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Circular To All Banks:

The Draft Framework For The Consolidated Supervision Of Banks In Nigeria

In keeping with global trend and current best practice in supervision, the Central Bank of Nigeria in conjunction with the Nigeria Deposit Insurance Corporation have developed the attached draft framework for the consolidated supervision of banks in Nigeria as a complement to the risk-based supervisory framework earlier released to the Nigerian banking industry in 2005. Amongst others, the framework is aimed at addressing the following supervisory objectives:

1. Ensuring that no banking activity goes on without supervision, irrespective of location, thus eliminating regulatory arbitrage.
2. Eliminating double leverage/gearing in the computation of capital adequacy of conglomerates.
3. Ensuring that all the risks incurred by a banking group, no matter where they are booked will be evaluated and controlled on a global basis.
4. Enabling the CBN/NDIC to identify more quickly, emerging problems and work with banking organizations and other supervisors as appropriate, to take prompt corrective measures on the issues.
5. Helping supervisors to gauge earlier, the effect of potentially adverse events on banking organizations and on the financial system in general.

The document, which is in four chapters, can also be accessed electronically on the CBN website at www.cenbank.org . Being an exposure draft, your views, suggestions and constructive criticisms are welcome, to further enrich the document. This should be forwarded to the Director of Banking Supervision within two weeks from the date of this circular.

It is envisaged that the final document will serve as a useful guide to supervisors and operators alike as the Nigerian banking system moves towards the adoption and implementation of consolidated supervision.

I.D. ABDULLAHI

For: DIRECTOR OF BANKING SUPERVISION

Date: 27th August, 2007.

EXPOSURE DRAFT
THE FRAMEWORK FOR CONSOLIDATED SUPERVISION OF BANKS IN NIGERIA

CHAPTER ONE

INTRODUCTION

1.1 The adoption of universal banking in Nigeria in 2001 brought about additional challenges to the Regulatory Authorities. Under the scheme, banks are allowed to undertake various financial service activities which cut across both money and capital markets as well as insurance business. Furthermore, the recently concluded banking sector consolidation programme through mergers & acquisitions and the increased capitalization of banks, have resulted in the emergence of bigger banks. One of the outcomes of the bank consolidation programme is increased competition within the sector and a heightened appetite by banks to become internationally active, particularly within the West African sub region as well as, Europe and America.

1.2 Following the above developments, financial institutions in Nigeria have expanded their activities, often through subsidiaries beyond their traditional areas of operation. Financial groupings have thus emerged, combining banking, insurance, pension funds, discount houses, finance companies, primary mortgage institutions, microfinance banks and securities businesses. From a regulatory perspective, the above developments have led to an appreciation of the limitations of the segmental approach to supervision in addressing the following concerns:

a) Contagion risk – the possibility that problems in one part of the group may affect other entities within the group;

b) Complex nature of banking entities - banks have become more complex and less transparent with some of them having overseas branches/affiliates/subsidiaries and, therefore, more difficult to manage than institutions with more clearly defined mandate and more specific focus. A network of complex and overlapping managerial and operational structures within a single conglomerate further accentuate the problem as risk diversification and risk-spreading arising out of this would also raise issues regarding risk management and risk based supervision that may not be easy to address in a solo regulatory paradigm.; and

c) arbitrage opportunities usually created by differing regulations and supervision standards among supervisory agencies as each of the subsidiaries in the group is supervised on a “solo basis” by the agency that oversees its sector of operation. The supervision of related entities on “solo basis” obscures the interdependencies that exist within groups.

1.3 Against the background of the foregoing and the existence of multiple supervisory and regulatory agencies (CBN, NDIC, SEC, NAICOM, PENCOM etc) as well as the need to embrace international best practice, the adoption of consolidated supervision of banks in Nigeria has become imperative. The Central Bank of Nigeria (CBN) and the Nigeria Deposit Insurance Corporation (NDIC) have, therefore, developed this framework to provide the required guidelines for the implementation of consolidated supervision of banks in Nigeria.

1.4 Although, consolidated supervision provides a useful basis for effective banking supervision, it should not be regarded as an alternative to the normal supervision of individual banks. Rather, it should be seen as complementing the supervision of banks on a "solo" basis. Thus, supervisors would still need to apply the same techniques of financial assessment and regulation in both cases.

1.5 This document is organized into four chapters. After the introduction in Chapter 1, Chapter 2 gives a conceptual background including the practices being adopted internationally by other regulators/supervisors. Chapter 3 discusses the details of the framework while Chapter 4 highlights the implementation issues that will need to be addressed for effective implementation of the framework.

CHAPTER TWO

CONCEPT AND PRACTICE OF CONSOLIDATED SUPERVISION

2.1 This chapter discusses the concept of consolidated supervision as well as some pertinent related issues. The chapter also reviews consolidated supervision practices in some selected jurisdictions.

2.2 MEANING AND OBJECTIVE OF CONSOLIDATED SUPERVISION

2.2.1 Consolidated supervision is a comprehensive approach to banking supervision which seeks to evaluate the strength of an entire group to which a bank belongs, taking into account all the risks which may affect the bank, regardless of whether such risks are carried in the books of the bank or the related entities (Bank of England 1998).

2.2.2 The basic objective of consolidated supervision of banks is the promotion of the overall evaluation, both quantitatively and qualitatively, of the strength of a group to which a bank belongs, in order to assess the potential impact of other companies in the group on the operations of the bank. The practice allows financial sector supervisors to understand the relationship among the legal entities and to assess and monitor how effectively the group identifies, measures, monitors and controls risks, and to recognize insipient problems.

2.2.3 In order to achieve the foregoing objective and address the supervisory concerns indicated in Chapter 1, the Basle Committee on

Banking Supervision (BCBS) came up with the concept of consolidated supervision. The Committee, in 1975, recommended that the supervisory authorities of banks with foreign subsidiaries, joint ventures and branches should monitor the risk exposure of such banks on the basis of consolidated reports that reflect their total business, irrespective of the legal entities or countries in which it is conducted. The Committee had subsequently, (in September 1997) incorporated in its "Core Principles for Effective Banking supervision", the need to ensure that supervision is conducted on a consolidated basis.

2.3 HISTORICAL PERSPECTIVE OF CONSOLIDATED SUPERVISION

2.3.1 The emergence of Financial Conglomerates (often with significantly large balance sheets and off balance sheet positions), arose from the deregulation of domestic and globalization of financial markets in the 1980/1990s. These institutions provided a wide range of financial services in different sectors and geographical locations. The complex structure and the wide ranging activities of these conglomerates created difficulties for regulators, which led to the agitation for more sophisticated supervisory methods capable of capturing the diversification in terms of revenues and risks attributable to financial conglomerates, all over the world.

2.3.2 Moreover, because of the diverse locations in which these entities operate, regulators in different countries were faced with the difficulty of having contact and responsibility for only a segment of any given conglomerate. Furthermore, some entities within the financial conglomerates undertake financial activities for which in some countries, licences may or may not be required, or not subject to any regulation. For example, financial activities such as leasing, re-insurance, consumer credit may be un-regulated in some countries.

2.3.3 The question of how to grapple with the growing trend in financial conglomeration is increasingly important to bank, insurance and securities regulators. It is also clear that both within any single country and among countries, there are considerable differences between insurance supervisors, bank regulators and securities authorities in terms of their regulatory objectives and standards, the scope of their powers and the instruments at their disposal. These differences stem, in part, from the nature of the businesses they supervise, traditions, histories, accounting practices and legal frameworks.

2.3.4 Over the past several years, various supervisory and regulatory groups have sought to explore the ways in which some of the supervisory concerns relating to financial conglomerates could be addressed. The groups including Basle Committee on Banking Supervision, the Working Group of the Conference of Insurance Supervisors of the European Economic Community (EEC), the Technical Committee of International Organisation of Securities Commissions (IOSCO), the Banking Advisory Committee of Commission of the European Communities and the Insurance Committee of the Commission of the European Communities published reports looking at the subject from their own perspectives.

2.3.5 To consider the subject of financial conglomeration from a joint perspective, a Tripartite Group of bank, securities and insurance regulators was set up on the initiative of the Basle Committee in 1993 to consider ways of improving the supervision of financial conglomerates. The Tripartite Group is an informal group with representatives from the G10 countries, Luxembourg and the EEC. The Tripartite Group considered the range of issues in the reports and supervision of financial conglomerates from a cross-industry perspective. A few highlights of the Joint Report are as follows:

i. Definition of the term "**Financial Conglomerate**" as any group of companies under common control whose exclusive or predominant activities consist of providing significant services in at least two different financial sectors (banking, securities and insurance)."

ii. **Mixed Conglomerates** are defined as those offering not only financial services but also non-financial or commercial services, of which financial conglomerates are the primary focus of supervision.

iii. The report suggested that supervisors' attention need to be drawn to the following:

a. That in terms of Capital Adequacy the desired group-wide perspective could be achieved either by adopting a consolidated type of supervision, as traditionally used by bank supervisors or by a "SoloPlus" approach, where the supervision of individual entities is complemented by a general Qualitative Assessment of the group as a whole, and usually by a Quantitative group wide assessment of the Adequacy of Capital. Various techniques were suggested for determining the Capital Adequacy, using Consolidated Accounts at the level of the parent company as the basis.

b. That there is a need for intensive cooperation between the supervisors responsible for different entities within a conglomerate and the necessary exchange of prudential information between them. There is a general support for appointing a **"Lead Supervisor or Co-ordinator"** that would be responsible for gathering such information and the drawing up of **Memoranda of Understanding or Protocols** between the relevant supervisors.

c. That in view of the need to remove the impediment created by the complex group structures, supervisors need powers to obtain adequate information regarding managerial and legal structure, and if necessary, prohibits structures which impair adequate supervision.

d. That Intra-group Exposures, Large Exposures at group level, problems in applying a Suitability Test to shareholders, Fit and Proper tests to managers, rights of access to information about non-regulated entities within a conglomerate, supervisory arbitrage and particular problems posed by mixed conglomerates engaged in both financial and non-financial activities are factors to be considered in consolidated supervision of financial conglomerates.

2.4 ISSUES IN CONSOLIDATED SUPERVISION

2.4.1 Corporate Grouping

2.4.1.1 In the context of Consolidated Supervision, three broad categories of corporate groups can be identified: banking groups, mixed-activity groups and financial conglomerates.

2.4.1.1.1 Banking Group

A banking group exists whenever a licensed bank establishes or acquires subsidiary companies (or takes participation) in order to carry on banking or financial service activities. Thus, a typical banking group might consist of a licensed bank with subsidiary companies engaged in a range of specialized financial service activities and possibly one or more subsidiary banks and it may also have branches or subsidiaries in foreign countries.

2.4.1.1.2 Financial Conglomerate

The term “financial conglomerate” refers to any group (or sub-group) of companies engaged in banking or related activities.

More technically, financial conglomerate means a group which engages in a range of different financial service activities which were traditionally kept separate by law and regulation in many countries. Such activities include banking, trading in securities and insurance.

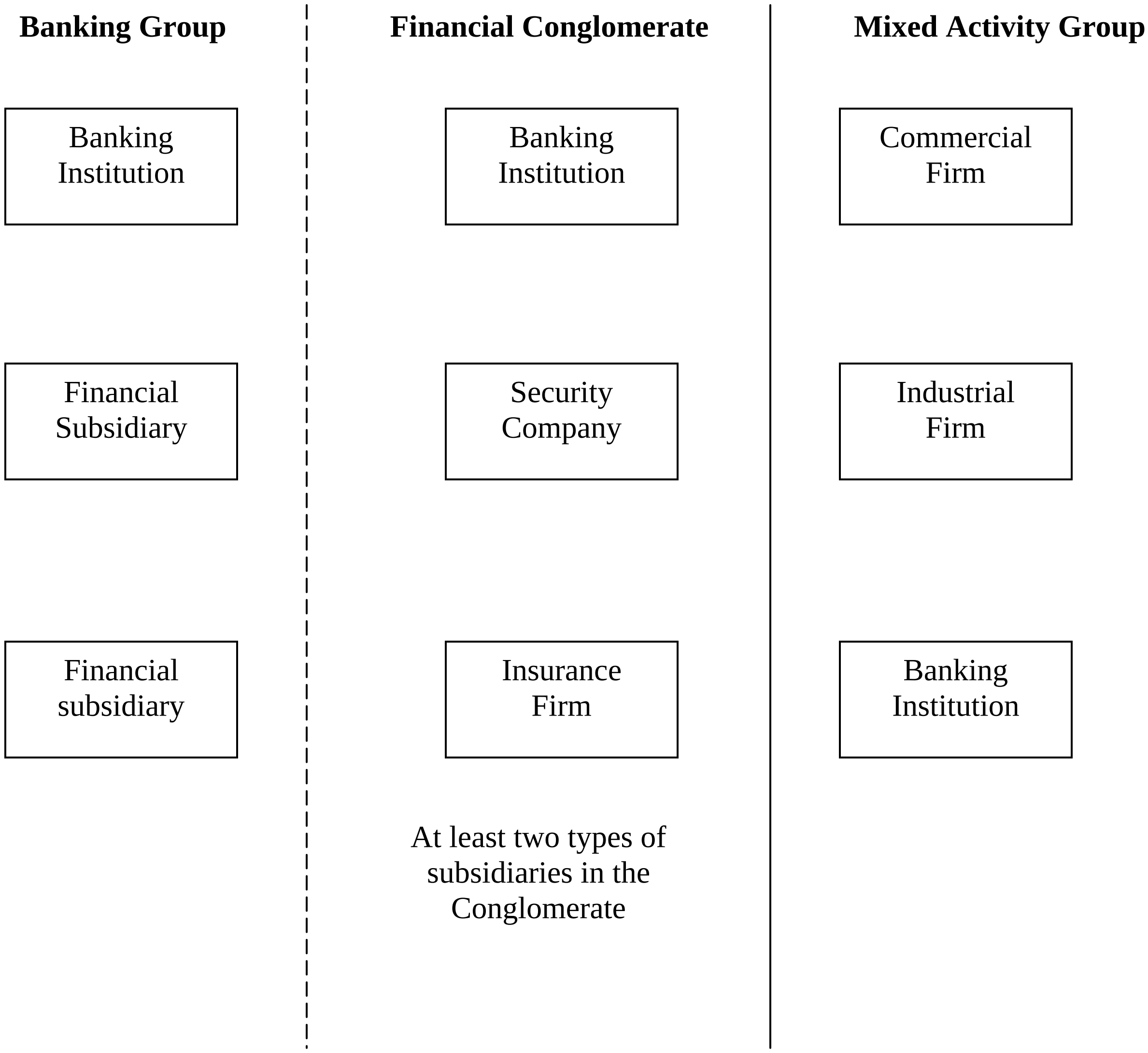
2.4.1.1.3 Mixed-Activity Group

A mixed-activity group is one which controls commercial and industrial companies as well as banks. Specifically, it is any group of companies offering not only financial services but also non-financial or commercial services. An important factor behind the emergence of mixed-activity groups has been the relatively large amounts of capital required for the establishment of new banks.

2.4.1.2 Other types of corporate groups which are identified by different names in certain jurisdictions will readily fit into one of the three types stated above. For instance, the corporate group type referred to in the U.S.A. as **Bank holding Companies (BHC)** would readily fit into the "banking group" described above.

2.4.1.3 Figure 2.1 gives the broad description of the corporate groupings.

Figure 2. 1: Banking Groups, Financial Conglomerates and Mixed Activity Groups



2.4.2 Approaches to Consolidated Supervision

Consolidated Supervision could be conducted on either a quantitative or qualitative basis or a combination of the two (hybrid) or **solo-plus basis**.

2.4.2.1 Quantitative Consolidated Supervision

Quantitative consolidated supervision is based on consolidated financial reports and prudential returns. The financial report reflects an accounting consolidation of the licensed entity with parts or the whole of the group to which the entity belongs. Consolidated prudential reports allow supervisors to monitor several aspects of the financial condition of banking groups on a quantitative basis. It is essential that supervisory authorities have legal powers to require banks to submit them. When introducing such reports, supervisory authorities must give guidance on the scope of consolidation which involves the types of entity which should be included in the consolidated prudential return and methods of consolidation which concern the accounting techniques which banks should use when compiling consolidated reports.

2.4.2.1.1 Scope of Consolidation

2.4.2.1.1.1 The scope of consolidation should cover only those related entities which carry on activities of a banking or financial services nature while risks inherent in non-financial service group companies should be assessed qualitatively.

2.4.2.1.2 Methods of Consolidation

2.4.2.1.2.1 Accounting regulations require companies with subsidiaries to publish consolidated financial statements. Consolidated financial reports for supervisors can be compiled using such accounting regulations with the exception that any non-financial companies in the group should be excluded from the consolidation. The methods of consolidation adopted should cover the different types of ownership that may arise in a group such as parent, subsidiary, associates, joint ventures and investments which are described below in line with IAS 27, 28 and 31:

a. **Parent/Holding Company**

A company is described as a parent or holding company of another or other companies where that company owns 50% and above or the whole of the equity of the other company(ies). A parent is therefore an entity that has one or more subsidiaries.

b. Subsidiary

A subsidiary is an entity that is controlled by another entity known as the parent or Holding Company.

Control is the power to govern the financial and operating policies of an entity in order to obtain benefits from the entity's activities. The existence of control is generally evidenced by one of the following:

- **Ownership:** Parent owning (directly or indirectly through subsidiaries) of more than 50 percent of the voting power
- **Voting Rights:** Power over more than 50 percent of the voting rights or power to cast the majority of votes at meetings of the board of directors
- **Policies:** Power to govern the financial and operating policies of the entity
- **Board of Directors:** Power to appoint or remove the majority of the members of the board of directors

c. **Associate**

An associate is an entity over which the investor has significant influence, and that is neither a subsidiary nor an interest in a joint venture.

Significant influence is the power to participate in the financial and operating policy decisions of the investee but does neither have control nor joint control over those policies. If an investor holds directly or indirectly through subsidiaries, 20 percent or more of the voting power of the investee, it is presumed that the investor has significant influence, unless it can be clearly demonstrated that this is not the case. Existence of Significant influence is evidenced by, inter alia, the following:

- Representation on the board of directors or governing body
- Participation in policy making processes
- Material transactions between parties
- Interchange of managerial personnel
- Provision of essential technical information.

d. **Joint Venture**

A joint venture is a contractual arrangement whereby two or more parties undertake an economic activity that is subject to joint control.

The following are characteristics of all joint ventures:

- Two or more venturers are bound by a contractual arrangement
- A joint venture establishes joint control; that is, the contractually agreed sharing of control over a joint venture is such that not one of the parties can exercise unilateral control
- A venturer is a party to a joint venture and has joint control over that joint venture.

2.4.2.1.2.2 **Quantitative Consolidated Supervision**

With on-site examination and consolidated prudential reports, supervisors can monitor several aspects of the financial condition of banking groups on a quantitative basis.

The minimum area of coverage should include the following;

a) **Capital Adequacy:** Measurement of capital adequacy on a consolidated basis regardless of whether the subsidiaries are domestic or foreign.

b) **Large exposures:** The monitoring and control of large individual exposures incurred by banking groups is an important aspect of consolidated supervision and regulation is needed to limit the amount of the exposure of a group towards a single counter party or group of related counter parties.

c) **Connected Exposures/Lending:** Limits on individual banks exposures to connected persons and separate legal entities controlled by them, should also be applied to banking groups and sub groups.

d) **Liquidity:** Few supervisors apply liquidity ratios or some other comparative quantitative measure on a consolidated basis.

2.4.2.2 Qualitative Consolidated supervision

Qualitative Consolidated Supervision entails the collection, review and analysis of information for the purpose of assessing the financial position and strength of the group to which a bank belongs. Qualitative Consolidated supervision could be employed to complement the quantitative aspect of consolidated supervision in certain cases where accounting consolidation is not meaningful due to the nature of particular assets and activities conducted in other parts of the group. An example of when a qualitative consolidated supervision could be employed is where an industrial or insurance group is involved.

While conducting qualitative consolidated supervision, the group as a whole is taken as an entity and attention is placed on its general business and the environment in which it operates. In order to evaluate material risks of the components of a group using qualitative consolidated supervision, focus is placed on salient organization and management indices such as:

* Structure of the group and the risk therein
* Fit and proper principles
* Information sharing among supervisors

2.4.2.2.1 Structure of the Group and Its Inherent Risks

In order to assess the structure of the group and the risks therein, the following constitute the types of information supervisors should have access to:

i. An organizational chart or other descriptive materials that depict:-

a) The supervised entity and any material holding companies, subsidiaries, or affiliates, with indications of which legal entities take or bear substantial risk.

b) The business line organization structure, with the supervised entity's place in the business line(s), the location of relevant business line management and

c) The supervisors of any material holding companies, subsidiaries, or affiliates.

ii. A chart depicting the management structure of the group, description of the responsibilities of different types of managers (e.g. legal entity, corporate, business line, etc) within the group, the relationship among managers and important types of interaction.

iii. A description of the roles and responsibilities of the group's board of directors, the composition of the board, and the roles and responsibilities of the board of the supervised legal entity and its composition.

iv. The level and distribution of capital among the material legal entities of the group, the group's approach to capital allocation on an economic and on a regulatory basis, and whether the group is in compliance with its capital requirements in all regulated legal entities.

v. Financial information on the supervised entity and its ultimate holding company, if applicable, including balance sheets (as of the most recent fiscal quarter and financial year-end and income statements (for the most recent year-to-date period and financial year end), and consolidated balance sheets and income statements where available.

vi. A description of the nature of the group's intra-group and related affiliate transactions and exposures, and indications of the volume of such transactions and the size of material intra-group financial exposures.

vii A description of the group's broad business strategy, and the group's view of its principal risk**:** for each principal risk, a description of the approach to measuring, managing and controlling that risk, the organization of risk management personnel and their reporting lines, limit structures or other risk control mechanisms in the regulated entity, and where relevant, the role of stress testing or contingency planning in managing risk at the business line, legal entity or group wide level.

viii. Policies and procedures of the group addressing the introduction of new products or business lines.

ix A description of the approach to managing the liquidity and funding profile of the supervised entity, including the liquidity of the material assets, the nature and stability of the entity's current funding sources and the availability of alternative funding: large payable, including securities payable, aggregate insurance claims payments, and out-of-the money over-the-counter derivative and foreign exchange contracts; and other significant cash and securities needs associated with exchange activities or clearing and settlement, as well as the conglomerate's approach to managing significant clearing and settlement arrangements through or for other firms.

x. The group's significant accounting policies and actuarial policies (where relevant), the role(s) of any internal or external actuaries.

xi. A description of the roles, responsibilities and organization of the financial control and compliance functions.

xii A description of the roles, responsibilities, organization and allocation or responsibilities between centralized and decentralized elements of the internal audit area and the role of external audit.

2.4.2.2.2 Fit and Proper Principles

There is the need to ensure that supervisors of entities within a banking group or financial conglomerate are able to exercise their responsibilities to assess whether the senior management personnel or key shareholders (as defined by a given threshold) are not a source of weakness to those entities. This should be carried out through 'fit and proper' test as follows:-

i. Fitness and propriety or other qualification test should be applied to managers and directors of other entities in a group or conglomerate if they exercise a material or controlling influence on the operations of regulated entities.

ii. Shareholders whose holding are above specified thresholds and/or who exert a material influence on regulated entities within that group or conglomerate should meet the fitness, propriety or other qualification test of supervisors.

iii. Fitness, propriety or other qualification test should be applied at the authorization stage and thereafter, on the occurrence of specified events. Supervisor's expectations are that the entities will take the measures necessary to ensure that fitness, propriety or other qualification test are met on a continuous basis.

iv. Where a manager or director is deemed to exercise a material influence on the operations of a regulated entity or has been a manager or director of another regulated entity within the group or conglomerate, the supervisor should endeavour to consult the supervisor of the other regulated entity as part of the assessment procedure.

v. Supervisors should communicate with the supervisors of other regulated entities within the group or conglomerate when managers, directors or key shareholders are deemed not to meet their fitness, propriety or other qualification tests.

2.4.2.2.3 Information Sharing

The information needs of supervisors vary considerably depending on several factors relating to the objectives and approaches of supervisors themselves and to the organization and structures of the financial conglomerates. The principles set out below are intended to assist supervisors in enhancing information sharing arrangements that will contribute to a more effective supervisory framework for financial conglomerates. For the purpose of this paper, the primary supervisor is generally considered to be supervisor of the parent or the dominant regulated entity in the conglomerate. Where the identity of the primary supervisor is not clear, the relevant supervisors should work cooperatively to identify, on a case by case basis, an appropriate information sharing structure.

The guiding principles for an effective information sharing arrangement are as follows:

i. **Sufficient information should be available to each supervisor reflecting the legal and regulatory regime and the supervisor's objectives and approaches, to effectively supervise the regulated entities residing within the conglomerate.** In that regard, supervisors need key descriptive information about the banking group or conglomerate such as organizational structure, management, financial condition, strategy and principal risks, and the main features of its policies, procedures and information system for managing and controlling risks. This information may be included in organization charts, financial statements, capital, liquidity and risk profiles, policy manuals and other written material.

ii. **Supervisors should be proactive in raising material issues and concerns with other supervisors. Supervisors should respond in a timely and satisfactory manner when such issues and concerns are raised with them. The following issues are pertinent in order to abide by this guiding principle:**

a. In order to avoid the flow of a large amount of extraneous information, it is important for supervisors to reach an understanding, either on a bilateral or multilateral basis, that such adverse or out-of-the-ordinary developments will be communicated to relevant supervisors. Supervisors that become aware of out-of-the-ordinary developments in carrying out their oversight responsibilities should initiate contact with and inform other relevant supervisors. It is especially important for supervisors to have the ability to contact other supervisors with request for specific information on material issues that are of concern and to receive a response in a timely and satisfactory manner.

b. Supervisors should communicate emerging issues and developments of a material and potentially adverse nature to the primary supervisor on a timely manner.

c. The lead supervisor should share with other relevant supervisors information affecting the regulated entity for which the latter have responsibility except in an unusual circumstance where supervisory considerations dictate otherwise.

d. Supervisors should purposely take measures to establish and maintain contact with other supervisors and establish a climate of cooperation and trust amongst themselves.

2.4.2.3 Solo-Plus Supervision

This supervisory approach focuses on individual group entities. Individual entities are supervised on a solo basis according to the requirements of their respective regulators and then complemented by a general quantitative and qualitative assessment of the group in order to evaluate material risks to the reputation and/or financial soundness of the supervised entity arising from its membership of the group.

2.4.2.4 In order to obtain necessary information for qualitative assessment of a group, supervisors often use an instrument which is usually referred to as Conglomerate Questionnaire. The instrument is a tool designed to facilitate discussion by one or more supervisors within a banking group about its:

* Organizational Structure, Corporate Governance and Management oversight;
* Risk Management; and
* Control Environment

2.4.2.5 By analyzing the information contained in the questionnaire, the user can obtain an overall picture of a banking group's organization and management structure, risk profile, internal controls and can discover conditions or issues that may require further analysis and investigation. The questionnaire is not designed to replace on-site examinations or investigations but to supplement supervisory activities. It can function as a starting point for discussion with the group's management and/or other supervisors of the group in supervising the conglomerate consistent with its risk profile.

2.4.3 Cross-Border Issues in Consolidated Supervision

2.4.3.1 Apart from intra-group activities, consolidated supervision also focuses on cross-border activities. In that regard, the BCBS indicated in its "Core Principles for Effective Supervision" Nos 23, 24 and 25 respectively as follows:

> "Banking supervisors must practice global consolidated supervision over their internationally-active banking organisations, adequately monitoring and applying appropriate prudential norms to all aspects of the business conducted by these banking organisations worldwide, primarily at their foreign branches, joint ventures and subsidiaries.

A key component of consolidated supervision is establishing contact and information exchange with the various other supervisors involved, primarily host country 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 purpose of carrying out consolidated supervision."

2.4.3.2 From the foregoing, it can be observed that the effectiveness of Consolidated Supervision on cross-border activities could only be attained where there is good collaboration between home and host country supervisors and also where the home and host supervisors are able to discharge their individual responsibilities creditably well. It is paramount that each supervisory authority must have an effective procedure and process for collating and validating information from affiliates, subsidiaries and branches either within or outside the jurisdiction of the parent or holding company. Also, supervisors must be able to evaluate and control perceived risks globally.

2.4.3.3 Role of Home Country Supervisors

At the minimum, home country supervisors should:

- Verify the information received through inspection, auditors' report and information received from host supervisors.
- Have access to information on intra-group transactions, affiliates and sister companies.
- Have power to prohibit corporate structures that deliberately impede consolidated supervision.

- Consult with host supervisors to ensure that the host supervisors are aware of the overall systems within which the foreign establishments are operating.
- Conduct on-site examination accompanied by host supervisors (at option of the host supervisors), or execute joint examination where sensitive portions of activities are carried out by host and evaluated jointly to assess the information gathered on safety and soundness of the regulated entities.
- Contact host supervisors with request for specific information on material issues that are of concern in a timely and satisfactory manner.
- Share with host supervisors and other relevant supervisors information affecting the regulated entity or entities except in an unusual circumstance where supervisory consideration dictate otherwise.
- Provide cross- market views of the regulated entities to host supervisors.

2.4.3.4 <u>Role of Host Country Supervisors</u>

By and large, the roles of Home Supervisors enumerated above are equally applicable to the host supervisors. In addition, the host supervisors should:-

- Determine whether the bank or the banking group is supervised by a home supervisor with practical capability of performing Consolidated Supervision.
- Confirm that the bank or the banking group obtain consent for outward expansion from the appropriate home supervisor.
- Concern itself with the level of support the parent is capable of providing to the regulated entities.
- Impose restrictive measures necessary to satisfy its prudential concerns where the regulated entities are not meeting minimum standards.

2.5 PRACTICES OF CONSOLIDATED SUPERVISION IN SOME SELECTED JURISDICTIONS

A brief overview of the approaches being adopted by some countries is given below:

2.5.1 The U. S. approach to the supervision of diversified financial groups falls under the "umbrella supervision" through which the Federal Reserve has supervisory oversight authority and responsibility for bank holding companies, including financial holding companies (FHCs). In addition to this overall supervisory framework, the Federal Reserve closely monitors inter-affiliate transactions and the attendant risks.

2.5.2 The Financial Services Authority (FSA) (UK) is currently in the process of updating its arrangements for the prudential supervision of financial conglomerates. It has recently issued proposals (Consultation Paper on 'Financial Groups Directive') to implement the EU Financial Conglomerates Directive in the UK. The new regime will apply extra prudential requirements at the mixed financial group level, covering the quality of group systems and controls and the adequacy of capital across the conglomerate.

2.5.3 The Australia Prudential Regulatory Authority (APRA), which is already a combined supervisor for both credit institutions (banks and other deposit takers) and insurance companies has brought out a comprehensive policy framework for the Prudential Supervision of

Conglomerate Groups consisting of only **Authorised Deposit-Taking Institutions.**

2.5.4 In Canada, there is no specific supervisory framework for conglomerates; they are supervised on the same basis as other financial institutions by the **Office of the Superintendent of Financial Institutions (OSFI).** As for monitoring related party transactions, all federally regulated financial institutions are subject to the self dealing regime based on the guidelines issued by OSFI which limits their ability to transact with related parties.

2.5.5 The Bermuda Monetary Authority (BMA) employs either qualitative or quantitative consolidated supervision, depending on the nature of a group's business, as a complement to supervision of individual licensed institutions. Consolidated supervision is performed by liaising with the relevant industry supervisors, if the outcome will be a more accurate assessment of the risks to which a licensed bank or investment business could be exposed. When conducting a quantitative consolidated supervision, specific capital ratios are set at both the solo and consolidated levels against which the institution and the group are evaluated, with the primary focus on the licensed institution. In cases where quantitative consolidation is inappropriate, owing to the nature of particular assets and activities conducted in other parts of a group, the BMA undertakes a qualitative consolidation of the group. Here, emphasis is on the group's general business and the environment, in which it operates, as well as its controls, organization and management in order to evaluate material risks to the reputation or financial soundness of the licensed institution.

2.5.6 Consolidated supervision is defined by the Gibraltar Supervisory Authority to mean a qualitative assessment of the overall strength of a group to which a licensed institution belongs and involves the evaluation of the potential impact of other group companies on the licensee. This principle is adopted whenever a licensed institution is a member of a wider group to complement solo supervision of the licensee. The assessment is based on a number of sources of information including the consolidated returns and the activities of the group's companies excluded in the consolidated returns due to the inappropriateness of inclusion of such items, for instance industrial and insurance companies. Activities of the group companies are taken into account to the extent that they have material influence on the reputation and financial soundness of the licensed institution. The purpose of consolidated supervision is not to supervise all the companies in the group, but to supervise the bank as part of its group. This is complemented with regular discussions with members of the group's management who have responsibility for the overall group position.

2.5.7 Consolidated supervision by the Reserve Bank of India is carried out through the prescription of the group-wide prudential norms for capital adequacy and large exposures for financial institutions. The prescription which is done on an ongoing basis takes into account the assets and liabilities of their subsidiaries/associates in addition to compliance by the financial institutions/subsidiaries/associates with prudential norms that may be applicable to them on solo basis, effective from 2003.

2.5.8 In spite of the variations in the approaches and structures, most of the supervisory regimes encompass the following elements, in varying degrees, in respect of monitoring of conglomerates :

- quantitative techniques;
- qualitative techniques; and
- inter-regulatory co-ordination and co-operation.

2.6 CURRENT SUPERVISORY FRAMEWORK IN NIGERIA

Financial market regulation in Nigeria is essentially institution-based. Hence, every sector has its apex regulator, viz: the Central Bank of Nigeria - CBN [for Universal Banks, Community Banks (CBs), Micro Finance Banks (MFBs), and Primary Mortgage Institutions (PMIs), Bureaux De Change (BDCs), Finance Companies and Development Finance Institutions (DFIs)] the Securities and Exchange Commission - SEC (for the capital market) and the National Insurance Commission - NAICOM (for the insurance sub-sector). This market segmentation is appropriately supported by separate legislation for the distinct mandates of the apex regulators.

The Central Bank of Nigeria (CBN) is the apex regulatory agency responsible for licensing financial institutions in Nigeria, excluding securities and insurance companies. Banking supervision is a joint responsibility of the CBN and the NDIC. The responsibility is carried out through on-site examination and off-site surveillance. The function of banking supervision is being carried out in CBN by the Banking Supervision Department (BSD) while in the NDIC, the function is being performed by Field Examination Department (FED) and Off-site Supervision Department (OSD).

The BSD, in addition, supervises Discount Houses while the Other Financial Institutions Department (OFID) of CBN supervises the other financial institutions, namely CBs, MFBs, Finance Companies, BDCs, PMIs and DFIs. The Special Insured Institutions Department (SIID) of NDIC jointly (with CBN) supervises also other deposit-taking financial institutions such as CBs, MFBs and PMIs. The Securities outfits are supervised by the SEC while the NACOM supervises the insurance companies.

Given the afore-mentioned scenario, the Financial Services Regulation Coordinating Committee (FSRCC), which is a forum for coordination and harmonization of regulation and supervisory activities in Nigeria, was established. The membership of the FSRCC comprise the apex regulators and other stakeholders such as the Federal Ministry of Finance, Corporate Affairs Commission (CAC), the Nigeria Deposit Insurance Corporation (NDIC) the Nigeria Stock Exchange (NSC), etc. The FSRCC is chaired by the CBN Governor while its objectives include: coordination of supervisory activities, reduction of regulatory arbitrage opportunities and information sharing.

The objectives of the FSRCC include:

* co-ordinate supervision of financial institutions especially conglomerates;
* reduction of arbitrage opportunities usually created by differing regulations and supervision standards among supervisory agencies;
* deliberate on problems experienced by any member in its relationship with any financial institution;
* eliminate any information gap encountered by any regulatory agency in its relationship with any group of financial institutions; etc

To facilitate information sharing, a Memorandum of Understanding (MoU) was executed by all the members of the FSRCC. The MoU contains safeguards for confidentiality of information.

CHAPTER THREE

THE PROPOSED FRAMEWORK

3.1 The proposed framework for Consolidated Supervision of Banks in Nigeria discusses the processes of supervising banking groups and their cross-border establishments as a complement to the solo supervision of banks by the Central Bank of Nigeria (CBN) and the Nigeria Deposit Insurance Corporation (NDIC).

3.2 The framework shall encompass the supervision of banking groups and financial conglomerates. For the purpose of this framework however, the term banking group shall be used for the two types of groupings.

3.3 The proposed consolidated supervision approach for the Nigerian banks is the solo-plus approach. In that regard, the supervision of banks on a solo basis by the CBN and NDIC shall be complemented by a quantitative and qualitative assessment of the banking group in order to assess the potential impact of other members of the group on the operations of the supervised bank.

3.4 The framework is therefore in two broad interrelated stages, namely:

* Solo supervision of banks: This involves the risk-based supervision of banks on a solo basis by the CBN and the NDIC; and

* Quantitative and qualitative assessment of the banking group in order to assess the potential impact of other members of the group, including overseas subsidiaries or affiliates of the group, on the operations of the supervised bank.

3.4.1 SOLO SUPERVISION OF BANKS

3.4.1.1 The supervision of banks on a solo basis by the CBN and NDIC shall be based on the following six stages described in the Framework for Risk-based Supervision, (RBS):

- Impact assessment of bank
- Risk assessment of bank;
- Development of risk mitigation programme;
- Evaluation and validation;
- Communicating the results of risk assessment and risk mitigation programme to the bank; and
- Implementation of risk mitigation programme as well as on-going assessment and response to risk escalation

3.4.1.2 For a detailed description of the stages, see the Framework for RBS.

3.4.2 ASSESSMENT OF THE GROUP

3.4.2.1 The assessment of the group is carried out at the risk assessment of bank stage under the RBS which is expected to have effects on the type of risk mitigation programme to be developed. The assessment shall be based on both the quantitative and qualitative approaches.

3.4.2.1.1 QUANTITATIVE APPROACH

3.4.2.1.1.1 Quantitative consolidated supervision entails preparation of consolidated financial reports and prudential returns. The resultant financial reports reflect an accounting consolidation of the supervised entity with parts or the whole of the group to which the entity belongs.

3.4.2.1.1.2 The major components of Quantitative Consolidated Supervision include the following:-

- Consolidated Financial Reporting
- Capital Adequacy Assessment to prevent double leveraging.
- Intra-group financial transactions review to avoid contagion risks.
- Large Exposures and Connected Lending review
- Liquidity Mismatches/Gaps review

3.4.2.1.1.2.1 **Consolidated Financial Reporting**

3.4.2.1.1.2.1.1 The consolidated financial reports and prudential returns shall be rendered to the CBN/NDIC periodically. The CBN/NDIC shall specify to the bank those subsidiaries whose assets, liabilities and off-balance sheet items are to be included in the bank's consolidated reports. In addition, the CBN and NDIC shall develop the format and specify other requirements for rendition of the prudential returns, in addition to those contained in e-FASS returns but excluding companies engaged in insurance business and businesses not providing financial services.

3.4.2.1.1.2.1.2 **Principal Elements**

i. A supervised entity shall prepare consolidated financial reports of the banking group to which it belongs based on the consolidation method(s) described hereunder and consistent with the provisions of:
   a. Companies and Allied Matters Act (CAMA) 1990,
   b. Banks and Other Financial Institutions Act, 1991 (as amended),
   c. International Accounting Standards

d. Generally Accepted Accounting Principles (GAAP).

Accounting Consolidation Methods

ii. The supervised bank shall draw up Consolidated Financial Reports using any of the following methods:

- ❷ FULL CONSOLIDATION METHOD shall be adopted in the case of a subsidiary i.e where direct or indirect participation of the supervised bank in the capital of the banking group exceeds 50% (or as may be defined by regulation) and is **controlled by the bank**.
- ❷ EQUITY METHOD shall be employed in the case of an Associate i.e where direct or indirect participation of the supervised bank in the capital of the banking group is between 20% and 50%. The Equity Method is a method of accounting by which an equity investment is initially recorded at cost and subsequently adjusted to reflect the investor's share of the net profit or loss of the investee.
- ❷ PRO-RATA CONSOLIDATION METHOD is appropriate in the case of Joint Ventures i.e where an entity is controlled jointly by the supervised bank and one or more banks or non-bank financial institutions as partners.

iii. For the purpose of preparing the consolidated financial reports, the accounting consolidation shall include the results of operations of the following entities:

a. Subsidiaries of the supervised bank providing services of a financial nature

b. Associated companies or affiliates of the supervised bank providing services of a financial nature

c. Joint ventures of the supervised bank in which the underlying service(s) to be provided is of a financial nature.

The accounting consolidation shall however, exclude the results of the following entities:

a. Companies providing non-financial services

b. Insurance companies

c. Companies in which the interest or holding of the supervised bank is less than 20%

iv. To facilitate accounting consolidation of the banking group, the accounting year end of the entities in the group shall be harmonized and made co-terminus.

3.4.2.1.1.2.1.3 **Supervisory Processes**

- The supervised bank shall prepare and submit a consolidated financial report of the banking group in a form and content specified by the Central Bank of Nigeria (CBN).
- The supervised bank shall submit on a half-yearly and yearly basis, un-audited and audited Consolidated Financial Statement (CFS), respectively. The CFS should include the Consolidated Balance Sheet, Profit and Loss Account and Notes to the Accounts in accordance with International Accounting Standards (IAS) 21, 27 and 28. The CFS shall be used to conduct consolidated supervision covering the following areas:

  * Capital Adequacy of the group;

* Large exposures of the group;
* Connected lending and
* Liquidity gaps review on a group-wide basis.

3.4.2.1.1.2.2 **Capital Adequacy Assessment**

3.4.2.1.1.2..2.1 **Principal Elements**

- Individual banks shall be assessed on a solo basis according to the capital requirements of the respective regulators.
- The assets and liabilities of the individual entities within the banking group shall be consolidated and the capital requirements applicable to banks shall be applied.
- Where a member of the group is an un-regulated entity, a notional capital requirement shall be assumed. In this regard, the capital requirement of a similar but regulated entity shall be deemed to be the capital requirement of the un-regulated entity. For example, where a banking group includes a Leasing Company (currently un-regulated in Nigeria), a regulated entity such as a Finance Company shall be deemed to be a similar entity in this regard and its capital requirement shall apply to the Leasing Company for that purpose. It must be noted however, that similarity is a function of the nature of business and scale of operations of the entities being compared. In the above example, both Leasing and Finance companies provide financing services and are deemed to operate on similar scale.
- The Capital/Risk Weighted Assets Ratio (CRAR) of 10% shall apply as specified under the Capital Measurement Techniques in Annexure 1.

3.4.2.1.1.2..2.2 **Supervisory Process**

- The supervisory approach here should focus on the supervised bank.
- Capital requirements are applied to the consolidated entity at the banking group level.
- The result shall be compared with the supervised bank's capital
- Capital Shortfall or Surplus shall therefore be established.
- Where there is a shortfall, the CBN shall require the supervised bank to inject fresh capital in the case of bank holding company
- In the case of a non-bank holding company, the CBN shall invoke the subsisting MOU and request the relevant regulator to direct the non-bank holding company to address the capital shortfall.

3.4.2.1.1.2.3 **Intra-Group Transactions & Exposures**

3.4.2.1.1.2.3.1 **Principal Elements**

- Intra-group transactions and exposures refer to direct and indirect claims which entities within banking group hold on each other, such as credit or line of credits which the parent company grants to a subsidiary or vice versa. It can also be in form of exposures of one subsidiary to another subsidiary in the group.
- Intra group exposures, both on and off-balance sheet have liquidity and solvency implications on a group which may lead to undesirable contagion risks.
- Intra-group transactions and exposures in form of equity, loans, debt, repo, inter-bank, call money etc. carried out for the purpose of trading or investment or in the normal course of business shall be tracked.
- In determining the data essential for monitoring Intra-group transactions and exposures the following shall be considered:

a) Intra group cross shareholdings (direct/indirect crossholdings); and

b) all transactions, having financial implication or otherwise in major markets, such as:

- ⊡ Fund based (equity, loans, deposits/placements and others);
- ⊡ Non-fund based (Guarantees, Bonds etc.)

3.4.2.1.1.2.3.1 **Supervisory Processes for Intra-Group Transactions**

The Supervisory processes for capturing intra-group transactions shall entail the following:-

- ★ Identifying all the intra-group financial transactions
- ★ Setting Prudential Limits
- ★ Developing prudential report to capture the extent of intra-group transactions
- ★ Assessing the impact of the intra-group transactions on the group.
- ★ For the purpose of tracking concentration of the supervised bank's exposure to counterparties within the banking group, it shall be the responsibility of the supervised bank to furnish data to the CBN and NDIC in respect of such exposures.
- ★ All intra-group transactions having financial implications and other matters such as intra-group cross-shareholding, inter-locking directorship, senior management, technical/service arrangements and others shall be reported on a periodic basis or as may be determined from time to time by the CBN.
- ★ Designing Monitoring activities to capture all relevant data, both the aggregate volume of transactions during the reporting period as well as the outstanding positions as at the end of the previous reporting period based on materiality criteria to be prescribed by the CBN.
- ★ Ring-fencing the supervised bank so as to mitigate the risk of contagion. This involves isolating the bank's operations from

those of other members of the group, where the supervisor perceives that their activities may expose the supervised entity to undue risks. Ring-fencing can take the form of placing severe limits on the exposure of the bank towards other group companies and the volume of funding it receives from them. In some cases, nil exposure limits may be appropriate.

3.4.2.1.1.2.4 **Large Exposures And Connected Lending**

3.4.2.1.1.2.4.1 **Principal Elements**

- All large exposures by the supervised entity to parties within the banking group shall be established using the provisions of all relevant circulars and BOFIA 1991 (as amended) relating to large exposure and single obligor rules.

3.4.2.1.1.2.4.2 **Supervisory Processes**

- The aggregate exposure by the supervised bank to a borrower shall not exceed the aggregate exposure limit set by the CBN in **Circular ref. no. BSD/9/2004 of July 16 2004** and any other circular that may be issued by the CBN from time to time. The current circular provides as follows:-
  - A large Exposure is any credit to a customer or a group of related borrowers that is at least 10% of the bank's shareholders' funds unimpaired by losses.
  - Aggregate Large Exposures in any bank should not exceed eight times the shareholders funds unimpaired by losses.
  - A director or a significant shareholder should not borrow more than 10% of the bank's Paid-Up capital except with the prior approval of the CBN.
  - A significant shareholding is defined as a holding of at least 5% of the bank's equity;

- o The maximum credit to all insiders should not exceed 60% of a bank's paid up capital.

- The CBN shall be furnished with sufficient information by the supervised bank to enable it assess major group wide exposures to individual counter parties.
- There should be a close liaison among the supervised bank, the CBN and and supervisors of other regulated entities within the banking group.

3.4.2.1.1.2.5 Liquidity Mismatches/Gaps

3.4.2.1.1.2.5.1 Principal Elements

- Assets/Liabilities Mismatches on a group wide basis
- Intra-group funding and impact on the supervised bank's liquidity position
- Ability of the supervised bank to source funds independent of the group
- Ability of the individual entities within the banking group to meet maturing obligations as and when due without negatively impacting the supervised bank.

3.4.2.1.1.2.5.2 Supervisory Processes

- Intra-group transactions and exposures should be netted off from the consolidated liquidity position in order to avoid double counting in line with relevant accounting principles and standards.
- The liquidity reports shall entail placing of all cash inflows and outflows of all the entities in the group, as covered within the scope of consolidation for the reporting purposes.
- The maturity profiles of the assets/liabilities of the group entities should be reported to the CBN, on a consolidated basis.

- The appropriate prudential limits for negative liquidity mismatches at the group level should be set by the CBN.

3.4.2.1.2 **QUALITATIVE APPROACH**

3.4.2.1.2.1 Qualitative Consolidated Supervision would entail the collection, review and analysis of information for the purpose of assessing the financial position and strength of the group to which a bank belongs. This shall be carried out by liaising with the relevant industry supervisors. The major components of qualitative consolidated supervision considered include the following:-

a. Structure of the group and inherent risks
b. Fit and proper principles
c. Group Corporate Governance / Management oversight
d. Control Environment
e. Risk Management and
f. Information sharing

3.4.2.1.2.1.1 **Structure of the Group and Inherent Risks**

3.4.2.1.2.1.1.1 **Principal Elements**

- An organogram or chart indicating the supervised bank and the banking group with its subsidiaries, affiliates and other related legal entities clearly showing which of the entities in the group carries substantial risk.
- The place/location of the supervised bank and its management in the banking group's business line structure.
- A chart showing the management structure of the banking group, reflecting responsibilities of managers along legal, corporate and business lines.
- Indication of the place of risk management function in the banking group's structure, its manning level, reporting lines and the role of stress testing or contingency planning in managing risk along business, legal or group wide basis.

- Description of the structure, roles, reporting lines of internal/financial controls and compliance functions within the banking group.

3.4.2.1.2.1.1.2 **Supervisory Processes**

- Scrutinize the organizational chart of the banking group for clear working relationships and reporting lines between the supervised bank and all material entities within the group.
- Ensure that the structure of the group does not impede effective supervision of the group on a consolidated basis.
- Where the need arises, Supervisors should meet with the Group Management with a view to enhancing their understanding of the group structure particularly where some members of the group are un-regulated.

3.4.2.1.2.1.2 **Fit and Proper Principles**

3.4.2.1.2.1.2.1 The Supervisors of entities within a group should exercise their responsibilities to assess whether those entities are soundly and prudently managed and directed by the board and management.

3.4.2.1.2.1.2.2 They should ascertain whether key shareholders do not constitute a source of weakness to those entities.

3.4.2.1.2.1.2.3 They should also have in place system designed to encourage the continued satisfaction of the fitness, propriety or other qualification test of supervisor and allow supervisory intervention where necessary.

3.4.2.1.2.1.2.4 Principal Elements

- Formal qualifications
- Previous experience
- Track records (visible achievements in previous place(s) of work

3.4.2.1.2.1.2.5 **Supervisory Processes**

3.4.2.1.2.1.2 The Supervisor shall:

- Assess the competence, formal qualifications, previous experience and track records of board and management of the banking group against specified thresholds particularly when they exercise a material or controlling influence on the operations of the supervised bank.
- Assess, against specified parameters, formal qualifications, previous experience and track records of shareholders whose holdings within the group are above specified thresholds and /or who exert a material influence on the supervised bank.
- Assess integrity and suitability tests for individual board members and Management team of the banking group which shall include criminal records, financial position, civil action against individuals to pursue personal debts, refusal of admission to, expulsion from professional bodies, previous questionable business practices and sanctions applied by regulators of other similar industries.

3.4.2.1.2.1.3 **Group Corporate Governance and Management Oversight**

3.4.2.1.2.1.3.1 **Principal Elements**

- There should be operational independence of the Board of the supervised bank.

- The Board should be accountable to the various stakeholders either in or outside the group.
- There should be transparency by the supervised bank in the discharge of its mandate.
- There should be observable integrity so that transactions are executed at arms length devoid of conflict of interest.
- The Board of the supervised bank must be seen to effectively carry out its oversight functions over Senior Management.
- Documentation of business strategy including corporate values, lines of responsibilities and accountability among various cadres of employees in the supervised bank and all its subsidiaries/affiliates whether local or foreign.
- The headship of the Board should be separated from that of the Management, and there should be more non executive members including independent members than the executive members.
- All Directors of the supervised bank should be knowledgeable in business and financial matters and relevant experience and exposure.
- There must be in place Board Committees such as Audit Committee, Risk Management Committee, Credit Committee, Finance and General Purpose, etc.
- The Management of the supervised bank and other entities shall have acceptable and well defined division of responsibilities and shall be committed and proactive, and have a definite succession plan.
- There should be balance of power and authority to avoid the possibility of an individual within the banking group or a group of individuals having unfettered powers over decision making. In the supervised bank.

- There should be enlightened, responsive, and responsible shareholders for the supervised bank and the other members of the group.
- There should be an established culture of compliance with internal policies and procedures as well as rules and regulations issued by each supervisor for all the members of the banking group.
- There should be regular management reporting and monitoring system as well as an articulate code of conduct for Directors, Management and Staff.
- Both Internal and External Auditors should be competent, independent and of high integrity.

3.4.2.1.2.1.3.2 **Supervisory Processes**

- Supervisors to confirm the ownership structure of the supervised entity to ensure conformity with regulatory guidelines
- Members of Board and Management of the supervised bank as well as those of other members of the banking group should be confirmed to be fit and proper persons by the appropriate supervisor.
- Supervisors to determine if Board performance appraisal system is in place and is effectively implemented by the supervised bank and other members of the group.
- Supervisors to confirm the existence and effectiveness of Board Risk Management Committee and a functional Risk Management Department with full complement of staff and acceptable reporting lines.
- Supervisors of the various entities in the group should be availed of their External Auditors reports.

3.4.2.1.2.1.4 **Control Environment**

3.4.2.1.2.1.4.1 Establishing and maintaining an effective system of internal control, including the enforcement of official lines of authority, appropriate segregation of duties, compliance as well as engagement of external auditors is at the heart of the Management responsibilities. Supervisors need to obtain information that allows them to assess and monitor how effectively the financial conglomerate is controlling the environment in which it operates.

3.4.2.1.2.1.4.2 **Principal Elements**

- Appropriate internal policies and procedures
- Competent independent internal audit
- Culture of compliance with rules and regulations
- Effective and efficient Audit Committee
- Adequate operational and financial control
- External Auditors of high integrity, independence and competence

3.4.2.1.2.1.4.3 **Supervisory Processes**

3.4.2.1.2.1.4.3.1 Supervision on a day to day basis and in the normal course of business will focus on understanding the group's structure, its major business activities, and how well it is managed.

3.4.2.1.2.1.4.3.2 Therefore the Supervisor shall:

- Review the banking group's policies and procedures with emphasis on significant accounting policies.
- Review internal audit and management reports and publicly available information (including market information on equity and debt prices of the banking group) as well as reports and data collected by other regulators.
- Obtain a description of the roles, responsibilities and organization of the financial control and compliance functions.

- Notify the bank of all required consolidated limits such as capital ratios, limits on consolidated large exposures, fx positions, large deposits etc.

3.4.2.1.2.1.4.3.3 To minimize regulatory burden on the supervised bank, the information will be gathered, to the extent practicable, from the parent organization, functional regulators, and publicly available sources.

3.4.2.1.2.1.5 **Risk Management**

3.4.2.1.2.1.5.1 **Principal Elements**

- Existence of a group–wide formal and uniform policies and procedures with regard to intra-group transactions;
- Existence of group-wide business strategy;
- Existence of group-wide corporate risk management system;
- Existence of group-wide risk control mechanism such as limits, contingency plans and stress testing, among others.

3.4.2.1.2.1.5.2 **Supervisory Processes**

- An adequate description of the conglomerate's business strategy and principal risks and clearly assessing the approaches to measuring and controlling those risks;
- Assess the adequacy of policies and procedures of the conglomerate with respect to all the activities of its principal entities including the introduction of new products or business lines.
- Off–site capabilities to assess the risks reported by the supervised bank on a consolidated basis;
- Assess the adequacy of the organization of the risk management personnel and their reporting lines;
- Assess the adequacy of the limits, other risk control mechanisms, results of stress tests and contingency plans for the conglomerate;

- Assess the adequacy of its approaches to managing liquidity, funding profile of the supervised entity and the management of all significant clearing and settlement arrangements within the conglomerate and other firms;
- Obtain and assess the information on the principal risks and the mechanism for managing and controlling those risks in the banking group from other local or foreign supervisors.

3.4.2.1.2.1.6 **Information Sharing**

Arrangement for sharing information between supervisors and protecting the confidentiality of such information should be in place. Supervisors should rely on the work of other supervisors to facilitate information sharing and other forms of supervisory cooperation.

3.4.2.1.2.1.6.1 **Principal Elements**

- Memorandum of understanding between the CBN/NDIC and other relevant local or foreign supervisors / regulators;
- Availability of adequate and relevant information on the banking group to all supervisors concerned;
- Level of co-operation between all supervisors as demonstrated by the timeliness with which issues raised are addressed;
- The right to exchange prudential and other information between local and foreign supervisors / regulators.
- Authority to share information of supervisory interest on individuals such as owners, shareholders, directors, managers or employees of supervised entities.

3.4.2.1.2.1.6.2 **Supervisory Processes**

- Confirmation of the existence and adequacy of the memorandum of understanding between CBN/NDIC and other relevant local and foreign supervisors/regulators; (See appendix 1 on factors to be considered on the issue of MOU)

- Assess the adequacy of information exchanged between other local and foreign supervisors / regulators;
- Ensure that material issues of concern are being timely and proactively raised and addressed with the cooperation of other relevant supervisors;
- Ensure that all Nigerian banks operating in foreign countries either as branches or subsidiaries receive the prior consent of the CBN and the host country authorities.

3.4.3 CROSS-BORDER SUPERVISION

3.4.3.1 Scope of Supervision of Cross-Border Banking Groups

3.4.3.1.1 The scope of supervising cross-border banks for the purpose of this framework shall incorporate the following cross-border relationships:

i) A subsidiary/associate or branch of a Nigerian bank having overseas operations, if they fulfill the relevant materiality criteria.

ii) A bank which is part of an overseas group, but operating in Nigeria.

3.4.3.2 The supervision of cross-border banking groups in Nigeria shall be considered along the line of the recommendations contained in the four **Minimum Standards** established by the Basle Committee as follows:

- The CBN shall adopt consolidated approach in the supervision of all Nigerian banks with foreign branches and/or subsidiaries as well as foreign banks operating in Nigeria.

- All Nigerian banks operating outside the shores of the country shall receive the prior consent of the CBN and the host country authority.

- The CBN as the home country supervisor shall possess the right to gather information from cross-border Nigerian banks.

- If the CBN determines that any of the above standards is not being met by any foreign bank wishing to operate in Nigeria, it could impose restrictive measures or prohibit the establishment of offices of such a bank in Nigeria.

3.4.3.3 The CBN shall ensure that the adequacy of its powers to obtain the information needed to exercise consolidated supervision are unimpeded. These are evaluated from the standpoints indicated below:

* Ensuring that the supervised bank has its own process for collecting and validating financial information from all its foreign affiliates, as well as for evaluating and controlling its risks on a global basis.

* Ensuring that the CBN receives regular financial information relating to both the whole of the group, and to material entities in the group (including the head office) individually.

* Ensuring that the CBN is able to verify that the information (i.e. through inspection, auditors' reports or information received from the host authority) is adequate for achieving the desired objectives of consolidation.

* Ensuring the existence of access to information on intra-group transactions, not only with downward affiliates but also, where appropriate, with sister companies or non-bank affiliates.

* Ensuring that the CBN has the power to prohibit corporate structures that deliberately impede consolidated supervision.

3.4.3.4 The effectiveness of the procedures put in place by the CBN to demonstrate its ability to capably perform cross-border supervision of banking groups would be determined by the following:

- Adequate control of authorization, both at the entry stage and on changes of ownership.

- Adequate prudential standards for capital, credit concentrations, asset quality (i.e. provisioning or classification requirements), liquidity, market risk, management controls, etc.

- Off-site capabilities (i.e. systems for statistical reporting of risks on a consolidated basis and the ability to verify or have the reports verified– e.g. e-FASS).

- The capability to inspect or examine entities in foreign locations.

- The existence of arrangements for frequent dialogue with the Management of the supervised entity.

- The existence of track records for taking remedial actions when problems arise.

3.4.3.4 **Information Sharing**

3.4.3.4.1 In the case of cross-border banking groups, intensive cooperation between supervisors home and host countries is very essential. Supervisors should also have the right to exchange prudential information. In that regard, there should be a clear channel of information flows as follows:

- From the parent bank or head office to the home supervisor.
- From the foreign subsidiary or branch to the host supervisor; and
- From the host supervisor to the home supervisor

3.4.3.4.2 Information need should differentiate between preliminary information, regular information for the purpose of supervision and exception information in a crisis situation.

3.4.3.4.3 There should be a clear definition of information needs which would be duly documented in the form of bilateral Memorandum of Understanding (**MoU**). Information requirements should consider essential, desirable and material data, with due consideration of the secrecy requirements that guarantee customers' confidentiality, except in criminal situations.

3.4.3.4.4 The **MoU** between Nigeria and other countries should address the following issues, among others:

i. Information access which is often inhibited by bank secrecy legislations.

ii. Supervisory techniques including cross-border on-site inspections by the CBN/NDIC.

iii. Defining the common standards to be adopted by host supervisors as to what constitutes effective consolidated supervision by the CBN/NDIC on one hand, and the determination of the appropriate mechanisms for assessing the standards of supervision by host supervisors, on the other.

iv. Introduction of sanctions for non-implementation of the standards in the event of inability of the authorities to obtain satisfactory evidences for implementation of the standards.

3.4.3.4.5 In addition to the foregoing in respect of information sharing, the CBN shall also consider the following:

i. Improving the access of home supervisors to information necessary for effective consolidated supervision;

ii. Improving the access of host supervisors to information necessary for effective host supervision.

iii. Ensuring that all cross-border banking operations are subject to CBN and host/home supervision.

3.4.3.4.6 **The required information shall both be quantitative and qualitative.**

3.4.3.4.6.1 Quantitative Information includes data that shall be required to:

- Calculate capital adequacy ratios;
- Determine large exposures or legal lending limits including intra-group exposures;
- Determine large deposits from single or group entities which could constitute funding risk; and
- Determine such other parameters such as geographic concentrations in relation to the balance sheet size or capital base of the institution or whichever threshold had been agreed upon.

3.4.3.4.6.2 Qualitative information requirements of the CBN for Consolidated Supervision of cross-border subsidiaries/branches are as follows:

- Efficient risk management systems covering the group activities.
- Internal control and audit procedures for controlling group's overseas operations.
- Monitoring of Changes in ownership and control of partly-owned subsidiaries.
- Channel of reporting of activities to the CBN and efficient response mechanism by both parties.

- Quality of Management and fit and proper test for individuals, where appropriate.

- Assessment tools for ensuring that assets quality and concentrations of risk assets are within the acceptable parameters.

- Monitoring of liquidity to prevent unnecessary reliance on a single-third party source.

- Level of compliance with statutory laws and regulations of both the CBN and host countries.

CHAPTER FOUR

ISSUES AND CHALLENGES IN THE IMPLEMENTATION OF THE FRAMEWORK FOR CONSOLIDATED SUPERVISION OF BANKS IN NIGERIA

4.1 Inter-Agency Co-operation and Co-ordination

4.1.1 The Financial Services Regulation Co-ordinating Committee (FSRCC) established in 1994 is presently charged with the responsibility for co-ordinating regulatory issues among the Agencies that regulate

Financial Institutions in the country. However, there is need to broaden its membership to include PENCOM and any other relevant regulatory agencies that may be established as well as expand its functions to formally address the special needs of consolidated supervision. The memorandum of Understanding currently existing among the members of the Financial Sector Regulation Coordinating Committee (FSRCC) should be reviewed/enhanced to facilitate Consolidated Supervision.

4.1.2 The recommended additional responsibilities for the enlarged body are as follows:

- There is need for FSRCC to maintain a central database in respect of all the financial institutions supervised by the different regulatory bodies with restricted access as may be agreed in the MOU.
- There is the need for each regulator to establish a nodal cell at its end to facilitate information sharing among all members of the FSRCC.
- The salient features of the outcome of the analysis done by each regulator and any development that may require the attention of any other regulator or regulators.

4.2 Capacity Building on Consolidated Supervision for Supervisors/operators

4.2.1 There is the need to address the knowledge and skills gap of Supervisors and operators on consolidated supervision through training and development of competences of staff of both the regulatory agencies and the banking groups.

4.3 Information Sharing

4.3.1 Each bank should establish its own mechanism for collecting and validating financial information from all its affiliates and subsidiaries (i.e. whether local or foreign). The regulator should put in place a procedure for assessing the adequacy of the bank mechanism for collecting financial information and reports to ensure reliability. Each bank should also establish the process for evaluating and controlling risks on a global basis. The banks should also institute necessary technological and administrative arrangements to facilitate submission of consolidated financial reports in the format and frequency requested by the regulators.

4.4 Transparency of Corporate Structures

4.4.1 The corporate structure of a banking group may be complex, particularly when a group has adopted a management structure under which staff members report on particular aspects of their work to a range of directors or senior managers of other members of the group and which may sometimes be located in other countries.

4.4.2 To allow for effective group-wide supervision, the structure of a particular banking group should be sufficiently transparent for prudential regulators to be able to ascertain where the various business lines are conducted, the risk profile of the group and its individual parts, the way in which internal risk management is organized and conducted, and what corporate, financial and other linkages exist between group members.

4.5 Different Accounting Year Ends of Members of Banking Group

4.5.1 Currently, there are different accounting year ends for members of the same banking group. There is need to harmonize the accounting year end of entities within a banking group as well as standardize the examination timetable by the various regulatory agencies to make the reports useful and relevant.

4.6 IT Platforms

4.6.1 There is the need for the provision of the necessary IT platforms that will drive the process in the affected institutions in order to ensure effective implementation of the consolidated supervision framework. The provision of the necessary IT platforms would assist in communicating to market participants about the renewed supervisory policy.

4.7 Self-regulation

4.7.1 For effective implementation of the consolidated supervision, there is need for self-regulation by the relevant professional bodies in the system such as the Chartered Institution of Bankers of Nigeria and Institute of Chartered Accountants of Nigeria, among others. It is believed that their involvement will ensure effective compliance by their members in the areas of information disclosure, ethical conduct and professionalism.

4.8 Enabling environment and platform for consolidated supervision

4.8.1 In order to achieve the above, the CBN should:-

- Adopt formats of conglomerate questionnaire to be used in obtaining details of the risk profile, system of controls and management structure in banking groups.
- Give guidance on the scope and methods of consolidation permissible in the country.
- Develop formats for rendition of consolidated prudential returns consisting of Consolidated Balance Sheet, Profit

and Loss Account, Capital Adequacy, Large Exposures, Intra-Group Exposures, Liquidity Mismatch etc.

* Develop format for reporting intra-group transactions that should include gross commitments, nature and maturity of the commitment, profit or loss associated with intra group transactions, cross shareholdings and confirmation of arms length nature of transactions.
* Set prudential limit for negative liquidity mismatch at the group level.
* Prescribe materiality criteria for reporting intra-group transactions and exposures.
* Set the threshold for reporting large exposures.

4.9 Legal Issues

4.9.1 Enhance cross- border co-operation with foreign supervisors by signing relevant Memoranda of Understanding (MOUs) that should address access to information and cross border inspection, guidelines for effective consolidated supervision and sanctions for non implementation etc.

4.9.2 An amendment to the BOFIA to empower and authorize supervisory authorities to:

- Obtain information from banks' affiliates (unregulated institutions) which may be needed for bank supervision;
- Request banks to obtain from their affiliates and submit consolidated prudential reports;
- Apply prudential requirements to banks on a consolidated basis eg ratios and limits;
- Where a bank belongs to a group or has an affiliate in foreign territories, the CBN should be empowered to request the bank for information regarding

each and all the members of the group or the foreign affiliates for the purpose of consolidated supervision.

4.10 Corporate Governance

4.10.1 The regulatory authorities should ensure that the relevant enabling legislations contain provisions empowering them (regulators) to enforce good corporate governance practice in their supervised entities.

ANNEXURE 2

CAPITAL ADEQUACY MEASUREMENT TECHNIQUES

The assessment of the capital adequacy on a group wide basis is aimed at addressing the problems of double/multiple gearing or over-leveraging of capital which are common problems in the assessment of capital adequacy in relation to financial conglomerates. To determine the adequacy of the capital of a group, the assets and liabilities of the individual companies in the group are consolidated and the capital requirements applicable to the parent company are determined by the same process. The result is then compared to the parent's capital requirement to determine the strength of the capital i.e capital shortfall or otherwise.

The Computation of the group-wide CRAR for the purpose of the Consolidated Prudential Regulation could be considered from the following stand-point:

i. Where the solo regulatory capital for the related entities, are more stringent than the parent financial institution, the regulatory capital and the risk-weighted assets of such entities as defined by their regulators should be adopted in the computation of the group-wide CRAR.

ii. Where the capital adequacy norms of the related entities at the solo level are non-existent or less stringent, the norms of the parent financial institution, under the extant capital adequacy norms, should be adopted for computing the capital adequacy ratio at the consolidated level. The same risk weights and, credit conversion factors should be notionally applied to the assets and the off-balance sheet items of the related entities.

iii. The group-wide risk-weighted assets (RWA) should be arrived at by adding the RWAs of the parent with that of the related entities.

iv. The regulatory capital, for the purpose of consolidation shall be Consolidated Tier 1 and Tier 11 capital. The regulatory capital of the entities and the eligible components of the capital for the parent FI and the related entities should be added for determining the group-wide Tier 1 and Tier 2 capital.

    The following deductions should be made from the Consolidated Tier 1 and Tier 2 Capital:

    i. The accumulated losses and intangible assets, if any, of the parent financial institution (FI) and the subsidiaries.

ii. Any Capital Shortfall in the regulatory capital, as prescribed by the solo regulator of subsidiaries engaged in financial activities.

iii. Shortfall, if any, in the regulatory capital in the unconsolidated entities i.e the entities which are not consolidated in the Prudential Regulatory returns but engaging in financial activities. The amount of shortfall to be deducted from group capital should be proportionate to the parent's/group's equity investment in such unconsolidated entity (ies).

iv. Insignificant investments such as the parent firm's investments in entities engaged in financial activities exceeding 20% but less than 50% of its Own Paid Up Equity Capital. (Associated Companies).

v. Significant minority and majority investments by the Financial institutions in commercial entities reckoned as 15% and 60% of the FIs equity capital for individual significant investment and aggregate of such significant investments, respectively.

The group-wide CRAR should be computed as shown above. However for the purpose of computing the Group wide CRAR, Pro-Rata share of the parent FI in the regulatory capital of its subsidiaries which is in excess of the subsidiary's own regulatory capital requirements, and which could be regarded as, in principle, available to support risk in the parent or in other entities in the group, should a shortfall arise, can be recognized in the group-wide capital adequacy assessment.

Capital adequacy for individual entities shall be determined on solo basis according to the capital requirements of their respective regulators. Financial institutions are therefore required to maintain on an on-going basis a Minimum Capital/Risk Weighted Assets Ratio (CRAR) of 10%

The solo supervision of individual entities is complemented by a quantitative group-wide assessment of the adequacy of capital.

The consolidated bank shall maintain a minimum Capital to Risk Weighted Assets Ratio prescribed by the bank regulator.

Where there is a shortfall in the capital adequacy ratio of any of the subsidiaries, the parent should maintain capital in addition to its own regulatory requirement to cover the shortfall.

Risks inherent in unconsolidated subsidiaries should be assessed and any shortfall in the regulatory capital should be deducted from the consolidated banks' capital in the proportion of its equity stake in the subsidiary.