CENTRAL BANK OF NIGERIA

UNDERSTANDING MONETARY POLICY SERIES NO 11

RISK-BASED BANKING SUPERVISION

Central Bank of Nigeria
33 Tafawa Balewa Way
Central Business District
P.M.B. 0187
Garki, Abuja
Phone: +234(0)946236011
Fax: +234(0)946236012
Website: www.cbn.gov.ng
E-mail: info@cbn.gov.ng

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Aims and Scope

Understanding Monetary Policy Series are designed to improve monetary policy communication as well as economic literacy. The series attempt to bring the technical aspects of monetary policy closer to the critical stakeholders who may not have had formal training in Monetary Management. The contents of the publication are therefore, intended for general information only. While necessary care was taken to ensure the inclusion of information in the publication to aid proper understanding of the monetary policy process and concepts, the Bank would not be liable for the interpretation or application of any piece of information contained herein.

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Correspondence

Enquiries concerning this publication should be forwarded to: Director, Monetary Policy Department, Central Bank of Nigeria, P.M.B. 0187, Garki, Abuja, Nigeria, E-mail: info.dmp@cbn.gov.ng

Central Bank of Nigeria

Mandate

▪Ensure Monetary and Price Stability
▪Issue Legal Tender Currency in Nigeria
▪Maintain External Reserves to safeguard the international value of the Legal Tender Currency
▪Promote a Sound Financial System in Nigeria
▪Act as Banker and Provide Economic and Financial Advice to the Federal Government

Vision

"To be a people-focused Central Bank promoting confidence in the economy and enabling an improved standard of living"

Mission Statement

"To **ENSURE** Monetary, Price and Financial System Stability as a Catalyst for Inclusive Growth and Sustainable Economic Development."

Core Values

Integrity
Partnership
Accountability
Courage
Tenacity

MONETARY POLICY DEPARTMENT

Mandate

To Facilitate the Conceptualization and Design of Monetary Policy of the Central Bank of Nigeria

Vision

To be Efficient and Effective in Promoting the Attainment and Sustenance of Monetary and Price Stability Objective of the Central Bank of Nigeria

Mission

To Provide a Dynamic Evidence-based Analytical Framework for the Formulation and Implementation of Monetary Policy for Optimal Economic Growth

FOREWORD

The Understanding Monetary Policy Series is designed to support the communication of monetary policy by the Central Bank of Nigeria (CBN). The series therefore, explain the basic concepts/operations, required to effectively understand the monetary policy framework of the Bank.

Monetary policy remains a very vague subject area to the vast majority of people in spite of the abundance of literature on the subject, most of which tend to adopt a formal and rigorous professional approach, typical of macroeconomic analysis.

In this series, public policy makers, policy analysts, businessmen, politicians, public sector administrators and other professionals, who are keen to learn the basic concepts of monetary policy and some technical aspects of central banking, would be treated to a menu of key monetary policy subject areas that will enrich their knowledge base of the key issues.

In order to achieve the primary objective of the series therefore, our target audience include people with little or no knowledge of macroeconomics and the science of central banking and yet are keen to follow the debate on monetary policy issues, and have a vision to extract beneficial information from the process. Others include those whose discussions of the central bank makes them crucial stakeholders. The series will therefore, be useful not only to policy makers, businessmen, academicians and investors, but to a wide range of people from all walks of life.

As a central bank, we hope that this series will help improve the level of literacy on monetary policy and demystify the general idea surrounding monetary policy formulation. We welcome insights from the public as we look forward to delivering contents that directly address the requirements of our readers and to ensure that the series are constantly updated, widely read and readily available to stakeholders.

Hassan Mahmud
Director, Monetary Policy Department
Central Bank of Nigeria

ABSTRACT

The financial system, especially the banking sector, are exposed to certain inherent risks particularly credit, market, and operational risks. The central bank, thus, ensures that the banking sector remains liquid and stable by regulating and supervising financial institutions operation to mitigate inherent risks. Banking supervision has shifted from being compliance based to risk-based as a result of the challenges and innovation experienced in the banking sector. The risk-based supervision approach encourages banks to develop and continuously update their internal risk management system in line with their objectives. Due to globalization, the financial world has become increasingly integrated. Banking supervisors must therefore continue to improve their effectiveness to enable them cope with the fast-changing profiles of banks.

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SECTION ONE

Introduction

1.1 Risks Inherent in Banking

Risk could generally be defined as the potential occurrence of an event that would have adverse impacts on set goals and objectives. In other words, risk is the exposure to loss or injury. In financial terms, it is the chance that an investment would not yield the expected outcome due to unforeseen circumstances and could result in the loss of part or all the principal and or the expected return. The financial system and in particular the banking, are exposed to certain inherent risks. The supervisory framework identified the main inherent risks in the banking sector in Nigeria as credit, market, and operational risks. Other risks that are also prevalent include interest rate risk, liquidity risk, business risk, and reputation risk. These are highlighted below:

- **Credit Risk** – the risk that one of the parties to a contract fails to fully discharge the terms of the contract; Credit risk is most simply defined as the potential that a bank borrower or counterparty will fail to meet its obligations by agreed terms.
- **Operational Risk**- the risk of a change in the value of a bank caused by losses incurred for inadequate or failed internal processes, people, and systems, or from external events (including legal risk), differ from the expected losses.
- **Market Risk** – is the risk that the whole financial market performance is affected by unforeseen circumstances such as recessions, political turmoil, or natural disasters. The risk cannot be averted by diversification as it affects all facets of the market. It is also referred to as systemic risk.
- **Interest Rate Risk** –is a type of risk originating from the variation of market prices owing to interest rate changes.
- **Liquidity Risk** – the risk that the asset owner is unable to recover the full value of the asset when sold (or for the borrower, credit not rolled over); it also refers to the risk that a commodity or asset cannot be sold quickly enough in the financial market without affecting the price. In terms of banking, liquidity risk is the risk of a bank not being able to have enough cash to carry out its day-to-day operations.
- **Reputational Risk-**Reputational risk is the risk of damage to a bank's reputation because of any reputational event arising from negative

publicity about its business practices, conduct or financial condition. Such negative publicity may affect public confidence in the bank and result in a decline in its customer base, business volume, revenue, liquidity or capital position. The reputational risk may also arise as a result of negative stakeholder opinions.

- Regulatory and Compliance Risks: Banks are also exposed to regulatory and compliance risks such as Money laundering and terrorist financing risk. Failure to adequately manage these risks exposes banks to losses and could also threaten their survival as business entities, thereby, endangering the stability of the financial system.

1.2 The Responsibility of the Central Bank for Banking System Stability

Monetary Theory considers financial system stability as a public good and as a desirable objective of public policy. The financial system is linked to the real economy through its financial intermediation role, in particular, its credit provision function. Households and firms (or consumers and producers) benefit from stable access to credit.

A stable financial system is one in which financial institutions, markets, and market infrastructures facilitate the smooth flow of funds between savers and investors. This helps to promote growth in economic activity. To achieve financial stability: (a) the key financial institutions must be stable and engender confidence that they can meet their contractual obligations without interruption or external assistance, and (b) the key markets are stable and support transactions at prices that reflect fundamental forces. There should be no major short-term fluctuations when there are no changes in economic fundamentals.

The minimum requirements of a stable financial system include the following:

- Clearly defined property rights;
- Central bank oversight of the payments system;
- Prudential regulation of financial institutions;
- Bank depositor protection;
- An institutional lender-of-last resort when private institutions refuse to lend to solvent borrowers in times of liquidity crisis;
- The provision of exit strategies to insolvent institutions; and
- An institution to ameliorate coordination failure among private investors/creditors.

The Central bank plays an essential role in guaranteeing that all the above requirements for mitigating risks inherent in the financial system and ensuring financial system stability is promoted. They do so by regulating and supervising financial institutions' operations, to prevent costly banking system crises and their associated adverse feedback effects on the economy. The central bank also ensures that the banking system remains liquid, thus, serving as a lender of last resort in an emergent liquidity need in the financial system.

1.3 Approaches to Banking Supervision

Supervision involves assessing the safety and soundness of regulated financial institutions, providing feedback to the institutions, and using supervisory powers to intervene promptly to achieve financial system stability objectives. However, not even the best banking supervision can prevent bank failures. The goal for banking supervisors is to mitigate, delay or prevent risks that could result in a banks' failure and loss of confidence in the banking system. Bank supervisors also gather information on trends in the financial sector to help the central bank meet its other responsibilities, including setting monetary policy.

In the past, central banks relied on reports from banks and routine examinations in evaluating the overall health of the institutions as well as their risk-management capabilities. In the process, they assessed bank loan portfolios and the general integrity of bank financial statements. In the end, the central bank simply commented on each bank's capital adequacy to managers and boards of directors on a case-by-case basis, often in qualitative terms. A popular supervisory framework for evaluating the overall performance of banks which was introduced in the United States in 1979 was the Capital adequacy, Asset quality, Management, Earnings, Liquidity, and Sensitivity to market risk (CAMELS) rating system. CAMELS yield a measure of the safety and soundness of a bank. When performing an examination to determine a bank's CAMELS rating, instead of reviewing every detail, the examiner evaluates the bank's overall health and ability to manage risk. Risk is equated to a bank's ability to collect from borrowers and meet its depositors' claims. Successful management of risk requires a bank to have clear and concise written policies. It would also have robust internal control systems such as separation of duties, for example, assigning credit evaluation and loan recovery to different staff. Two other rating scales used by regulators are Probability of Failure (PF) and Consequences Given Failure (CGF), which are two-dimensional grading scales.

After the Latin American financial and currency crisis in the early 1980s, the Basel Committee on Banking Supervision introduced the 1988 Capital Accord. The Accord required that banks meet a minimum capital ratio equal to at least 8 per cent of total risk-weighted assets. Emphasis was placed on capital adequacy which would serve as a buffer against losses and protect bank depositors. In addition, it would enable banking regulators to have an adequate standard for banks' capital base.

The 1988 Basel Capital Accord, known as Basel I, was widely viewed as having achieved its principal objective of promoting financial stability. However, the limited differentiation among degrees of risk meant that calculated capital ratios were often uninformative and likely to provide misleading information about a bank's capital adequacy relative to its risks. It was therefore possible for banks to engage in regulatory capital arbitrage by selling, securitising, or otherwise avoiding exposures for which the regulatory capital requirement was higher than the market requires and pursuing those for which the requirement was lower than what the market would apply to that asset. Large banks engaging in capital arbitrage could, as a result, hold too little capital for the assets they retain, even though they meet other Basel I rules.

A revised capital adequacy rule for banks (Basel II) was therefore published in June 2004. Basel II uses a "three pillars" concept – (1) minimum regulatory capital requirements addressing three major components of risk that a bank faces: credit risk, operational risk, and market risk (other risks are not considered fully quantifiable at this stage); (2) supervisory review by giving regulators much improved 'tools' over those available to them under Basel I and providing a framework for dealing with all the other risks a bank may face, such as systemic risk, pension risk, concentration risk, strategic risk, reputational risk, liquidity risk and legal risk, which the accord combines under the title of residual risk (it gave banks power to review their risk management system); and (3) market discipline by developing a set of disclosure requirements which would allow market participants to gauge the capital adequacy of an institution.

The 2007/2008 global financial crisis found banking supervision wanting in many jurisdictions. Focus had remained primarily on compliance, i.e. on finding violations to banking laws, rules, and regulations at the institutional level only. Bank inspectors relied extensively on transaction testing such as reconciling data, counting cash and securities, and another detailed checking. If a bank was found to have problems or be non-compliant, the central bank may use its authority to request that the bank correct the problems. Bank regulation included issuing specific regulations and guidelines to govern the operations, activities, and acquisitions of banking companies some of them too complex for the regulators to fully comprehend. With the introduction of information technology-driven financial products such as automated teller machines (ATMs), internet banking, mobile banking, and advances in data processing and transfer systems, as well as complex derivative products, bank supervisors were challenged to develop robust and effective means to address new challenges. It was found that bank regulation and supervision needed to adopt macro-prudential orientation and also be forward-looking or preemptive of potential risks.

Accordingly, the Basel Committee on Banking Supervision proposed the Basel III (or the Third Basel Accord) is a global regulatory standard on bank capital adequacy, stress testing, and market liquidity risk. It became necessary to develop a more risk-focused approach that would lend itself to the identification of major risk areas, and redefine supervision rules to emphasize the need for effective risk-management systems and structures in banks, including clearly defining roles and responsibilities for management for oversight of risks. These efforts resulted in what is now commonly known as the Risk-Based Supervision (RBS) approach. By placing a premium on risk mitigation rather than risk avoidance, RBS seeks to encourage each bank to develop and continuously update its internal risk management systems to ensure that it is commensurate with the scope and complexity of its operations. A supervisor following a risk-based approach will attempt to:

- Identify those banks in which risks are greatest;
- Identify within each bank those areas in which risks are greatest; and
- Apply scarce supervisory resources to minimise the overall —regulatory risk.

SECTION TWO

RISK-BASED BANKING SUPERVISION

2.1 What is Risk-Based Banking Supervision (RBS)?

RBS is a robust, proactive, and sophisticated (qualitative & quantitative) process based on risk profiling of an institution which enables better evaluation of risks through separate assessment of inherent risks and risk management processes. It is a dynamic and forward-looking process, placing greater emphasis on early identification of emerging risks and system-wide issues

According to USAID (2008), banking supervision is arriving at a single, comprehensive, informed opinion about the condition and performance of a bank and taking appropriate actions if conditions or performances are poor in any way. To form an opinion, the bank supervisor examines financial data, past and present; the bank's management structure, policies, and procedures; the bank's record of making decisions in the past – bad or good; and a comparison of a bank's condition and performance with similar banks.

RBS can be broad or narrow in scope. In its broad interpretation, it relates to both policy and implementation of the whole bank supervision approach. Under its narrower interpretation, it relates to the methodology adopted increasingly to guide on-site inspections of banks. Principle 7 of the Basel Committee's 25 Core Principles of Effective Banking Supervision provides that ―*Supervisors must be satisfied that banks and banking groups have in place a* ***comprehensive risk management process*** *(including Board and senior management oversight) to identify, evaluate, monitor and control or mitigate all material risks and to assess their overall capital adequacy in relation to their risk profile. These processes should be commensurate with the size and complexity of the institution."*

Why do we Supervise Banks?

- ✓ To safeguard depositors of banking organisations against preventable losses, thereby promoting confidence in the financial system;
- ✓ To encourage the smooth operation of the payments system, free from systemic failures of financial institutions;
- ✓ To avert the misuse of financial institutions by money launderers and terrorism financiers; and

- ✓ To enhance the effective operation of the financial system to serve as channels for monetary policy transmission.

How are Banks Supervised?

The five mechanisms used to supervise banks include:

i) Licensing new banks;

ii) On-site examination and off-site monitoring;

iii) Accounting and reporting requirements;

iv) Enforcement of laws, regulations, and principles of sound financial management to achieve corrective action; and

v) Ensuring the orderly exit of financial institutions from the market when necessary.

Why RBS?

RBS is a modern approach to supervision that focuses largely on determining the current financial condition of a bank, based on historical financial data. It is suitable for quantifying a bank‘s current problems through the use of audit-like examination procedures.

The **benefits** of Risk-based Banking Supervision are:

- ✓ Cost-effective use of supervisory resources through a greater focus on risk, which in turn results in better use of supervisory resources;
- ✓ A consistent framework for evaluating banks through the separate assessment of inherent risks and risk management processes;
- ✓ Early identification of emerging risks of individual banks and on a sectoral basis;
- ✓ A better appreciation by supervisors of the characteristics of banks' businesses, the risks they face, and the quality of their management; and
- ✓ Instills in banks‘ management the culture of risk management and oversight.

2.2 Characteristics of RBS

- **Dynamism:** it is a dynamic process in which emphasis is more on understanding and anticipating the possible risks that a supervised bank will be facing when carrying out its normal business plan. It, therefore, goes beyond a bank's current financial status.

- **Flexibility**: it provides flexible and responsive supervision to foster consistency, coordination, and communication among supervisors.

- **Forward-looking:** RBS requires supervisors to have a holistic view of the bank and to understand the relationships between the risks. In doing so, supervisors consider a wide range of considerable risks since the starting point for banking supervision is the business processes of a bank.

- It strongly emphasises understanding and assessment of the quality of risk management systems in banks to identify, measure, monitor, and control risks in an appropriate and timely manner.

- It focuses on qualifying problems by identifying poor risk management practices.

- It recognises risks that are external to an individual as against those that are bank-specific. External sources of risk could include the economy or operating environment, market, and competitors amongst others.

- It is an ongoing process whereby the risks of a bank are assessed, and an appropriate supervisory plan is designed and executed to address those risks. In other words, it is a process of continuously updating risk assessments through on-site and off-site reviews of market intelligence that creates an _early warning' or _rating' system for the supervisory authority to anticipate and deal with emerging issues.

- It encourages rational use of scarce supervisory resources. RBS gives the supervisors a formal framework to allocate scarce supervisory resources. Bank supervisors efficiently allocate resources based on the risk profile of individual banks and proactively monitor and supervise the banks to promote safety, soundness, and stability of the financial system.

- RBS requires supervisors to be satisfied that banks are complying with their formal risk management practices. Experienced and knowledgeable supervisors are needed to exercise subjective judgments continuously.

- The central rule of RBS is the relationship between risks and capital – the higher the risk profile of a bank, the higher the capital it must hold. For-profit maximisation, excess capital is not desirable to a bank because of the costs of servicing that capital. Therefore, there is a substantial benefit for banks to maintain strict risk management practices to avoid holding additional capital that may be redundant.

2.3 How is RBS Conducted?

RBS is performed by assessing all the risks that a bank is faced with and the measures put in place to control those risks. Supervisors assess the financial position of the bank in the context of the identified risks and its ability to raise more capital if it is required to do so. The inputs into the assessment come from on-site and off-site reviews and general market information.

In an examination of banks (i,e their policies, processes, and systems), compliance is a critical issue. Under RBS, a low-risk that has sound policies and structures to mitigate risks and always implements them effectively, and is equally well capitalised with access to additional capital if required.

2.4 Preconditions for successful RBS

There are five requirements to effectively implement RBS, these are:

State of the enabling law: The supervisory agency must have the power under the law to enforce compliance of risk-based processes and the authority to use a graduated range of powers to intervene so that the interventions can be consistent with the risk assessment.

Structure of the Supervisory Agency: RBS framework possesses the ability to compare institutions and to establish how a bank's profile is changing over time. Therefore, the supervisory authority needs to be structured in such a way as to ensure a high level of consistency to exploit these advantages.

Training and Guidance for Supervisors: Continuous and follow-up training is essential. There should be a guide on the attributes of supervised banks and the control environment for the supervisors.

Risk Rating Model: Generally, models summarise each of the risks and control factors measured. These are summarised into an overall risk assessment.

Measurement Tool: Under RBS, supervisors are required to justify the ratings that have been assigned to each risk and control factor.

SECTION THREE

RISK-BASED BANKING SUPERVISION IN NIGERIA

3.1 Background

In line with global best practices and as part of reforms, the CBN commenced the implementation of risk-based supervision of banks in Nigeria in 2006. It was part of a holistic set of strategies and initiatives designed by the Bank to ensure that governance best practices are embedded in the industry. Moreso, the CBN ensured that risk-based supervision (RBS) principles, methodology, and processes are established across the CBN and *Nigeria Deposit Insurance Corporation (NDIC)*. A programme management structure was established within the Bank to ensure that there was a high level of communication within the industry, implementation quality was measurable and bank examiners acquired the necessary skills. A monitoring mechanism was also established to measure the programme's impact and ensure a high level of responsiveness to issues raised by the industry. In addition, the risk-based supervision manual and supporting guidelines for the implementation of RBS were developed by the Bank and other relevant stakeholders.

3.2 Preparation Made so Far

The CBN has introduced several measures in line with the global recognition of the imperative of effective risk management and control systems in banks. Among others, is the establishment of a Risk Management Department to facilitate the institutionalisation of a comprehensive risk management framework in the Nigerian financial system thereby promoting a stable financial system. Also in recognition of the potential role of risk officers in improving risk management practices in banks, the CBN established a Chief Risk Officers' (CROs) Forum to, among others, promote strong risk expertise and corporate governance across the sector, provide early warning signals on systemic risk issues, and provide feedback on the impact of CBN's existing policies, directives, circulars and guidelines.

The implementation of RBS (BASEL II) has been vigorously pursued by all stakeholders and it has helped to prepare the banks for the eventual implementation of the New Capital Accord (BASEL III). The risk-based supervisory framework is still at the rudimentary level in the country and needs to be enhanced by data integrity, capacity building, robust IT infrastructure, and related research and development (R&D) activities.

Structure of RBS Framework

The framework consists of six key steps, each of which requires the preparation of specific documentation. Table 1 relates RBS steps to tangible outputs as in the table below:

Table 1: Risk-Based Supervision Steps and Outputs

S/N	Steps	Risk-Based Tools/Report
1	Understanding the institution	➢ Institutional profile
2	Assessing the institution 's risk	➢ Preliminary Risk Matrix ➢ Risk Assessment summary
3	Planning and Scheduling Supervisory Activities	➢ Supervisory plan
4	Defining Examination Activities	➢ Scope memorandum
5	Performing Examination Practices	➢ CAMEL's Rating, Risk Matrix
6	Reporting findings and recommendations and follow-ups	➢ Supervision Reports ➢ Updated Institutional Profile

Adapted from East AFRITAC's Guidebook Implementation of Risk-Based Supervision, 2009

Scope

RBS process in Nigeria includes ongoing/off-site monitoring and on-site examination of the institutions. Off-site monitoring, for instance, provides an early warning of the potential areas of concern or risk exposure as well as macro information about the banking industry. This includes Stress Testing and an Early Warning System.

Stress testing is a tool to assess potential vulnerability in the financial sector due to changing market conditions. Stress tests measure exposures of individual banks and the whole banking sector's resilience to shocks. Stress testing helps to provide necessary information on the likely financial performance of banking institutions' under exceptional but possible scenarios, thereby providing an opportunity to take necessary measures to curtail the effects of such potential changes in the market environment and conditions.

An effective **Early Warning** system provides management of the supervisory authority with prudential reports on the condition, performance, and compliance status of supervised banks. Usually, early warning systems are based on the CAMELS indicators. They reflect the variation in bank asset risk and leverage because they capture the market, credit, operational, and liquidity risks faced by banks.

On-site examination, on the other hand, enhances the sustenance of public confidence and integrity of the banking system. It also provides the best means of determining the institution's adherence to laws and regulations and helps to prevent problem situations from remaining uncorrected and deteriorating to the point that resolution is required. Both on-going/off-site monitoring and on-site examination activities culminate into composite risk rating. The composite risk rating is a significant factor in determining a supervisory response and plan for an institution. The degree of supervisory intervention will reflect the risk profile of the institution and is largely driven by the composite risk rating. The Composite Risk is rated as (1) **low, (2) moderate, (3) above average (4) high.**

Risk-Based Ratings and Supervisory Actions

The outcome of the risk profiling of a bank requires regulatory actions based on the composite risk rating of the bank, as shown below:

S/N	Composite Risk Rating	Condition of a Bank	Supervisory Action
1	Low Composite Risk Rating	✓ Sound in every respect ✓ Stable financial situation ✓ Adequate and standard policies and procedures ✓ Robust risk management in place ✓ Good corporate governance ✓ No breach of regulatory procedures	Subjected to the —normal supervisory process

2	Moderate Composite Risk Rating	✓ Sound fundamentally ✓ No significant deficiency in financial condition ✓ Moderate deficiency in policies and procedures ✓ Need improvement in management confidence	➢ Notify management of the regulators' concern and the corrective measures ➢ Meet and discuss the supervisory concerns and remedial actions with management ➢ Enhance monitoring ➢ Conduct frequent follow up on-site reviews ➢ Board Resolution of actions to be taken by the bank ➢ Enter into MoU with the institution to deliver on remedial if the need arose ➢ Require institution to increase its capital, provisions, strengthen controls, etc ➢ Impose business restrictions
3	Above Average Composite Risk Rating	✓ Threat to financial solvency ✓ Supervisory concerns ranging from moderate to severe ✓ Strong possibility of	➢ Enhance monitoring of remedial measures ➢ Conduct frequent follow up on-site reviews ➢ Enter into MoU with

		deterioration of safety and soundness	the institution to deliver on remedial measures if the need arose ➢ Require institution to increase its capital, provisions, strengthen controls, etc ➢ Impose business restrictions
4	High Composite Risk Rating	✓ Exhibit unsafe and unsound practices or conditions ✓ Doubtful future financial viability	➢ Direct external professionals to assess loan quality, the sufficiency of reserves, etc ➢ Enhance the scope of business restriction

In 2000, when the CBN introduced a universal banking model, banks became one-stop shops, offering a range of financial services - insurance, mortgage, stockbroking, merchant banking, commercial banking, and Bureau de Change, among others under one group. However, it created supervisory issues as banks were putting shareholders' funds at risk through their subsidiaries owing to a lack of consolidated supervision. Even though the framework specified cooperation and coordination among the regulatory authorities, which was to be facilitated by the Financial Services Regulation Coordination Committee (FSRCC), unfortunately, the FSRCC hardly met between 2004 and 2009 and the consequence was a lack of effective regulation.

With RBS, several changes have taken place not only in the way things are done but also and more importantly, in the attitude of both the supervisors and banks' management. There is more awareness of risks, more techniques, and tools to manage the risks and more understanding of why it is important to have adequate risk management systems on the part of banks and supervisors. Below is the new standard for banking supervision for the two partners in risk management:

New Rules of Banking Supervision

(a) For Supervisors and Regulators

- ✓ *rigorous pre-examination arrangement;*
- ✓ *more communication with top management of banks;*
- ✓ *a clear understanding of risks and risk management systems of banks;*
- ✓ *capacity to evaluate the quantity, quality, and direction of risks;*
- ✓ *ability to communicate ate clearly and concisely the Risk Ratings; ✓ take timely remedial actions upon identifying extreme risk exposure; and ✓ implement continuous supervision.*
- ✓

(b) For Banks

- ✓ *board of directors to take active accountability for running the bank;*
- ✓ *broad risk management programmes to deal with key risks;*
- ✓ *create and maintain formal risk management structure such as Risk Management Committee, Risk Manager, etc; and*
- ✓ *open to regular self-assessments and independent reviews.*

Comparison between the Old Approach and Risk-Based Supervision Approach

Table 2: The Old Approach vs Risk-Based Supervision Approach

Traditional Approach	Risk-Based Approach
Transactions-based testing	Process-oriented testing
Point-in-time assessments	Continuous assessments
Standard Procedures	Risk-profile driven procedures
Historical Performance	Forward-looking indicators
Focuses on risk avoidance	Focuses on risk mitigation

SECTION FOUR

Conclusion

Globalisation has made it possible for the financial world to be intertwined in such a way that a crisis in one seemingly remote place can easily and quickly spread among financial systems. The GFC and the economic effects of the COVID 19 pandemic and the rise in digital and cryptocurrencies is an illustration of this phenomenon. The challenge for bank regulators and supervisors is thus, to keep on improving their effectiveness to properly cope with the fast-changing risk profiles of banks. The RBS approach has become even more appropriate as it enables supervisors to be on top of developments without crippling innovations in the banking system. All parties have at the same time, gained a deeper understanding of new types of risks including macro-prudential risks.

Another challenge for bank regulators and supervisors is to continue building and retaining the required capacity. Successful implementation of RBS depends on the availability of experienced and capable personnel within the banking supervision function. The introduction of RBS by CBN in the financial sector has proved to be effective not only in achieving its objective of enhanced supervision but also in transferring skills and knowledge to the operators in the process. The related guidelines issued by the Bank have equally supported the capacity-building needs in the financial system. Built capacity needs to be continuously enhanced and retained by the beneficiary or else it may be lost.

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