# IMPACT OF THE IMPLEMENTATION OF BASEL II IN THE NIGERIAN BANKING SECTOR

## Introduction

The Central Bank of Nigeria (CBN) on 10th December, 2013, announced the implementation of the Basel II and III recommendations of the Basel Committee on Banking Supervision (BCBS) with effect from January 2014. All commercial banks licensed by the CBN will be required from the said date to comply with Basel II Accord.

## History of the Basel Accords

The Basel Accords are a series of recommendations for the regulation of the international banking industry. They prescribe globally accepted standards for improving banks' ability to absorb economic and financial shocks, improving risk management practices in banks, strengthening transparency and disclosure requirements for banks and have been adopted by more than 140 countries of the world. The BCBS was formed in 1974 by the committee of Central Banks and Banking Supervisory Authorities of the G10 nations, in response to the recurrent disruptions in the international Financial Markets. First of which was the Bankhaus Herstatt crisis of 1974 which saw the German Banking Authorities withdrawing Herstatt's banking license because of its enormous foreign exchange exposures which tripled the value of its capital. This led to severe losses to other banks outside of Germany who had transacted foreign exchange counterparty businesses with Herstatt. This was followed closely in October of the same year by the collapse of the Franklin National Bank of New York which had incurred huge foreign exchange losses as a result of ill discretion in its banking practices.

The BCBS was determined to standardize the capital adequacy requirement for international banks, maintain healthy leverage ratios that will ensure their ability to meet up with their financial obligations as and when they arise.

## The thrust of the Basel Accords

The BCBS has since inception, introduced three guidelines, each of the subsequent ones seeking to review the previous in line with global practices and more recent market realities.

Basel I Accord, (the first of the three banking regulation guidelines) came into effect in 1988. It is commonly known as the Capital Adequacy Accord because its main focus was to ensure the stability of international banking systems by addressing the inequalities resulting from the variations in capital adequacy requirements for banks in different jurisdictions. The Accord provides for a minimum capital ratio of capital to risk weighted assets of 8% (that is, banks are required to maintain in their reserve at least 8% of the value of their off balance sheet exposures). There were subsequent amendments to the Basel 1 in 1991 and 1996 respectively to deal with issues of bilateral netting and market risks.

The failure of Basel I Accord to address other imminent risks (other than credit risk) associated with banking operations led to the emergence of Basel II Accord which is commonly referred to as the 'measurement of capital and standards framework of 2004'. The new framework expanded its focus to include internal assessment procedures to determine capital adequacy compliance and external disclosure requirements to encourage continued improvement in risk measurement and control. It introduced a systemic framework for assessing credit, market and operational risks.

The Basel II Accord still retained the minimum capital ratio of 8% of risk-weighted assets as provided in Basel I Accord but required banks to rely on standardized assessment methodologies of external rating agencies in the calculation of their risk weighted assets.

The third and most recent of the accords, Basel III Accord was introduced by the BCBS in October 2010 on the heels of the global financial crisis in an attempt to enhance the Basel II Accord framework to meet up with the demands of a more sophisticated financial market which saw the banks creating various forms of off balance sheet vehicles and undertaking complex securitization deals sometimes utilizing subprime assets.

The Basel III Accord establishes more stringent capital requirements, tripling the amount of capital banks must keep on hand to absorb losses during financial crisis. It also requires banks to maintain higher common equity than before, including a capital conservation buffer of 2.5% of their assets.

## Impact of the Basel Accords on the International financial market

The Basel Accords, though non-mandatory guidelines has seen the rate of compliance grow to over 140 countries as at May, 2013. The accords have set new standards of best practices which international banks now strive to attain. It has also succeeded in standardizing capital adequacy requirements across nations whilst strengthening central banks and banking supervisory authorities in participating countries through continuous engagements to address corporate governance, risk management, disclosure and other inherent issues affecting the International Finance Market.

## Probable Impact of Basel II Accord on the Nigerian Banking Sector

The CBN has indicated that it will not adopt a wholesale approach in the implementation of Basel II Accord. Instead, it has provided a set of implementation guidelines which have been varied to reflect the peculiarity of the Nigerian banking sector. To this extent, the CBN, amongst others, has varied the risk weight assigned to specific credit risks on financing transactions. The table below shows some of the risks and the assigned weights.

| DESCRIPTION OF RISK | CBN ASSIGNED WEIGHT | CORRESPONDING WEIGHT IN BASEL II |
|---|---|---|
| Claims on sovereign or central bank in domestic currency if funded in Nigerian Naira. | 0% | 0% – 150% |
| Claims on domestic Public Sector Entities (commercial and non-commercial entities owned by federal government, state government or a local government). | 100% | 20% – 150% |
| Preferential treatment of claims on banking institutions with a maturity of 3 months or less. | 20% | 20% – 150% |
| Claims on residential mortgage loans. | 100% | 35% |
| Inter-bank transactions and exposures guaranteed FGN or CBN. | 0% | 0% – 150% |
| Unrated (on – balance sheet) Securitization Instruments. | 1250% | None |
| Rated (on – balance sheet) Securitization Instruments. | 20% - 1250% | None |

The implementation of the new CBN guideline is sure to make Nigerian commercial banks pay greater attention to risk management, internal controls and underwriting standards, as the limit of the banks' balance sheet exposures will now determine their capital adequacy requirements.

Further, the guidelines have included risk ratings for securitization transactions to prevent banks from repackaging their bad or subprime loans into securities in a bid to reduce their capital requirement. Even where these securities are structured as non – recourse, they will have to meet certain prescribed risk transfer requirements criteria. However, the CBN in order to cover the field provides that all banks must hold the minimum capital against all securitization exposures whether on or off balance sheet.[i]

The CBN risk weight mechanism has however been greatly criticized for being more favourable towards credits granted to Federal Government (FGN) and its agencies. Banks will therefore be more disposed to financing FGN related projects, as they have 0% risk weight irrespective of the social impact of such projects. This by itself will impact on the availability of credit to real sectors of the economy.

**Conclusion**

The decision of CBN to implement Basel II accords is very commendable, even more commendable is the inclusion of firm controls against synthetic transactions (such as securitizations) which can be used by banks to manipulate their capital adequacy requirements. This shows that the CBN is forward looking and has infused some of the principles of the Basel III accords in its guidelines. That said, there may be a need to improve human capacity within banks and CBN to effectively implement the Basel II accord in Nigeria.

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[i] See generally CBN Guidance Notes on Calculation of Capital Requirements for Credit Risk