replacements for the visits to oracles and witches that characterized risk management and decision making in the days of yore'*. We must always remember *GIGO!*

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