CENTRAL BANK OF NIGERIA

BANKING SUPERVISION
ANNUAL REPORT 2000

The Banking Supervision Annual Report is a publication of the Bank Examination and Banking Supervision Departments of the Central Bank of Nigeria. The publication reviews policy and operational issues affecting the banking sector and its regulators/supervisors, with the main objective of disseminating information on current issues.

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ISSN: 1595-0387

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FOREWORD

DR. SHAMSUDDEEN USMAN
Deputy Governor
Domestic Monetary &
Banking Policy

As in the preceding year, the banking industry continued to witness challenging developments which pointed to the emergence of a virile and stable financial system in Nigeria.

Efforts at eradicating the distress plague of the early 1990s were further boosted by the handing over of some distressed banks to new investors after the fulfilment of specified conditions, which included appropriate re-capitalisation, installation of new Boards and Managements, and adequate internal controls. A few banks are still undergoing the process of recapitalisation/restructuring and will be handed over as the processes are completed. Three banks which failed to attract new investors and appeared to have no potential for survival, had their banking licenses revoked and were handed over to the Nigeria Deposit Insurance Corporation (NDIC) for liquidation.

Following years of intense clamour for universal banking (UB), and its subsequent approval-in-principle by the CBN in 1999, the guidelines which marked the formal adoption of UB in Nigeria were finally released. The guidelines spelt out a new definition of banking in Nigeria. Expectedly, the euphoria generated by the eventual adoption of UB has energised the banking sector with high expectations of buoyed activities in the coming years, due to the perceived level playing field. To the CBN, the advent of UB has further deepened the liberalisation of the financial system. The enthusiasm shown so far by the operators is indicative of highly innovative and competitive banking operations in the near future.

No doubt, recent developments in the financial system pose great challenges to the supervisory role of the CBN. Thus, to further refine the supervisory apparatus, the Banking Supervision and Bank Examination Departments of the CBN, were re-organised into team-based structures, whereby a team of supervisors/examiners are assigned to a group of banks for a period of time. The anticipated benefits include, the in-depth knowledge of, and mutually beneficial interaction with the institutions, which should lead to a greater understanding of, and information about the institutions, with a consequent improvement in their supervision.

To effectively manage the ever-widening financial system, an additional supervisory department known as the Other Financial Institutions Department (OFID) was created to take charge of other players in the system, such as the finance companies, community banks, primary mortgage institutions and bureaux de change. The department, which is expected to take-off fully in the coming year would, to a large extent, sanitise the other financial institutions sub-sector currently experiencing distress.

The efficient functioning of the nation's economy, no doubt, depends largely on the strength of its financial system. In recognition of the vital role of the financial system, the CBN moved swiftly to check certain unwholesome activities of some operators that can be inimical to the system. Specifically, some banks found to have engaged in foreign exchange malpractices, such as round tripping of foreign exchange, were identified and promptly sanctioned. In view of the unsalutory effects of such financial malpractices on the nation's economy, stiffer sanctions are being contemplated, to serve as a deterrent against recurrence.

The increasing liquidity overhang in the economy further tasked the CBN on the need to create additional tools to mop up the excess and stabilise the system. Furthermore, in view of the adverse effects of the huge cash outside the banking system on monetary policy objectives, one of our goals in formulating future monetary policies is to shift focus, gradually, from cash in the banking system to cash outside it. Already, measures, such as aggressive enlightenment campaigns, are being taken to encourage the banking habit.

It is important to mention that some development finance institutions with overlapping roles are being merged by the Government, in an attempt to give them better focus and achieve a more rapid socio-economic development of the country.

Contemporaneously, the on-going re-engineering process in the CBN will re-position the Bank adequately to effectively discharge its crucial role of regulating the financial system. Encouraged by the constructive comments we received on previous editions of the Report, we urge readers not to spare the rod. Meanwhile, we are set on a course to strive to achieve continuous improvement.

DR. SHAMSUDDEEN USMAN
Deputy Governor
Domestic Monetary & Banking Policy

CENTRAL BANK
OF NIGERIA

PREFACE

O. I. IMALA
Director
Banking Supervision Dept.

M. A. BAMIRO
Director
Bank Examination Dept.

The Central Bank of Nigeria (CBN), in the year 2000, improved and re-engineered its supervisory processes in order to sustain the maintenance of a safe and sound financial system. With the encouraging effort towards curbing distress in the banking system, the supervisory authorities have further put an effective machinery in place which will limit the cost of resolving bank failure and the risk of systemic financial crisis in the future, build public confidence and promote financial intermediation in the system. The CBN, in its effort of realising these, uses this medium as a vital tool for disseminating information on its supervisory responsibilities and activities for enlisting understanding and co-operation.

As with the earlier editions, the Banking Supervision and Bank Examination Departments, through this fourth edition of the Annual Report, seek to inform the public and other stakeholders of their activities, as well as major developments and topical issues in the financial services industry.

The Report is presented in five chapters. Chapter one, which covers developments in the financial services industry, presents updates on co-operation among supervisory agencies at the domestic and regional levels, regulation of the other financial institutions, universal banking in Nigeria and distress resolution in the banking system. Another area covered in the chapter is centralised supervision of deposit taking institutions in Nigeria.

Chapter two deals with contemporary issues that are relevant to supervision, such as peer rating of banks, financial derivatives and the implication of universal banking on the Nigerian capital market. The growing concern over the high risks being assumed by banks in their

off-balance sheet engagements is also discussed.
An effective framework for supervision is imperative for the sustenance of a sound, stable and virile financial system. In order to ensure that banks which are out of distress do not fall back to their former precarious conditions, the need arises for closer monitoring of these restructured institutions. In this regard, the supervision of restructured banks is discussed in chapter three. Also treated in the chapter is the assessment by the World Bank Financial Sector Mission, of the level of compliance with the Basle Core Principles for Effective Banking Supervision in Nigeria.

Chapter four, as usual, is devoted to performance trends in the banking sector in the year 2000, with a comparative analysis of the previous year's performance on deposits, credits, assets, liquidity, capital adequacy and earnings. Unlike the earlier editions, this chapter is enriched with the provision of consolidated data on the balance sheet structure, growth rates, as well as earnings and profitability of banks. Some performance ratios are also introduced.

The year under review witnessed the re-organisation of the supervisory departments into team-based structures, a discussion of which is featured in chapter five. Also covered in the chapter is risk-focused supervision, which was one of the sub-themes at the 2000 Bank Examiners' Conference.

The Directors of Banking Supervision and Bank Examination Departments, seize this opportunity to express their appreciation for the continued co-operation and support of the CBN management in the production of the Annual Report. We also place on record, the contributions of the staff of the two Departments and members of the Banking Supervision Annual Report Committee, to whom we express our gratitude for the successful production of this Report.

M. A. BAMIRO
Director
Bank Examination Department

O. I. IMALA
Director
Banking Supervision Department

CENTRAL BANK
OF NIGERIA

CHIEF (DR) JOSEPH OLADELE SANUSI

Governor

Central Bank of Nigeria.

APPENDIX 2

BSD/DO/CIR/VOL.1/02/2001

January 4, 2001

To all Licensed Banks

RE: COMMENCEMENT OF UNIVERSAL BANKING IN NIGERIA

Further to our Circular BSD/DO/CIR/VOL.1/10/2000 of December 22, 2000, on the commencement of Universal Banking in Nigeria, we state below the specific requirements that should be met by a bank that intends to undertake retail banking activities.

i. Putting in place at its Head Office and all its branches the essential facilities for cashiering and clearing house activities, to the satisfaction of the CBN e.g Appropriate banking halls, cashiers cubicles, strong rooms, loading bays and the associated security arrangements;

ii. Competent and experienced staff at top management and other cadres in respect of the new operations; and

iii. Adequate insurance policy to cover the envisaged volume of cash transactions.

All the affected banks are therefore advised to ensure the availability of the above, as well as the CBN's prior approval, before commencement of retail banking activities.

Signed
O. I. IMALA
Director of Banking Supervision

Chapter One

DEVELOPMENT IN THE FINANCIAL SERVICES INDUSTRY

1.01 Update on Co-operation Among Supervisory Agencies

Co-operation among regulatory agencies continued to be fostered through the activities of the Financial Services Regulation Co-ordinating Committee (FSRCC), on the local scene, and the Committee of Bank Supervisors in West and Central Africa, in the sub-region. The FSRCC held six meetings during the period under review and the issues addressed included:

- Adoption of the Code of Good Practices and Transparency for Financial Agencies by the members.
- Approval by the Honourable Minister of Finance for the establishment of a Capital Market Desk at the Ministry.
- Compilation and distribution of a proposed information exchange index.
- Agreement in-principle by the FSRCC to design an information technology arrangement for the proposed linking of the financial regulators.
- Release of the draft guidelines on Universal Banking to banks and other financial institutions for their comments.

The Sixth annual meeting of Bank Supervisors in West and Central Africa.

On the international scene, the sixth annual meeting of Bank Supervisors in West and Central Africa was held in Conakry from 30th October to 1st November, 2000. The Basle Committee and Bank of France (General

Secretariat of the Banking Commission) were represented and they provided facilitators.

The Governor of the Central Bank of Guinea, in his keynote address, emphasised the impact of globalisation on banking operations, changes in information technology, liberalisation of the capital markets, universal banking system and the distress syndrome. He concluded by tasking member countries to consider the impact of these events on their roles as supervisors.

Thereafter, member countries shared experiences on various developments in their financial systems.

Two papers were presented. In the first paper titled "Management Policies of Bank Restructuring", Mr. Gilles Morrison of the Banking Commission of the French Republic highlighted the factors responsible for bank distress. He identified mergers and acquisitions as a form of bank restructuring in recent times and concluded by making suggestions on how to address the problems of bank distress.

The second paper titled "Transparency in Banking/Finance and Market Discipline", was treated under the three pillars of the new capital adequacy framework, that is, minimum capital requirement, supervisory review process and market discipline. The paper encouraged banks to enforce discipline, openness and integrity. It also touched on the need for banks to put in place sound internal controls and to embark on information technology acquisition.

It is expected that co-operation among supervisors will continue to be strengthened both locally and internationally, through these bodies.

1.02 Update on the Regulation of the Other Financial Institutions Sub-sector

Merging the DFIs for better performance

A major development in the Other Financial Institutions (OFI) subsector during the year under review, was the merger of various development finance institutions aimed at streamlining their operations. In this regard, the Federal Government approved the merger of Nigerian Bank for Commerce and Industry (NBCI), Nigerian Industrial Development Bank (NIDB) and the National Economic Reconstruction Fund (NERFUND) to form a new bank to be known as Bank of Industry. The Nigerian Agricultural, Co-operative and Rural Development Bank (NACRDB) had earlier been formed from the merger of Nigeria Agricultural and Co-operative Bank (NACB), Peoples Bank of Nigeria (PBN) and the Family Economic Advancement Programme (FEAP). The Government has also proposed the merger of Federal Mortgage Bank of Nigeria (FMBN) and Federal Mortgage Finance Limited (FMFL). It is expected that these mergers will overcome most of the problems of these institutions.

Other developments in the sub-sector are summarised as follows:

a) **Finance Companies**

Following the verification exercise carried out in 1999, 208 finance company licences were revoked while 462 approvals-in-principle (A.I.P) were cancelled, thus leaving 72 licensed finance companies and 23 A.I.P. holders as at December 31, 2000.

b) **Primary Mortgage Institutions (PMIs)**

The spot-check carried out on PMIs revealed that out of the 195 handed over to the CBN by the Federal Mortgage Bank of Nigeria (FMBN) in 1997, only 74 were in operation during the year under review. The guidelines for the operation of primary mortgage institutions were issued, while the CBN licensed only one PMI. The guidelines were concluded after inputs from and consultations with all the stakeholders.

c) **Community Banks**

During the period under review, 114 accounting firms as well as National Board for Community Banks (NBCB) examiners joined hands with CBN examiners to undertake the on-site examination of community banks, in order to determine their financial conditions and suitability for the issuance of final licence by the CBN. The reports were being finalised as at the end of the year.

d) **Bureaux de Change**

The number of bureaux de change remained at 260, as in the previous year. The CBN, during the year, requested the bureaux de change to regularise their positions with regard to the new minimum share capital of x10 million, the new mandatory deposit of x500,000 and the renewal fee of x10,000. As at the end of the year, many companies had complied.

Furthermore, a committee was set up to review the operational guidelines of the bureaux de change, in order to address the problems encountered by the operators in the sub-sector.

The establishment of the Other Financial Institutions Department (OFID) in the CBN, which is expected to take off fully in the coming year, will further strengthen the supervision and regulation of the sub-sector.

1.03 Update on Universal Banking

Following the approval-in-principle granted by the CBN Management in 1999 for the introduction of universal banking (UB), and its subsequent publication in the year 2000 Monetary Policy Circular No. 34, a committee comprising members from the CBN, Nigeria Deposit Insurance Corporation (NDIC), Securities and Exchange Commission (SEC), National Insurance Commission (NAICOM) and representatives of commercial banks, merchant banks and discount houses was set up to draft the guidelines for the practice of universal banking in Nigeria.

Bnnking business in Nigeria re-defined.

The committee completed its assignment by the middle of the year and submitted its report to the CBN management. The CBN Governor, in the exercise of the powers conferred on him by section 61 of the Banks and Other Financial Institutions Act (BOFIA) 1991 (as amended), published the new definition of banking business in Nigeria, through an official Government Gazette No. 91 Vol. 87 of December 31, 2000. The Guidelines for the practice of UB in Nigeria were also issued to take effect from January 1, 2001.

Highlights of the guidelines on UB.

According to the guidelines, all conventional banks (commercial and merchant) were to be granted uniform licences to practice UB. With such a licence, the distinction between commercial and merchant banking would be removed and banks would have the liberty to undertake, in addition to traditional banking functions, capital market activities as well as insurance marketing services, either directly or through subsidiaries. Each of these activities is expected to be approved and regulated by the relevant regulatory bodies.

The challenges of UB as highlighted in the 1999 edition of the Banking Supervision Annual Report were considered in the formulation of the

Guidelines. Accordingly, crucial areas like consolidated supervision of financial conglomerates, which might emerge, were addressed. In this regard, while the CBN was accorded the apex regulator status in the case of banks that would engage in other activities, the need for further co-operation and co-ordination of regulatory efforts, through the Financial Services Regulation Co-ordinating Committee (FSRCC), was emphasised. The imperative of adequate training and exposure of the supervisory staff of each sub-sectoral regulatory agency was also given prominence. Similarly, the co-operation of operators in the banking system, through the activities of Self Regulatory Organisations (SRO) and other bodies in the banking system was also solicited, to ensure the successful implementation and operation of UB in Nigeria.

Need to review BOFIA and other laws.

The committee on the guidelines for UB noted the need to review all the relevant laws, such as BOFIA 1991 (as amended), Securities & Investment Act and the Insurance Act. Consequently, it identified areas of conflict and made necessary recommendations for their amendment.

1.04 Update on Distress Resolution in the Banking System

Four restructured banks sold ....

In furtherance of its distress resolution efforts, the CBN sold four banks (New Nigeria Bank Plc, African Continental Bank Plc, First African Trust Bank Limited and Nationwide Merchant Bank Limited), earlier acquired, to new investors. The sale was sequel to the recommendations of the Joint CBN/NDIC Executive Committee on Problem Banks which evaluated the bids and turn-around plans from prospective investors.

The banks were subsequently handed over to the new investors who had earlier deposited various amounts required for their recapitalisation, after the fulfilment of the following conditions:

- appointment of boards and top management teams acceptable to the CBN;
- submission of acceptable organograms; and
- payment of a purchase consideration of N1,000 (One thousand naira only).

On its own part, the CBN management granted partial waivers on the banks' overdrawn accounts with the CBN, and converted the balance to 5-year term loans with moratorium of two years, as a gesture of its support to the restructured banks.

For the recapitalisation/restructuring of three other banks (Orient Bank of Nigeria Plc, Nigeria Universal Bank Ltd and New Africa Merchant Bank Ltd), approvals-in-principle were granted to new investors that had met the stipulated conditions, including the deposit of the amount required for recapitalisation in escrow accounts with the CBN .

.... and three more bank licences revoked

Furthermore, the banking licences of three other banks, namely; Premier Commercial Bank Plc., Ivory Merchant Bank Limited and Rims Merchant Bank Limited, were revoked. In accordance with the provisions of BOFIA 1991, as amended, the CBN appointed the NDIC as the official liquidator for the banks.

1.05 Centralised Supervision of Deposit-taking Institution in Nigeria

Deposit-taking institutions, defined.

The Banks and Other Financial Institutions Act (BOFIA) 1991, as amended, provides that a person shall be deemed to be receiving money as deposits if the person accepts deposits from the general public as a feature of its business or if it issues an advertisement or solicits for such deposits. Deposit-taking institutions, therefore, are those institutions that accept money from the general public as deposits and whose activities affect and influence resource allocation and the attainment of macro-economic stability.

Deposit-taking institutions in Nigeria include licensed banks, community banks, primary mortgage institutions and discount houses. The finance companies, by their guidelines, are allowed to “borrow” and not accept deposits from the general public, although this “borrowing” essentially entails funds mobilisation. The development finance institutions (DFIs) operate under varying statutory mandates which enable them to either accept deposits from the general public or channel credit to the preferred sectors of the Nigerian economy.

The Issue of Multiple Regulatory/Supervisory Authorities

Prior to January 1997, different authorities were charged with the responsibilities for the regulation and supervision of financial institutions whose activities involved funds mobilisation and allocation of resources among the various sectors of the Nigerian economy. For example, the CBN was responsible for the supervision of licensed banks, finance companies and discount houses. The Federal Ministry of Works and Housing and the Federal Mortgage Bank of Nigeria were responsible for the licensing and supervision of primary mortgage institutions (PMIs) while the National Board for Community Banks was responsible for the supervision of community banks (CBs).

Similarly, the DFIs were under the supervision of their respective supervising Ministries while the bureaux de change (BDCs) were licensed by the Federal Ministry of Finance.

Multiple regulatory framework in Nigeria, peculiar to the regulation of deposit taking institution.

Generally, financial services are classified into three major groups - banking, insurance and securities businesses - for the purpose of supervision. Whereas, in Nigeria, securities business is supervised by the Securities and Exchange Commission (SEC) and insurance business by the National Insurance Commission of Nigeria (NAICOM), banks and other deposit-taking institutions are under multiple regulatory authorities. Although the BOFIA was amended in 1997 to bring all deposit-taking institutions under the supervisory purview of the CBN, the enabling laws of the other regulators, such as the National Board for Community Banks and the Federal Mortgage Bank of Nigeria, are still in force. Thus, these organisations are still exercising their supervisory powers over their respective subsectors through actions that sometimes run counter to the supervisory objectives of the CBN. This situation harbours several weaknesses, such as circumvention of regulation, weakening of the effectiveness of monetary policy measures and duplication of functions and responsibilities.

In spite of the shortcomings of the new arrangement, the CBN has since assumed the responsibility for the overall regulation and supervision of deposit-taking institutions in Nigeria. Some of the actions taken in this regard include:

- designing appropriate supervisory strategies for the various institutions under its supervisory purview;

- increasing the minimum paid-up capital of each category of financial institution;
- issuing comprehensive guidelines for the different deposit taking institutions; and
- carrying out inspection of CBs and PMIs to determine their existence, viability and suitability for licensing.

In order to achieve an effective and efficient centralised supervision, as envisaged in the afore-mentioned amendment of the BOFIA, there is need to review the existing laws of the erstwhile regulators to reflect the new supervisory arrangement.

The benefits to be derived from a centralised supervision of deposit-taking institutions in Nigeria will include the following, among others:

The benefit of centralised supervision.

a) **Formulation of co-ordinated supervisory strategies.**
The centralised supervision of deposit-taking institutions will engender the formulation of workable and credible supervisory strategies for the affected institutions. This will also enhance the sustenance of coordinated surveillance on the activities of the institutions.

b) **Elimination of supervisory overlap/arbitrages.**
The circumvention of regulation by taking advantage of supervisory overlap and varied regulatory requirements will be minimised.

c) **Information sharing on a timely basis.**
At present, licensed banks, discount houses, primary mortgage institutions, community banks, finance houses, bureaux de change and development finance institutions are supervised by the

Banking Supervision and Bank Examination Departments of the CBN. The joint meetings of the two departments, for example, provide a forum for sharing information and addressing pertinent supervisory issues affecting the institutions.

d) **The establishment of a credible data management system.** This will cover all aspects of supervision from licensing to liquidation.

Chapter Two

ISSUES IN SUPERVISION

2.01 Peer Rating of Banks

Peering enhances effectiveness of bank rating as a tool for detecting emerging problems in banks

Bank rating, as a supervisory tool, enables supervisors to evaluate the performance of banks and serves as an early warning signal for detecting emerging problems. To properly rate a bank, both quantitative and qualitative factors are considered. Quantitative assessment is usually based on either the CAMEL or LACE approach, while qualitative assessment is based on such factors as compliance with laws and regulations, control environment, etc. The effectiveness of bank rating is further enhanced, if it allows for comparison, both horizontally and over time. Horizontal comparability in bank rating is achieved by categorising banks with similar characteristics into peer groups.

There has been some semblance of peer rating of banks in Nigeria, with such descriptions as "the big three", "first generation banks", "new generation banks" etc. There are a number of issues to be considered, however, when grouping banks into peer groups.

The first condition is the bases or criteria used. The descriptions in the preceding paragraph reflect the basis of categorisation used. Generally, any of the major balance sheet items can be used. These include assets size, as in the first example above, and volume of deposits. There have been groupings also on the basis of ownership, e.g. state-owned/privately-owned banks; by the segment of the banking industry to which the bank belongs, e.g. merchant/commercial; by business line; by geographical spread and the health status of the bank. These criteria can be used singly or in combination, but the most commonly used is the assets size.

Secondly, the group interval should be sufficiently wide to accommodate a reasonable number of banks.

Peer group analysis is undertaken on the basis of financial ratios for a group of banks taken together.

Peer group analysis is undertaken on the basis of the financial ratios for a group of banks taken together. It is used to ascertain whether an individual bank is performing in a significantly different way from its peers and the reason for such a difference, which may attract supervisory concern. Each bank's ratios are compared with the peer group to which it belongs. Within each peer group, either a simple identification of the worst performer, as compared to the peer average, is made, or the financial ratios are sorted from best to worst and percentile rankings calculated. Banks whose financial ratios have deteriorated relative to the average of their respective peer groups can then be identified.

The analysis is also used to examine trends in the banking sector as a whole, or in a particular segment of the banking sector, and to carry out a systematic analysis across the selected field. In a limited form, it is used for performance stress testing and scenario analysis.

Peer group analysis on its own is not sufficient to identify the complex risk structure of a banking institution, as changes in the performance, either of peer groups or of the banking system as a whole, are not accounted for in the results. If an entire peer group deteriorates, the percentile scores of individual banks within the peer group may not change, even though the bank's condition has worsened. Conversely, when a bank migrates to a larger or smaller peer group due to change in size, the institution's percentile scores may change significantly, even if its underlying financial condition has not changed. The analysis also depends on the data reported in the statutory returns and annual accounts. The integrity, timeliness and quality of the processing of data as well as sound accounting practices are a pre-condition for the analysis to be effective.

Peer rating in Nigeria is assets based

Currently, the peer rating of Nigerian banks is based on assets size. The banks are grouped as follows: x5 billion and below, above x5 billion to x10 billion, above x10 billion to x20 billion, above x20 billion to x100 billion, and over x100 billion and Group averages are calculated and applied in the final rating. The assessment of group performance is also facilitated by comparing the group averages with the industry average (see Table 1).

TABLE 1

PEER RATING OF BANKS AS AT DECEMBER 31, 2000

GROUP	Assets Base x,billion	No. of Banks	** Group Average		Group Rating
			Quarter ended 30 June 2000	Quarter ended 31 Dec. 2000	Current Quarter
Commercial:					
One	Above 100	3	55.59	54.68	Satisfactory
Two	20 to 100	21	57.68	57.46	Satisfactory
Three	10 to 20	14	55.61	55.32	Satisfactory
Four	5 to 10	16	55.40	53.75	Satisfactory
Five	5 and below	10	34.26	49.67	Marginal
Merchant:					
One	Above 10	5	64.32	64.38	Satisfactory
Two	4 to 10	10	62.36	61.33	Satisfactory
Three	4 and below	12	52.29	56.23	Satisfactory

Source: Banking Analysis System, CBN.

***** Group average is derived by dividing the sum of the composite scores for the group by the number of banks in the group.***

The choice of assets size is informed by the fact that it allows for better comparison of performance indicators than any of the other criteria. As the Nigerian banking system grows in sophistication, other criteria can be employed. This will be necessary to address the disruption that migration from one peer group to another engenders.

From Table 1 above, commercial banks are fairly evenly distributed in the "below x5 billion to x100 billion" bands (i.e. Groups 2 to 5). During the period, there was no migration of any bank to another band. As expected, the banks in the lowest band (i.e. x5 billion and below), were rated marginal and will require drastic supervisory action. For reasons of peer comparison, merchant banks in the same range (i.e. x5 billion and below), were rated satisfactory unlike their commercial counterparts, not only because of their assets size, but due to other factors which are embedded in the computation of the banks' individual composite scores.

The scope of peer rating, and in fact rating as a whole, will need to be expanded especially in the light of the new capital accord which relies heavily on rating, both internal and external, in capital adequacy measurement.

2.02 Financial derivatives: Need for Disclosure Requirements and Supervision

Nigerian banks are increasingly getting involved in the use of financial derivatives which carry considerable market risk. More worrisome, however, is the fact that derivative transactions are often shown off-balance sheet, without specific reference to the underlying transactions. Obviously, this situation should elicit keen supervisory interest.

Derivative - an instrument whose value derives from an underlying asset.

Broadly defined, a derivative instrument is a financial transaction that is based on, or derived from, an underlying asset. This may be a commodity, a currency, an interest rate, or a security. Derivative instruments include a wide assortment of financial contracts, including forwards, futures, swaps and options that are applied to:

- facilitate capital market transactions;
- monetise contractual opportunities; and
- leverage special tax, accounting or regulatory situations.

To ensure better understanding of the concept, the following basic types of derivatives are further explained.

Futures and Forwards

Contract to buy or sell at a future date.

These arrangements oblige the holder of the contract to buy or sell a defined amount of an underlying asset at a given future date. Futures and forwards can be used as instruments for taking positions on interest and exchange rates or equities and commodities. While Futures are traded on exchanges, Forwards are available only over-the-counter (OTC).

An example of an interest rate derivative, for instance, is a forward rate agreement in which two parties agree the interest rate to be paid on a loan or deposit with a specified maturity at an agreed future date; a rate which is payable no matter the market movements. It is noteworthy that there may be no obligation to make a deposit or loan as the agreement is derived from a notional sum and covers only the difference between the contracted rate of interest and the current market rate.

Swaps

Swaps enable exchange of payments at intervals over a period of time.

These are customised OTC instruments which enable two counter-parties to exchange payments at specified intervals over a specified period of time. Swaps are usually based on exchange or interest rates. Foreign exchange swaps, for instance, involve the simultaneous purchase and sale of the same amount of foreign currency for two different value dates. As a bank buys and sells the same amount of foreign currency against another currency, no exchange position is created and, therefore, there is no exchange rate risk. However, as value dates are different, a mismatch is created which exposes the bank to the risk of forward differentials in interest rates.

Options

Options give the right to buy or sell at a fixed price on/or before a future date

An option, which can be traded through financial exchanges or over-the-counter (OTC), gives the buyer the right, but not the obligation to buy or sell a specified instrument at a fixed price before or on a certain date in the future. The seller of an option has the obligation to sell or buy. The seller of the option is exposed solely to market risk in respect of market movements, whereas the buyer is, additionally, exposed to credit risk.

The aforementioned structures can be applied to a range of underlying assets, whose values depend upon changes in rates or prices such as interest and exchange rates or equity and commodity prices. However, volatility in interest rates, exchange rates and asset prices usually create a climate of uncertainty. Derivative markets have, therefore, developed to provide a more efficient means of managing, controlling, and hedging risk than conventional financial instruments. Derivatives facilitate the specific identification and management of basic risks such as credit risk, market risk, liquidity risk, operations risk and legal risk, and have the potential to enhance the safety and soundness of banks and also produce a more efficient allocation of financial risks. However, derivatives also repackage these basic risks in combinations that can be quite complex, and hence can threaten the safety and soundness of banks, if not clearly understood and properly managed.

Basle committee guildline on derivatives

It is in the light of the risks inherent in derivatives activities that the Basle Committee on Banking Supervision formulated a set of guidelines on the sound risk management of derivatives activities for use by supervisory authorities and banks. The guidelines, which are intended to enhance the prudent supervision of the risk management of derivatives by financial institutions, broadly advocate:

- appropriate management oversight;
- adequate risk management processes that integrate prudent risk limits, sound measurement procedures and information systems, continuous risk monitoring and frequent management reporting; as well as
- comprehensive internal controls and audit procedures.

In the opinion of the Basle Committee, the conscientious adherence to the guidelines is crucial in circumstances where the growing complexity, diversity and volume of derivatives products, facilitated by rapid advances in technology and communications, pose increasing challenges to managing these risks. The Committee, however, encourages the appropriate modification of the broad guidelines to suit the peculiar operating circumstances and features of the local banking environment. From this standpoint, therefore, the Nigerian supervisory authorities will:

- find the guidelines useful in re-assessing their existing supervisory methods and procedures for monitoring how banks control risks in derivatives;
- engage personnel with sufficient technical skills and knowledge to understand the issues and perform independent verification of the reliability of the increasingly sophisticated models applied by banks to measure and manage risks;
- maintain regular contact with the banks' managements to facilitate a thorough understanding of their operations;
- pay special attention to banks' procedures for assessing and managing all risks, including credit risk; and
- certify the existence of adequate policies and procedures for identifying, monitoring and controlling market risks, particularly exchange and interest rates risks.

Existing procedures for evaluating derivatives inadequate.

To enhance effective, risk-focused supervision of derivatives activities, the existing procedures for evaluating derivatives operations, which merely require banks to provide suitable documentary evidence, and evidence of appropriate management authorisations and risk management capability of banks, will be reviewed to incorporate far-reaching disclosure requirements such as:

- the provision of the breakdown of derivatives held for trading purposes and those held for non-trading purposes and the basis of valuation expressly spelt out for each category;

- the analysis of counter-party credit risk;
- the maturity analysis of derivatives exposures;
- provision of quantitative information about market and counter-party risk on all on- and off-balance sheet instruments; and
- the reporting of derivatives activities on a 'total' basis, which is more informative, instead of a 'net' position.

The overall objective of the foregoing requirement is to ensure broader disclosure by financial institutions of their market and counter-party risk in derivatives operations.

Constraints to effective supervision of derivatives include poor understanding of products

In view of the severe constraints to effective supervision of derivatives, which include insufficient understanding of the products, risks and control requirements, inadequate documentation and accounting standards, and un-integrated markets, the more supervisors know about what a bank is up to in its derivatives activities, the better the judgement that can be made about its credit quality and risk exposure.

With banks making increasing use of derivatives, and with the appearance of more complex applications such as credit default swaps, USD/NGN options, issuance and investments in foreign currency denominated bonds with Naira settlement, equity derivatives etc, the supervisory emphasis should focus more on risk monitoring and risk management procedures of off-balance sheet transactions.

2.03 The Nigerian Capital Market under Universal Banking

State of the Capital Market

One of the noticeable features of most emerging capital markets is that they yield higher rates of return than the developed markets. However, the markets also have various shortcomings which include high risk (commensurate with the rate of return), lack of transparency, lack of infrastructure, low liquidity and paucity of instruments. These constraining factors make most of the markets unattractive to investors from the developed financial centres.

The Nigerian capital market, for a long time harboured all the above features. For example, the market was for sometime regarded as one of the best performing markets in the world (International Finance Corporation: Emerging Stock Markets Factbook, 1995). On the downside, there were many problems. The legal environment, for a long time, proved to be an impediment to foreign investors as some of the laws, such as the Exchange Control Act, 1962 and the Nigerian Enterprises Promotion Act, 1989, inhibited foreign investment. The market also exhibited the other negative features earlier mentioned.

With changes in the political landscape however, some of the positive aspects of the Nigerian market have been further enhanced, while the unwholesome aspects are being addressed. Investment risks have been significantly mitigated and the transparency of the market has been improved upon, with the reforms in the last few years. The infrastructure has been improved with the establishment of the Central Securities Clearing System, the internationalisation of the market and the change from the call-over system of trading to the screen-based automated trading system. The newly established Abuja Stock Exchange, which is expected to commence operations before long as a fully automated Exchange, will boost the capacity and performance of the capital market. To make the legal system more investor-friendly, the Nigerian Investment Promotion Commission Act 1995, Foreign Exchange (Monitoring and Miscellaneous Provisions) Act 1995, as well as the Investment and Securities Act 1999, were enacted to repeal the earlier versions.

Nigerian capital market, shallow and illiquid.

However, with regard to the dearth of instruments and low liquidity in the market, occasioned by low trading activities, nothing visible has happened. There were only 260 securities comprising 195 equities, 47 industrial loans (debentures), 12 Federal Government stocks, 4 State/ Municipal bonds and 2 preference shares listed on the Nigerian Stock Exchange (NSE) as at the end of December, 2000 (NSE Daily Official List, 29/ 12/2000). The total capitalisation stood at x472.90 billion (about US $4.30 billion).

The liquidity of the market is a function of the trading activities but this has not recorded appreciable improvement. In spite of the enlightenment programmes carried out by the capital market regulators, the attitude of Nigerians towards investment in the market has not changed, even among the elite. Securities are still mostly bought for keeps and not traded, even when their values are taking a plunge or appreciating to the level that substantial gains could be lost or made through their disposal. For example, the total value of the turnover in the market (equities) in 2000 was x28.15 billion, which amounted to a 6% turnover ratio. Thus, in terms of listing, market capitalisation as well as trading activities, the Nigerian market still ranks behind some other African markets, as well as other emerging markets in Asia and Latin America. According to the Nigerian Stock Market Annual, 1999 (quoting the International Finance Corporation Factbook, 1997), the positions of some of these markets as at 1996 were as follows:

TABLE 2

CAPITAL MARKET ACTIVITIES IN SELECTED COUNTRIES

S/N	COUNTRY	No. of Listing	Market capitalisation US $'M	TRADING VALUE US $'M	TURNOVER RATIO
1	Egypt	646	14,173	2,463	22.1
2	South Africa	626	241,571	27,202	10.4
3	Brazil	551	216,990	112,108	61.5
4	Chile	291	65,940	8,460	12.1
5	India	8,800	122,605	109,448	87.6
6	Malaysia	621	307,179	173,568	65.5
7	Mexico	193	106,540	43,040	43.6
8	South Korea	760	138,817	177,266	110.5
9	Taiwan	382	273,608	470,193	204.1

Source: Nigerian Stock Market Annual, 1999

The above indices show that Nigeria was, as at 2000, yet to reach the positions attained by those markets as at 1996.

With the above situation, it is not surprising that, in terms of foreign portfolio investment, the Nigerian market commands only a mention, but not the attention of serious foreign investors. Nevertheless, it is heartening to note that there has been gradual improvement over time in this regard. This is evident in the continuous, though declining, flow of foreign portfolio investment into the Nigerian capital market as recorded in 1998 (US $49.7 million), 1999 (US $26.5 million) and 2000 (US $12.4 million [provisional]). Thus, with the improvement in the investment environment, and the introduction of new instruments, more foreign investment is envisaged.

UB will contribute to deepening of the capital market

The adoption of universal banking (UB) which will allow banks to offer a wide range of services, including capital market activities should contribute to the deepening of the capital market.

Banks and other financial institutions operating in the capital market are expected to undertake all the capital market activities as envisaged under the UB system, including underwriting, issuing house activities, mergers and acquisitions, investment and funds management and securities trading, both on behalf of clients, as well as on their own accounts. The expected inflow of foreign portfolio investment occasioned by the improvement in the investment climate will boost activities in the market. However, with the aforementioned problems of paucity of instruments and the low trading in the Nigerian capital market, this expectation may not be realised. Thus, at least in the short run, banks that focus mainly on capital market activities might be idle. In order to exploit the expansionary capacity of the market and boost activities, it is imperative that more securities be introduced into the market. The oversubscription often generated by the privatisation of government-owned enterprises through public offers, and the consequent rationing of the shares of such organisations, underscores the quest by investors for investment outlets and the need for more securities in the market.

Capital market provides long term funds for both business and government

The operators and regulators in the capital market, therefore, have a role to play in sensitising the business community and the various tiers of government to the opportunities presented by the capital market in the implementation of their business and development plans. Business organisations should be encouraged to obtain an increasing proportion of their long term capital, required for sustainable business expansion, through equity and debentures rather than bank finance. This is because banks have limited amounts of long-term funds and, therefore, seldom lend long. Utilising the capital market, therefore, relieves organisations of the undue stress presented by bank facilities. The Federal Government should, furthermore, rid itself of the financial and political burden of running the remaining public enterprises by privatising them. This will not only free up the substantial funds invested in them for other development projects, but will also bring efficiency to those organisations. The various state and local governments should also take advantage of the market to raise funds through bonds to finance various development programmes, including water projects, housing, roads and bridges, rather than waiting for allocation from the Federal Government. Some states had done this in the past. Recently, the Edo State Government patronised the market by floating a N500 million bond to finance a housing scheme, from which the bond will be serviced and repaid. The issue was markedly oversubscribed, to the extent that part of the oversubscription was absorbed to raise the issue to N1 billion. Other states should be encouraged to take similar steps. Utilising the capital market in these cases will not only help the development of the economy but will also introduce more securities to the market.

Another way of boosting the availability of securities in the market is through the introduction of derivatives. Derivatives, which are relatively unknown in our markets, form a major part of the investment portfolio of investors, both individual and institutional, in most advanced countries as well as some developing countries of the world. They provide sources of income for investors through arbitrage, position-taking and market-making activities. They are also used by financial nstitutions and fund managers as speculative instruments and asset and liability management tools to hedge against risks in investment portfolios.

The supervision of the capital market activities of banks, under the UB system, will be a joint responsibility of the Central Bank of Nigeria and

Supervision of capital market activities of banks under UB, would be a joint responsibility of CBN and SEC.

the Securities and Exchange Commission, as enunciated in the UB guidelines. This will give effect to the cooperation envisaged by Section 38A of the Central Bank of Nigeria Act 1991 [as amended], which gave formal recognition to the Financial Services Regulation Coordinating Committee [FSRCC] made up of all the regulators in the financial sector.

Banks operating in the capital market are expected to comply with the SEC and Stock Exchanges registration and operational guidelines. These institutions will ensure that their requirements are complied with at all times. The Central Bank of Nigeria, on the other hand, will undertake the prudential supervision of the banks to ensure that undue risks are not assumed by them.

It is therefore expected that the CBN and SEC will jointly provide the guidelines for the derivatives operations of banks, since the CBN primarily supervises banks while the SEC supervises all operators in the capital market. In doing this, the Basle Committee proposals on the supervision of derivatives will be very helpful, especially in the areas of information requirement from banks, internal control and audit system, risk management and capital requirement. The Central Bank of Nigeria had earlier subscribed to and adopted the Basle Committee's Capital Accord of 1988 as well as the Core Principles for Effective Banking Supervision, and has always participated in the Committee's surveys, training and other programmes. The CBN will therefore be able to access more information on further developments in the supervision of derivatives activities to enhance the supervisory framework. In addition, the information sharing arrangement among supervisory bodies will be useful in this regard.

Another dimension that UB may bring to the capital market is increased competition, such that services will not only become more available, but will also improve in quality. This will therefore be a desirable development.

The Nigerian capital market is in need of more securities to provide investment outlets for investors of all categories. With more banks expected to go into capital market activities as a result of the adoption of UB, the need for more investment instruments has become more imperative. The Nigerian economy provides enough fertile ground for the introduction of more instruments such as derivatives, which are already in use in other countries. Derivatives are veritable sources of income and means of hedging against various risks in investment and credit operations for banks, investors and businesses world-wide. Luckily, the enabling law is in place and the SEC is in a position to provide the markets as well as register the securities.

2.04 Public Complaints Against Banks

Over the years, many users of banking services have expressed dissatisfaction with the quality of services provided.

Public complaints against banks date back to the pre-CBN period, which was characterised by the absence of specific banking regulations. Victims of banking malpractices or bank failure had little or no established avenues for redress.

Following the serious financial losses suffered by bank customers during the banking crisis of the 1950s, public confidence in the banking system was seriously eroded. The then colonial government realised that no economy could operate and be expected to achieve growth and development without a healthy banking industry, capable of sustaining depositors' confidence.

Public complaints desk is domiciled in Banking Supervision Department

Consequently, the Central Bank of Nigeria was established in 1959 and charged with a number of responsibilities which included maintaining a sound and healthy financial system. To achieve this objective, the CBN created the Banking Supervision Department, which in addition to supervising the banking system, attended to customers' complaints against banks. Initially, this function was performed on an ad-hoc basis, but was later made one of the responsibilities of the Bankers Committee Secretariat, domiciled in the Banking Supervision Department.

Nature and Types of Public Complaints

Public complaints against banks are several and varied. The most frequent types are highlighted below:

i) Exploiting the ignorance of unsuspecting customers through excess commissions and illegal charges.

ii) Refusal by banks to open certain types of accounts e.g. salary accounts.

iii) Failure to issue bank statements regularly to customers.

iv) Illegal disposal of customers' properties pledged as collateral for credit facilities.

v) Shortages in cash withdrawals.

vi) Unilateral application of interest rates outside the terms negotiated with customers.

vii) Refusal to honour the terms of performance bonds.

viii) Excess charges on bank drafts.

ix) Introduction of extraneous terms into contracts with customers, to short-change them.

x) Unauthorised/arbitrary debiting of customers' accounts.

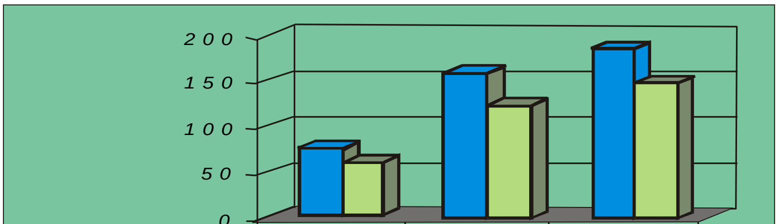
xi) Release of funds transferred from overseas to impersonators.

xii) Imposition of previously undisclosed charges on customers' accounts.

xiii) Failure to credit customers' ledgers with the amounts deposited.

It is pertinent to observe that the trend of public complaints against banks has been rising in recent times as shown in Figure 1.

FIGURE 1: VOLUME OF PUBLIC COMPAINTS RECEIVED AND RESOLVED (1998 - 2000)



	1998	1999	2000
Number of Complaints Received	77	157	186
Number of Complaints Resolved	62	123	149

Source: Bankers Committee Office, Banking Supervision Department, CBN

Two factors are mainly accountable for the rising trend. The first is the Structural Adjustment Programme, which embodied the liberalisation of the financial system. Inspite of the fact that the CBN has carried the banks along in the implementation of the deregulation policies, with special emphasis on self regulation and discipline, the operators sometimes deliberately misinterpret 'deregulation' to mean "the absence of regulation".

Increasing trend in public complaints caused by labour turnover and misinterpretation of deregulation

The second is the high labour turnover in the banking industry, occasioned by re-engineering programmes. As a means of survival, most of the retrenched bank personnel became consultants and offered their services to the customers of their former employers, with a view to helping them recoup any spurious or excess charges hitherto undiscovered.

In the spirit of transparency, complaints received are handled systematically as detailed below:

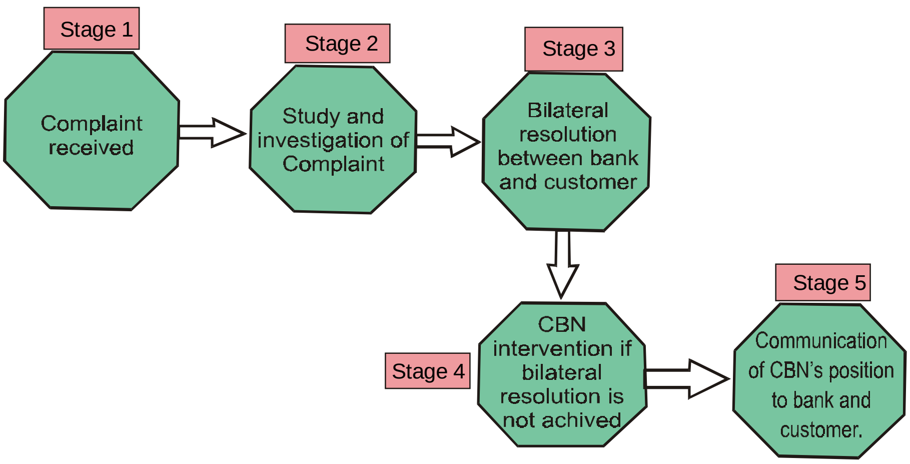
Procedure for Handing Public Complaints

First, when a complaint is received and registered, an officer studies the issues involved and sends an inquiry letter to the bank with a photocopy of the complainant's petition. The purpose is to enable the bank state its own side of the matter within a stipulated time frame. A holding reply is also forwarded to the complainant.

On receipt of the bank's response, a photocopy (unedited) is sent to the complainant for study and comments. He is also advised to revert to the CBN, should the bank's response be unsatisfactory. At this stage, some banks invite the complainant directly for discussions and bilateral resolution. Cases that are resolved at this point often terminate with either the complainant or the bank informing the CBN of the resolution, with documentary evidence of the agreement(s) reached.

However, whenever there are claims and counter-claims with neither party ready to yield or shift its position, a tripartite meeting is usually arranged comprising the complainant, the bank and the CBN. Depending on the findings at the meeting, a verdict could be given, based on appropriate regulatory documents at the very first sitting, followed up with a letter to the parties. In some cases, the parties are requested to arrange a bilateral meeting with a view to ironing out identified differences by reference to directives, guidelines and interpretations offered by the CBN.

FIGURE 2: STAGES OF PUBLIC COMPLAINTS RESOLUTION



Preference for CBN's intervention in public complaints.

Going by the readiness of both the banks and the banking public to promptly respond to invitations for dispute resolution meetings and the continuous increase in the number of public complaints received, it is logical to infer that the process is largely preferred by both parties to other options, possibly because of the following inherent advantages:

- time economy;
- low cost;

- no adverse publicity; and
- relaxed and peaceful environment, thus ensuring the retention of bank-customer relationship.

The increasing awareness of the facility, can be another factor in the rising trend observed earlier.

Problems and Constraints of the Public Complaints schedule.

Despite the relevance and the supportive role of complaints resolution in monetary policy execution, a number of constraining factors exist.

Perhaps the greatest problem of this service is the deliberate misconception of the banking system's de-regulation as the repeal of all rules and regulation regarding banking services. It is this misleading notion that has made many banks to see the Bankers Tariff, Monetary Policy and Credit Guidelines and some others as obnoxious documents and therefore irrelevant to the current dispensation. Bankers continue to express shock whenever those documents are referred to at resolution meetings.

As the resolution process is seen as an administrative or moral-suasion approach, banks occasionally exhibit reluctance to comply with the decisions reached. The problem of "contempt of court" is another constraint. There were instances when the CBN discovered that cases brought to it had already become subjects of litigation in the law courts.

The involvement and presence of professionals like lawyers, accountants, consultants, etc. at the resolution meetings, more often than not, complicates the cases, as they always tend to instigate and prompt their clients against any concessionary plea by the banks. Rigidity on the part of either or both parties is also a very great problem encountered in undertaking complaints resolution.

Ethics and Professionalism Sub committee, established

As stated earlier, public complaints cut across virtually all the banks in the industry. In view of the enormity of the problems and the inadequacy of the existing mechanism to stem the tide, the Bankers Committee at its 251st meeting held on December 19, 2000, established The Ethics and Professionalism Sub-Committee as a way of promoting self-regulation. The sub-committee is charged with the development of standard codes of banking practice and professional ethics, consideration of complaints from the public against the banks, complaints by banks against the regulatory authorities or other banks, as well as recommendation of sanctions.

Consequently, the sub-committee listed thirty three (33) misconducts which were classified under the following broad headings:

- Conflict of Interest.
- Abuse of Trust/Office.
- Lack of Full Disclosure.
- Misuse of Information.
- Insider Abuse.
- Offer and Acceptance of Gratification.
- Non-conformity with Standards and Guidelines.
- Breach of Prudential Regulations.

As currently practised, the public complaints processes by the Bankers Committee office, represent the practical form of the moral-suasion aspect of the CBN's annual Monetary, Credit, Foreign Trade and Exchange Policy Guidelines. The recent establishment of the Ethics and Professionalism Sub-Committee by the Bankers Committee, furthermore, is a step in the right direction, which will not only provide an alternative to the Public Complaints Desk at the CBN, but may in fact, eventually replace it, if and when the benefits of self regulation and the ethical practice it seeks to promote, are fully realised.

2.05 The Challenges of Audit Trail in an Electronic Banking Environment

Technological innovations have made business processes easier and more accessible. The fusion of computers, the internet and other technologies has removed distances between entities. The banking industry has been involved in re-engineering its processes that were hitherto manually and mechanically driven, through the use of Information Technology (IT). There is therefore no gain-saying the fact that the banking environment in Nigeria, in the last decade, has metamorphosed from manual to automated systems.

As a result of these developments, the supervisor faces considerable challenges, as advances in IT continually change entity-wide business processes and structures. The audit trail therefore provides an in-road which gives reasonable assurance that all processes are running as intended and, where possible, real crime and perceived dangers are traced easily and preventive measures introduced in time.

Audit trail facilitates ascertainment of the reliability of information.

The audit trail allows for the tracing of transactions through a system. Although it is associated with auditing, it is an important factor in internal control, when appraising the effectiveness and reliability of any computer system. The audit trail, in an electronic banking environment, facilitates the work of auditors and supervisors in ascertaining the reliability or otherwise of the information contained in the master file. This comes by way of logs generated by the system. Some electronic banking practices do not present themselves for effective logs e.g. telephone and internet banking. Where logs and reports are difficult to generate, electronic banking poses the following challenges:

i) **Loss of audit trail.**

Documentary evidence is often available in manual control procedures, but many procedures in an electronic banking environment do not give rise to creation of documents, a fact, which leads to what is termed "loss of audit trail". Therefore, to appraise the system becomes more difficult and an alternative compliance test is needed, which is also technological in nature.

ii) **Lack of visibility of information.**

Information is readily visible in manual/mechanical systems, while files and records in an electronic/automated environment are not humanly readable and therefore will require the assistance of the computer to enable supervisors make use of the information contained therein.

iii) **Insufficient skills.**

Lack of technical skills could pose a great problem when appraising a computerised environment, due to lack of a visible audit trail. Training in specialised tools, such as computer assisted audit programs, is required to extract meaningful data/information in this environment.

iv) **Continuous changing of data in an on-line real-time system.**

In such an environment, information is processed immediately and the master file is updated instantaneously at a high speed and frequency. It therefore becomes difficult to have an audit trail of the underlying transactions.

v) **Batch processing environment.**

In contrast with the on-line, real-time environment, information is processed in batches, in a batch processing environment. It is important that the internal control for input and output is satisfactory. This forms the basis for the audit trail, as what goes into the computer determines what comes out. Unfortunately, no internal control is one hundred percent fool-proof. The auditor/ supervisor concerns himself with what goes on around the computer with regard to the procedures of initiating a transaction to authorisation and input into the system. What happens to the information in the computer is obscure, but the expected output and controls form the basis of the reliability of the system.

The following measures, among others, would help to overcome the problems posed by possible loss of audit trail.

i) The importance of training and re-training supervisors and auditors in such a dynamic environment cannot be over emphasised. The needed skills to employ IT itself to enhance performance in order to achieve efficiency and effectiveness should be acquired. This is only possible through training.

ii) At the implementation of any software package or program developed in-house, it is necessary to consult skilled auditors who will ensure that the necessary audit trail is built into the system.

iii) In an on-line, real-time environment, computer-assisted auditing packages such as ACL, IDEA, etc should be used to interrogate the system in order to obtain information.

iv) In a batch processing system, management should ensure that there is strict compliance with procedures laid down for controls, from originating a transaction to its processing.

As business processes continue to change with internet banking, telephone banking and e-commerce, among others, without due consideration for the audit trail, supervisors and auditors will continue to face increasing challenges and should be poised to overcome them.

2.06 The Effects of Information Technology on Money Laundering and Financial Crimes

Businesses, including illicit activities are being done electronically across the world

Today's businesses are basically driven by Information Technology (IT), whether it is by the use of telephones, faxes, computers, or through the internet. Computer and telecommunication technologies are therefore the major elements of IT, transforming both national and global economies into information-driven societies and breaking barriers created by international boundaries. Businesses, including illicit activities, are being done electronically across the world using the internet, credit/debit cards, smart cards and many other e-payment systems which are the products of IT. The internet is the basic environment enabling innovations in electronic commerce in general, and new payment technologies in particular. The traditional payment system is gradually giving way to e-payment.

Money laundering is the process of "washing" monies derived from illicit activities, especially drug trafficking, advance fee fraud (otherwise known as "419") and other forms of illegal activities. It is the process through which proceeds from criminal activities take on the appearance of legitimacy. Money laundering and financial crimes in general, operate across international boundaries. They involve the networking of individuals from within a natural geographical location to international networks covering many countries. This has made it difficult for individual countries, including Nigeria, to successfully tackle it alone.

Financial crimes exploit the benefit of IT as legitimate business do.

The speed at which the digital economy is evolving is making it more and more attractive for people, the world over, to do business in an electronic form. This also makes it attractive for drug barons who can contact their collaborators anywhere around the world and send proceeds seamlessly across. Those involved in advance fee fraud see IT as a faster and neater channel to prey on their victims. Money launderers purchase and re-sell luxury and prohibited items. The proceeds are passed through a complex international web of legitimate businesses, aided by IT infrastructure, mainly in banks. In some countries, especially those with very low disclosure requirements, unrestricted funds transfers are common. Similarly, criminals use very high value credit cards to pay for goods and services and settlements are made with funds held in off-shore banking havens.

The globalisation of cyberpayment systems also offers money launderers opportunities to exploit national differences in security standards and oversight rules. Cyberpayment values can also be programmed to expire after a certain number of transfers, to conceal the movement of illicit funds. Money launderers exploit whatever limits that are established, like the structuring of transactions below currency reporting limits, obtaining multiple cards (credit or debit), using multiple names, or employing multiple issuers.

Criminals can exploit the partial anonymity of internet funds transfer process to steal funds from unsuspecting consumers. In turn, encryption used in internet transmissions of value can impede the tracing of funds flow associated with suspected illegal activities. The spread of these technologies may challenge the conventional strategies for combating money laundering and financial crimes.

Money launderers also buy publicly quoted and viable company shares via organised stock exchanges and banks offshore. They eventually trade on these shares and discretely off-load the shares, thereby “washing” the illicit funds clean. Most stock exchanges, Nigeria’s inclusive, are IT-driven, which makes trading faster and, if information requirement for participating in the exchange is limited, it unwittingly facilitates money laundering activities.

In conclusion, it must be acknowledged that it is not all woes, using IT to transact business. The volume of information that is required in a business transaction can be a deterrent to the use of IT to perpetrate crime. There is a lot of personal identification, a lot of encryption and a whole lot of information requirements on the account holder, before he has access to e-money products. IT has made it possible for banks to have large databases for every customer so that they know the customer very well and can retrieve information on him at a very high speed.

It is imperative that a national IT policy be put in place to standardise security and cryptographic considerations, which will help stamp out money laundering activities as the measure will have a deterrent effect on the criminals. The implementation of the IT policy will effectively limit money laundering activities and financial crimes.

2.07 The Problems and Prospects of Micro Credit Institutions in Nigeria

MCIs are veritable tools for rural transformation and poverty alleviation.

Micro Credit Institutions (MCIs) are institutions that provide financial assistance to medium and small-scale enterprises. In some cases, the activities of the MCIs are considered by governments as political and economic tools for rural transformation and poverty alleviation. In some recent publications of the World Bank, the impact of MCIs in poverty alleviation and rural development was noted. The governments of many developing countries, Nigeria inclusive, have set up MCIs to address the investment needs of the poor.

In Nigeria, considerable impact has been made by non-governmental organisations (NGOs) in the area of provision of financial assistance to the poor, as well as to the operators of medium and small scale enterprises.

MCIs are either government or NGO sponsored.

There are two types of MCIs in Nigeria; government-sponsored MCIs, such as development finance institutions (DFIs) and NGO-sponsored institutions. In recent times however, commercial activities have been on the increase, with finance companies and banks (mostly community banks), venturing into the funding of micro credit schemes for some target markets, such as rural women credit schemes, craftsmen and artisan credit schemes, etc. It is important to state that the earlier micro credit scheme in Nigeria used a direct credit approach, whereby the government or donor agencies released funds to rural-based micro businesses, especially subsistence agriculture.

The Problems of Micro Credit Institutions (MCIs)

There are many problems confronting MCIs in Nigeria. Salient among these are:

i) **Government Interference.**

Many micro credit institutions that were established and funded by the government are used to serve political and other non-economic purposes. Such interference distracts the focus of the MCIs which impact adversely on the viability and success of the institutions.

ii) **Wrong Perception by the Borrowers/Beneficiaries of the Credit Assistance.**

Many beneficiaries/borrowers of micro credit funds often have a wrong perception of the credit assistance they receive, especially where such assistance is from government-sponsored MCIs. In Nigeria, some borrowers often think that the assistance is their share of the national cake, which does not need to be repaid.

iii) **The Structure of Government-Sponsored MCIs.**

Most government-sponsored MCIs have over-bloated structures, with resultant huge overhead costs.

iv) **Inconsistencies in Government Policies.**

Inconsistencies in government policies in respect of the target groups that should benefit from government credit assistance affect the performance of the MCIs.

v) **Poor Banking Habit**

Poor and low income earners, who are the target groups of MCIs, generally keep their funds outside the banking system. This makes it difficult for deposit mobilisation efforts of MCIs to yield the desired results.

vi) **Lack of Acceptable Collateral for Credit by Beneficiaries.**
The borrowers/beneficiaries of micro credit schemes in Nigeria do not possess conventional/acceptable collateral for loans. Efforts at proposing intangible collateral such as group/cross guarantees, and third party guarantees, have not been successful.

vii) **Illiteracy and Poor Business Knowledge.**
The target groups/markets of MCIs are usually the less privileged, illiterate, poor and low income earners of the society.

It is a general belief that for any group to take advantage of developmental aid, it requires basic education. This target group requires the simple knowledge of records to fully utilise development assistance. This problem can, to an extent, be addressed by the current Federal Government's Universal Basic Education (UBE) Scheme.

viii) **Lack of Distinction Between Personal and Business Accounts.**
There is the difficulty in the application of the business entity concept by most micro and small business operators in Nigeria. Consequently, credit assistance for business and production purposes can easily find its way into personal spending by the proprietors.

ix) **Unsatisfactory Repayment Caused by Low Output Prices.** Generally, operators of micro enterprises produce goods and services that are common and homogenous. They are therefore unable to determine the prices as the market is controlled by the forces of demand and supply. The resultant low return, occasioned by the low output/ prices, make the repayments of the loans difficult.

Supervisory Imperative for Micro Credit Institutions

The activities of MCIs are of great interest to the regulatory authorities for the following reasons:-

- Provision of data for planning.
- Setting of minimum standards for compliance.
- Performance assessment and measurement of the impact of MCIs.

To address the aforementioned needs, the CBN has recently constituted an inter-departmental committee to undertake the work of producing a working paper towards the formulation of a national policy on micro finance/credit institutions and also to articulate a framework for the supervision of micro finance institutions. This is a step towards having a national survey of micro credit institutions. The document will appraise the impact that the MCIs have on the lives and businesses of the beneficiaries/recipients of such assistance. Secondly, such information and data bank will provide a guide to interested parties that would want to identify with the subsector and target group for both commercial and development purposes. The supervisory framework, when put in place, will enhance confidence building and patronage. This is necessary for the sustainable growth and development of the MCIs and the economy in general. Bench marks will be developed to measure and assess the performance of MCIs both in the short and long run, and as such, they would be better focused towards acheiving their desired objective. The work of the committee will, hopefully, be concluded soon.

Prospects abound for MCIs in Nigeria due to the large size of the market. To stem the failure of the MCIs, a new culture and structure must be adopted. The attitude of borrowers towards credit extended has to change. Lenders and donors should regard the recipients of credit assistance as commercial customers. Banks should also be encouraged to participate more actively in the funding of micro credit schemes.

2.08 The Management of Banks' Off-Balance Sheet Exposure: A Supervisory Perspective

Off-balance sheet (OBS) exposures are commitments or contingent liabilities which may not have impact on the bank's assets until they crystalise. They involve transactions which are contingent in nature and therefore not recognised as assets or liabilities in the bank's balance sheet at the time the transactions are consummated. The range of OBS engagements is broad. The most common ones among banks are:

- bankers acceptances (BAs)
- commercial papers (CPs)
- documentary letters of credit (LCs)
- guarantees, bonds and indemnities
- litigation
- derivatives
- underwriting commitments

Off-balance sheet transactions harbour similar risks as on-balance sheet items.

The types of risks associated with most off-balance sheet transactions are in principle not different from those associated with on-balance sheet transactions and should, therefore, be regarded as an integral part of a bank's overall risk profile. Some of the risks inherent in off-balance sheet transactions include:

i) Credit risk - the possibility of loss due to default.

ii) Interest rate risk - the danger that fluctuations in interest rates might create losses for the bank.

iii) Liquidity and funding risks - the risk that a bank will be unable to purchase or otherwise obtain the necessary funds to meet its obligations as they fall due.

iv) Foreign exchange risk - the risk that a bank may suffer losses as a result of adverse exchange rate movements. Forward transactions, swaps, options or futures can either reduce or increase exposure to exchange rate risks.

An array of measures to manage risks associated with off-balance sheet transactions.

To manage the risks associated with off-balance sheet transactions, the following measures should be taken by a bank:

- The Board of Directors should put in place a written policy on the type and level of off-balance sheet risks a bank will undertake and should be regularly informed of the off-balance sheet risk exposures of the bank.
- The Management should ensure that there is a well-defined division of responsibilities between dealing, accounting and internal supervision.
- The bank should identify risks inherent in new products and activities and ensure that they are subject to adequate controls before being undertaken. Major initiatives should be approved in advance by the board or its delegated committee.
- It should establish and enforce operating limits and other practices that maintain exposures within levels consistent with its internal policies.
- Accounting and information systems should be adequate to capture, monitor and report all off-balance sheet exposures and related risks.
- Internal controls should be regularly evaluated for adequacy and integrity.
- There should be an effective internal audit.
- The bank should also evaluate the legal structure of the countries in which it is operating, to ensure that its customers' obligations can be legally enforced.
- The management should ensure that the structure of the bank's business and the level of interest rate risk it assumes are

effectively managed; that appropriate policies and procedures are established to control and limit these risks, and that resources are available for evaluating and controlling off-balance sheet risks.

Supervisors must ensure that banks recognise, monitor and control risks.

The risks inherent in off-balance sheet transactions must be recognised, monitored and controlled. Supervisors play a critical role in ensuring that a bank's management does this. To limit imprudent risk-taking by banks, supervisors should:

- be satisfied that banks have in place a comprehensive risk management process (including appropriate board and senior management oversight) to identify, measure, monitor and control all off-balance sheet risks;
- regularly obtain sufficient information to assess a bank's off-balance sheet risk exposures. Such information could be obtained through standardised reports that are submitted by banks, through on-site examinations including spot-checks and regular discussions with players in the industry;
- ensure that generally accepted financial concepts and risk management techniques are in place;
- monitor compliance with guidelines for, and limits placed on a bank's foreign exchange/open position;
- develop and utilise prudential requirements to ensure that risks are weighed and are adequately captured in their measurement of capital adequacy; and
- regularly review supervisory policies to ensure that they take full account of developments in off-balance sheet business.

In Nigeria, the misconception, misclassification and misuse of OBS transactions, especially BAs and CPs, by banks prompted the supervisory authority to issue a circular reference No. BSD/PA/4/97 of August 12, 1997, in which the working definitions of these instruments were stated. The circular also sought to ensure standardised and uniform reporting in banks' books. To ensure that OBS activities are captured within the capital adequacy framework, a risk weighted measure of 20% is used in the computation of the capital adequacy of a bank. Futhermore, 20% of the value of OBS exposures, other than collateralised LCs, are added to an obligor's direct credit in determining the bank's statutory lending limit to that obligor. Banks are required to obtain CBN approval for, and comply with, limits placed on documentary letters of credit that are not cash collateralised, with a 100% risk weighted measurement. A foreign exchange open position limit based on a bank's capital, is also set for each bank, in order to control foreign exchange risks.

Complexity of some OBS activities makes risk measurement difficult.

The increasing use of financial instruments which do not involve the acquisition by banks, of conventional on-balance sheet assets, raises some difficult questions not only for a bank's management but also the supervisory authorities. Many pose complex problems in relation to risk measurement and management of control systems and the implications for the overall level of risk carried by the banks are not easily assessed. The supervisory authorities, therefore, seek to ensure that the risks assumed by banks in their off-balance sheet operations are never so large as to constitute a significant threat either to the solvency and liquidity of individual banks or to the health and stability of the banking system as a whole.

2.09 The Future of Branch Banking in Nigeria vis-a-vis Developments in Information Technology

Branch Banking in Nigeria: **Past and Present:** In recognition of the roles played by banks in harnessing funds to promote economic growth and development, monetary policies in Nigeria had encouraged the establishment of bank branches both in the urban and rural areas. As a result, the number of bank branches, grew from 752 in 1980 to about 2,444 in 2000.

Branch banking is the process by which banks establish outlets for the purpose of, among others, increasing their market share and bringing banking services closer to the people.

Branch banking has undergone extensive changes in Nigeria. In the past, banking operations were entirely manual, requiring a large number of employees and enormous paper work. Even simple activities, involved several stages. The three stages of processing data (input, processing, and output) were also clearly separated and often far apart. Huge storage spaces were required for documents, and the processing, which took a long time, was fraught with human errors. Although segregation of duties was easy to enforce, audit trails could clearly be established and internal control checks installed at the several stages of the operations.

Supervision was simple in the era of manual/mechanical banking.

The supervision of banks in that era was simple, as the supervisors were able to trace all transactions from the beginning to the end, despite the enormous manual work.

With the introduction of computers into the operations of banks, the demarcation between input, processing and output has become obscure. Some complex operations can no longer be broken into clearly demarcated stages. As bank branches are linked on-line, real-time, the audit trail becomes elusive. Segregation of duties is reduced as one or two persons can initiate, execute and conclude processes that would have involved many hands. Operations are fast, accurate and records kept in soft forms, which require less space.

Regulation of banks is now more sophisticated. Banks can now make some of their returns in soft forms, while regulators need to use sophisticated computer applications to monitor them.

Evidence abounds to show that branch banking is costly and that many customers will prefer to do their banking without visiting the banks. For example, a national survey carried out in Britain recently showed that about 30% of the respondents preferred telephone banking. This trend is expected to rise globally.

A gradual move towards branchless banking?

Many bank branches are linked with their head office on-line, real-time and some customers can access their balances using “read only” facilities from their offices and homes. With the expected improvement in telecommunications, customers in Nigeria should be able, not only to check their balances by telephone, but also to transact banking business, like cash withdrawals and transfers, using the computer system.

In the long run, banks without branches would operate in Nigeria. In such a situation, the bank would need no branch, as direct communication would exist between each customer and the bank electronically. A full range of banking services would be provided by such banks, including account opening, without the customers visiting the bank. The inherent risk would however be enormous and regulators must brace up to the challenges.

National laws and regulations would not be enough to monitor banks. There would be a need therefore for cross-border integration and harmonisation of regulatory activities. Thus supervisors must insist on the installation of sophisticated control devices to safeguard the operations of banks.

Chapter Three

FRAMEWORK FOR SUPERVISION

3.01 Supervision of Restructured Banks

Signs of distress still present in the banking system

The early 1990s witnessed the distress and subsequent collapse of some banks. Out of the debris of some of the distressed banks have emerged recapitalised and restructured banks, wearing new names and flaunting impressive business visions and mission statements.

However, there are fears that the banking industry may witness yet another distress, considering the fact that those factors which caused the distress of the 1990s still persist. Such factors include poor management, low capital base, chronic illiquidity, poor quality of risk assets, outright frauds through unconventional and unprofessional banking practices, a harsh economic terrain and inconsistent government policies.

Currently, recapitalised/restructured banks are subjected to the same supervisory framework, as other banks, which does not take cognisance of their peculiarities. It is therefore imperative to fashion a proactive framework for monitoring these banks.

Need to subject restructured banks to special supervisory framework.

A workable supervisory framework should be one that is anchored on conservatism and prudence. Therefore, a basic starting block would be the formulation of a set of guidelines by the regulatory authorities, against which the performance of the restructured banks will be measured. Based on this fundamental premise, the following framework would be ideal:

i) The formal ratification of the bank's business plan by the regulatory authorities, after due evaluation and amendment.

ii) Fresh funds injected into the bank should be domiciled in an escrow account with the CBN, and released after the fulfilment of specific conditions, such as the appointment of boards and top management, submission of acceptable organograms, etc.

iii) The regulatory authorities should put the institutions under constant supervisory oversight, to curtail over-ambitious policies and activities, by monitoring the overall performance, on say, a quarterly basis. In this regard, supervisory attention should ensure that:

- expansion (e.g. branch expansion) is controlled to avoid over-trading and excessive overheads;
- the controls in place are effective; and
- risk assets are created with caution and prudence.

iv The constant review of the board/top management profile, including an in-depth evaluation of the minutes of board and top management meetings, to ascertain the quality of deliberations vis-a-vis the overall policy direction, would serve a useful tool.

v) Supervision should focus on the exhaustive review of income and expenditure profiles to forestall unconventional accounting practices and reporting of false profits. Furthermore, the management should be constantly schooled in prudence on overheads.

vi) The supervisory framework should incorporate the appraisal of the bank's subsisting ability to attract and retain competent and well motivated personnel, which invariably, is an essential ingredient for business survival.

To ensure their continuing viability, the banks should embrace good corporate governance exemplified by:

- the installation of virile, robust and visionary boards and managements, based on the "fit and proper persons" maxim;
- appropriate management oversight, depicted by expert risk management abilities, to hedge externalities in particular;
- avoiding over-riding individual interest, to minimise conflicts; and
- appropriate re-orientation and checks on inherited staff to minimise culture contamination.

Supervisory framework should encourage growth of restructured banks.

An effective supervisory framework would involve prompt and uncompromising sanctioning of infractions. As desirable as a regime of stringent supervision is in the management of restructured institutions, the rules should, however, be flexible enough to encourage the optimal exploitation of viable business opportunities. That is, the supervision need not necessarily be so hounding as to stifle a bank's normal growth.

Imperative for a proactive supervisory approach.

Given that the failure of some banks in the 1990s was, perhaps unfairly blamed on the ineffectiveness of the supervisory authorities, the imperative for a proactive supervisory apparatus, that would live up to its functions of ensuring a stable and sound financial system cannot be over-emphasised. To meet this challenge, the doctrine of self-regulation by operators, should be encouraged and stringent laws against financial malpractices enacted and faithfully enforced to achieve the intended purpose.

Finally, it must be recognised that the overall supervisory objective would be to ensure that the restructured banks uphold high standards of transparency and ethics, to regain public confidence.

3.02 Assessment of Compliance with the Basle Core Principles

World Bank Financial Sector Mission assesses compliance with the Core principles.

The World Bank Financial Sector Mission commenced the assessment of the Basle Core Principles in Nigeria through its initial visit in January 1999. Following the response to its questionnaires and subsequent discussions with the regulatory authorities in Nigeria, the Mission issued a report on the degree of compliance with the Principles. For the purpose of the assessment, the 25 Basle Core Principles were further expanded to 30 [principle 1 dealing with the preconditions for effective supervision was further broken into 6] while the state of compliance was categorised into four, namely, fulfilled, largely fulfilled, largely unfulfilled and unfulfilled.

Supervisory framework displays rules and procedures adequate for effective supervision.

The World Bank, during the presentation of its findings on the financial sector to the Nigerian authorities in June 2000, observed that the supervisory framework displayed rules and procedures adequate for effective supervision. The report also commended the adequate legal framework and the remarkably effective job done in dealing with troubled banks.

Details of some of the Mission's assessments and comments by the regulatory authorities are highlighted below.

Permissible activities of licensed institutions.

Under the current regulatory framework, regulators are in a position to ensure that all banks and non-bank financial institutions including finance companies, primary mortgage institutions, discount houses and bureaux de change are licensed. Beyond the institutions under the CBN regulatory purview, other operators in the financial system - capital market and insurance - must be licensed by their respective regulators - the Securities and Exchange Commission and the National Insurance Commission, respectively. In the specific case of bank licensing, there is strict control over the use of the word "bank" in the name of institutions. This Principle was adjudged both from self-assessment and by the Mission to have been fulfilled.

Regular contact with bank management and supervisors' understanding of bank operations.

Supervisors display a good knowledge of activities performed by Nigerian banks

This Principle was also considered to have been fulfilled. Mainly in the course of examination, supervisors come in close contact with the management of the supervised institutions. This has been further improved in recent times in the series of focused meetings between the supervisors and the management of supervised banks at the executive level. The approach has reduced significantly the seeming distrust between the two sides of the divide. As regards the understanding of banks' operations, supervisors display a good knowledge of activities performed by Nigerian banks, thereby enabling them to discharge their duties effectively and with credibility. The latest change in the executive management of the CBN has further enhanced this understanding, with a good representation of experienced operators in the new team.

Independent validation of supervisory information either through on-site examination or use of external auditors.

This Principle was adjudged to have been fulfilled. The Mission observed that full on-site examinations are conducted on the average of once in 18 months. This may not be sufficient for big banks and those in distress. In addition, however, other types of examination such as target, which is focused on a particular area of the bank's operation (e. g. credit), maiden (usually conducted in the first 6 months of a new bank's operation) and special (for a bank that is perceived to be in serious problem) are common. With the adoption of risk-based approach to supervision, adequate coverage of the high-risk areas of banks' operations are expected. The examination cycle is also expected to shorten with the restructuring of the regulatory departments into a team-based arrangement rather than the erstwhile functional set-up. The idea of outsourcing some supervisory functions has been adopted. A policy position has already been taken in the case of community banks and a number of auditors and retired examiners have been registered for this purpose. The BOFIA requires that the financial statements of banks be audited, and approved by the CBN before publication. To ensure the independence of auditors, the banking laws require that any change of auditor by the banks must be with the approval of the CBN.

Consolidated supervision.

Though there is no specific provision in the banking law for consolidated supervision, the Banks and Other Financial Institutions Act requires that supervisors shall have access to all the books of a licensed bank. On the basis of this, the Nigerian supervisory authorities have commenced the supervision of related institutions on a consolidated basis. Co-operation among supervisors in the various sectors of the financial system is being greatly facilitated by the establishment of the Financial Services Regulation Co-ordinating Committee [FSRCC]. The establishment of this body is the first major step towards incorporating specific provisions for consolidated supervision into the banking laws. Consolidated supervision is still limited within the Nigerian financial system, as offshore banking is minimal. This informed the "fulfilled" rating granted to this Principle by the Mission.

Global supervision, foreign bank branches and cooperation with foreign supervisors.

Few Nigerian banks operate off-shore

Very few Nigerian banks operate offshore. The few offshore operations have always been subject to supervision by the authorities with the cooperation of the host supervisors. For example, the Financial Services Authority [FSA] of U.K. has always contacted the CBN for information on the management and internal control practices of the three Nigerian banks that have branches in the U.K.

The World Bank Mission concluded that issues related to cross-border supervision were not relevant to Nigerian banks as their activities were domestic to a very large extent.

Country and market risks.

Hitherto, banks and supervisors in Nigeria had not been focusing on these issues. However, with the adoption of risk-based approach to supervision, the framework would be put in place to address the issues which are yet to be given due attention. The assessment was "not applicable" as the risk exposures were almost nil.

Supervisory powers.

Both the CBN and the NDIC have sufficient and comprehensive legal powers to take adequate and timely actions on banks in distress. This was demonstrated in the liquidation of 26 terminally distressed banks in 1998 and, recently, by the revocation of the licences of three (3) banks in December 2000. The World Bank Mission expressed fear about political pressure, which might hinder the supervisory authorities in exercising their powers and rated this principle as largely fulfilled.

Other principles adjudged to be largely fulfilled included those dealing with loan classification, money laundering, off-site and on-site supervision, powers to address compliance with laws, transfer of ownership, power to review acquisitions and investments, management process to control material risks and accounting policies and disclosures.

Internal Control.

Appraisal of banks is focused on analysis of financial ratios and compliance with regulations.

It is expected that with the risk-based approach to on-site supervision, greater and more focused attention would be given to internal control. The appraisal of banks is focused on analysis of financial ratios and compliance with regulations. Although the CBN has enough power under the existing banking law to bring erring bank directors into line or to outrightly remove them, the critical role of the board in safeguarding the assets of the bank is not emphasised in the laws. This principle was consequently adjudged largely unfulfilled.

Operational independence.

The CBN Act grants the Bank autonomy.

The 1999 amendment to the CBN Act granted autonomy to the CBN in the execution of its functions. The World Bank Mission was, however, of the view that the CBN may not perform its duties independently from political forces since the government, from a legal standpoint, could influence most actions taken or intended to be taken by the regulatory authorities. Efforts are being focused on addressing the inadequacies in the Banking Act through approprate amendment.

The Mission found the supervisors seriously lacking in the provision and upgrading of Information Technology [IT] systems. This principle was assessed to be largely unfulfilled but efforts to achieve fulfilment were underway especially as the CBN has initiated actions to upgrade its IT systems.

Management Information.

The Mission was of the view that Management Information Systems [MIS], which would enable supervisors to identify concentration and related issues, were lacking. Moreover, it argued that Nigeria's practice of restricting the definition of "large exposures" to 20% or 50% of capital for commercial or merchant banks, respectively, was unsatisfactory and questioned the rationale for allowing merchant banks to hold high single exposures than commercial banks whose activities were more diversified. The Mission concluded that the Principle on management information was not fulfilled and efforts to achieve fulfilment were not underway. It however noted the efforts of the CBN to collect information on loans of N1 million and above through the Credit Risk Management System (CRMS) or Credit Bureau and advised that it should be incorporated into the supervisory data process. However, when Universal Banking becomes operational in 2001, the restriction on single obligor limits for commercial and merchant banks would be streamlined.

Connected lending.

The Mission was also of the view that the core principle on connected lending was largely unfulfilled and efforts to achieve fulfilment were not underway. The reason was that regulatory safeguards were not sufficient to discourage unsound lending practices, nor were penalties stiff enough to avert such unsound practices.

The issue of insider abuse had been a source of concern to regulators in Nigeria. Serious steps had been taken to address the problem including the implementation of the Failed Banks (Recovery of Debts) and Financial Malpractices in Banks Act 1994 with the cases hitherto handled by Special Tribunals now moved to dedicated divisions of the Federal High Courts. However, a new policy position regarding borrowing by key shareholders and directors of banks would be taken in 2001.

Legal framework.

The core principle on legal framework and the provisions relating to the authorisation of banking establishments and on-going supervision was assessed to be unfulfilled and efforts to achieve fulfilment underway, without actually stating what action had not been addressed. The Mission confirmed the granting of larger autonomy to CBN, which the regulatory authorities believed had eliminated obstacles to achieving fulfilment.

Licensing of banks.

The CBN has continued to license new banks while the inspection of community banks to determine their viability for the grant of licences was carried out. While the Mission was aware of the CBN autonomy, it was not aware that the CBN had started granting licences to new banks or had started the inspection of community banks for licensing. Consequently, the "unfulfilled" rating, for the reason that, no new bank had been licensed, and that no final licence had been issued to a community bank, would be reviewed.

Prudential reporting.

The Core Principle on Prudential Reporting involving the processing of returns from banks was assessed "unfulfilled and efforts to achieve fulfilment not underway". This assessment was based on the fact that the level of the IT systems of the regulators and the banks does not allow for the best use of information. The Mission believed that the Bank Analysis System (BAS) might partially remedy the situation. The authorities totally agreed with the Mission's assessment but hoped that the present policy thrust of the CBN towards the development of IT would, to a large extent, remedy the situation.

Legal protection to supervisors and corrective action.

There were other principles which, in the opinion of the Mission, required legal provisions, otherwise they would remain “unfulfilled and effort to achieve fulfilment not underway”. These included, among others, legal protection for supervisors, and corrective action by CBN and NDIC on distressed/failing banks without government interference. It is therefore the responsibility of the supervisors to make a comprehensive proposal to the National Assembly on the relevant provisions that need to be amended/included in the CBN and Banks and Other Financial Institutions Acts.

In its summary of the assessment of Banking Supervision against the 30 core principles, the World Bank Mission indicated that 9 were fulfilled, 11 largely fulfilled, 5 largely unfulfilled and 5 unfulfilled .

In conclusion, where there is disagreement between the self-assessment and the view of the Mission, a review is necessary, in the light of recent developments. However, the lapses observed are indicative of areas requiring further supervisory action.

Chapter Four

PERFORMANCE TRENDS IN THE BANKING SECTOR

The economic situation in 2000 indicated mixed developments. As in previous years, the performance of the financial sector was influenced by the operation of the fiscal and monetary policies. The minimum rediscount rate (MRR) was progressively reduced from 18% to 14%, the cash reserve requirement (CRR) from 12% to 10% and liquidity ratio from 40% to 35%.

The economic situation in 2000 indicated mixed developments.

Banks' deposit and lending rates, on the average, declined marginally but the spread between them remained wide.

Eight (8) merchant banks converted to commercial banks, while a new commercial bank was licensed and commenced operations in August, 2000. The three (3) banks which had their licences revoked in December, 2000, are in the process of liquidation. By a circular dated December 22, 2000, Universal Banking (UB) was approved to take off from January 1, 2001. A total of 88 banks were in operation as at the end of the year, with a total branch network of 2444. Below are the highlights of the banks' performance in 2000.

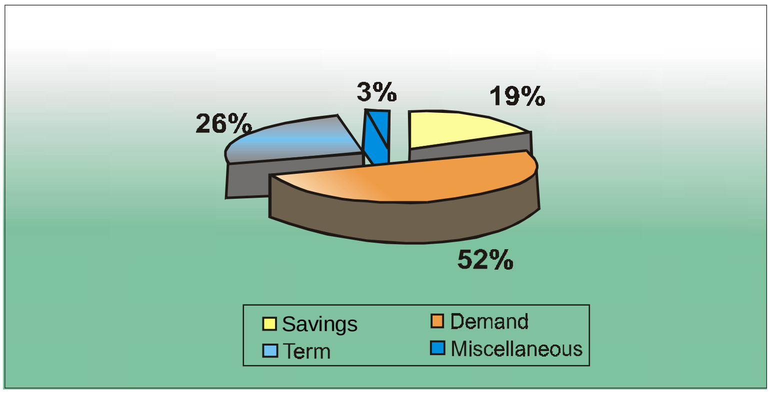
4.01 Deposit

The aggregate bank deposits increased by about 60% from x535 billion in 1999 to N859 billion as at December, 2000. At N446 billion,

Aggregate bank deposits increased by 60%.

demand deposits accounted for 52% of the total deposits, followed by term x227 billion or 26%; savings x164 billion or 19%; and miscellaneous deposits x22 billion or 3% (Fig. 3).

FIGURE 3: DEPOSITS PROFILE OF NIGERIA BANKS (2000)



Sources: Monthly Bank Returns

Commercial banks' deposits stood at x754 billion or 88% of the total deposits while x105 billion or 12% was for merchant banks. Figures 4 and 5 show the structure of commercial and merchant banks' deposits.

FIGURE 4: DEPOSITS STRUCTURE COMMERCIAL BANKS (2000)

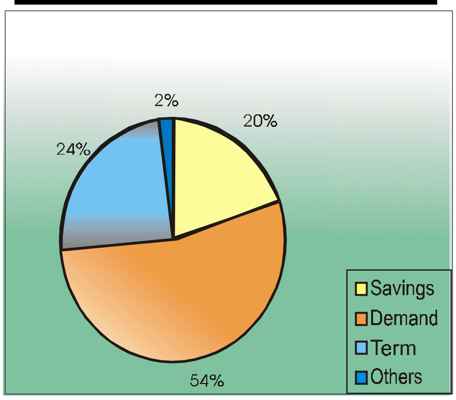
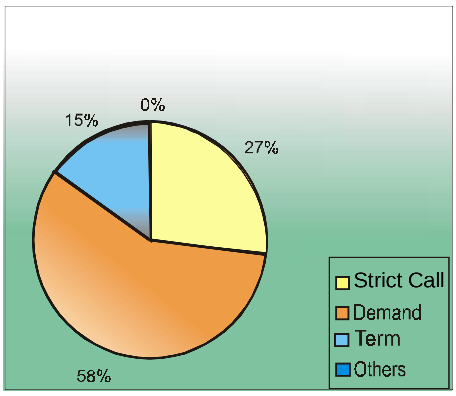


FIGURE 5: DEPOSITS STRUCTURE MERCHANT (2000)



Sources: Monthly Bank Returns

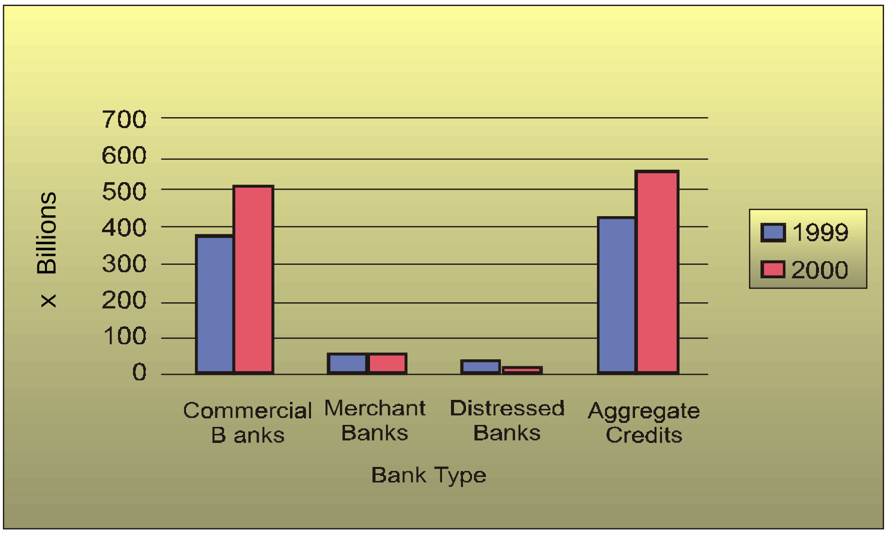
Deposits for 2000 remained consistently higher than the corresponding periods in 1999. The total deposits held by distressed banks amounted to N4.6 billion or 0.54% of the aggregate industry deposits. The aggregate credit/deposit ratio for the industry was 66% compared with 80% in 1999.

4.02 Credit

Aggregate credit grew by 35%

Credits, which constitute the most significant assets of commercial and merchant banks accounted for 35% of the gross assets of the banking system as at December, 2000. Aggregate credits amounted to x567 billion as at December, 2000, an increase of 35% from the 1999 figure of x420 billion. Commercial banks' share of aggregate credits increased from 87.62% in 1999 to 90% in 2000, while that of merchant banks declined from 12.38% to 10% in the period under review. The conversion of more merchant banks to commercial banks partly accounted for the changes. (Fig. 6)

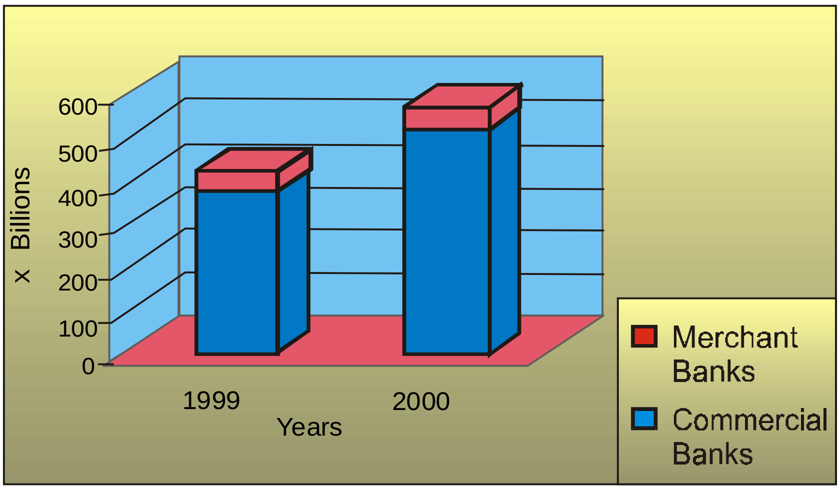
FIGURE 6: CREDIT TRENDS AMONG BANKS (1999 - 2000)



Sources: Monthly Bank Returns

The non-performing credits in 2000 were x109 billion or 19% of the aggregate credits (1999: x101 billion or 24%) comprising x102 billion or 93%) for commercial banks and x7 billion (7%) for merchant banks. The provision for non-performing credits amounted to N85 billion, in the proportion x79 billion (92%) for commercial banks and x6 billion (8%) for merchant banks. Distressed banks' outstanding credit to the economy was x13 billion (3%) in the year under review as against x33 billion (7.8%) in the previous year. The decrease was due to the recapitalisation/ restructuring of some distressed banks and the revocation of the licences of three others. The annual comparative credit levels of healthy and distressed banks are shown in Fig. 7 below.

FIGURE 7: COMMERCIAL & MERCHANT BANKS' SHARE OF AGGREGATE CREDIT



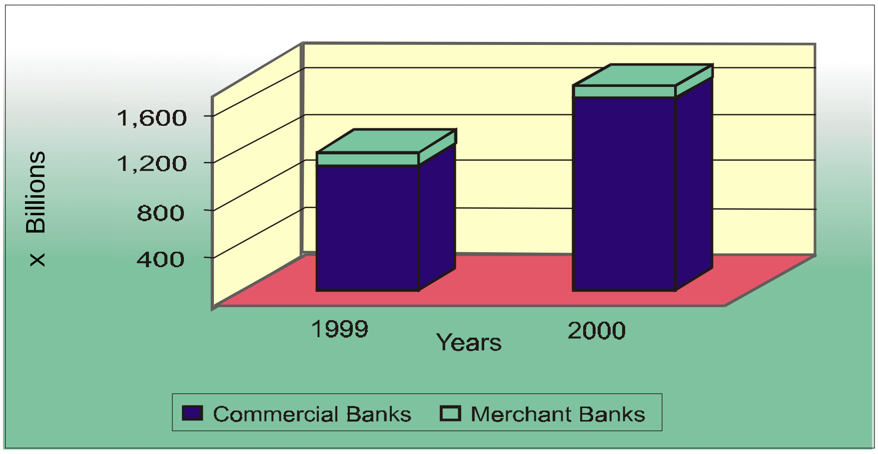
Sources: Monthly Bank Returns

4.03 Assets

An increase of 48% in total assets of banks.

The total assets (gross) of the banking system stood at x1,748 billion as at December 2000. This showed an increase of 48% over the figure of x1,184 billion recorded in the previous year. Commercial banks' share of the total assets increased from 89% in 1999 to 92% in 2000.

FIGURE 8: COMMERCIAL & MERCHANT BANKS' SHARE OF TOTAL ASSETS (1999 - 2000)



Sources: Monthly Bank Returns

Distressed banks accounted for x26 billion or 1.5% of total assets as at December 2000, as against x69.4 billion or 6% in 1999. The cumulative provisions on gross assets of the banking system increased by 27% from x79 billion in 1999 to x102 billion in 2000 resulting in net total assets of x1,094 billion and x1,646 billion for 1999 and 2000, respectively (inclusive of depreciation). Commercial banks accounted for 89% of the aggregate provisions in 2000.

FIGURE 9: DISTRESSED BANKS' SHARE OF TOTAL ASSETS IN 1999

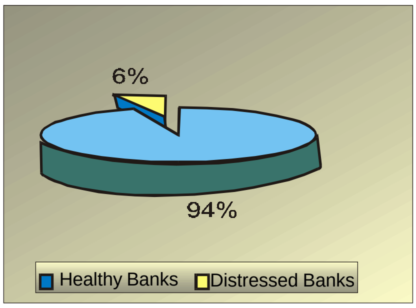
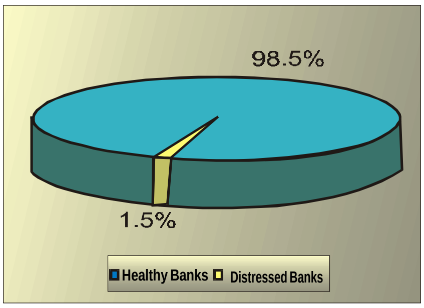


FIGURE 10: DISTRESSED BANKS' SHARE OF TOTAL ASSETS IN 2000



Sources: Monthly Bank Returns

4.04 Liquidity

In 2000, the prescribed minimum liquidity ratio was reduced from 40% to 35%. Five (5) banks (4 commercial and 1 merchant) failed to meet the minimum liquidity ratio of 35% for the month of December, 2000, compared with ten (10) (8 commercial and 2 merchant) in the corresponding period of 1999.

4.05 Capital Adequacy

The total qualifying capital for the purpose of assessing capital adequacy of commercial and merchant banks at the end of December 2000 amounted to x125 billion compared with x67.5 billion in 1999. Out of the eighty-eight (88) banks in operation at the end of 2000, seventy seven (77) (54 commercial and 23 merchant) met the prescribed minimum capital adequacy ratio of 8% as against 69 (39 commercial and 30 merchant) in the corresponding period of 1999. Eleven (11) banks in 2000, compared with 18 banks in 1999 were insolvent. Eight (8) of the eleven (11) banks were sold to new investors while three (3) that could not be sold or recapitalised, had their licences revoked during the year. For the purpose of providing a closer watch on the banks in the system, the regular measurement of the banks' capital adequacy will be intensified.

4.06 Earnings

TABLE 4

EARNINGS AND PROFITABILITY OF BANKS

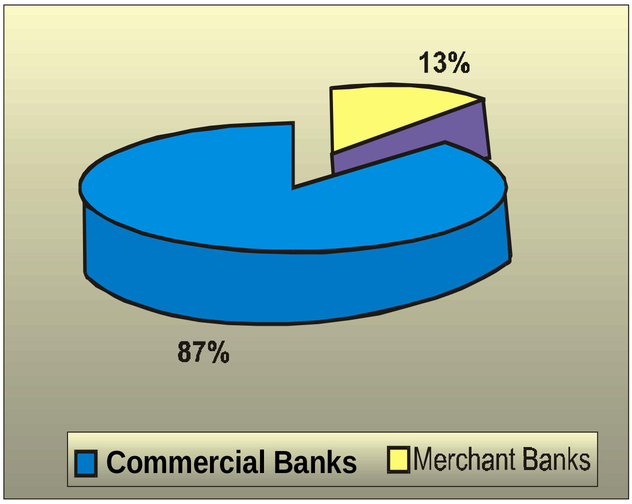
	Amount (x'M)		Growth %
	31 Dec 1999	**31 Dec 2000**	**1999/2000**
Interest Income	40,169	58,826	46.4
Interest Expenses	18,115	26,048	43.8
Net Interest Income	22,054	32,778	48.6
Non-Interest Income	15,032	26,084	73.5
Operating Expense	28,844	38,611	33.9
Profit Before Tax	24,520	44,330	80.8
Performance Ratios:	%	%	
Return on Assets	2.1	2.7	
Return on Equity	26.3	35.2	
Net Interest Margin	292.6	317.7	
Yield on Earnings Assets	3.9	3.9	
Funding Cost	2.0	2.3	
Efficiency	36.7	30.2	

Source: Banking Analysis System, CBN.

The aggregate profit before tax (PBT) (unaudited) of commercial and merchant banks in 2000 was x44.33 billion, an increase of x19.81 billion (80.79%) over the corresponding figure x24.52 billion in 1999.

Commercial banks' share of the profit was 87% while merchant banks accounted for 13% (Figure: 11).

FIGURE 11: COMMERCIAL & MERCHANT BANKS' SHARE OF PROFIT



Source: Monthly Bank Returns

The return on assets increased in 2000 to 2.7% from 2.1% recorded in 1999 (See Table 4).

4.07 Balance Sheet Structure and Growth Rates

Loans and Advances continued to constitute the largest portion of banks' asset profile. In 1999, it accounted for 35.5% of total assets while in 2000, a marginal decrease was recorded as it accounted for 32.5%. This decrease, however, was largely due to the fact that banks preferred to invest additional funds mobilised during the year in liquid assets (which is the second largest component of the assets profile of banks), rather than tying them down in loans, in order to record favourable liquidity positions.

While banks enjoyed significant leverage from deferred payments (payables), over 49% of funds available to them during the year 2000, were from customers' deposits. Similarly, about 45% of their funding in the previous year was also from deposits. Shareholders' funds (equity and reserves) covered only 7.9% and 7.4% of the banking system's assets in 1999 and 2000, respectively.

TABLE 5

BALANCE SHEET STRUCTURE OF BANKS

		31 Dec 1999 Amount(N'M)	%	31 Dec 2000 Amount(N'M)	%	% Growth
ASSETS	Cash and Due from Other Banks	325,595	27.5	447,744	25.6	37.5
	Money at Call and Placements	69,234	5.8	138,942	7.9	100.7
	Govenrment Securities & Other Short Term Funds	206,330	17.4	330,998	18.9	60.4
	Loans and Advances/Leases	419,919	35.5	567,433	32.5	35.1
	Investments	8,836	0.7	13,315	0.8	50.7
	Other Assets	98,309	8.3	172,603	9.9	75.6
	Fixed Assets	56,273	4.8	77,137	4.4	37.1
	Total	**1,184,496**	**100.0**	**1,748,172**	**100.0**	**47.6**
LIABILITIES	Total Deposit	535,856	45.2	859,438	49.2	60.4
	Due to other Banks	92,865	7.8	99,029	5.6	6.6
	Other Borrowed Funds	5,572	0.5	7,434	0.4	37.3
	Other Liabilities	456,809	38.6	656,254	37.4	43.7
	Shareholders' Equity	45,566	3.9	58,812	3.6	26.3
	Reserves	46,828	4.0	67,205	3.8	43.5
	Total Liabilities	**1,184,496**	**100.0**	**1,748,172**	**100.0**	**47.6**
	Off-Balance Sheet Items	188,110		269,012		**43.0**

Source: Monthly Bank Returns

Figures 12 and 13 illustrate the assets and liabilities structure of the Nigerian banking system during the year under review.

FIGURE 12: ASSETS STRUCTURE OF BANKS (2000)

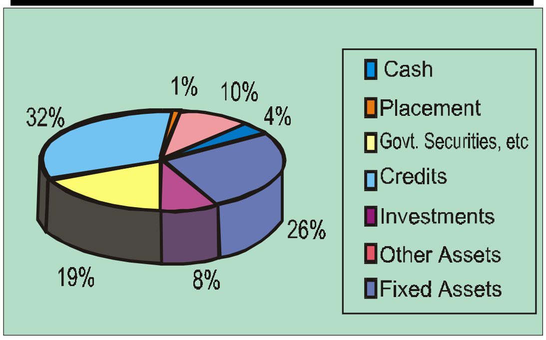
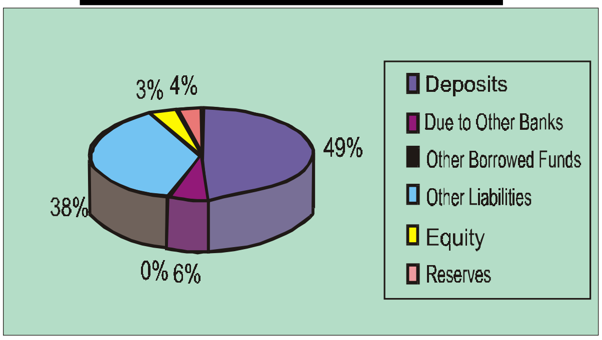


FIGURE 13: LIABILITIES STRUCTURES OF BANKS (2000)



Source: Monthly Bank Returns

Chapter Five

CAPACITY BUILDING FOR SUPERVISION

5.01 Restructuring of the Banking Supervision Process

In the communique issued at the Banking Supervision retreat in 1999, the need to restructure the supervisory process was unanimously accepted by the participants. This idea was later adopted and fine-tuned in the Project Eagles' recommendations for the supervisory function.

Hitherto the supervisory process was structured along functional lines whereby the various aspects were handled on a divisional basis. The arrangement had the advantage of building specialisation in the various functional areas. Thus, over time, a crop of experts in such areas as licensing, investment analysis, management appraisal, distress resolution, prudential, foreign exchange, money laundering, and EDP examinations, emerged. However, the arrangement was fraught with several problems such as lack of co-ordination, communication gaps and overlaps. Under the arrangement, there was the need to rotate staff at intervals to ensure that supervisors were versatile in all areas of supervision. Unfortunately, this happened infrequently and, as a result, the expertise that was built was along very narrow areas of operation. Therefore, in order to address the short-comings, a team-based structure was adopted.

Under the new structure, supervisors were formed into teams. The institutions being supervised were also grouped and assigned to these teams. The arrangement resulted in three groups comprising three teams each for off-site supervision and eight groups of two teams each for on-site supervision. In addition to the functional teams, there are support units for administration, training, monitoring and the Bankers Committee.

The new structure is expected to be more responsive, as it ensures the flattening of the heirachical structure, the empowerment of people to take action and improved process co-ordination. Each group is headed by a Deputy Director who reports to the Director. Every member of the team reports to the team leader, who in turn reports to the group head. To boost the effectiveness of the new framework, work processes and approval levels were reviewed to eliminate bottle-necks and improve the response time.

The envisaged benefits of the new arrangement include:

- Acquisition of a broad-based knowledge of supervision by the examiner in a shorter period of time.
- Comprehensive knowledge of the banks and a complete view of their condition which will facilitate the use of such supervisory tools as bank rating and other early warning signals.
- Promotion of consolidated supervision. To this end related institutions were grouped together as far as possible to enable the supervisor observe the interrelationship of the institutions in terms of their operations, ownership and management and also put him in a position to guard against such group problems as contagion and assets switching.
- Promotion of esprit de corps within the teams/groups. As members in a team have different backgrounds and experience, the intra-team interaction would greatly promote learning and exchange of ideas.
- Greater ability to measure performance.

Some problems are however envisaged with the new approach. Issues that cut across teams or groups may suffer neglect, both in execution and co-ordination. To address this problem, such issues were identified at the take-off of the new framework and specifically assigned to group heads for co-ordination.

There is the need to speed up the upgrading of the Banking Analysis System (BAS) and other IT facilities to promote information sharing among the teams.

There is the danger also of a complete lack of knowledge of the condition of the banks outside one's team. This again calls for effective internal communication and interest in the activities of other teams.

Overall, however, the team-based supervision, if properly managed, will enhance staff productivity, reduce idle time and expose examiners to all facets of supervision.

5.02 Staff Training and Development

As part of the effort to enhance capacity building for the supervision process, increased attention was focused on training in various aspects of supervision to improve on the quality of service delivery.

Bank Examiners Courses (Foundation, Levels I, II and III) were conducted twice during the year. A total of 212 Examiners participated in the programmes. An Electronic Data Processing Audit Course for Bank Examiners was also organised twice, with 34 Examiners in attendance.

A total of 111 staff attended other local courses, including Report Writing for Auditors, Electronic Banking in Nigeria, Securities for Bank Lending, Financial Analysis for Investment Advice and Bank Inspection and Audit in a Computerised Environment. A sizeable number of staff also attended local courses organised by the Personnel Department.

Twenty six (26) overseas courses involving thirty six (36) members of staff were also undertaken.

Efforts will continue in building the necessary capacity, to enable supervisors cope with the increasing challenges of the financial services industry.

5.03 The 2000 Bank Examiners' Conference

The 7th Annual Bank Examiners' Conference was held at the Gateway Hotel, Abeokuta, from October 18 to 20, 2000.

The Governor, in his keynote address, noted that the theme of the conference, *Transparency and Ethics in the Nigerian Banking Industry: Imperatives for the Growth of the Financial System*, was topical, in view of the disturbing trend in the banking industry. He also noted that the most recent distress syndrome witnessed in the financial system was largely attributable to the lack of transparency and sound ethical conduct exhibited by some operators in the industry, and stated that unless something drastic was done to arrest the trend, the entire financial system and ultimately the economy, would be in grave danger.

In the addresses given by the Director of Banking Supervision, Central Bank of The Gambia and The President of the Chartered Institute of Bankers of Nigeria, they stressed the need for a high level of transparency and ethical conduct in the banking industry which would impact positively on the achievement of a sound and healthy financial system.

Four papers were presented, namely, Transparency and Ethics in the Nigerian Banking Industry: Imperatives for the Growth of the Financial System; Information Technology with Emphasis on E - commerce and E-money; Core Principles for Effective Banking Supervision and Risk-based Supervision; and Financial Derivatives, the Foreign Exchange Market and Regulatory Overview.

The Chairman of Dunlop Nigeria Plc, Mr. G.O. Onosode, presented the theme paper, "Transparency and Ethics in the Nigerian Banking Industry: Imperatives for the Growth of the Financial System." He stated that unethical practices in the banking industry fell under two broad categories - acts done or omitted to be done by the bank as an institution and conduct or misconduct of the bank's personnel. He also observed that unethical practices were frequently a product of moral deficiencies on the part of either the owners or the employees. There were also instances where official policy and/or practices of a bank were exploitative in nature and breached sound principles or best practices, to take advantage of the ignorance of the customer. From the institutional perspective, the incentive to follow the path of non-transparency and unethical conduct was the desire to maximise the "bottom-line". Some of the unethical practices and lack of transparency included the falsification of books of accounts, window-dressing to hide losses, insider-abuse in the granting of credits, manipulation of transactions and value dates and fraud by owners and staff of the bank. He was of the opinion that unethical practices and lack of transparency might result in short-term gains but were destructive and costly in the long run, and would be vitiated by the effect of sanctions imposed by the CBN. They would also result in loss of customers, erosion of capital, illiquidity, greater susceptibility to frauds and forgeries and erosion of public confidence in the financial system, thus exacerbating the prevailing poor banking culture in the country.

In conclusion, he stated that unethical practices should be severely punished by the regulators, as banking was premised on trust. Unethical acts would cumulatively retard the growth of the economy by frustrating the development of entrepreneurship through under-utilisation of existing assets to finance expansion, with the resultant sub-optimal growth of the economy, which in turn would impact adversely on the growth of the financial sector.

The second paper, Developments in Information Technology with Emphasis on E-commerce and E-money, was presented by the Managing Director/Chief Executive Officer of Gemcard Nigeria Limited, Mr. A. Nwuba. He observed that developments in information technology had eliminated many of the physical requirements of transactions, thereby leading to reduced costs, increased efficiency, convenience and speed of electronic transactions. He also noted that e-commerce had altered the current distribution models in the international markets and enabled suppliers/producers of goods and services to reach end-users directly because of the global connectivity of the internet. This process of dis-intermediation had resulted in the elimination of the middleman, and significantly reduced the cost of delivering goods and services. He was also of the opinion that e-money could promote the efficiency of the payment system, reduce the handling of cash and the attendant costs and risks of error, cashier theft and robbery. Some of the e-money products which have gained acceptance in Nigeria include electronic funds transfer, credit cards, debit cards, financial electronic data interchange (F-EDI), home banking, storage value cards and direct data entry which facilitate direct debits and/or credits to the payer/payee's account.

He emphasised that information technology presents regulators with dramatic challenges. Some of the problems include the lack of visible evidence of the transaction process, lack of real transparency and lack of information and computer systems integrity. In addition, a number of electronic payment systems are extra-jurisdictional and may impact on the regulator's ability to regulate and monitor them effectively. He was of the opinion that policies should evolve from both the operators and regulators to ensure that the public interest and the integrity of the financial system were not compromised.

In his paper, Core Principles for Effective Banking Supervision and

Risk-based Supervision, Mr. O. I. Imala, the Director of Banking Supervision, CBN, reviewed the core principles and concluded that the World Bank Mission's assessment of the state of compliance in Nigeria was favourable. He said that the Mission's report commended the effective action taken in dealing with troubled banks in Nigeria and adjudged that the Nigerian supervisory framework had fulfilled 9 of the principles, 11 were largely fulfilled, 5 largely unfulfilled, while 5 were unfulfilled. Efforts to attain fulfilment, he said, were adjudged to be on the way in 2 each of the largely fulfilled and the largely unfulfilled categories. He noted that some of the principles were not critical in the present context of the Nigerian financial system.

In the second part of the paper, Concept and Methodology of Risk-based Supervision, he talked about efforts made by both the Bank of England and the Federal Reserve System of the USA, to redefine the risk-based supervisory framework and provide a better and more consistent identification of risks in authorised institutions. In developing its risk-based approach, he said, the Bank of England merged the RATE (Risk, Assessment, Tool of Supervision and Evaluation) and SCALE (Schedule 3, Compliance, Assessment, Liaison and Evaluation) approaches to the RATE framework. The objective was to ensure effective assessment of the bank's business, design effective supervisory plans and make use of appropriate supervisory tools. The RATE framework comprises three phases, each of which takes place during a "supervisory period" (length of time spent in undertaking formal risk assessment on a particular bank). The phases are:

i) Risk assessment phase during which the supervisor undertakes a formal risk assessment of the bank using evaluation factors, the CAMELBCOM;

ii) the feed back phase when the supervisor will feed back his views on the bank's risk profile in a letter to the bank; and

iii) evaluation phase when the supervisor undertakes an evaluation of the risk assessment, the supervisory programme and its use of the tools of supervision.

He concluded by reviewing the step-by-step guide on the use of the RATE framework which the supervisor must undertake in order to perform risk assessments.

In the fourth paper, Financial Derivatives: the Foreign Exchange Market and Regulatory Overview, Mr. M. Accad, the Managing Director/Chief Executive Officer of Citibank Nigeria Limited, reviewed the Nigerian foreign exchange market and concluded that the naira was still largely a managed currency which tends to depreciate in steps. He noted that the regulatory environment was one in which only authorised dealers were allowed to take proprietary position in the foreign exchange markets while outward remittance of foreign currency must be backed by acceptable account transactions. Furthermore, only residents are allowed to access domestic forward markets to cover genuine foreign exchange exposures. He examined derivatives which he defined as financial instruments whose values derive from the value(s) of other underlying physical and/or financial assets. Derivatives include, but are not limited to, forwards/futures, swaps and options and their uses are to:

- transfer financial and commodity risk exposure;
- assume preferred financial risk exposures;
- access capital markets that are generally inaccessible;
- access investment markets that are generally inaccessible; and
- win customers in certain situations.

He identified five general categories for derivatives application viz:

i) modifying operation exposures;
ii) managing assets and liabilities;
iii) facilitating capital market transactions;
iv) monetising contractual opportunities; and
v) leveraging special tax, accounting or regulatory situations.

In concluding, he said that there was the need for a well-formulated policy for achieving progressive product development for strengthening our financial market. To achieve this, he opined that regulators should:

- have regular contact with banks' management for a thorough understanding of the institutions' operations;
- pay special attention to banks' procedures for assessing and managing all risks, including credit risk; and
- certify the existence of adequate policies and procedures for identifying, monitoring and controlling market risk, including, in particular, exchange rate and interest rate risks.

At the end of the Conference, a communique, which highlighted major recommendations, was issued.

APPENDIX 1

BSD/DO/CIR/VOL.1/10/2000

22ND DECEMBER, 2000

TO: ALL LICENSED BANKS

GUIDELINES FOR THE PRACTICE OF UNIVERSAL BANKING IN NIGERIA

1.0 INTRODUCTION

Following the CBN approval-in-principle of the adoption of Universal Banking (UB) in Nigeria, and the subsequent ratification of the Report of the Committee on the Preparation of Guidelines for same, the Governor of the Central Bank of Nigeria in the exercise of the powers conferred on him by the provisions of Section 61 of Banks and Other Financial Institutions Decree (BOFID) 1991 as amended, has approved the issuance of the following guidelines to all banks for the implementation of universal banking in Nigeria with effect from January 1, 2001.

To give effect to the adoption of the concept therefore, banking business in Nigeria shall be defined as:

"The business of receiving deposits on current, savings or other accounts; paying or collecting cheques drawn or paid in by customers; provision of finance, consultancy and advisory services relating to corporate and investment matters; making or managing investment on behalf of any person; and the provision of insurance marketing services and capital market business or such other services as the Governor of the Central Bank of Nigeria, may, by gazette, designate as banking business."

Banks are free to choose which activity or activities to undertake (money or capital market activities or insurance marketing services or a combination thereof) and are expected to comply with the guidelines specified for such activity or activities. Consequently, a bank will be regulated based on the type of activities it engages in.

In view of the above, a single uniform licence will be issued to all conventional banks desirous of practising Universal Banking without delineation as to "commercial" or "merchant", after returning the old licence to the Central Bank for cancellation.

Non-conventional banks like the development and other specialised institutions shall continue to perform their specialised roles.

2.0 ACTIVITIES THAT BANKS CAN UNDERTAKE

Apart from the conventional banking functions like receiving deposits on current, savings, or other accounts, paying or collecting cheques drawn by or paid in by customers, provision of finance or credit facilities, banks, under the UB programme, can choose to undertake one, or a combination of the following:

- Clearing House activities
- Capital Market Activities e.g. Underwriting/Issuing House activities
- Insurance services

3.0 RELEVANT GUIDELINES

3.1 Clearing House Activities

Banks undertaking central clearing house activities will be expected to meet the capital requirement, branch network and a minimum level of information technology as will be specified eventually by the Nigerian Inter-bank Settlement System/Nigerian Automated Clearing System (NIBSS/NACS) project.

Banks are also expected to comply with the current Clearing House Rules.

Pending the conclusion of the NIBSS project, all banks under the UB can apply to be admitted into the Clearing House based on the existing Clearing House Rules.

3.2 Underwriting/Issuing House Activities

Underwriting in Nigeria includes standby and firm underwriting. Issuing house activities essentially involve arranging the issue of equity and/or debt instruments on behalf of another company, local, state or federal governments and the provision of advisory services on funding opportunities, capital restructuring, etc.

Banks embarking on underwriting/issuing house activities under UB practice in Nigeria are expected to comply with the following regulations:

i) Meet the registration and all other regulatory requirements specified by the capital market regulator, that is, the Securities and Exchange Commission.

ii) Classify as loans all securities acquired under underwriting commitment and not disposed of within twelve months, which, furthermore, should be subjected to the prudential requirements and restrictions on loans e.g. the single obligor restriction, loan loss provision, etc.

iii) Ensure that underwriting on firm commitments does not exceed the single obligor limit of 35% of shareholders funds unimpaired by losses. Furthermore, the prevailing prudential lending ratio between deposits and loans and advances should be maintained.

iv) Ensure that their stand-by commitments, should not exceed the limit of 1.75 times their shareholders funds unimpaired by losses.

v) Maintain adequate and separate records for all capital market activities.

vi) Use existing return formats to render separate returns on capital market activities as determined by the respective regulator -
i.e CBN, SEC, etc. pending the harmonisation of the return formats.

vii) Disclose their capital market activities in both the regulatory returns and the published accounts.

3.3 **Insurance Activities**

Banks can provide insurance services as specified below.

a) Agency services) (a & b marketing services)
b) Brokerage services)
c) Underwriting services)(c & d underwriting services)
d) Loss adjusting services)
e) Re-insurance services)
f) Retrocessionaire services) (e & f - reinsurance services)

Banks may provide insurance marketing services (a) and b) above) directly. However, banks may provide underwriting (c) and d) above)and re-insurance services indirectly through a subsidiary or an associated company.

Banks can therefore undertake insurance services as specified under the insurance guidelines as outlined below and can invest in subsidiary companies that engage in financial activities only as provided for in Section 21 (d) of BOFIA 1991, as amended.

The following regulations are for banks that may wish to engage in insurance business under universal banking.

i) An insurance subsidiary of a bank shall comply with the capitalization requirements under the Insurance Decree No.2 of 1997 and any subsequent amendments;

ii) All insurance activities wherever they occur shall be licensed and regulated by NAICOM and subject to the provisions of the Insurance Decree of 1997 or such other insurance laws as may be enacted.

iii) An insurance policy should not be rejected solely because the policy has been issued or underwritten by a person not associated with the bank when such insurance is required in connection with a loan or extension of credit.

iv) A debtor, insurer, or insurance agent or broker must not pay a separate charge for the handling of insurance that is required in connection with a loan unless such is required when the bank's affiliate is the licensed insurance agent or broker providing the insurance.

v) There should be no payment or receipt of any commission or brokerage fee for service as a broker or agent unless such a person is properly licensed by NAICOM.

vi) A bank shall not release any insurance information about a customer to any person other than an employee, agent, subsidiary, or affiliate of a bank for the purpose of soliciting or selling insurance without the consent of the customer.

vii) A bank shall not use health information obtained from the insurance records of customers for any purpose, without the customer's consent except for activities as licensed insurance agent or brokers.

viii) A bank shall not insist, for extension of credit, on the condition that the customer obtains insurance from the bank's affiliate/associate or a particular insurer, agent, or a broker, but must inform the customer or prospective customer that insurance is required in order to obtain a loan, and that approval of a loan is contingent upon the customer obtaining insurance, or that insurance is available from the institution.

ix) Banks shall not require that, when a customer's application for a loan is pending and insurance is offered to the customer or it is required in connection with the loan, a written disclosure be provided to the customer indicating that his choice of an insurance provider will not affect the credit decision or credit terms except that the bank may impose reasonable requirements concerning the credit worthiness of the insurance provider and scope of coverage.

x) The bank shall clearly and conspicuously disclose to the customer, prior to the sale of any insurance policy, that such policy is not:

(a) a deposit;
(b) insured by the NDIC;
(c) guaranteed by the bank; and
(d) an investment.

xi) Credit and insurance transactions should be completed through separate documents when a customer obtains insurance and credit from a bank;

xii) An insurance company shall not transfer its funds to a bank which is either its holding or associated company without clearance from NAICOM except for the purpose of investment.

xiii) A bank shall not issue instructions to its insurance subsidiary or associate that will affect the insurance funds adversely or commit insurance funds to a purpose outside insurance, except dividends declared;

xiv) A bank shall not include the expenses of insurance premiums in the primary credit transaction without the customer's consent, where the customer obtains insurance and credit from a bank;

xv) Banks shall be required to maintain separate and distinct records relating to insurance transactions and such records should be made available to the appropriate regulators;

xvi) Banks should also disclose specifically among other things earnings from insurance activities in their published accounts.

4.0 SUPERVISORY FRAMEWORK UNDER UNIVERSAL BANKING

UB practice in Nigeria is expected to engender the emergence and existence of financial conglomerates and large banking groups which will involve the different regulatory authorities in Nigeria - CBN, SEC, NAICOM and CAC. Greater co-operation and co-ordination will therefore be expected among these regulatory authorities particularly through the FSRCC of which the CBN is the Chairman.

The CBN however, would be the lead regulator, where a bank undertakes other financial activities specified under the UB practice in Nigeria. Consequently, the CBN would be responsible for the consolidated supervision of such banks.

5.0 **NEED FOR SELF REGULATORY ORGANISATIONS**:

The involvement of the industry operators in the preparation of UB guidelines underlines the need for the co-operation of the operators in the smooth operation of UB in Nigeria. In the same manner, the co-operation of Self Regulatory Organisations (SROs) is a crucial tool for the effective regulation of UB practice in Nigeria. Consequently the CBN and the other regulators will continue to encourage the emergence and survival of, and co-operation among, SROs, under the Universal Banking system.

O. I. IMALA
DIRECTOR OF BANKING SUPERVISION
DECEMBER 2000