FRAMEWORK FOR CONTINGENCY PLANNING FOR BANKING SYSTEMIC DISTRESS AND CRISES

1.00 INTRODUCTION

1.01 The history of financial distress in the Nigerian banking system dated back to the 1930s when about 21 bank failures were recorded prior to the establishment of the Central Bank of Nigeria in 1958. The first financial crisis was attributable to a number of reasons including the under capitalisation of banks, weak management, inappropriate corporate governance structures, reckless use of depositors funds, excessive growth (over-trading), lack of regulation and supervision and politicisation. The second financial crisis in Nigeria which started in 1989 with the identification of seven distressed banks worsened gradually until 1993 when it led to the collapse of the inter-bank market and spread to all segments of the financial system.

The ability of the supervisory agencies to contain, manage and resolve the distress syndrome was severely handicapped due to the absence of a comprehensive regulatory framework for distress/crises management.

It is against this background that the CBN/NDIC Executive Committee on Supervision directed its Technical Committee to review the Toronto Leadership Forum's framework on Contingency Planning for Banking System Distress and Crises with a view to its adoption for the Nigerian financial system in line with best practices.

In developing the framework, the CBN/NDIC Executive Committee adopted the Toronto's Leadership Forum's definition of systemic distress and crises as "... those situations where the solvency and/or liquidity of many or most banks have suffered shocks that have shaken public confidence." Specifically, a systemic distress could be said to have occurred when at least two of the following situations arise:

-Where the banks that are critically distressed control 20% of the total assets in the industry;

- S 15% or more of total deposits are threatened; and

- S 35% of banking system=s total loans are not performing

1.02 The framework for contingency planning consists of a set of identified policies, actions and processes necessary for the prevention, management and containment of banking systemic distress and crises. Thus, its implementation *would enable the supervisory authorities to reduce the likelihood of the occurrence of systemic distress by sharpening supervisory processes, inducing self-regulation amongst banks management, lowering the cost of crisis resolution and providing requisite advance consideration and agreements by all stakeholders*.

1.03 The structure of the framework consists of:

a) an evaluation of the supervisory policies and processes in determining the financial condition of banks and a robust safety net;

b) guidelines for developing contingency plans by banks;

c) established thresholds for supervisory intervention incorporating appropriate action plans;

d) a regime of explicit supervisory commitments and incentives for all stakeholders; and

e) a defined composition and functions of a Crisis Management Unit.

1.04 The rest of the document provides details on the elements of the framework. The second section evaluates the current supervisory processes of determining the financial condition of banks. Our current on-site and off-site approach in relation to risk-based and consolidated supervision along with issues relating to adequate disclosure of information by banks and supervisory disposition to self regulation were reviewed. Section three proposes a matrix of events and supervisory measures that could be employed to prevent and/or contain distress in order to avert systemic crises as well as sensitise banks management to impending regulatory/supervisory actions that would promptly be taken in responding to deteriorating condition of a bank. As a corollary, banks would be required to put in place their own contingency plans for capital and liquidity restoration, amongst others. Thus enhancing a bank=s ability to withstand both temporary or long term disruptions in its ability to fund some or all of its activities in a timely manner and at a reasonable cost. Accordingly, section four proposes guidelines for developing contingency plans for banks. Section five recommends a regime of commitments and incentives for all stakeholders while section six recommends the composition of a Crisis Management Unit and the events that would trigger its takeoff. Lastly, section seven contains the summary and recommendations.

2.00 DETERMINING THE FINANCIAL CONDITION OF BANKS

2.01 The objective of supervision is to promote the safety and soundness of financial institutions through on-going evaluation and monitoring, including the assessment of risk management systems, financial condition and compliance with laws and regulations. The supervisory agencies cannot effectively deal with systemic banking crises without an in-depth knowledge of the condition of the banks they supervise.

2.02 The main focus in determining the condition of banks prior to a crisis situation is to enable supervisors promptly distinguish between banks which have good chances of emerging from any crisis and those that are terminally distressed.

2.03 A major characteristic of a systemic crisis is that the financial condition of a bank could worsen rapidly due to deteriorating economic conditions and/or a run. In essence, there would be a need to quickly and incisively diagnose the condition of the banks in the system whenever there is a systemic crisis. In that direction, supervisors should ensure that the banks adopt realistic accounting policies and standards in generating their financial statements towards valuation of their assets and liabilities.

2.04 In the event of a systemic crisis, there may be the need to simultaneously determine the condition of all banks. In embarking on such an exercise, the supervisors should appraise their capacity such that whenever it is necessary they can out-source to supplement in-house capacity. The outsourcing should focus on external auditors/consultants skilled in bank assessment and valuation. However, the bank=s auditors should be excluded from the latter for objectivity. Where necessary, independent valuers may be co-opted towards realistic assessments of the banks asset.

2.05 After an objective assessment of the condition of the banks using all the existing financial criteria and ratios, including the maintenance of proper records which portray the realistic value of the bank=s assets and liabilities, all the banks in the system should then be classified in accordance with a uniform bank rating system. This exercise will yield a first-class assessment that can be useful in establishing supervisory priorities while supporting a decision by the Central Bank/NDIC in providing liquidity and triggering actions to restructure or take-over the control of banks, amongst others.

2.06 The recent adoption of Universal Banking under-scores the need to strengthen the on-site and off-site monitoring processes of the supervisory authorities. That will require the use of techniques such as risk-based assessment, consolidated supervision and cross-border cooperation amongst supervisors. In that direction, the framework for both risk based assessments and consolidated supervision should be developed with full co-operation of all the regulatory bodies i.e. CBN, NDIC, NAICOM and SEC. That would be invaluable towards realistic determination of the financial conditions of the bank.

2.07 The accuracy and reliability of statutory returns rendered by the banks had always been in doubt. It is therefore necessary for Supervisory Authorities to put in place appropriate incentives for operators to render accurate returns.

2.08 The Bank Analysis System (BAS) currently in use is yet to overcome the problem of accuracy and reliability of statutory returns due to the limited capacity of the Bank Data Entry (BDE) module which operates on a stand-alone machine. Without interface with the banks= systems, the returns keyed in the BDE cannot guarantee accuracy. To minimise the possibility of tampering with the data , the BDE module should be enhanced, so as to be compatible with the banks= systems, such that their financials are automatically generated. The BAS should also be Web-Enabled to facilitate direct communication with the supervisory authorities. This would also enable both on-site and off-site examiners to directly access any information from the banks= financial records.

2.09 There is also the need to have a more integrated approach to the determination of the financial condition of the banks. On-site examination is meant to complement off-site monitoring of the condition of the banks. On-site examiners are supposed to be continuously updated with the off-site monitoring reports. In the same vein, external auditors= review of banks= financial statements would be more useful if an integrated approach with the on-site and off-site examinations is adopted.

2.10 The cooperation and integrity of bank managers and shareholders are essential ingredients in determining the financial condition of banks. It is therefore essential to review the procedures for the determination of the fitness and properness of bank managements and shareholders as the current level of malpractices reveal serious inadequacies in that regard. In addition to the recent CBN circular on the requirements for both nominal directors and members of the top management team (which further recognised the shortcoming of the "fit and proper" person's test), we suggest the following additional ways of enhancing the "fit and proper" person's test:

i] foster a closer relationship with the State Security Services (SSS);

ii] The establishment of a data base on persons convicted and or declared bankrupt;

2.11 To supplement supervisory authorities' efforts in monitoring the condition of banks, self regulatory organisations (SROs) and rating agencies should be encouraged and supported.

2.12 As a feedback mechanism in the determination of the condition of banks, off-site monitoring reports should be made available to the operators. This will also enhance their cooperation and foster a "stakeholder" approach to supervision.

2.13 One of the objectives of crisis resolution by the supervising authority is to protect the interests of depositors, especially the small savers. This is necessary so as to prevent serious damage to the ability of the banking system to perform its intermediary role in the economy. In addition to an effective supervision mechanism, there are two major elements in the provision of safety nets during a crisis period. These include provision of liquidity in the form of lender-of-last-resort function of the monetary authority and the establishment of deposit protection/guarantee scheme to protect depositors.

2.14 While liquidity support can be provided to help banks meet deposit withdrawals and prevent widespread loss of confidence it can prove costly, because it can help keep non viable, loss-making banks in operation, finance capital flight and result in inflation. The challenge is therefore how to meet legitimate liquidity needs while avoiding the provision of liquidity to banks with no prospects of recovery.

2.15 As part of the routine supervision and regulatory function, this framework proposes that banks should be required to have in place their own contingency funding plans which define the manner in which they would maintain liquidity in times of distress. Although borrowing from the Central Bank should be seen as a last resort, banks must ensure that the assets and documentation required to support collateralized borrowing from the Central Bank are in good order.

2.16 As part of the deposit protection scheme, the supervisory authorities should examine bank's practices in making disclosure to customers regarding different types of instruments, especially investment and trust-accounts. Steps should be taken to ensure that customers and the general public can readily distinguish between those instruments that are general obligations of the bank including deposits that are protected and those that are solely at the risk of the customer. One way to do this is to publish widely the terms and limits of the deposit protection scheme. This could be done through bank product pamphlets, bank brochures, jingles and advertisement, amongst others. The deposit protection scheme should also be extended to licenced non-bank deposit taking financial institutions.

3.00 THRESHOLDS FOR SUPERVISORY INTERVENTION

3.01 This section provides the arrangement for official intervention in the event of bank distress and crises which shall be enforced by the relevant departments of CBN/NDIC upon directives from the CBN/NDIC Executive Committee.

3.02 Sections 33 to 35 of the Banks and Other Financial Institutions Act (as amended) have spelt out the actions that the CBN and NDIC can take in the control of a failing bank. However, these provisions of the Act are not explicit on the various indicators of the health of a bank other than capital. With respect to capital, the Act recognises under capitalisation only as a situation where the capital to risk weighted assets ratio is below 5%. Thus, the Act does not provide for other adverse indicators on such factors as liquidity, management, earnings and internal control, a situation which calls for explicit thresholds for regulatory actions.

3.03 The objective of explicit thresholds for regulatory/supervisory intervention is to ensure consistency and more systematic approach to distress resolution which are essential for maintaining overall stability in the financial sector. The condition, timing, and type of intervention can have serious implications on the sector. The design and application of interventions should create adequate incentives for all stakeholders to exercise caution and act prudently.

3.04 Below are the conditions in a bank, which may warrant supervisory intervention to mitigate the risk of systemic crisis. Corresponding supervisory actions have also been suggested. These actions are in addition to those stipulated in the relevant sections of the BOFI Act. These should be fully disclosed to all stakeholders for the purpose of transparency.

No	Condition of a Bank	Restriction/Supervisory Action
1	Capital Adequacy a] Under capitalised banks (i.e. banks with Capital Adequacy Ratio -CAR- greater than or equal to 5% but less than the prescribed minimum level of 8%)	i) Conduct special examination ii] Restrict dividend distribution iii] Restrict investment in other subsidiaries/related companies. iv] Restrict investment in fixed assets
	b] Significantly under capitalised banks (i.e. Banks with CAR less than 5% but equal to or greater than 2%)	i] Restrict new lending to recoveries (zero based lending). ii] Request for business plan on how fresh funds are to be injected into the bank. iii] CBN to review business plan within two weeks and communicate to the bank its acceptability or otherwise iv] Fresh capital must be injected not later than 3 months from the time the business plan was accepted by the CBN. v] The CBN should make the final capital call on the bank within 4

		months from the time of acceptance of the business plan. Vi] Within two months after the final capital call CBN may take-over management and control of the Bank and hand it over to NDIC vii] The CBN may appoint the NDIC which may consider the following options: (a) Recapitalisation and restructuring by new investors. (b) Create incentives for healthy banks to take over the sick one. (c) Encourage private debt factoring companies to acquire the bad debts of the bank.
		(d) Recommend the revocation of licence.
	c] Critically under capitalised (i.e. banks with CAR less than 2%) d) Insolvent banks (i.e. banks that have negative CAR)	Take-over management and control and/or revoke the licence S Revoke the licence
	<u>LIQUIDITY</u> a) <u>Fairly illiquid bank</u> i) A bank that records a liquidity ratio greater than 20% but less or equal to 25%. ii] A bank which suffers clearing operation losses for 5 consecutive days i.e. adverse clearing settlement position without adequate cover to the extent that recourse had to be made to the clearing collateral iii] A bank whose account with CBN was overdrawn, and not covered on the next working day consecutively for five working days within a month.	i] Invite management for a discussion on its plans to improve liquidity. ii] Request the bank to realise assets that do not qualify for inclusion in liquidity ratio computation
	b] <u>Significantly Illiquid Bank</u> i] A bank that records a liquidity ratio	i] The CBN to conduct spot check to

	greater than 10% but less or equal to 20%. ii] A bank with overdrawn CBN account not covered the next working day for seven times within a month. iii] A bank that is a net taker of up to 25% of its total deposit. iv] The bank's ratio of total loans portfolio to total deposits is 20 percentage points above existing prudential ratio for three consecutive months. v] A bank that incurs clearing operations losses continuously for 10 days.	investigate the problem of the bank ii] Invite the Board and management for discussion. iii] Advise the bank to divest from subsidiaries or related companies iv] Solicit for short-term liquidity support from NDIC.
	c) <u>Critically Illiquid Bank</u> i] A bank that records liquidity ratio equal to or less than 10 percent. ii] A bank that is unable to meet its maturing obligations. iii] Clearing operation losses for 15 continuous days or up to 20 days during a calendar month. iv] A bank with overdrawn CBN account not covered the next working day more than 10 consecutive days within a month	i] Change management and/or board. ii] Suspend the bank from clearing until it makes good its clearing position.
	d] <u>Systemic Illiquidity</u> Systemic illiquidity could be said to have occurred when: i] 10% of the banks in the system have applied for liquidity support from CBN/NDIC. ii] 10% of the banks in the system are having adverse clearing settlement positions which are not promptly covered and are drawing on their clearing collaterals; and/or iii] 15% of total deposits in the system are threatened due to bank's inability to honour obligations. These could be due to macro economic shocks or changes in government policy	Financial support and other lender of last resort actions
3	<u>MANAGEMENT</u> Any of the following shortcomings in the management of a bank will warrant supervisory intervention.	

	i] Conducting banking business in an unsound and unsafe manner ii] Continuous violation of laws, rules and regulations or banks charter or by-laws or monetary policies iii] Squabbles among shareholders, directors and officers iv] Irregularities in the handling of assets and liabilities accounts, such as kitting, lapping, theft, misappropriation, etc. where possible losses can impair paid-up capital or are equal to 20% of shareholder=s funds. v] Long standing industrial action preventing normal/regular operations vi] Persistent petition against management vii] Late or non-publication of annual accounts viii] High staff turn-over	i] Invite management and Board for discussion ii] Removal and sanction of erring officers iii] Change in Board and/or Management of the bank by CBN iv] A referral process that will submit any suspected improper or illegal activities for review and possible prosecution.
4	<u>ASSETS QUALITY</u> a) <u>Fairly unacceptable Assets Quality</u> Where the proportion of non-performing credits to total credits is 10% above the tolerable limit of 20%.	i] Request for action plan from management to address the problem within six months. ii] CBN to conduct a special/target examination to determine the factors responsible for the non-performing credit iii] Officers to be sanctioned for improperly booked loans.
	b) <u>Critically Unacceptable Asset Quality</u> i] Where the ratio of non-performing credits to total credits is 20 percent above the tolerable limit. ii] Where 25% of non-performing credits are insider related.	In addition to [i] , [ii] and [iii] above, the CBN/NDIC may direct that: i] The bank should recall improperly booked loans ii] Adirector(s)be removed/blacklisted for non-performing insider credits iii] Further loans to subsidiary/ related companies be stopped (where the subsidiary/related company is unhealthy) iv] Loans to subsidiary/related company be recalled v] Bank should divest from the subsidiary/related company

		where the activities of the subsidiary/ related company are inimical to the health of the bank.
5	EARNINGS i) Where a bank records losses for two consecutive quarters. ii) Drop in net operating income by 20% relative to previous year.	i) Write management to draw their attention to the lapse. ii] Invite management to discuss lapses.
6.	INTERNAL CONTROL i) Absence of manual of operations in a bank ii] Absence of programmed review of banks operations guidelines (Operation manuals should be reviewed at least once in 2 years) iii] Rising trend of frauds/forgeries	I] Write management to draw their attention to the lapse. ii] CBN to conduct a target examination to review the bank=s internal control processes and operating manuals

4.00 GUIDELINES FOR BANKS IN DEVELOPING THEIR OWN CONTINGENCY PLANS

Many banks have not sufficiently addressed the risks associated with the loss or extended disruption of business operations to fully appreciate the need for contingency planning. The regulatory authorities therefore need to direct the operators to prepare their contingency plans.

4.01 NEED FOR CONTINGENCY PLAN

As banks rely less and less on core deposits as a stable funding source and rely more on secondary sources of funding, the need for contingency plans becomes more critical.

The adoption of contingency plans will assist the banks in the following ways:

i] Minimize disruptions of service to their customers

ii] Minimize financial loss due to disruptions; and

iii] Ensure a timely resumption of normal operations in the event of a disaster

4.02 Policy

The board of directors and senior management of financial institutions are responsible for:

i] Establishing policies, procedures and responsibilities for comprehensive contingency planning;

ii] Reviewing and approving the institution=s contingency plans annually, documenting such reviews in board minutes.

4.03 Back-Up Liquidity

Contingency plan should include procedures for making up cash flow shortfalls in adverse situations. Banks have available to them several sources of such funds, including previously unused credit facilities. Depending on the severity of the liquidity problems, a bank may choose - or be forced - to use one or more of these sources. The plan should spell out as clearly as possible the amount of funds a bank has available from these sources, and under what scenarios it could use them. Banks must be careful not to rely excessively on back-up lines and need to understand the various conditions, such as notice periods, that could affect the bank's ability to access quickly such lines. Indeed, banks should have contingency plans for times when their back-up lines become unavailable.

Banks should consider under what circumstances and for what purposes they would establish committed lines of funding, for which they pay a fee, which will be available to them under abnormal circumstances if uncommitted facilities fail.

4.04 ACTION PLAN FOR SOME SELECTED PARAMETERS

In addition to these broad guidelines, the banks will be required to make specific plans for addressing deterioration in some selected parameters. These are listed below:

1] <u>CAPITAL</u> **<u>Capital impairment</u>:** **i] Where the CAR is less than the prudential minimum;** **ii] Where the paid up capital is impaired by losses**	**The bank's contingency plan must address:** **How the bank intends to inject additional capital from:** **i] existing shareholders;** **ii] the capital market/and or new investors (private placement); and** **iii] secondary sources i.e. debentures/preference shares** **Such a plan should be specific, realistic, achievable and time bound.**
2] <u>LIQUIDITY</u> **<u>Illiquidity</u>** **i] Clearing operations losses continuous for 5 days;** **ii] Bank's liquidity ratio is below the prescribed minimum level twice in the last six months;** **iii] A bank borrows from the interbank an amount equal to 25% of its deposit liability;**	**The plan should address the following areas:** **i] Standby agreement with other banks/other financial institutions which they can fall back on;** **ii] Balance-sheet restructuring, where problem is medium/long term in nature;** **iii] Possession of cash drawing facility (CDF) at the CBN;** **iv] Overnight drawing facility with other**

iv] The bank's ratio of total credits to total deposits is 20 points above prudential ratio as of the preceding quarter end.	institutions; v] Mitigating persistent clearing operations losses; vi] Additional sources of liquidity information should include confirmed lines of credit and loans available for sale, including types and volume; vii] The plan should identify vulnerable liabilities and alternative funding sources;
3] <u>MANAGEMENT</u> i] Continuity of top management and board. ii] Personnel Protection	The bank must put in place a succession plan in the event that it losses any member of its executive management The bank must develop emergency preparedness procedures to ensure the protection of the employees in the event of an emergency while at work. (An evacuation and protective area procedure should be established for the bank. Included should be a list of records & assets that need to be secured without endangering the employees).
4] <u>ASSETS QUALITY</u> i) Improper booking of credits ii) Where non-performing credits exceed 20% of total credit	The plan should articulate how to: i] effect accelerated debt recovery ii] address compliance with procedures by officials of the bank iii] review of credit manuals & various credit committee approval levels; and iv] undertake a periodic review of off-balance sheet transactions
5] <u>EARNINGS</u> i] Reported losses for two consecutive quarters ii] Drop in net operating income of at least 20% from the previous one year.	i] Plan must specify how to address losses ii] In addition the plan must be able to identify the causes of the loss e.g. excessive overheads or expensive cost of funds iii] Plan must address the need to improve earnings
6] <u>INFORMATION TECHNOLOGY (IT)</u> Management is responsible for controlling the IT and its use in the organisation. The continued availability of advanced IT is integral to effective Management decision making	a] The plan is an extension of the bank's internal control and physical security meant to guarantee continued operations and data recovery when the bank's information system becomes disrupted or in operative. b] The plan must include the following: i] Provision for off-site back-up of critical data files, software, hardware,

	documentation, as well as alternative means of processing information; **ii] Provision to implement any change(s) in user method necessary to accomplish alternative processing should the need arise;** **iii] Arrangement for periodic testing to demonstrate and document its efficiency;** **iv] Continuous review of the adequacy of the hardware/software system;** **v] the establishment of a damage assessment team which will be responsible for determining the extent of the disaster and the restoration of the site;** **vi] The establishment of a back-up team for the off-site hardware and software;**

4.05 TIME FRAME

All banks are expected to have in place contingency plans within twelve (6) months of the release of the guidelines.

5.00 ESTABLISHING A CRISIS MANAGEMENT UNIT(CMU)

5.01 When banking distress becomes systemic and reaches a crisis proportion, which is likely to impact on the entire financial services industry, the routine processes and procedures of the regulatory/supervisory authorities to deal with the situation may be inadequate. Possible conflicts among the different supervisory institutions can also undermine the overall effectiveness of their independent efforts to deal with the crisis. To address the twin problem of institutional capacity and weaknesses in coordination, there is a need to set up a Crisis Management Unit (CMU).

5.02 The CMU is a temporary, single purpose body meant to deal with any systemic crisis in the event of an emergency. However, because of its contingent nature and the need to act with speed, its composition and responsibilities have to be identified in advance. The CMU should have absolute control over matters related to the crisis and have the authority to take appropriate decisions. Thus, for the CMU to deal with crises speedily, it must have the required power and authority.

5.03 There will be a need to incorporate the necessary legal framework for the establishment of the CMU.

5.04 The success of the CMU in handling any crisis is contingent on the existence of an adequate mechanism for determining the actual financial condition of the banks. This should be supported with a reliable databank on the financial condition which is regularly updated. Accounting rules and standards should also accurately reflect the banks' assets and liabilities as well as results of operation. Finally, the effectiveness of management should be reasonably determined.

5.05 RESPONSIBILITIES OF THE CRISIS MANAGEMENT UNIT (CMU)

Below are the proposed responsibilities of the CMU, its membership, and list of events that can trigger it into action.

Responsibilities

i] Overall management of the crisis by coordinating the actions of regulatory/supervisory agencies of any sub-sector of the financial services industry;

ii] Adopting an inter-agency approach on issues related to crisis management and resolution by establishing a single channel of communication. In the event of any crisis situation, it will also prepare official statements early so as to avoid misinformation;

iii] Establishing credibility and restoration of confidence in the banking industry;

iv] Conducting mock exercises to prepare staff for any crisis; and

v] Taking any other action that may be necessary for the attainment of its objectives.

5.05 MEMBERSHIP OF THE CMU

Considering the responsibilities of the CMU and the authority to be vested in it, membership should include:

a]	Governor, Central Bank of Nigeria	-	Chairman
b]	Minister of Finance	-	Member
c]	Managing Director/CEO, NDIC	-	Member
d]	DG, Securities and Exchange Commission	-	Member
e]	Commissioner for Insurance (NAICOM)	-	Member

The Secretariat of the CMU would be in CBN.

5.06 EVENTS THAT WOULD WARRANT THE FORMATION OF THE CMU

It is proposed that at least two of the following events should trigger the formation and take-off of the CMU:

i] Where banks that are critically distressed control 20% of total assets in the banking system.

ii] When 15% or more of total bank deposits are threatened; and

iii] When 35% of the banking industry's total loans and advances are non-performing;

5.07 MANDATE

When the conditions necessitating the establishment of the CMU are met, the Governor of CBN should take action and inform the President of its take-off.

5.08 LEGAL FRAMEWORK

Incorporate the composition, functions and trigger events of CMU into BOFIA.

6.00 SUPERVISORY COMMITMENTS AND INCENTIVES

6.01 The fragility of banking requires that greater care be taken by regulatory authorities and operators to minimise the domino effect of any bank crisis and/or failure. Experience has shown that no amount of formal regulation will prevent problems from emerging in the banking sector. Therefore achieving an effective regulatory regime requires a shift in emphasis from prescriptive regulation to creating an appropriate incentives structure. However, the incentives should not be such that they will engender moral hazard. While sufficient incentives or assistance must be provided, they should be structured such that the banks shareholders and managements do not unduly benefit.

6.02 As banking crises frequently occur when there are weak incentives to act prudently, a necessary ingredient of a robust and stable financial system is the creation of appropriate and efficient incentives and sanctions for all market participants and, most especially, bank owners, bank managers and the financial system's supervisors.

6.03 Incentives for Bank Owners

Bank owners have an important role in the monitoring of bank managements and their risk taking. There are several ways in which bank owners can be encouraged to act prudently. These include, among others:

a. Ensuring that banks have appropriate levels of equity capital. Low capital creates a moral hazard in that, given the small amount owners have to lose, the more likely they are to condone excessive risk-taking. Corporate governance arrangements should be such that equity holders actively supervise managers.

b. Ensuring that owners lose out in any restructuring operations in the event of failure. Failure to penalise shareholders in the restructuring of unsuccessful banks has been a major shortcoming in some rescue operation in Latin America.

c. Ownership structures that foster shareholder monitoring and oversight can also be encouraged. This includes private ownership of banks to strengthen the monitoring of management.

6.04 <u>Internal Incentives for Management</u>

6.05 Creating the right incentive structures for the managers of financial institutions is equally as important as those for the owners. In fact, the two should be seen in combination. There are several procedures, processes and structures that can reinforce internal risk control mechanisms. These include the establishment of strong internal control and procedures for reporting to senior management/supervisors. These are in addition to making a top management or board member a compliance officer on risk analysis and management systems.

6.06 Supervisors can strengthen the incentives for reinforcing internal risk control mechanisms by relating the frequency and intensity of supervision and inspection visits to the perceived adequacy of the internal risk control procedures and compliance arrangements.

6.07 Specific measures designed to create correct incentive structures include:

- Ensuring the existence of a strong and effective risk analysis for assessing risks ex ante, and assets values ex post. This includes timely and accurate provisions against bad or doubtful debts.

- Ensuring that managers lose if the bank fails.

- Ensuring a high degree of professionalism among bank managers and decision - makers by having penalties (including dismissal and possible prosecution)

7.00 CONCLUSION AND RECOMMENDATIONS

While official regulation plays an important role in fostering a safe and sound banking system, the events surrounding systemic crises can quickly put to test the official safety net that supports the banking system. In the light of our experience in the recent past, it is imperative to be pro-active and have in place a contingency plan. The proposed framework for contingency planning for the prevention and containment of systemic banking distress and crises calls for its adoption by all stakeholders.

BANKING SUPERVISION DEPARTMENT
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ADDENDUM 1

CONDITIONS UNDER WHICH A BANK MAY BE CONSIDERED A PROBLEM BANK

A. LIQUIDITY

1. A bank whose account with the CBN was overdrawn and not covered the next working day consecutively for five working days within a month;

2. A bank which suffers clearing operation losses for 5 consecutive days i.e. adverse clearing settlement position without adequate cover to the extent that recourse had to be made to the clearing collateral;

3. Inability to pay maturing obligations;

4. A bank that records a liquidity ratio that is 5 percentage points below the prescribed minimum level twice in the last six months; and

5. A bank that is a net taker of up to 25% of its total deposits

B SOLVENCY

1. A bank with capital adequacy ratio greater than or equal to 5% but less than the prescribed minimum level of 8%;

2. A bank that has a proportion of non-performing loans to total credit up to 10% above the tolerable limit of 20%;

3. Large amount of loans that are renewed repeatedly without real/partial payment of principal and/or interest;

4. Large amount of expenses, valuation reserves not booked and/or large amount of assets or income booked already but the propriety of which is being disputed, which if adjusted by examiners, will impair/wipe-off paid-up capital; and;
5. Total loans in excess of single borrower's limit (including loans which on paper do not belong to a particular borrower or group of borrowers but which actually belong to the said borrower after considering certain features).

C RESULT OF OPERATIONS

1. Operating losses for two consecutive quarters; and
2. Drop in net operating income of at least 20% from the previous one year although operations for the year resulted to a net income;

D OTHERS

1. Deposit run on a bank;

2. Long-standing strike preventing regular operations;

3. Dissension/struggle for power among shareholders/directors/offices;

4. Continuous violation of laws, rules and regulations;

5. Irregularities in the handling of assets and liability accounts such as kiting, theft, misappropriation, etc. where the expected losses will impair paid-up capital or is equal to 20% of shareholders funds unimpaired by losses; and

6. High staff turnover