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SUSTAINING A SOUND FINANCIAL SYSTEM: THE ROLE OF REGULATORS

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ABSTRACT

This paper identifies and articulates the roles regulatory institutions should and do play in promoting sound financial institutions. It examines the objectives and goals of regulations as well as forms of regulation. Within the context of macro-prudential regulation, it contextualizes the core set of Financial Soundness Indicators for Deposit Money banks. The paper suggests a number of things the CBN should do to ensure sustainable financial soundness of financial institutions in Nigeria.

Key Words: Regulators, Financial System, Financial Institutions, Financial Soundness Indicators, Supervision.

INTRODUCTION

The aim of this paper is to identify and articulate the roles the regulatory institution should play in promoting a sound financial system in Nigeria. To achieve this aim, section 1 of the paper attempts to establish the rationale for world wide concern for the existence of effective and efficient financial services industry. The paper proceeds in section 2 to establish the theoretical framework for our discussion of the subject of the paper considering, sequentially, the objectives of regulation, the forms of regulation and ancillary regulatory matters.

In section 3, an attempt is made to expose the parameters of "soundness" and unsoundness" to clarify a central theme of the paper. The benefits of a sound financial system are briefly outlined in section 4 whilst in section5, the paper

suggests what roles the regulatory institutions are expected to play in order to realize those benefits mentioned in section 4, immediately above. The paper concludes with the author's opinion in section 6.
It is considered appropriate to start our discussions with the question: Do we need the financial system in the elaborate manner we have it in western economies? Yes and No is the response. This question was first raised in 1934 by Schumpeter [(1)] and since then no unqualified and unequivocal yes or no answer has been found to that question.The Pros and Cons on the subject have, however, agreed on a few basic issues. One is that if you operate a capitalist economic system the answer is: you need the financial system because the decision to save and invest is left at the discretion of individuals and so there is need to have financial intermediaries. However, if you operate a socialist/communist economic system you do not need the financial system for the decision to save and invest lies,under that arrangement,with the central government.

In Nigeria, because of our choice of the capitalist path of development, a safe, sound and efficiently functioning financial system is a sine qua nom[(2)].Another important settled issue in this debate,so far,is that the role of the financial system depends on whether it is:

- Supply leading or demanding following [(3)]
- Repressed or not[(4),(5),(6)]
- Hoarding money or truly financializes savings[(7)].

It is worth noting that Roubin and Sala-i-Marton C (1992) in an empirical study of financial repression and economic growthshows how this financial repression "reduces the growth rate of the economy… and confirmed the predictions of the theory in that financial repression affects growth negatively…."[(8)]

In the discussion of our subject, the next relevant question to ask is: why should we be concerned with the soundness of the financial system?It is because of the central and critical roles the sector plays in the economy in:

- Ensuring effective and efficient financial intermediation
- Promoting effective and efficient payment system
- Supporting social and economic development efforts of governments, and societies.
- Improving the quality of investment so as to increase the productive capacity of the economy[(9)].

THEORETICAL FRAMEWORK

It will be instructive at this juncture to define prudential regulations and supervision so as to distinguish between the two concepts that are sometimes thought of as synonymous. Llewellyn (1986) states that regulation means "a body of specific rules or agreed behaviour, either imposed by some government or other external agency or self-imposed by explicit or implicit agreement within the industry, that limits the activities and business operations of financial institutions. Supervision is the process of monitoring to ensure that institutions are conducting their businesses either in accordance with regulations or, more generally, in prudent manner" [(10)]. Put in another way, it can be said that "prudential regulations establish the outside limits and constraints placed on banks to ensure the safety and soundness of the banking system. They are the key elements to prevent, limit or stop the damage caused by poor management"[(11)].

Objectives of Regulation

In view of the critical importance of the finance industry, it hardly need be argued that it needs adequate regulation. Given that position, what are the goals of regulation? Snikey Jr. (1989) states that these are:

- The protection of depositors and the deposit insurance fund;
- The protection of the economy from the vicissitudes of the financial system; and
- The protection of bank customers from the monopoly power of banks"[(12)].

By the nature of the business of finance, the institutions trade with other peoples' (depositors') funds. Because of the consequences of loss of money by depositors and in particular the impact on the development of banking habit, governments often establish deposit insurance institutions to protect depositors' interest. It is clear from this that an important objective of regulation must be the avoidance of loss of confidence resulting from lost deposits and the creation of circumstances that would make the need for the support of deposit insurance fund necessary to salvage bank failures.

In section 1 above, the importance of the role of the banking industry was noted. Governments make effort to regulate the industry to ensure that it functions efficiently and thus provide support for economic activities rather than hamstrungthe economy. If due to stress and difficulties, the banking industry has to generally cut back, substantially, on the supply of investible funds to the economy, this would lead to adverse consequences as a result of reverse multiplier effect of such an action. Such consequences would include unemployment and reduction in the level of goods and services available and consequently the overall well being of society.

In most developing countries, in particular, as well as in advanced countries of the world, the finance industry has a strange-hold on the financial services available to the economies. Without regulation this monopoly power could very easily be abused.

In addition to playing their traditional role of intermediation, banks in developing countries of the world have to play an important role in developing their operating environments. Banks in these developing societies have, for instance, to develop indigenous entrepreneurs and facilitate the supply of bankable projects. As a result of this, the authorities in most developing countries, regulate the banks to "ensure that they play a proper role in economic development" (13). All of these policy goals can be summed up by the statement that: "the rationale for government intervention in the financial system may be viewed from a number of standpoints:

- Efficiency;
- Diversity of choice;
- Competitive neutrality
- Stability of the financial system;
- Macroeconomic stability; and
- Social objectives" (14).

In essence, three interests are served by seeking these goals:

a. The interest of stakeholders in banks (depositors, customers, etc.)
b. The entire financial system, and
c. The institutions

"However, it is not always clear whether regulation is designed to protect the consumer (depositors, for example), the financial system as a whole (what is termed the systemic interest) or the regulated institutions themselves.Regulation in practice seldom serves the exclusive interest of the customer, and there is a systemic interest to protect which may be in the immediate interest of the consumer of financial services. While regulation sometimes work in the interest of the regulated, this is usually rationalized in the terms of a systemic interest or the interest of the consumer"(15).

All of these goals are very intricately related. Success in the attainment of the goal of one of these parties often benefits the other parties, directly or indirectly. It has been asserted that “the fundamental purpose of prudential regulation of financial institutions is to deal with the risks to which such institutions are exposed”(16). Once this primary objective is attained, the interests of the consumer, the system and the regulated i.e. the institutions would have been served.

Whilst seeking to attain the multiple but mutually reinforcing goals of regulation, regulators are often confronted with conflict of purpose. To ensure the protection of depositors’ interest, for example, regulators place some restrictions on the freedom of actionor operation of banks.These restrictions are often detrimental to “allocative efficiency i.e. (the extent to which an institution is successful in directing savings into the highest yielding forms of investment), “operational efficiency”, (the extent to which resource costs are minimized for any given level of service provided); and “dynamic efficiency” (the capacity of the system to adapt to changing needs, generate innovations in financial services and raise productivity”(17).

To neutralizethis potential conflict, regulators would have to establish a balanced posture that would best cater for all these interests with stakes in the efficient operation of the financial services industry. All in all, it has been suggested, that “from a public policy perspective, the government’s goal to ensure the stability of the financial system should be of paramount importance. The failure of a large bank or multiple bank failures may force a sudden contraction of the money supply, a failure of the payments system, a severe dislocation of the real economy, and real or implicit obligations on the part of the government. The failure of any bank, no matter how small, may lead to contagion and loss of confidence in the system unless the government can demonstrate its ability to handle bank failures in an orderly and systematic fashion”(18).

Forms of Regulation

The ingenuity of the regulator, the nature and characteristics of the economic environment and the behaviour of the regulated institutions define the forms of regulations adopted for a financial system. Whilst there can be listed a number of prudential regulations that are common to most economies, between developed and developing societies and within each of these societies, there will be found variations inthe essential elements of regulation and/or in the nature and pattern of regulation. Writers have attempted to classify forms of regulation, variously.

Spong,[19]for instance,puts prudential regulations into three classes, viz:

a. Regulation for depositor protection and monetary stability;
b. Regulation consistent with an efficient and competitive financial system and
c. Regulation for consumer protection".

Llewellyn [20] suggests that regulation may be classified into environmental, legal, self-imposed, moral suasion, self-regulation and external agency. He also expressed the view that regulations could be classified as geographical, functional, ownership, pricing, entry and establishment and business operation [21].

In Dale's view, prudential regulations could be classified into "preventive (i.e. designed to limit risks incurred); protective (i.e. offer protection in the event of failure) and supportive (i.e. lender-of-last resort function) [22]". These classifications do not and are not intended to put the groups of regulations into exclusive zones. Indeed, it is infeasible to do so as some regulations may be both preventive and protective in nature.

The basic or generic forms of prudential regulations for all types of financial institutions and in most economies include:

- Restriction on the use of types of business names (e.g. bank) without requisite license.
- Geographical restriction of business to area of authority of the charter authority.
- Licensing
- Controls over changes in operations
- Opening and closing of branches
- Requirement of adequate management
- Record keeping requirement
- Capital adequacy
- Information pooling and co-ordination.
- Liquidity requirement
- Restriction on activities e.g. prohibition from investing in gambling
- Moral Suasion
- Self Regulation [23]
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Ancillary Regulatory Matters

In addition to these, there are other matters that are considered by regulatory authorities in determining whether a bank is well managed or not and the extent to which it requires close surveillance to ensure it is safe and sound.

- As an example, at the Bank of England, other important prudential regulation matters considered include "the institution's general strategy and objectives; planning arrangements; policies on accounting, lending and other exposures, and bad debt and tax provisions; policies and practices on the taking and valuation of security, on the monitoring of arrears, i.e. on following up debtors in arrears, and interest rate matching; and recruitment arrangements and training to ensure that the institution has adequate numbers of experienced and skilled staff in order to carry out its various activities in a prudent manner [(24)].This is, for instance, the rationale for the recently introduced CompetencyFramework for Deposit Money Banks in Nigeria.
- Another key issue in prudential regulation is the prohibition of plurality of management function or cross or inter-locking directorship.
- The requirement to disclose the infringement of laws, rules and regulations and non-compliance with regulatory authorities' directives is indicative of the quality as well as the integrity of management as perceived by a banks' public-regulators, customers, and depositors in particular. Whilst the Bank and other Financial Institutions Act makes it obligatory for bank auditors to disclose or report these information to the CBN, the auditors'report to the shareholders discloses violations of laws and penalties suffered in consequence. Section 29(7) of this Act requires that "If an auditor appointed under this section, in the course of his duties as an auditor of a bank, is satisfied that:
  - (a) there has been a contravention of this Act, or that anoffence under any other law has been committed by the bank or any other person; or
  - (b) losses have been incurred by the bank which substantially reduce its capital funds; or
  - (c) any irregularity which jeopardizes the interest of depositors or creditors of the bank, or any other irregularity has occurred; or
  - (d) he is unable to confirm that the claims of depositors or creditors are covered by the assets of the bank, he shall immediately report the matter to the Bank".

Bank's auditors are required to play similar roles aimed at enhancing the prudential regulation of banks in most other countries. In South Africa, for instance, bank auditors "are required to satisfy themselves that banks and building societies maintain proper records of all their transactions, make adequate provision for bad and doubtful debts as well as possible losses, do not engage in unsound financial activities and comply with the requirements laid down in the respective Acts", Section 38 (1 – 3) of the Nigeria Deposit Insurance Corporation similarly provides for auditors of banks insured by the Corporation. In the Bahamas, it is affirmed that the report of the "external audit by firms approved by the Central Bank is an important ingredient, of our supervisory system"(25). In the same vein, under a policy that came into effect in 1987, the Bank of England "expects to receive from every authorized institution:

- 'A Reporting Accountants' report on 'accounting and other records and internal control systems' – annually.
- A Reporting Accountants' report on prudential returns – as specified by the Bank from time to time; and
- Ad hoc reports from auditors and Reporting Accountants, on their initiative, when circumstances arise that justify the need for this kind of communication"(26).

Over-optimism by banks about the prospects in an economy's sector or sub-sector often leads to over-concentration in or over exposure to such economic sectors and projects therein. This has on occasions led to unpleasant circumstances for banks and banking industries nationally and internationally. To prevent this, regulatory authorities have developed prudential guide rules of all sorts to suit their peculiar needs. In this regard, for instance, the CBN Act No. 24 of 1991{Section 39 5 (a)} provides that the Bank shall have power to require that all applications to any bank for loans exceeding such amount as the Bank may specify shall be submitted by the bank to the Bank for approval and no such loans shall be made without such approval. Large exposures by banks in the U.K., in the course of their operations, are covered by the Banking Act 1987. Section 38 {1} of the Act requires U.K. incorporated banks to make a report to the Bank if:

a. It has entered into a transactions relating to any one person as a result of which it is exposed to the risk of incurring losses in excess of 10% of its available capital resources; or

b. It proposes to enter into a transaction or transactions relating to any one person which, either alone or together with a previous transaction or previous transactions entered into by it in relation to that person, would result in its being exposed to the risk of incurring losses in excess 25% of those resources. (27)

In view of the fact that notification of large exposures is not enough, the Bank of England has appropriately put in place a prudential measure to address the risk problems such exposures portend. “Where a U.K. incorporated bank has a number of exposures to a non-bank counterpart of more than 10% of capital base, the Bank will generally require higher capital ratios to be maintained than would otherwise be the case”. (28)

Bilateral discussions between the regulators and regulatees and trilateral (including the external auditors and/or Reporting Accountants in the case of U.K.) has proved to be useful means of prudential regulation of banks. The importance and focus of these prudential discussions can be gauged from the report of the practice in the Bahamas stated thus:

“As an adjunct to the annual appraisal system, the Central Bank has set up a regular scheme of prudential discussions, particularly in cases where certain adverse aspects or trends about the financial position of a bank are disclosed by the examination of balance sheets. The dialogues, which are well-structured and issue-oriented, constitute the corner-stone of the system of supervision in as much as they seek to establish a close and intimate contact with the principals of the banks.

Frank discussion and reasoned debate take place on issues provoking concern. In these dialogues, we go beyond the compass of the balance sheet and evaluate a bank’s policies/postures in various key areas, its system and procedures of risk management and internal controls and take a critical view of its planned positions as well as its past performance record. Besides, we do have a look at other no less important and critical – intangibles, like the pattern of ownership, corporate style, degree of management autonomy, managerial capability and competence and name of the institution in the market-place” (29).

Planning represents for any business organization, an attempt to control its future activities by taking action today that yield the preferred operating results tomorrow. That is why planning is sometimes referred to as control-in-the future. Prudential regulations put in place today is similarly aimed at "correctly/appropriately" orientating banks operations. It is for this reason that the consideration of the long-range plans of banks is today a prudential regulation measure particularly in advanced banking systems. It can be said, generally, that a bank with a well articulated plan is likely to operate more efficiently than one without. Indisputably,changes in competitive conditions, volatility in the financial market, technological advances and deregulation increase the risks within the operating environment" of banks anywhere in the world today and provide sufficiently compelling reasons for planning" [(30)].

Closely associated with the regulatory tool of planning is budgeting. The budget is employed to translate into more measurable and operational terms the objectives specified in the plan. Whilst the plan usually spans a period of 3, 5 or more years, the budget is prepared for a shorter term, usually one year. Because it is an annual ritual, it provides an opportunity, each year, for the review and possible revision, of the plan. That is to say that "as a planning and control device, a budget provides a benchmark to measure results and the adjustments necessary to meet performance objectives" [(31)].

Taken together, the plan and the budget provide a useful tool of self-regulation, self-examination and self-control for banks. Properly employed, theseinstruments of control can also be of immense use for bank regulators as the plan and the budget provide an insight into the future prospects of the bank to which they relate. Rather than wait to correct errors made by banks, the regulator can actually prevent errors being committed by closely appraising the plan and the budget of the bank to identify flaws, evidence of over-optimism or pessimism, unrealistic assumptions about future events etc, contained therein and pointing these up if only as "a devil's advocate".

Evidence of Soundness and Unsoundness

To fully appreciate the soundness of a financial sector it is instructive to consider the parameters of soundness as well as those of unsoundness. Sanusi described this succinctly in stating that "A sound banking system can be defined as one in which most of the banks, accounting for most of the system's assets and liabilities, are solvent and are capitalized to withstand negative shocks. In this context, and, particularly in a dynamic and competitive market environment, efficiency and profitability are closely linked and theirinteraction determines the prospects of future solvency. On the other hand, inefficient banks will make losses and eventually become insolvent and illiquid. It is well known that owners and managers of unsound banks have unhealthy incentives to declare unearned income and show non-performing loans as performing in order to stay in business" [32].

Broadly in a developing economic environment as in Nigeria, the soundness of a financial sector will be evident from the existence of:

- Capital Adequacy
- Liquidity
- Quality Management
- Sustainable and quality profitability
- Ability and willingness to support socio-economic development.[33]

From the experiences of the last global financial crisis which became manifest in 2007/2008, global financial services regulators have learnt that micro-prudential regulation is inadequate to stem national and international financial crisis. They have, therefore, resorted to complementing it with macro –prudential regulations. A key component of the macro – prudential regulation is the Financial Soundness Indicators (FSIs) for Deposit Takers. The core set of Financial Soundness Indicators articulated by the International Money Fund (IMF) is as stated in Table 1; referenced in Yaaba and Adamu[34].

Table 1: Core set of Financial Soundness Indicators for Deposit Takers

Capital Adequacy	– Regulatory Capital to Risk Weighted Assets
	- Regulatory Tier1 Capital-to-Risk Weighted Assets
	- Non – Performing Loans Net of Provision-to-Capital
Asset Quality	- Non Performing Loans-to-Total Loans
	- Selected Distribution of Loans-to-Total Loans
Earnings and Profitability	– Return on Assets
	-Return on Equity
	- Interest Margin-to-Gross Income
	- Non-interest Expenses-to-Gross Income
Liquidity	– Liquid Assets-to-Total Assets (Liquid Asset Ratio)
	- Liquid Assets to short – term Liabilities.

Source: IMF – FSI Compilation Guide, 2006.

What makes the FSIs to be appropriate for macro-prudential regulation is that they "tend to measure, in aggregate terms, the current financial health and soundness of the financial institutionsin a country as well as their corporate and household counterparties" (Yaaba&Adamu) [35].

It is noteworthy that in appraising and reporting annually, on banking sector soundness the Central Bank of Nigeria has employed the FSIs as can be gauged from CBN Annual Reports and Financial Statements for the years Ended 31st December (2008 to date).Hitherto, the CBN has used the CAMEL parameters to measure the banking sector soundness, which has been found globally inferior to FSIs.

Unsoundness is evident from:

- No relationship between efficiency and profitability leading to a situation in which the future can't be guaranteed, as their profitability comes from round tripping, abuse of customers and rent-seeking activities.[36]
- Defaults leading to Collaterization of inter-bank [37]
- Unethical Practices [38]
- Non-compliance with regulations
- Inability to positively influence economic growth and development[39]

- The existence of uninformed Board and management
- Weak and/or abusive CEOs
- Poor Lending and operating practices
- Insider abuse & fraud evidenced by:
  - Fictitious loans, non repayment of loans
  - Risky trading with and lending to clients – at the stage of “desperate management” [40]
  - Production of false records as returns to the regulators and supervisors.
  - Self dealing
  - Inappropriate transactions with affiliates
  - Excessive bonus, salaries, fees & commissions
- Inexplicable resort to the capital market not justified by capital requirements for expansion of operations.
- Unimaginably high spread between borrowing and lending rates of banks [41]
- Making high profit even with 52.5% liquidity ratio.[42]

Benefits of a Sound Financial System [43]

These include:

- Protects depositors and taxpayers
- Promotes a strong and growing economy
- Fewer failure of financial institutions enabling the emergence of a strong, well capitalized deposit insurance fund.
- Consumers will have access to a wider range of services at the least possible cost
- Consumers will also enjoy the convenience of nation-wide access to services.
- Jobs are preserved because loans are not called at the first sign of economic down - turn.
- Small businesses that lack access to securities markets can count on banks in bad times as well as good.

The Role of Regulatory Institutions

To be efficient and effective, regulators must give attention to four basic issues/goals, which include:[44]

❖ Preserving the system:- This is important because these institutions are, essentially, public utilities that touch the lives of all citizens of the jurisdiction of the bank.

- Preventive:- To achieve prevention, laws and regulations are put in place to ensure risk diversification, avoidance of conflict of interest, asset quality, consumer protection and solvency.

- Prudential:- prudential supervision focuses on, amongst others, liquidity, policies, procedures, risk management, internal control and audit.

- Remedial:- No matter what regulators do, hiccups, crisis and even “financial earthquake” may arise. Thus remedial actions that include moral suasion, legal actions and ultimately the acquisition of troubled institutions must be planned for.

More specifically, if the regulators are to ensure a safe and sound banking system in Nigeria, the CBN should:

- Strengthen Examination and Compliance assurance tests.
- Training and Retraining of Regulators’ personnel. After all you can only regulate the system you know intimately well.
- Engage in wide consultations before the introduction of important regulations. The regulator shouldbe more of a doctor than a policeman.
- Impose prompt and firm sanctions to serve as deterrent to owners and all levels of personnel in erring banks.
- De-politicize the Boards of Regulatory Institutions. If government must put politicians on the Board of CBN, the nominees should be those with credible track records and men and women of integrity.
- Encourage banks to, deliberately, create framework for building ethical business organizations – with goals, targets and monitoring system and procedure.
- Define and assign greater responsibilities to directors and management of financial institutions to promote and ensure good corporate governance.
- Define and assign greater responsibilities to external auditors as well as seek better co-operation between regulators and external auditors, particularly, in the area of exchange of information.
- Make the Financial Service Regulation Co-ordinating Committee more robust and effective.
- Develop a comprehensive, robust and effective ‘Secondeeprogramme’ amongst members of the Financial Services. Regulation Co-ordinating Committee and between the regulators and the regulated.

- Openly frown at banking practices that kill banking habit such as:
    - The demand for high minimum deposits beyond the limits agreed in the industry as contained in the Bankers' Tariff.
- Professionally lobby the National Assembly to ensure that they do make laws that develop and promote the soundness of the financial sector.
- Strengthening the real sector through intervention financing programmes.

CONCLUSION

On a final note, we dare to suggest that in our effort to enhance the soundness of the financial sector, regulation is not probably our problem. Rather it is supervision to ensure banks are of acceptable "good behaviour" by remaining compliant with subsisting regulations.[45]This is a key,if not, the key to enhancing a sound financial sector in Nigeria.

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