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LETTER TO THE DOMESTIC SYSTEMICALLY IMPORTANT BANKS IN NIGERIA

FRAMEWORK FOR THE REGULATION AND SUPERVISION OF DOMESTIC SYSTEMICALLY IMPORTANT BANKS (SIBs) IN NIGERIA

In line with global trends, and as part of reform efforts to foster financial stability, the Central Bank of Nigeria (CBN) and the Nigeria Deposit Insurance Corporation (NDIC) have developed the attached Framework for the Regulation and Supervision of Domestic Systemically Important Banks in Nigeria. The Framework specifies among others, the assessment methodology for identifying the SIBs, higher loss absorbency and additional regulatory requirements such as liquidity, stress testing, disclosure and reporting requirements.

The Framework takes effect from March 1, 2015.

Yours faithfully,

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Framework for Regulation and Supervision of Domestic Systemically Important Banks

Central Bank of Nigeria
Nigeria Deposit Insurance Corporation

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1.0 PREAMBLE

The global financial crises, which started in 2007, have led to the need for the strengthening of the regulation of Systemically Important Financial Institutions (SIFIs). The failure of large and complex financial institutions generates severe undesirable externalities that include disruption of the financial system and the real economy. One of the fall-outs of the meltdown is the call for measures to deal with this class of institutions. Consequently, the G20 leaders at their meeting of November 2011 requested the Basel Committee on Banking Supervision (BCBS) and the Financial Stability Board (FSB) to develop a framework for Domestic Systemically Important Banks (D-SIBs)¹ in addition to the Global Systemically Important Financial Institutions (G-SIFIs).

When Systemically Important Banks (SIBs) were in danger of failure in the past, only one model of rescue had been followed which was government capital injections/bailouts and guarantees to keep the financial system stable, while shareholders lost out, as a result of dilution in shareholding. This has warranted the need for enhanced supervisory measures for D-SIBs which current regulatory policies do not adequately address.

SIBs have become the target of legislation and regulatory reforms as a result of the financial crises, which has led to increase in bank capital requirements and introduction of higher capital surcharges. Hence, the Central Bank of Nigeria (CBN) and Nigeria Deposit Insurance Corporation (NDIC), have developed a supervisory framework for D-SIBs in Nigeria. This initiative is in tandem with BCBS and other global initiatives where each jurisdiction or country designs a policy framework for the identification and regulation of their D-SIBs so as to limit the economic impact of bank distress and promote financial system stability.

¹The Basel Committee as well as the Financial Stability Board do not establish laws, regulations or rules for any financial institution directly but are only policy research and development entities; therefore they act in an advisory capacity. Thus, each country's regulators responsibilities to enact whatever portions of the recommendations they deem appropriate and define what a *Systemically Important Financial Institution* is.

2.0 DEFINITION

The Financial Stability Board described G-SIFIs as "financial institutions whose distress or disorderly failure, because of their size, complexity and systemic interconnectedness, would cause significant disruption to the wider financial system and economic activity"². A SIFI can be a bank, an insurance company, or any other financial institution whose failure might trigger a financial crisis. The BCBS has identified factors for assessing a financial institution as systemically important based on size, interconnectedness, substitutability, cross-jurisdictional activity and complexity. In Nigeria, due to the dominance of banks in the financial system, this framework shall focus on the enhanced supervision of SIBs.

This framework has adopted similar indicators used in determining G-SIFIs by the BCBS in the identification and supervision of SIBs in Nigeria.

3.0 OBJECTIVE

The objective of this framework is to ensure that all SIBs are subjected to appropriate degree of oversight and regulation. This entails defining the regulatory parameters and calibrating the intensity of oversight by the regulators.

The overall goal of this framework is to:

- comply with the BCBS requirements on Supervision of D-SIBs,
- ensure transparent assessment of the basis for their regulation,
- create incentives for stronger risk management practices that would reduce the systemic risk which SIBs pose to the system, and
- Limit the impact of external negativities on the financial system.

²The FSB designates banks as G-SIBs annually based on emerging data and publish the G-SIBs every November.

4.0 ASSESSMENT METHODOLOGY

The BCBS suggested several methodologies for identifying SIBs which include the indicator-based measurement approach, bucketing approach, supervisory judgement, periodic review and refinement. However, in this framework, the indicator-based measurement approach as well as supervisory judgement were used to determine SIBs in Nigeria.

4.1 Indicator-based measurement approach

The indicator-based measurement approach considers the following factors in the classification of SIBs:

- Size
- Interconnectedness
- Substitutability
- Complexity

Size

The size of a bank is of critical importance to the stability of the financial system and the economy. Since there is no uniform global standard for the assessment of the size of a bank, this framework adopted total assets as the principal determinant in the assessment of size.

In Nigeria, when banks are compared according to their size as measured by total assets, the data showed that the eight (8) largest banks accounted for more than 70% of the total industry assets.

Interconnectedness

The more interconnected a bank is to other financial institutions, the greater the potential for the failure of that bank to transmit distress through the financial system and the broader economy. The systemic impact of a bank greatly depends on its degree of interconnectedness with other financial institutions and can be measured by the volume of its intra financial

systems assets and liabilities³, short-term financing by interbank and money market operations. In this framework, the determinant of interconnectedness is net-interbank transactions.

Substitutability

The systemic impact of a bank's distress is greater when it cannot easily be replaced in a short term period either as a market participant or financial service provider. Typical determinants of substitutability are value of assets under custody, payments cleared and settled through payment systems, values of underwritten transactions in debt and equity markets and quantum of lending and deposits of a particular bank. This framework identified total net credits and total deposits of a bank as the determinants of its substitutability.

Complexity

The systemic impact of a bank would be higher if its business model, structure and operations make it difficult or very costly to liquidate by the regulatory authorities. Complexity can be viewed from the network of both domestic and foreign subsidiaries as well as its affiliation with institutions in other sectors of the financial system, which can complicate the process of liquidation of the bank. In tandem with Nigeria's current banking model, the major determinants considered were the branch network and number of foreign subsidiaries.

Weights

In adopting the indicator-based measurement approach, weight of 30% each was assigned to size and substitutability, while complexity and interconnectedness were weighted 25% and 15%, respectively. The determinants within complexity were assigned 12.5% each whereas determinants under substitutability were each assigned 15% weight.

³ Intra-financial system assets/liabilities is calculated as the sum of lending/deposits to/by financial institutions, holdings of securities issued by the bank or other financial institutions, net mark to market reverse repurchase agreements with other financial institutions, net mark to market securities lending/borrowings to/from financial institutions and net mark to market OTC derivatives with financial institutions.

4.2 Supervisory Judgement

The Central Bank of Nigeria applied supervisory judgement in arriving at the results that were derived from the indicator-based measurement approach of the assessment methodology. While the BCBS Indicator-based measurement approach assigned equal weights to all factors, this framework has taken into cognizance the domestic environment in assigning varied weights to the factors.

5.0 IDENTIFIED SIBs

For a bank to be continually classified as SIB, the assessment criteria must be met for six (6) consecutive months. Any bank classified as SIB would remain as such for a period of 6 months after which a re-assessment would be carried out by the CBN.

For a bank to be considered as a SIB, its “cumulative score”⁴ should be at least 5% using the indicator-based measurement approach, subject to review by the Central Bank of Nigeria from time to time. A bank that had total assets of at least 5% as well as minimum total credits and deposit liabilities of 6% each of the industry in the past six (6) months can be considered as a SIB.

6.0 HIGHER LOSS ABSORBENCY

The capital adequacy ratio (CAR) for banks in Nigeria currently stands at 10% and 15% for national/regional banks and banks with international banking licence, respectively. In the computation of CAR recommended by BCBS, Tier 2 capital should not constitute more than 50% of the qualifying capital, that is, 100% of Tier 1. However, banks designated as SIBs would be required to maintain a minimum CAR of 15% out of which Tier 2 capital should not constitute more than 25% of the qualifying capital. In other words, Tier 1 capital should be at least 75% of the bank’s qualifying capital. In addition, SIBs in Nigeria would be required to set aside Higher Loss Absorbency⁵ (HLA) or additional capital surcharge of 1% to their respective

⁴ Cumulative score represent the aggregate score of the four (4) factors used in identifying a SIB under the indicator- based measurement approach.

⁵ The Higher Loss Absorbency (HLA) policy measure is to deal with the cross-border negative externalities created by systemically important banks which current regulatory policies do not fully address. It will enhance the going concern loss absorbency of SIBs and reduce the probability of their failure.

minimum required CAR. This should be met with Common Equity Tier 1 (CET1) capital⁶. The aim of the additional loss absorbency requirement is to ensure that the SIBs have a higher share of their balance sheet funded by instruments that re-enforce the resilience of the institution as a going concern.

In a situation where the foreign subsidiary of a Nigerian bank is considered systemically important by the host authority, the Central Bank of Nigeria and the host authorities would make arrangements to coordinate and cooperate on the appropriate HLA requirement, within the constraints imposed by the relevant laws in the host jurisdiction.

7.0 ADDITIONAL REQUIREMENTS

In addition to the HLA requirement for systemically important banks in Nigeria, the following additional requirements and policy measures are considered appropriate to address the risks posed by the SIBs.

Liquidity Standards

The current liquidity ratio requirement for banks shall be imposed on the SIBs; however, this would be subject to change from time to time.

Stress Testing

Stress testing requirements are designed to work in tandem with the capital plan. The results of the test would be used to make appropriate changes to the bank's capital structure. The CBN and NDIC shall conduct periodic analysis of the capital of each SIB to evaluate its ability to absorb losses in situations of adverse economic and financial conditions.

The SIBs would be required to carry out stress test of their capital and liquidity on a quarterly basis and the result of the stress test would be reviewed by the Central Bank of Nigeria.

⁶Common Equity Tier I capital is the highest quality component of a bank's capital as it is capable of fully absorbing losses whilst the bank remains a going concern.

Recovery and resolution Planning

The SIBs shall be required to develop specific recovery plan which shall be submitted to the Central Bank of Nigeria and Nigeria Deposit Insurance Corporation by 1st January of every year.

Enhanced Supervision

There shall be greater frequency and intensity of on-site and off-site supervision of SIBs. Monthly monitoring of the key performance indicators of the SIBs shall be carried out by the CBN in order to ensure their safety and soundness as well as the going concern status of the banks. Banks shall be expected to provide high quality data to the regulatory authorities for the purpose of the enhanced supervision. In the event that an SIB has a High Composite Risk rating, half-yearly meetings shall be held with the board and management to address issues of supervisory concern.

Disclosure Requirements

The SIBs shall make quarterly disclosures of their financial condition and risk management activities to the regulators as prescribed by the Central Bank of Nigeria. The disclosures shall include but not limited to the following areas:

- Risk governance and risk strategies/business model
- Capital adequacy and risk weighted assets
- ICAAP Policy and Computation
- Liquidity/Funding
- Market risk
- Credit risk
- Operational risk
- Other identified risks

SIBs are expected to adopt international bank risk disclosure best practices.

Addendum to monthly SIB report

The current monthly report captures the following:

1. Total Credit and their classification, growth, sectoral spread or concentration.
2. Non-performing credit to Total credit.
3. Director-related credit.
4. Recoveries.
5. Top 100 Users of fund.
6. Liquidity Ratio.
7. Capital Adequacy Ratio.
8. Net-Interbank placement.
9. Government Bond and Treasury Bills holding and their Mark to Market gain/loss.
10. Unaudited Profit/Loss.
11. Net Open Position.
12. Shareholders' Fund.
13. Gain/Loss on Foreign Exchange Derivative.

In addition to the above, the under-listed shall also be monitored:

1. The top 100 users of funds should be further analyzed and related to the industry.
2. Top 50 providers of funds.

3. Government (public sector) deposits.
4. Corporate Governance issues should be reported on.
5. Liquidity Contingency Funding Plan.
6. Analysis of Contingent Assets and Liabilities containing the trend and comparison to the Total Assets and Total Credit.
7. Quarterly management report of Off-shore subsidiaries should be reviewed and reported on.
8. Details of placement with off-shore banks to be compared with the lines of credit from the correspondent banks (from FX Group).
9. Recovery plan should be monitored and reported on.
10. The quarterly disclosures of a SIB's financial condition and risk management activities should be reviewed and monitored.
11. SIBs should render monthly returns on the extent of compliance with the Basel framework. This should include risk measures, targets, violations and other measures as suggested by Basel II.
12. Quarterly unaudited financial statement.

8.0 SANCTIONS

Appropriate sanctions shall be imposed for non-compliance with the requirements of this Framework.