THE CHALLENGES OF IMPLEMENTING THE BASEL 2 ACCORD IN NIGERIAN BANKS.

By

Rufus Folorunso Akinyooye

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DEDICATION

I dedicate this research to Divine Providence that made it possible for me as an employee of Union Bank of Nigeria Plc to be moving from one important department to the other without any effort on my part throughout my twenty-seven years of service with the bank.

The knowledge I gathered within the period is the bedrock of this research.

To God is the glory.

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In conducting this research I received a lot of help from a number of people and various banks. In particular I want to express my sincere gratitude to my supervisor Dr, M. E. Abolo whose guidance made this research a success. I also want to thank Mr. Willis Ogankpa my research assistant. Thanks are also due to all my friends and associates in the banks because they saw to the response to my questionnaires. It was my promise to keep their names confidential because of the very sensitive nature of this research and the fiduciary nature of their duties.

Abstract

The Basel 2 Accord is a comprehensive framework for improving banks safety and soundness by more closely linking regulatory capital requirements with bank risk, improving the ability of supervisors and financial markets to assess capital adequacy, and giving banking organizations stronger incentives to improve risk measurement and management. The framework was laid in 1999 by the Central banks of the Group of Ten countries otherwise known as G10 comprising Belgium, Canada, France, Germany, Italy, Japan, Netherlands, Sweden, Switzerland, United Kingdom, United States, and Luxembourg. The aim is to regulate the management of risks in their large internationally active banks described as banks which insolvency could create significant distress on other banks in countries within the G10, the Organization for Economic Cooperation and Development [OECD], and the world as a whole. Such systemic banks are considered as 'significant' banks in other countries outside these two groups none of which Nigeria belongs to. This research examines the relevance of the Accord to the Nigerian banking industry and against the backdrop of the Basel 1 Accord that proceeded it with a view to determining how much it fits into the situation on ground and if not what changes will be required to make it fit so as to ensure successful implementation given the much heralded desire of Nigeria to implement the Accord. The sample population comprised 284 respondents randomly drawn from five major Banks in Nigeria. The sampling technique employed the stratified sampling technique in drawing the sample population. Two main hypotheses were formulated which were later subdivided into sixteen sub-hypotheses and were used to guide the study. The responses received on the statements made in the study were provided by using simple percentage and mean after constructing frequency tables for the items addressing each of the statement. The survey design was used in gathering information from the population under study. All the hypotheses postulated were tested at 0.05 level of significance using the Chi-square statistics. The following findings were made from the study after testing the hypotheses formulated for the study: The technical competence of the board and management of all the banks need to be fine-tuned before Basel 2 Accord can be successfully implemented. This is because the challenges posed by the Basel 2 Accord requires individual with superb technical know-how. It was recorded that there is need for Nigerian banks to be able shoulder Nigeria's debt rescheduling strategies before Basel 2 Accord can successfully be implemented. Further finding revealed that the high ownership concentration of certain board of some banks needs to be decentralized in order to remove hitches of one-man or key-man dominance before Basel 2 Accord can successfully be implemented in Nigeria. Nigeria also needs to evolve a stable political climate for any meaningful banking practice to take place even before Basel 2 Accord can successfully be implemented. The finding also showed that the present merging process of aligning different entities of mergers will need to be integrated and in line with Basel 2 Accord guidelines before Basel 2 Accord can successfully be implemented. Nigerian banks need to go beyond their present level of information technology systems which have to be integrated with their accounting systems and record before Basel 2 Accord can successfully be implemented. Similarly the present management capacity of most banks need to be overhauled and re-invigorated with directors and managers that possess the inert qualities of good banking experience before Basel 2 Accord can successfully be implemented. On the issue of risk management it was observed that a robust risk management needs to be in place before Basel 2 Accord can successfully be implemented. The issue of resurgence of high-level malpractices

such as round tripping of forex, falsification of records, insider- abuses etc also need to be addressed before Basel 2 Accord can successfully be implemented. The finding of this research also revealed that the problems associated with rendition of false returns, continued concealment need to be addressed before Basel 2 Accord can successfully be implemented. It was also recorded that inadequate operational and financial control of most banks must strictly be addressed before Basel 2 Accord can successfully be implemented. vi

Nigerian banks need to go beyond their present transparency level and always adequately disclose information (e.g. risk management strategies, risk concentration, performance measures e.t.c) to the stakeholders before Basel 2 Accord can successfully be implemented. Further result showed that Nigerian banks need to fully comply with the comprehensive risk management framework as spelt out by the Basel 2 recommendation before Basel 2 Accord can successfully be implemented. However it was observed that Nigerian bank's risk management framework need not capture all the risks the banks are likely to encounter before Basel 2 can successfully be implemented. Finally the credit ratings of Nigerian Banks need to essentially meet up with that of Basel's 2 recommendations before Basel 2 Accord can successfully be implemented. The result showed that many structural and institutional changes must take place within the Nigerian banking industry before Basel 2 Accord can be successfully implemented.

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CHAPTER 1

A) Introduction

The Basel 2 Accord is the framework laid in 1999 by the Central Banks of G10 countries to regulate the management of risks in large internationally active banks in their domain and in the Organization for Economic Cooperation and Development (OECD) member countries. The focus is on the provision of risk-based regulatory capital for all the exposures of these systemic banks to enable them withstand any threat to their solvency. The first phase of Loss Data Gathering has been operative for the past three years and is due for take-off in December this year 2006 in G10 member countries.

The Accord is being named after the city of Basel Switzerland, which is home to the Basel Committee on Banking Supervision (BCBS). The Committee comprises representatives of the Central Banks and Supervisory authorities of the Group of Ten (G10) countries of Belgium, Canada, France, Germany, Italy, Japan, Netherlands, Sweden, Switzerland, United Kingdom, United States, and Luxembourg. The Bank for International Settlement (BIS) also based in Basel Switzerland formed it.

According to the Encyclopaedia Britannica, the Bank for International Settlement itself was formed in Basel Switzerland in 1930 as the agency to handle the payment of reparations by Germany after the First World War and as an institution for cooperation among the central banks of various countries especially those that were later to become known as the G10 countries. It has been performing the latter function since and the Basel Accords are examples of it.

It should be mentioned that prior to the Basel 2 Accord there was the Basel 1, which is officially known as the International Convergence of Capital Measurement and Capital Standards. The same Basel Committee on Banking Supervision (BCBS) issued it in 1988 for compliance by G10/OECD member countries in 1992. Many countries outside the two jurisdictions including Nigeria embraced a certain part of the Accord specifically the recommendation of a minimum of 8% (10% in Nigeria) of capital to risk-weighted asset. It became effective in Nigeria in January 2004.

The idea behind both Accords is that for every identified risk listed, a bank must mandatorily set aside a regulatory capital of not less than 8% of the exposure added to its existing capital to determine its capital adequacy for the exposure. The Basel 1 Accord deals mainly with Credit risk, as that is what was perceived at that time as the cause of bank failures. The unabated failure of banks worldwide in spite of this Accord however led to the search for and discovery of more risks, notable among which are Market and Operational risks.

The role of Supervisors, the need for more disclosures by banks and the recognition of ratings of Sovereigns, and the banks and corporate located therein by internationally accredited external rating agencies came into focus. They form a sizeable lot in the Basel 2 Accord. While Basel 1 Accord succeeded in getting an international convergence on what a bank's capital should be and the standard for measuring its adequacy, Basel 2 attempts to increase the number of identifiable risks to include Market and Operational Risks and those that regulatory authorities could determine from time to time.

The calculation of the regulatory capital of any affected bank must be based on the recognition of these risks.

Meanwhile, it is worth mentioning that the on-going consolidation of banks in Nigeria, which has resulted in the liquidation of fourteen banks, is one of the spadework being done by the CBN to prepare the Nigerian banking industry for the Basel 2 Accord. According to the apex bank's publication titled "Frequently Asked Questions on Consolidation" (2005), the exercise is to increase the capacity of banks in Nigeria to meet the requirement of the Basel 2 Accord through increased capital base. It is being anticipated that an increased capital base would provide them with the resources to meet the cost of compliance including the resources to set up credit information bureaus.

The January 2006 credit ratings by Fitch IBCA and Standard and Poor's both internationally recognized rating agencies that gave Nigeria a BB-rating are also part of the spadework because a credit rating by an internationally recognized rating agency is a pre-requisite for any sovereign desiring to be recognized under the Basel 2 Accord.

So far, Nigeria has been considered by the Bank for International Settlement (BIS) as one of the Participating Jurisdictions in Africa having responded to the BIS Financial Stability Institute (FSI) Basel 2 Implementation Questionnaire (BIS2004). Expectations are thus high that Nigeria would participate if only to show the world that we are following the tide of progress. But then there are challenges in terms of human and material resources. Many structural and institutional changes are also required in the Nigerian banking industry before the Accord can be successfully implemented.

The cost implication is enormous, and to start with is the cost of the on-going consolidation exercise especially the N120billion required to pay off the depositors of the banks liquidated by

virtue of the exercise. The loss of jobs by the erstwhile employees of the liquidated banks also has its cost implication for the country.

The light at the end of the tunnel however is that a successful implementation of the Accord should produce a salutary effect on banking in Nigeria by reducing the rate of bank failures. Bank failure is an anathema in any economy, developed, developing or underdeveloped. No matter how small the bank is, its failure is usually felt in its immediate vicinity and even far beyond it. In order to develop, every economy needs a resilient banking industry.

As the erstwhile Finance Minister Dr. Mrs. Ngozi Okonjo-Iweala (2004) rightly stated, "a stable and virile financial system is crucial to the growth and development of every economy". This she said is because the financial system, particularly the banking sector performs the vital role of financial intermediation. The effectiveness and efficiency of these, she said would depend on the degree of safety, soundness and the stability of the banking system. She acknowledged the importance of the banking sector in economic development, that, she said is the more reason, governments the world over regulate it more than other sectors. In addition, she said, bank failures are widely viewed in all countries as more damaging to the economy than failures of other types of firms of similar size. She said their failure may produce losses to depositors and other creditors, break long-standing bank-customer relationships, disrupt payment system, and spill over in a domino fashion to other banks, financial institutions and markets, and even to the entire macro-economy.

Even though the Nigerian Deposit Insurance Corporation (NDIC) in its role as a government owned insurer of bank deposits would naturally come in as liquidators to line up the banks assets against its deposit liabilities, the refund of deposits is usually too little and too late.

Despite Presidential assurances, the famous soccer star Austin J. J. Okocha is yet to get back his US$1m. or so trapped in closed Savannah Bank Plc. the liquidation process of which is still pending in the courts. Most of the depositors of this bank have not been paid and no one knows when they would be. As a matter of fact Ogunleye (2004) stated that out of the 32 insured banks closed in 1998 only 9 have gotten their depositors fully repaid the statutory limits of their insured deposits as at the end of January 2004. The banks are:

(1) ABC Merchant Bank Ltd.

(2) Alpha Merchant Bank Ltd.

(3) Amicable Bank of Nigeria Ltd.

(4) ICON Ltd. (Merchant Bankers).

(5) Kapital Merchant Bank Ltd.

(6) Nigeria Merchant Bank Ltd.

(7) Pan African Bank Ltd.

(8) Premier Commercial Bank Ltd.

(9) Rims Merchant Bank Ltd.

The NDIC itself was created in 1988 as a deposit insurance scheme under the Nigeria Deposit Insurance Corporation Decree No. 22 of 1988 now Cap. 301 Laws of the Federation 1990 as amended. It commenced operation in 1989. The establishment was part of the reform measures taken to strengthen the safety net of the banking sector following the adoption of the Structural Adjustment Program (SAP) in 1986.

The primary goal of the NDIC is to maintain stability and public confidence in the banking sector by guaranteeing payment to depositors in the event of failure of insured institutions as well as promoting safe and sound banking practices through effective supervision. To achieve this goal, section 5 of the NDIC Act states the key functions of the Corporation as follows:

(a) Insuring all deposit liabilities of licensed banks and such other deposit –taking financial institutions operating in Nigeria;

(b) Giving assistance in the interest of depositors, in case of imminent or actual financial difficulties of banks particularly where suspension of payments is threatened;

(c) Guaranteeing payments to depositors in case of imminent or actual suspension of payments by insured banks or financial institutions up to the maximum amount as provided for in Section 26 of the Act;

(d) Assisting monetary authorities in the formulation and implementation of banking policy so as to ensure sound banking policy practice and fair competition among banks in the country;

(e) Pursuing any other measures necessary to achieve the functions of the Corporation provided such measures and actions are not repugnant to the functions of the Corporation.

Much as the Corporation was empowered, it has ever since its inception been battling with hydra-headed forces determined to checkmate its activities.

Below is a summary of liquidation related matters of the NDIC as at December 31, 2004:

OFFENSIVE CASES (DEBT RECOVERIES)

	No. of cases	Value
(a) Pending	1049	N14, 140,226,566.92
		US$46,589,770.13
(b) Judgment obtained	743	N6, 186,846,745.12
		US$34,141,326.19
© Judgment enforced	27	N223, 158,114.44

			US$4,244,322.99
(d) Litigation recoveries	NIL		N1, 682,310,327.58
			US$533,144.83
(e) Debt recovery cases		105	N843, 511,769.49
			US$117,049.33
DEFENSIVE CASES.			
(a) Pending		404	
Contingent Liability			N3, 230,394,583.08
			US$8,909,458.17
Counterclaim			N271, 240,082.24
(b) Judgments		91	
In favour		62	NIL
Against		29	N92, 960,142.12
(Defensive litigation settled		7	N46, 094,971.62
LIQIUDATION RELATED CRIMINAL CASES.			
Pending		18	N4, 040,800,000.00

Source: NDIC Returns 2004.

Okonjo-Iweala (2004) would want the relationship between coverage limit and moral hazard to be considered, moral hazard being the tendency of bank operators to take high risks because of the presence of a deposit insurer like NDIC. She said this is particularly important in Africa where deposit insurance tends to be confused with conventional insurance, with the result that total coverage is expected rather than the best practice of limited coverage.

B) Statement of the general problem

The problem is bank failures worldwide and the apparent inadequacy of the Basel 1 Accord to stem the tide necessitating a revision of the framework now being called the Basel 2 Accord. The official name of both Accords remains International Convergence of Capital Measurement and Capital Standards with Basel 2 having “a revised framework” tagged to it.

Nigeria as a sovereign has the additional problem of its banking industry facing enormous structural and institutional challenges that would need to be overcome before any positive result could come out of the implementation of the Accord. The structural challenge would be how the banking system as presently organized could be restructured to conform to the one envisaged by the framers of the Basel 2 Accord. The institutional challenge would be how some long-established customs in the industry and the mind-set of the practitioners and the supervisors could be changed to conform to what are being expected to be on ground before Basel 2 could be implemental. There are also legal constraints because of Nigeria's stage of development.

The cost is going to be enormous in terms of human and material resources, but no matter how long it takes, Nigeria must be seen as conforming to world standard in its banking industry if it is to retain its position in the comity of nations.

The first bank failure in Nigeria was recorded in 1930 when Industrial and Commercial Bank Ltd. the first indigenous bank was closed. About 55 banks were to fail later up to 2002 with the closure of Savannah Bank Plc. (See Tables 1 &2). Needless to say that millions of Nigerians lost their savings and investments in these failed banks and some probably lost their lives too as a result of the personal distress and hopelessness caused by their financial losses.

TABLE 1: Failed Banks in Nigeria (1936-1968)

NAME	YEAR ESTABLISHED	YEAR CLOSED
(1) Nigerian Mercantile Bank Ltd	1931	1936
(2) Nigerian Farmers & Comm. Bank Ltd	1947	1953
(3) Pan Nigerian Bank Ltd.	1951	1954
(4) Standard Bank of Nig. Ltd	1951	1954
(5) Premier Bank Ltd.	1951	1954
(6) Nigerian Trust Bank Ltd.	1951	1954
(7) Afro-Seas Credit Bank Ltd.	1951	1954
(8) Onward Bank of Nigeria Ltd.	1951	1954
(9) Central Bank of Nigeria Ltd	1951	1954
(Not affiliated with present day)		
(10) Merchant Bank Ltd.	1952	1954
(11) Metropolitan Bank of Nig. Ltd.	1952	1954
(12) Provincial Bank of Nig. Ltd.	1952	1954
(13) Union Bank of British Africa Ltd	1952	1954

(14) United Commercial Credit Bank Ltd	1952	1954
(15) Mainland Bank Ltd.	1952	1954
(16) Cosmopolitan Credit Bank Ltd.	1952	1954
(17) Group Credit & Credit Bank Ltd	1952	1954
(18) Industrial Bank Ltd.	1952	1954
(19) West African Bank Ltd.	1952	1954
(20) Bank of Lagos	1959	1968

Source: CBN Economic & Financial Rev. Vol. 6 No. 1 (1968)

The causes of the failure of these banks as could be judged from their rapidity were essentially malpractices, bad management and under-capitalization.

The scenario was to repeat itself forty-three years later when between 1994 and year 2000 the following banks collapsed.

TABLE 2: Failed Banks in Nigeria (1968-2000)

NAME	YEAR ESTABLISHED	YEAR CLOSED
(1) Allied Bank of Nig. Plc	1962	1968
(2) Amicable Bank of Nig. Plc	1991	1998
(3) Commercial Bank Nig. Plc	1988	1998
(4) Commerce Bank of Nig. Plc	1989	1998
(5) Co-operative & Comm. Bank Plc	1954	1998
(6) Credite Bank Nig. Ltd.	1990	1998
(7) Highland Bank Plc	1988	1998
(8) Lobi Bank of Nig. Ltd.	1983	1994
(9) Mercantile Bank of Nig. Plc	1971	1998
(10) North-South Bank of Nig. Plc	1988	1998
(11) Pan African Bank Ltd.	1971	1998
(12) Pinnacle Comm. Bank Ltd.	1991	1998
(13) Premier Com. Bank Ltd.	1987	1998
(14) Progress Bank of Nig. Ltd	1982	1998
(15) Republic Bank Ltd.	1989	1995
(16) United Comm. Bank Ltd.	1991	1998
MERCHANT BANKS		
(1) Abacus Merchant Bank Ltd	1987	1998
(2) Alpha Merchant Bank Ltd.	1981	1998
(3) Century Merchant Bank Ltd.	1988	1998
(4) ABC Merchant Bank Ltd.	1984	1998
(5) Continental Merchant Bank Ltd.	1975	1998

(6) Crown Merchant Bank Ltd.	1988	1998
(7) Great Merchant Bank Ltd	1990	1998
(8) Group Merchant Bank Ltd.	1990	1998
(9) Icon Merchant Bank Ltd	1975	1998
(10) Ivory Merchant Bank Ltd.	1989	2000
(11) Merchant Bank Ltd.	1987	1998
(12) Nigerian Merchant Bank Ltd.	1973	1998
(13) Prime Merchant Bank Ltd.	1988	1998
(14) Royal Merchant Bank Ltd.	1991	2000
(15) Victory Merchant Bank Ltd.	1990	1998

Source: NDIC Annual Report 2002.

C) Background to the subject matter

As mentioned earlier, the on-going consolidation of banks in Nigeria and the first ever credit rating of Nigeria by two internationally accredited rating agencies are part of the spadework for the implementation of the Basel 2 Accord. The Central Bank of Nigeria (CBN) is gradually introducing Risk Based Supervision, an integral part of the Basel 2 Accord and it is not hiding this. As a matter of fact, Basel 2 compliance is the driving force behind virtually every move in the regulatory sector these days, yet most of the practitioners are completely unaware of the challenges ahead, beyond rating and consolidation.

There appears to be no in-depth understanding of what the Accord entails especially among the operators judging from the mystique that usually dominate any conversation on it. It is as if nobody wants people to know that they have never seen or read this Accord, let alone make any judgment about it. And yet a lot of money is being sunk into every move with no clear-cut idea about the implication.

The purpose of this Research is to trace what brought about this Accord, analyze its content against the background of the Nigerian banking landscape with a view to bringing out the structural and institutional challenges that needed to be overcome for a successful implementation.

The Accord has to be demystified so that all the funds that are being sunk presently and yet to be sunk by commercial banks and the regulatory authorities in their effort to be seen as being compliant would not be in vain. It is equally important that the banking industry in Nigeria is able to identify parts of this Accord that are relevant to the country's stage of economic development and infrastructure through its history and analysis.

D) Rationale for the study

In any economy, developed or underdeveloped, bank failure is an anathema. It ripples through the economy like a tsunami leaving behind it collapsed businesses, failed dreams, broken homes and broken promises. No matter how small a bank is, even in developed economies, the failure cannot but be felt throughout the immediate surrounding and even far beyond it.

The failure of any other business hardly attracts the attention of any Government, not so for banks. At the slightest sign of weakness of any bank, either closing it down or helping it to recapitalize so as to prevent spreading the syndrome in the industry.

Prior to the adoption of what came to be known as the Basel I Accord in 1988 regulatory authorities in G10/OECD Countries believed that the Credit Risk management of banks was the cause of bank failures. For this reason, the Accord was designed to address that risk only which was defined as the risk of counter party failure to pay back what was borrowed.

Banks nevertheless continued to fail and the Group of ten (G10) Countries [Belgium, Canada, France, Germany, Italy, Japan, Netherlands, Sweden, Switzerland, United Kingdom, United States] that originally designed the Basel I Accord had to meet again to design what is now known as the Basel 2 Accord that takes into focus other risks banks are exposed to.

Nigeria recorded more bank failures throughout the 90s than any other decade in its history and already halfway into another decade at least fourteen banks have been closed down this year 2006 as part of the on-going consolidation exercise.

Compliance with the Basel 2 Accord is being expected to have a salutary effect on the health of the banking industry in Nigeria, but there are challenges.

The cost involved is also enormous and most of it could be a waste of resources if the message in the Accord was not well understood before embarking on the implementation process.

At the national level, the on-going consolidation exercise is one of the spade works for the Basel 2 Accord implementation and to say the cost is enormous will be an understatement in terms of money to be paid or not to be paid to the depositors of the closed banks put at about N120 bn. The loss of job by the employees of closed or merged banks and the mere cost of the consolidation exercise itself are additional costs to the Nigerian people.

The recently announced credit rating of Nigeria by Fitch IBCA, and Standard and Poor's rating agencies which are acclaimed internationally also involved enormous cost to the nation. These two exercises as costly as they are seem just the proverbial tips of the iceberg. Much more will come to the banks and the nation jointly and severally. Being able to provide the necessary resources will also be a challenge considering the precarious state of the economy.

The entire banking industry in Nigeria and other developing nations with the regulatory authorities should benefit from this Research.

E) Limitations

The confidential nature of all the information within the four walls of a bank and the fiduciary duties of all employees rank and file to keep them so was a major limitation in this research. The entire judgment sample had to be taken from Union Bank of Nigeria Plc and Four other high top banks in Nigeria, not only because the author considered it a fair representation of

what makes up the Nigerian banking industry, but also because information relating to the Basel 2 Accord was available mostly at the General Management level of any bank and not to all and sundry.

Even at that the focus on these banks was limited to answering of the questionnaire by its staffers to test the level of their awareness of the Accord and the challenges posed by the implementation as a mirror of the mindset of the Nigerian banking industry.

No part of this research should therefore be taken as a reflection of all the practices in Nigeria Banks. The author had at different fora, especially seminars and workshops interacted with staff of virtually all the present twenty-five banks in various cadres and sought their verbal opinions on all the issues contained in this research as they relate to the terrain of the Nigerian banking industry and challenges posed by the implementation of the Basel 2 Accord. Their responses had been identical and they are what had been reflected in this research.

The major constraint there had been the unwillingness of the staff of banks to write down anything on a questionnaire having to do with the highly confidential information relating to the Basel 2 Accord. However to overcome this constraint the researcher had to promise strict confidentiality of the information they would provide. Those that completed the Questionnaire did so mostly under anonymity and when verbal they would request not to be quoted.

F) Definition of terms.

RISK- is the probability that outcomes will vary from expectations.

CREDIT RISK- is the probability that a borrowing counter party will not meet obligations in and on time.

MARKET RISK- is the risk that changes in market conditions will affect the affect the liquidity of a bank and the quality of its assets.

OPERATIONAL RISK- is the risk of losses resulting from inadequate or failed internal processes, people and systems, or external events.

SPECIFIC RISK-is the risk of holding a long or short position in an individual equity.

GENERAL RISK-is the risk of holding a long or short positioning of the market as a whole.

COUNTRY RISK –is the risk that economic, social, and political events in a foreign country will adversely affect an institution's financial interest.

TRANSFER RISK- is the possibility that an asset cannot be serviced in the currency of payment because the obligor country lacks the necessary foreign exchange or has put restraints on its availability.

CREDIT RISK MITIGANTS (CRM)- are collaterals, guarantees, and credit derivatives.

SPECIALISED LENDING- is the financing of individual projects where the repayment is highly dependent on the performance of the underlying pool or collateral.

SECURITIZATION-is the transfer of ownership and/or risks associated with the credit exposures of a bank to other parties.

BILATERAL NETTING- is a legally enforceable arrangement between a bank and a counter party that creates a single legal obligation covering all included individual contracts. In effect a banks obligation, in the event of the default or insolvency of one of the parties, would be the net sum of all positive and negative fair values of contracts included in the bilateral netting arrangement.

CREDIT DERIVATIVE-is a contract, which transfers credit risk from a protection buyer to a credit protection seller. Credit derivative can take many forms, such as credit default options, credit limited notes and total return swaps

DERIVATIVE-is a financial contract whose value is derived from the performance of assets, interest rates, currency exchange rates, or indexes Derivatives transactions include a wide assortment of financial contracts including structured debt obligations and deposits, swaps, futures, options, caps, floors, collars, forwards and various combinations thereof.

EXHANGE-TRADED DERIVATIVE CONTRACTS- are standardized derivative contracts that are transacted on an organized exchange.

GROSS NEGATIVE FAIR VALUE.-is the sum total of the fair values of contracts where the bank owes money to its counter parties, without taking into netting. This represents the

maximum losses the bank's counter parties would if the bank defaults and there is no netting of contracts, and no bank collateral was held by the counter parties

GROSS POSITIVE FAIR VALUE-is the sum total of the fair values of contracts where the bank is owed money by its counter parties, without taking into account netting. This represents the maximum losses a bank could incur if all its counter parties default and there is no netting of contracts, and the bank held no counter party collateral.

NOTIONAL AMOUNT- is the nominal or face amount that is used to calculate payments made on swaps and other risk management products. This amount generally does not change hands and is thus referred to as notional.

OVER-THE-COUNTER DERIVATIVE CONTRACT-is a privately negotiated derivative contract transacted off organized exchanges.

STRUCTURED NOTES -are non-mortgaged-backed debt securities, whose cash flow characteristics depend on one or more indices and / or have embedded forwards or options.

TOTAL RISK-BASED CAPITAL- is the sum of tier 1 plus tier 2 capital. Tier 1 capital consists of common shareholders equity, perpetual preferred shareholders equity with non-cumulative dividends, retained earnings, and minority interests in the equity accounts of consolidated subsidiaries. Tier 2 capital consists of subordinated debts, intermediate-term preferred stock, cumulative and long-term preferred stock, and a portion of a bank's allowance for loan and lease losses.

LOOTING-is the tendency of the operators of a bank to transfer as much value as possible out of a failing institution into the hands of shareholders.

CHARTER VALUE-is the stream of future earnings of a bank with a positive discounted value.

MORAL HAZARD- is the tendency of the operators of a bank to take high risks when faced with a threat of closure due to undercapitalization.

CHAPTER II

LITERATURE REVIEW

Introduction

As a further demonstration of his break with Rome and the Roman Catholic Church, King Henry the VIII of England dissolved the monasteries in 1530.Up to that time the monasteries were where the gentry and aristocracy kept their wealth of gold. They had to move them to the Towers of London only to have them seized by King Charles 1(1600-1649) to finance his Wars. The English Civil war and the unsettling aftermath led the gentry and aristocracy to seek a safer place for their gold and this they found in the vaults of the London goldsmiths. By 1677 there were forty-four goldsmiths in London who accept gold for safe-custody giving receipts in exchange. As mentioned above the receipts became the forerunner of banknotes. Their clients could also request a fractional sum to be given to a third party, and these too eventually became the forerunner of modern day cheques.

a) The history of Money and the banks

According to Joe Cribb (1999) it is not known exactly when money was first used. The oldest written record of it he said, are from Ancient Mesopotamia (now in Southern Iraq) about 4.500 years ago. Ancient Mesopotamia cuneiform inscriptions according to him, describe payments being made with weighted amount of silver. Since then, weighted amount of metals have been used as money in many parts of the world, and this led to the invention of coins.

Cribb (1999) also show that in other parts of the world many items had been used as money in the past. Examples of these are stone discs used to make social payments and settle disputes by the people of Yap, an island in the Pacific Ocean, Iron hoes used by the Sudanese and ancient Chinese to make payments; bars of rock salt widely used as money in Ethiopia, Cowries shell, used for payments in China (about 3.500 years ago) India, Thailand and Africa especially Nigeria, whose people also used copper rings known as manilas. Tiny red feathers glued together and tied on to vegetable fiber coils that could be up to 30 feet (10m) long were used by the Pacific Islanders of Santa Cruz as money, while a belt of beads known as wampum made from white and purple clam shells once served as money among North American Indians.

Here in Nigeria, Arab traders first introduced cowry and manila into West Africa in 1870. Portuguese traders, whose monopoly of trade in West Africa was eventually broken when the British arrived a few years later, popularized the two items. Prior to that time trade in whatever Nigeria was then, was by barter.

The British introduced the use of silver coins in Nigeria through the establishment of African Banking Corporation in 1892. Elder Dempster founded the bank and it enjoyed the monopoly of issuing legal tender British silver coins (the only money in circulation then). In 1893 its business operations were taken over by the then newly established British Bank for West Africa that was to become the forerunner of present day First Bank of Nigeria Plc. It enjoyed the monopoly until the creation of the West African Currency Board in 1912. The Board was established to issue and it did issue a West African currency convertible to British Pound Sterling to facilitate the British-West African trade.

In 1913, special British silver coins were introduced into the four British colonies of Nigeria, Ghana, Sierra Leone and the Gambia in the denominations of three pence, six pence, one shilling, and two shilling. They were declared legal tender in June of that year.

According to Cribb (1999) the earliest known coin were made during the 7th Century B.C in the Kingdom of Lydia (in modern day Turkey). Weighted lumps of electrum (a mixture of gold and silver) were reportedly used by the Lydian as money, and were stamped with pictures to confirm their weight and therefore their value in payments. The shape of the coins was unimportant but the stamp on it was a personal seal that identified the person that guaranteed the coins weight. The Lydian invention was the first and because it was a success it was developed in Europe to standardize other forms of metal money, like copper lumps in Southern USSR, and Italy, bronze tools and shells in China, silver rings in Thailand, gold an silver bars in Japan. Coins being metals weigh heavily some at 3.5kg and when this is combined with the unique title to money that passed automatically to whoever is holding it the importance of its safekeeping comes to be recognized and appreciated.

.Cribb (1999) said it was the Chinese who first saw the advantages of handling money in the form of printed-paper documents. During the 10th Century according to him, the Chinese government issued heavy iron coins that were worth little. People started to leave their coins with merchants in exchange for the merchant's handwritten receipts. In the early 11th Century, Cribb said, the government took over from the merchants and printed receipts that could be officially used as money though with fixed values to make the system simpler. Murray N. Rothbard in his book The Mystery of Banking says that since printing was first invented in

ancient China, it should not be surprising that government paper money began there as well. He said it emerged when the government had to find an alternative to the physical transportation of gold collected in taxes from the provinces to the capital Beijing. As a result, in the mid-eighth century, provincial governments began to set up offices in the Capital selling paper drafts, which could be collected in gold in the provincial capitals. He said in 811-812, the central government outlawed the private firms involved in this business and established its own system of drafts on provincial government called "flying money". According to Rothbard the first government paper money in the Western world was issued in the British American province of Massachusetts in 1690. The province, he said, was accustomed to engaging in periodic plunder expeditions against the then more prosperous French Quebec. The successful plunderers would then return to Boston and sell their loot. They were however beaten back early in 1690 and the soldiers returned to Boston, the provincial capital, empty handed and in dire need of their pay. To avoid the catastrophe that could follow should the disgruntled soldiers become unruly, the Massachusetts government tried unsuccessfully to borrow about four thousand pounds sterling from Boston merchants because of its unfavourable credit rating at that time.

It therefore decided in December 1690 to print seven thousand pounds in paper notes, and use them to pay the soldiers with a two-fold pledge that it would redeem the notes in gold or silver out of tax revenues in a few years, and that absolutely no further paper notes will be issued. More paper notes were to be issued by the government later and even those given to the soldiers continued unredeemed for nearly forty years.

Cribb (1999) further disclosed that the origin of the word "dollar" might have come from a corruption of the word "thalers" which is a shortening of Joachimshtalers. He said during the 15th century, the discovery of large silver mines in Joachimsthal in Bohemia (modern day Austria) led to the issue of new, large, silver coins called Joachimshtalers. The silver from this mine was reportedly exported throughout Europe as "Thalers" in various denominations as coins soon to be "dollars" in the U.S. According to Cribb (1999) the Swedish Stockholm Bank began to issue Europe's first printed paper money in 1661 following a shortage of silver coins. They were issued in "thalers" of various denominations.

As already mentioned above the gentry and the aristocracy of London had found haven for their gold wealth in the vaults of the London goldsmiths who gave them receipts to pay creditors and they were to become the forerunner of modern day cheques. The paper money idea soon spread to Japan where feudal clans and temples acting as banks began issuing notes in the 17th Century. At about the same time printed paper money began to be issued in the United Kingdom. A Scotsman John Law introduced the paper money idea to France and in 1718 the bank that he had set up in Paris received the French king's approval to issue notes valued in silver coin. A Norwegian Jorgen Thor Mohlen issued the first paper money for circulation in Norway in exchange for coins that he used to fund his businesses. Pope Paul V established Europe's first national bank called Bank of the Holy Spirit at Rome in 1605. Its "scudi" note was first issued for circulation in 1786 during the reign of Pope Pius VI (Cribb 1999).

As could be seen in these beginnings, banks and individuals were the issuers of bank notes in exchange for the value of metal coins deposited by the individuals. These individuals circulate the notes for commercial transactions until a holder in due course of any of the notes decided

to redeem it from the issuing bank for the gold or silver coin it represented. In effect while the governments were minting coins, the circulation of paper money was a private affair between individuals and their banks.

The Royal Bank of Scotland traced the history of British banking on its web site and according to them an Act of 1708 restricted banks with more than six partners from issuing bank notes. As a result many of the then new banks remained small partnership well into the nineteenth century, in order to retain this very profitable right of note issue. Indeed, it says, in 1784 only seven banks had more then one office and this led to the formation of an increasing number of separate but allied banks. In response to these developments in the provinces says RBS two distinct kind of banks were emerging in England in the forms of the West End bankers with a clientele of landed aristocrats and the City bankers serving merchants and manufacturers and acting as agents to country banks. The majority of British banks in Georgian Britain were partnerships with their solvency dependent on the personal wealth of the partners and the confident they could command in the local community. This appears to be the reason for the people's above-board expectation of modern day bank workers. They are expected to be impeccable in their character and like Caesar's wife, to be above board. RBS disclosed that many banks collapsed during the early nineteenth century when sudden "runs" i.e. panic cash withdrawals by nervous customers rendered them insolvent. More banks failed forcing the United Kingdom government to permit from 1826 the formation of joint stock banks allowing the risk to be spread amongst many proprietors.

Lancaster Banking Company was said to become the first British joint stock bank in 1826. Many others were established thereafter with many branches across England and Wales. The issues of banknotes had to be dealt with by the passage of the 1844 Bank Charter Act by the government of Sir Robert Peel regulating the issue of English banknotes. A year later a similar act was passed limiting the note issue of the nineteen banks in Scotland and requiring any excess to be partly covered by bullion reserves. The result was to stop the formation of new banks and perpetuate the tradition of separate Scottish note issues. More banks failed later including Overend, Gurney and Co. in 1866 and City of Glasgow Bank in 1878 (RBS 2005).

It is worthy of note that with a bank being Sole Proprietorship or a Partnership the prime movers are not insulated in the event of a collapse. As a matter of fact, they face ruins in their private lives. As limited liability companies however they only need to obtain license to operate and open even just a branch office. Depositors' cash would start flowing in from the very first day, available for their use any way the operators liked. If the bank failed they simply go home. Honohan (1997) identified this problem as one of the three failure syndromes under "Poor management and other microeconomic deficiencies" His review of international experience shows a multitude of cases where the simplest explanation for bank failure is poor management manifested partly in self-lending or lending to entities associated with the bank's shareholders or managers. He said as a matter of fact that over the years, many banks – even successful ones – have been set up with the idea of providing a convenient and inexpensive form of financing to the founder's enterprises.

Back home here in Nigeria this has been the underlying cause of many bank failures. Below are examples.

HIGHLIGHTS OF FACILITIES GRANTED TO OWNERS AND DIRECTORS OF SOME SELECTED BANKS IN-LIQUIDATION

S/N	BANK IN-LIQUIDATION	NO OF DIRECTOR INVOLVED	AMOUNTS AT AS CLOSURE	% OF TOTAL RISK ASSETS GRANTED TO OWNERS
1.	Alpha Merchant Bank Plc	11	1,314,418,700.43	33%
2.	United Commercial Bank Ltd.	5	741,755,808.86	30%
3.	Financial Merchant Bank Ltd	1	383,061,096.00	100%
4.	Highland Bank of Nig. Plc	12	33,197,157.58	38%
5.	Commercial Trust Bank Ltd.	1	247,749,719.10	38%
6.	ABC Merchant Bank Ltd	8	272,981,634.00	49%
7.	Royal Merchant bank Ltd	7	646,940,182.23	69%
8.	North-South Bank of Nig. Ltd.	13	240,668,637.62	32%
9.	Abacus Merchant Bank Ltd.	14	568,888,254.11	47%
10.	Credite Bank Nig. Ltd	6	379,634,611.47	76%
11.	Prime Merchant Bank Ltd	1	539,292,310.00	64%
12.	Amicable Bank of Nig. Ltd.	7	149,854,896.00	56%
13.	Century Merchant Bank Ltd	5	272,072,261.00	32%
14.	Group Merchant Bank Ltd	13	595,836,077.20	80%
15.	Commerce Bank Plc	4	1,294,851,665.64	52%
16.	Pinnacle Comm. Bank Ltd	10	298,766,751.76	20%
17.	Republic Bank Ltd.	1	161,375,466.00	38%

SOURCE: NDIC QUARTERLY JUNE 2002

Honohan (1997) appreciated this kid-gloves treatment when he said, "such lending is tightly constrained by regulation in most countries, but the regulations are frequently evaded, bypassed or waived". Otunba W. O. O. Ajayi the founder of Financial Trust Bank Ltd (Item 3 above) pocketed 100% of the deposits brought to his bank by customers and even though he was sent to jail other Directors of failed banks were not that unfortunate.

In 1900 according to the RBS (op. cit) there were around 250 private and joint stock banks in Britain even though the business of banking was limited in scope. Only the well to do kept personal bank accounts and services were largely restricted to the provision of loans, current and deposit accounts, and safe custody facilities. Virtually all bank employees were men. The outbreak of the First World War brought in a period of rapid change in the banking industry according to RBS as the banks were drawn into funding the government war loans and advances and note issue increased rapidly. Many bank officers and temporary junior clerks, and the recruitment of female staff on an unprecedented scale filled the vacancies created by enlisted clerks of military age.

Mergers followed thereafter to create the present "Big Five" in British banking of Westminster. National Provincial, Barclays, Lloyds and Midland Banks. (RBS op. cit). The present day Bank of England was founded in 1694 as a Commercial bank by a Scot named William Paterson with a capital of £1.2m, which was advanced to the British government in return to issue notes up to that amount. It was privately owned until 1946 when an Act of Parliament provided for its nationalization . In 1997 the bank was given power to set interest rates while its supervision of the British Banking industry was transferred to the Security and Investment Board.

In the United States commercial banks started out as state chartered banks.

Under this system a bank could only begin operations by a specific act of state's legislature.

The charter issued by the legislature would specify in what activities the bank could and could not engage, the interest rate that could be charged for loans and paid on deposits, the reserve ratio, the necessary capital ratio and so forth. The issuing state was also responsible for regulating the activities of the banks it created.

The first bank licensed in this manner was the Bank of North America in 1782.

It operated in Philadelphia and was modelled after the Bank of England that was then a Commercial bank. It was permitted to accept gold and silver coins, also called specie for deposit and to issue banknotes in exchange. State chartered banks continued to grow from then on and they continued to issue bank notes some in excess of their specie deposits.

Banknotes as originally known were not money.

Money was in gold or silver coin according to Article 1, Section 10 of the United States constitution. Under the U. S. Statute Code the terms "lawful money" is to be construed as gold or silver coin of the United States.

The United States Coinage Act of 1792 provides in Section 11

that the "proportional value of gold to silver in all coins which shall by law be current as money within the United States". In effect up till today in the United States constitution gold and silver coins are the legitimate money of that country (McCarthy 2004). As individuals took possession of these coins through commerce however they deposited them in banks that gave them their notes promising to redeem the note for the value of gold or silver deposited. The banks however could and they did go a little further by issuing these same notes representing loans to individuals that came to them asking for funds. Problem would come when news, true or false circulates that the bank was having problem redeeming its notes. Holders of notes of the bank would rush to it (a run) and demand redemption and with all the specie on deposit gone, a bank would have to close its doors for good.

Central banking came slowly to the United States as Congress

chartered the first Bank of the United States in 1791 to engage in general commercial banking and act as the fiscal agent of the U. S. government. Its charter was not renewed in 1811. A similar fate befell the Second Bank of the United States chartered in 1816 and closed in 1836. In 1838 the State of New York adopted the Free Banking Act, which permitted anyone to engage in banking, upon compliance with certain charter conditions. Free banking spread rapidly to other states, and from 1840 – 1863 all banking business was done by State – chartered institutions. In many Western States according to the Encyclopedias it degenerated into "wildcat" banking because of the laxity and abuse of state laws. Bank notes were issued against little or no security, and credit was over expanded; depressions brought waves of bank failures especially the multiplicity of State bank notes, which caused great confusion and loss. The congress of the United States had to pass the National Bank Act of 1863, which provided for a system of banks to be chartered by the United States government.

An amendment to the Act in 1865 granted banks chartered to issue bank notes and placed a prohibitive tax on state bank notes thus bringing all banks under federal supervision. Most banks in existence at that time became federally chartered but some being banks of deposit were unaffected by the tax and continued under their state charters, thus giving rise to what became known as "dual banking system".

Recurrent banking panics caused by over-expansion of credit, inadequate bank reserves, and inelastic currency prompted the United State congress in 1908 to create the National Monetary Commission to investigate the banking and currency fields and to recommend legislation. The result was the passing of the Federal Reserve Act of 1913. The Act created the Federal Reserve System, which according to the Encyclopaedias is the central banking authority of the United States. It acts as a fiscal agent for the U.S government, is custodian of the reserve accounts of Commercial banks, and is authorized to issue Federal Reserve Notes (the dollar bills) that constitute the entire supply of paper currency of the United States of America. It consist of the Board of Governors, the 12 Federal Reserve Banks, the Federal Open Market Committee, the Federal Advisory Council and Consumer Advisory Council. Member banks are in the thousands and the U.S. government holds no share. A Federal Reserve Bank is a privately owned corporation established under the Federal Reserve Act to serve the public interest; it is governed by a board of nine directors, six of who are elected by the member banks and three of who are appointed by the Board of Governors of the Federal Reserve System.

The 12 Federal Reserve Banks are located in Boston, New York, Philadelphia, Chicago, San Francisco, Cleveland, Ohio, Richmond, Virginia; Atlanta, Georgia; St. Louis, Missouri, Minneapolis, Minnesota, Kansas City, Missouri; and Dallas, Texas. The Federal Open Market Committee, consisting of the seven members elected by the Federal Reserve banks is responsible for the determination of Federal Reserve Bank policy in the purchase and sale of securities in the open market.

The Federal Advisory Council consists of 12 members one of who is elected by the board of directors of each of the Federal Reserve districts. All national banks are required to be members of the Federal Reserve System, and state banks may become member if they

met membership qualifications. The entire banking system of the United States is thus in private hands as the United States government depends on the Federal Reserve System popularly known as "the Fed" to borrow by issuing its own bond through the Treasury Department payable to the Federal Reserve. The "Fed" in turn credits the Treasury authorizing it to print the dollars up to the face value of the bond. This is what it would use to purchase the U.S. government Bond thereby releasing this volume of money into circulation. Should the Fed want to reduce the supply of money it sells any of the U.S government bonds in the open –market to God-knows-who but through a member bank of the Federal Reserve (Samuelson 1973) whose account the Fed would debit to retire the face value of the bond sold. This is the Open-Market operation of the Fed and it is the most powerful in the control of money supply in the economic system of the United States. The other two methods are the adjustment of the legal reserve ratio of member banks and the manipulation of the discount rate to regulating of the discount rate to regulate the money supply.

According to the Encyclopaedia Britannica the early 20th century was the great era of the international gold standard. Gold coins circulated in most part of the world; paper money, whether issued by private banks or by government was convertible on demand into gold coins or gold bullion at an official price and bank deposits were convertible into either gold coin or paper currency that was itself convertible into gold. There was at that time single world money called by different names in different countries. A U.S. dollar for example was defined as 23.22 grains of pure gold (25.8 grains of gold 0.9000 fineness). A British pound sterling was defined as 113.00 grains of pure gold (123.274 grains of gold 11/12th fine). In effect one British pound equals 4.8665 U.S. dollars at the official parity. In a few countries there was the gold-exchange standard under which the currency was convertible at a fixed price into the currency of usually the British pound, which was itself convertible to gold.

That was the gold-standard era and under it the quantity of money in each country was determined by the specie-flow adjustment analyzed by the 19th Century economists.

Internationally, an inflow of gold into a country triggers a rise in its money supply and tends to raise prices in that country relative to prices in other countries. Goods from

that country would become expensive and would thus discourage exports while encouraging imports. The demand for foreign currency to pay for imports and the decrease of it because the country was not exporting would raise the price of foreign currency until it becomes cheaper to pay for imports by exporting gold to the exporting countries to obtain the foreign currency needed. As gold continues to move out of a country the money supply decreases and prices would start coming down. The scenario would start repeating itself in the country that was exporting. A boom and burst scenario. In effect, even though the gold standard was useful in the control of money supply at home, it was cumbersome for international trade, as countries would have to be exchanging gold to pay for goods and services. A monetary realist even suggested that if the world should go back to the gold standard, its economy would be in the hands of countries like Russia and South Africa having enormous deposits of the commodity (Hein 1998). Another major obstacle to the gold standard is that it would not allow governments to do whatever it wanted to do in terms of policy whereby it could decide to create jobs, undertake projects it considered worthwhile or engage in expansionist tendencies like fighting wars. For these reasons, throughout the period of the European revolutions, governments were going on and off the gold standard until the Great Depression of 1930 after which it could be said that they permanently went off.

The Great Depression itself was an approximately 10 year economic slump affecting all Western industrialized countries. It started with the collapse of the United States stock market in 1929 the reason for which included the proliferation of bank holding companies and investment companies creating debts and large bank loans that could not be liquidated. Many banks were forced into insolvency and in the U.S alone in 1933 11,000 out of its 25,000 banks failed. From the U.S. the depression became international because of the special and intimate relationship that had developed between the industrialized nations after the First World War. The United States had emerged from the war as the major creditor and financier of post-war Europe whose national economies had been greatly weakened by the War. With the collapse of the U.S. economy, its flow of credit to the European nations dried up and theirs started collapsing as well. Great Britain and Germany were the hardest hit as they were the major beneficiaries / debtors of the U.S.

Prior to the Depression, governments usually expected the impersonal market forces of the private sector to eventually correct imbalances during business down turns. They failed that

time, and this inspired the government to effect fundamental changes in their economic structures collectively including control measures to ensure economic stability.

Among the measures taken in 1933 was President Franklin

D. Roosevelt's devaluation of the gold content of the dollar to 59.06 percent of what it had been formerly and beginning in 1934 of a silver purchase program. Also in 1933 the United States Congress raised the buying price of gold from about US$21 to US$35 an ounce and called in all solid gold items except those tied up in wedding rings, dental fillings, and rare coins. The official explanation for this was to prevent holders and hoarders of gold from making a windfall profit from the devaluation of the gold content of the dollar. All gold certificates were also called in and Congress ruled that they were not to be exchanged for gold upon being called in but simply for ordinary paper dollars. From this point on the citizen's ownership of gold in certificates and coins ceased to exist (Samuelson 1973). All the gold bullions confiscated by the United States government have been in the United States Gold Bullion Depository in Fort Knox, Kentucky U.S. A. since 1938. They are stored in concrete and steel vaults inside a bombproof building under heavily armed guards (Cribbs 1999).

According to Wikipedia, the free Encyclopaedia the United States of America as at the 14th of July 2004 holds the largest official reserves of gold in the whole world at 8,136.4 tonnes. Others in tonnes are as follows:

- Germany 3,439.5
- IMF 3,217.3
- France 3,024.6
- Italy 2,451.8
- Switzerland 1,515.9
- Netherlands 777.5
- ECB 766.9
- Japan 765.2
- China, Mainland 600.0
- Spain 523.3
- Portugal 482.3
- Taiwan 423.6
- Russia 390.1
- India 357.8
- Venezuela 357.1
- Austria 317.1
- United Kingdom 312.5

- Lebanon 286.8
- Belgium 257.8
- Philippines 243.9
- BIS 194.3
- Sweden 185.4
- Algeria 173.6
- Libya 143.8
- Saudi Arabia 143.0
- Singapore 127.4
- South Africa 123.8
- Turkey 116.1
- Greece 107.5
- Romania 105.1
- Poland 102.9
- Indonesia 96.4
- Thailand 82.7
- Australia 79.7
- Kuwait 79.0
- Egypt 75.6
- Denmark 66.5
- Pakistan 65.3
- Kazakhstan 55.3

The gold certificates however are being held by the Federal Reserve to form a bulk of its assets next in value only to U.S. government securities, on its balance sheet (Samuelson op. cit)

Other measures taken include the 1933 passages of the

Glass-Steagall Act and the Banking Act. The former prohibited commercial banks from involvement in the securities and insurance businesses while the latter strengthened the powers of supervisory authorities, increased controls over the volume and use of credit, and provided for the insurance of bank deposits under the Federal Deposit Insurance Corporation (FDIC). The Banking Act of 1935 altered and strengthened the powers of the Federal Reserve Board of Governors in the field of credit management tightened existing restrictions on banks engaging in certain activities, and enlarged the supervisory power of the FDIC. Within that decade in 1930 the Bank for International Settlement (BIS) was formed to administer the Treaty of Versailles Owen F. Young Plan on the war reparation of 121, 000, 0000, 0000 Reich marks in 59 annuities imposed on Germany after the First World War. The Great Depression led to the inability of Germany to pay the agreed installments, which Great Britain and France badly needed,

for reconstruction. The development contributed in no small measure to the debilitating impact of the depression on those countries. Adolf Hitler came to power in Germany in 1933 and repudiated the Treaty of Versailles including the war reparation. The BIS was to emerge later and remain an integral part of world finance up till today.

The United States is undoubtedly the most powerful economy in the world and all other countries after the collapse of the Soviet Union seem to follow them. The banking and monetary structures however are what the third world appear not to fully comprehend.

Commercial banking started out as an almost private affair between a bank and its customers. And then the government stepped in to regulate by first taking over the issue of notes, and then confiscating the gold backing the notes and replacing it with more notes that are not redeemable and putting the entire operation in the hands of a privately owned corporation – the Fed.

Despite all the reforms under President Roosevelt the Depression wore on. It took the advent of the Second World War to breathe life into the economy of the United States. According to the Encyclopaedia Britannica, during the New Deal years of President Franklin Roosevelt the American response to threats of war in other parts of the world was to seek security through isolation. Series of neutrality laws were enacted by Congress to keep the United States out of any new conflict, not even the outbreak of the Spanish Civil War in 1936 could tempt the country into war.

And then Germany invaded Poland in 1939 to touch off the Second World War. The United States Congress had to revise the Neutrality Act to allow Great Britain and France at war with Germany to purchase arms on a cash and carry basis. In 1940 France fell to the Germans and the U.S had to throw all its support to Great Britain. President Franklin Roosevelt had to campaign for and won an unprecedented third term to prosecute the war. On December 7, 1941, Japan bombed Pearl Harbour in the United States to drag that country fully into the Second World War. The following day December 8, 1941 the United States declared war against Japan. With the United States fully at war the economy was revived and progress came into the country at an unprecedented pace because of the production generated by the war effort.

The Bretton woods agreement

The Second World War was still raging in July 1944 when 730 delegates from all 44 Allied Nations (i.e. the members of the United Nations during the war including the signatories to the Treaty of Versailles of 1920) gathered at Mount Washington Hotel situated in Bretton Woods, New Hampshire, U.S. A. for the United Nations Monetary and Financial Conference. Victory was already at hand for the Allied Nations and what remained a hard nut to crack was an economic system that would lead the world away from the impromptu bilateral agreements among states which had characterized financial regulatory co-operation up to that time. They were more of fire-fighting approaches than a planned global regulatory system for trade and finance.

Within the first three weeks of July 1944 the planners at Bretton Woods led by the United States and Great Britain succeeded in setting up a system of rules, institutions and procedures to regulate the international political economy. They established the International Bank for Reconstruction and Development (World Bank), the International Monetary Fund (IMF) and brought in the Bank for International Settlement with the sole purpose of influencing the reserve policy among the Central banks of members.

The most significant achievement of the Bretton Woods Conference was the pegging of the exchange rate among member countries (notably the G10) at US $35.00 to an ounce of gold thus making the United States dollars the reserve currency of the world virtually replacing gold. Member countries agreed to maintain the parity with 1% plus or minus. Central Banks of the world put their reserves in U.S. dollars and at the pegged rate the United States had enough gold to redeem its dollars in circulation.

And then came the 60s when the fear of the spread of communism in Asia gradually saw the U.S getting involved militarily in Viet Nam. It needed more dollars than those in circulation to finance its troops in that country and so had to print more dollars with no backing of gold. More dollars continued to be printed and because of the fear that there may not be enough gold to redeem the avalanche of dollars, a run on gold ensued, driving up the price of the commodity. The price started an upward climb so much that US$35.00 could not buy an ounce of gold anymore in the late sixties.

In August 1971 the United States closed the “gold window” by refusing from then on to exchange the dollar for gold. By the middle of 1972 gold was selling for US$70.30 an ounce. In February 1973 the Bretton Woods Currency exchange agreement collapsed and the “gold window” there was closed with a negotiated price of US$44.00 an ounce. A floating exchange regime replaced it when it re-opened in March1973.

The road to the Basel Accords

Braithwaite and Drahos (2001) said that it would be an exaggeration to say that the whole Bretton Woods system broke down. What broke down was the pegged exchange rate agreement that made the U.S dollar convertible to gold. After all, the structures created by the Bretton Woods Accords are still standing and waxing stronger by the day in the likes of the World Bank, IMF and the Bank for International Settlement (BIS). The floating exchange rate regime that succeeded the closed Bretton Woods “gold window” brought doom to the economies of the G10 countries and by extension the rest of the world as banks that were holding large foreign currency denominated assets started collapsing. The decision of the U.S.

to close its gold window was unilateral and the run on gold that preceded the announcement did not allow many banks to protect themselves. Because the Bretton Woods exchange rate agreement was a universal one, its breakdown threw the entire economies of the world into what was once the exclusive preserve of developed economies i.e. the printing and circulation of fiat money. After the collapse of the Bretton Woods exchange agreement the first bank to fail was Herstatt Bank in Germany in June 1974. The failure of this bank, which was the largest, and the most spectacular failure in German banking history since 1945 (BCBS 2004) was attributed directly to the collapse of the Bretton Woods exchange accord. The bank had speculated on the foreign exchange market, which became riskier under the post Bretton Woods free-floating currencies system. The bank's failure reverberated throughout the world as banks exposed to Herstatt suffered losses at the end of the day that its licence was withdrawn giving rise to what became known as the "Hersatt risk" in the financial world's parlance (ibid).

To the rescue came the 1974 inflow of petrodollars to the oil producing nations of Middle East and Latin American countries and their outflows to the banks in G10 countries. The increase in fuel bill impoverished non-oil producing underdeveloped economies and they had to look for funds to meet up. On the other hand banks in G10 countries were awash with loanable petrodollars from oil producing countries and glee fully they lent to the hungry non-oil producing countries, which were under puppet dictatorial, and corrupt regimes favoured by the United States for their anti-communist postures. It is noteworthy that at this time most of the G10 countries had put in place some sort of insurance over deposits in their commercial banks patterned after the Federal Deposit Insurance Corporation (FDIC) in the United States established by the Banking Act of 1933. Where a separate body did not exist, the country's Central Bank stood by the banks, which would be lending through the International Monetary Fund (IMF) anyway. These lending G10 banks, which came to be known as "internationally active banks", lend as a consortium through the IMF, which would on-lend to be the lenders to the third world countries having balance of payment deficits because of the oil crisis. (Stambuli11998). It follows that any default would reverberate throughout the countries of lending banks.

As less developed countries borrowed short term to service their debts through G10 banks their debts grew by leaps and bounds because they must not default. Mexico was the first to throw in the towel in 1982 by announcing on September 6 of that year the postponement of all debt payments until the end of 1983. This was a potential crisis for internationally active banks, which had lent Mexico huge sums over the previous eight years. Within the international financial system several banks had lent to Latin American countries considerably more than their total capital. In 1982, claims of selected U.S. banks on 4 major Latin American debtors namely Mexico, Brazil, Venezuela, and Argentina were US $176billion. The eight largest banks in the U.S.namely Citicorp, Manufacturers Hannover, Bankers Trust, Bank America, J. P. Morgan, First Chicago Chase Manhattan and Chemical were owed US$37 billion on that amount representing 147% of their capital and Reserves. If other countries were to follow suit, a number of internationally active banks would have collapsed or forced to be rescued at enormous cost to their countries taxpayers. Since half of the debts of less developed countries originated from non-U.S. banks, the debt crisis became international. Memories of the Great Depression of the 1930s loomed large (Lutz 2000). Once again the banks had over lent and were faced with defaults. The IMF had to come up with subsidies, debt re-scheduling

and forms of agreements between creditor and debtor countries to stabilize the situation so that the loans could continue to be serviced. In the U.S. 80 banks including Continental Illinois collapsed in 1984 (BCBS 2004). The collapse of Continental Illinois that was considered then as being "too big to fail" brought home to the United States Government the need to cooperate with other G10 countries to evolve a risk management process that would ensure that banks have adequate capital to withstand occasional upheavals. The Basle Committee on Banking Supervision (The Basle Committee) an organ of the Bank for International Settlement (BIS) was commissioned to investigate the state of capitalization of member countries' internationally active banks and to review the techniques they use to calculate capital (Lutz 2000). It is noteworthy that up to that time the word "capital" meant different things to different G10 countries. While the United States was using the fixed rate approach, the United Kingdom was using the risk-based approach set between the Bank of England and individual banks. In Germany, Supervisory agencies and leading banking associations decided. In Japan the banks were undercapitalized (ibid).

The outcome of the deliberation of the Committee is what came to be known as the Basel 1 Accord.

BASEL 1 ACCORD – International convergence of capital measurement and capital standards.

Item 1 - Declares that the report represents the outcome of the Basel Committees work over several years to secure international convergence of supervisory regulations governing the Capital adequacy of international banks.

The significance of this declaration is that even the Basel Committee set up by the G10 countries still had a tough time convincing member countries to alter their concept of a bank's capital and come to agree on a uniform measurement of capital adequacy and the minimum standard to be achieved.

Lutz (2000) traced the history of this issue from the 70s when there was divergence in the concept of regulatory capital of banks among the banks especially in G10 countries. According to her, there was on the one end the more static or fixed rate approach (gearing ratio) long used in the United States, Canada, and Japan. On the other end was the more flexible, risk-based approach implemented in the United Kingdom, Germany, France, Switzerland, Belgium, Sweden, and the Netherlands. The fixed rate model in the United States by then prescribed banks to calculate their reserves based on a fixed capital-to-asset ratio of 5.5%. This meant that for every $100 in bank investment, American banks were required to put $5.50 in reserves, regardless of the actual risk involved in the transaction.

For Germany and the United Kingdom the regulatory capital was more risk- based as banks booking riskier loans were being made to provide larger reserves, while the less risky assets were rewarded with lower percentages of regulatory capital. In the United Kingdom, for example, the capital ratios were set through informal agreement between representatives of the Bank of England and the managers of the individual banks, whereas in Germany the national regulatory authorities worked out a trade wide standard in cooperation with the banking associations.

Item 2 - States the intention that national authorities of member countries would prepare papers setting out their views on the timetable and the manner in which the Accord would be implemented in their respective countries with a view to implementing it as soon as possible. It further stated that the document was being circulated to supervisory authorities in countries outside the G10 for banks conducting "significant" international business. An international business would be significant if it involved cross-border lending between G10 banks and others ostensibly within OECD a default of which could endanger the capital of the G10 banks.

Item 3 - States the two fundamental objectives of the Basel Committee's work on regulatory convergence which are (1) that the new framework would serve to strengthen the soundness and stability of the international banking system and (2) that the new framework would be fair and with a high degree of consistency in its application to banks in different countries and produce a level playing ground for competition among international banks.

Item 4 - Reveals that while the Committee was deliberating on this Account the authorities of the European Community in Brussels were pursuing a parallel initiative to develop a common solvency ratio to be applied to Credit institutions within the Community. The Committee said it had maintained contact with the body so as to ensure consistency between the Basel framework and that of Brussels more so that the latter would only apply to credit institutions generally while the former was being directed more specifically to banks doing international business.

Item 5 - States that the Committee, while developing this framework recognized the divergence of supervisory and accounting systems in individual member countries and had sought to harmonize them. It had provided for a transitional period within which the existing circumstances can be reflected in flexible arrangement that allow time for adjustment.

Item 6 - Permits national discretion in the application of risk weightings in certain very limited respect with the hope that they will not be significant enough to compromise the basic objectives.

Item 7 - Stresses that the agreed framework provided for only minimum levels of capital for internationally active banks. Higher levels could be adopted at national discretion.

Item 8 declares that the framework was directed towards assessing capital in relation to credit risk and advised supervisors to take other risks like interest rate risk and investment risk into account in assessing overall capital adequacy. The Committee would continue to monitor provisioning policies by banks in member countries with a view to promoting convergence of policies there as in other regulatory matters.

Item 9 - Discloses the Committee's awareness of the divergence among member countries in the fiscal treatment and accounting presentation for tax purposes of certain classes of provision

for losses and of Capital reserves derived from retained earnings as they affect internationally active banks in terms of comparability of their real or apparent Capital positions. The committee wished to keep these tax and accounting matters under review although a convergence in tax regimes would have been desirable.

Item 10 - Describes the scope of the agreement, which is to banks on a consolidated basis, including subsidiaries undertaking banking and financial business. The Committee recognized the changes going on in the ownership structure of banks within the financial conglomerate and would wish it did not weaken the capital position of the bank or expose it to risks stemming from other parts of the group.

Item 11 - Introduces the division of the Accord into four sections with the first section dealing with the Constituent of Capital, and the second dealing with the risk weighting system. Section three deals with the target standard ratio while section four deals with transitional and implementing arrangements.

Items 12 - to 23 contain the extremely crucial definition of what a bank's regulatory capital should be. Item 14 (a) stated the committee's conclusion that regulatory capital should be defined in two tiers in a way that at least 50% of a bank's capital base will consist of a core element comprised of equity capital and published reserves from post-tax earnings (tier 1). Item 14 (b) deals with Supplementary Capital, which can be admitted into tier 2 up to an amount, equal to that of the core capital subject to national authorities discretion on what may be included. Included in the Committee's recommendation as to what could be included however are: -

(1) Undisclosed Reserves - which are unpublished or hidden reserves. Many member countries that do not recognize undisclosed Reserves either as an accepted accounting concept or as a legitimate element of Capital had argued for excluding them from the core equity Capital element.

(2) Revaluation Reserves - this could arise from a revaluation of certain assets to reflect their current value subject to a discount of 55% on the difference between the historic cost book value and market value. National supervisory authorities must be convinced that the assets were prudently valued.

(3) General Provisions/general loan - loss reserves - Item 18 described this as the reserves created against the possibility of future losses and would only qualify for inclusion in Supplementary Capital if they are not ascribed to particular assets and do not reflect a reduction in the valuation of particular assets. The Committee recognized the difficulty in

identifying these reserves because of the diversity of accounting, supervisory and fiscal policies in respect of provisioning and national definitions of Capital.

Item 20 has the Committee aiming to develop before the end of 1990 firm proposals applicable to all member countries, so as to ensure consistency in the definition of general provisions and general loan-loss reserves eligible for inclusion in the capital base should the interim and final minimum target standards fail to be observed.

(4) Hybrid debit capital instruments - These are some capital instrument which item 22 says combine certain characteristics of equity and certain characteristics of debt. Each of them has particular features, which can make them qualify as capital. Should they have close similarity to equity especially the ability to support losses on on-going basis without triggering liquidation, they may be included in Supplementary Capital. Some instruments in member countries were specifically mentioned as being eligible.

(5) Subordinated term debt - It was concluded that this instrument can be included if it has a minimum original term of over five years but only to a maximum of 50% of the core capital element and subject to adequate amortization arrangements.

Item 24 -States that the following deductions should be made from the Capital base for the purpose of calculating the risk-weighted Capital ratio:

(i) Goodwill, as a deduction from tier I.

(ii) Investment in subsidiaries engaged in banking and financial activities which are not consolidated in National Systems. This is to prevent duplication of the same capital resources in different parts of the group.

Items 25-27 are on the Committees deliberation on the possibility of requiring deduction of cross-bank holding of capitals whether in form of equity or other capital instruments. Several G-10 countries are making the deduction currently in order to discourage cross holding of capital in their banking system, instead of drawing them from outside investors. The Committee called it double gearing (or double leveraging) and said it could have systemic dangers for the banking system by creating a domino effect should one institution is troubled.

The Committee was not in favour of a general policy but nonetheless agreed that: -

(a) Individual national supervisory authorities can use their discretion to apply a policy of deduction;

(b) In the absence of (a) cross-bank holding of Capital instrument will bear a risk-weight of 100%;

(c) Reciprocal cross-holdings of bank capital designed to inflate the capital position of the banks concerned should not be permitted.

(d) The Committee promised to closely monitor the degree of double gearing in the international banking system and did not preclude the possibility of introducing constraint at a later date. Towards this end it advised supervisory authorities to keep adequate statistics that would enable them and the Committee to monitor the development of banks cross holding of capitals.

Section II deals with the risk weights, which appears to be the most widely accepted part of this Accord worldwide.

Item 28 states the Committee's preference for a weighted risk-ratio in which capital is related to different categories of assets or off-balance sheet exposure, weighted according to broad categories of relative riskiness. It believes that a risk ratio approach has the following advantages over the simpler gearing ratio approach:

(i) It provides a fairer basis for making international comparisons between banking systems whose structures may differ;

(ii) It allows off-balance sheet exposures to be incorporated more easily into the measure;

(iii) It does not deter banks from holding liquid or other assets, which carry Low risk.

Item 29 lists the five weights used as 0,10,20,50 and 100%. The Committee admits that there are some broad-brush judgments in deciding which weight should apply to different types of assets. It cautioned that the weightings should not be regarded as a substitute for commercial judgment for the purpose of market pricing of the different instruments.

On categories of risk captured in the framework item 31 declares that they are only credit risk and country transfer risk. Individual Supervisory authorities however have the discretion to build in certain other types of risk. There is no convergence in this area and as such no standardization.

Item 32 states that individual supervisory authorities should be free to apply either a zero or a low weight to claims on governments i.e. G10/OECD countries.

Item 33 is on Country Transfer risk, which is the possibility that a borrowing country may not be able to generate the foreign exchange, required to service its debt.

In this item the Committee disclosed that in its earlier consultative paper, two alternative approaches were put forward for consideration and comments. The first was a simple differentiation between claims on domestic institutions (central governments, official sector, and banks) and claims on all foreign countries. Second was a differentiation on the basis of an approach involving the selection of a defined grouping of countries considered to be of high credit standing.

Item 34 states that the banking associations in G10 countries were overwhelming in support of the second option of a differentiation of countries on the basis of grouping them according to their credit standing.

Item 35 declares that the countries for this second option would be full members of OECD or countries which have concluded special lending arrangements with the IMF associated with the Funds General Arrangement to Borrow.

OECD Countries are Australia, Austria, Belgium, Canada, Czech Republic, Denmark, Finland, France, Germany, Korea, Luxembourg, Mexico, Netherlands, New Zealand, Norway, Poland, Portugal, Slovak Republic, Greece, Hungary, Iceland, Ireland, Italy, Japan, Spain, Sweden, Switzerland, Turkey, United Kingdom and United States.

Item 36 states that claim on contract governments within the OECD will attract a zero weight (or a low weight if the national supervisory authority elects to incorporate interest rate risk); and claims on OECD non-centrals government public-sector entities will attract a low weight. Claims on central governments within the OECD will attract a zero weight (or a low weight if the national supervisory authority elects to incorporate interest rate risk); and claims on OECD non-central government public-sector entities will attract a low weight. Claims on central governments and central banks outside the OECD will also attract a zero weight if the funding and denomination are in their national currencies. In effect servicing them would not require foreign exchange hence the transfer risk would be zero.

Item 37 agrees there is no need to differentiate interbank short-term claims whether incorporated inside or outside OECD. Long-term cross-border loans with a residual maturity of up to and including one year will however attract a 20% risk weight wherever incorporated banks will be weighted at 20% while for banks incorporated outside OECD the risk weight will be 100%.

. The provision seems to favour interbank claims within the OECD by imposing lower weights while claim on banks incorporated outside the group attract a 100% risk weight. In effect any OECD member bank doing cross-border lending business with banks incorporated outside the group must be ready to provide a regulatory capital of 100% for all the advances made to such banks. The purpose appears to be to discourage cross-border lending to less developed countries of this world so as to ensure the safety of OECD / G10 banks.

Item 38 deals with claims on non-central government and public sector entities (PSEs). It declares that in order to preserve a degree of convergence in the weight applicable to claims on G10 public sector entities below the level of central governments (i.e. States, Local authorities etc.) the weight should be 0, 10, 20 or 50%. PSEs in other countries within the OECD will have a 20% standard weight attached to claims on them. The Committee subjects this arrangement to review in pursuit of further convergence towards common weights and consistent definitions in member countries and in the light of decisions that would be taken within the European Community on the specification of a common solvency ratio for credit institutions. For commercial companies, claims on them will be a uniform 100% if they are owned by the public sector to avoid competitive inequality with similar private sector commercial enterprises.

Item 39 is on Collateral and guarantees and it recognizes the limitation in reducing credit risk. It further states that because of the divergent practices and experiences of member countries it has not been found possible to develop a basis for recognizing collateral generally in the weighting system. The more limited recognition was however given to loans secured against cash or against securities issued by OECD central governments and specified multilateral

development banks. They are to attract zero weight. Loans partially collaterised by these assets will also attract the same low weight for the collateralized part.

Item 40 states that loans or other exposures guaranteed by OECD central governments, OECD public-sector entities, or OECD incorporated banks will attract the weight applicable to a direct claim on the guarantor, which is 20% for banks. For non-OECD incorporated banks however the 20% risk weight will be applicable only where the underlying transaction has a residual maturity not exceeding one year.

Item 41 is on loans secured by residential property, which is to attract a risk weight of 50% whether rented or owner-occupied. It is not to be applicable to real estate companies.

Item 42 is on Off-balance sheet engagements, which the Committee believes should be caught within the capital adequacy framework. It further states the approach, which is that all categories of Off-balance sheet engagements will be converted to credit risk equivalents by multiplying the nominal principal amounts by a specified credit conversion factor. The resulting amount will be weighted according to the nature of the counter party. The different instruments and techniques are divided into five broad categories, which are: -

(a) Those that substitute for loans (e.g. general guarantees of indebtedness, bank acceptance guarantees and standby letters of credit serving as financial guarantees for loans and securities) - these will carry 100% credit risk conversion factor;

(b) Certain transaction - related contingencies (e.g. performance bonds, bid bonds warranties and stand-by letters of credit related to particular transactions) -a 50% credit risk conversion factor;

© Short-term, Self-liquidating trade-related contingent liabilities arising from the movement of goods (e.g. documentary credits collaterised by the underlying shipments) – a 20% credit risk conversion factor;

(d) Commitments with an original maturity exceeding one year and all Note Issuance Facilities (NIF) and Revolving Underwriting Facilities (RUF) – a 50% credit risk conversion factor.

(e) Other Commitments (e.g. formal standby facilities and credit lines) with an original maturity of over one year – a 50% credit risk conversion factor;

(f) Similar Commitments with an original maturity of up to one year, which can be unconditionally cancelled at anytime – a credit, risk conversion of zero percent.

(g) Sale and repurchase agreements and asset sales with recourse where the credit risk remains with the bank – a credit risk conversion factor of 100%.

(h) Forward asset purchases, forward deposits and partly paid shares and Securities, which represent commitment with certain draw down – a credit conversion factor of 100%.

Item 44 sets out the target standard ratio of capital to weighted risk assets at 8% which will translate into 8k for every N1.00 lent being the minimum to be set aside for the computation of capital adequacy. Core capital element is to be at least 4% of this ratio. The computation therefore is Total Qualifying Capital (i.e. Tiers 1 & 2) divided by the Total Amount of Risk Weighted Assets (i.e. risk assets weighted as prescribed 0, 20, 25, and 50, 100%). The result must be a minimum of 8% if a bank is to be considered as being adequately capitalized.

The committee states that this ratio is expressed as a common minimum standard, which international Banks in member countries must have observed by the end of 1992. As could be seen here emphasis is on international banks in G10 member countries or at best OECD. The rest of this document from Items 45 to 50 was devoted to transitional and implementing arrangements.

David Clementi (2000) said, "We should of course be under no illusion that the ratios chosen in 1988 were arrived (at) through a scientific process". To buttress his point he cited an episode where a Committee member once asked his staff on why the number 3 was chosen for the calculation of a ratio. He said they answered that two was too low and four too high.

He also did not mince words in saying that the Basel 1 Accord was "aimed principally at internationally active G10 banks" and that it was designed to spread the risk and penalty of failure between shareholders and regulatory authorities that could be forced to become lenders of last resort or liquidators. He said that apart from equity capital acting as buffer against insolvency, it helps to align the objectives on the firm's owners with the objectives of the regulatory authorities. Where the owners of a bank invest pinpoint capital and watch their bank gradually becoming insolvent through the erosion of capital, they usually come to have an incentive to "gamble for resurrection" by taking higher risks. He concluded that once their investment becomes high too, they would have much to lose in the event of a failure. As a matter of fact they would lose everything especially where the deposits were insured. Milne and Whalley (1998) argued along the same vein but against regulatory minimum capital requirement, which they said, once it has fallen below the required minimum could increase the owners' appetite for high risks for the sake of survival. Should the high risks fail then the moral hazard of transferring as much as possible of the banks resources into the hands of the shareholders (looting) would come in. Either way the shareholders lose because as what Arturo Estrella et al (1999) called Charter value (an intangible value that disappears with the closure of the institution) would have disappeared. According to them, the charter value of the bank produces a strong incentive to the owners of the bank to manage as a going concern. As long as it remains a going concern owners could always benefit by either selling their shareholding or watching it appreciate. It would thus be in their interest to keep the bank afloat and that would also be in the interest of the regulatory authorities that would no longer have to worry much on a bank failure that could upset the financial applecart. The Basel 1 Accord was in effect a subtle method of getting banks in G10 countries especially the internationally active ones to be more risk-averse so as not to threaten the economy of their home countries and by extension those of the entire Group.

Compliance in Nigeria

Most banks in the world including Nigeria embraced this particular provision of capital for risk-weighted assets and it seems to have become the standard except that CBN stopped short of requiring banks to actually charge it to their operating profit.

Its circular BSD/11/2003 of August 4, 2003 (effective January 2004) re-calibrated the capital adequacy measurement of the Basel 1 Accord in an apparent effort to make it fit into the Nigerian setting as follows:-

RISK WEIGHTS	ON-BALANCE SHEET ASSETS
0%	Placement with Discount houses secured with Treasury Bills.

20%	(1) Claims on banks in Nigeria/OECD Countries. (2) Placement with Discount House Unsecured.
50%	Negotiable Certificates of Deposits.
100%	(1) Overdue balance with illiquid banks (2) Claims on banks in non-OECD (3) Non-negotiable Certificate of Deposits (4)Bankers Acceptance Industrial Investments (5) Loans to Federal Government Agencies and Parastatals (6)Loans fully secured by mortgage on residential property.

OFF BALANCE SHEET ASSETS

For off-Balance Sheet engagements the CBN set the following credit Conversion factors to be used in adjusting the risk weight.

INSTRUMENTS	CREDIT CONVERSION FACTOR
(1) Direct credit substitutes, e.g. general guarantees of indebtedness (including standby letter of credit serving as financial guarantees for loans and securities) and acceptances (including endorsements with the character of acceptances.	100%
(2)Certain transaction – related contingent items (e.g. performance bonds, bid bonds, warranties and standby letters of credit related to particular	

transactions)	50%
(3) Short-term self-liquidating trade-related contingencies (such as documentary credits collaterized by the underlying shipment).	20%
(4) Sale and repurchase Agreements and asset sales with recourse where the credit risk remains with the bank	100%
(5) Forward assets purchases, forward deposits and partly-paid shares and securities, which represents commitments with certain drawdown	100%
(6) Note issuance facilities and revolving underwriting facilities.	50%
(7) Other commitments (e.g. formal standby facilities and credit lines) with an original maturity of over one year.	50%
(8) Similar commitments with an original maturity of up to one year, or which can be unconditionally cancelled at any time.	0%

Basel 1 specifications on constituents of capital, General provision and Deductions of Investment in subsidiaries were also adopted.

As mentioned above CBN does not make it mandatory for Nigerian banks to charge these provisions to their operating profit once they had provisioned enough for Doubtful debts to the satisfaction of the CBN in their Balance Sheets. By this singular indulgence the CBN may have defeated the very purpose of the Basel 1 Accord since setting aside these capital charges from a bank's profit and including it in its capital as Loan Reserve would only have continued to strengthen such bank. Less of its resources would have been expended on taxes and dividends and capital appreciation would have been the lot of its shareholders.

KPMG (2004) rated Nigerian banks in terms of compliance with Basel 1 Accord as follows:

(1) Corporate Governance – Partially Compliant

(2) Statutory Returns – Partially Compliant

(3) Capital Adequacy – credit Risk – Fully Compliant

(4) Capital Adequacy – Market Risk – Not Compliant

(5) Risk weights – On-Balance Sheet – Fully Compliant

(6) Risk weights – Off-Balance Sheet – Fully Compliant

(7) Asset-Liability Management – Partially Compliant

(8) Accounting Standards – Partially Compliant

(9) Internal Control – Partially Compliant

(10) Banking Legislation – Partially Compliant

Critics of this Accord have always been quick to point out its weaknesses as follows:

(1) It does not assess capital adequacy in relation to a bank's true risk profile i. e. one size fits all;
(2) Focus on a single risk measure i.e. credit risk;
(3) The OECD / non-OECD does not properly address country risk;
(4) It does not provide proper incentives for credit risk mitigation techniques like hedging etc;
(5) It enables regulatory arbitrage through securitisation etc.

The real reason however may have been given by Lutz (2000) who said the Basel 2 Accord is more of a co-operation between the regulators and the practitioners in the field rather than the regulators-only approach of the Basel 1 Accord. In her paper she examined the reasons for the transition from the first Accord to the second, which she said, was triggered by globalization. This globalization, she said was characterized by not only territorial expansion of economic activity but also by structural changes within international markets, combined with the emergence of qualitatively new forms of financing. She detailed three broad categories of development that characterized these structural shifts as:

(1) An increasing share of financial intermediation taking place through capital markets as opposed to bank lending. Credit-worthy borrowers stated bypassing the banks to transform their liabilities into tradable securities known as Securitization. With declining loan business being continuously made unattractive by the Basel 1 Accord provision especially as it affects exposures to third world countries after the Mexico debt crisis, commercial banks started expanding into more profitable lines of business like investment banking where profits are made through brokerage commissions instead of interest on credits.

(2) Institutional investors like insurance companies, pension funds, or mutual funds became major players on the global securities markets.

(3) The emergence of financial derivatives.

With this scenario, the concept of regulatory capital required to cushion the effect of the newly identified risks changed, and since the banks were the inventors, the regulatory authorities had no choice but to partner with them in the task of calculating appropriate regulatory capital. The result was to eventually become the Basel 2 Accord. This explains Lutz (2000) argument that the Basel 2 Accord is a co-operation between the regulators and the practitioners in the field.

THE BASEL 2 ACCORD- INTERNATIONAL CONVERGENCE ON CAPITAL MEASUREMENT AND CAPITAL STANDARDS- A REVISED FRAMEWORK

Item 1 - Describes the Basel 2 Accord as the outcome of the Basel Committee on Banking Supervision work over recent years to secure international convergence on revisions to supervisory regulations governing the Capital adequacy of internationally active banks. It confirms the Accord and that

the Central Bank Governors and Heads of Banking Supervision of the Group of Ten Countries have endorsed the Standard it contains.

As mentioned above the Group of Ten Countries consists of Belgium, Canada, France, Germany, Italy, Japan, Luxembourg, the Netherlands, Spain, Sweden, Switzerland, The United Kingdom, and the United States.

Item 2 - Is on transitional arrangements to this revised framework, which the Basel Committee expects to be available for implementation as at year-end 2006. In an apparent reference to the United States the Committee expects that in a number of instances some member countries could still want to conduct additional impact assessments on the Accord. These it says should be sent to their national authorities not the Basel Committee, as was the case when the Accord was in consultative Document stage issued for comments by stakeholders.

Item 3 - Discloses the worldwide circulation of this Accord to non-G10 countries with a view to encouraging them to consider adopting it at a time consistent with their broader Supervisory priorities. It advises each national Supervisor to consider carefully the benefits of the Accord to its banking system when developing a timetable and approach to implementation.

Item 4 - Declares that the fundamental objective of the committees' decision to revise the Basel 1 Accord has been to develop a framework that would further strengthen the soundness and stability of the international banking system while maintaining sufficient consistency that capital adequacy regulation will not become a competition weapon.

Item 5 - Expresses the Committee's belief that the revised framework contains more risk-sensitive regulatory capital requirements that are conceptively sound

and pay due regard to the divergence in supervisory and accounting systems of member countries. It declares the committee's retention of key elements of the Basel 1 Accord in the revised framework. Among these are the 8% of capital to risk – weighted assets, the basic structure of the 1996 Market Risk Amendment, and the definition of eligible capital.

Item 6 - Considers as significant innovation in the revised framework the greater use of assessments of risks provided by banks' internal system as inputs to capital calculations. It states the committees desire to ensure the integrity of bank's internal rates and the set of demands contained in the Accord to achieve this. It expects each supervisor to develop a set of review procedures for ensuring that banks' systems and controls are adequate to serve as the basis for the capital calculations.

Item 7 - Makes it known that the revised framework provides a range of options for determining the capital requirements for credit risk and operational risk for selection by supervisors and banks of approaches that are most appropriate for their operations and their financial market infrastructure. The committee advocates consistency.

Item 8 – Is on the role of home country supervisors as leaders of enhanced co-operation with host country supervisors to ensure effective implementation of the Accord. Towards this end the committee has issued general principles for the cross-border implementation of the Accord and more focused principles for the recognition of operational risk and capital charges under Advanced Measurement Approaches (AMA) for home and host supervisors. It should be mentioned that a home supervisor is one based in the country where a bank or corporate was incorporated. A host supervisor is however one based in a foreign location that such bank or corporate could be operating.

Item 9 – Stresses that the revised framework is designed to establish minimum levels of capital for internationally active banks and that national authorities will be free to adopt arrangements that set higher levels of minimum capital as in the Basel 1 Accord. It also declares that national authorities in place for the capital adequacy of their banking organizations.

Item 10 – Advises banks in countries where risks in the local banking market are relatively high to consider if banks should be required to hold additional capital over and above the Basel minimum.

Item – 11 – Highlights the complementary nature of the famous three Pillars and the need for banks and their supervisors to notice this.

Item 12 – Recognizes the divergence of regulatory and accounting approaches between member country and the committee's.

Item 13 – Highlights the changes relative to the committee's most recent consultative proposal of April 2003.

Items 14 – Contains the Committee's promise to take necessary actions should a review of this Accord at any time reveal that the committee's objectives on overall capital adequacy would not be achieved.

Items 15 - & 16 – Are on the nature of this Accord, which the Committee desires as a more forward-looking approach to capital adequacy supervision, one that has the capacity to evolve with time.

Item17 – Reiterates the Committee's intention to undertake additional work on the definition of eligible capital.

Item 18 – States the committee's resolve to continue to engage the banking industry in a discussion of prevailing risk management practices, including those practices aiming to produce quantified measures of risk and economic capital.

Item 19 – Is on the layout of the Accord.

Part 1: Scope of Application.

Items 20-23 – State that the framework will be applied on a consolidated basis to internationally active banks as a means to preserve the integrity of capital in banks with subsidiaries by eliminating double gearing.

Other groups are: (1) any holdings company that is the parent entity within a banking group, to ensure that it captures the risk of the whole banking group.

(2) Internationally active banks at every tier within a group.

(3) Stand alone banks to ensure the protection of depositors.

Items 24-39 – Are on what get captured in consolidated activities of affected banking securities and other financial subsidiaries including insurance entities.

Part 2: The First Pillar – Minimum Capital Requirements

Item 40 – Reiterated that the capital ratio is to be calculated using the definition of regulatory capital, risk weighted assets and a floor of 8%. It limits Tier 2 capital to 100% Tier 1 capital.

Items 41-43 – Are on the amendments made to the Base 1 Accord in 1998 and their application under the Basel 2 Accord as they relate to Tier 1 capital. General Provision can now be included in Tier 2 under the standardized approach to credit risk subject to the limit of 1.25% of risk-weighted assets. Under the Internal Ratings Based (IRB) approach however the item is no longer allowed to be included in Tier 2 Capital.

Item 44-49 – are on transitional arrangements for banks using the Internal Ratings Based (IRB) approach for credit risk and Advanced Measurement Approach (AMA) for operational risk. The periods applicable are from year-end 2005 to year-end 2008.

Credit risk – The standardised approach

Items 50-51 – are on the two broad methodologies available to banks for calculating their capital requirement for credit risk. One alternative will be to measure credit risk in a standardized manner, based on the ratings of the obligor by an external credit rating agencies, the likes of Standard and Poor's, Moody's Investor Services, FitchIBCA and to a lesser extent our Augusto & Co rating agency. The other methodology is the use of the bank's own internal ratings of the obligor, subject to the explicit approval of the bank's supervisor.

Item 52 states that in determining the risk weights banks may use assessments by external credit assessment institutions recognized as eligible for Capital purposes by national Supervisors in accordance with the following criteria contained in Items 90 & 91 of the Accord.

Item 90 - says National Supervisors are responsible for determining whether an external credit assessment institution (ECAI) meets the criteria listed in item 61, and the Supervisory process for their recognition should be made public to enable new entrants to come in.

Item 91 deals on eligibility criteria each of which an ECAI must satisfy before recognition, and they are: -

(1) **Objectivity**: The methodology for assigning credit assessments must be rigorous, systematic and subject to some form of validation based on historical experience. Moreover, assessments must be subject to ongoing review and responsive to changes in financial condition. Before being recognized by supervisors, an assessment methodology for each segment, including rigorous back testing, must have been established for at least one year and preferably three years.

(2) **Independence:** An ECAI should be independent and should not be subjected to political or economic pressures that may influence the rating. The assessment process should be as free as possible from any constraints that could arise in situations where the composition of the Board of Directors or the Shareholder Structure of the assessment institution may be seen as creating a conflict of interest.

(3) **International access/Transparency:** The individual assessments should be available at both domestic and foreign institutions with legitimate interest and at equivalent terms. In addition, the general methodology used by the ECAI should be publicly available.

(4) **Disclosure:** An ECAI should disclose the following information: its assessment methodologies, including definition of default, the time horizon, and the meaning of each rating; the actual default rates experienced in each assessment category; and the transition of the assessments, e.g. the likelihood of AA ratings becoming A over time.

(5) **Resources:** An ECAI should have sufficient resources to carry out high quality credit assessments. These resources should allow for substantial ongoing contact with Senior and operational levels within the entities assessed in order to add value to the credit assessments. Such assessments should be based on methodologies combining qualitative and quantitative approaches.

(6) **Credibility:** To some extent, credibility is derived from the above criteria. In addition, the reliance on an ECAI's external credit assessments by independent parties (investors, insurers, trading partners) is evidence of the credibility of an ECAI. The credibility of an ECA1 is also underpinned by the existence of internal procedures to prevent the misuse of confidential information. In order to be eligible for recognition, an ECAI does not have to assess firms in more than one country. These are the conditions under which an ECAI will be recognized as being qualified to rate banks, Corporate and Sovereigns for the purpose of measuring credit risk under the first alternative in the Standardized Approach.

INDIVIDUAL CLAIMS

(i) Claims on Sovereigns.

Item 53 states the risk weighting of claims on Sovereigns and their Central banks as follows: -

Credit Assessment	AAA to AA-	A+ to A-	BBB+ to BBB-	BB + to B-	Below B-	Unrated
Risk Weight	0%	20%	50%	100%	150%	100%

Item 54 directs that at national discretion, a lower risk weight may be applied to a bank exposure to its sovereign (or Central Bank) provided such exposure is funded and remain denominated in the Sovereigns domestic currency. Other exposures to this Sovereign (or Central Bank) in this same currency can enjoy the same risk weight in other banks within the sovereign with the permission of other national supervisory authorities.

Item 55 allows that for the purpose of risk weighting claims on Sovereigns, Supervisors may recognize the country risk scores assigned by Export Credit Agencies (ECAs) qualified under the OECD methodology. Banks may choose to use the risk scores published by individual ECAs that are recognized by their Supervisor, or the consensus risk scores of ECAs participating in the "Arrangement on Guidelines for officially Supported Export Credits". Under the OECD agreed methodology there are seven risk score categories associated with minimum export insurance premiums and their risk weight.

ECA Risk Scores	1	2	3	4 to 6	7
Risk Weight	0%	20%	50%	10%	150%

Item 56 **suggests zero % risk weight for claims on Bank for International Settlement, the IMF, the European Central Bank and the European Community.**

(ii) Claims on non-central government public sector entries (PSEs).

Item 57 directs that claims on domestic PSEs should be risk weighted at national discretion, but subject to either option 1 or option 2for claims on banks set out in items 34 to 38.

Item 58 states that subject to national discretion, claims on certain domestic PSEs my also be treated as claims on the sovereigns in whose jurisdictions the PSEs are established depending on their revenue raising powers. Where such discretion is exercised other national supervisors may allow their banks to risk weight claims on such PSEs in the same manner.

(iii) Claims on multilateral development Banks (MDBs)

Items 59 states that the risk weight applicable to claims on MDBs will generally be based on external credit assessments as set out under option 2 claims on banks but without the possibility of using the preferential treatment for short term claims. While the Committee promised a continuous evaluation on a case-by-case basis of MDBs, a highly rated one that would want its debts to attract a 0% risk weight must fulfill to the Committee's satisfaction the following criteria:

(a) Very high quality long-term issuer ratings, i.e. majority of an MDB's external assessments must be AAA;

(b) Shareholder structure is comprised of a significant proportion of sovereigns with long term issuer credit assessments of AA – or better, or the majority of the MDB's fund raising are in the form of paid-in equity / capital and there is little or no leverage.

© Strong shareholder support demonstrated by the amount of paid-in capital contributed by the shareholders; the amount of further capital the MDBs have the right to call, if required, to repay their liabilities; and continued capital contributions and new pledges from sovereign shareholders;

(d) Adequate level of capital and liquidity (a case-by-case) approach is necessary in order to assess whether each institution's capital and liquidity are adequate and;

(e) Strict statutory lending requirements and conservative financial policies, which would include among other conditions a structured approval process, Internal credit worthiness and risk concentration limits (per country, sector and individual exposure and credit category), large exposures approval by the board or a committee of the board, fixed repayment schedules, effective monitoring of use of proceeds, status review process, and rigorous assessment of risk and provisioning to loan loss reserve.

Currently, only the following MDBs are eligible for a 0% risk weight on their debts: the World Bank Group comprised of the International Bank for Reconstruction and Development (IBRD) and the International Finance Corporation (IFC), the Asian Development Bank (ADB), the African Development Bank (AfDB), the European Bank for Reconstruction and Development (EBRD), the Inter-American Development Bank (IADB), the European Investment Bank (EIB), the Nordic Investment Bank (NIB), the Caribbean Development Bank (CDB), the Islamic Development Bank (IDB) and the Council of Europe Development Bank (EDB)

(i) Claims on Banks

Item 60 states there are two options for claims on bank and that national supervisor will apply one option to all banks in their jurisdiction. Claims on unrated banks may not attract risk weights lower than that of its sovereign of incorporation**.**

Item 61 contains the first option and it is that claims on all banks incorporated in a given country will be assigned a risk weight one category less favourable than that of the sovereign. Banks incorporated in sovereign with BB+to B- or completely unrated will be risk weighted at a cap of 100%.

Option 1

Credit Assessment of	AAA	A + to	BBB +	BB +	Belo	Unrate

Sovereign	to AA-	A -	to BBB-	to B -	w B -	d
Risk Weight	20%	50%	100%	150%	150%	100%

Item 62 contains the Second option, which bases the risk weighting on the external credit assessment of the bank itself with claims on unrated banks being risk-weighted at 50%. Under this option, a preferential risk weight that is one category more favourable may be applied to claims with original maturity of three months or less, subject to a floor of 20%. Banks risk-weighted at 150% will not be eligible for this option.

Option 2

Banks Credit Assessment	AAA to AA -	A+A-	BBB + to BBB -	BB + to B -	Bellow B	Unrated
Risk Weight	20%	50%	50%	100%	150%	50%
Risk Weight for Short Term Claims	20%	20%	20%	50%	150%	20%

Item 64 states that where the national supervisor has chosen to apply the preferential treatment contained in Item 28 it can also assign, under both options 1 and 2 a risk weight that is one category less favourable than that assigned to claims on the sovereign. Item 28 states that at national discretion, a lower risk weight may be applied to banks' exposures to their sovereign (or Central bank) of incorporation denominated in domestic currency and funded in that currency.

Item 65 states that claim on securities firm may be treated as claims on banks if their capital requirements are subject to the Accord's Consolidated regulation and Supervision with respect to downstream affiliates.

(v) **Claims on Corporate**

Item 66 presents the risk weighting of rated corporate claims, including claims on insurance companies. It states the standard risk weight for unrated claims on Corporate at 100%. As for unrated corporate, no claim on them may be given a risk weight better than that of its sovereign of incorporation.

Credit Assessment	AAA to AA -	A + to A -	BBB + to BB -	Below BB -	Unrated
Risk weight	20%	50%	100%	150%	100%

Item 67 states that supervisory authorities should increase the standard risk weight for unrated claims where they judge that a higher risk weight is warranted by the overall default experience in their jurisdiction. They may also consider whether the credit quality of corporate claims held by individual banks should warrant a standard risk weight higher than 100%.

Item 68 has it that at national discretion, and subject to supervisory approval, banks can risk weight all corporate claims at 100% without regard to external rating. Where the supervisor grants this permission, it must ensure that banks apply a single consistent approach i.e. either to use ratings wherever available or not at all.

(vii) Claims included in the regulatory retail portfolios

Items 69 & 70 are on claims that qualify for consideration as retail claims for regulatory capital purposes and inclusion in a regulatory retail portfolio. These exposures may be risk-weighted at 75% except they are past due loans described in **Item 75**. They must however meet the following criteria:

(a) Orientation criterion - The exposure must be to an individual or persons or to a small business;

(b) Product criterion - The exposure takes the form of any of the following: revolving credits and lines of credit (including credit cards and overdrafts), Personal term loans and leases (e.g. installment loans, auto loans and leases Student and educational loans, personal finances) and small business facilities and commitments. Securities (such as bonds and equities), whether

listed or not, are specifically excluded and mortgage loans if they qualify for treatment as claims secured by residential property in **Item 72.**

© Granularity criterion - The supervisor must be satisfied that the regulatory retail portfolio is sufficiently diversified (granulated) to a degree that reduces the risks in the portfolio, warranting 75% risk weight.

(d) Low value of individual exposures – the maximum aggregated retail exposure cannot exceed an absolute threshold of one million Euros to one counterparty.

(viii) Claims secured by residential property

Item 72 states that lending fully secured by mortgages on residential property whether borrower-occupied or rented out will be risk weighted at 35%. The Supervisory authorities are to ensure without prejudice to their national arrangements for the provision of housing finance, that this concessionary weight is applied restrictively for residential purposes and in accordance with strict prudential criteria such as the existence of substantial margin of additional security over the amount of the loan based on strict valuation rules. The risk weight can be increased where supervisors judge the criteria are not met.

Item 73 directs that Supervisors can evaluate the appropriateness of the preferential risk weight of 35% to their circumstances and can ask banks to increase it to the appropriate level.

(ix) Claims secured by Commercial real estate

Item 74 express the Committee's view that because of the trouble that lending to this sector had caused in the banking industry of many countries the risk weight should not be less than 100%. Exceptions however will be for well-developed and long-established markets, mortgages on office and / or multipurpose commercial premises and / or multi-tenanted which can be considered for a preferential risk weight of 50% for the portion of the loan that does not exceed the lower 50% of the market value or 60% of the mortgage lending value of the property securing the loan. This exceptional treatment will be subject to the fulfillment of two tests (1) losses stemming from commercial real estate lending up to the lower of 50% of the market value of 60% of loan-to-value (LTV) based on mortgage-lending-value (MLV) must not exceed 0.3% of the outstanding loans in any given year; (2) Overall losses stemming from commercial real estate lending must not exceed 0.5% of the outstanding loans in any given year. If either of these tests is not satisfied in a given year, the eligibility to use this preferential treatment will cease and the original eligibility criteria would need to be satisfied again before it could be applied in the future. Countries applying this treatment must publicly disclose that these and other additional conditions (available from the Basel Committee Secretariat) are met. Past due claims under this treatment will be risk-weighted at 100%.

(x) Past due loans

Item 75 states that other then a qualifying residential mortgage loan the unsecured portion of any loan that is past due for more than 90 days, net of specific provisions will be risk weighted as follows:-

- 150% when specific provisions are less than 20% of the outstanding amount of the loan.
- 100% when specific provisions are higher than 20% of the outstanding amount of the loan.
- 100% when specific provisions are not less than 50% of the outstanding amount of the loan, but with supervisory discretion to reduce the risk weight to 50%.

Item 76 is for defining the secured portion of the past due loan, the eligible collateral and guarantees of which it says will be the same as for Credit risk mitigation purposes. There will be a transitional period of three years during which a wider range of collateral may be recognized, subject to national discretion. It further says that past due retail loans are to be excluded from the overall regulatory retail portfolio when assessing the granularity criterion specified above for risk-weighting purposes.

Item77 states that in addition to the above, a past due loan fully secured by collateral not recognized under the standardized approach will attract a 100% risk weight when provisions reach 15% of the outstanding amount of the loan. Supervisors are to ensure collateral quality**.**

Item 78 says in case of qualifying residential mortgage loans, when such loans are past due for more than 90 days they will be risk weighted at 100%, net of specific provisions.

(xi) Higher risk categories

Item 79 lists the claims that will be risk weighted at 150% or higher as follows:

- Claims on Sovereigns, PSEs, banks, and securities firms rated below B-
- Claims on corporate rated below BB-
- Past due loans as set out above.
- Securitisation tranches that are rated BB+ and BB- to be risk weighted at 350% as set out in Item 528.

Item 80 says national supervisors may decide to apply a 150% or higher risk weight reflecting the higher risks associated with some other assets, such as venture capital and private equity investments.

(xii) Other Assets

Item 81 states that at national discretion gold bullion held in a bank's own vault or on an allocated basis to the portion backed by bullion liabilities can be treated as cash and risk-weighted at 0%.

(xiii) Off-Balance Sheet items

Item 82 says Off-balance sheet items under the standardized approach will be converted into credit exposure equivalents through the use of Credit conversion factors (CCF). Counter party risk weighting for Over the Counter (OTC) derivative transactions will not be subject to any specific ceiling.

Item 83 is on commitments with original maturity of one year and above which it says would receive a CCF of 20% and 50% respectively. Any commitment however that are unconditionally cancelable at any time by the bank without prior notice, or that effectively provide for automatic cancellation due to deterioration in a borrower's credit worthiness, will receive a 0% CCF.

Item 84 states that a CCF of 100% will be applied to the lending of bank's securities or the posting of securities as collateral by banks, including instances where these arises our of repo-style transactions.

Item 85 is on short-term self-liquidating trade letters of credit arising from the movement of goods (e.g. documentary credits collaterised by the underlying shipment) which it says will attract a 20% CCF applicable to both issuing and confirming banks**.**

Item 86 cautions that where there is an undertaking to provide a Commitment, banks are to apply the lower of the two applicable CCFs.

Item 87 says CCFs not specified above remain as defined in the Basel 1 Accord.

2. External credit assessments

Items 90 and 91 that deal with the recognition process and the eligibility criteria have already been dealt with above. The implementation considerations are what items 62 to 78 contain.

3. Implementation considerations

(i) The mapping process

Item 92 states that supervisors will decide which assessment categories correspond to which risk weights. This is the mapping process and it should be objective. It should result in a risk weight assignment consistent with that of the level of credit risk reflected in the tables relevant. It should cover the full spectrum of risk weights.

Item 93 is on conducting the mapping process and factors that supervisors should assess include among others, the size and scope of the pool of issuers that each ECAI covers, the range and meaning of the assessment that it assigns and the definition of default used by the ECAI.

Item 94 directs that banks must use the chosen ECAI and their ratings consistently for each type of claims, for both risk weighting and risk management purpose. Banks are not to be allowed to "cherry pick" the assessment provided by ECAIs.

Item 95 says banks must disclose ECAIs that they use for the risk weighting of their assets by type of claims, the risk weights associated with the particular rating grades as determined by supervisors through the mapping process as well as the aggregated risk weighted assets for each risk weight based on the assessments of each eligible ECAI.

(ii) Multiple assessments

Item 96 states that if there is only one assessment by an ECAI chosen by a bank for a particular claim, that assessment should be used to determine the risk weight of the claim.

Item 97 says the higher risk weight will be applied where there are two assessments by ECAIs chosen by a bank mapping into different risk weights.

Item 98 is on where there are three or more assessments with different risk weights, in which case the assessments corresponding to the two lowest risk weights should be referred to and the higher of those two risk weights applied.

(iii) Issuer versus issues assessment

Item 99 directs that where a bank invests in a particular issue that has an issue-specific assessment, the risk weight of the claim will be based on this assessment; otherwise, the following general principles will apply:

- Where the borrower has a specific assessment for an issued debt but not the one that the bank invested in, a risk weight lower than that which applies to an unrated claim could apply if the claim ranks pari passu or senior to the claim with an assessment cannot be used and the unassessed claim will attract the risk weight for unrated claims.
- Where the borrower has an issuer assessment, this assessment will appear to senior unsecured claims on that issuer. Other unassessed claims will be treat as unrelated. If either the issuer or a single issue has a low quality assessment (mapping into a risk weight equal to or higher than that which applies to unrated claims), an unassessed claim on the same counter party will be assigned the same risk weight as is applicable to the low quality assessment.

Item 100 says whether the bank intends to reply on an issuer or an issue-specific assessment, the assessment must take into account and reflect the entire amount of credit risk exposure the bank has with all debt owed to it – e.g. the credit risk associated with repayment of both principal and interest in the case of a loan.

Item 101 directs that no supervisory recognition of credit risk mitigation techniques will be taken into account if the credit enhancement is already reflected in the issue specific rating. This is to avoid double counting of credit enhancement factors.

(iv) Domestic currency and foreign currency assessments

Item 102 states that where unrated exposures are risk weighted based on the rating of an equivalent exposure to those borrowers, the general rule is that foreign currency ratings would be used for exposures in foreign currency. Domestic currency ratings, if separate, would only be used to risk weight claims denominated in the domestic currency. If however an exposure arises through a bank's participation in a loan that has been extended by an MDB whose preferred creditor status is recognized in the market, the borrower's domestic currency rating may be used for risk weighting purposes instead of his foreign currency rating.

(v) Short term/long term assessments

Item 103 says that for risk weighting purposes, short-term assessments are deemed to be issue specific, and can only be used to derive risk-weights for claims arising from the rated facility. Except as stated under Item 75, they cannot be generalized to other short-term claims. It declares that in no event can a short-term rating be used to support a risk weight for an unrated long-term claim. Short-term assessments may only be used for short-term claims against banks and corporate. Below is a framework for banks exposures to specific short-term facilities such as a particular issuance of commercial paper.

Credit assessment	A-1/P-1	A-2/P-1	A-3/P-3	Others
Risk Weight	20%	50%	100%	150%

Item 104 says if a short-term rated facility attracts a 50% risk weight, unrated short-term claims cannot attract a risk weight lower than 100%. If an issuer has a short-term facility with an assessment that warrants a risk weight of 150%, all unrated claims, whether long-term or short-

term, should also receive a 150% risk weight, unless the bank uses recognized credit risk mitigation techniques for such claims.

Items 105 states that where national supervisors have decided to apply option 2 (Item 36) under the standardized approach, to short-term interbank claims to banks in their jurisdiction, the interaction with specific short-term assessment is expected to be the following**:**

- The general preferential treatment for short-term claims, as defined in Items 62 and 64, applies to all claims on banks of up to three months original maturity when there is no specific short-term claim assessment.
- When there is a short-term assessment and such an assessment maps into a risk weight that is more favourable or identical to that derived from the general preferential treatment, the short-term assessment should be used for the specific claim only. The general preferential treatment should apply to other short-term claims.
- When a specific short-term assessment for a short-term claim on a bank maps into a less favourable risk weight, the general short-term preferential treatment for interbank claims cannot be used. All unrated short-term claims should receive the same risk weighting as that implied by the specific short-term assessment.

Item 106 is on the institution making the short-term assessment to be used, and this it says, must meet all the eligibility criteria for recognizing ECAI under the Accord.

(VI) LEVEL OF APPLICATION OF THE ASSESSMENT

Item 107 determines this, which is that external assessments for one entity within a corporate group cannot be used to risk-weight other entities within the same group.

(vii) Unsolicited ratings

Item 108 says that as a general rule, banks should use solicited ratings from eligible ECAIs. At national discretion however, Supervisory authorities may allow banks to use unsolicited ratings in the same way. Where an ECAI attempts to use unsolicited rating to pressurize an entity to obtain solicited rating, Supervisors should consider whether to continue recognizing such ECAI as eligible for capital adequacy purposes.

B. The Standardized Approach – Credit risk mitigation

Item 109 and 110 introduce a number of techniques banks use to mitigate credit risks. Among these are collateralization of exposures by first priority claims, in whole or in part with cash securities; the guarantee of a loan exposure by a third party; the buying of a credit derivative to offset various forms of credit risk. Banks may also agree to net off loans owed them against deposits from the same borrower.

Should these techniques meet the requirements for legal certainty as described in Items 117 and 118, this revised approach to Credit Risk Mitigation (CRM) would show the permission of a

wider range of credit risk mitigants to be recognized for regulatory capital purposes than as permitted under Basel 1 Accord.

(ii) General remarks

Item 111 describes the framework set out in Section II as being applicable to the banking book exposures in the Standardized Approach.

Item 112 says that the comprehensive approach for the treatment of collateral (Items 130-138 and 145-181) will also be applied to calculate the counterparty risk charges for Over The Counter (OTC) derivatives and repo-style transactions booked in the trading book.

Item 113 directs that no transaction in which CRM techniques are used should receive a higher capital requirement than an otherwise identical transaction where such techniques are not used.

Item 114 is on the effect of CRM which it says will not be double counted and as such no additional supervisory recognition of CRM for regulatory capital purposes will be granted on claims for which an issue-specific rating is used that already reflects that CRM.

Item 115 warns that while the use of CRM techniques reduces or transfer credit risk, simultaneously may increase other risks to the bank, such as legal, operational, liquidity and market risks. Therefore it is imperative that banks employ robust procedures and process to control these risks, including strategy; consideration of the underlying credit; valuation; policies and procedure; systems, control of roll-off risks; and management of concentration risk arising from the bank's use of CRM techniques and its interaction with the bank's overall credit risk profile Where these risks are not adequately controlled, supervisors are permitted to impose additional capital charges or take other Supervisory actions as detailed in Pillar 2.

Item 116 is on the Pillar 3 capital requirements, which it says must also be observed for banks to obtain capital relief in respect of any CRM techniques.

(iii) Legal Certainty

Items 117 and 118 state that in order for banks to obtain capital relief for any use of CRM techniques, all documentation used in collateralized transactions and for documenting on-balance sheet netting, guarantees and credit derivatives must be binding on all parties and legally enforceable in all relevant jurisdictions. Banks are expected to have conducted sufficient legal review to verify this and have a well-founded legal basis to reach this conclusion and reconduct such review as necessary to ensure continuing enforceability.

2. **Overview of Credit Risk Mitigation Techniques**

(i) **Collateralized transactions**:

Item 119 describes collateralized transaction as one in which:

- Banks have a credit exposure or potential credit exposure to a counter party, and
- that credit exposure is hedged in whole or in part by collateral posted by the counter party or by a third party on behalf of the counter party.

Item 120 allows banks to reduce their credit exposure to a counter party when calculating their capital requirements to take account of the risk mitigating effect of eligible financial collateral (e.g. cash or securities defined in Items 145 and 146).

Overall framework and minimum conditions

Item 121 allows banks to opt for either the simple approach which similar to the 1988 Capital Accord (Basel 1) substitute the risk-weighting of the collateral for the risk-weighting of the counter party for the collaterized portion of the exposure (subject to a 20% floor), or for the comprehensive approach, which allows fuller offset of collateral against exposures, by effectively reducing the exposure amount by the value ascribed to the collateral. Banks may operate under one but not both approaches in the banking book. In the trading book only the comprehensive approach is allowed. Partial collateralization is recognized in both approaches. Mismatches in the maturity of the underlying exposure and the collateral will be allowed under the comprehensive approach only.

Items 122 to 126 are on the standard a collateral must meet before it could provide capital relief under either approach. Item 123 says the mortgaging process must ensure that the bank has the right to liquidate or take legal possession of the collateral in a timely manner in the event of default, insolvency or bankruptcy, of the mortgagor. Furthermore, banks must take all steps necessary to fulfill requirements under the law applicable to the bank's interest in the collateral for obtaining and maintaining an enforceable security interest. Item 124 directs that in order for collateral to provide protection, the credit quality of the counter party and the value of the collateral must not have a material positive correlation e.g. Securities issued by the counter party - or any related group entity.

Item 125 says banks must have clear and robust procedures for the timely liquidation on collateral to ensure that legal conditions required for declaring the default of the counter party and liquidating the collateral are observed, and that collateral is liquidated promptly.

Item 126 says banks must take steps to ensure that collateral held by a custodian is segregated from the latter's.

Item 127 states that a capital requirement will be required of banks on either sides of the collaterised transaction. Likewise both sides of the securities lending and borrowing transactions will be subject to explicit capital charges, as will the posting of securities in connection with a derivative exposure or other borrowing.

Item 128 says where a bank acting as agent, arranges a repo-style transaction between a customer and a third party and provides a guarantee e to the customer, the bank becomes the primary obligor and will be required to calculate capital requirement as such.

The Simple Approach

Item 129 is on the simple approach and as contained in Items 182 to 185, a collateral must be pledged for at least the life of the exposure if it is to be recognized in the Simple Approach. It must be marked to market and revalued with a minimum frequency of six months. Item 182 goes further to say that those portions of claims collaterised by the market value of recognized

collateral will receive the risk weight applicable to the collateral subject to a floor of 20% except under the conditions contained in Items 183 to 185. The remainder of the claim is to be assigned to the risk weight appropriate to the counter party.

Item 183 under the heading "Exceptions to the risk weight floor" says that transactions, which fulfill the criteria, as contained in Items 170 and 171 receive a risk weight of 0%. If the counter party to the transactions is not a core market participant, the transaction should receive a risk weight of 10%. Still on the simple approach Item 184 says that OTC derivate transactions subject to daily mark-to-market, collateralized by cash and where there is no currency mismatch should receive a 0% risk weight can be provided where the exposure and the collateral are denominated in the same currency, and either:

- The collateral is cash on deposit; or
- The collateral is in the form of sovereign/PSE securities eligible for a 0% risk weight, and its market value has been discounted by 20%.

Item 145 state the following collateral instruments as eligible for recognition under the Simple Approach:

(a) Cash on deposit with the lending bank including banks certificates of deposit or comparable instruments.

(b) Gold

© Debt Securities rated by a recognized external credit assessment institution where these are either:

- At least BB- when issued by Sovereigns and PSEs that are treated as Sovereigns by the national Supervisor; or
- At least BBB- when issued by Order issuers (including banks and securities firms); or
- At least A-3/P-3.

(d) Debt securities not rated by a recognized external credit assessment Institution where these are:

- Issued by a bank; and
- Listed on a recognized exchange; and
- Qualify as a senior debt; and
- All rated issues of the same seniority by the issuing bank are rated at least BBB- or A-3/P-3 by a recognized external credit assessment institution; and
- The bank holding the securities as collateral has no information to suggest that the issue justifies a rating below BBB- or A-3/P-3 (as applicable) and;
- The Supervisor is sufficiently confident about the market liquidity of the security.

(e) Equities that is included in a main index.

(f) Undertakings for collective investments in Transferable Securities (UCITS) and mutual funds where:

- A price for the units is quoted daily; and
- The UCITS/mutual fund is limited to investing in the instruments listed above.

The Comprehensive approach

Item 130 states that in the comprehensive approach, when taking collateral, banks will need to calculate their adjusted exposure to a counterparty for capital adequacy purposes to take account of the effect of that collateral. Banks are expected to use haircuts to adjust both the amount of the exposure to the counter party and the value of any collateral received in support of that counter party to take account of future fluctuations in the value of each, occasioned by market movements. This is to produce volatility-adjusted amount for both exposures and collateral. It is expected that unless either is cash, the volatility adjusted amount for exposure will be bigger than the exposure and for collateral it will be lower.

Item 131 cautions that where the exposure and collateral are held in different currencies an additional downwards adjustment must be made to the volatility adjusted collateral amount to take account of future fluctuation in exchange rates.

Item 132 says where the volatility adjusted exposure amount is greater than the volatility adjusted collateral amount (including any further adjustment for foreign exchange risk), banks shall calculate their risk-weighted assets as the difference between the two multiplied by the risk weight of the counter party.

Following is the precise framework as set out in Items 147-150 under the heading The Comprehensive Approach - Calculation of Capital requirement.

According to Item 147 calculation for a collateralized transaction exposure amount after risk mitigation is:

$E^* = \max \sum O, \{Ex (1+He)- CX (1-Hc-Hfx)\}$ where

E^* = the exposure value after risk mitigation

E = Current value of the exposure

He = haircut appropriate to the exposure

C = the current value of the collateral received

Hc = haircut appropriate for collateral

Hfx= haircut appropriate for currency mismatch between the collateral and exposure.

Item 133 limits banks to two ways of calculating the haircuts and these are: Standard Supervisory haircuts and own-estimate haircuts.

Supervisory haircuts

Item 151 contains these assuming daily mark-to-market, daily remerging and a 10-business day holding period) all expressed in percentages. Standard Supervisory haircuts are fixed levels provided by the Committee**.**

Issue rating for Debt Securities	Residual Maturity	Sovereigns	Other Issuers
AAA to AA-/ A-1	≤1 year	0.5	1
	>1≤5 years	2	4
	>5 years	4	8
A+to BBB-/ A-2/ A-3 and unrated bank securities per Item 116(d)	≥1 year >1 year < 5 yrs. > 5 years > 5 years	1 3 6	2 6 12
BB + to BB	ALL	15	
Main index equities and Gold		15	
Other equities listed on a recognized exchange		25	
UCITS/ Mutual funds		Highest haircut applicable to any security in which the Fund can invest.	
Cash in the same currency	as in 116(a)	0	

Included under the heading sovereign are public Sector entities (PSEs) which are treated as sovereigns by the national Supervisor and Multilateral development banks receiving 0% risk weight. Other issuers include Public Sector entities (PSEs) not treated as Sovereign by the national Supervisor.

Item 152 recommends 8% as the standard Supervisory Haircut for currency risk where exposure and collateral are denominated in different currencies based on a 10-business day holding period and daily mark-to-market.

Item 153 is on transactions in which the bank lends non-eligible instruments (e.g.non-investment grade corporate debt securities). The haircut to be applied should be the sameas for equity quoted on the second tier of a recognised exchange.

Own estimates for haircut

Item 154 says supervisors may permit banks to calculate haircuts (H) using their own internal estimates of market price volatility and foreign exchange volatility. Permission to do so will be conditional on the satisfaction of minimum qualitative and quantitative standards stated in Items 156-165. When debt securities are rated BBB-/A-3 or higher, supervisors may allow banks to calculate a volatility estimate for each category of security.

In determining relevant categories, institutions must take into account (a) the type of issuer of the security, (b) its rating (c) its maturity, and (d) its modified duration. Volatility estimates must be representative of the securities actually included in the Category for that bank. For debt securities rated below BBB-/A-3 or for equities eligible as collateral, the haircuts must be calculated for each individual security.

Items 156 to 161 are on the Quantitative criteria while **Items 162 to 165** are on the Qualitative criteria both of which must be satisfied before supervisors may permit banks to use their own internal estimates to calculate haircuts.

Item 166 to 169 are on Adjustment for different holding periods and non-daily mark-to-market or remerging.

Item 170 sets out the conditions under which Supervisors may choose not to apply the haircuts specified under the comprehensive approach and may instead apply a zero H provided the counter party is a "core market participant".

Item 171 says core market participants may include at the discretion of the national supervisor the following entities: -

(a) Sovereigns, Central banks and PSEs;
(b) Banks and Securities firms;
(c) Other financial companies (including insurance companies) eligible for a 20% risk weight;
(d) Regulated mutual funds that are subject to Capital or leverage requirements;
(e) Regulated pension funds; and
(f) Recognized Clearing organizations.

Items 173 to 177 are on the treatment of repo-style transactions with master netting arrangements.

Items 178 to 181 deal with the use of Value at Risk (VaR) models as an alternative to the use of Standard or own-estimate haircuts to reflect the price volatility of the exposure and collateral for repo-style transactions, taking into account correlation effects between security positions.

Items 182 to 185 have been cited above.

Items 186 to 187 are on collateralized OTC derivatives transaction and they include the calculation of the counter party credit risk charge for an individual contract.

Item 188 is on netting On-balance Sheet while **Items 189 to 201** are on conditions under which Guaranties and credit derivatives contracts will be recognised.

Item 202 to 210 are the definitions of security mismatches for the purpose of calculating risk-weighted assets.

CREDIT RISK – THE INTERNAL RATINGS BASED APPROACH

Items 211 to 214 are an overview of this alternative methodology to the Standardized Approach. Under this approach, subject to the explicit approval of the Supervisor and the fulfillment of certain conditions, a bank can use its own internally generated ratings to calculate its capital requirement as defined in this Accord.

Items 215 to 243 require banks to categorize banking book exposures into five broad classes of assets with different underlying risk characteristics as follows:

(a) Corporate Exposures – defined as a debt obligation of a corporation, partnership, or proprietorship but not small – and medium sized entities (SME) as defined in the Accord.

A corporate exposure must possess all the following characteristics:

- It must have been made to an entity.
- Its liquidation must be dependent on the income generated by virtue of its existence.
- The lender must have a substantial degree of control over the exposure and the income that is being generated.
- The primary source of repayment must be the income it generates.

Corporate Exposures are further divided into five sub-classes of specialized lending and these are project finance, object finance, commodities finance, income producing real estate, and high volatility commercial real estate.

(b) Sovereign Exposures – defined as all exposures to counterparties treated as sovereigns under the standardized approach including their central banks, Some Public Sector Entities (PSEs) and Multilateral Development Banks (MDBs) that meet the criteria for a 0% risk weight, and the entities referred to in paragraph 56 of the Accord.

© Bank Exposures are defined as those to banks and securities firms outlined in Item 65 of the Accord. They also include claims on domestic Public Sector Entities (PSEs) treated as such under the standardized approach, and Multilateral Development Banks (MDBs) that do not meet the criteria for a 0% risk weight under the standardized approach.

(d) Retail Exposures are defined as those that meet the following criteria:

- They must be to individuals and could be revolving credits lines of credit, personal loans are leases, irrespective of size.
- Residential mortgage loans.
- Small business loans less than one million euro.

(e) Equity Exposures are defined as including both direct and indirect ownership interests in the assets and income of a commercial enterprise or of a financial institution that is not consolidated or deducted as stated in Part 1 of the Accord.

An equity exposure must also meet all the following requirements:

- It is irredeemable except through sale of the investment or the right to it or liquidation of the issuer.
- It does not embody an obligation on the part of the issuer.
- It conveys a residual claim on the assets or income of the issuer.

The following must also be categorized as Equity:

- An instrument with the same structure as those permitted as Tier 1 Capital for banking organizations.

- An instrument that embodies an obligation on the part of the Issuer and meets any of the following conditions:-

  (i) The Issuer may defer indefinitely the settlement of the obligation;

  (ii) The obligation requires settlement by issuance of a fixed number of the Issuer's equity shares;

  (iii) The obligation requires settlement by Issuance of a variable number of issuers' equity shares.

  (iv) The holder has the option to require that the obligation be settled in equity shares.

(f) Purchased receivables are divided into retail receivable and corporate receivables.
Items 244 and 245 are for foundation and Advanced Approaches under the Internal Ratings Based Approach.

There are three key elements for each of the assets and they are as follows:

- Risk Components – estimates of risk parameters provided by banks, some of which are supervisory estimates.
- Risk-weight functions – the means by which risk components are transformed into risk-weight assets and therefore capital requirements.
- Minimum requirements – the minimum standards that must be met in order for a bank to use the IRB approach for a given class of asserts.

Items 246 – 262 Clarify the difference between the foundation and Advanced Approaches under the Internal Ratings Based (IRB) for many of the asset classes indicated. Under the foundation approach banks provide their own estimate of Probability of Default (PD) and rely on supervisory estimates for other risk component. Under the Advanced approach, banks provide more of their own estimates of Probability of Default (PD): Loss Given Default (LGD) and Exposure at Default (EAD) and their own calculation of Effective Maturity (M) subject to meeting the minimum standard. The Committee makes it mandatory for banks to use the risk-weight functions provided in this Accord for the purpose of deriving their capital requirements.

Items 263 to 269 are on Transition arrangements and banks adopting the foundation or advanced approaches of the IRB are required to calculate their capital in Items 45 to 49 of this Accord. Different time frames are indicated for banks adopting the foundation IRB approach and those moving directly from the Basel 1 Accord to the Advanced Approaches to credit and operational risk. The transition period is scheduled to start from the date the Accord is implemented and will last three years from that date. The minimum requirements for the

period, which can be revoked at the discretion of the national supervisor, are indicated for corporate, sovereign, banks, retail and equity exposures.

Items 270 to 325 are on the rules for calculating the Unexpected Loss (UL) capital requirements for corporate, sovereign and bank exposures.

Items 326 to 338 are on the method of calculating the Unexpected Loss (UL) capital requirements for retail exposures, while Items 339 to 373 are on the same topic for Equity Exposures. Items 302 to 373 handle the same topic for Purchased Receivable and the treatment of its purchase price discount.

Items 374 to 386 discuss the method by which the difference between provisions and Expected Losses (EL) may be included in or must be deducted from regulatory capital as defined in the Accord.

Items 387 to 537 seem to have put paid to the argument by the few Nigerian bankers that have over read this Accord which is that the Internal Ratings Based Approach is what Nigeria banks should adopt for the calculation of regulatory capital under this Accord. These Items contain the twelve minimum requirements a bank must satisfy before it could enter and continue to use the Internal Ratings Based Approach (IRB). They are applicable to both Foundation and Advanced Approaches of the IRB and are as follows:

(i) Composition of minimum requirements;

(ii) Compliance with minimum requirements;

(iii) Rating system design;

(iv) Risk rating system operations;

(v) Corporate governance and oversight;

(vi) Use of internal ratings;

(vii) Risk quantification;

(viii) Validation of internal estimates

(ix) Supervisory LGD and EAD estimates

(x) Requirements for the recognition of leasing;

(xi) Calculation of capital charges for equity exposures and

(xii) Disclosure requirements.

(1) Composition of minimum requirements:

Item 388 states that to be eligible for the IRB approach a bank must demonstrate to its Supervisor that it meets certain minimum requirements **at** the onset and on an ongoing basis. Many of these requirements are in the form of objectives that a qualifying bank's risk rating systems must fulfil. The focus, it says, is on banks' abilities to rank-order and quantifies risk in a consistent, reliable and valid manner.

Item 389 is on the overarching principle behind these requirements which is that rating and risk estimation systems and processes provide for a meaningful assessment of borrower and transaction characteristics, a meaningful differentiation of risk; and reasonably accurate and consistent quantitative estimates of risk. It states furthermore that the systems and processes must be consistent with internal use of these estimates. The committee recognizes that divergence in markets, rating methodologies, banking products, and practices require banks and Supervisors to customize their operational procedures. Since it is not the Committee's intention to dictate the form or operational detail of banks' risk management policies and practices, it expects the Supervisor to develop detailed review procedures to ensure those banks' systems and controls are adequate to serve as the basis for the IRB approach.

Item 390 states that these minimum requirements apply to all asset classes unless otherwise noted. The Standards related to the process of assigning exposures to borrower or facility grades (and the related oversight, validation, etc.) apply equally to the process of assigning retail exposures to pools of homogeneous exposures, unless noted otherwise.

Item 391 says these minimum requirements apply to both foundation and advanced approaches unless otherwise noted. It expects all IRB banks to produce their own estimates of PDs (Probability of Default) except for certain equity exposures and certain exposures that fall within the specialized lending (SL) sub-class. They must also adhere to the overall requirements for rating system design operations, controls, and corporate governance, as well as the requisite requirements for estimation and validation of PD measures.

(2) Compliance with minimum requirements

Item 392 is on banks overall credit risk management practices, which it says must be consistent with the evolving, sound practice guidelines issued by the Committee and national Supervisors.

Item 393 says where a bank if not in complete compliance with all the minimum requirements, it must produce a plan for a timely return to compliance, and seek approval from its Supervisor, or demonstrate that the degree of such non-compliance is immaterial in terms of the risk posed to the institution. Otherwise, the Supervisors should reconsider the bank's eligibility for he IRB approach. Supervisors may take other appropriate supervisory action for the duration of any non-compliance.

Rating System design

Item 394 describes "rating system" as comprising all of the methods, processes, controls, and data collection and IT Systems that support the assessment of credit risk, the assignment of internal ratings, and the quantification of default and loss estimates.

Item 395 allows a bank to utilize multiple rating methodologies/Systems within each class of assets but not to allocate borrowers across rating systems (i.e. cherry-picking by choice of rating system). It directs banks to demonstrate that each system used for IRB purposes is in compliance with the minimum requirements at the outset and on-going basis.

Items 396 to 400 are on rating dimensions setting the standards for Corporate, Sovereign and bank exposures. According to Item 358, a qualifying IRB rating system must have two separate and distinct dimensions: (a) the risk of borrower default and (b) transaction specific factors.

Items 401 and 402 set the Standards for retail exposures and say that the rating system must be oriented to both borrower and transaction risk, and must capture all relevant borrower and transaction characteristics. It is the banks that must demonstrate that this process provides for a meaningful differentiation of risk, provides for a grouping of sufficiently homogeneous exposures and allow for accurate and consistent estimation of loss characteristics at pool level.

Items 403 to 409 are on the rating structure and they set the Standards for Corporate, Sovereign, retail, and bank exposures.

Item 410 says a bank must have specific rating definitions, processes and criteria for assigning exposures to grades within a rating system. The rating definitions and criteria must be both plausible and intuitive.

- The grade descriptions and criteria must be sufficiently detailed to allow those charged with assigning ratings to consistently assign the same grade to borrowers or facilities posing similar risk.
- Written rating definitions must be clear and detailed enough to allow third parties to understand the assignment of rating, such as internal audit or an equally independent function and supervisors, to replicate rating assignments and evaluate the appropriateness of the grade/pool/assignments.
- The criteria must also be consistent with the bank's internal lending standards and its policies for handling troubled borrowers and facilities.

Item 411 advises banks to take all relevant available information into account in assigning ratings to borrowers and facilities. It says the information must be current and that the less information a bank has the more conservative it must be in the assignment of exposures to

borrower and facility grades of pools. For as long as the bank considers other relevant information an external rating can be used as the primary factor determining an internal rating assignment.

Items 412 and 413 are on Specialized Lending (SL) product lines within the Corporate asset class while Items 414 to 416 are on assessment horizon and the advised that banks must use a long time horizon (over 1 year) in assigning ratings. They recommend that a borrower's rating must represent the bank's assessment of the borrower's ability and willingness to contractually perform despite adverse economic conditions or the occurrence of unexpected events.

Where limited data is available a bank must adopt a conservative bias to analysis.

USE OF STATISTICAL MODELS AND OTHER MECHANICAL METHODS

Item 417 lists the requirements applicable to statistical models and other mechanical methods used to assign borrower or facility ratings or in estimation of PDs, LGDs, or EADs. The committee acknowledge the limitations of these methods and as such permits them as the primary or partial basis of rating assignments which can play a role in the estimation of loss characteristics.

It still advocated the need for sufficient human judgment and oversight as being necessary to ensure that all relevant information, including that which is outside the scope of the model, is also taken into consideration and the appropriate use of the model. The following are the requirements.

- The bank must have in place a process for vetting data inputs into a statistical default or loss prediction model which includes an assessment of the accuracy, completeness, and appropriateness of the data specific to the assignment of an approved rating.
- The bank must demonstrate that the data used to build the model are representative of the population of the bank's actual borrowers or facilities.
- When combining model results with human judgment, the judgment must take into account all relevant information not considered by the model. The bank must have written guidance describing how human judgment and model results is to be combined.
- The bank must have a regular cycle of model validation that includes monitoring of model performance and stability; review of model relationships; and testing of model outputs against outcomes.

DOCUMENTATION OF RATING SYSTEM DESIGN

Item 418 directs banks to document their rating systems' design and operational details. This documentation must evidence banks' compliance with the minimum standards, and must address topics such as portfolio differentiation, rating criteria, responsibilities of parties that rate borrowers and facilities, definition of what constitutes a rating exceptions, frequency of rating reviews, and management oversight of the rating process. A bank must document the rationale for choice of internal rating criteria and must be able to provide analyses

demonstrating that rating criteria and procedures are likely to result in ratings that meaningfully differentiate risk. Rating criteria and procedure must be periodically reviewed to determine whether they remain fully applicable to the current portfolio and to external conditions.

In addition, a bank must document a history of major changes in the risk rating process subsequent to the last supervisory review. The organization of rating assignment including the internal control structure must also be documented.

Item 419 says banks must document the specific definitions of default and loss used internally and demonstrates consistency with the reference definitions set out in Items 452 to 460

Item 420 directs banks that employ statistical models in the rating process to document their methodologies in addition to the following:

- A detailed outline of the theory, assumptions and/or mathematical and empirical basis of the assignment of estimates to grades, individual obligors, exposures, or pools, and the data source(s) used to estimate the model;
- Establishment of a rigorous statistical process (including our-of-time and out-of-sample performance tests) for validating the model; and
- Indication of any circumstances under which the model does not work effectively.

Item 421 explains that the use of a model obtained from a third-party vendor that claims proprietary technology is not a justification for exemption from documentation or any other of the requirements for internal rating systems.

The burden of satisfying the Supervisor is on the models vendor and the bank.

RISK RATING SYSTEM OPERATIONS

Items 422 and 423 are on the coverage of ratings and they direct that for Corporate, Sovereign, and bank exposures, each borrower and all recognized guarantors must be assigned a rating and each exposure must be associated with a facility rating as part of the loan approval process. Similarly for retail, each exposure must be assigned to a pool as part of the loan approval process. Item 385 says each separate legal entity to which the bank is exposed must be separately rated. A bank must have policies acceptable to its Supervisor regarding the treatment of individual entities in a connected group including circumstances under which the same rating may or may not be assigned to some or all related entities.

Item 424 to 426 are on the integrity of rating process and they set the standard for Corporate Sovereign, and bank exposures. **Item 424** specifically recommends independence for the party that performs the rating assignments and periodic rating reviews. The party must not stand to benefit directly from the extension of credit. Supervisors must carefully review the range of practices that ensures this independence. The operational process must be documented in the bank's procedures and incorporated into bank credit policies and underwriting procedures and must reinforce and faster the independence of the rating process.

Item 425 directs that borrowers and facilities must have their ratings refreshed at least on annual basis. Higher risk borrowers or problem exposures, must be reviewed more frequently and a new rating must be conducted should material information come to light on them.

Item 426 expects banks to have an effective process to obtain and update relevant information on the borrower's financial condition, and on facility characteristics that affect LGD's and EADs e.g. the collateral. As mentioned above the borrowers rating must be updated.

Item 427 sets the standards for retail exposures and it directs that a bank must review the loss characteristics and delinquency status of each identified risk pool on at least an annual basis. It must also review the status of individual borrowers within each pool as a means of ensuring that exposures continue to be assigned to the correct pool.

Item 428 is on Overrides and says that for rating assignments based on expert judgment, banks must clearly articulate the situations in which their officers may override the output of the rating process, including how and to what extent such overrides can be used and by whom. For model-based ratings, the banks are expected to have guidelines and processes for monitoring cases where human judgment has overridden the models ratings, variables were excluded or inputs were altered. The guidelines must include identifying personnel that are responsible for approving the Overrides. Bank must identify overrides and separately track their performance.

Item 429 to 433 are on Data maintenance for Corporate, Sovereign, and bank and retail exposures.

Item 429 says a bank must collect and store data on key borrower and facility characteristics to provide effective support to its internal credit risk measurement and management process, to enable the bank to meet the other requirements in the Accord, and to serve as a basis for Supervisory reporting. The data is expected to be sufficiently detailed to allow retrospective re-allocation of obligors and facilities to grades. Banks must collect and remain data on aspects of their internal ratings as required under Pillar 3 of the Accord.

Item 430 directs banks to maintain rating histories on borrowers and recognized guarantors, including the rating since the borrower/guarantor was assigned an internal grade, the dates the ratings were assigned, the methodology and key data used to derive the rating and the personnel/model responsible. The banks must retain default, and the timings and circumstances of such defaults. They must also retain data on the PDs and realized default rates associated with rating grades and rating migration in order to track the predictive power of the borrower rating system.

Items 431 directs banks using the IRB approach to also collect and store a complete history of data on the LGD and EAD estimates associated with each facility and the key data used to derive the estimate and the person/model responsible. Banks must also collect data on the estimated and realized LGDs and EADs associated with each defaulted facility. If they reflect the credit risk mitigating effects of guarantees/credit derivatives through LGD, such data must be retained on the LGD of the facility before and after evaluation of the effects of the guarantee/credit derivative. Information about the details of loss or recovery (e.g. collateral, liquidation, proceeds and guarantees) time required for recovery and administrative costs.

Item 432 encourages banks under the foundation approach and utilizing Supervisory estimates to retain the relevant data on loss and recovery experience for corporate exposures under the foundation approach and utilizing Supervisory estimates to retain the relevant data on loss and recovery experience for corporate exposures under the foundation approach, data on realized losses for banks using the Supervisory slotting criteria for Specialized Lending (SL).

For retail exposures **Item 433** says banks must retain data used in the process of allocating exposures to pools including data on borrower and transaction risk characteristics used either directly or through use of a model, as well as data on delinquency. They are also to retain data on the estimated PDs, LGDs and EADs, associated with pools of exposures. For defaulted exposures, banks must retain the data on the pods to which the exposure was assigned over the year prior to default and the realized outcomes on LGD and EAD.

Items 434 to 437 are on stress tests used in assessment of capital adequacy and according to **Item 434** an IRB bank must have in place sound stress testing processes for use in the assessment of capital adequacy. Stress testing must involve identifying possible events or future changes in economic conditions that could have unfavourable effects on a bank's credit exposures and assessment of the bank's ability to withstand such changes. It gives examples of scenarios that could be usefully examined as (i) economic or industry downturns; (ii) market-risk events; and (iii) liquidity conditions.

Item 435 also wants banks to perform credit risk stress test to assess the effect of certain specific conditions on its IRB regulatory capital requirements. The bank is at liberty to chose the test to be employed subject to Supervisory review, but must be meaningful and reasonably conservative. Individual banks are allowed to develop different approaches to undertaking this stress test requirement, as the Committee's objective is no to require banks to consider worst-case scenarios. It is expected though to consider at least the effect of mild recession scenarios.

Whatever method is used, says **Item 436** the bank must include a consideration of firstly its own data, which should allow estimation of the ratings migration of at least some of its exposures. Secondly, banks should consider information about the impact of smaller deterioration in the credit environment on a bank's ratings, giving some information on the likely effect of bigger, stress circumstances. Thirdly, banks should evaluate evidence of ratings migration in external ratings. It would include the broad matching of each bank's buckets to rating categories.

Item 437 says national supervisors may wish to issue guidance to their banks on how the tests to be used for this purpose should be designed, bearing in mind the conditions in their jurisdictions. It cautioned that the results of the stress test might indicate no difference in the capital calculated under the Accord IRB approach especially if the bank already uses such an approach for its internal rating purposes. Where a bank operates in several markets, it need not test for such conditions in all those markets, but should stress test portfolios containing the vast majority of its total exposures.

CORPORATE GOVERNANCE AND OVERSIGHT

Item 438 on corporate governance says all material aspects of the rating and estimation processes must be approved by the Board of Directors or a designated Committee thereof and Senior Management. The Committee (Basel) 0recognizes the divergent management structures

of member countries but stress that the parties must possess a general understanding of the bank's risk rating system and detailed comprehension of its associated management reports. Senior management must provide notice to the board of directors or a designated committee thereof of material changes or exceptions from established policies that will have material impact on the operations of the bank's rating system.

Item 439 states that Senior Management must also have a good understanding of the rating system's design and operation and must approve material differences between established procedure and actual practice. Management must also ensure continuously that the rating system is operating properly. Management and staff in the credit control function must meet regularly to discuss the performance of the rating process, areas needing improvement, and the status of efforts to improve previously identified deficiencies.

Item 440 says internal ratings must be an essential part of the reporting to these parties. Reporting, it says must include risk profile by grade, migration across grade, s, estimation of the relevant parameters per grade, and comparison of realized default rates against expectations. Reporting frequencies may vary with the materiality of information and the level of recipient.

Item 441 and 442 are on Corporate governance in credit risk control and **Item 441** directs that banks must have credit risk control units that are responsible for the design or selection, implementation and performance of their internal rating systems. The unit(s) must be functionally independent from the personnel and management functions responsible for originating exposures. Their areas of responsibility must include:

- Testing and monitoring internal grades;
- Production and analysis of summary reports from the bank's rating system, to include historical default data sorted by rating at the time of default and one year prior to default, grade migration analyses, and monitoring of trends in key rating criteria;
- Implementing procedures to verify that rating definitions are consistently applied across departments and geographic areas;
- Reviewing and documenting any changes to the rating process, including the reason for the changes; and
- Reviewing the rating criteria to evaluate if they remain predictive of risk. Changes to the rating process, criteria or individual rating parameters must be documented and retained for supervisors to review.

Item 442 is on the duties of the credit risk control unit among which are active participation in the development, selection, implementation and validation of rating models. It must also assume oversight and supervision responsibilities for any models used in the rating process, and ultimate responsibility for the ongoing review and alterations to rating models.

Item 443 is on internal and external audits and it directs that they must review at least annually the bank's rating system and its operations, including the operations, including the operations of the credit function and the estimation of PDs, LGDs and EADs. Areas o review include adherence to all applicable minimum requirements. Internal audit must document its findings. Some national supervisors it says may also require an external audit of the bank's rating assignment process and estimation of loss characteristics.

USE OF INTERNAL RATINGS

Item 444 emphasizes the essential role that internal rating and default and loss estimates must play in the credit approval risk management, internal capital allocations and corporate governance functions of banks using IRB approach. Rating systems and estimates designed and implemented exclusively for the purpose of qualifying for the IRB approach and only to provide IRB inputs are not acceptable. It is recognized that banks will not necessarily be using exactly the same estimates for both IRB and all internal purposes.

Item 445 makes it mandatory for a bank to have a credible track record in the use of internal ratings information. The bank, it says, must demonstrate that it has been using a rating system that was broadly in line with the Accord's minimum requirements for at least the three years prior to qualification. A bank using the advanced IRB approach must demonstrate that it has been estimating and employing LGDs and EADs in a manner consistent with the Accord's minimum requirements for at least the three years preceding qualification. It clarified that improvement to a bank's rating system will render it non-compliant with the three year requirement.

(7) RISK QUANTIFICATION – Overall requirements for estimation

Items 446 to 451 are on the structure and intent and Item 408 states that all banks using the IRB approaches must estimate a PD for each internal borrower grade for corporate, sovereign and bank exposures or for each pool in the case of retail exposures.

Item 447 directs that PD estimates must be a long-run average of one-year realized default rates for borrowers in the grade, with the exception of retail exposures.

ITEM 448 ALLOWS A BANK TO UTILIZE INTERNAL DATA AND DATA FROM EXTERNAL SOURCES (INCLUDING POOLED DATA) ONLY THAT IT MUST DEMONSTRATE THAT ITS ESTIMATES ARE REPRESENTATIVE OF LONG RUN EXPERIENCE. INTERNAL ESTIMATES OF PD, LGD, AND EAD MUST INCORPORATE ALL RELEVANT AND AVAILABLE DATA, INFORMATION AND METHODS.

Item 449 directs that estimates must be grounded in historical experience and empirical evidence and not based purely on subjective or judgmental considerations. Any changes in lending practice or the process for pursuing recoveries over the observation period must be taken into account, and banks must review their estimates on a yearly basis at least.

Item 450 expects the estimation technique to perform well in out-of-sample tests and to this end it directs that the population of exposures represented in the data used for estimation and

lending standards in use when the data were generated, and other relevant characteristics should be closely matched to or comparable with those of the bank's exposures and standards. The bank must also demonstrate that economic or market conditions that underlie the data are relevant to current and foreseeable conditions. The number of exposures in the sample, and the data period used for quantification must be sufficient to provide the bank with confidence in the accuracy and robustness of its estimates.

Item 451 cautions that because estimates of PDs, LGDs, and EADs are likely to involve unpredictable errors, a bank must add to its estimates a margin of conservatism that is related to the likely range of errors**.**

Item 452 to 457 contain the definition of default and according to Item 414 a default is considered to have occurred with regard to a particular obligor when either o both of the following events has taken place.

- The bank considers that the obligor is unlikely to pay its credit obligations to the banking group in full, without recourse by the bank to actions such as realizing security if held).
- The obligor is past due more than 90 days on any material credit obligation to the banking group. Overdrafts will be considered as being past due once the customer has breached an advised limit or been advised of a limit smaller than current out standings.

Item 453 dwells further on an obligor's indication of unlikeliness to pay as including:

- The bank puts the credit obligation on non-accrued basis.
- The bank makes a charge-off or account specific provision resulting from a significant perceived decline in credit quality subsequent to the bank taking on the exposure. The exception will be in some jurisdictions where specific provisions on equity exposures are set aside for price risk, and do not signal default.
- The bank sells the credit obligation at a material credit-related economic loss.
- The bank consents to a distressed restructuring of the credit obligation where this is likely to result in a diminished financial obligation caused by the material forgiveness, or postponement of principal, interest or (where relevant) fees.
- The bank has filed for the obligor's bankruptcy or similar order in respect of the obligor's credit obligation o the banking group.
- The obligor has sought or has been placed in bankruptcy or similar protection where this would avoid or delay repayment of the credit obligation to the banking group.

Item 454 requires national supervisors to provide appropriate guidance as to how these elements must be implemented and monitored.

Item 455 cautions that for retail exposures default by a borrower on one obligation does not require a bank to treat all other obligations to the banking group as defaulted.

Item 456 says a bank must record actual defaults on IRB exposure classes using the reference definition above. It must also use it for its estimation of PDs, and (where applicable) LGDs and EADs.

Item 457 state that if the bank considers that a previously defaulted exposure's status is such that no trigger of the reference definition any longer applies the bank must rate the borrower and estimate LGD as they would for a non-defaulted facility. Should the reference definition subsequently be triggered, a second default would be deemed to have occurred.

Item 458 is on re-ageing of facilities and it directed that a bank must have clearly articulated and documented policies in respect of the counting of days past due, in particular in respect of re-ageing of the facilities, and the granting of extensions, deferrals, renewals and rewrites to existing accounts. At a minimum the re-ageing of the facilities, and the granting of extensions, deferrals, renewals and rewrites to existing accounts. At a minimum the re-ageing policy must include: (a) approval authorities and reporting requirements; (b) minimum age of a facility before it is eligible for re-ageing; (c) delinquency levels of facilities that are eligible for re-ageing; (d) maximum number of re-ageing per facility; and (e) a reassessment of the borrower's capacity to repay. It says these policies must be applied consistently over time, and must support 'the use test' (i.e. if a bank treats a re-aged exposure in a similar fashion to other delinquent exposures more than the past-due out off point, this exposure must be recorded as in default for IRB purposes). It allows supervisors to establish more specific requirements on re-ageing for banks in their jurisdiction.

Item 459 is on the treatment of Overdraft and the directives that it must be subject to a credit limit set by the bank and brought to the knowledge of the customer. Any excess above authorized limit must be cleared within 180 days (subject to the applicable past-due trigger) otherwise it would be considered as defaulted. Unauthorized overdrafts will be considered as zero limit and will become past due the day it was created. If not repaid with 180 days it would be considered in default. It directs banks to have in place rigorous internal policies for assessing the credit worthiness of customers who are offered overdraft facilities.

Item 460 defines loss used in estimating LGD as economic loss and that when measuring it all relevant factors should be taken into account. It must include material discount effects and material direct and indirect costs associated with collecting on the exposure. Accounting losses must be compared with economic losses and the bank's recovery efforts and rates must be reflected in their LGD estimates. Adjustment to such estimates however, is advised to be conservative until the bank has sufficient internal empirical evidence of the impact of its recovery efforts.

Item 461 to 463 is on requirements specific to PD estimation for corporate, sovereign, bank and retail exposures

Item 461 under Corporate Sovereign and bank exposures allow banks to use one or more of the following three specific techniques (1) internal default experience; (2) mapping to external data;

(3) statistical default models. Other information and techniques as appropriate can be used to estimate the average PD for each rating grade.

Item 462 is on the use of these three techniques.

Item 463 specifies that irrespective of whether a bank is using external, internal or pooled data sources, or a combination of the three, for its PD estimation, the length of the underlying historical observation period used must be at least 5 years for at least one source. If the available observation period spans a longer period for any source, and this data is relevant, this longer period must be used.

For retail exposures **Item 464** stresses that given the bank-specific basis of assigning exposures to pools, banks must regard internal data as the primary source of information for estimating loss characteristics. It permits banks to use external data or statistical models for quantification provided a strong link can be demonstrated between (a) the bank's process of assigning exposures to a pool and the process used by the external data sources, and (b) between the bank's internal risk profile and the composition of the external data. In all cases, it says, banks must use all relevant data sources as points of comparison.

Item 465 directs that the process of estimating losses must meet the minimum standards for estimation of PD and LGD set out here, and the outcome must be consistent with the concept of a default-weighted LGD as defined in **Item 468**

Item 466 prescribes at least 5 years as the length of the historical observation period for a bank's estimation of loss characteristics irrespective of whether it is using external, internal, pooled data sources, or a combination of the three. Should the available observation period spans a longer period, this longer period must be used.

Item 467 advisers banks should adjust PD estimates upward for anticipated seasoning effects to avoid gyrations in their required capital position arising from short-term PD horizons. Such adjustment must however be applied in a consistent fashion over time. **Item 473** adds that the less data a bank has, the more conservative it must be in its estimation. A bank, it says, need not give equal importance to historic data is it can demonstrate to its Supervisor that more recent data is a better predictor of loss rates.

Items 468 to 473 contain the requirements specific to own-LGD estimates and set the Standard for all assets i.e. Corporate, Sovereign, bank and retail exposures.

Items 474 to 477 are on the requirements for own-EAD estimates setting the standards for all assets as mentioned above. **Items 478 and 479** contain additional standards for these classes.

Items 478 to 490 are on the minimum requirements for assessing effect of guarantees and credit derivatives and set the standard for all assets. **Items 480 to 482** are specifically on guarantees while **Items 483 and 484** are on eligible guarantors and guarantees. **Items 485 to 487** are on adjustment criteria. **Items 488 and 489** are on Credit derivatives while **Items 490** is on exceptions to the minimum requirements outlined in **Items 480 to 489.**

Items 491 and 492 contain the requirements specific to estimating PD and LGD (or ED) for qualifying purchased receivables with **Item 492** containing the minimum requirements for estimating PD and LGD (or EL).

Item 493 is on the minimum operational requirement for a bank purchasing receivables while **Item 494** is on legal certainty of the transaction.

Item 495 is on how to monitor the quality of receivables while **Item 496** is on effectiveness of workout systems. **Item 497** still on effectiveness is for Controlling Collateral, credit availability, and cash. **Items 498 and 499** are on compliance with the bank's internal policies and procedures.

(8) VALIDATION OF INTERNAL ESTIMATES

ITEM 500 DIRECTS THAT BANKS MUST HAVE A ROBUST SYSTEM IN PLACE TO VALIDATE THE ACCURACY AND CONSISTENCY OF RATING SYSTEMS, PROCESSES AND THE ESTIMATION OF ALL RELEVANT RISK COMPONENTS. A BANK MUST DEMONSTRATE TO ITS SUPERVISOR THAT THE INTERNAL VALIDATION PROCESS ENABLES IT TO ASSESS THE PERFORMANCE OF INTERNAL RATING AND RISK ESTIMATION SYSTEMS CONSISTENTLY AND MEANINGFULLY.

ITEM 501 WANTS BANKS TO REGULARLY COMPARE REALIZED DEFAULT RATES WITH ESTIMATED PDS FOR EACH GRADE AND BE ABLE TO DEMONSTRATE THAT THE REALIZED DEFAULT RATES ARE WITHIN THE EXPECTED RANGE FOR THAT GRADE.

Item 502 says banks must also use other quantitative validation tools and comparisons with relevant external data sources. The analysis must be based on data that are appropriate to the portfolio, are updated regularly, and cover a relevant observation period.

Item 503 says banks must demonstrate that quantitative testing methods do not vary systematically with the economic cycle and that changes in methods and data must be clearly and thoroughly documented.

Items 504 and 505 encourage banks to compare realized LGDs and EADs to those set by the Supervisors where they (the banks) rely on Supervisory, rather than internal estimates of risk parameters.

SUPERVISORY LGD AND EAD ESTIMATES

Item 506 to 522 contain the additional minimum requirement of banks under the foundation IRB approach which do not meet the requirement for own-estimates of LGD and EAD. They must meet the additional requirements in order to receive recognition for additional collateral types. According to **Item 507** in order to be recognised as collateral, a commercial real estate (CRE) or residential real estate (RRE) for corporate, sovereign and banks must be where the risk of the borrower is not materially dependent on the performance of the underlying project or property, but rather on the underlying capacity of the borrower to repay from other sources. The value of the collateral itself must not be dependent on the performance of the borrower.

Item 516 is on risk management and it directs banks to have a sound processes for determining the credit risk in receivables. Such a process should include, among other things, analyses of borrowers' businesses and industries.

REQUIREMENTS FOR RECOGNITION OF LEASING

Item 523 is on leases that do not expose the bank to residual value risk and will be accorded the same treatment as exposures collaterised by the same type of collateral and as such the minimum requirements for the collateral type must be met. In addition the bank must also meet the following standards:

Robust

Annex II of the Accord is not another approach for determining regulatory capital; rather it is a collection in one place of the simplest option for calculating risk-weighted assets under the first option mentioned above. It is titled "The Simplified Standard Approach". The general rule is that exposures should be risk-weighted net of specific provisions and recognition is given to credit risk mitigation techniques which may include Collaterisation in whole or in part with Cash or Securities, guarantees or insurance.

Under item 2 of this Annex claims on sovereigns and their central banks will be risk-weighted on the basis of the rating of Export Credit Agencies (ECA) participating in the "Arrangement on Officially Supported Export Credits".

- risk management on the part of the lessor with respect to the location of the asset, the use to which it is put, its age, and planned obsolescence;
- A robust Legal framework establishing the lessor's legal ownership of the asset and its ability o exercise its rights as owner in a timely fashion and;
- The difference between the rate of depreciation of the physical asset and the rate of amortization of the lease payments must not be so large as to overstate the Credit Risk Mitigation attributed to the lease.

Item 524 is on leases that expose the bank to residual value risk which it described as the bank's exposure to potential loss due to the fair value of the equipment declining below its residual estimate at lease inception. They are to be treated as follows: -

- The discounted lease payment stream will receive a risk weight appropriate for the lessee's financial strength (PD) and supervisory or own-estimate of LGD, which ever is appropriate.
- The residual value will be risk-weighted at 100%.

CALCULATION OF CAPITAL CHARGES FOR EQUITY EXPOSURES

Item 525 introduces the internal models market-based approach. It directs that to be eligible for this approach a bank must demonstrate to its supervisor that it meets certain quantitative and qualitative minimum requirements at the onset and continuously. A bank that fails to demonstrate continue compliance with the minimum requirements must develop a plan for

rapid return to compliance, obtain its Supervisor's approval of the plan, and implement that plan in a timely fashion. In the interim, banks would be expected to compute capital charges using a simple risk weight approach.

Item 526 contains the committee's recognition of differences in markets, measurement methodologies, equity investments and management practices that require banks and supervisors to customize their operational procedures. It declares that it is not the Committee's intention to dictate the form or operational details of banks' risk management policies and measurement practices for their banking book equity holdings. It stresses that some of the minimum requirements are specific and that each Supervisor will develop detailed examination procedures to ensure that banks' risk measurement systems and management controls are adequate to serve as the basis for the internal models approach.

Item 527 is on Capital charge and risk quantification and it sets the minimum quantitative standards applicable for the calculation under the internal models approach.

Item 528 is on risk management process and control used by banks to manage their banking book equity investments which it said, are expected to be consistent into the evolving sound practice guidelines issued by the Committee and national Supervisors. It sets the standard required under internal models approach.

Items 529-536 are on validation and documentation under internal models for regulatory capital purposes.

Items 529 specifically states that institutions employing this models are expected to have in place a robust system to validate the accuracy and consistency of the model and its inputs. They must also fully document all material elements of their internal models and modeling process. The modeling process itself as well as the systems used to validate internal models including all supporting documentation, validation results, and the findings of internal and external reviews are subject to oversight and review by the bank's Supervisor.

DISCLOSURE REQUIREMENTS

ITEM 537 DIRECTS THAT IN ORDER TO BE ELIGIBLE FOR THE IRB APPROACH, BANKS MUST MEET THE DISCLOSURE REQUIREMENT SET OUT IN PILLAR 3 OF THIS ACCORD. THESE ARE MINIMUM REQUIREMENTS FOR USE OF IRB; FAILURE TO MEET THAT WILL RENDER BANKS INELIGIBLE TO USE THE RELEVANT IRB APPROACH.

CREDIT RISK - SECURITISATION FRAMEWORK

Item 538 restricts banks to the application of the Securitisation framework as contained in this Accord for determining regulatory capital requirements on exposures arising from traditional and synthetic securitisations or similar structures that contain features common to both. It recognizes that securitisations may be structured in many ways and as such directs that the capital treatment of a securitisation exposure must be determined on the basis of its economic substance rather than its legal form. It expects Supervisors to look to the economic substance of a transaction to determine whether it should be subject to the securitisation framework for the purpose of determining regulatory capital. It encouraged banks to consult with their

national Supervisors when there is uncertainty about whether a given transaction should be considered a securitisation.

Item 539 describes a traditional Securitisation as a structure where the cash flow from an underlying pool of exposures is used to service at least two different stratified degrees of credit risk. Payment to the investors depends upon the performance of the specified underlying exposures, as opposed to being derived from an obligation of the entity originating the exposures. The stratified/tranched structures that characterize securitisation differ from ordinary senior/subordinated debt instruments because junior securitisation tranches can absorb losses without interrupting contractual payments to more senior tranches, whereas subordination in a senior/subordinated debt structure is a matter of priority of rights to the proceeds of liquidation.

Item 540 describes a Synthetic securitisation as a structure with at least two different stratified risk positions or tranches that reflect different degrees of credit risk where credit risk of an underlying pool of exposures is transferred, whole or in part, through the use of funded (e.g. credit linked notes) or unfunded (e.g. credit swaps) credit derivatives or guarantees that serve to hedge the credit risk of the portfolio. Accordingly, the investors' potential risk is dependent upon the performance of the underlying pool.

ITEM 541 STATES SECURITISATION EXPOSURES AS INCLUDING BUT NOT RESTRICTED TO THE FOLLOWING: -

- Asset-backed securities, mortgage-backed securities, credit enhancements, liquidity facilities, interest rate or currency swaps, credit derivatives and tranched cover.
-

Item 542 says underlying instruments in the pool being securitised may include but are not restricted to the following: loans, commitments, asset-backed and mortgage-backed securities, corporate bonds, equity security and private equity investments. The underlying pool may include one or more exposures.

Items 543 to 552 are on definitions and general terms peculiar to asset securitisation.

Item 543 will consider a bank as originating bank for risk-based capital purposes with regard to a certain securitisation if it meets either of the following conditions: **-**

(a) The bank originates directly or indirectly exposures included in the securitisation; or

(b) The bank serves as a sponsor of an asset-backed commercial paper (ABCP) Conduit or similar programme that acquires exposures from third-party entities. In the context of such programmes, a bank would generally be considered a sponsor, and in turn, an originator if it, in fact or in substance, manages or advises the programme, places securities into the market, or provides liquidity and/or credit enhancements.

Item 544 describes an Asset-backed commercial paper programme as one that predominately issues commercial paper with an original maturity of one year or less backed by asset or other exposures held in a bankruptcy remote, SPV entity.

Item 545 defines a clean-up call as an option the permits an originating bank or a servicing bank to call the securitisation exposures (e.g. asset-backed securities) before all of the underlying exposures have been repaid. In the case of traditional securitisations, this is generally accomplished by repurchasing the remaining securitisation exposures once the pool balance or outstanding securities have fallen below some specified level. In the case of a synthetic transaction, the clean-up call may take the form of a clause that extinguishes the credit protection.

Item 546 defines a credit enhancement as a contractual arrangement in which the bank retains or assumes a securitisation exposure and in substance, provides some degree of added protection to other parties to the transaction. Credit- enhancing interest-only strip is however being defined by **Item 547** as an on-balance sheet asset that(1) represent a valuation of of cash-flows related to future margin income, (2) is subordinated.

Item 548 defines early amortization provisions as mechanisms that once triggered allow investors to be paid prior o the originally stated maturity of the securities issued. For risk-based capital purposes an early amortization provision will be considered either controlled or non-controlled. A controlled amortization provision must meet the following conditions: -

(a) The bank must have an appropriate capital / liquidity plan in place to ensure that it has sufficient capital and liquidity available in the event of early amortization.

(b) Throughout the duration of the transaction, including the amortization period, there is a pro-rata sharing of interest, principal, expenses, losses and recoveries based on the balances of receivable outstanding at the beginning of each month.

(c) The bank must set a period for amortization that would be sufficient for 90% of the total debt outstanding at the beginning of the early amortization period to have been repaid or recognized as in default; and

(d) The pace of repayment should not be any more rapid than would be allowed by straight-line amortization over the period set out in ©.

Item 549 warns that an early amortization provision that does not satisfy the conditions for a controlled early amortization provision will be treated as a non-controlled early amortization provision.

Item 550 defines Excess spread as gross finance charge collections and other income received by the trust or special purpose entity (SPE) minus certificate interest, servicing fees, charge-offs and other senior trust or SPE expenses.

Item 551defines Implicit Support as one that arises when a institution provides support to a securitisation in excess of its predetermined contractual obligation.

Item 552 defines a Special Purpose Entity (SPE) as a corporation, trust, or other entity organized for a specific purpose, the activities of which are limited to those appropriate to accomplish the purpose of the SPE and the structure of which is intended to isolate the SPE from the credit risk of an originator or seller of exposures. It goes further that SPEs are commonly us as financing vehicles in which exposures are sold to a trust or similar entity in exchange for cash or other assets funded by debts issued by the trust.

Item 554 is on the requirements for traditional securitisations and it states that an originating bank that meets the following conditions may exclude securitised exposures from the calculation of risk-weighted assets but must still hold regulatory capital against any securitised exposures they retain:

(a) Significant credit risk associated with the securitised exposures has been transferred to third parties.

(b) The transferor does not maintain effective or indirect control over the transferred exposures. The assets are legally isolated from the transferor in such a way (e.g. through the sale of assets or sub participation) that the exposures are put beyond the reach of the transferor and its creditors, even in bankruptcy or receivership. These opinions must be supported by an opinion provided by a qualified legal counsel.

(c) The securities issued are not obligations of the transferor. Thus, investors by purchasing the securities only have claim to the underlying pool of exposures.

(d) The transferee is an SPE and the holders of the beneficial interests in that entities have the right to pledge or exchange them without restriction.

(e) It will be determined that a transferor has maintained effective control over the transferred credit risk exposures if it: (i) is able to repurchase from the transferee the previously transferred exposures in order to realize their benefits; or (ii) is obligated to retain the risk of the transferred exposures. The transferor's retention of servicing rights to the exposures will not necessarily constitute indirect control of the exposures.

(f) Clean-up calls must satisfy the following conditions set out in 518 (1) its exercise must not be mandatory, in substance or in form, but rather at the discretion of the originating

bank; (2) it must not be structured to avoid allocating losses to be absorbed by credit enhancements or positions held by investors or otherwise structured to provide credit enhancement; and (3) it must only be exercisable when 10% or less of the original underlying portfolio or reference portfolio value remains.

(g) The securitisation does not contain clauses that (i) require the originating bank to alter systematically the underlying exposures such that the pool's weighted average credit quality is improved unless this is achieved by selling assets to independent and unaffiliated third parties at market prices; (ii) increase the yield payable to parties other than the originating bank, such as investors and third-party providers of credit enhancements, in response to a deterioration in the credit quality of the underlying pool.

Item 555 is on operational requirements for Synthetic securitisation for which the use of CRM techniques (i.e. collateral, guarantees and credit derivatives) for hedging the underlying exposure may be recognized for risk-based capital purposes. The following conditions must however be met:

(a) Credit risk mitigants must comply with the requirements as set out in Section 11.D

(b) Eligible collateral is limited to that specified in **Items 145 and 146**

© Eligible guarantors are limited to core market participants as defined in **Item 195**. Banks may not recognize SPEs as eligible guarantors in the securitisation framework.

(d)Banks must transfer significant credit risk associated with the underlying exposures to third parties.

(e) The instruments used to transfer credit risk may not contain terms or conditions that limit the amount of credit risk transferred e.g.:-

- Clauses that materially limit the credit protection or credit risk transference;
- Clauses that require the originating bank to alter the underlying exposures such that it can result in improvements to the pool's weighted average credit quality;
- Clauses that increase the banks' cost of credit protection in response to deterioration in the pools quality;
- Clauses that increase the yield payable to parties other then the originating banks, such as investors and third party providers of credit enhancements in response to deterioration in the credit quality of the underlying pool.
- Clauses that provide for increases in a retained first loss position or credit enhancement provided by the originating bank after the inception of the transaction.

(f) An opinion must be obtained from a qualified legal counsel that confirms the enforceability of the contracts in all relevant jurisdictions.

(g) Clean-up calls must satisfy the condition under **Item 557** already mentioned above.

Item 559 says that is a clean-up call, when exercised is found to serve as a credit enhancement, the action will be considered a form of implicit support provided by the bank and will be treated in accordance with the Supervisory guidance pertaining to securitisation transactions.

Item 558 warns that a clean-up call, which does not meet the above criteria, will attract a capital requirement. For a traditional securitisation, the underlying exposures will be treated as if they were not securitised. For Synthetic securitisations, the bank must hold capital against the entire amount of the securitised exposures as if they did not benefit from any credit protection.

D. TREATMENT OF SECURITISATION EXPOSURES

Items 560 to 564 are on calculation of minimum capital requirement and Item 560 says banks are required to hold regulatory capital against all of their securitisation exposures, including those arising from the provision of credit risk mitigant to a securitisation transaction, investments in asses-backed securities, retention of a subordinated tranche, an extension of a liquidity facility or credit enhancement, as set forth below. Repurchased securitisation will be treated as retained securitisation exposures.

Item 561 requires banks to deduct a securitisation exposure from regulatory capital at 50% from Tier1 and 50% from Tier 2 except for "capitalized assets" which **Item 562** defines as any expected future margin income that has been capitalized, carried as an asset on balance sheet and recognized in regulatory capital.

Item 564 says when a banking organization provides implicit support to a securitisation; it will be required, at a minimum to hold capital against all of the exposures associated with the securitisation transaction as if they had not been securitised. Additionally, the bank is required to disclose publicly that (a) it has provided non-contractual support and (b) the capital impact of doing so.

Item 565 is on the operational requirements for the use of external credit assessment in the treatment of securitisation exposures. It sets the operational criteria applicable in the standardized and IRB approaches in the securitisation framework as follows: -

(a) To be eligible for risk-weighting purposes, the external credit assessment must take into account and reflect the entire amount of credit risk exposure the bank has with regard to all payments owed to it. An example given is that if a bank is owed both principal and interest, the assessment must fully take into account and reflects the credit risk associated with timely repayment of both principal and interest.

(b) The external credit assessments must be from an eligible ECA I as recognized by the bank's national supervisor in accordance with **Items 90-108** except that in contrast to

bullet point three of **Item 91** eligible credit assessment must be publicly available, that is, the rating is of the type that is published in an accessible form and included in the ECAI's transition matrix. In effect ratings that are made available only to the parties to a transaction do not meet this requirement.

© Eligible ECAIs must have a demonstrated expertise in securitisations, which may be evidenced by strong market acceptance.

(d) A bank is expected to apply external credit assessments from eligible ECAIs consistently across a given type of securitisation exposure. Further, a bank cannot use one institutions credit assessments for one or more tranches and another ECAI's credit assessment for other positions (whether retained or purchased) within the same securitisation structure that may or may not be rated by the first ECAI.

In cases where two or more eligible ECAIs can be used and these assess the credit risk of the same securitisation exposure differently. **Items 96 to98** above will apply.

(a) Where a provider provides CRM directly to an SPE assessed A minus or better and reflected in the external credit assessment assigned to the securitisation exposure(s), the risk weight associated with that external credit assessment should be used. In order to avoid any double counting there will be no additional capital recognition of the CRM techniques. If the CRM provider is assessed below A minus, the covered securitisation exposures should be treated as unrated.

(b) In the situation where a credit risk mitigant is not obtained by the SPE but rather applied to a specific securitisation exposure within a given structure, the bank would treat the exposure as if it is unrated and then use the CRM treatment outlined in Section IID or III to recognize the hedge.

Items 566 to 605 are on standardized approach for securitisation exposures while **Items 606 to 643** are on the Internal Rating-based approach.

V. OPERATIONAL RISK

Item 644 defines Operational risk as the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events including legal risk, but not strategic and reputational risks.

Item 645 outlines three methods o calculating Operational risk capital charges in a continuum of increasing sophistication and risk sensitivity: (i) the basic Indicator Approach; (ii) the Standardized Approach; and (iii) Advanced Measurement Approaches. (AMA).

Item 646 encourages banks to move along the spectrum of available approaches as they develop more sophisticated operational risk measurement systems and practices.

Item 647 expects internationally active banks and banks with significant operational risk exposures to use an approach that is appropriate for the risk profile and sophistication of the institution. It permits bank to use the Basic Indicator Approach or Standardized Approach for some parts of its operations and an AMA for others subject to the meeting of conditions set out in **Items 680 and 683.**

Item 648 will not allow a bank to revert to a simpler approach once it has been approved for a more advanced approach without supervisory approval.

It adds that if a supervisor determines that a bank using a more advanced approach no longer meets the qualifying criteria for this approach, it may require the bank to revert to a simpler approach for some or all of its operations, until it meets the conditions specified by the supervisor for returning to a more advanced approach.

The Basic Indicator Approach

Items 649 to 651 contain what the Basic Indicator Approach is under Operations Risk for which a regulatory Capital must be held.

Item 649 says any bank using this Approach must hold Capital equal to a fixed percentage (denoted alpha) of average annual gross income over the previous three years. This could be expressed as follows:-

$K_{BIA} = [\Sigma (GI_{1...n} \times a)] / n$

Where

K_{BIA} = the capital charge under the Basic Indicator Approach

GI = annual positive three years gross income

N = number of the three years for which gross income was positive.

a = 15% which is set by the Committee, relating the industry wide level of the indicator.

Item 650 defines Gross Income as the net of interest income plus net non-interest income both being as defined by national Supervisors and/or national accounting standards. The intention is that this measure (i) should be gross of any provision (e.g. for unpaid interest); (ii) exclude realized profits/losses from the sale of securities in the banking book (iii) exclude extraordinary or irregular items as well as income derived from insurance.

Item 651 says that as a point of entry for capital calculation, no specific criteria for use of the Basic Indicator Approach are set out in this Accord.

THE STANDARDISED APPROACH

Item 652 divides banks' activities into eight business lines under the standardized Approach and these are corporate finance, trading and sales, retail banking, commercial banking, payment and settlement, agency services, asset management, and retail brokerage.

Item 653 points out that within each business line, gross income is a broad indicator that serves as a proxy for the scale of business operation risk exposure within each of these business lines. The capital charge for each business line is calculated by multiplying gross income by a factor (denoted beta) assigned to that business line. Beta serves as a proxy for the industry-wide relationship between the operational risk loss experience for a given business line and the aggregate level of gross income for that business line. It further points out that in the standardized approach gross income is measured for each business line, not the whole institution, i.e. in corporate finance, the indicator is the gross income generated in the corporate finance business line.

Item 654 is on the calculation of total capital charge, which it says is the simple summation of the regulatory capital charges across each of the business lines. It expresses it as follows: -

$K_{TSA} = \{\Sigma_{years\ 1\text{-}3}{}^{max}[\Sigma(GI_{1\text{-}8}{}^{X}\beta_{1\text{-}8}),)]\}/3$ where:

K_{TSA} = the capital charge under the Standardized approach

$GI_{1\text{-}8}$ = annual gross income in a given year for each of the given eight business lines.

$ß_{1\text{-}8}$ = a fixed percentage, set by the committee, relating to the level of required capital to the level of the gross income for each of the eight business lines. The values of the B (betas) are part of the item.

THE ALTERNATIVE STANDARDISED APPROACH

Footnote to the title The Standardized Approach on Page 142 of the Accord says that at national supervisory discretion a supervisor can choose to allow a bank to use the Alternative Standardized Approach (ASA) provided the bank is able to satisfy its supervisors that this alternative approach provides an improved basis by, for example, avoiding double counting of risks. The difference relates to only two business lines and these are retail banking and commercial banking.

ADVANCED MEASUREMENT APPROACH (AMA)

Item 655 to 659 introduce the AMA approach and **state** that under it, the regulatory capital requirement will equal the risk measure generated by the bank's internal operational risk measurements system using the quantitative and qualitative criteria for the AMA discussed below. Use of AMA is subject to Supervisory approval.

QUALIFYING CRITERIA

Item 660 to 663 are on the general criteria for any bank that intends to use the Standardized or AMA approach and the minimum are as follows: -

- Its Board of Directors and Senior Management, as appropriate, are actively involved in the oversight of the operational risk management framework.
- It has an operational risk management system that is conceptually sound and is implemented with integrity.
- It has sufficient resources in the use of the approach in the major business lines as well as the control and audit areas.

Item 661 gives supervisors the right to insist on a period of initial monitoring of a bank's Standardized Approach before it is used for regulatory capital purposes.

Item 662 seems to contain the catch as it mandates a bank to develop specific policies and have documented criteria for mapping gross income for current business lines and activities into the standard framework and this it says must be reviewed and adjusted for new or changing business activities as appropriate.

THE STANDARDIZED APPROACH

Item 663 directs an internationally active bank using the Standardized Approach to meet the following requirements:

(a) It must have an operational risk management system with clear responsibilities assigned to an operational risk management function is responsible for developing strategies to identify, assess, monitor and control/mitigate operational risk; codifying firm-level policies and procedures concerning operational risk management and control for the design and implementation of a risk-reporting system for Operational risk.

(b) As part of the bank's internal operational risk assessment system, the bank must systematically track relevant operational risk data including material losses by business line. Its operational risk management system must be closely integrated into the risk management process of the bank. Its output must be an integral part of the process of monitoring and controlling the bank's operational risk profile. The bank must have techniques for creating incentives to improve the management of operational risk throughout the firm.

(c) There must be regular reporting of operational risk exposures, including material operational losses, to business unit management, senior management, and to the board of directors. The bank must have procedures for taking appropriate action according to the information within the management reports.

(d) The bank's operational risk management system must be well documented. The bank must have a routine in place for ensuring compliance with a documented set of internal policies, controls and procedures concerning the operational risk management system, which must include policies for the treatment of non-compliance issues.

(e) The bank's operational risk management processes and assessment system must be subject to validation and regular independent review. These reviews must include both the activities of the business units and of the operational risk management function.

(f) The banks operational validation processes must be subject to regular review by external auditors and/or Supervisors.

Item 664 is on the Advanced Measurement Approach and the general standard a bank should meet is the same under the Standardised Approach although **Item 665** subjects such a bank to a period of intial monitoring by its supervisor before the Approach can be used for regulatory capital purposes.

Item 666 lists out the qualitative Standard a bank must meet before it is permitted to use the Advanced Measurement Approached (AMA) for Operational Risk Capital.

Items 667 to 668 are on the Quantitative Standards while **Item 669** is on detailed criteria describing a series of quantitative standards that will apply to internally- generated operational risk measures for regulatory capital purposes.

Items 670 to 673 are on the qualities of a bank's internal loss data and the standard it must meet for the purpose of calculating regulatory capital purposes. **Item 674** does the same for external data.

Item 675 is on scenario analysis of expert opinion which it directs banks to use in conjunction with external data to evaluate its exposure to high-severity events. This approach it says, draws on the knowledge of experienced business managers and risk management experts to derive reasoned assessment of possible severe losses.

Item 676 is on business environment and internal control factors, which it says a bank firm-wide risk assessment methodology must capture especially if they can change, its operational risk profile. It sets out the standards a banks risk measurement framework must meet before it could be used for regulatory capital purposes.

Item 677 to 679 are on risk mitigation and they give recognition to insurance in terms of risk mitigating impact with Item 678 listing out the criteria a bank must comply with before it could take advantage of it.

Item 680 to 682 contain the standards a bank must meet before it could be permitted to use Advanced Measurement partially.

Items 684 to 718 are on Trading Book issues with **Item 685** describing a trading book as consisting of positions in financial instruments and commodities held either with intent to trade with or hedge other elements in the trading book.

PILLAR 1 AND THE CHALLENGES POSED

Introduction

In a nutshell Pillar I of the Basel 2 Accord sets out minimum capital requirements. It maintains both the current definition of capital and the minimum requirement of 8% of capital to risk-weighted assets. To ensure that risks within the entire banking group are considered, the Basel 2 Accord will be extended on a consolidated basis to holding companies of banking groups. Like the Basel I Accord, focus is on internationally active banks in G10 Countries and significant banks in other countries.

The Accord focuses on improvements in the measurement of risks, i.e., the calculation of the denominator of the capital ratio and proposes for the first time a measure for operational risk, while the market risk measure remains unchanged. The calculation for a bank's capital ratio is as follows:

Total capital (unchanged)	
Credit risk + Market risk + Operational Risk	**= The bank's capital ratio (minimum 8%)**

For the measurement of credit risk, two principal options are being proposed. The first is the ***standardized approach***, and the second the ***internal rating based (IRB) approach***. There are two variants of the IRB approach, foundation and advanced. The use of the IRB approach will be subject to approval by the supervisor, based on the standards established by the Basel Committee in the Accord.

The standardized approach is conceptually the same as in the Basel I Accord, but is more risk sensitive. A bank allocates risk-weighted asset values. A risk weight of 100% means that an exposure is included in the calculation of risk weighted assets at its full value, which translates into a minimum capital charge equal to 8% of that value. Similarly, a risk weight of 20% results in a capital charge of 1.6% (i.e. one-fifth of 8%).

Under the Accord, the risk weights are to be refined by reference to a rating provided by an external credit assessment institution (such as a rating agency) that meets strict standards. For example, for corporate lending, the existing Accord provided only one risk weight category of 100% but the new Accord will provide four categories (20%, 50%, 100% and 150%).

Under the Internal Ratings Based (IRB) approach, banks will be allowed to use their internal estimates of borrower creditworthiness to assess credit risk in their portfolios, subject to strict methodological and disclosure standards. Distinct analytical frameworks are provided for different types of loan exposures, for example corporate and retail lending, whose loss characteristics are different.

Under the IRB approach, a bank estimates each borrower's creditworthiness, and the results are translated into estimates of a potential future loss amount, which form the basis of minimum capital requirements. The framework allows for both a foundation method and more advanced methodologies for corporate, sovereign and bank exposures. In the Foundation methodology, banks estimate the probability of default associated with each borrower, and the supervisors will supply the other inputs of Estimate at Default (EAD) and Loss Given Default (LGD). In the Advanced methodology, a bank with a sufficiently developed internal capital allocation process will be permitted to supply other necessary inputs as well. Under both the Foundation and Advanced IRB approaches, the range of risk weights will be far more diverse than those in the Standardised approach, resulting in greater risk sensitivity.

The new Accord introduces more risk sensitive approaches to the treatment of collateral, guarantees, credit derivative, netting and securitization, under both the Standardised approach and the IRB approach.

As mentioned above the new Accord introduces for the first time Operational risk as another risk which capital must be set aside for. Operational risk is being defined as the risk of direct or indirect loss resulting from inadequate or failed internal processes, people and systems and from external events.

The financial stability institute of the BIS sent Questionnaire to 25 jurisdictions in Africa namely:

Angola	Libya	South Africa
Botswana	Mauritius	Sudan
Egypt	Morocco	Tanzania
Ethiopia	Mozambique	Uganda
Ghana	Namibia	Zambia
Kenya	Nigeria	Zimbabwe
Lesotho	Sierra Leone	

COBAC - (Cameroon, Central African Republic, Chad, Congo, Equatorial Guinea, and Gabon)

WAEMU - (Benin Republic, Burkina Faso, Ivory Coast, Guinea Bissau, Mali, Niger, Senegal and Togo)

Responses were received from 22 of which 20 fully completed the Questionnaire and the other two provided short notes on general preparatory work completed the Questionnaire and the other two provided short notes on general preparatory

work without responding to the specific issues raised in the Questionnaire (BIS 2004).

According to the report, most of the respondents recognize the important role that Basel II will play in strengthening their financial systems. Sixteen of the 22 jurisdictions that responded (72%) intend to implement Basel II between 2006 and 2009. Five jurisdictions were undecided and one had taken the decision not to implement the framework in the near future. Most of those, which had decided to adopt Basel II, indicated that they would do so in progressive stages. They underscored the need to move at a measured pace, gradually adopting the less sophisticated approaches and then moving to the more advanced approaches. Also, most jurisdictions recognize the need for proper sequencing to achieve an appropriate balance between implementing Basel II and addressing other, equally important but competing challenges such as adopting effective risk-based supervision.

Jurisdictions that were undecided were actively engaged in this process and had planned senior management strategic retreats or workshops to determine the appropriate implementation strategy. Nine of the respondents were, however, undecided on the scope of implementation. The majority, underscored progressive implementation, from the simple to the more sophisticated, over a period extending beyond 2009.

Except for one jurisdiction, none of the respondents anticipate being able to implement Basel II at end-2006. A significant number of jurisdictions intend to implement Basel II between 2007 and 2009 and, more importantly, 65% of banking

assets will be covered during this period. As indicated above, only one respondent does not intend to implement the framework, citing costs associated with anticipated systems development and staff training for a financial system without internationally active banks, as well as rudimentary money and capital markets. On Pillar 1 – minimum capital requirements, most of the respondents expect that their banks will use the standardized approach or simplified standardized approach during the period 2007 – 2009 for calculating the capital charge for credit risk. However, one major player, most probably South Africa intends to adopt the foundation internal ratings-based (IRB) approach for credit risk and the standardized approach for operational risk at end-2006. It is estimated that Basel II will cover 58% and 79% of the banking assets in Africa at end-2006 and during 2007 – 2009 respectively. The foundation IRB approach for calculating the capital charge for credit risk will be adopted for the majority of banking assets in the region.

The major driver for this trend seems to be the significant amount of banking assets attributed to one large jurisdiction and, to a lesser extent, banking assets controlled by internationally active banks operating in the region. Most of the banking assets will fall primarily under either the simplified standardized or standardized approach for credit risk (about 30% in 2007 – 2009) according to the report.

Nigeria responded to this questionnaire and is being regarded as a participating jurisdiction by the BIS today but as mentioned above many structural and institutional changes will need to take place before the Accord can be successfully implemented.

STRUCTURAL CHALLENGES- PILLAR 1

The Basel 2 standards provide banks with the flexibility to rely on data derived from various sources as long as the bank can demonstrate the relevance of the external data to its own exposures. Regardless of source, high quality data are critical for formulating effective internal risk assessments. From a broader risk management perspective, access to such data will enable a bank to evaluate the performance of its risk estimation system in a consistent and meaningful manner.

Nigerian banks will need to implement substantial structural changes to their internal systems to prepare for appropriate data collection and revised reporting requirements. These changes may require system integration, modification and new software. They will need to review the necessary system changes and develop a realistic implementation timetable to carry out such changes.

Banks in Nigeria will need to consider their data needs very seriously and to comprehend fully the techniques they will need to use to derive appropriate estimate of risk based on those data. In practical terms they will be expected to have in place or be actively developing a data warehouse that will enable them to collect, store and draw upon loss statistics in an efficient manner over time.

Since data availability varies across banks, portfolios, jurisdictions and risk types, banks in Nigeria will need to develop private initiatives / processes for credit information sharing, away from the CBN controlled CRMS, and for assessing comparability of pooled data with internal bank experience.

As mentioned above, the present day Bank of England was founded as a commercial bank in 1694 by a Scot named William Paterson with a capital of one million, two hundred thousand pounds advanced to the then British government in return for the privilege to issue bank notes up to that amount. It was privately owned until 1946 when an Act of the British Parliament provided for its nationalization. In 1997, the bank was given power to set interest rates while its supervision of the British banking industry was transferred to the Securities and Investments Board.

In the United States of America, the Federal Reserve Act of 1913 established what could be considered a central bank. The Act created the Federal Reserve System to act as the central banking authority of the United States. It functions as the fiscal agent for the United States government, is the custodian of the reserve accounts of commercial banks, and is authorized to issue Federal Reserve Notes otherwise known as the U.S. dollars. It consists of the Board of Governors, the 12 Federal Reserve banks, the Federal Open Market Committee, the Federal Advisory Council, and the Consumer Advisory Council. Virtually all the commercial banks

in the United States are members while the government of the United States holds none of the shares.

A Federal Reserve Bank is therefore a privately owned corporation established under the Federal Reserve Act to serve the public interest. Its board consists of nine directors, six of who are elected by member banks while the remaining three are appointed by the Board of Governors.

In effect the entire banking system of the United States is in private hands. The United States government borrows by issuing its bond to be purchased by the Federal Reserve popularly known as The Fed. Who in turn credits the United States Treasury Department authorizing it to issue the dollar notes up to the face value of the bond.

These are the banking structures of the principal originators of the Bretton Woods Agreement, which eventually gave birth to the Basel 1 and 2 Accords.

In contrast, the Central Bank of Nigeria (CBN) was established through the Central Banks Act of 1991 (Amended) with all the capital subscribed and held by the Federal government of Nigeria according to **Article 4 (2)** of the Act. **Article 2** of the same Act states the principal object of the CBN as follows:

(1) Issue legal tender currency in Nigeria;

(2) Maintain external reserves to safeguard the international value of the legal tender currency;

(3) Promote monetary stability and a sound financial system in Nigeria;

(4) Act as a banker and financial adviser to the Federal Government of Nigeria.

As if the CBN is expected to make a profit, **Article 5 .1(a)** of the Act mandates it in respect of each financial year to determine its operating surplus with **Article 5(3)** directing that such surplus be paid to the Federal Government.

The Board of the CBN consists of (1) The Governor; (2) Four Deputy Governors; (3) Permanent Secretary, Ministry of Finance, and (4) Five Directors. The banking industry has no representative on the Board of the CBN, as it is the President that appoints the four Directors mentioned above. As a matter of fact **Article 12:1(b)** specifically forbids a director, officer or employee of any bank licensed under the Banks and Other Financial Institutions Act (1991 Amended) from becoming Governor, Deputy Governor, or Director of the CBN.

Article 17 gives the CBN the sole right of issuing legal tender notes and coins throughout the Federation. According to **Article 24** the CBN is also the custodian

of all external financial assets of the Federal Government of Nigeria consisting of all or any of the following:

(a) Gold coin or bullion;

(b) Balance at any bank outside Nigeria;

(c) Treasury bills issued by foreign countries;

(d) Securities of or guarantees by any foreign country;

(e) Securities of or guarantees by international financial institutions;

(f) Nigeria's gold tranche in the International Monetary Fund;

(g) Allocation of Special Drawing Rights made to Nigeria by the IMF.

Article 25 directs the bank to use its best endeavour to maintain these external reserves at levels it considers appropriate for the monetary system of Nigeria.

Article 27 (u) authorizes the CBN to promote the establishment of bank clearing systems and provide facilities for the conduct of clearing business on its premises with **Article 27(v)** allowing it to grant temporary advances to needy clearing banks.

Articles 31(2) is on its relationship with the Federal Government and by virtue of its provision the CBN can receive/disburse Federal funds and keep the account without any charge to the Federal Government. It could also do the same for desiring states, local governments, Funds, institutions or corporations, established by Federal, States, and Local Governments according to **Article 35**.

Article 33 says the CBN can also lend to the Federal Government in case of temporary deficiency of budget revenue and could charge interest.

The CBN is also the banker to other banks in and outside Nigeria according to **Article 37** of its Act while **Articles 38 to 41** empower it to supervise and regulate all the banks in Nigeria.

The relevance of these provisions is to demonstrate that, unlike its counterparts in the U.S.and the U.K. that have history of the private initiative, the Nigerian CBN has always been a government outfit with all the trappings of bureaucracy. It has always been supervising the banks and regulating them in a command and control structure and without their representation or input.

The Basel 2 Accord implementation requires the co-operation of the banks and their supervisors i.e. the CBN and NDIC if it is to yield the expected result.

As Lutz (2000) has pointed out, the Basel 2 Accord is more of a co-operation between the regulators and the practitioners in the field than the regulators- only approach of the Basel 1 Accord, which is similar to the way things, are in the Nigerian banking industry today.

Under Pillar 1 of Basel 2 Accord the minimum capital requirement issue is mainly on credit risk and this happens to be the risk applicable to Nigerian banks. Market risk is also in Pillar 1 but it has more to do with bonds issued by or being purchased by sovereigns, corporate or banks whose rating can change to depreciate the value at any hour of any day making constant watch very essential. It is not common in Nigeria yet.

Operational risk is very new and has more to do with credit derivatives and the risks associated with them post-Baring's collapse in 1995. Again Nigeria is not into this yet but we can use the idea to prevent future problems.

The main risk facing the Nigerian banking industry therefore is credit risk, which is the risk of default by the counter-party. Without the mutual co-operation of the regulators and the practitioners all the problems causing bank failures in Nigeria will continue to bedevil the industry.

Under the Standardized Approach risk weights will be based on the ratings of the primary obligor by an External Credit Assessment Institution (ECAI) or an Export Credit Agency (ECA) participating in the only recognized "Arrangement on Guidelines for Officially Supported Export Credit.' Such agency must meet the strict conditions set for them. It should be mentioned that the primary obligor could be sovereigns, or banks and corporate within them who issue bonds and engage in Over the Counter Trading (OTC) in credit derivatives. The bonds they issue for sale are claims on them and if they are investment-grade types their continuously favorable ratings becomes a necessity for their investors' confidence and future patronage.

But how do these rating agencies perform this exercise of rating sovereigns, banks and corporate bodies?

Amato and Furfine (2003) examined credit rating agencies claim that they "rate through the cycle". That is, a firm's credit rating, conditional on its underlying financial characteristics, should be independent of the state of the business cycle. They quoted Standard and Poor's (2002) as saying "There is no point in assigning high ratings to a company enjoying peak prosperity if that performance level is expected to be only temporary. Similarly there is no need to lower ratings to reflect poor performance as long as one can reliably anticipate that better times are just around the corner." They examined in their paper whether this claim was true by empirically testing whether the state of the economy of the United States is an important determinant of a firm's credit rating conditional on the business and the financial characteristics of the rated firm. They examined the universe of U. S. firms rated by Standard and Poor"s agency between 1981 and 2001 using an ordered probit model. They found very little evidence that credit ratings are influenced by business cycle. In effect the rating agencies claim is true, as they seem to take a longer-term perspective and are usually reluctant to change ratings in response to short-term fluctuations in the status of a firm. Ratings are therefore not procyclical. The implication of their findings is that since a major cornerstone of the Basel 2

Accord is of sovereigns, banks and corporate bodies the reliability of the exercise is crucial. With ratings by agencies not procyclical it follows that if a firm rated in boom period, as AAA should encounter a devastating problem the rating agencies may not feel inclined to rate this company anytime during that period. Meanwhile reliance would continue to be placed on the old rating to the probable detriment of those that continue to use it

For the rating of firms in Nigeria today we can only speak of Agusto and Company Ltd. and it is doubtful if it could meet the strict criteria set out in Item 91 of the Accord especially as it relates to independence. This is because the founder Mr. Bode Agusto is presently holding a Ministerial position in the Budget Office of the Federal Ministry of Finance. Apart from this it is doubtful if companies in Nigeria are actually conducting themselves preparatory for such exercise judging from the fraudulent ways most of them conduct their affairs. They seem to have too much to hide. The banks too are not as transparent as demanded by this Accord. The alternative is to have internationally accredited rating agencies in Nigeria and hope they would be incorruptible. Without credible rating agencies the banking industry would not be able to have access to the rating of firms that is a pre-requisite under the Standardized Approach. With such handicap Nigeria banks may not be able to move to the Internal Ratings Based Approach that is based on very stringent conditions laid out in the Accord.

For the rating of sovereigns Ul Haque et al (1997) attempted to answer the questions as to which economic, political, and social factors influence credit ratings, and to what extent they are consistent with the theories developed by economists about creditworthiness. To answer the question they studied credit ratings compiled by two magazines –Institutional Investors, and Euro money and by Economist Intelligence Unit (EIU), a publisher of business reports. They discovered that although the ratings of all the three agencies measure a country's ability and willingness to service its financial obligations, they were based on different methodologies and compiled by different types of experts. They found out that the ratings were based on an evaluation of a number of macroeconomic, financial, and political variables including a country's economic growth rate, its current account balance relative to GDP, and various ratios like savings to investment, external debt to GDP, and interest payment to GDP. In addition, they found out that a country's vulnerability to external shocks was being gauged by the degree to which it relied on a single export. A country's willingness to service its financial obligations they said, was measured both by financial variables such as arrears on international bank loans, debt rescheduling, access to bond markets, and cost of various forms of trade credits, and by political considerations. This typically includes policies towards creditors, the likely policies of opposition parties, the government's capacity to implement measures needed to stabilize the economy and meet external payments, and the likelihood and potential effects of political instability. They disclosed that while the criteria of these agencies for assessing credit risks suggested a precise relationship between a country's credit rating

and the political, economic and financial variables specific to that country, the judgment of the rating analyst played an important role, both in evaluating economic and political variables (e.g. drawing conclusions about the degree of political stability) and in determining how much weight should be attached to different variables within each group of factors. Thus a fair amount of subjective judgment went into the final evaluation. They observed that during the debt crisis triggered by Mexico in the 80s the ratings of sovereigns generally declined across all regions of the world. Towards the end of the decade especially after a period of consolidation however, ratings for countries in Asia, Latin America the Caribbean's and the Middle east showed improvement, but those for African countries and Europe declined. Their data suggested that the response of various ratings to changes in the economic situations of countries occurred at different speeds. Euro money's ratings improved in 1988, at the beginning of the third period, when countries began to rebuild creditworthiness, whereas Institutional Investor's ratings did not improve until 1990.

It also suggested that economic performance was measured in terms of a country's rate of growth and the rate of inflation. Their preliminary analysis revealed that countries experiencing high inflation appear to have been treated more harshly in terms of rating by being categorized as "problem countries". Once a country was placed in the problem category it's rating went down dramatically, and the rating agencies ignored small changes in inflation. Euromoney imposes the largest penalty for high inflation as it could reduce such country's rating by as much as 60 to 80 percentage points out of a possible 100 percent. Moreover, both Euromoney and Institutional Investors ratings penalized countries that are not in the high inflation group when their inflation rates went up. Institutional Investors also penalized low-debt countries when the ratio of their debt to GDP rose.

Their data further suggested that regional contagion effects and structural characteristics were evident in ratings by all three rating agencies. They disclosed that after accounting for domestic and external factors Euromoney would traditionally give developing countries in Asia, Europe and the Middle East ratings 10 to 20 percentage points higher than it would give countries in Latin America, the Caribbean's and Africa. Similarly ratings of the Economic Intelligence Unit (EIU) tended to be highest for countries in Asia and Europe. Euromoney and Institutional Investors give significantly higher ranking to countries exporting manufactured goods than to exporters of other types of goods while EIU appeared to give strongly negative ratings to fuel exporters like Nigeria and producers of primary products like most African countries.

Huhne (2000) defines sovereign risk as consisting of two types of risks and these are default risk and transfer risk. The former refers to a sovereign not being able to generate debt service in its own currency. The latter is when such sovereign is unable to purchase enough foreign exchange to service its foreign currency debt obligations. In many emerging markets he said, the latter dominates the assessment of a sovereign's credit worthiness. The significance

of this fact is that under the Basel 2 Accord no bank or corporate can have a higher rating than its host sovereign. According to him the focus of sovereign rating is actually defaulting which he defines as any alteration of the terms of the original contract. This could be a rescheduling or outright repudiation either of which could inflict capital losses on the creditor. One could only hope that the much celebrated debt relief granted Nigeria recently by the Paris Club would not be viewed as being in this category as rescheduling.

Erb et.al. (1996) asked the question "what is country risk and how should it affect global investment strategies?" They explored five measures of country risks, which are: political risk economic risk, financial risk, composite risk and country credit ratings. Political Risk Services of International Country Risk Guide (ICRG) reported on the first four while Institutional Investors reported on country credit ratings. They initially investigated whether the risk indexes contain information about future expected returns with their analysis conducted in two ways. First, they formed a portfolio of countries that experienced a favourable increase in risk rating (less risky) and another portfolio for those that experienced a negative decrease (more risky). They formed the portfolios after the risk information was available and balanced them every six months. They found that these measures provided information about expected equity returns and further supplemented the analysis with time- series/cross sectional regressions that measure the amount of information contained in each metric. The result was that the financial –risk measure contained the most information about future expected returns and that political risks contained the least.

They next investigated the link between these country-risk measures and some more standard measures of risk. They investigated for example, whether a country's beta is correlated with the Morgan Stanley Capital International (MSCI) World Index. They also investigated as an alternative the relation between the country-risk measures and equity volatility. They then explored the interface between country-risk analysis and investment strategies based on country fundamental information such as book-to-price ratios. They found that the risk indexes are highly correlated with the fundamental attributes. Their finding proves that value -oriented strategies earn higher returns because they reflect higher risk exposure.

Gand and Parsely (2004) examined the response of equity mutual fund flows to sovereign rating changes in 85 countries from 1996-2002. They found that sovereign downgrades are strongly associated with outflows of capital from the downgraded country while improvement in a country's sovereign rating are not associated with discernible changes in equity outflows. They discovered that highly transparent countries experience smaller outflows around downgrades and that flows around downgrades are consistent with a flight to quality phenomenon. In other words, highly transparent non-event countries are net recipients of capital inflows, and these inflows increase with the severity of the cumulative downgrades abroad. They got the same result after controlling for country size, legal traditions, market liquidity, crisis versus

non-crisis periods, and are invariant to different assumptions regarding the within-month distribution of equity flows monthly predicted benchmark flows and persistence of equity flows. Taken together, the result suggested that improving transparency could mitigate some of the perceived negative effects associated with global capital flows.

Their primary data set was a monthly panel of mutual equity positions covering 85 countries during the seven years ending December 2002. They matched these holdings to sovereign credit rating changes issued by Standard and Poor's, and a host of country-specific data. Using both cross-section and time-series dimensions allowed them to examine several questions.

First was whether the response of flows differed by: event type (e.g. upgrades versus downgrades); country type (developed versus emerging); a country's legal origin and rule of law traditions; the liquidity of its equities market, the size of the real economy; or the level of a country's sovereign rating.

Second was the investigation of whether more transparent

Countries were less vulnerable to bad news, such as downgrades. The third was whether more transparent, non-event countries benefit from bad news abroad by attracting portfolio flaws away from countries experiencing downgrades. Finally, since the sample period bracketed several crisis episodes, they tested whether the response systematically varies between crisis and non-crisis period.

As mentioned above their results showed that transparency has an independent, statistically significant and economically meaningful effect on portfolio flows even after controlling for all the variables especially the legal origin.

Cantor and Packer (1996) define sovereign rating as assessment of

the relative likelihood that a borrower will default on its obligations. According to them governments generally seek credit ratings to ease their own access and those of other issuers domiciled within their borders, to international capital markets, where many investors prefer rated securities over unrated ones even if they posses identical credit risks. Cantor and Packer (op. cit) disclosed that ratings are important not only because some of the largest issuers in the international capital markets are national governments, but also because 'these assessments affect the ratings assigned to borrowers of

the same nationality. The rule of the thumb however is no local municipality, provincial government, or private company can be rated higher than the host/home sovereign.

But how clear are the criteria underlying sovereign ratings and,

how much of an impact do ratings have on borrowing costs for sovereigns? To explore these questions Cantor And Packer (op.cit) presented the first systematic analysis of the determinants and impact of the sovereign credit ratings assigned by the two leading and unarguably the two most internationally recognized U.S. agencies, Moody's Investors Service and Standard and Poor's. The rapid growth in rating requests and the wealth of data now available made it possible for them to estimate which quantitative indicators are weighed most heavily in the determination of ratings, to evaluate the predictive power of ratings in explaining a cross-section of Sovereign bond yields, and to measure whether rating announcements directly affect market yields on the day of the announcement.

What they discovered is that, during that period, Moody's and

Standard and Poor's were each rating more than fifty sovereigns using different symbols in assessing credit risk. In other words every Moody's symbol has its counterpart in Standard and Poor's rating scale as illustrated below:

RATING SYMBOLS FOR LONG-TERM DEBT

Interpretation	Moody's	Standard & Poor's
INVESTMENT GRADE		
RATINGS		
Highest Quality	Aaa	AAA
High Quality	Aa1	AA+
	Aa2	AA
	Aa3	
AA-		
Strong Payment Capacity	A1	A+
	A2	A
	A3	A-
Adequate Payment Capacity	Baa1	BB+
	Baa2	BBB
	Baa3	BBB-
	Speculative – Grade Rating:	
Likely to fulfil obligations,		
Ongoing uncertainty	Ba1	BB+
	Ba2	BB
	Ba3	BB-
High-risk obligations	B1	B+
	B2	B
	B3	B-

With these corresponding symbols they were able to compare the sovereign rating assigned by the two agencies. Of the forty-nine countries rated by both Moody's and Standard and Poor's in September 1995, twenty-eight received identical ratings from the two agencies, twelve were rated higher by Standard and Poor's, and nine were rated higher by Moody's. When the agencies disagreed, their ratings in most cases differed by one notch on the scale, or two notches as it was for seven countries.

To find out how these ratings are determined Cantor and Packer (op.cit) used regressions analysis to measure the relative significance of eight variables that are usually cited repeatedly by rating agencies in their reports as determinants of

sovereign ratings. The eight variables, the relationship between each of them and a country's ability and willingness to service its debt are as follows:

(1) **Per capital income**: The greater the potential tax base of the borrowing country, the greater the ability of a government to repay debt. The variable can also serve as a proxy for the level of political stability and other important factors.

(2) **GDP growth**: A relatively high rate of economic growth suggests that a country's existing debt burden will become easier to service over time.

(3) **Inflation:** A high rate of inflation points to structural problems in the government finances. When a government appears unable or unwilling to pay for current budgetary expenses through taxes or debt issuance, it must resort to inflationary money finance. Public dissatisfaction with inflation may in turn lead to political instability.

(4) **Fiscal Balance:** A large federal deficit absorbs private domestic savings and suggests that a government lacks the ability or will to tax its citizenry to cover current expenses or to service its debits.

(5) **External Balance:** A large current account deficit indicates that the public and private sector together rely heavily on funds from abroad. Current account deficits that persist result in growth in foreign indebtedness, which may become unsustainable over time.

(6) **External Debt:** A higher debt burden should correspond to a higher risk of default. The weight of the burden increases as a country's foreign currency debt rises relative to its foreign currency earnings from exports.

(7) **Economic Development:** Although level of development is already measured by the per capita income variable, the rating agencies according to Cantor and Packer appear to factor a threshold effect into the relationship between economic development and risk.

In effect, once countries reach a certain income level or level of development, they may be less likely to default. They proxied for this

minimum income or development level with a simple indicator variable noting whether or not a country is classified as industrialized by the International Monetary Fund (IMF).

(8) **Default History:** Other things equal, a country that has defaulted on debt in the recent past is widely perceived as a high credit risk. They cited both theoretical considerations of the role of reputation in sovereign debt and related empirical evidence, which indicate that defaulting sovereigns suffer a severe decline in their standing with creditors. They factored in credit reputation by using an indicator variable that notes whether or not a country has defaulted on its international bank debt since 1970.

The conclusion is that out of the above eight variables, six appear to play an important role in determining a country's rating: per capita income, GDP growth, inflation, external debt, economic development, and default history. Their analysis also show that sovereign ratings effectively summarizes and supplement the information contained in macroeconomic indicators and are therefore strongly correlated with market determined credit spreads. They found evidence that the rating agencies opinions independently affect market spread. Their event study analysis broadly confirms that the announcements of changes in the agencies sovereign risk opinions are followed by bond yield movements in the expected direction that are statistically significant. They admitted that they were puzzled by their findings that (i) the impact of rating announcements on spreads is much stronger for below-investment-grade than for investment grade sovereigns and (2) that rating announcements that are more fully anticipated, at least by their proxy measures, have a larger impact than those that are less anticipated.

They concluded that although the agencies ratings have a largely predictable component they also appear to provide the market with information about non-investment-grade sovereigns that goes beyond that available in public data.

According to Roman Kraussl (2003/22) credit rating agencies provided standardized evaluation of the likely risks and returns associated with alternative investments according to standardized credit worthiness categories. They assign credit ratings for the purpose of generating information about default probabilities that are pertinent for pricing of corporate, municipal and sovereign issuers. Credits rating agencies, he said, supply market participants with a system of relative credit worthiness of all bond issues by incorporating all the components of default risk into a single code: the credit rating. The

investor makes the final decision to invest or not. He said the rating agencies interpret their sovereign credit ratings as forward-looking indications of the relative risk that a sovereign debt issues will not have the ability and willingness to make full and timely payments of principal and interest over the life of a principal and interest over the life of a particular rated financial. He divides sovereign credit risk analysis into two, which are Economic, and political risks. Economic risk, he said, deals with the government's ability to repay its obligations on time and is a function of both qualitative and quantitative factors. While political risk addresses the sovereign willingness to repay its outstanding debt on time.

Roman Kraussl (2003/18) again contributing to the debate about the credit rating agencies evaluation of sovereign risk in emerging markets lending, analyzes the role of credit rating agencies in international financial markets. His study particularly analyzes whether sovereign credit ratings have an impact on the financial stability in emerging market economies. The event study and panel regression results indicate that credit rating agencies have substantial influence on the size and volatility of emerging markets lending.

The empirical results are significantly stronger in the case of government's downgrades and negative imminent sovereign credit rating actions such as credit watches and rating outlooks than positive adjustments by the credit rating agencies while the market participants anticipated sovereign credit rating changes have a smaller impact on financial market in emerging economies.

According to him, there are two broad categories of credit ratings and they are investment-grade and speculative or non-investment-grade. Investment grade issues he said are typically considered to be appropriate investments for institutional investors. Standard and Poor's issues rated BBB- and above are investment grade, while Moody's split is made at Baa3.

In recent years he said, both rating agencies have supplemented their credit risk assessments with credit watches and rating outlooks, respectively designed to indicate the credit rating agencies perspectives on development that might induce a rating change. As a consequence, a sovereign credit rating upgrade to investment-grade is vital since it opens up a much wider investor base by making the bonds appropriate for enclosure in benchmark investment-grade indexes. The implication of this is that the sovereign credit rating upgrade will result in both increased and more stable demand for bonds of that particular emerging market.

SOVEREIGN CREDIT RATINGS AS AT JANUARY 2004

CREDIT (MOODY'S / S & P / FITCH)	UPGRADES AND NEW COVERAGE AGENCY RATIONALE
The Bahamas (A3 / A- / NR)	**Positive Factors:** • Stable political environment. • Consistent macroeconomic policy. • Stable, well regulated banking sector **Negative factors:** • Economy is heavily dependent on tourism. • Vulnerability to external shocks. • Ongoing large current account deficits
Bahrain (Baa1 / A- / A-)	**Positive Factors:** • Well-regulated financial sector. • The outlook for the fiscal deficit, for transparency and for structural reforms is improving. • Declining geopolitical risk **Negative factors:** • The public accounts are highly vulnerable to shifts in oil prices. • A high proportion of the government, revenue is derived from Abu Saafa, a concessionary oil field in Saudi Arabia's territorial waters.

	• High unemployment.
Brazil (B2/B+/B+)	**Positive Factors:** • Political consensus in favour of economic reforms. • Stable macroeconomic environment. • Declining external vulnerability. **Negative factors:** • Large public sector debt burden. • Heavily weighted towards short-term, floating rate and/or foreign currency /inflation-indexed terms.
China A2/BBB/A-)	**Positive Factors:** • Fiscal soundness • General government surplus since 1997 • Declining public sector debt. **Negative factors:** • Declining external competitiveness. • Tax and social benefits structure that encourages abuse. High levels of part-time workers and a shorter than normal workweek.
Denmark (Aaa/AAA/AAA)	**Positive Factors:** • Ongoing structural reforms linked to European Union (EU)

	accession, along with the prospect of joining the European Monetary Union. **Negative factors:** • Significantly different levels of compliance with the Maastricht criteria across accession countries. • GDP per capita remains low compared with the EU average. Ongoing large current account deficits
EU Accession Countries Cyprus (A2 / A / A-)	**Positive Factors:** • Continuing convergence with wealthy euro zone peers. • Sustained improvement in the public budgetary stance. • Competitiveness gains through liberalization, deregulation, privatization and infrastructural investment. **Negative factors:** • Incomplete pension reforms started in 2002. • Transfer payments from EU will decline following accession of ten new members in May 2004.
Estonia (A1 / A- / NR)	**Positive Factors:** • Increasing foreign exchange reserves.

	• Encouraging Growth prospects. • Improving external position. **Negative factors:** • Lack of fundamental improvement in government finances. • Lack of structural reform.
Latvia (A2 / BBB+ / BBB+)	**Positive Factors:** • Narrowing fiscal shortfall. • Improved external ratings position. • Substantial decline in public debt rating. • Increasing foreign direct investments. **Negative factors:** • Hefty debt repayment schedule. • Restricted access to international capital. • Ongoing political difficulties.
Lithuania (A3 / BBB+ / NR)	**Positive Factors:** • Improving external position. • Structural reforms are underway. • Improving fiscal and monetary policy co-ordination. • Ongoing financial and political support from the U.S. **Negative factors:** • Growing public sector debt. • Geopolitical risk associated with

	Palestine. • Significant dependence on the volatile technology sector. **Positive Factors:** • Narrowing fiscal deficit. • Stable political environment. • Healthy foreign reserves. **Negative factors:** • Decline in foreign direct investment. • Anticipated increase in pubic sector debt.
Malta (A3 / A / A-)	**Positive Factors:** • Passage of tax reform. • Recovering growth prospects. • Stable foreign exchange earnings from the services sector. **Negative factors:** • Inadequate public pension system fixed public sector wage increases. • High public sector debt to GDP ratio.
Poland (A2 / BBB+ / BBB+)	**Positive Factors:** • Ongoing access to international and domestic sources of funding. • Improving liquidity and transparency. • Passage of tax reforms. **Negative factors:**

	• Social and political unrest. • High public sector unrest. • Low tax to GDP ratio. • Sizeable informed sector. • Low GDP per capita.
Slovakia (A3 / BBB / BBB+)	**Positive Factors:** • Political stability • Rapid growth in investment, incomes and foreign reserves. • Prudent fiscal and monetary politics. • Ongoing, albeit gradual, structural reforms. **Negative factors:** • Uncertain resilience of fiscal accounts in the case of a sustained decline in Oil prices. • Limited reforms in banking and pubic administration.
Slovenia (As3 / A+ / A+)	**Positive Factors:** • Structural reforms to labour and product markets. • Solid debt management has led to an improved maturity structure for government debt. • Fiscal prudence. **Negative factors:** • Inflation exceeding EU norm. • Productivity levels remain below the continental EU average.

	• GDP per capita remains below the euro zone median.
Greece (A1 / A+ / A+)	**Positive Factors:** • Ongoing access to international and domestic sources of funding. • Improving liquidity and transparency. • Passage of tax reforms. **Negative factors:** • Social and political unrest. • High public sector unrest. • Low tax to GDP ratio. • Sizeable informed sector. • Low GDP per capita.
India (Ba1 / BBB / BB)	**Positive Factors:** • Political stability • Rapid growth in investment, incomes and foreign reserves. • Prudent fiscal and monetary politics. • Ongoing, albeit gradual, structural reforms. **Negative factors:** • Uncertain resilience of fiscal accounts in the case of a sustained decline in Oil prices. • Limited reforms in banking and pubic administration.
Indonesia (B2 / B / B+)	**Positive Factors:** • Structural reforms to labour and

	product markets. • Solid debt management has led to an improved maturity structure for government debt. • Fiscal prudence. **Negative factors:** • Inflation exceeding EU norm. • Productivity levels remain below the continental EU average. GDP per capita remains below the euro zone median.
Israel (A2 / A- / A-)	**Positive Factors:** • External strength: rising foreign reserves and large current account surpluses. • Positive fiscal outlook underpinned by public sector reform and improved tax administration. • Strong economic rebound supported by domestic demand and export growth. **Negative factors:** • Low ratio of tax revenue to GDP. • Incomplete corporate, financial and legal reforms. • Higher than desirable government debt ratios.
Malaysia (Baa1 / A- / BBB+)	**Positive Factors:** • Currency appreciation. • Moderating debt burden.

	• Improving external liquidity ratios. • Higher levels of confidence in lira-denominated assets. **Negative factors:** • Substantial debt burden and limited fiscal flexibility. • High real interest rates • Ongoing vulnerability to interest rate or exchange rate-related shocks.
Panama (Ba1 / BB / BB+)	**Positive Factors:** • Broad-based sources for foreign currency. • Moderate external debt with a good maturity structure. **Negative factors:** • Economic contraction. • Ongoing problems in the energy sector. • Difficulties finalizing an agreement with the IMF. • Low foreign reserves. • Currency instability. • Lack of a solid institutional base. ‘ • Potential for upcoming elections to derail any progress on reforms.
Peru (Ba3 / BB- / BB-)	**Positive Factors:**

	• Declining public sector debt ratio. • Positive growth. • Expected continuation of fiscal surplus position. **Negative factors:** • Difficulties achieving IMF targets. • Weakening growth prospects. • Lack of government commitment to the reform process. • High sensitivity to oil movements. • Political uncertainties.
Russia (Baa3 / Ba2 / NR)	**Positive Factors:** • Good macroeconomic environment. • Dependable foreign exchange earnings derived from remittances and maquiladora exports. • Moderate external and pubic sector debt. **Negative factors:** • Minimal flexibility to with financial sector distress, as the country does not have a 'lender of last resort'. • Limited fiscal flexibility.
Spain Aaa / AA+ / AAA	**Positive Factors:**

	• Ample foreign exchange reserves. • Solid export base. • Well-structured maturity profile. **Negative factors:** • Unsettled political environment. • Declining foreign direct investment. • Worrying high fiscal deficit. • Energy sector reform stalled.
Thailand (Baa1 / BBB / BBB)	**Positive Factors:** • Consistently high economic growth. • High level of remittances. • Commitment to reforms. • Moderate external debt. **Negative factors:** • Growing trade shortfall. • Concerning increases in domestic credit accompanied by banking sector weakness. Strained relations with IMF regarding the Poverty Reduction and Growth Facility.
Turkey (B1 / B+ / B+)	
Dominican Republic (B2 / CCC / B)	
Ecuador (Caa2 / CCC+ / CCC+)	
EI Salvador (Baa3 / BB+ / BB+)	
The Philippines (Ba1 / BB / BB)	
Vietnam	

(B1/BB-/BB-)

Source: Global Economic Research (January 2004)

The purpose of the foregoing is to illustrate the importance of sovereign ratings, which happens to be the cornerstone of the Basel 2 Accord. Developed countries depend on and trust their rating agencies especially the three featured here that they would avoid getting exposed to any country that has not obtained their rating. Should any of their banks attempt to lend to such country, the Basel 2 Accord is being structured to make such lending so expensive through regulatory capital requirement that such bank would have a second thought. Since the Basel 2 Accord provides that no Corporate can be rated higher than its host sovereign it follows that no corporate body in an unrated country can borrow at equal terms with their counterparts in rated countries. In effect sovereign rating is the bedrock of Basel 2, while all other considerations follow at a far distance. The extra ordinary reliance and importance being placed on the rating agencies especially the three featured above seem to confirm Lutz (op.cit) idea that the Basel 2 Accord is more of a co-operation between the regulators and the practitioners in the field than the regulators-only approach of Basel 1. The practitioners are no more than the G10/OECD) banks and the rating agencies they recognize while the regulators continue to be their Central Banks through the Basel Committee.

The procyclicality of external rating especially the extent and timing of migration have been subject to more research according to Segoviano and Lowe (2002). They said that in 17 recent financial crises, sovereign ratings by the major rating agencies were adjusted downwards prior to the crises in less than a quarter of the cases. In most episodes, they said, the downgrade comes during the crises. Ditto for the ratings of corporate borrower where downgrades tend to be concentrated at the trough of the economic cycle, and upgrades being more likely when economic conditions are robust. Ervin and Wilde (2001) conclude that capital requirements would be quite volatile if banks were to use external ratings as the basis for assigning internal ratings and Probability of Defaults (PD).

McDonough (2004) mentioned the procyclicality of rating, as being another general concern expressed as it is being thought that the Basel 2 Accord increased sensitivity to risk will reinforce behavioural patterns in banking organizations that may increase the cost of credit during downturns in the business cycle and vice-versa. He said the Committee is working to address this concern. Caterineu – Rabell et al (2003) on this procyclicality issue declares that a rating approach conditioned on the economic conditions prevailing when a loan was made could lead to a much greater increase in capital requirement on non-defaulted assets. They are of the opinion that given complete freedom banks would choose a countercydical approach i.e. reducing ratings in a recession even though that would cut across the objectives of the Basel 2 Accord which is to deliver more

capital when risks rise making the approach to be likely unattractive to the Committee or any supervisor.

Their analysis show that under a countercyclical rating scheme, banks will increase the risk weight on loans in booms which will in turn lead to an increase in the interest rate paid by the corporate sector on loans. This, they say, leads the corporate sector to reduce their borrowing, which reduces the default dispersion of the corporate sector and increases bank expected profits. In a recession, according to them, banks will reduce the risk weight on loans leading to a reduction in the interest rate paid by the corporate sector on loans. This leads the corporate sector to borrow more than would have been with other bank rating schemes. Default rises, they say, but remains below the levels that would have been seen with other bank rating schemes. Under the countercyclical rating scheme bank profits are, overall, higher across the cycle than they would be under either of the other rating schemes. This is because banks benefit from higher interest payments in booms and lower default rates in recessions.

Under a procyclical rating scheme according to Catarineu – Rabell et all (2003), banks will reduce the risk weight on loans in booms leading to increased borrowing which will result in increased default dispersion by the corporate sectors but overall defaults are lower than in the countercyclical case. In recessions banks will increase the risk weight and interest rates on loans leading the corporate sector to reduce borrowing. Default rates are higher then in the counter cyclical case. The procyclical regime, according to them, delivers profits which are less affected by default rates than under the countercyclical approach but overall, across the cycle, bank profitability would be lower than under the countercyclical scheme for ratings.

They also analyzed the neutral rating scheme under which the risk weights on loans would be invariant to the point in the economic cycle. This regime would manifest monotonic behaviour in booms and in recessions but would not do so in the aggregate. During expansionary periods according to them, it would resemble the countercyclical scheme and in recession it would resemble he procyclical scheme. Overall, it would deliver lower bank profits than either the counter cyclical or the procyclical schemes. That capital inflows to developing countries could dry up because of the regulatory capital requirement of Basel 2 appears to be the main concern of Professor Stephany Griffith – Jones et al (2001 & 2003). They fear that the minimum regulatory capital requirement under the Internal Ratings Basel (IRB) approach of the Accord would increase and could lead to a reduction of capital inflows to developing countries. Ironically this appears to be precisely what the Basel 2 Accord is being structured to achieve.

REGULATORY CAPITAL REQUIREMENT UNDER BASEL 2 ACCORD FOR A TENTATIVE CLAIM OF US $100.00 ON A CORPORATE BORROWER

RATING	PROBABILITY OF DEFAULT	US $ REGULATORY CAPITAL REQ.	US $ BASEL 2 STANDARDIZED APPROACH	US $ BASEL 2 IRB FOUNDATION

		UNDER BASEL 1		
AAA	0.03	8	1.6	1.13
AA	0.03	8	1.6	1.13
A	0.03	8	4.00	1.13
BBB	0.20	8	8.00	3.16
BB	1.408	8	8.00	12.35
B	6.60	8	12.00	30.96
CCC	15.00	8	12.00	47.04

Source: Bank of England's spring Quarterly Bulletin, 2001

REGULATORY CAPITAL REQUIREMENT UNDER BASEL 2 ACCORD FOR A TENTATIVE CLAIM OF US $100.00 ON A CORPORATE BORROWER

RATING	PROBABILITY OF DEFAULT	US $ REGULATORY CAPITAL REQ. UNDER BASEL 1	US $ BASEL 2 STANDARDIZED APPROACH	US $ BASEL 2 IRB FOUNDATION
AAA	0.03	8	1.6	1.13
AA	0.03	8	1.6	1.13
A	0.03	8	4.00	1.13
BBB	0.20	8	8.00	3.16
BB	1.408	8	8.00	12.35
B	6.60	8	12.00	30.96
CCC	15.00	8	12.00	47.04

Source: Bank of England's spring Quarterly Bulletin, 2001

REGULATORY CAPITAL REQUIREMENT UNDER BASEL 2 ACCORD FOR A TENTATIVE CLAIM OF US $100.00 ON A SOVEREIGN

APPOACH	RISK WEIGHT	REG. CAP. AA (OECD)
BASEL I	0	0
Standardized	0	0
IRB	7	7
		BBB (Non OECD)
BASEL 1	100	8.00
Standardized	50	4.00
IRB	40	3.2
		BB (Non OECD)
BASEL 1	100	8.00
Standardized	100	8.00
IRB	379	30.3
BASEL 1		B (Non OECD)
Standardized	100	8.00
IRB	100	8.00
	630	50.4

Source: Griffith – Jones & S. Spratt (2001)

According to Charles Cobb Jr. in his article posted to the website of allafrica.com on April 24, 2002 titled "Seek Credit Rating, Powell urges African Ministers" only four countries in sub-Saharan Africa at that time had ratings before Fitch rated Nigeria recently in 2006. They were Senegal, Botswana, Mauritius and South Africa. He was reporting on the "Sovereign credit ratings" conference convened by the then U. S. Secretary of State, Collins Powell. He called the conference the state Department's "first ever" meeting on private capital markets and credit rating for African countries. The conference apparently took place on the Tuesday of that week and Collins Powell was reported to have told the two dozen African Central bankers attending the conference in Washington D. C. that not having a widely used credit rating system stymies investment in Africa. He was quoted as saying "It's simple. It's straightforward. It's not rocket science. By attaining a Sovereign credit rating, your country will help reduce risk and encourage investment". A sovereign credit rating gives courage to capital" Veronica Kalema, Associate Director for Africa for Fitch Ltd. one of the rating agencies featured above was quoted in the same article as saying at the conference that "credit ratings are used by investors as indication of the likelihood of getting their money back in accordance with the terms on which they invested.

According to the article, African participants seemed non-committal during a conference break some were said to have worried aloud about the cost of rating which was put at US$35,000 as "surveillance" fee that does not include travel and

other on-site expenses, plus a US$115000 annual maintenance fee, even after Walter Kansteiner the U. S. Secretary of State for African Affairs had promised that the U. S. will pay these fees for African nations for the fist year. They were also reported to have raised questions about the ratings value and the mandatory acceptance of deep probes into what they considered as sensitive economic and political aspects of their nations to compile information that would remain the property of a private company. David Riley the Managing Director of Fitch Ltd who was said to have been at the conference to speak to the African group was reportedly frank and blunt about this when he said, "we (the rating agencies) essentially have to make judgments. In the end the report reflects our judgment". The then Nigerian ambassador to the United States, Professor Jibril Aminu was quoted to have expressed another concern at the conference. "The effect of being rated low, that is a thing that is really worrying some people here. They do have some worry about the impact of this thing on their credit worthiness if their ratings turned out to be negative". He was further quoted as saying that sovereign credit rating could "work for some countries, but this is not likely to be a priority for Nigeria. A country like Nigeria might be interested but I have the feeling they wouldn't take the time". Nigeria finally took the time and got its first ever credit rating in January 2006.

As mentioned above another form of credit rating that is acceptable under Basel 2 Accord is from Export Credit Agencies (ECAs). **Item 29** of the Accord states that for the purpose of risk weighting claims on sovereigns, supervisors may recognized the country risk scores assigned by Export credit Agencies (ECAs). It further states that in order to qualify, an ECA must publish its risk scores and subscribe to the OECD agreed methodology. The Item allows banks to choose using the risk scores published by individual ECAs that are recognized by their supervisor or the consensus risk scores of ECAs participating in the "Arrangement on Guidelines for officially Supported Export Credit" Below are the ratings of participating countries as at 28th October 2005.

Country Risk Classifications of the Participants to the Arrangement on Officially Supported Export Credits 2005

	Country Code ISO Alpha 3	Country Name English	01-Jan-2005 28-Jan-2005	21-Jan-2005 06-May-2005	29-Apr-2005 27-Jun-2005	20-Jul-2005 28-Oct-2005	21-Oct-2005 31-Dec-205
1	AFG	Afghanistan	-	-	-	-	
2	ALB	Albania	6	6	6	6	
3	DZA	Algeria	4	4	3	3	
4	ASM	American Samoa	-	-	-	-	
5	AND	Andorra	-	-	-	-	

6	AGO	Angola	7	7	7	7	
7	ATG	Antigua and Barbuda	7	7	7	7	
8	ARG	Argentina	7	7	7	7	
9	ARM	Armenia	7	7	7	7	
10	ABW	Aruba	4	4	4	4	
11	AUS	Australia	0	0	0	0	
12	AUT	Austria	0	0	0	0	
13	AZE	Azerbaijan	6	6	6	6	
14	BHS	Bahamas	3	3	3	3	
15	BHR	Bahrain	3	3	3	3	
16	BGD	Bangladesh	6	6	6	6	
17	BRB	Barbados	-	-	-	-	
18	BLR	Belarus	7	7	7	7	
19	BEL	Belgium	0	0	0	0	
20	BLZ	Belize	6	6	6	6	
21	BEN	Benin	7	7	7	7	
22	BMU	Bermuda	-	-	-	-	
23	BTN	Bhutan	-	-	-	-	
24	BOL	Bolivia	7	7	7	7	
25	BIH	Bosnia and Herzegovina	7	7	7	7	
26	BWA	Botswana	2	2	2	2	
27	BRA	Brazil	6	6	6	6	
28	BRN	Brunei	2	2	2	2	
29	BGR	Bulgaria	4	4	4	4	
30	BFA	Burkina Faso	7	7	7	7	
31	BDI	Burundi	-	-	-	-	
32	KHM	Cambodia	-	-	-	-	
33	CMR	Cameroon	7	7	7	7	
34	CAN	Canada	0	0	0	0	
35	CPV	Cape Verde	7	7	7	7	
36	CYM	Cayman Islands	-	-	-	-	
37	CAF	Central African Republic	7	7	7	7	
38	TCD	Chad	7	7	7	7	

39	CHI	Channel Islands	-	-	-	-	
40	CHL	Chile	2	2	2	2	
41	CHN	China	2	2	2	2	
42	TWN	Chinese Taipei	1	1	1	1	
43	COL	Colombia	5	5	5	5	
44	COM	Comoros	-	-	-	-	
45	COG	Congo	7	7	7	7	
46	COD	Congo, Dem, Rep	7	7	7	7	
47	CRI	Costa Rica	3	3	3	3	
48	CIV	Cote d'ivore	7	7	7	7	
49	HRV	Croatia	4	4	4	4	
50	CUB	Cuba	7	7	7	7	
51	CYP	Cyprus	3	3	3	3	
52	CZE	Czech Republic	2	2	2	2	
53	DNK	Denmark	0	0	0	0	
54	DJI	Djibouti	-	-	-	-	
55	DMA	Dominica	-	-	-	-	
56	DOM	Dominican Republic	6	6	6	6	
57	ECU	Ecuador	7	7	7	7	
58	EGY	Egypt	4	4	4	4	
59	SLV	El Salvador	4	4	4	4	
60	GNO	Equatorial Guinea	7	7	7	7	
61	ERI	Eritrea	-	-	-	-	
62	EST	Estonia	3	2	2	2	
63	ETH	Ethiopia	7	7	7	7	
64	FRO	Faeroe Islands	-	-	-	-	
65	FJI	Fiji	-	-	-	-	
66	FIN	Finland	0	0	0	0	
67	FRA	France	0	0	0	0	
68	PYF	French Polynesia	-	-	-	-	
69	GAB	Gabon	7	7	7	7	
70	GMB	Gambia	7	7	7	7	
71	GEO	Georgia	7	7	7	7	
72	DEU	Germany	0	0	0	0	
73	GHA	Ghana	6	6	6	6	

74	GRC	Greece	0	0	0	0	
75	GRL	Greenland	-	-	-	-	
76	GRD	Grenada	-	-	-	-	
77	GUM	Guam	-	-	-	-	
78	GTM	Guatemala	6	6	6	6	
79	GIN	Guinea	7	7	7	7	
80	GNB	Guinea-Bissau	7	7	7	7	
81	GUY	Guyana	7	7	7	7	
82	HTI	Haiti	7	7	7	7	
83	HND	Honduras	7	7	7	7	
84	HKG	Hong Kong, China	2	2	2	2	
85	HUN	Hungry	2	2	2	2	
86	ISL	Iceland	0	0	0	0	
87	IND	India	3	3	3	3	
88	IDN	Indonesia	6	6	6	6	
89	IRN	Iran	4	4	4	4	
90	IRQ	Iraq	7	7	7	7	
91	IRL	Ireland	0	0	0	0	
92	IMY	Isle of Man	-	-	-	-	
93	ISR	Israel	3	3	3	3	
94	ITA	Italy	0	0	0	0	
95	JAM	Jamaica	6	6	6	6	
96	JPN	Japan	0	0	0	0	
97	JOR	Jordan	5	5	5	5	
98	KZ	Kazakhstan	5	4	4	4	
99	KEN	Kenya	6	6	6	6	
100	KIR	Kiribati	-	-	-	-	
101	KOR	Korea	0	0	0	0	
102	PRK	Korea, Dem Rep. (North)	7	7	7	7	
103	KWT	Kuwait	2	2	2	2	
104	Kgz	Kyrgyz Stan	7	7	7	7	
105	LAO	Laos	7	7	7	7	
106	LATVIA	Latvia	3	2	2	2	
107	LBN	Lebanon	7	7	7	7	

108	LSO	Lesotho	6	6	6	6	
109	LBR	Liberia	7	7	7	7	
110	LBY	Libya	7	7	7	7	
111	LIE	Liechtenstein	-	-	-	-	
112	LTU	Lithuania	3	2	2	2	
113	LUX	Luxembourg	0	0	0	0	
114	MAC	Macao	2	2	2	2	
115	MKD	Macedonia	7	7	7	7	
116	MDG	Madagascar	7	7	7	7	
117	MWI	Malawi	7	7	7	7	
118	MYS	Malaysia	2	2	2	2	
119	MDV	Maldives	5	5	5	5	
120	MLI	Mali	6	6	6	6	
121	MLT	Malta	3	2	2	2	
122	MHL	Marshall Islands	-	-	-	-	
123	MRT	Mauritania	7	7	7	7	
124	MUS	Mauritius	3	3	3	3	
125	MYT	Mayo tee	-	-	-	-	
126	MEX	Mexico	3	3	3	2	
127	FSM	Micronesia	-	-	-	-	
128	MDA	Moldova	7	7	7	7	
129	MCO	Monaco	-	-	-	-	
130	MNG	Mongolia	7	7	7	7	
131	MAR	Morocco	4	4	4	4	
132	MOZ	Mozambique	7	7	7	7	
133	MMR	Myanmar	7	7	7	7	
134	NAM	Namibia	-	-	4	4	
135	NPL	Nepal	7	7	7	7	
136	NLD	Netherlands	0	0	0	0	
137	ANT	Netherlands Antilles	5 *	5 *	5 *	5 *	
138	NCL	New Caledonia	-	-	-	-	
139	NZL	New Zealand	0	0	0	0	
140	NIC	Nicaragua	7	7	7	7	
141	NER	Niger	7	7	7	7	
142	NGA	Nigeria ***	7	7	7	7	

143	MNP	Northern Mariana Islands	-	-	-	-	
144	NOR	Norway	0	0	0	0	
145	PMN	Oman	2	2	2	2	
146	PAK	Pakistan	6	6	6	6	
147	PLW	Palau	-	-	-	-	
148	PAN	Panama	4	4	4	4	
149	PNG	Papua New Guinea	6	6	6	6	
150	Pry	Paraguay	7	7	7	7	
151	PER	Peru	5	5	5	5	
152	PHL	Philippines	5	5	5	5	
153	POL	Poland	2	2	2	2	
154	PRT	Portugal	0	0	0	0	
155	Pri	Puerto Rico	-	-	-	-	
156	QAT	Qatar	2	2	2	2	
157	ROU	Romania	4	4	4	4	
158	RUS	Russian Federation	4	4	4	4	
159	RWA	Rwanda	7	7	7	7	
160	KNA	Saint Kitts and Nevis	7 *	7 *	7 *	7 *	
161	LCA	Saint Lucia	-	-	-	-	
162	VCT	Saint Vincent and the Grenadines	5 *	5 *	5 *	5 *	
163	WSM	Samoa	-	-	-	-	
164	SMR	San Marino	-	-	-	-	
165	STP	Sao Tome and Principe	7	7	7	7	
167	SAU	Saudi Arabia	3	3	3	3	
168	SEN	Senegal	6	6	6	6	
169	SCG	Serbia and Montenegro	7	7	7	7	
169	SYC	Seychelles	7	7	7	7	
170	SLE	Sierra Leone	7	7	7	7	
171	SGP	Singapore	0	0	0	0	
172	SVK	Slovak Republic	3	2	2	2	
173	SVN	Slovenia	2	2	2	2	
174	SLB	Solomon Islands	7	-	-	-	
175	SOM	Somalia	7	7	7	7	

176	ZAF	South Africa	3	3	3	3	
177	ESP	Spain	0	0	0	0	
178	LKA	Sri Lanka	3	3	3	3	
179	SDN	Sudan	7	7	7	7	
180	SUR	Suriname	7	7	7	7	
181	SWZ	Swaziland	-	-	-	-	
182	SWE	Sweden	0	0	0	0	
183	CHE	Switzerland	0	0	0	0	
184	SYR	Syria	7	7	7	7	
185	TJK	Tajikistan	7	7	7	7	
186	TZA	Tanzania	6	6	6	6	
187	THA	Thailand	3	3	3	3	
188	TLS	Timor-Lester	-	-	-	-	
189	TGO	Togo	7	7	7	7	
190	TON	Tonga	-	-	-	-	
191	TTO	Trinidad and Tobago	2	2	2	2	
192	TUN	Tunisia	3	3	3	3	
193	TUR	Turkey	5	5	5	5	
194	TKM	Turkmenistan	7	7	7	7	
195	VIR	U.S. Virgin Island	-	-	-	-	
196	UGA	Uganda	7	7	7	7	
197	UKR	Ukraine	6	6	6	6	6
198	ARE	United Arab Emirates	2	2	2	2	
199	GBR	United Kingdom	0	0	0	0	
200	USA	United States	0	0	0	0	
201	URY	Uruguay	6	6	6	6	
202	UZB	Uzbekistan	7	7	7	7	
203	VUT	Vanuatu	-	-	-	-	
204	VEN	Venezuela	6	6	6	6	
205	VNM	Viet Nam	5	5	5	5	
206	PSE	West Bank and Gaza	-	-	-	-	
207	YEM	Yemen	6	6	6	6	
208	ZMB	Zambia	7	7	7	7	
209	ZWE	Zimbabwe	7	7	7	7	

Source: Official website of OECD.

As could be seen above Nigeria {***} was rated 7 the lowest (i.e. highest risk) along with most African countries. The rating remains the same as at June 30th, 2006, almost six months after the FitchIBCA rating for Nigeria. The highest (lowest risk countries) rating is zero indicating no risk at all for investors. All countries are somewhere in between indicating the level of riskiness or no ratings at all as in the cases of Afghanistan, American Samoa, Andorra etc. In effect Nigeria and most African countries are high-risk countries that no G10/OECD bank would want to invest in. Even the presently rated ones are vulnerable to what Roman Kraussl (2003/22) calls "financial contagion" because the entire region of Sub-Saharan Africa is characterized by poverty, dishonesty, instability and continuous ethnic, religious and political upheavals, with the exception of South Africa to a reasonable extent.

Roman Kraussl (2003/22) had attempted to formalize a definition of "financial contagion" by distinguishing four transmission mechanisms through which financial market crises might be propagated across countries. Firstly he said, several countries could be similarly affected by a common shock, such as an abrupt change in world interest rates. Secondly, trade linkages can spread a financial crisis, as currency devaluation in one country weakens macroeconomic fundamentals in other countries by diminishing the competitiveness of their exports. Thirdly he said, financial market interdependence can also contribute to the transmission of a financial crisis, as preliminary instabilities in one country can lead international investors to withdraw their loans elsewhere, thereby generating a "credit crunch" in other emerging market economies. Finally, a financial crisis in one country can worsen market participants' perception of the economic conditions and prospects in other countries with similar characteristics, as a consequence setting off a widespread fall in international investors. The implication of these to African countries is that the region must be thoroughly cleaned up in accordance with international standard of the financial world before credit rating can have any meaningful significance. In effect even our Fitch rating may not be worth much considering the region of Africa that is characterized by instability.

Kraussl (2003/18) credited the following quotation to Friedman (1999) in the New York Times Magazine "There are two superpowers in the world today in my opinion. There is the United States and there is Moody's Bond Rating Service. The United States can destroy you by dropping bombs, and Moody's can destroy you by downgrading your bonds. And believe me, it's not clear sometimes who's more powerful". This is the height of the absolute significance that the Western world places on their rating agencies. But the rating agencies themselves are not entirely comfortable with the front burner that the Basel 2 Accord has placed them.

According to Kraussl (2003/23) the credit rating agencies have expressed concern that the utilization of their risk assessments for capital adequacy requirements has the propensity to undermine the objectivity of the rating process and may negatively influence the agencies independence. They are worried that an increasing application of their risk assessments to the regulatory process will

ultimately lead to calls for official supervision and regulation of their business. He said Cantor (2001) argues that such regulation would result in conformity and weaken the role of credit ratings as beneficial independent evaluation of financial market risk.

The International Labour Organization (ILO) is also not entirely comfortable with the existing sovereign credit rating process. In the Ideas Bank on its website (www.ilo.org) it is suggesting that in order to provide a more comprehensive picture of a country's economic state, Sovereign Credit Ratings need to include further variables that indicate labour market conditions and measures of social development. It is suggesting that instead of panel-beating the existing process being used by the three internationally recognised sovereign credit rating agencies (Moody's, Fitch, Standard and Poor's) a fourth should be established that would include objective measures of social development.

If sovereign credit ratings are the means of the Basel 2 Accord, then regulatory capital will be the end because this is what will be determined by any credit rating, sovereign or corporate.

According to Wilson (1998) however the exact definition of what constitutes a bank's capital remains subjective even though Basel 1 Accord had attempted an international convergence for regulatory capital purposes. Wilson (1998) says several forms of measurement can be applied and including a wider range of liabilities can extend any particular definition. According to him the Bank of England has changed the form many times over the years and had extended the definitions.

Clementi (2000) confirmed this when he said he quoted the resolution of Basel Committee to maintain in the Basel 2 Accord the existing definition as contained in Basel 1.

In other words, he said, the Committee is not revising their earlier definition of capital. According to him there have been some modification to the definition since 1988. This includes the introduction of another layer of less permanent capital to back short-term trading risks, and more recently to accommodate some more innovative types of issues which can be aligned with Tier 1 for capital purposes. In his opinion it would be intellectually more satisfying to be reviewing the whole framework together, but for the committee's decision not to revisit the issue presently, which he believes is a defensible pragmatic one. This is because, according to him, modernizing the denominator is proving difficult and contentious enough without involving the numerator as well. He however advocates a discussion should take place at some point as to whether the definition of capital had achieved the right composition on elements and emphasis on those elements.

Using the current Base 1 Accord's definition of capital as a benchmark there is the question of the importance to a bank. Clementi (2000) was very frank about the issue after he had recognized the two-typed role of capital, or specifically equity capital as a buffer against insolvency. He said it helps to protect the system and

limit calls on the safety net. Secondly, he said, equity capital helps to align the objectives of the firm's owners with the objectives of the authorities. According to him, where the owners of the firms invest only pinpoint capital, or see their investment erode to the point where the firm is only marginally solvent, owners have in incentive to "gamble for resurrection", because with limited liability, taking on extra risk has substantial potential upside but no extra downside for owners.

This is what Milney and Whalley (1998) called "moral hazard" the basic analysis of which they generalized to a dynamic setting which there are constrains on the issue of equity capital and a random regulatory audit. In this setting, they said, bank capital is held as a form of self-insurance against poor asset returns, with the bank retaining earnings in order to build up capital reserves towards a desired level and so reduce the probability of losing ownership of the future profit stream. According to them, this self- insurance interpretation of bank capital has a number of implications, both for the relationship between capitalization and risk-taking and for the design of regulatory policy. They show that the critically under capitalized bank under immediate threat of closure even if it is fundamentally profitable, is concerned only with survival leading to short-sighted risk-loving behaviour they also call "moral hazard". On the other hand they say, a moderately undercapitalized bank is concerned with the future as well as the present, and thus, in order to protect future profit (or charter value) is risk-averse. According to their analysis bank regulations and supervision are fundamentally about identifying bad banks, closing those, which are unprofitable, and closely monitoring those with low profits and high asset risk. They concluded that minimum (regulatory) capital standards, while reducing the exposure of the regulator, are relatively unimportant as determinant of bank behaviour.

Clementi (2000) also cautioned that we should not overstate the role of capital in ensuring the health of the banking system. He said if other fundamentals are shaky – such as the macroeconomic environment, the legal system, or the framework for asset valuation and auditing – capital is likely to produce limited comfort. He identifies capital adequately as only one aspect of prudential regulation, others being: liquidity management along with systems and control.

Wilson (1998) believes banks need capital (1) to deal with losses and still be able to stay afloat; (2) to support the basic infrastructure of the bank; (3) to cope with financial innovations which since the early 80s have increased the contingent liabilities of banks thereby making their balance sheets more complex thus making the issue of capital adequacy more relevant. According to Olson (2005) even though Pillar 1 of the Basel 2 Accord is expected to produce a minimum level of regulatory capital, he expects that each institutions actual capital held will vary according to its own risk profile and business mix.

Nigerian banks, like banks all over the world need strong capital bases to survive and unless they recognize the relevance of setting aside part of their profit to satisfy the minimum regulatory requirement as prescribed in the Basel 2 Accord it could be hard for them.

INSTITUTIONAL CHALLENGES- PILLAR 1

Institutional challenges are how long established customs and practices in the Nigerian banking industry and the mind-set of the practitioners and the supervisors could be changed to conform to the expectations.

As already mentioned above, both the Bank of England and the Federal Reserve System of the United States started out as commercial banks and as such were imbued with the entrepreneurial spirit needed to achieve the objectives of the Basel 2 Accord. One thing that Nigerian banks never seem to recognize is credit risk, which is the risk of default by the counter-party. It is as if they had absolute confidence in the borrowers proposal that they never thought anything could go wrong. Many at times, however, things do go wrong that would make the borrower default, if he had any intention of repaying in the first instance.

Ogunleye (2001) noted that a number of banks had poor credit policies and in cases where good policies were in place they were not faithfully implemented. He said loans were granted without due regard to ability of borrowers to repay and without collateral. Where collateral was available, according to him, the credit administration processes were found to be weak as credits were not being properly appraised and monitored, thereby impairing the quality of the risk assets on the banks.

QUALITY OF ASSETS IN THE BANKING INDUSTRY (1989-2003)

PERIOD	**PARAMETERS**			
	Total Loans and Leases of Distressed banks ₦billion	Total Non performing Loans and Leases of Distressed banks ₦billion	Ratio of Non performing Loans and Leases of Distressed Banks to Total Loans and Leases of Distressed Banks (%)	Ratio of Non performing Loans to Total Loan Assets of the Industry (%)
1989	4.3	2.9	67.4	40.8
1990	6.4	4.7	73.4	44.1
1991	5.4	4.1	76	39
1992	11	7	43	45.5
1993	25	15	58	41

1994	39	26	67	43
1995	91	45	50	32.9
1996	52	41	79	33.9
1997	50	40	80	25.81
1998	224	19	79	19.35
1999	29	21	72	25.61
2000	26	20	77	21.50
2001	36.9	19.2	52	16.90
2002	105	39.9	38	21.27
2003	129.8	98.3	75.7	21.59

Source: NDIC Annual Reports and Bank Returns.

He also identified institutional factors that have continued to cause distress in Nigerian banks and these must be addressed if the Basel 2 Accord is to be successfully implemented.

Financial Institutions' Assessment Of The Causes Of Distress in the Industry (Percentages)

Causes	All Financial Institutions %	Commercial Banks %	Merchant Banks %	Community Banks %	Finance Houses **%**
Bad Loans and Advances	19.5	30.1	12.9	17.2	20.3
Fraudulent practices	16.7	16.4	18.8	18.5	18.9
Under Capitalization	11.8	7.6	9.6	12.7	9.0
Rapid changes in Government Policies	10.8	9.8	5.5	16.9	13.5
Bad Management	17.9	13.1	21.7	14.0	16.4
Lack of adequate supervision	16.9	20.1	29.4	17.5	17.5
Undue reliance on foreign exchange trading	6.4	2.9	2.1	3.2	4.4

Totals	100.0	100.0	100.0	100.0	100.0

SOURCE:A CBN / NDIC collaborative study of distress in the Nigerian banking industry.

Pillar 1 of the Basel 2 Accord is mostly on credit risk management and Imala (2004) pointed out the weakness of Nigerian banks in this aspect of management. He identified poor credit administration as the bane of the development of banks in Nigeria resulting in predatory borrowers abuse of the system by taking multiple credits from banks. Nigerian banks must recognize credit risk in all credit proposals so that when lending to a trader in Alaba Market for electronics the difference in credit risk between that trader will not be the same as that of an exposure to Julius Berger Plc.

The bedrock of the Pillar 1 Accord is on data, its collection, evaluation, storage and use for rating purposes internally or externally. Modern techniques of risk management reflected in the methodological approach of the Basel 2 Accord involve the estimation of probabilities of default (PD) on the lending loan portfolio, as well as loss-given-default (LGD). Banks in Nigeria have no such data on corporate and individual credit records.

The Central Bank of Nigeria Credit Risk Management System (CRMS) is the closest to a credit Bureau but then the integrity of the data is doubtful, as many banks seem not to be reporting all their lending to the Bureau. Nigerian banks are also reluctant to share information on borrowers and some would even deliberately lend without seeking information from other banks just to poach the customer who would have disclosed to him of being indebted to the other bank.

Loss data gathering is a crucial requirement for banks in Pillar 1 of the Basel 2 Accord and this is lacking in Nigerian banks. Computation of probability of default (PD), loss-given-default (LGD), Migration mapping are all required for the creation of historical loss database. This is a time consuming process. Without a loss database that has integrity, Nigerian banks may be better of staying with the Basel 1 Accord.

Another institutional challenge that Nigerian banking industry faces in its attempt to implement the Basel 2 Accord is its perception of a bank's profit profile. In Nigeria today, most people will invest in banks that pay large dividends without minding their soundness in terms of capital. Basel 2 Accord calls for risk-adjusted returns, stress tested with provisions for Expected and Unexpected Losses and further setting aside of the regulatory capital based on risk-weighted assets as dictated in the Accord. Should this be implemented, the profit attributable to share holders will have to be reduced through these deductions into Loan Loss Reserve account, which is presently not part of the Reserve accounts of Nigerian banks. This deduction will leave less profit for the shareholders and this will not go down well with them, as it is not the current practice in Nigeria. Stress testing the performance of a bank as being envisaged by the Basel 2 Accord could produce healthier banks because the capital base would be increased and its shareholder would enjoy its appreciation more than the one or two naira per share paid out as dividends with pains on the bank as a corporate body.

As mentioned above, risk management is not what the Board of most banks in Nigeria recognized and give free hands to as expected in the Basel 2 Accord as could be seen in the failure of banks prior to the on-going consolidation.

Another institutional challenge Nigerian banks will need to overcome is the elimination of overdraft as a form of lending.

According to Wilson (1988) the overdraft subject to agreed limit was the common means of lending in the U.K. for many years. The loan technique was adopted in 1971 after the introduction of Competition and Control Act of that year. The Basel 2 Accord recognizes overdraft as a one-off transaction that must be liquidated within 90 to 180 days if it is not to be considered as defaulted. Item 459 of the Accord stresses that banks must have in place rigorous internal policies for assessing the credit worthiness of customers who are offered overdraft accounts.

In many Nigerian banks overdraft is the predominant form of lending. Customers are usually offered this facility upon approval by the appropriate arms of the bank and subject to the fulfilment of the Conditions Precedent to draw down and expiry on a given future date. The total amount would be placed at the customer's disposal to be drawn at his pleasure and the expectation would usually be that he would be coming in daily to lodge in his sales proceeds. The average Nigerian customer would draw the full amount of this facility and take it to another bank where he operates a credit account. He would lodge it in this second bank and be going at irregular intervals to the lending bank to perfunctorily make deposit into his overdrawn account and could come back the following day to draw it out. The average Nigerian banker charges this customer a Commission on Turnover at the agreed per mille to make a revenue for the bank. At month ends interest would be debited to the account of this customer and his liability would increase all other charges would also be debited. This exercise will be repeated every month and the customer's debit balance will continue to grow. At a point all deposit he makes into this account will continue to be swallowed by the account at this lending bank and a breaking point will come when he would not be able to service the debt anymore and would flee from the banker's reach.

Prior to the on-going consolidation exercise the average Nigerian bank took pride in the quantity of its lending portfolio and not necessarily the quality. With a gargantuan loan portfolio the average Nigerian bank knew that it would be able to justify the fantastic profit it would want to declare come year-end. Through restructuring it would continue to declare its Non-Performing risk assets as Performing and continue at pains to the bank corporate to pay dividend on them to its shareholders so that the Board members could continue to keep their jobs, while those among them holding substantial units of the share of the bank would continue to reap big harvest of dividends.

All these must change if the implementation of the Basel 2 Accord is expected to produce the desired positive result.

THE SECOND PILLAR-SUPERVISORY REVIEW PROCESS

A. Importance of Supervisory Review

Items 720 states the intention of the New Accord's supervisory review process as not only to ensure that banks have adequate capital to support all the risks in their business, but also to encourage banks to develop and use better risk management techniques in monitoring and managing their risks.

Item 721 is on the recognition by the Supervisory review process of the responsibility of bank management in developing an internal capital assessment process and settling capital targets that are commensurate with the bank's risk profile and control environment. In the Basel 2 Accord, bank management continues to bear responsibility for ensuring that the bank has adequate capital to support its risks beyond the core minimum requirements.

Item 722 expects Supervisors to evaluate how well banks are assessing their capital needs relative to their risks and to intervene, where appropriate. This interaction is intended to foster an active dialogue between banks and supervisors such that when deficiencies are identified, prompt and decisive action can be taken to reduce risk or restore capital. It advises Supervisors to adopt an approach to focus more intensely on those banks whose risk profile or operational experience warrant's such attention.

Item 723 states the committee's recognition of the relationship that exists between the amount of Capital held by the bank against its risks and the strength and effectiveness of the bank's risk management and internal control processes. It warns that increased Capital should not be viewed as the only option for addressing increased risk confronting a bank. Other means to be considered include strengthening risk management, applying internal limits, strengthening the level of provisions and reserves, and improving internal controls. It stressed that capital should not be regarded as a substitute for addressing fundamentally inadequate control or risk management process.

Item 724 recognizes three main areas that might be particularly suited to treatment under Pillar 2 and those are (1) risks considered under Pillar 1 that are not fully captured by the Pillar 1 process (e.g. credit concentration risk); (2) those factors not taken into account by the Pillar 1 process (e.g. interest rate risk in the banking book, business and strategic risk); (3) factors external to the bank (e.g. business cycle effects). It further states two important aspects of Pillar 2, which are the assessment of compliance with the minimum standards and disclosure requirements of the more advanced methods in Pillar 1 in particular, the IRB framework for credit risk and the Advanced Measurement Approach (AMA) for operational risk. Supervisors must ensure that these requirements are being met, both as qualifying criteria and on a continuing basis.

Four Key Principles of Supervisory Review

Principle1: Banks should have a process for assessing their overall capital adequacy in relation to their risk profile and a strategy for maintaining their capital levels.

Item 726 to this end states that banks must be able to demonstrate that chosen internal capital targets are well founded and these targets are consistent with their overall risk profile and current operating environment. In assessing capital adequacy, bank management needs to be mindful of the particular stage of the business cycle in which the bank is operating. Rigorous, forward-looking stress testing that identifies possible events or changes in market conditions that could adversely impact the bank should be performed. While it finally charges a bank management with the primary responsibility of ensuring that the bank has adequate capital to support its risks, **Item 727** lists the five main features of a rigorous process as follows: -

- Board and senior management oversight;
- Sound Capital assessment;
- Monitoring and reporting; and
- Internal control review.

BOARD AND SENIOR MANAGEMENT OVERSIGHT

Item 728 defines a sound risk management process as the foundation for an effective assessment of the adequacy of banks' capital positions. Bank management is responsible for understanding the nature and level of risk being taken by the bank and how these risks relate to adequate capital levels. It is also responsible for ensuring that the formality and sophistication of the risk management process are appropriate in light of the risk profile and business plan.

Item 729 stresses that the analysis of banks' current and future capital requirements in relation to strategic objectives is a vital element of the strategic planning process. Towards this end, the strategic plan should clearly outline the bank's capital needs, anticipated capital expenditures, desirable capital level, and external capital sources. It advises the senior management and the board to view Capital planning as a crucial element in being able to achieve its desired Strategic objectives.

Item 730 charges the bank's board of directors with the responsibility of setting the bank's tolerance for risks. The board should also ensure that management establishes a framework or assessing the various risks, develops a system to relate risk to the bank's capital level, and establishes a method for monitoring compliance with internal policies. It is likewise important that the board of directors adopts and support strong internal controls and written policies and procedures and ensures that management effectively communicates these throughout the organization.

SOUND CAPITAL ASSESSMENT

Item 731 lists fundamental elements of sound capital assessment as follows: -

- Policies and procedures designed to ensure that the bank identifies, measures and reports all material risks;
- A process that relates capital to the level of risk;
- A process that states capital adequacy goals with respect to risk, taking account of the bank's strategic focus and business plan; and
- A process of internal controls reviews and audit to ensure the integrity of the overall management process.

COMPREHENSIVE ASSESSMENT OF RISKS

Item 732 directs that all material risks faced by the bank should be addressed in the capital assessment process and that a process should be developed to estimate risks. It recommends the following risks to be considered and they are contained in **Items 733 to 742** They are: credit risk; operational risk; market risk; interest rate risk in the banking book; Liquidity risk; and Other risks such as reputation and strategic risk which admittedly are not easily measurable.

MONITORING AND REPORTING

Item 743 directs the bank to establish an adequacy system for monitoring and reporting risk exposures and how the bank's changing risk profile affects the need for capital. The bank's senior management or board of directors should on a regular basis, receive reports on the bank's risk profile and capital needs. These reports should allow senior management to: -

- Evaluate the level and trend of material risks and their effect on capital levels;
- Evaluate the sensitivity and reasonableness of Key assumptions used in the capital assessment measurement system;
- Determine that the bank holds sufficient capital against the various risks and that they are in compliance with established capital adequacy goals; and
- Assess its future capital requirements based on the bank's reported risk profile and make necessary adjustments to the bank's Strategic plan accordingly.

INTERNAL CONTROL REVIEW

Item 744 stresses the importance of internal control to the Capital assessment process. It directs the board of a bank to regularly verify whether the system of internal controls is adequate to ensure well-ordered and prudent conduct of business.

Item 745 wants a bank to conduct periodic reviews of its risk management process to ensure its integrity, accuracy, and reasonableness. Areas recommended for review include:

- The appropriateness of the bank's Capital assessment process given the nature, scope and complexity of its activities;
- The identification of large exposures and risk concentrations;
- The accuracy and completeness of data inputs into the bank's assessment process;
- The reasonableness and validity of scenarios used in the assessment process; and
- Stress testing and analysis of assumptions and inputs.

Principle 2: Supervisors should review and evaluate bank's internal capital adequacy assessments and strategies, as well as their ability to monitor and ensure their compliance with regulatory Capital ratios. Supervisors should take appropriate Supervisory action if they are not satisfied with the result of this process.

Item 746 towards this end directs Supervisory authorities to regularly review the process by which banks assess their capital adequacy, the risk position of the bank, the resulting capital levels and the quality of Capital held. They should also evaluate the degree to which banks have in place a sound internal process to assess capital adequacy. It cautioned however that the emphasis of the review should be on the quality of the bank's risk management and controls and should not result in Supervisors functioning as bank management. It recommends that the periodic review can involve some combination on the following:

- On-site examinations or inspection;
- Off-site review;
- Discussions with bank management
- Review of work done by external auditors, (provided it is adequately focused on the necessary capital issues; and
- Periodic reporting.

Item 747 to 755 explain more on the issues involved in Principle 2 under the headings; (1) Review of adequacy of risk assessment; (2) assessment of Capital adequacy; (3) Assessment of the control environment; (4) Supervisory review of compliance with minimum Standards and (5) Supervisory response.

Principle 3: Supervisors should expect banks to operate above the minimum regulatory capital ratios and should have the ability to require banks to hold capital in excess of the minimum.

Items 757 and 758 provide the details of this principle.

Principle 4: Supervisors should seek to intervene at an early stage to prevent capital from falling below the minimum levels required to support the risk characteristics of a particular bank and should require rapid remedial action if capital is not maintained or restored.

Item 759 towards this end directs that Supervisors should consider a range of options if they become concerned that banks are not meeting the requirements embodied in the supervisory principles outlined above. These actions may include intensifying the monitoring of the bank; restricting the payment of dividends; requiring the bank to prepare and implement a satisfactory capital adequacy restoration plan; and acquiring the bank to raise additional capital immediately.

Item 760 admits that the permanent solution to banks' difficulties is not always increased capital, and that some of the required measures may take a period of time to implement. Therefore, increased capital might be used as an interim measure while permanent measures to improve the bank's position are being put in place. Once these permanent measures have been put in place, and have been seen by supervisors to be effective, the interim increase in capital requirement can be removed.

Specific issues to be addressed under the Supervisory review process

Item 762 to 778 addressed this topic under the following headings:

(1) Interest rate risk in the banking book;

(2) Credit risk;

(3) Operational risk;

(4) Market risk.

Supervisory transparency and accountability, enhanced cross-border communication/cooperation are the other aspects of the Supervisory review process discussed in **Items 779 to 783.**

Item 784 to 807 are on Securitisation under the supervisory review process and the following topics were discussed:

(1) Significance of risk-transfer;

(2) Market innovations;

(3) Provision of implicit Support;

(4) Residual risks;

(5) Call provisions;

(6) Early amortization.

INSTITUTIONAL CHALLENGES – PILLAR 2

As mentioned above, institutional challenges are how some long established customs in the Nigerian banking industry and the mindset of the practitioners / supervisors could be changed to conform to what are being expected on ground before Basel 2 Accord could be implemented.

The Pillar 2 as the Supervisory review process poses about the most daunting challenges as it contains preconditions for the implementation of Pillar 2 itself as contained in the Basel 2 Accord. The guiding principle of this Pillar of the Basel 2 Accord is contained in the Basel Committee's publications titled "Core Principles for Banking Supervision' (1997) and 'Core Principles Methodology (1999).

These publications contained the attributes of an effective banking supervision system that could be considered as being capable of implementing the Pillar 2 of the Basel 2 Accord. The system must have been assessed preferably by a third party like the IMF, World Bank, Regional Supervisory groups, regional development banks, and consulting firms. There are 25 core principles which compliance by a banking supervision system must be assessed.

The Supervisors themselves can also perform a self-assessment of their system. Whatever the context, according to the publication, the following factors are crucial:

- Assessment is best when performed by an outside party consisting of at least two individuals with varied perspective so as to provide checks and balances;
- It must be done with the cooperation of all relevant authorities;
- It must not be done by non-experts as their judgment could be misleading;
- It may require legal experts to interpret certain aspects as they relate to the country's legislative structures;
- It must be deep in terms of details so as to allow a judgment on whether criteria are fulfilled in practice and concept.

Before even the assessment could take place, the assessors should form a view as to whether the following preconditions are in place:

(1) Sound and sustainable macro-economic policies;

(2) A well-developed public infrastructure;

(3) Effective market discipline;

(4) Procedures for the efficient resolution of conflicts in banks;

(5) Mechanisms for providing an appropriate level of systemic protection (or public safety).

These five (5) preconditions to assessment seem to be major institutional challenges that must be overcome, if the implementation of the Basel 2 Accord is to succeed in Nigeria.

Sound and Sustainable Macro-Economic Policies

The Basel Committee admits that these are not within the competence of banking supervisors, but they expect supervisors to react, if they perceive that existing policies are undermining the safety and soundness of the banking system. In Nigeria, this challenge will be both structural and institutional. It will be structural in the sense that neither the CBN nor the NDIC is independent of the government and as such, they cannot go against its policies. None is autonomous and besides, they would have been party to any government decision in the first instance. Ogunleye (2001) cited as Economic/Political factors responsible for bank failures in Nigeria, the following:

(a) Large Federal budget deficits that resulted in hyper-inflation and increased debt burden caused by the collapse of oil prices in 1981 and the resultant slow-down in economic growth. According to him, the adverse effect of these was borrower's inability to service their debts thus leaving the banks with high levels of non-performing loans. He said the banks also had difficulty in sourcing new deposits to finance additional or long-term funding.

(b) Wide range of reforms brought about by the structural Adjustment Program (SAP) introduced in 1986.

(c) The cumulative effect of the political uncertainty prior to and after the1993 June 12 elections which led to a run on smaller banks by depositors seeking the safety of their funds leading the banks to scout around for funds to keep them afloat and finance their assets;

(d) The unprecedented level of fraud and other malpractices that existed in banks prior to the promulgation of the Failed Banks and Financial Malpractices Act of 1994;

(e) Nigerians not being used to paying their bills view bank loans as their share of the national cake.

The challenge will be institutional because the CBN/NDIC having no representative of commercial banks on their boards see commercial banks with the fantastic profit they declare every year more like beasts of burden who can always take on additional load at any time. With such a mind-set, they are not likely to fight on the side of commercial banks even if they see that government policy could undermine the safety and soundness of the banking system. They would expect the banks to fight themselves; after all it is their survival that is at stake not that of the CBN. The banks at their own corner would rather grumble and resign themselves to the situation because the CBN is their banker, the question being who would bell the cat.

(2) A well-developed public infrastructure

Part of what these publications describe as a well-developed public infrastructure which if not adequately provided, can contribute to the weakening of financial systems are as follows:

(a) A system of business laws, including corporate, bankruptcy, contract, consumer protection and private property laws, which is consistently enforced and provides a mechanism for fair resolution;

(b) Comprehensive and well defined accounting principles and rules that commands international acceptance;

(c) An efficient and independent judiciary, and well regulated accounting, auditing and legal professions;

(d) Well defined rules governing and adequate supervision of, other financial markets and their participants;

(e) A secure and efficient payment and clearing system for the settlement of financial transactions where counterparty risks are controlled.

The standard of all these are still low in the Nigerian banking supervision system and bringing it up to the Basel 2 Accord standard will be more of an institutional challenge than structural.

The regulators of the banking industry, which are the CBN and NDIC would, have been expected to rise to the occasion but their efforts are being hindered by a

number of issues which according to Mr. Ignatius. O. Imala, (2004) the Director of Banking Supervision at the CBN is as follows:

(1) Falsification of bank returns/call reports which makes it very difficult and extremely expensive for the regulators to ascertain the true financial conditions of the banks. He said that often bank returns are falsified deliberately to hide management inefficiency by presenting a false robust picture of the bank and hide frauds and insider abuses;

(2) High volume of delinquent insider related credits, arising largely from poor financial disclosure and auditing requirements;

(3) Inadequate representations of non-executive directors on the Board. This usually arises from the lack of in-depth knowledge of, and inability to interpret financial statements and corporate strategies;

(4) Formulation of self-seeking policies;

(5) Weak capital base of banks

(6) Poor credit administration resulting in predatory borrowers abuse of the system by taking multiple credits from different banks and allowing such credits to go bad. He cited poor understanding of clients business, inadequate credit appraisal and poorly structured loan contracts as some of the factors responsible for the deteriorating risk asset quality in the banking industry;

(7) The paucity of executive capacity in the industry caused by the inability of banks to adequately train their staff, and the culture of staff poaching in the banking sector which has led to inexperienced officers manning sensitive portfolios and positions beyond their capabilities;

(8) The prolonged judicial process, which causes delays in and hinders the effectiveness of supervisory processes. He cited as an example the protracted liquidation process of Savannah Bank Plc which license was revoked in 2002;

(9) Difficulties in the reviewing of supervisory legal framework. He said the ability of the regulatory authorities to effectively carry out the statutory supervisory functions is impaired by the inadequacies in the existing legal framework.

As for Mr. Ogunleye (op cit) the militating factors should include the following:

(a) Limitation of the supervisory personnel in terms of IT and inadequate number of staff to carry out more regular on-site examinations. According to him, with improved capacity in IT some banks were able to manipulate their records thereby hiding loses and fraudulent activities.

(b) Inability of CBN to take prompt corrective action prior to the promulgation of the Banks and Other Financial Institutions Act of 1991;

(c) Illiquidity position of some banks exacerbated as a result of CBN's use of stabilization securities as a monetary policy tool;

(d) The introduction of the Prudential Guidelines on assets classification and provisioning for doubtful loans exposed weak and poorly managed banks;

(e) The culpable acts of external auditors of the banks who apparently would see but would not report fraudulent activities of some banks that eventually went on to fail. He acknowledged though that banking supervision alone cannot prevent bank failures but that it can minimize the impact.

(f) Poor public perception of the Deposit Insurance scheme as a conventional insurance company;

(g) The incidence of distress in other Deposit-taking institutions;

(h) Inadequate information disclosure by insured banks thus making the integrity of their data questionable;

(i) Depositors apathy and ignorance;

(j) Inability to settle guaranteed deposits promptly because of the poor state of the records of many closed bank, and litigation by the owners;

(k) Inadequacy of the pegged N50, 000 insured deposit set in 1988;

(l) Threat of political interference by high profile politicians;

(m) Threat to depositors funds that could be used to make political loans under the present democratic dispensation with such loans not usually repaid;

STRUCTURAL CHALLENGES- PILLAR 2

As mentioned above, the Basel Committee's publications contain preconditions to being assessed as a bank supervision system that can implement the Basel 2 Accord Pillar 2. Among the preconditions set are (1) a well-developed public infrastructure; (2) procedures for efficient resolution of problem in banks.

Osinbajo (2005) reported that a 1997 study conducted on the duration of trials in the Lagos High court produced the following results:

Type Of Case	**Trial Time**
Land matters	7 – 8 years
Personal matters	3 – 4 years
Commercial cases	3 – 5 years
Family cases	2 – 5 years

According to him, the overall average for cases in Lagos High Courts is 4.25 years. Lagos State being the commercial capital of Nigeria has the largest judiciary in the nation and handles by far more court cases than any other state judiciary. He also reported on another study conducted by the Federal Ministry of Justice in August 2001, which showed that it took an average of 5.9years for a contested case to move from filing to judgment.

Imala (2004) also cited this as prolonged judicial process, which causes delays in and hinders the effectiveness of the supervisory process. He cited the difficulties in the reviewing of supervisory legal framework and how it was impairing the supervisory functions.

Once the five preconditions mentioned above are in place, the assessment will now be for compliance with the twenty-five Core Principles for Effective Banking Supervision as contained in the Basel Committee's publication, not yet the Basel 2 Accord.

According to the CBN Banking Supervision Annual Report (2004), Nigeria has fully complied with 10 out of the 25 principles as shown below:

In this Report, the CBN identified the following as the most common constraints to full compliance with the 25 Basel Committee's Core Principles for effective banking supervision:

(1) Lack of capacity to develop guidelines on practices and procedures for risk management;

(2) Implementation of a capital charge for market risk;

(3) Capacity to develop a risk based framework for identifying, measuring, monitoring and controlling individual risks;

(4) Harmonization of regulations on loan loss provisions. Suspension of interest and charge on irrecoverable debts, as well as directives on credit policy, internal control and corporate governance.

At the regional West African Monetary Zone (WAMZ) level the Report specified that additional efforts would be needed to ensure compliance BCP 12 on Market Risk, 13 on Other Risks, 15 on anti-money laundering, 20 on consolidated supervision and 22 on Remedial Measures.

It also advised that the current efforts by the regional central banks in developing legal and regulatory frameworks needed to be augmented by the harmonization of the following procedures at the regional level:

- Market risk monitoring and prescribing for it a capital charge;
- Risk management process for identifying, measuring, monitoring and controlling risks banks are exposed to;
- Prudential Guideline rules and streamlining the ratios to ensure conformity and competitive equality;
- Training programs on risk management and the supervisory process;
- Policy directives on internal controls, corporate governance, and code of conduct for the region;
- Regulations on provisioning, suspension of interest and charge-off of bad debts;
- Adoption of International Accounting Standard and implementing harmonized guidelines;
- Sensitizing of banks on Basel 2 Capital Accord issues.

With the above developments one would think the CBN is going the Basel 2 Accord way until one sees the Risk-based Supervision that is being introduced by the apex bank.

According to its 58-page publication titled "Framework for Risk-based Supervision of Banks in Nigeria" the framework involves a series of structured stages that are designed to:

(1) Focus the supervisor's attention on the risks that threaten the achievement of supervisory objectives; and

(2) Enable the supervisor devise a risk mitigation programme to address those risks.

The main supervisory objectives on which this framework is based are as follows:

(1) Promoting stability and soundness of the banking system;

(2) Ensuring consumer protection; and

(3) Reducing financial crimes.

It is divided into six stages after the full-scale maiden examination and they are as follows:

(A) Full scope examination of a bank covering 20 risk elements listed under Business Risks, and Control Risks. This examination is promised to be a one-off event, as 'subsequent examinations will depend on the supervisors' assessment and perception of the risks of individual banks"

(B) Impact assessment of banks to determine the systemic effect of the failure of any particular bank. At this stage assessed banks would be categorized as Very High; High; Medium; Low; and Very Low. These are to be defined as "impact thresholds".

(C) Risk assessment of banks.

(D) Development of Risk Mitigation Programme.

(E) Determining the supervisory period.

(F) Evaluation and validation; and

(G) Communicating the results of the assessment and risk mitigation programme to the bank.

Emphasis seems to be more of auditing/examination than on the type of supervision being advocated under the Basel 2 Accord. The approach seems to be more of that of the Financial Services Authority of the United Kingdom than that of the Basel 2 Accord. The CBN could be at a crossroad, as going the Basel 2 way would entail a complete departure from the old structure of command and control, and regulators–know- best.

THE THIRD PILLAR- MARKET DISCIPLINE

A General Considerations

Items 757 to 768 are on general considerations with Item 757 (Disclosure requirements) stating the Committee's belief that the rationale for this Pillar 3 is sufficiently strong to warrant the introduction of disclosure requirements for banks using the New Accord. Supervisors are expected to have an array of measures that they can use to require banks to make such disclosures, some of which will be qualifying criteria for the use of particular methodologies or the recognition of particular instruments and transactions.

Items 758 and 759 are on the guiding principles of this Pillar 3 (Market discipline) the purpose of which is to complement the minimum capital requirement (Pillar 1) and the Supervisory review process (Pillar 2). The Committee aims to encourage market discipline by developing a set of disclosure requirements which will allow market participants to assess key pieces of information on the scope of application, capital, risk exposures, risk assessment processes, and hence the capital adequacy of the institution. The Committee believes that such disclosures have particular relevance under the New Accord, where reliance on internal methodologies gives banks more discretion in assessing capital requirements.

Item 760 and 761 are on how Supervisors can achieve appropriate disclosure. They state the Committee's awareness that Supervisors have different powers available to them to achieve the disclosure requirements and that market discipline can contribute to a safe and sound banking environment, and Supervisors require firms to operate in a safe and sound manner. Under these ideal conditions Supervisors could require banks to disclose information. Alternatively, supervisors have the authority to require banks to provide information in regulatory reports and could make some or all of the information there publicly available.

The Committee acknowledges that there are a number of existing mechanisms by which Supervisors may enforce requirements. These vary from country to country and range from "moral suasion" through dialogue with the bank's management (in order to change the latter's behaviour) to reprimand and financial penalties. The nature of the exact measures used will depend on the legal powers of the Supervisor and the seriousness of the disclosure deficiency. It acknowledges however that it is not intended that direct additional capital requirements would be a response to non-disclosure. The exception however is where disclosure is a qualifying criterion under Pillar 1 to obtain lower risk weightings and/or to apply specific methodologies, in which case there would be a direct sanction of not being allowed to apply the lower weighting or the specific methodology.

Items 762 to 765 are on Pillar 3 interaction with accounting disclosures while Items 766 is on materiality. It specifies that a bank should decide which disclosures are relevant for it based on the materiality concept. Information would be regarded as material if its omission or misstatement could change or influence the assessment or decision of a user relying on that information. The Committee is not setting specific thresholds for disclosure as these can be open to manipulation and are difficult to determine.

Item 767 recommends that disclosures should be made on a semi-annual basis, subject to the following exceptions: Qualitative disclosures that provide a general summary of a bank's risk management objectives policies, reporting system and definitions may be published on an annual basis; large internationally active banks and other significant banks (and their significant subsidiaries) must disclose their Tier 1 and total capital adequacy ratios, and their components on a quarterly basis, in cases where information on risk exposure or other items is prone to rapid charge, then banks should also disclose information on a quarterly basis. In all cases, banks are directed to publish material information as soon as practicable.

Item 768 is on Proprietary and Confidential information. It sets the limitation of the disclosure requirement.

Item 769 & 770 contain the General disclosure principle which say that banks should have a formal disclosure policy approved by the board of directors that addressed the bank's approach for determining what disclosures it will make and the internal controls over the disclosure process. In addition, banks should implement a process for assessing the appropriateness of their disclosures, including validation and frequency of them.

Item 771 is on Qualitative Disclosures and it contains three tables as they relate to the scope of application; Capital Structure, and Capital adequacy.

Item 772 to 775 are on Risk exposure and assessment. **Item 772** states that the risks to which banks are exposed and the techniques that banks use to identify, measure, monitor and control those risks are important factors market participants consider in their assessment of an institution. It considers the following key banking risks; credit risk; market risk; interest rate risk; equities in the banking book, operational risk; credit risk mitigation and asset securitisation.

Structural Challenges – Pillar 3

Pillar 3 is market discipline. The idea here is that market forces ought to supplement supervisors' oversight of financial institutions. In this way, banks learn from investors and depositors how their risks are perceived, and supervisors from the market as well.

The important issues under this Pillar are informational transparency and well functioning financial markets. Under this Pillar, banks will be required to disclose to the public the new risk-based capital ratios and more extensive information about the credit quality and managing risks. Such disclosures are expected to improve market discipline.

Market discipline refers to a market-based incentive scheme in which investors in bank liabilities, such as subordinated debt or uninsured deposits demand higher yields on their investments if they see the banks taking high risks. Market discipline is needed because banks are prone to engage in moral hazard behaviour. They collect deposits and invest them in risky assets. To safeguard against insolvency, they hold capital buffers against defaults without taking the interest of the depositors or the society as a whole into account. Market discipline is a mechanism that can potentially curb banks' incentive to take excessive risk, by making it more costly to them.

To the extent that Basel 2 Accord shifts some of the burden of bank oversight from supervisors to markets, it is important to ascertain whether market discipline can be effective, and under what condition it might not be.

Blum (2002) and Cordella and Yeyati (1998) show that in the absence of bankruptcy, costs and corporate governance problems between bank shareholders and manager, if bank deposits are uninsured and the bank's risk choice is observable by depositors, the bank's risk choice will be efficient. The reason is that banks internalize the impact of their risk choice on depositors since these in turn will demand higher compensation if the bank incurs higher risk. In an atmosphere of this nature, there would be perfect market discipline and no moral hazard.

On the other hand however, if deposits are insured or the bank's choice is not observable by depositors, the bank will most likely choose a higher risk profile at their peril. The reason is that depositors will not demand a higher return in response to higher risk choices by the bank. There will be no market discipline in such a situation and the bank's choice of its risk of default is subject to moral hazard.

This framework suggests that the effectiveness of market discipline in curbing banks from excess risk-taking is dependent upon: -

(1) The extent of government safety net;

(2) The degree to which the bank if financed by uninsured liabilities; and

(3) The extent of observability of bank risk choices. Market discipline is likely

to be more effective, the lower the degree of explicit or implicit government guarantees relating to bank liabilities, the higher the amount of insured liabilities in the bank's balance sheet and the greater the degree of bank disclosure.

Depositor protection is likely to weaken market discipline. Demirgik-Kunt and Sobaci (2000) provide evidence that explicit deposit insurance like the Nigerian Deposit Insurance Corporation (NDIC) tends to increase the likelihood of banking crises in a sample of 61 countries over the years 1980 – 97.

In the absence of an explicit deposit insurance scheme, there may be an expectation that the government will reimburse depositors in the event of a bank failure. The uncertainty surrounding this probable and ad hoc reimbursement could however make depositors to be more wary of where they put their funds. Martinez Perid and Schruckler (2001) show that for the cases Argentina, Chile and Mexico Depositors responded to bank's risk choices even though deposit insurance schemes exist in these countries. This suggests that even explicit depositor protection schemes may not always be credible to investors and they may choose to be on guard themselves.

Of there is a ceiling on the size of deposits that are covered by the insurance scheme e.g. the N100, 000.00 of NDIC, market discipline could be demanded by depositors of larger amount. Should coverage be unlimited however, market discipline could tend to be weak. De Hicolo (2000) analyses the impact of deposit insurance coverage relative to per capita GDP on insolvency risk as captured by a measure of the distance to default. He finds that this variable is negatively related to insolvency risk for the largest banks in his sample but insignificant overall.

The Fitch IBCA rating agency assigns ratings that reflect the probability of government bail out. The rating is known as the Fitch IBCA Public Support rating. It ranges from 1 (near certain bail-out) to 5 (bail-out very unlikely). Group, Vesala and Vulpes (2001) show that subordinated debt yields reflect bank risk for banks with a public support rating of 3 and higher, but do not reflect bank risk for banks whose public support rating is 1 or 2. Their study suggests that market discipline is largely absent if markets believe that a bailout is very likely. Ellis and Flannery (1992) find that Certificate of Deposit (CD) rates paid by large money center banks include significant default premia. The reason is that CDs are not covered by deposit insurance schemes. In addition, banks are informed investors in the interbank market. A lending bank is likely to be subject to the same kind of shocks to risk and profitability as the borrowing bank.

As a result, certificates of deposits are sensitive to the risk the borrowing bank is taking. Some schools of thought are advocating the use of subordinated debts like Certificates of Deposits (CDs) as a tool to subject banks to strongest market discipline (Evanoff & Wall 2000) Cordella and Yeyati (1998) as well as Boot and Schmeits (2000) point to the commitment effect of bank disclosure. Banks that disclose more information choose lower default risk in equilibrium. The idea is that a bank that discloses its risk profile exposes itself to market discipline and will therefore get penalized by investors for choosing higher risk. This effect is absent

if investors do not know the risk profile of the bank and weaker if the amount of information available to investors is limited.

Kliger and Sarig (2000) believe that investors have more information about a bank if the bank is rated by a major rating agency. This is because rating agencies act as intermediaries in the disclosure process. They gain access to information that is not publicly available to investors and feed this information into the rating. This, according to them is why in 98% of cases, firms' solicited for ratings and pay for such rating. It allows firms to incorporate inside information into the assigned ratings without disclosing specific details to the public at large. Their study suggests that investors have more information on an individual bank if it is rated and that market discipline is likely to be stronger for rated banks. Enhancing market discipline through more disclosures and/or uninsured liabilities appears beneficial in that both mechanisms seem to provide incentives for firms to maintain adequacy solvency standards.

The implication of these for the Nigerian banking industry is that under the present structure disclosures hardly go beyond the statutory requirements of a bank's financial statement. Any other disclosure could easily be misunderstood by the public or be misinterpreted by competing banks to the industry's disadvantage.

The bank-customer fiduciary relationship would need to be re-examined and restructured to provide for the disclosures. The depositing and investing public will also need to be sensitized as to the relevance and importance in the new framework.

The Nigerian Accounting Standards Board will also need to be dragged in as a stakeholder.

INSTITUTIONAL CHALLENGES - PILLAR 3

As mentioned above disclosure by banks in Nigeria are presently limited to the statutory requirements. Even Item 811 of the Pillar 3 acknowledges that the number of existing mechanisms by which supervisors may enforce vary from country to country and range from moral suasion through dialogue with the banks management (to influence a change in behaviour) to reprimand or financial penalties. The CBN/NDIC would need legal backing in form of enabling laws to demand this requirement from banks.

The Nigerian Business Times of May 1-7, 2006 reported that FitchIBCA noted in its latest report on Nigeria after the maiden rating in January 2006 that the Nigerian banking industry still suffers from serious challenges. The challenges were listed as being in form of (1) poor asset quality (2) poor corporate governance, (3) general lack of transparency, and (4) low depositor confidence.

WEAK ASSET QUALITY

Banks in Nigeria prefer to lend as overdraft with the borrower drawing out the full amount within a short period leaving the account in the red. All that would then be required of him/her would be depositing of funds in this same overdrawn account and withdrawing then at will with the bank charging a commission (COT) on such withdrawals. This overdraft limit gets renewed almost automatically upon expiration unless the customer specifically requested for its cancellation, which is extremely rare. Interest on the facility gets capitalized/refinanced unless the customer pays in to bring back the account to agreed limits. Meanwhile the customer granted overdraft facility has the prerogative of drawing his limit to the full and using the funds to open an account in another bank that he could be operating on a creditor basis. Occasionally he would be coming back to credit his overdrawn account in the lending bank with the Cheques drawn on his creditor account elsewhere or even cash to keep the overdrawn account current.

Eventually he would abandon the account (and this happens very frequently) upon the failure of his business or his own demise, leaving the lending bank with a non-performing credit. If there were collateral any attempt to foreclose would usually attract a court injunction the case of which could drag on for years. In the end the lending bank writes off a significant portion if not all of this debt. In Nigerian banks, overdraft facility is not expected to ever be fully repaid, as this would reduce the interest being earned and thus the banks profit. Had a customer's facility been a loan the amount would have promptly been credited to his account upon approval and satisfaction of requirements prior to draw down. A separate loan account would have been debited and the installmental payment could have been debited monthly to his personal account or a designated account where credit balances would always be available (that would have been one of the conditions of the approval) to absorb them. Every installmental payment would be reducing the bank's exposure permanently while the collateral would continue to be in excess of the exposure starting with the first reduction. Interest would have continued to be earned and the customer would have continued to be maintaining even all his creditor accounts in the same bank since all he would need to repay at the end of the

month would be the due principal and interest repayment or his loan. He would have no need of opening any other account secretly somewhere else as the concentration of his financial dealings in a single bank could only further endear him to the lucky bank. As for the bank, every reduction in the loan account is new loanable funds with interest on the reducing balance legitimately earned. Everyone would have been better off as even the customer would have been happy seeing his debt reducing and paving the way for a new one upon full repayment. One unpaid installment would be enough to put the bank on alert of a possible problem with the customer and a second one missed would definitely call for a hot chase while the situation was still fresh or just beginning.

Wilson (1998) noted that banks in the United States have been lending via term loans since the 1930s when such form of lending was introduced. He said banks in the U.K. experimented with term loan lending in the early 60s and had to revert to it in 1971 after the introduction of Competition and Credit Control Act. Prior to that time British banks were lending via overdraft and this technique is apparently what was handed over to their Nigerian successors in the first generation banks especially. Big companies of the past have failed and many of their overdraft facilities had to be written off at the expense of the shareholders.

Ogunleye (2005) disclosed that the magnitude of Non-performing loans in the banking industry has been of concern to the Regulators. According to him even though the proportion of this category of loans to the Total Assets of the industry was recording a downward trend after peaking at 45.5% in 1992, its sheer size of ₦199.62 billion in 1992 (21.27%) and ₦260.19 billion (21.59%) in 2003 was disturbing.

> He quoted bad loans and advances for this but this author would rather say they were caused by overdrafts that eventually became perpetual debts, which the borrowers had to abandon. The volume of such debts can confidently be put at 95% of all the bad debts in the country's financial system categorized under Prudential Guidelines.

One thing about a bank's Balance Sheet is that unlike other Commercial enterprises, a bulk of the liabilities is funds deposited by its customers, taxes payable to governments and dividends payable to shareholders. The Assets (apart from Fixed) on the other hand are these same deposits lent out to its borrowing customers at a rate set by the bank and / or the regulatory authorities. The Reserves and called-up share capital further helps to finance these Assets and with Reserves being the result of operations that were made possible with depositors' funds, the only funds generated by the shareholders is the called-up share capital. The

called-up share capital is by itself a very tiny negligible fraction of a bank's available fund to finance its Assets. As for the Asset as mentioned above, a bulk of them are funds lent to the public under various nomenclatures, and the fixed Assets of the bank the acquisition of which resulted from intermediation functions with depositors' funds.

For the year ended 31st March 2005 the Total Asset of First Bank of Nigeria Plc was N377.496 billion out of which N12, 108 billion or 3.2% was Fixed Assets. Ranking highest in the Assets list are Loans and Advances at N114.673 billion or 30% followed by Bills Discounted at N100.135 billion or 26.5%. Cash and short-term funds stood at N94.363 billion or 8%. Investments account for N24.655 billion or 7%. Used to finance these were Deposits and current accounts at N265.378 billion or 70%; other Liabilities at N61.482 billion or 16%; current and Deferred Taxation at N5.964 or 2%; share capital @ N1.976billion or 0.52%. All the Reserves stood at N42.696 or 11.3% available to finance the Assets.

For Union Bank of Nig. Plc during the same period Total Assets stood at N398.271 billion with Fixed Assets at N14.482 billion or 45. Cash and short Term funds ranked highest at N217.657 billion or 55%. Loans and Advances followed at N78.684 billion or 20% while Bills Discounted was next at N47.320 billion or 12%. Other Assets followed at N22.632 billion or 6% while other investments at N9.926 billion or 3% accounted for the balance.

Available to finance these were Deposits, current and other accounts at N200.511 billion or 50%; Taxation, Deferred Tax and Dividend T N146.267 billion or 37%; called-up share capital at N2.237 billion or 0.56 and N36.892 billion Reserves or 9%.

As could be seen above the called-up share capitals of the two largest banks in Nigeria accounted for less than one per cent of the funds required in financing their Assets. Depositors' funds bear the brunt and this is why they are usually hit the hardest in the event of a bank failure. Many original shareholders would have recouped their investments many times over through dividends and scrip issues and as such would have very little to lose in the event of a collapse at least not in the short run. Not so for the depositors whose hard earned savings become trapped in the collapsed bank and may not be able to make ends meet starting from the first day of the news of the collapse. Many businesses would collapse too and many individuals would face ruins, never to be able to make it in their lives again. This is being evidenced by the protracted legal battle going on between banks closed under the on-going consolidation exercise, and the Central Bank of Nigeria.

POOR CORPORATE GOVERNANCE

The CBN (2006) has just published a code on the above mentioned with effect from April 3rd, 2006. In it fifteen weaknesses of banks in Nigeria were identified as follows:

(1) Disagreement between Board and Management giving rise to Board squabbles.

(2) Ineffective Board oversight functions.

(3) Fraudulent and self-serving practices among members of the Board, management and staff.

(4) Overbearing of the Chairman or MD / CEO, especially in family-controlled banks.

(5) Weak internal controls.

(6) Non-compliance with laid-down rules in internal control and operational procedures.

(7) Ignorance of and non-compliance with rules, laws, and regulation guiding banking business.

(8) Passive shareholders.

(9) Poor risk management practices resulting in large quantum of non-performing credits including insider-related credits.

(10) Abuses in lending, including lending in excess of single obligor limit.

(11) Sit-tight directors.

(12) Succumbing to pressure from other stakeholders e.g. shareholders who want higher dividends or depositors who want higher interest rates on their deposits.

(13) Technical incompetence, poor leadership and administrative ability.

(14) Inability to plan and respond to changing business circumstances.

(15) Ineffective management information system.

These are structural challenges of the highest magnitude and must be overcome before the Basel 2 Accord implementation can be expected to yield a desirable result.

The Code contains rules that banks corporate, and their Directors must obey as Best practices in corporate governance. The snag is the person charged with the responsibility of ensuring enforcement i.e. bank's Chief Compliance Officer. Article 6.1.11 specifically charge the CCO with monitoring the implementation of the corporate governance code. The person would definitely be a staff of the bank and the question would be whether he/ she could in all honesty perform such duty without jeopardizing his/her own employment since the proverbial person that pays the piper should call the tune.

As for general lack of transparency, the author believes that the banks represent a microcosm of the society. If there is transparency in the society the bank cannot afford to be opaque. The same goes for low depositor confidence. Most Nigerians have no confidence in anything Nigerian including the banks because there is no transparency in most of the things being done in the society and as such the beat goes on.

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CHAPTER THREE

RESEARCH METHODOLOGY

3.1 RESEARCH APPROACH AND ITS JUSTIFICATION

The grounded theory approach (Glasser and Strauss, 1967) was adopted as the research methodology. The school of thought in favour of this approach opines that the knowledge sought in any research is grounded in the data the researcher is able to collect, and as such, the finding of the research emerged from the analysis of the results achieved. The ground theory approach encourages the use of research questions and statement of hypotheses.

The method used in this research was descriptive and qualitative study approach that involved an intensive use of literature review and by collecting primary data. Further data and materials were extracted from technical reviews, official government documents, banks official files, CBN reports, NDIC reports, textbooks, journals, materials sort from internet, seminars papers and Newspaper articles. The data collected were grouped and analyzed where necessary and appropriately

3.2 RESEARCH DESIGN AND INSTRUMENT USED

The study utilized both the qualitative and quantitative data from both primary and secondary sources. The qualitative approach allows the researcher to seek information or opinion from the subjects without influencing their choice of response on the issues raised in the study. The design involved the use of questionnaire in collecting the required information. The qualitative approach involved the sourcing of relevant data from publications such as government briefs, News letters, Journal materials, Economic and Developmental Reviews as well as various published and unpublished papers on the subject.

A Structured questionnaire was used as the instrument for the study. This was used to gather information from the research subjects. The questionnaire was divided into four sections. The section A consists of items on issues of regulatory capital requirement (Pillar 1). The section B consists of items on issues of supervisory review (Pillar 2). The section C consists of items on issues of market discipline (Pillar 3). The section D contains additional structural and institutional factors influencing implementation of Basel 2 Accord.

3.2 AREA AND SCOPE OF STUDY

This study covered five major competitive banks in Nigeria. The choice of these banks was based on their pedigree and to seek a wider view on the issues raised in the study.

3.4 RESEARCH POPULATION AND SAMPLE SIZE

The population of the study includes all the bank workers in Nigeria. The population sample for the study was 284 subjects randomly drawn from the five banks.

3.5 SAMPLING PROCEDURE EMPLOYED

The sampling technique employed the stratified sampling technique in drawing the sample population. The sample population represented the entire population for the study because they possess the characteristics required for the research study.

3.6 PROCEDURE FOR DATA ANALYSIS

The primary data were results from opinion poll from respondents using the questionnaires designed to elicit responses from the respondents on the variables under study. Prior to the administration of the research instrument, the researcher personally visited the banks used for the study to solicit support in the area of administration of the questionnaire. The researcher personally administered some of the questionnaires through the heads of departments of the banks used for the study. However, the researcher also employed online administration of the questionnaire to some banks personnel believed could provide useful information regarding the issues raised in the study. The online administration was employed in order to reach out to those bank personnel who had earlier promised to provide the needed information on the sensitivity of the study that the researcher was unable to meet on face to face during the administration of the questionnaire because of administrative bureaucracy or bottle neck encountered. For those personnel whom the questionnaires were personally administered, the researcher made consistent visitation for the questionnaires to be completed and recovered. The researcher gave three weeks time frame for the completion of the research instrument. A total of 350 questionnaires were administered after which 284 were recovered. This represented 81.14 percent recovery rate.

The secondary data are classified data extracted from bank journals and reports and other relevant publications of CBN, NDIC and Government briefs.

3.7 STATISTICAL TECHNIQUE FOR DATA ANALYSIS

Information extracted from the administered questionnaires was presented in the form of frequency distribution tables, while the analyses and interpretation were carried out through the use of simple percentages. Furthermore, in order to provide empirical support for the research study all the hypotheses formulated was tested using the chi-square statistical method. The choice of this statistical tool was based on the statement of the hypotheses formulated. The chi-square computation is as depicted below:

$$\chi^2 = \sum (O_f - E_f)^2$$

E_f

Where; χ^2 = chi-square

O_f = observed frequency

E_f = expected frequency

Equally the degree of freedom was ascertained using the formula: (Row-1) (Column – 1), while the level of significance was 0.05 probability level.

Decision rule

For decision rule, when the chi-square calculated is less than the chi-square tabulated, the null hypothesis (Ho) was accepted and the alternate hypothesis (H_1) is rejected. On the other hand, when the chi-square calculated is greater than the chi-square tabulated, the null hypotheses (Ho), was rejected and the alternate hypothesis (H_1) accepted.

CHAPTER FOUR.

DATA PRESENTATION AND ANALYSIS

4.0 INTRODUCTION

This chapter highlights the data analysis. To analyse the data in relationship to the research questions all the responses on the items addressing the research questions were collated and presented in the contingency tables and bar charts, after which simple percentage and mean were used to analyse the data.

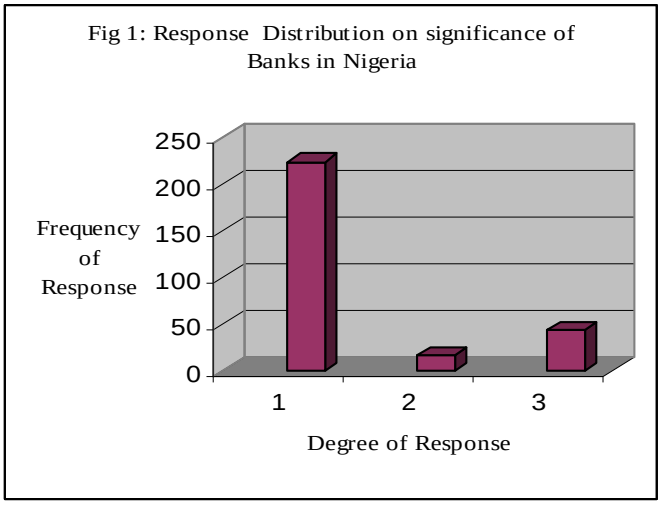
All the hypotheses postulated were tested at 0.05 levels of significance using the Chi-square test.

4.1 ANALYSIS OF QUESTIONS ON MINIMUM CAPITAL REQUIREMENT

TABLE 4.1.1: DISTRIBUTION OF RESPONSE ON SIGNIFICANCE OF BANKS IN NIGERIA

STATEMENT	YES	NO	I DON'T KNOW	TOTAL	MEAN
1. Would you consider your bank a significant* bank in Nigeria?	224 (78.87)	17 (5.99)	43 (15.14)	284 (100.00)	2.64
Weighted Response	672	34	43	749	

Source: Field report 2006 *Bank capable of upsetting the economies of their country should they be insolvent. **Key**: Upper figures represent Frequencies and figures in brackets represent Percentages



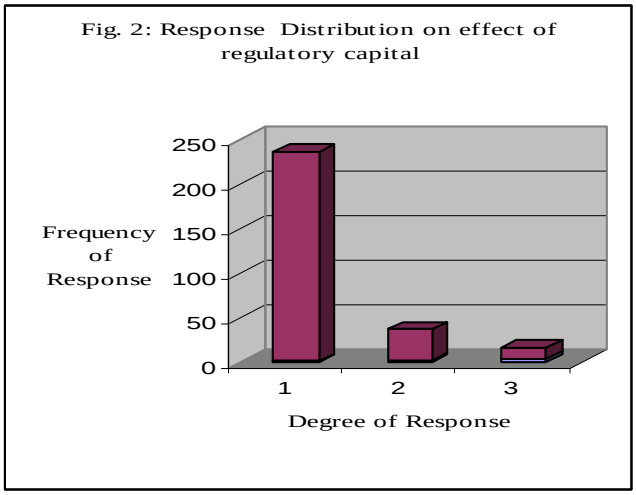
(Key 1=Yes, 2=No, 3=I don't know)

From the results depicted in the table 4.1.1 and Fig.1 on the issue of significance of banks in Nigeria, the calculated mean response value of 2.64 showed that the respondents agreed with the statement. From the overall response of 284 received, it was found that 224 (78.87%) respondents said yes, 17(5.99%) respondents reported no, while 43(15.14%) respondents reported that they don't know. Judging from the overall result, it could therefore be inferred that the banks used for the survey are big enough to upset the economies of Nigeria, should it become insolvent.

Table 4.1.2: Distribution of Response on effect of regulatory capital

STATEMENT	YES	NO	NO RESPONSE	TOTAL	MEAN
2. Do you agree that with the Basel 2 accord's idea that once regulatory capital is strong and kept strong consistently, it could act as a buffer to commercial banks during economic down turn?	236 (83.10)	35 (12.32)	13 (15.48)	284 (100.00)	2.79
Weighted Response	708	70	13	791	

Source: Field report 2006: **Key**: Upper figures represent Frequencies and figures in brackets represent Percentages



Key 1=Yes, 2=No,3=I don't know)

From the results in table 4.1.2 and Fig.2, it was observed that majority of the respondents i.e. 236(83.10%) agreed with the statement presented to them. This observation was further confirmed by the calculated mean response value of 2.79. However 35(12.32%) respondents did not agree with the statement while 13(15.48%) did not respond to this question.

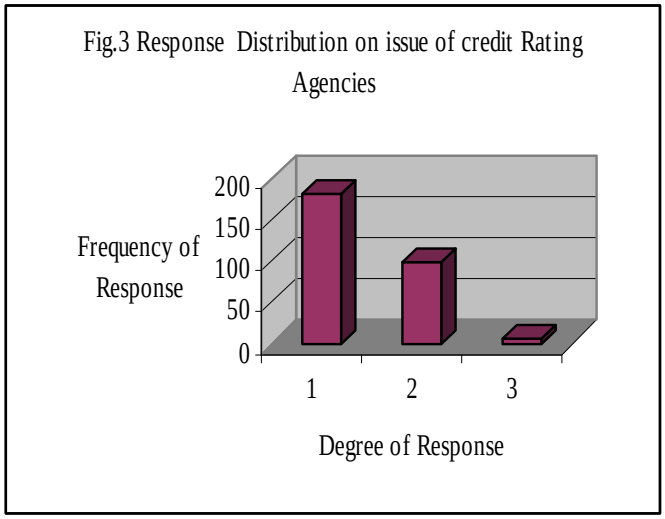
When some of the reasons for their choice of answer were assessed. Some of those who said yes posited that the goal for this idea is to promote adequate capitalisation and improve risk management. It will also check the problem accruable from bad management and political instability. Consequently it will aid in sustaining economic activities and developmental initiatives. The capital would also instil a level playing ground for the bank against unexpected operational risk associated with default in loan repayment or reduced activity by customers.

Table 4.1.3: Distribution of Response on issue of credit Rating Agencies

STATEMENT	YES	NO	NO RESPONSE	TOTAL	MEAN

3. Do you think that Nigeria has any credit rating agency like Standard and Poor's, Moody's investor Services, FitchIBCA etc,	182 (64.09)°	97 (34.15)	5 (1.76)	284 (100.00)	2.62
Weighted Response	546	194	5	745	

Source: Field report 2006 **Key**: Upper figures represent Frequencies and figures in brackets represent Percentages



(Key 1=Yes, 2=No,3=No Response)

The result shows in table 4.1.3 and Fig.3 show that more than half of the bank workers reported that Nigeria has credit rating agency that act as external rating agency saddled with the responsibility of rating of sovereigns and corporate. 182(64.09%) respondents affirmed positively to the statement while 97(34.15%) respondents said such does not exist in the country.

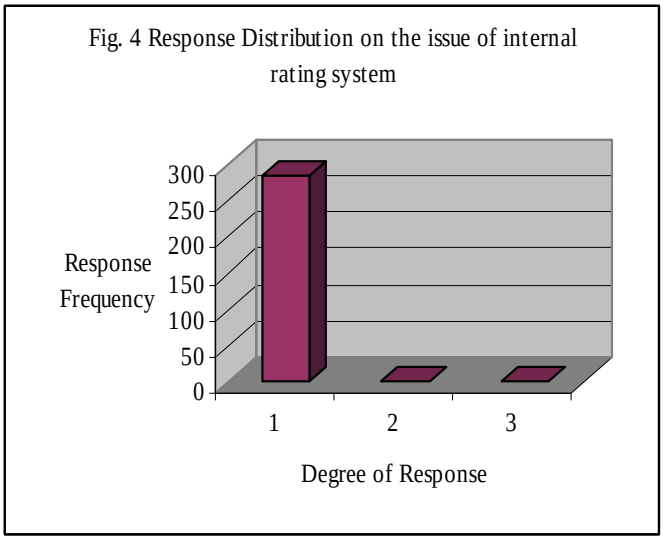
The overall mean response value of 2.62 confirmed the degree of agreement. The commonest agency in Nigeria is Augusto and company. It was also reported that Banks are a times rated by the Central bank supervisory team.

Table 4.1.4: Distribution of Response on the issue of internal rating system

STATEMENT	YES	NO	NO RESPONSE	TOTAL	MEAN

4. Are there internal rating systems for the customers?	284 (100.00)	0 (0.00)	0 (0.00)	284 (100.00)	3.00
Weighted Response	852	0	0	852	

Source: Field report 2006 **Key**: Upper figures represent Frequencies and figures in brackets represent Percentages



Key: 1=Yes, 2=No, 3=No Response)

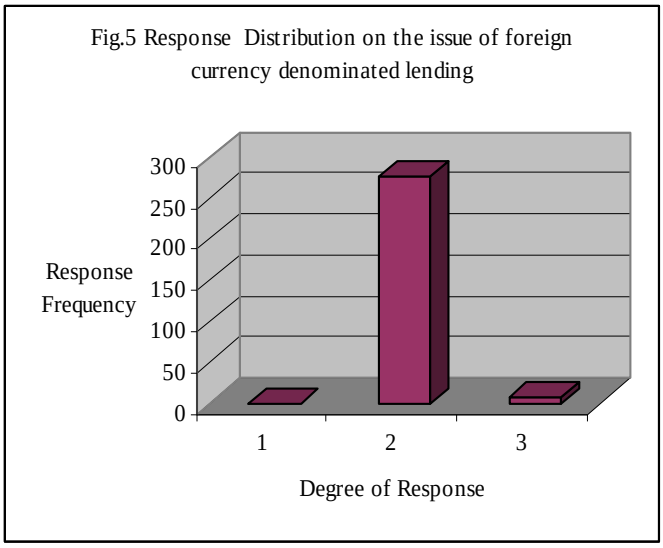
From the results in table 4.1.4 and fig.4 all the 284(100.0%) respondents reported that their bank have internal rating system for their customers.

Table 4.1.5: Distribution of Response on the issue of foreign currency denominated lending

STATEMENT	YES	NO	NO RESPONSE	TOTAL	MEAN
5. Are you aware of any of your Bank's foreign currency denominated lending to the government of a foreign country, its Central Bank, Corporate or banks in it or its public Sector Entities (PSE)?	0 (0.00)	276 (97.18)	8 (2.82)	284 (100.00)	1.97

Weighted Response	0	552	8	560	

Source: Field report 2006 **Key**: Upper figures represent Frequencies and figures in brackets represent Percentages



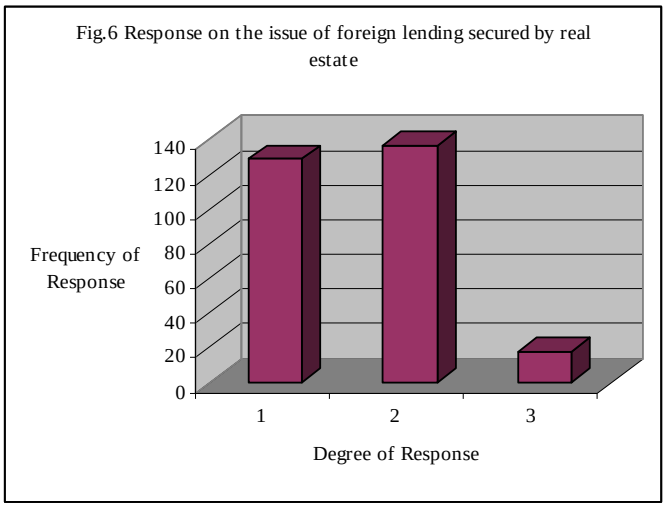
(Key 1=Yes, 2=No,3=No Response)

When the respondents were presented the Statement ' Are you aware of any of your Bank's foreign currency denominated lending to the government of a foreign country, its Central Bank, Corporate or banks in it or its public Sector Entities (PES)?' It was observed that almost all the respondents' i.e. 276(97.18%) respondents reported that they were not aware of such. When the mean response was computed it was observed that the mean response value of 1.97 confirmed the same result. However 8(2.82%) of the respondents did not respond to the statement (See Table 4.1.5 and fig.5).

Table 4.1.6: Distribution of Response on the issue of foreign lending secured by real estate

STATEMENT	YES	NO	NO RESPONSE	TOTAL	MEAN
6. Are you aware of any of your Bank's foreign currency lending secured by commercial or residential real estates outside the shores of Nigeria?	129 (45.42)	137 (48.24)	18 (6.34)	284 (100.00)	2.39
Weighted Response	387	274	18	679	

Source: Field report 2006 **Key**: Upper figures represent Frequencies and figures in brackets represent Percentages



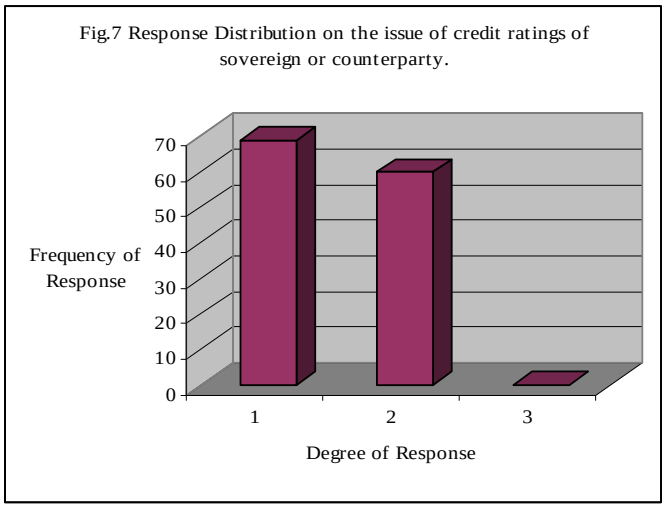
(Key 1=Yes, 2=No, 3=No Response)

From the results in table 4.1.6 and fig.6 on the issue of foreign lending secured by real estate, the calculated mean response value 2.39 showed that the respondents were not aware if their bank lent foreign currency secured by commercial or residential real estates outside the shores of Nigeria. Out of the 284 responses received 129(45.42%) respondents reported that they were aware that their bank lent foreign currency secured by commercial or residential real estates outside the shores of Nigeria, while 137(48.24%) respondents said that they were not aware of such. However 18(6.34%) respondents did not respond at all.

Table 4.1.7: Distribution of Response on the issue of credit ratings of sovereign or counterparty.

STATEMENT	YES	NO	NO RESPONSE	TOTAL	MEAN
7. *Are you aware of the credit ratings of the sovereign or counterparty offshore prior to the approval of the facility?	69 (53.49%)	60 (46.51)	0 (0.00)	129 (100.00)	2.54
Weighted Response	207	120	0	327	

Source: Field report 2006 **Key**: Upper figures represent Frequencies and figures in brackets represent Percentages. If answer to Q 5or 6 is yes *.



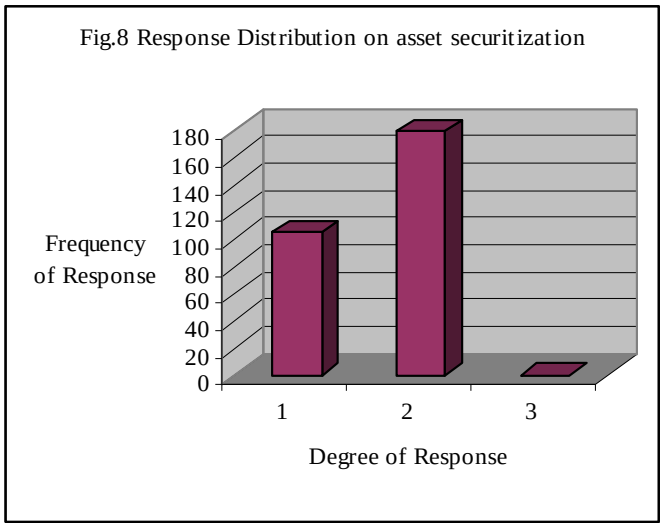
(Key 1=Yes, 2=No, 3=No Response)

From the results in table 4.1.7 and fig.7 when the respondents were presented the statement, 'Are you aware of the credit ratings of the sovereign or counterparty offshore prior to the approval of the facility?' The computed mean response value of 2.54 sort of confirmed that the respondents are aware. This was supported by 69(53.49%) respondents who said yes, while 60(46.51%) respondents said no. This therefore implies that few of the bank workers are conversant about some of the guidelines of the Basel one framework.

Table 4.1.8: Distribution of Response on asset securitization

STATEMENT	a*	b*	NONE OF THE ABOVE	TOTAL	MEAN
7. What is Asset Securitization?	105 (36.97)	179 (63.03)	0 (0.00)	284 (100.00)	2.37
Weighted Response	315	358	0	673	

Source: Field report 2006 **Key**: Upper figures represent Frequencies and figures in brackets represent Percentages. Security for a facility (a*) A bank's group of identical assets and funds flow sold as security to a third party (b*)



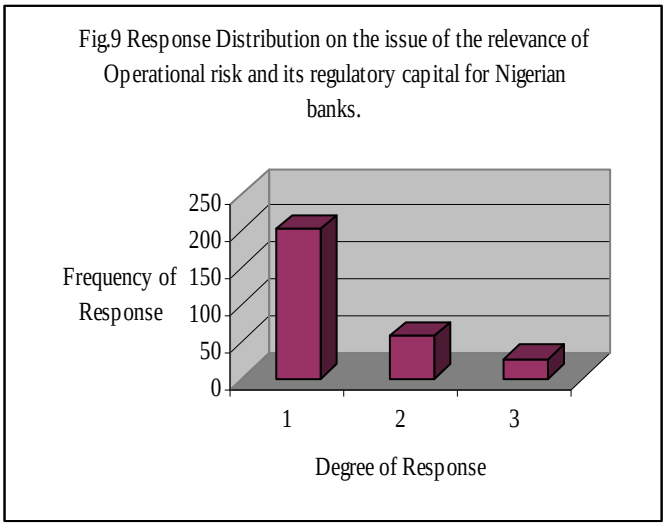
(Key 1=a*, 2=b*, 3=No of the above)

From the results in table 4.1.8 and fig.8 when the respondents were asked "what is asset securitization? It was found that they had divergent views on this term of which a greater number i.e. 179(63.03%) respondents defined it as a bank's group of identical assets and funds flow sold as security to a third party, while 105(36.97%) respondents defined it as security for a facility.

Table 4.1.9: Distribution of Response on the issue of the relevance of Operational risk and its regulatory capital for Nigerian banks.

STATEMENT	YES	NO	I DON'T KNOW	TOTAL	MEAN
9. Do you consider the minimum regulatory capital of 8% set aside for operational risk as relevant to the Nigerian banking industry?	202 (71.13)	57 20.07	25 (8.80)	284 (100.00)	2.62
Weighted Response	606	114	25	745	

Source: Field report 2006. **Key**: Upper figures represent Frequencies and figures in brackets represent Percentages



(Key 1=Yes, 2=No, 3=I Don't know)

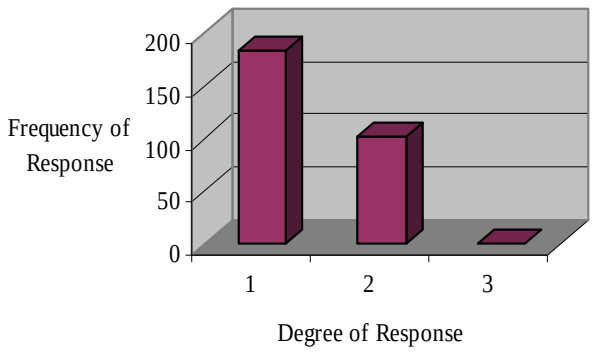
From the results in tables 4.1.9 and fig.9 it was reported that a greater number 202(71.13%) of the respondents reported that they always consider the minimum regulatory capital of 8% set aside for Operational risk as relevant to the Nigerian banking industry. However 57(20.07%) respondents were of the view that this is not relevant while 25 (8.80%) respondents reported that they don't know. When the mean response value was computed, a value of 2.62 confirmed a degree of high agreement with the statement.

Table 4.1.10: Distribution of Response on the issue of keeping permanent record in the branch or Department.

STATEMENT	YES	NO	I DON'T KNOW	TOTAL	MEAN
10. Do you keep permanent record in your branch or department of periods and duration of host failures?	184 (64.79%)	102 (35.91)	0 (0.00)	284 (100.00)	2.66
Weighted Response	552	204	0	745	

Source: Field report 2006 **Key**: Upper figures represent Frequencies and figures in brackets represent Percentages

Fig.10 Response Distribution on the issue of keeping permanent record in the branch or Department.



(Key 1=Yes, 2=No, 3=I Don't know)

From the results in table 4.1.10 and fig.10 when the respondents were asked "if they keep permanent record in their branch or department off periods and duration of host failures"

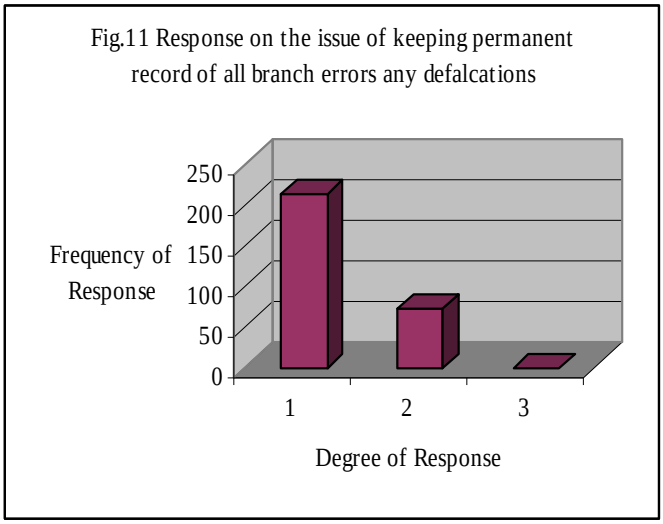
It was recorded that majority of the respondents positively responded to the statement that they do. This was supported by the calculated mean respond value of 2.66 and a total of 184(64.79%) respondents who confirmed that they do keep such records.

However 102(35.91%) respondents said they do not keep permanent record in there branch or department off periods and duration of host failures.

Table 4.1.11: Distribution of Response on the issue of keeping permanent record of all branch errors any defalcations

STATEMENT	YES	NO	I DON'T KNOW	TOTAL	MEAN
11. Do you keep permanent record of all branch errors and defalcations as to the date and amount involved?	213 (75.0)	71 (25.0)	0 (0.00)	284 (100.00)	2.75
Weighted Response	639	142	0	781	

Source: Field report 2006 **Key**: Upper figures represent Frequencies and figures in brackets represent Percentages



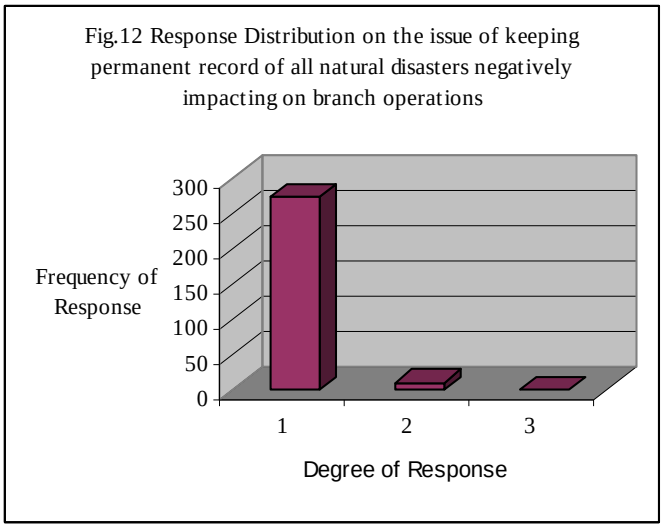
(Key 1=Yes, 2=No, 3=I Don't know)

When the respondents were presented the statement 'Do you keep permanent record of all branch errors and defalcations as to the date and amount involved?' The results showed that a greater number 213(75.0%) said yes they do (See table 4.1.11 and Fig. 11). However 71(25.0) respondents said no to the statement. The calculated mean response value of 2.75 confirmed the degree of agreement with the question. This therefore shows that they keep permanent record of all branch errors and defalcations as to the date and amount involved

Table 4.1.12: Response Distribution on the issue of keeping permanent record of all natural disasters negatively impacting on branch operations

STATEMENT	YES	NO	I DON'T KNOW	TOTAL	MEAN
12. Do you keep permanent record of all natural disaster that impacted negatively on branch or departmental operations	273 (96.13)	11 (3.87)	0 (0.00)	284 (100.00)	2.96
Weighted Response	819	22	0	841	

Source: Field report 2006. **Key**: Upper figures represent Frequencies and figures in brackets represent Percentages



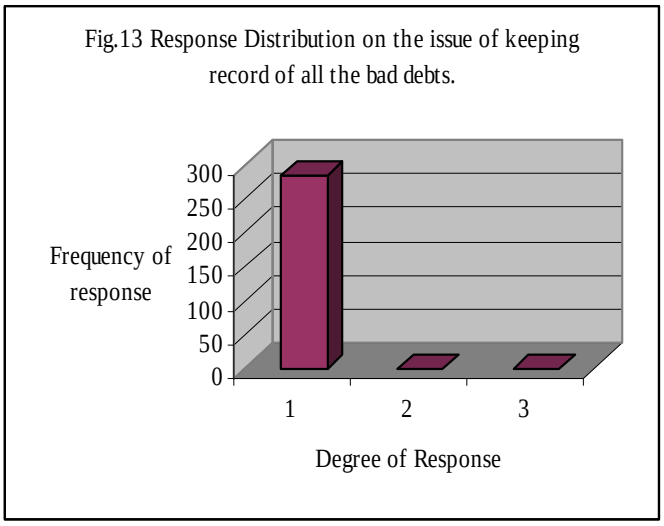
(Key 1=Yes, 2=No, 3=I don't know)

From the results in table 4.1.12 and Fig.12, it was observed that 273(96.10%) respondents reported that they keep permanent record of all natural disaster that impacted negatively on branch or departmental operations while 11(3.86%) said they do not keep permanent record of all natural disaster that impacted negatively on branch or departmental operations. The calculated mean response value of 2.96 also confirmed the degree of agreement that they do in deed keep such records. This therefore infers that most banks in Nigeria keep permanent record of all natural disaster that impacted negatively on branch or departmental operations.

Table 4.1.13: Response Distribution on the issue of keeping record of all the bad debts.

STATEMENT	YES	NO	I DON'T KNOW	TOTAL	MEAN
13. Do you keep permanent record of all the bad debts created by accounts domiciled in your branch within the past three years at least?	284 (100.0)	0 (0.00)	0 (0.00)	284 (100.00)	3.00
Weighted Response	852	0	0	852	

Source: Field report 2006. **Key**: Upper figures represent Frequencies and figures in brackets represent Percentages



(Key 1=Yes, 2=No, 3=I Don't know)

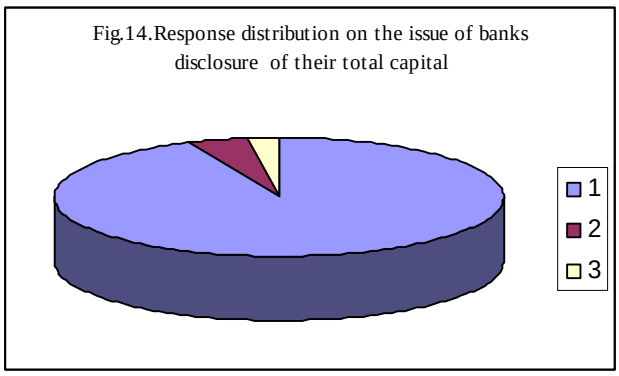
When the respondents were presented the above statement, all the respondents said they keep permanent record of all the bad debts created by accounts domiciled in your branch within the past three years at least. The computed mean response value of 3.0 and the 284(100.0%) responses received confirmed this observation. (See table 4.1.13 and Fig.13).

4.2 ANALYSIS OF QUESTIONS ON MARKET DISCIPLINE

Table 4.2.1: Response Distribution on the issue of banks disclosure of their total capital

STATEMENT	YES	NO	I DON'T KNOW	TOTAL	MEAN
1. Should banks disclose their Tier 1 and the capital adequacy ratios, and their components to the public on a quarterly basis?	265 (93.31)	13 (4.58)	6 (2.11)	284 (100.00)	2.91
Weighted Response	795	26	6	827	

Source: Field report 2006. **Key**: Upper figures represent Frequencies and figures in brackets represent Percentages



(Key 1=Yes, 2=No, 3=I don't know)

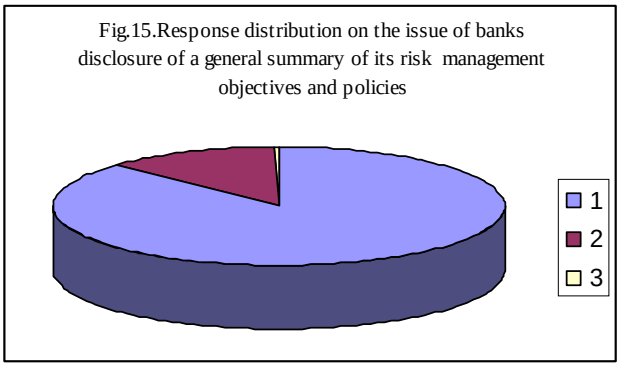
From the results in table 4.2.1 and fig.14, it was observed that majority of the respondents i.e. 265(93.31%) respondents are of the view that banks should disclose their Tier 1 and the capital adequacy ratios, and their components to the public on a quarterly basis. However 13(4.58%) reported that it should not while 6(2.11%) respondents said they don't know whether it is advisable. The computed mean response value of 2.91 also confirmed that the majority of the respondents supported the disclosure.

Table 4.2.2. Response Distribution on the issue of banks disclosure of a general summary of its risk management objectives and policies

STATEMENT	YES	NO	I DON'T	TOTAL	MEAN

			KNOW		
1. Should a bank provide a general summary of its risk management objectives and policies, reporting systems and definition to the public on an annual basis?	248 (87.33)	35 (12.32)	1 (0.35)	284 (100.00)	2.87
Weighted Response	744	70	1	815	

Source: Field report 2006. **Key**: Upper figures represent Frequencies and figures in brackets represent Percentages



(Key 1=Yes, 2=No, 3=I don't know)

When the response of the respondents on issue of disclosure of its risk management objectives and policies it was observed that 248(87.33%) respondents posited that banks should provide a general summary of its risk management objectives and policies, reporting systems and definition to the public on an annual basis. This was supported by the calculated mean response value of 2.87. However 35(12.32%) respondents reported that it should not while only 1(0.35%) respondent said I don't know.

Table 4.2.3. Response Distribution on the issue of banks disclosure of its other risk management objectives and policies

STATEMENT	YES	NO	I DON'T KNOW	TOTAL	MEAN

3. Should the following be disclosed: i. Summary information on the terms and conditions of the main features of all capital instruments.	123 (43.91)	156 (54.93)	5 (1.76)	284 (100.00)	2.42
Weighted Response	369	312	5	686	
ii. The amount of Tier 1 capital with separate disclosure of the component.	114 (40.14)	170 (59.86)	0 (0.00)	184 (100.00)	2.40
Weighted Response	342	340	0	682	
iii. The total amount of Tier 2 and Tier 3 capital.	137 (48.24)	96 (33.80)	51 (17.96)	284 (100.00)	2.30
Weighted Response	411	192	51	654	
iv. Deductions from Tier 1 and Tier2 capital.	145 (51.06)	78 (27.46)	61 (21.48)	284 (100.00)	2.29
Weighted Response	435	156	61	652	
v. Total eligible capital.	129 (45.42)	60 (21.13)	97 (34.15)	284 (100.00)	2.13
Weighted Response	387	120	97	604	
vi. A summary discussion of the bank's approach to assessing the adequacy of its capital to support current and future activities.	203 (71.48)	81 (28.52)	0 (0.00)	284 (100.00)	2.72
Weighted Response	609	162	0	771	
vii. Capital requirements for credit risk.	197 (69.37)	51 (17.96)	36 (12.67)	284 (100.00)	2.57
Weighted Response	591	102	36	729	

viii. Capital requirements for market risk.	185 (65.14)	67 (23.59)	32 (11.27)	284 (100.00)	2.54
Weighted Response	555	134	32	721	
ix. Capital requirements for operational risk.	173 (60.92)	82 (28.87)	29 (10.21)	284 (100.00)	2.51
Weighted Response	519	164	29	712	
x. Total and Tier 1 capital ratio.	203 (71.48)	63 (22.18)	18 (6.34)	284 (100.00)	2.65
Weighted Response	609	126	18	753	

Source: Field report 2006. **Key**: Upper figures represent Frequencies and figures in brackets represent Percentages

From the results in table 4.2.3 it was observed that a greater number of the respondents i.e. 156(54.93%) respondents said that banks should not disclose summary information on the terms and conditions of the main features of all capital instruments. This was confirmed by the computed mean value of 2.42. However 123(43.91%) respondents reported that they should disclose such while 5(1.76%) respondents were neutral to the statement.

In another result, it was observed that 170(59.86%) respondents were of the view that banks should not disclose the amount of Tier 1 capital with separate disclosure of the component while 114(40.14%) respondents said they should. The calculated mean response value of 2.40 confirmed the degree of disagreement. Further observation showed that majority of the respondents' i.e 137(48.24%) posit that banks should always disclose the total amount of Tier 2 and Tier 3 capital while 96(33.8%) respondents said that it should not be disclosed and 51(17.96%) respondents were neutral in their response.

When the respondents were presented the statement should the banks disclose their deductions from Tier 1 and Tier2 capital? 145(51.06%) respondents reported that they should while 78(27.48%) respondents reported that they should not disclose such. However the mean response of 2.29 was found to compliment the observation made by those who said that it should not. Judging from this observation it means that banks should not disclose their deductions from Tier 1 and Tier2 capital.

In another response it was also discovered that the respondents reported that banks should not disclose their total eligible capital. The computed mean response value of 2.13 supported this observation. When the respondents were presented the statement 'should banks disclose the summary discussion of the bank's approach to assessing the adequacy of its capital to support current and future activities? A greater number of the respondents i.e. 203(71.48%) respondents were of the view that it should be disclosed while 81(28.52%) respondents said it should not be disclosed. The calculated mean response value of 2.72 confirmed the degree of agreement with the statement.

On the issue of capital requirements for credit risk majority of the respondents' i.e. 197(69.37%) respondents said it should be disclosed while 51(17.96) respondents said it should not. Similar result was received when the issue of disclosure of capital requirements for market risk was presented to the respondents. The calculated mean response value of gave credence to this observation.

In assessing whether capital requirements for operational risk should be disclosed it was recorded that 173(60.92%) respondents were of the view that it should be disclosed while 82(28.87%) respondents said it should not be disclosed. However only 29 respondents representing 10.21% of the respondents were neutral in their response.

Finally when the statement 'should the Total and Tier 1 capital ratio be disclosed' majority of the respondents posited that it should be disclosed while 63(22.18%) respondents were of the view that it should not be disclosed. Judging from the computed mean value of 2.65, this confirmed that there is need to disclose the Total and Tier 1 capital ratio.

Table 4.2.4. Response Distribution on the issue of banks description and disclosure of its other risk management objectives and policies

STATEMENT	YES	NO	I DON'T KNOW	TOTAL	MEAN

4) With regards to Basel 2 accord which requires banks to involve strategies and processes and other policies for mitigating risk. Do you agree that these should be disclosed?	198 (69.72)	49 (17.25)	37 (13.03)	284 (100.00)	2.57
Weighted Response	594	98	37	729	
Should the following be disclosed to the public in trying to avert risks...? i) Definition of past due and impaired loans for accounting purposes.	181 (63.73)	63 (22.18)	40 (14.09)	284 (100.00)	2.50
Weighted Response	543	126	40	709	
ii) Description of approaches followed for specific and general allowances and statistical methods.	175 (61.62)	86 (30.28)	23 (8.10)	284 (100.00)	2.54
Weighted Response	525	172	23	720	
iii) Discussion of the bank's credit risk management policy.	155 (54.58)	124 (43.66)	5 (1.76)	284 (100.00)	2.53
Weighted Response	465	248	5	718	
iv) Total gross credit risk exposures broken down in significant areas by major types of credit exposure.	161 (65.69)	107 (37.68)	16 (5.63)	284 (100.00)	2.51
Weighted Response	483	214	16	713	

v) Geographical distribution of exposures, broken down in significant areas by major types of credit exposures.	188 (66.20)	79 (27.82)	17 (5.98)	284 (100.00)	2.60
Weighted Response	564	158	17	739	
vi) Industry or counterparty type distribution of exposures, broken down by major types of credit exposure.	206 (72.54)	53 (18.66)	25 (8.80)	284 (100.00)	2.64
Weighted Response	618	106	25	749	
vii) Residual contractual majority breakdown of the whole portfolio broken down by major types of credit exposure.	192 (67.61)	68 (23.94)	24 (8.45)	284 (100.00)	2.59
Weighted Response	576	136	24	736	
5) Should the following be disclosed? Counterparty type on amount of past due / impaired loans specific and general allowance	213 (75.00)	63 (22.18)	8 (2.82)	284 (100.00)	2.72
Weighted Response	639	126	8	773	
i) Reconciliation of changes in the allowances for loan impairments.	191 (75.00)	76 (22.18)	17 (2.82)	284 (100.00)	2.61
Weighted Response	573	152	17	742	

Source: Field report 2006. **Key**: Upper figures represent Frequencies and figures in brackets represent Percentages

From the results depicted in table 4.2.4, when the respondents were presented the statement 'should the banks disclose their strategies and processes and other policies for mitigating risk to the public. The highest response was received from 198(69.72%) respondents who said yes this was followed by 40(17.25%)

respondents who said they should not disclose such while 37(13.03%) respondents were neutral in their response. The computed mean response of 2.57 also confirmed that there is need to disclose such to the public.

In analysing other items such as definition of past due and impaired loans for accounting purposes, description of approaches followed for specific and general allowances and statistical methods and discussion of the bank's credit risk management policy be disclosed to the public. The responses received showed that majority of the respondents were of the view that all the aforementioned items should be disclosed to the public.

In another result received it was observed that 155 (54.58%) respondents were of the view that the total gross credit risk exposures broken down in significant areas by major types of credit exposure should be disclosed. This was followed by 124(43.66%) respondents who said that it should not be disclosed, while only 5(1.76%) respondents were neutral in their response. when the calculated mean response was assessed it was found that the mean response value of 2.51 confirmed that it should be disclosed to the public.

When the respondents were presented the statement whether 'the geographical distribution of exposures, broken down in significant areas by major types of credit exposures' be disclosed to the public. It was found that the highest response was received among 188(66.20%) respondents who said that it should be disclosed unlike 79(27.82%) respondents who reported that it should not be disclosed. The mean response value of 2.66 computed for this item confirmed that it should be disclosed.

Further analysis showed that the computed mean response value of 2.64 confirmed that majority of the respondents i.e. 206(72.54%) respondents were of the view that industry or counterparty type distribution of exposures, broken down by major types of credit exposure should be disclosed. However 53(18.66%) of the respondents reported that this should not be disclosed while 25(8.80%) respondents were neutral in their response.

Finally it was observed that a greater number of the respondents' i.e. 191(67.25%) respondents said that reconciliation of changes in the allowances for loan impairments should be disclosed to the public as away of averting risk. The computed mean response value of 2.61 supported this observation. However 76(22.18%) of the respondents were of the view that it should not be disclosed.

4.3 ANALYSIS OF QUESTIONS ON SUPERVISORY REVIEW PROCESS

TABLE 4.3.1 RESPONSE ON ISSUE OF INTERNAL LOSS DATA

STATEMENT	YES	NO
1. As supervisors, would you say commercial banks in Nigeria have enough loss data internally that could help the CBN/NDIC to review the adequacy of the risk measures they could use in assessing their internal capital adequacy?	√	×

Source: Field report 2006 Key: √ =agreed ×= Disagreed

From the table the supervisors were of the view that commercial banks in Nigeria have enough loss data internally that could help the CBN/NDIC to review the adequacy of the risk measures they could use in assessing their internal capital adequacy.

Table 4.3.2 Response on the extent to which internal loss data can be used

STATEMENT	SMALL	RESONABLE	LARGE
2. If the answer to No 1 is 'Yes', to what extent would you say they should use this loss data operationally in setting limits, evaluating business line performance and controlling risk generally in line with the Basel 2 Accord?	×	×	√

Source: Field report 2006 Key: √ =agreed ×= Disagreed

The supervisors are of the view that the banks should to a large extent use the loss data operationally in setting limits, evaluating business line performance and controlling risk generally in line with the Basel 2 Accord. (See Table 4.3.2)

Table 4.3.3 Response on the issue of guideline of risk-based supervision being adopted by the CBN

STATEMENT	YES	NO
3. Would it be correct to say that the guideline of risk-based supervision being adopted by the CBN as contained in the publication "Framework for Risk-based Supervision of Banks in Nigeria" dated December 13, 2005 was patterned after that of the Financial Services Authority (FSA) of the United Kingdom instead of those contained in the Basel Committee's publication titled "Core Principles for Effective Banking Supervision"	√	×

Source: Field report 2006 Key √ = Yes ×= No

The supervisors reported that the guideline of risk-based supervision being adopted by the CBN as contained in the publication "Framework for Risk-based Supervision of Banks in Nigeria" dated December 13, 2005 was patterned after that of the Financial Services Authority (FSA) of the United Kingdom instead of those contained in the Basel Committee's publication titled "Core Principles for Effective Banking Supervision". (See Table 4.3.2).

Table 4.3.4 Response on the issue of justifiable preference on the adopted risk

based supervision.

STATEMENT	OPTION
4. Which of the following reasons would be more appropriate to justify the preference the above option	
(a)The Nigerian banking industry has more in common	
(b)The banking industry in Nigeria does not have the ca	√
©The Basel Committee's recommendations as contained	√
	√

Source: Field report 2006 Key: √ =agreed ×= Disagreed

According to the response received on those factors influencing the choice of the preference to statement (3) the supervisors were of the view that all the aforementioned Vis a viz:

- The Nigerian banking industry has more in common with the British banking industry than with the Americans.
- The banking industry in Nigeria does not have the capacity yet to meet the requirements of the Basel Committee's recommendation as contained in their publication "Core Principles for Effective Banking Supervision" and
- The Basel Committee's recommendations as contained in their publication are too complicated for the Nigerian banking industry to implement justify the reason for the preference to the option to statement 3.

Table 4.3.5 Response on the level of compliance with externally assisted assessment

STATEMENT	C	LC	MNC	NC	REMARK
7. What is the level of compliance now with each of the following as they relate to Externally Assisted Assessment?					
BCP 1.1. Responsibilities and objectives	×	×	×	√	Non compliant
BCP 1.2. Independence and resources	×	×	×	√	Non compliant
BCP 1.3 Legal framework	×	×	×	√	Non compliant
BCP 1.5. Legal protection	×	×	×	√	Non compliant
BCP 1.6. Information sharing	×	×	×	√	Non compliant
BCP 6.0 Capital adequacy	×	×	×	√	Non compliant
BCP 7.0 Credit policies	×	×	×	√	Non compliant
BCP 8.0 Loan Evaluation and Loss provision	×	×	×	√	Non compliant
BCP 9.0 Large exposure limits	×	×	×	√	Non compliant
BCP 10.0 Connected lending	×	×	×	√	Non compliant
BCP 11.0 Country Risk	×	×	×	√	Non compliant
BCP 12.0 Market risks	×	×	×	√	Non compliant
BCP 13.0 Other risks	×	×	×	√	Non compliant
BCP 14.0 Internal control and Audit	×	×	×	√	Non compliant
BCP 20.0. Consolidated supervision	×	×	×	√	Non compliant
BCP 21.0 Accounting and disclosure	×	×	×	√	Non compliant
BCP 22.0 Remedial Measures	×	×	×	√	Non compliant
BCP 23.0 Global Consolidated Supervision	×	×	×	√	Non compliant

BCP 24.0 Host Country Supervision	×	×	×	√	Non compliant
BCP 25.0 Supervision of foreign banks	×	×	×	√	Non compliant

Source: Field report 2006 Key: √ =agreed ×= Disagreed, C=Compliance, LC= Largely Compliance, MNC= Materially Non Compliance, NC= Non Compliance

From the results in table 4.3.5 on the issue of level of compliance with externally assisted assessment. The supervisors reported that all the items BCP1.1-25.0 they were presented with on the above issue that all the banks have not complied with any of them. This therefore implies that, complying with some of the Basel committee's core principles for effective Banking Supervision pose serious problems to banks in Nigeria.

Table 4.3.6 Response on how soon would Nigeria be compliant with the Basel 2 Accord

STATEMENT	Three years	More than three years	Less than three years
How soon do you think Nigeria would be able to be compliant with the Basel 2 Accord?	√	×	×

Source: Field report 2006 Key: √ =agreed ×= Disagreed

From the results in table 4.3.6, the supervisors reported that it would take three years for Nigeria to be compliant with the Basel 2 accord.

4.4 ANALYSIS OF QUESTIONS ON STRUCTURAL AND INSTITUTIONAL FACTORS INFLUENCING THE IMPLEMENTATION OF BASEL 2 ACCORD

SA A D SD TOTAL MEAN

1. The technical competence of the board and management of all the banks in Nigeria need to be redefined or restructured before Basel 2 Accord can be successfully implemented.	156 (54.93)	113 (39.79)	12 (4.23)	3 (1.05)	284 (100.00)	3.49
2. The high ownership concentration of certain board of directors of some banks have to be decentralised in order to remove hitches of one-man or key-man dominance before Basel 2 can successfully be implemented.	41 (14.44)	28 (9.86)	67 (23.59)	148 (52.11)	284 (100.00)	1.84
3. Basel 2 Accord cannot be successfully be implemented if Nigerian banks cannot shoulder Nigeria's debt rescheduling strategies.	84 (29.58)	118 (41.55)	39 (13.73)	43 (15.14)	284 (100.00)	2.86
4. The Nigerian political climate must be stable for any meaningful banking practice to take place before Basel 2 can successfully be implemented.	113 (39.79)	82 (28.87)	39 (13.73)	50 (17.61)	284 (100.00)	3.08
5. There is need for the issue of knowledge gaps in the competence of the Board of management, the harmonised role and salary structure of Bank staffers with an improved working environment for Basel 2 to be successfully implemented in Nigeria.	79 (27.82)	95 (33.45)	52 (18.31)	58 (20.42)	284 (100.00)	2.69
6. Banks in Nigeria need to go beyond their present level of information technology development before Basel 2 can successfully be implemented.	126 (44.37)	103 (36.27)	27 (9.51)	28 (9.86)	284 (100.00)	3.15
7. The present merging process of aligning different entities of mergers will have to be properly integrated and should be in line with Basel 2 guidelines before Basel 2 Accord can successfully be implemented.	94 (33.10)	106 (37.32)	53 (18.66)	31 (10.92)	284 (100.00)	2.93
8. The present management capacity of most banks have to be overhauled and re-invigorated with directors and managers that possess the inert qualities of good banking experience before Basel 2 can successfully be implemented in Nigeria.	97 (34.15)	73 (25.70)	65 (22.89)	49 (17.25)	284 (100.00)	2.77
9. A robust risk management should be in place in Nigeria before Basel 2 can successfully be implemented.	156 (54.93)	128 (45.07)	0 (0.00)	0 (0.00)	284 (100.00)	3.55

10. The issue of resurgence of high level malpractices such as round-tripping of forex, falsification of records, insider-abuses etc have to be addressed among banks in Nigeria.	76	89	63	56	284	2.65
	(26.76)	(31.34)	(22.18)	(19.72)	(100.00)	
11. Inadequate operational and financial control of most banks in Nigeria must strictly be addressed before Basel 2 can successfully be implemented.	105	124	19	36	284	3.05
	(36.97)	(43.66)	(6.69)	(12.68)	(100.00)	
12. The problems associated with rendition of false returns, continued concealment should be addressed before Basel 2 can successfully be implemented.	118	103	37	26	284	3.10
	(41.55)	(36.27)	(13.03)	(9.15)	(100.00)	
13. Nigerian banks have to fully comply with the comprehensive risk management framework as spelt out by the Basel 2 Accord recommendations before Basel 2 can successfully be implemented.	53	47	98	86	284	2.24
	(18.66)	(16.55)	(34.51)	(30.28)	(100.00)	
14. Nigerian banks have to go beyond their present transparency level and always adequately disclose information (e.g. risk management strategies, risk concentration, performance measures e.t.c) to the stakeholders before Basel 2 can successfully be implemented.	185	96 .	3	0	284	3.64
	(65.14)	(33.80)	(1.06)	(0.00)	(100.00)	
15. Nigerian bank's risk management framework have to capture all the risks Nigeria banks are likely to encounter before Basel 2 can successfully be implemented.	68	78	59	79	284	2.48
	(23.94)	(27.47)	(20.77)	(27.82)	(100.00)	
16. The credit ratings of Nigerian Banks have to essentially meet up with that of Basel 2 Accord recommendations before Basel 2 can successfully be implemented.	35	28	137	84	284	2.05
	(12.32)	(9.86)	(48.24)	(29.58)	(100.00)	

Source: Field report 2006. **Key**: Upper figures represent Frequencies and figures in brackets represent Percentages

From the results in table 4.4 on the issue of structural and institutional factors likely to influence the implementation of Basel 2 Accord in Nigeria. It was observed that when the respondents were presented with the statement "The technical competence of the board and management of all the banks in Nigeria

need to be redefined or restructured before Basel 2 Accord can be successfully implemented." Majority of the respondents [i.e. 156(54.93%)] strongly agreed with the statement while [113(39.79%)] respondents agreed with statement. Using the calculated mean response value of 3.49 under the 4-point likert scale confirmed a degree of agreement. In another response received it was observed that 148(52.11%) respondents however strongly disagreed with the statement " that the high ownership concentration of certain board of directors of some banks have to be decentralised in order to remove hitches of one-man or key-man dominance before Basel 2 can successfully be implemented. This was supported by 67(23.59%) respondents who also disagreed with the statement. The computed mean value of 1.84 ranked within the degree of disagreement under the four–point likert scale.

Further result received showed that majority of the respondents [i.e. 118(41.55%)] agreed with the statement "Basel 2 Accord cannot be successfully be implemented if Nigerian banks cannot shoulder Nigeria's debt rescheduling strategies. However, 84(29.58%) of the respondents strongly agreed with the statement. Using the computed mean response value of 2.86 as yardstick, this value fell within the likert point scale of agreement.

When the respondents were presented the statement "the Nigerian political climate must be stable for any meaningful banking practice to take place before Basel 2 can successfully be implemented. The responses received showed that a combined total of respondents [i.e. 195(68.66%)] strongly agreed with the statement, while only a total of [89(31.34%)] disagreed with the statement.

In another response received it was observed that a greater number of the respondents i.e. 95(33.45%) agreed with the statement while 79(27.82%) respondents strongly agreed with the statement that there is need for the issue of knowledge gaps in the competence of the Board of management, the harmonised role and salary structure of Bank staffers with an improved working environment for Basel 2 to be successfully implemented in Nigeria. The computed mean response value of 2.69 also laid credence to the observation made.

In analyzing another statement which says Banks in Nigeria need to go beyond their present level of information technology development before Basel 2 can successfully be implemented. 'It was recorded that the respondents strongly agreed with the statement as depicted by a total of 126(44.37%) responses while 103(36.27%) respondents also agreed with the statement. The calculated mean response value of 3.15 also supports the observation.

When the respondents were presented the statement “The present merging process of aligning different entities of mergers will have to be properly integrated and should be in line with Basel 2 guidelines before Basel 2 Accord can successfully be implemented.” It was observed that majority of the respondents i.e. a combined total of 200 respondents representing 70.42% of the total distribution agreed with the statement while a total of 84 (39.58%) respondents disagreed with the statement.

However when the respondents were presented with the statement ‘The present management capacity of most banks have to be overhauled and re-invigorated with directors and managers that possess the inert qualities of good banking experience before Basel 2 can successfully be implemented in Nigeria.’ It was found that majority of the respondents strongly agreed with the statement. This was confirmed by 97 respondents or 34.15% of the subjects who responded in affirmative while 73 respondents or 25.70% also agreed with the statement. This was supported by the calculated mean response value of 2.77. However when the respondents were presented with the statement ‘a robust risk management should be in place in Nigeria before Basel 2 can successfully be implemented.’ The responses received showed that 156 respondents out of the total of 284 respondents strongly agreed with the statement as confirmed by the mean response value of 3.55 which fell within the range of strongly agreed. In another response when the respondents were presented the statement “The issue of resurgence of high level malpractices such as round-tripping of forex, falsification of records, insider- abuses etc have to be addressed among banks in Nigeria.” A greater percentage of the respondents i.e. a combined total of 58.10 % respondents, accounting for a total of 165 respondents agreed with the statement. Similarly, when the statement ‘Inadequate operational and financial control of most banks in Nigeria must strictly be addressed before Basel 2 can successfully be implemented.’ It was recorded that the highest response was received from the respondents who agreed with the statement. From the result, 124 respondents or 43.66% of the total respondents agreed with the statement while 105 respondents or 43.66% strongly agreed. The responses received from the respondents when they were presented with the statement “The problems associated with rendition of false returns, continued concealment should be addressed before Basel 2 can successfully be implemented. The responses received from the respondents showed that they agreed with the statement. Out of the total of 284 respondents, 118 representing 41.55% of the distribution strongly agreed with the statement while 103 respondents or 36.27% agreed with the statement. In another response it was observed that majority of the respondents disagreed with the statement when

they were presented the statement that " Nigerian banks have to fully comply with the comprehensive risk management framework as spelt out by the Basel 2 Accord recommendations before Basel 2 can successfully be implemented. Out of the 284 respondents that supplied information to the items a total of 184 respondents representing 64.79% of the total distribution disagreed with the statement. The calculated mean response value of 2.24 fell within the range of disagreement in the four- point likert scale. On the issue of whether "Nigerian banks have to go beyond their present transparency level and always adequately disclose information (e.g. risk management strategies, risk concentration, performance measures e.t.c) to the stakeholders before Basel 2 can successfully be implemented. It was observed that almost all the respondents agreed with the statement as a total of 281 respondents or 98.94% of the total distribution agreed with the statement which therefore implies that this statement is an important issue in the implementation of the Basel 2 Accord in Nigeria. However when the respondents were presented the statement "Nigerian bank's risk management framework have to capture all the risks Nigeria banks are likely to encounter before Basel 2 can successfully be implemented. It was observed that there was no clear cut agreement or disagreement with the statement as the respondents almost equally agreed or disagreed with the statement. Finally when the respondents were presented with the statement" The credit ratings of Nigerian Banks have to essentially meet up with that of Basel 2 Accord recommendations before Basel 2 can successfully be implemented. Majority of the respondents disagreed with the statement as a total of 212 respondents or 77.82 % of the respondents disagreed with the statement. This therefore implies that the credit ratings of Nigerian Banks have to essentially meet up with that of Basel 2 Accord recommendations before Basel 2 can successfully be implemented.

4.5 TEST OF HYPOTHESES

A hypothesis is a statement made about some characteristics of a population that should be supported or rejected based on available sample data. It is a proposed explanation, which may or may not be true. For the purposes of this survey work,

hypothesis chosen are deemed true before the conduct of the survey. They are then subjected to tests that may prove them untrue.

The Null Hypothesis

The Null Hypothesis is denoted by Ho. Its acceptance or rejection depends on the result of the statistical computation

The Alternative Hypothesis

This is the opposite of the null hypothesis. It is denoted by Hi, the one available where the null hypothesis is rejected.

Restatement of Hypotheses

In this research work the chi-square method of hypothesis testing was employed to test the following hypothesis:

The following null and alternative hypotheses postulated were used to guide the study.

1. H_o. Many structural changes (labour force, ethical practices, and political considerations e.t.c) would not likely take place in Nigerian Banking industry before Basel 2 Accord can be successfully implemented.

   H_1. Many structural changes (labour force, ethical practices, and political considerations) must take place in Nigerian Banking industry before Basel 2 Accord can be successfully implemented.

2. H_o. Many Institutional changes (Capital adequacy, market discipline, consistent and improved external rating, rigorous supervisory standard) would not likely take place in Nigerian Banking industry before Basel 2 Accord can be successfully implemented.

H_1. Many Institutional changes (i.e credit risk, operational risk, market risk) must take place in Nigerian Banking industry before Basel 2 Accord can be successfully implemented.

To test these hypotheses each of the stated changes shall be treated separately as Sub-Hypotheses in order to establish the import of each statement.

Sub-Hypotheses on structural changes

a) H_{01}: The technical competence of the board and management of all the banks does not need to be fine-tuned before Basel 2 Accord can be successfully implemented.

H_1: The technical competence of the board and management of all the banks need to be fine-tuned before Basel 2 Accord can be successfully implemented.

b) H_{02}: There is no need for Nigerian banks to be able shoulder Nigeria's debt rescheduling strategies before Basel 2 Accord can successfully be implemented.

H_2: There is need for Nigerian banks to be able shoulder Nigeria's debt rescheduling strategies before Basel 2 Accord can successfully be implemented.

c) H_{03}: The high ownership concentration of certain board of some banks need not be decentralized in order to remove hitches of one-man or key-man dominance before Basel 2 can successfully be implemented.

H_3: The high ownership concentration of certain board of some banks needs to be decentralized in order to remove hitches of one-man or key-man dominance before Basel 2 Accord can successfully be implemented.

d) H_{04}: The issue of knowledge gaps in the competence of the Board of management, the harmonized role and salary structure of staff with an

improved working environment need not be met before Basel 2 Accord can successfully be implemented.

H_4: The issue of knowledge gaps in the competence of the Board of management, the harmonized role and salary structure of staff with an improved working environment need to be met before Basel 2 Accord can successfully be implemented.

e) H_{05}: Nigeria need not evolve a stable political climate for any meaningful banking practice to take place even before Basel 2 Accord can successfully be implemented.

H_{05}: Nigeria need to evolve a stable political climate for any meaningful banking practice to take place even before Basel 2 Accord can successfully be implemented.

f) H_{06}: The present merging process of aligning different entities of mergers may not well be integrated and in line with Basel 2 Accord guidelines before Basel 2 Accord can successfully be implemented.

H_6: The present merging process of aligning different entities of mergers will need to be integrated and in line with Basel 2 Accord guidelines before Basel 2 Accord can successfully be implemented.

g) H_{07}: The banks need not go beyond their present level of information technology systems which have to be integrated with their accounting systems and record before Basel 2 Accord can successfully be implemented.

H_7: The banks need to go beyond their present level of information technology systems which have to be integrated with their accounting systems and record before Basel 2 Accord can successfully be implemented.

h) H_{08}: The present management capacity of most banks need not to be overhauled and re-invigorated with directors and managers that possess

the inert qualities of good banking experience before Basel 2 Accord can successfully be implemented.

$H_{8:}$ The present management capacity of most banks need to be overhauled and re-invigorated with directors and managers that possess the inert qualities of good banking experience before Basel 2 Accord can successfully be implemented.

i) $H_{09:}$ A robust risk management needs not be in place before Basel 2 Accord can successfully be implemented.

$H_{9:}$ A robust risk management needs to be in place before Basel 2 Accord can successfully be implemented.

j) $H_{010:}$ The issue of resurgence of high level malpractices such as round-tripping of forex, falsification of records, insider- abuses etc need not be addressed before Basel 2 Accord can successfully be implemented..

$H_{10:}$ The issue of resurgence of high-level malpractices such as round tripping of forex, falsification of records, insider- abuses etc need to be addressed before Basel 2 Accord can successfully be implemented.

k) $H_{011:}$ The problems associated with rendition of false returns, continued concealment need not be addressed before Basel 2 Accord can successfully be implemented.

$H_{11:}$ The problems associated with rendition of false returns, continued concealment need to be addressed before Basel 2 Accord can successfully be implemented.

L) $H_{012:}$ Inadequate operational and financial control of most banks need not be strictly addressed before Basel 2 Accord can successfully be implemented.

H_{12}: Inadequate operational and financial control of most banks must strictly be addressed before Basel 2 Accord can successfully be implemented.

m) H_{013}: Nigerian banks need not go beyond their present transparency level and always adequately disclose information (e.g. risk management strategies, risk concentration, performance measures e.t.c) to the stakeholders before Basel 2 Accord can successfully be implemented.

H_{13} Nigerian banks need to go beyond their present transparency level and always adequately disclose information (e.g. risk management strategies, risk concentration, performance measures e.t.c) to the stakeholders before Basel 2 Accord can successfully be implemented.

n) H_{014}: Nigerian banks need not fully comply with the comprehensive risk management framework as spelt out by the Basel 2 recommendation before Basel 2 Accord can successfully be implemented.

H_{14}: Nigerian banks need to fully comply with the comprehensive risk management framework as spelt out by the Basel 2 recommendation before Basel 2 Accord can successfully be implemented.

p) H_{016}: The credit ratings of Nigerian Banks need not essentially meet up with that of Basel's 2 recommendations before Basel 2 Accord can successfully be implemented.

H_{016}: The credit ratings of Nigerian Banks need to essentially meet up with that of Basel's 2 recommendations before Basel 2 Accord can successfully be implemented.

As stated above, these hypotheses were tested with the aid of Chi-Square distribution at 0.05 levels of significance (i.e. a 95% confidence interval limit). The computation involves using the formula

$$\chi^2 = \frac{\Sigma(O - E)^2}{E}$$

Where O = Observed frequency

E = Expected frequency in respect of each other

The steps followed for the calculations are:

i. Calculation of test statistics, χ^2

ii. Determination of degree of freedom

iii. Determination of critical values from statistical tables

iv. Deciding whether to accept or reject the null hypothesis

Decision Rule

The test statistics χ^2T and the critical value χ^2 C are compared. Where the test statistic is greater than or equal to the critical value, then the null hypothesis will be accepted while the alternative hypothesis rejected at the same significance level.

Thus:

Where $\chi^2T > \chi^2C$ - Reject the Null Hypothesis

Where $\chi^2 T < \chi^2C$ - Accept the Null Hypothesis

The degree of freedom DF determines the number of expected frequency to be computed,

DF = r – 1, where r is the number of rows in a task.

Hypothesis One

H_o. Many structural changes (labour force, ethical practices, and political considerations e.t.c) would not likely take place in Nigerian banking industry before Basel 2 Accord can be successfully implemented.

H_1. Many structural changes (labour force, ethical practices, and political considerations) must take place in Nigerian banking industry before Basel 2 Accord can be successfully implemented.

To test this hypothesis each of the structural changes shall be treated separately in order to establish the import of each statement.

Sub-Hypotheses on structural changes

a) H_{01}: The technical competence of the board and management of all the banks does not need to be redefined or restructured before Basel 2 Accord can be successfully implemented.

H_1: The technical competence of the board and management of all the banks need to be redefined or restructured before Basel 2 Accord can be successfully implemented.

To test this hypothesis the chi-square distribution was used.

Table 4.5.1 Test of technical competence of the board and management of all the banks on the implementation of the Basel 2 Accord

Variables	O	E	O- E	$(O- E)^2$	$(O- E)^2 / E$
SA	156	71	85	7225	101.76
A	113	71	42	1764	24.85
D	12	71	-59	3481	49.03
SD	3	71	-68	4624	65.13
TOTAL	284			χ^2	240.77

Source: Field Report 2006

Test Statistic = $\chi^2 T = \Sigma \frac{(O - E)^2}{E} = 240.77$

Degree of freedom DF = r – 1 = 4 – 1 = 3

Critical Value = χ^2 0.05 = 7.82 (from tables)

Decision

From the table 4.5.1 above, the calculated χ^2-value of 240.77 is greater than the critical χ^2- value of 7.82 at 3df and 0.05 levels of significance. This shows that the null hypothesis is rejected, while the alternate hypothesis is accepted. This therefore implies that the technical competence of the board and management of all the banks need to be redefined or restructured before Basel 2 Accord can be successfully implemented.

b) H_{02}: There is no need for Nigerian banks to be able shoulder Nigeria's debt rescheduling strategies before Basel 2 can successfully be implemented.

H_2: There is need for Nigerian banks to be able shoulder Nigeria's debt rescheduling strategies before Basel 2 can successfully be implemented.

Table 4.5.2 Test of the capability of Nigerian banks to shoulder Nigeria's debt rescheduling strategies before the implementation of the Basel 2 Accord

Variables	O	E	O- E	$(O- E)^2$	$(O- E)^2 / E$
SA	84	71	13	169	2.38
A	118	71	47	2209	31.11
D	39	71	-32	1024	14.42
SD	43	71	-28	784	11.04
TOTAL	284			χ^2	58.95

Source: Field Report 2006

Test Statistic = $\chi^2 T = \Sigma \frac{(O - E)^2}{E} = 58.95$

Degree of freedom DF = r – 1 = 4 – 1 = 3

Critical Value = χ^2 0.05 = 7.82 (from tables)

Decision

From the table 4.5.2 above, the calculated χ^2-value of 58.95 is greater than the critical χ^2- value of 7.82 at 3df and 0.05 levels of significance. This shows that the null hypothesis is rejected, while the alternate hypothesis is accepted. This therefore implies that there is need for Nigerian banks to be able shoulder Nigeria's debt rescheduling strategies before Basel 2 can successfully be implemented.

c) H_{03}: The high ownership concentration of certain board of directors of some banks need not be decentralised in order to remove hitches of one-man or key-man dominance before Basel 2 can successfully be implemented.

H_3: The high ownership concentration of certain board of directors of some banks need to be decentralised in order to remove hitches of one-man or key-man dominance before Basel 2 can successfully be implemented.

Table 4.5.3 Test of the influence of ownership concentration of board of directors on the implementation of the Basel 2 Accord

Variables	O	E	O- E	$(O- E)^2$	$(O- E)^2 / E$

SA	41	71	-30	900	12.67
A	28	71	-43	1849	26.04
D	67	71	-4	16	0.23
SD	148	71	77	5929	83.51
TOTAL	284			χ^2	122.45

Source: Field Report 2006

Test Statistic = $\chi^2 T = \Sigma \frac{(O - E)^2}{E} = 122.45$

Degree of freedom DF = r – 1 = 4 – 1 = 3

Critical Value = χ^2 0.05 = 7.82 (from tables)

Decision

From the table 4.5.3 above, the calculated χ^2-value of 122.45 is greater than the critical χ^2- value of 7.82 at 3df and 0.05 levels of significance. This result shows that the null hypothesis is rejected, while the alternate hypothesis which states that the high ownership concentration of certain board of directors of some banks need to be decentralised in order to remove hitches of one-man or key-man dominance before Basel 2 can successfully be implemented is accepted.

d) H_{04}: The issue of knowledge gaps in the competence of the Board of management, the harmonised role and salary structure of staff with an improved working environment need not be met before Basel 2 can successfully be implemented.

H_4: The issue of knowledge gaps in the competence of the Board of management, the harmonised role and salary structure of staff with an improved working environment need to be met before Basel 2 can successfully be implemented.

Table 4.5.4 Test of the issue of knowledge gaps in the competence of the Board of management on the implementation of the Basel 2 Accord

Variables	O	E	O- E	$(O- E)^2$	$(O- E)^2 / E$
SA	79	71	8	64	0.90
A	95	71	24	576	8.11
D	52	71	-19	361	5.08
SD	58	71	-13	169	2.38
TOTAL	284			χ^2	16.47

Source: Field Report 2006

Test Statistic = $\chi^2T = \Sigma\frac{(O - E)^2}{E}$ = 16.47

Degree of freedom DF = r – 1 = 4 – 1 = 3

Critical Value = χ^2 0.05 = 7.82 (from tables)

Decision

From the table 4.5.4 above, the calculated χ^2-value of 16.47 is greater than the critical χ^2- value of 7.82 at 3df and 0.05 levels of significance. This result shows that the null hypothesis is rejected, while the alternate hypothesis which states that the issue of knowledge gaps in the competence of the Board of management, the harmonised role and salary structure of staff with an improved working environment need to be met before Basel 2 can successfully be implemented is accepted.

e) H_{05}: Nigeria need not evolve a stable political climate for any meaningful banking practice to take place even before Basel 2 can successfully be implemented.

H_{05}: Nigeria need to evolve a stable political climate for any meaningful banking practice to take place even before Basel 2 can successfully be implemented.

Table 4.5.5 Test of the influence of political climate on the implementation of the Basel 2 Accord

Variables	O	E	O- E	$(O- E)^2$	$(O- E)^2 / E$
SA	113	71	42	1764	24.85
A	82	71	11	121	1.70
D	39	71	-32	1024	14.42
SD	50	71	-21	441	6.21
TOTAL	284			χ^2	47.18

Source: Field Report 2006

Test Statistic = $\chi^2T = \Sigma\frac{(O - E)^2}{E}$ = 47.18

Degree of freedom DF = r – 1 = 4 – 1 = 3

Critical Value = χ^2 0.05 = 7.82 (from tables)

Decision

From the table 4.5.5 above, the calculated χ^2-value of 47.18 is greater than the critical χ^2- value of 7.82 at 3df and 0.05 levels of significance. This shows that the null hypothesis is rejected, while the alternate hypothesis is accepted. This therefore implies that Nigeria need to evolve a stable political climate for any meaningful banking practice to take place even before Basel 2 can successfully be implemented.

f) H_{06}: The present merging process of aligning different entities of mergers may not well be integrated and in line with Basel 2 guidelines before Basel 2 Accord can successfully be implemented.

H_6: The present merging process of aligning different entities of mergers will need to be integrated and in line with Basel 2 guidelines before Basel 2 Accord can successfully be implemented.

Table 4.5.6 Test of the issue of Bank merging process on the implementation of the Basel 2 Accord

Variables	O	E	O- E	$(O- E)^2$	$(O- E)^2 / E$
SA	94	71	23	529	7.45
A	106	71	35	1225	17.25
D	53	71	-18	324	4.56
SD	31	71	-40	1600	22.54
TOTAL	284			χ^2	51.80

Source: Field Report 2006

Test Statistic = $\chi^2 T = \Sigma \frac{(O - E)^2}{E} = 51.80$

Degree of freedom DF = r – 1 = 4 – 1 = 3

Critical Value = χ^2 0.05 = 7.82 (from tables)

Decision

The result in table 4.5.6 above showed that the calculated χ^2-value of 51.80 is greater than the critical χ^2- value of 7.82 at 3df and 0.05 levels of significance. This result shows that the null hypothesis is rejected, while the alternate hypothesis which states that the present merging process of aligning different entities of

mergers will need to be integrated and in line with Basel 2 guidelines before Basel 2 Accord can successfully be implemented is accepted.

g) H_{07}: The banks need not go beyond their present level of information technology systems which have to be integrated with their accounting systems and record before Basel 2 can successfully be implemented.

H_7: The banks need to go beyond their present level of information technology systems which have to be integrated with their accounting systems and record before Basel 2 can successfully be implemented.

Table 4.5.7 Test of the influence of information technology systems on the implementation of the Basel 2 Accord

Variables	O	E	O- E	$(O- E)^2$	$(O- E)^2 / E$
SA	126	71	55	3025	42.61
A	103	71	32	1024	14.42
D	27	71	-44	1936	27.26
SD	28	71	-43	1849	26.04
TOTAL	284			χ^2	110.33

Source: Field Report 2006

Test Statistic = $\chi^2 T = \Sigma \frac{(O - E)^2}{E} = 110.33$

Degree of freedom DF = r – 1 = 4 – 1 = 3

Critical Value = χ^2 0.05 = 7.82 (from tables)

Decision

From the table 4.5.7 above, the calculated χ^2-value of 110.33 is greater than the critical χ^2- value of 7.82 at 3df and 0.05 levels of significance. This shows that the null hypothesis is rejected, while the alternate hypothesis is accepted. This therefore implies that the banks need to go beyond their present level of information technology systems which have to be integrated with their accounting systems and record before Basel 2 can successfully be implemented.

h) H_{08}: The present management capacity of most banks need not to be overhauled and re-invigorated with directors and managers that possess the inert qualities of good banking experience before Basel 2 can successfully be implemented.

H_8: The present management capacity of most banks need to be overhauled and re-invigorated with directors and managers that possess the inert qualities of good banking experience before Basel 2 can successfully be implemented.

Table 4.5.8 Test of the issue of management capacity of Nigerian banks on the implementation of the Basel 2 Accord

Variables	O	E	O- E	$(O- E)^2$	$(O- E)^2 / E$
SA	97	71	26	676	9.52
A	73	71	2	4	0.06
D	65	71	-6	36	0.51
SD	49	71	-22	484	6.82
TOTAL	284			χ^2	16.91

Source: Field Report 2006

Test Statistic = $\chi^2 T = \Sigma \frac{(O - E)^2}{E} = 16.91$

Degree of freedom DF = r – 1 = 4 – 1 = 3

Critical Value = χ^2 0.05 = 7.82 (from tables)

Decision

The result in table 4.5.8 showed that the calculated χ^2-value of 16.91 is greater than the critical χ^2- value of 7.82 at 3df and 0.05 levels of significance. This result shows that the null hypothesis is rejected, while the alternate hypothesis which states that the present management capacity of most banks need to be overhauled and re-invigorated with directors and managers that possess the inert qualities of good banking experience before Basel 2 can successfully be implemented is accepted.

Hypothesis Two

H_o. Many Institutional changes (Capital adequacy, market discipline, consistent and improved external rating, rigorous supervisory standard) would not likely take place in Nigerian Banking industry before Basel 2 Accord can be successfully implemented.

H_1. Many Institutional changes (i.e credit risk, operational risk, market risk) must take place in Nigerian banking industry before Basel 2 Accord can be successfully implemented.

To test this hypothesis the institutional factors shall be split into sub-hypothesis and all tested using the chi-square distribution.

Sub-hypotheses on institutional changes

i) H_{09}: A robust risk management need not be in place before Basel 2 can successfully be implemented.

H_9: A robust risk management need to be in place before Basel 2 can successfully be implemented.

Table 4.5.9 Test of the influence of robust risk management on the implementation of the Basel 2 Accord

Variables	O	E	O- E	$(O- E)^2$	$(O- E)^2 / E$
SA	156	71	85	7225	101.76
A	128	71	57	3249	45.76
D	0	71	-71	5041	71.00
SD	0	71	-71	5041	71.00
TOTAL	284			χ^2	289.52

Source: Field Report 2006

Test Statistic = $\chi^2 T = \Sigma \frac{(O - E)^2}{E} = 289.52$

Degree of freedom DF = r – 1 = 4 – 1 = 3

Critical Value = χ^2 0.05 = 7.82 (from tables)

Decision

From the table 4.5.9 above, the calculated χ^2-value of 289.52 is greater than the critical χ^2- value of 7.82 at 3df and 0.05 levels of significance. This shows that the null hypothesis is rejected, while the alternate hypothesis is accepted. This therefore implies that a robust risk management need to be in place before Basel 2 can successfully be implemented.

j) H_{010}: The issue of resurgence of high level malpractices such as round-tripping of forex, falsification of records, insider- abuses etc need not be addressed before Basel 2 can successfully be implemented..

H_{10}: The issue of resurgence of high level malpractices such as round-tripping of forex, falsification of records, insider- abuses etc need to be addressed before Basel 2 can successfully be implemented.

Table 4.5.10 Test of the issue of resurgence of high level malpractices on the implementation of the Basel 2 Accord

Variables	O	E	O- E	$(O- E)^2$	$(O- E)^2 / E$
SA	76	71	-1	1	0.014
A	89	71	18	324	4.56
D	63	71	-8	64	0.90
SD	56	71	-15	225	3.16
TOTAL	284			χ^2	8.63

Source: Field Report 2006

Test Statistic = $\chi^2 T = \Sigma \frac{(O - E)^2}{E} = 8.63$

Degree of freedom DF = r – 1 = 4 – 1 = 3

Critical Value = χ^2 0.05 = 7.82 (from tables)

Decision

The result in table 4.5.10 showed that the calculated χ^2-value of 8.63 is greater than the critical χ^2- value of 7.82 at 3df and 0.05 levels of significance. This result shows that the null hypothesis is rejected, while the alternate hypothesis which states that the issue of resurgence of high level malpractices such as round-tripping of forex, falsification of records, insider- abuses etc need to be addressed before Basel 2 can successfully be implemented.

k) H_{011}: The problems associated with rendition of false returns, continued concealment need not be addressed before Basel 2 can successfully be implemented.

H_{11}: The problems associated with rendition of false returns, continued concealment need to be addressed before Basel 2 can successfully be implemented.

Table 4.5.11 Test of the problems associated with rendition of false returns and continued concealment on the implementation of the Basel 2 Accord

Variables	O	E	O- E	$(O- E)^2$	$(O- E)^2 / E$

SA	118	71	47	2209	31.11
A	103	71	32	1024	14.42
D	37	71	-34	1156	16.28
SD	26	71	-45	2025	28.52
TOTAL	284			χ^2	90.33

Source: Field Report 2006

Test Statistic = $\chi^2 T = \Sigma \frac{(O - E)^2}{E} = 90.33$

Degree of freedom DF = r – 1 = 4 – 1 = 3

Critical Value = χ^2 0.05 = 7.82 (from tables)

Decision

From the table 4.5.11 above, the calculated χ^2-value of 90.33 is greater than the critical χ^2- value of 7.82 at 3df and 0.05 levels of significance. This shows that the null hypothesis is rejected, while the alternate hypothesis is accepted. This therefore implies that the problems associated with rendition of false returns, continued concealment need to be addressed before Basel 2 can successfully be implemented

L) H_{012}: Inadequate operational and financial control of most banks need not be strictly addressed before Basel 2 can successfully be implemented.

H_{12}: Inadequate operational and financial control of most banks must strictly be addressed before Basel 2 can successfully be implemented.

Table 4.5.12 Test of the influence of inadequate operational and financial control system on the implementation of the Basel 2 Accord

Variables	O	E	O- E	$(O- E)^2$	$(O- E)^2 / E$
SA	105	71	34	1156	16.28
A	124	71	53	2809	39.56
D	19	71	-52	2704	38.09

SD	36	71	-35	1225	17.25
TOTAL	284			χ^2	111.18

Source: Field Report 2006

Test Statistic = $\chi^2 T = \Sigma \frac{(O - E)^2}{E} = 111.18$

Degree of freedom DF = r – 1 = 4 – 1 = 3

Critical Value = χ^2 0.05 = 7.82 (from tables)

Decision

The result in table 4.5.12 showed that the calculated χ^2-value of 111.18 is greater than the critical χ^2- value of 7.82 at 3df and 0.05 levels of significance. This result shows that the null hypothesis is rejected, while the alternate hypothesis which states that inadequate operational and financial control of most banks must strictly be addressed before Basel 2 can successfully be implemented.

m) $H_{013:}$ Nigerian banks need not go beyond their present transparency level and always adequately disclose information (e.g. risk management strategies, risk concentration, performance measures e.t.c) to the stakeholders before Basel 2 can successfully be implemented.

H_{13} Nigerian banks need to go beyond their present transparency level and always adequately disclose information (e.g. risk management strategies, risk concentration, performance measures e.t.c) to the stakeholders before Basel 2 can successfully be implemented.

Table 4.5.13 Test of the issue of Nigerian present transparency level on the implementation of the Basel 2 Accord

Variables	O	E	O- E	$(O- E)^2$	$(O- E)^2 / E$
SA	185	71	114	12996	183.04
A	96	71	25	625	8.80
D	3	71	-68	4624	65.13
SD	0	71	-71	5041	71.00
TOTAL	284			χ^2	327.97

Source: Field Report 2006

Test Statistic = $\chi^2T = \Sigma\frac{(O - E)^2}{E}$ = 327.97

Degree of freedom DF = r – 1 = 4 – 1 = 3

Critical Value = χ^2 0.05 = 7.82 (from tables)

Decision

From the table 4.5.13 above, the calculated χ^2-value of 327.97 is greater than the critical χ^2- value of 7.82 at 3df and 0.05 levels of significance. This shows that the null hypothesis is rejected, while the alternate hypothesis is accepted. This therefore implies that Nigerian banks need to go beyond their present transparency level and always adequately disclose information (e.g. risk management strategies, risk concentration, performance measures e.t.c) to the stakeholders before Basel 2 can successfully be implemented.

n) H_{014}: Nigerian banks need not fully comply with the comprehensive risk management framework as spelt out by the Basel 2 recommendation before Basel 2 can successfully be implemented.

H_{14}: Nigerian banks need to fully comply with the comprehensive risk management framework as spelt out by the Basel 2 recommendation before Basel 2 can successfully be implemented.

Table 4.5.14 Test of the compliance of Banks comprehensive risk management framework on the implementation of the Basel 2 Accord

Variables	O	E	O- E	$(O- E)^2$	$(O- E)^2 / E$
SA	53	71	-18	324	4.56
A	47	71	-24	576	8.11
D	98	71	27	729	10.27
SD	86	71	15	225	3.17
TOTAL	284			χ^2	26.11

Source: Field Report 2006

Test Statistic = $\chi^2T = \Sigma\frac{(O - E)^2}{E}$ = 26.11

Degree of freedom DF = r – 1 = 4 – 1 = 3

Critical Value = χ^2 0.05 = 7.82 (from tables)

Decision

The result in table 4.5.14 showed that the calculated χ^2-value of 26.11 is greater than the critical χ^2- value of 7.82 at 3df and 0.05 levels of significance. This result shows that the null hypothesis is rejected, while the alternate hypothesis which states that Nigerian banks need to fully comply with the comprehensive risk management framework as spelt out by the Basel 2 recommendation before Basel 2 can successfully be implemented.

O) H_{015}: NIGERIAN BANK'S RISK MANAGEMENT FRAMEWORK NEED NOT CAPTURE ALL THE R

H_{015}: Nigerian bank's risk management framework need to capture all the risks the banks are likely to encounter before Basel 2 can successfully be implemented.

Table 4.5.15: Test of the issue of Nigerian bank's risk management framework on the implementation of the Basel 2 Accord

Variables	O	E	O- E	$(O- E)^2$	$(O- E)^2 / E$
SA	68	71	-3	9	0.13
A	78	71	7	49	0.69
D	59	71	-12	144	2.03
SD	79	71	8	64	0.90
TOTAL	284			χ^2	3.75

Source: Field Report 2006

Test Statistic = $\chi^2 T = \Sigma \frac{(O - E)^2}{E} = 3.75$

Degree of freedom DF = r – 1 = 4 – 1 = 3

Critical Value = χ^2 0.05 = 7.82 (from tables)

Decision

From the result in table 4.5.15 above, the calculated χ^2-value of 3.75 is less than the critical χ^2- value of 7.82 at 3df and 0.05 levels of significance. This shows that the null hypothesis is accepted, while the alternate hypothesis is rejected. This therefore implies that Nigerian bank's risk management framework need not

capture all the risks the banks are likely to encounter before Basel 2 can successfully be implemented.

P) H_{016}: THE CREDIT RATINGS OF NIGERIAN BANKS NEED NOT ESSENTIALLY MEET UP WITH T

H_{016}: The credit ratings of Nigerian Banks need to essentially meet up with that of Basel's 2 recommendations before Basel 2 can successfully be implemented.

Table 4.5.16 Test of the influence of credit ratings of Nigerian Banks on the implementation of the Basel 2 Accord

Variables	O	E	O- E	$(O- E)^2$	$(O- E)^2 / E$
SA	35	71	-36	1296	18.25
A	28	71	-43	1849	26.04
D	137	71	66	4356	61.35
SD	84	71	13	169	2.38
TOTAL	284			χ^2	108.02

Source: Field Report 2006

Test Statistic = $\chi^2 T = \Sigma \frac{(O - E)^2}{E} = 108.02$

Degree of freedom DF = r – 1 = 4 – 1 = 3

Critical Value = χ^2 0.05 = 7.82 (from tables)

Decision

The result in table 4.5.16 showed that the calculated χ^2-value of 108.02 is greater than the critical χ^2- value of 7.82 at 3df and 0.05 levels of significance. This result shows that the null hypothesis is rejected, while the alternate hypothesis, which states that the credit ratings of Nigerian Banks need to essentially meet up with that of Basel's 2 recommendations before Basel 2 can successfully be implemented is accepted.

CHAPTER V

DISCUSSION OF THE RESULTS

As could be seen above in Table 4. 1. 1. Seventy-nine percent of respondents for the five banks used for this survey declared their banks as 'significant banks' being big enough to upset the economy of Nigeria should any of them become insolvent. Eight-three percent of respondents on Table 4.1.2 also agreed that regulatory capital once strong and kept strong consistently could act as a buffer to commercial banks during economic downturns. The significance of this response is that the adoption of Basel 2 Accord should compel Nigerian banks to recognise the importance of regulatory capital. The starting point of this should be compliance in full with the Basel 1 Accord on risk weighted assets ratio of a minimum of 8% to be set aside as regulatory capital for every exposure. The situation on ground presently is that the Central Bank of Nigeria does not require banks in Nigeria to set aside this percentage at all once it considered itself satisfied with the doubtful debts provision of any bank in line with the Prudential Guidelines.

The response that Agusto & Company Ltd the only recognised rating agency in Nigeria compares favourably with the likes of Standards & Poor's, Moody's Investor Services, and Fitch IBCA is more of an act of patriotism than the reality on ground because Agusto & Co is nowhere near them in terms of international credibility and acceptance. For one thing the local rating of companies in Nigeria is yet to reach international standards because the integrity of the data they use is questionable. For another, the company cannot claim it is independent of the government when its founder and majority shareholder Mr. Bode Agusto is presently a serving federal minister.

The response on the issue of internal rating system for customers of banks in Nigeria on Table 4.1.4 is not unconnected with the duty of bank workers to keep

secret all the issues considered as being confidential on all customers. Apart from this the internal rating system recommended by the Basel 2 Accord is not the same as that the Nigerian banks are familiar with.

To the banks in Nigeria an internal rating system is no more than their individual opinion of a given customer independent of external sources. Information sharing especially on credit risk is not reliable in Nigerian banks as they poach each other's customers. There is also no reliable data on a given customer's credit worthiness as most banks rely on how popular the name of a company is or that of any of its directors.

The Annual Reports of most companies are also not reliable because of the collusion of their external auditors who would gratuitously produce several versions of a company's annual report. One version could be for the shareholders, another one for their bankers and yet another one for the government.

Quantifying Operational risk and setting aside a certain percentage of risk weighted regulatory capital in Nigerian banks could be a hard nut to crack given the situation on ground in the Nigerian banking industry. The reason for this is that not only does the risk appear to be too wide to be covered; the areas affected are not very familiar with the Nigerian banking industry. Basel 2 Accord describes Operational risk as the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events including legal risk, but not strategic and reputation risks. Under loss resulting from inadequate or failed internal processes it cannot be gainsaid that banks in Nigeria operate daily more under these two risks than otherwise. Internal processes fail or are inadequate in Nigerian banks than otherwise because of poor infrastructure especially in the areas of power supply transportation and communication. Data in Nigerian banks are also of questionable integrity. People employed in the banks are also not honest and this is a major cause of bank failures.

Capital charges can be calculated in one of the three ways under the Basel 2 Accord for Operational risk and they are (1) Basic Indicator approach, (2) Standard approach, (3) the Advanced Measurement approach. While the Basic Indicator approach requires any bank using it to hold capital equal to a fixed percentage of average annual gross income over the previous years, the use of the other two approaches require the meeting of certain minimum qualifying criteria which are as follows:

(a) Its board of directors and senior management are actively involved in the oversight of the Operational risk management framework.

(b) It has an Operational risk management system that is conceptually sound and is implemented with integrity.

(c) It has sufficient resources in the use of the approach as well as the control and audit areas.

No post-consolidation Nigerian bank is capable of meeting these criteria within the foreseeable future let alone adopts either of the two approaches. The Basic Indicator approach therefore appears to be what Nigerian banks are left with.

The issue of Market Discipline under Pillar 3 of the Accord is of major importance. That over ninety-three percent of respondents agree that banks in Nigeria should disclose their Tier 1 and 2 capitals and capital adequacy ratios on a quarterly basis means the country's banking industry is coming of age. It means that even before the adoption of Basel 2 Accord banks in Nigeria can start the adoption of transparency as a working tool. So far the situation on ground is that of absolute secrecy. Since the components of Tier 1 of a bank's capital are equity capital and published reserves from post-tax earnings, the quarterly disclosure should allow stakeholders especially the depositors to keep track of them through a year-round collation as opposed to the once-a-year disclosure in the published Annual reports, the details of which are usually sketchy.

The response on Table 4.2.2 that a bank should disclose on an annual basis a general summary of its risk management objectives and policies is also of monumental significance. This is because risk identification is still alien to the Nigerian banking industry as huge cultural, geographical, structural and institutional gulfs exist within the ethnic divides.

The response of the supervisors that banks in Nigeria have enough data that could be used internally to help the supervisors (CBN / NDIC) to review the adequacy of the risk measures they could use in assessing their capital adequacy come as no surprise because the supervisors believe in the adequacy of their Credit Risk Management System (CRMS) which at present serves as the only Credit bureau for the banks. Banks themselves know that the data in the CRMS is of questionable integrity since some of them cover up their good customers. A CBN official under condition of anonymity disclosed that some data on companies sent in as trial data at the inception of the CRMS were still in the system waiting to be expunged. The Loss data required under the Basel 2 Accord is however more robust than those being used under the CRMS.

The fine-tuning of the technical competence of the boards and management staff of all the banks comes to question in Table 4.4.1 and about percent of respondents agree that this must take place before the Basel 2 Accord can be successfully implemented. This will have to take place through massive re-orientation to give them the mindset necessary for a successful implementation. The ability to shoulder the Nigeria debt rescheduling strategies should provide a litmus test of the fine-tuning and over seventy-one percent of respondents agreed with this statement.

Table 4.4.3 addresses the issue of the high ownership concentration of the boards of certain banks and most respondents did not see why it should have any bearing on the successful implementation of the Basel 2 Accord. This must have been borne out of the one-man business structure that characterised the pre-consolidation era of the Nigerian banking industry. Nigerians are apparently used to this structure and could not see and could not see it making any difference in the Basel 2 Accord implementation. Also the present structure of the Nigerian banking industry is still dependent on the theoretical definition of risk and its management as they apply to foreign countries. No one seems to have taken the pain to identify risks peculiar to the Nigerian political and economic terrain with a view to fashioning out a robust risk identification and management structure just for Nigeria. All the respondents in this survey however agree that a robust risk management system must be in place before Basel 2 Accord can be successfully implemented. They nevertheless disagreed that the banks must comply with the comprehensive risk management framework as spelt out in the Basel 2 Accord before the Accord can be implemented successfully.

The findings in this research are in tune with existing knowledge only that it is high time the Nigerian banking industry started looking at the Nigerian banking and investing public as being different from those they read of in overseas textbooks. The CBN appears saddled with so much responsibility that a review is imperative. The CBN was ostensibly patterned after the Bank of England, which was started as a private corporation and had since been stripped of most of its original functions. The Bank of England no longer mints or supervises the banks. The United States Federal Reserve is still a private organisation owned by member commercial banks in the United States. The CBN on the other hand continues to be a one hundred percent government owned company with all its original functions intact. The command and control structure of its approved banks remains its central function.

Another significant finding in this research is the absence of through the statue of the CBN any representative of the commercial banks on its board. The same goes for the board of the NDIC. This appears to be a major flaw as the regulation of the banking industry is devoid of the operators' participation, thus leaving the exercise in the hands of the supervisors/regulators who understand the commercial banks only through what they hear at seminars or read in textbooks. They never worked in commercial banks. Commercial bank workers are also handicapped the same way, as they too never worked in CBN before.

Depositors also lacked representatives on the boards of these two corporations even though it is their hard-earned money that commercial banks wine and dine over with the supervisors supervising them.

PROOF OF HYPOTHESES

Proof for null Hypothesis One (Ho_1):

From the table 4.6.1, the calculated χ^2-value of 240.77 is greater than the critical χ^2-value of 7.82 at 3df and 0.05 levels of significance while the from table 4.4 the calculated mean response value of 3.49 was found to be high enough to support the statement which states that "The technical competence of the board and management of all the banks in Nigeria need to be redefined or restructured before Basel 2 Accord can be successfully implemented from which the hypothesis is framed. The computed χ^2- value of 240.77 shows that $\chi^2 T < \chi^2 C$ according to the decision rule hence the null hypothesis is rejected, while the alternate hypothesis is accepted. This therefore implies that the technical competence of the board and management of all the banks need to be redefined or restructured before Basel 2 Accord can be successfully implemented.

Proof for Null hypothesis two (Ho_2)

From the result in table 4.6.2, the calculated χ^2-value of 58.95 is greater than the critical χ^2- value of 7.82 at 3df and 0.05 levels of significance or 95% confidence level while the calculated mean response value of 2.86 in table 4.4 supporting this hypothesis fell within the mean response level of agreement according to the four-point likert scale. Judging from calculated χ^2-value of 58.95 over the critical value of 7.82 ($\chi^2 C > \chi^2 T$). This therefore infers that the null hypothesis is rejected, while the alternate hypothesis is accepted. Hence there is need for Nigerian banks to be able shoulder Nigeria's debt rescheduling strategies before Basel 2 can successfully be implemented in Nigeria.

Proof for Null hypothesis three (Ho_3)

From the result table 4.6.3, on the analysis of the hypothesis which states that the high ownership concentration of certain board of directors of some banks need to be decentralised in order to remove hitches of one-man or key-man dominance before Basel 2 can successfully be implemented. The calculated χ^2-value of 122.45 was found to be greater than the critical χ^2- value of 7.82 at 3df and 0.05 levels of significance while the mean response value of 1.84 on the item in table 4.4 from which the hypothesis was framed was found to be low and in favour of majority response for those who disagreed with the statement which states that "The high ownership concentration of certain board of directors of some banks have to be decentralised in order to remove hitches of one-man or key-man dominance before Basel 2 can successfully be implemented. When this observation is used as yardstick one expects the computed χ^2-value to be lower than the critical χ^2-value. However a contrary result was obtained which supports the rejection of the null hypothesis, while the alternate hypothesis which states that the high ownership concentration of certain board of directors of some banks need to be decentralised in order to remove hitches of one-man or key-man dominance before Basel 2 can successfully be implemented is accepted.

Proof for Null hypothesis four (Ho_4)

From the results in table 4.6.4 above, the calculated χ^2-value of 16.47 is greater than the critical χ^2- value of 7.82 at 3df and 0.05 levels of significance while the computed mean response value of 2.69 for the statement in table 4.4 addressing this hypothesis was found to fall within the range for those who agreed with this statement. Hence it can confidently be said that the result shows that the null hypothesis is rejected since ($\chi^2C > \chi^2 T$), while the alternate hypothesis which states that the issue of knowledge gaps in the competence of the Board of management, the harmonised role and salary structure of staff with an improved working environment need to be met before Basel 2 can successfully be implemented is accepted.

Proof for Null hypothesis five (Ho_5)

From the result in table 4.6.5, the calculated χ^2-value of 47.18 was found to be greater than the critical χ^2- value of 7.82 at 3df and 0.05 levels of significance while the computed mean response value of 3.08 in table 4.4 for the statement addressing the hypothesis was found to be high and fell within the four-point likert scale of agreement meaning that the Nigerian political climate must be stable for any meaningful banking practice to take place before Basel 2 can successfully

be implemented. Judging from the calculated χ^2-value of 47.18 which was also found to be greater than the critical value of 7.82 ($\chi^2C > \chi^2 T$) at the 95% confidence level shows that the null hypothesis is rejected, while the alternate hypothesis is accepted. This therefore implies that Nigeria need to evolve a stable political climate for any meaningful banking practice to take place even before Basel 2 can successfully be implemented.

Proof for Null hypothesis six (Ho_6)

The result in table 4.6.6 showed that the calculated χ^2-value of 51.80 is greater than the critical χ^2- value of 7.82 at 3df and 0.05 levels of significance while the result in table 4.4 for the statement addressing the hypothesis found that the calculated mean response value of 2.93 was high enough to infer degree of agreement on the statement that states' The present merging process of aligning different entities of mergers will have to be properly integrated and should be in line with Basel 2 guidelines before Basel 2 Accord can successfully be implemented. Hence the computed χ^2-value of 51.80 shows that the null hypothesis is rejected, while the alternate hypothesis which states that the present merging process of aligning different entities of mergers will need to be integrated and in line with Basel 2 guidelines before Basel 2 Accord can successfully be implemented is accepted.

Proof for Null hypothesis seven (Ho_7)

From the result in table 4.6.7, the calculated χ^2-value of 110.33 is greater than the critical χ^2- value of 7.82 at 3df and 0.05 levels of significance. This shows that the null hypothesis is rejected, while the alternate hypothesis is accepted while the calculated mean response value of 3.15 on the statement from which the hypothesis is framed was found to be high and fell within the four-point likert scale of agreement with the statement. Since the ($\chi^2C > \chi^2 T$) it therefore implies that the banks need to go beyond their present level of information technology systems which have to be integrated with their accounting systems and record before Basel 2 can successfully be implemented. Hence the acceptance of the alternate hypothesis.

Proof for Null hypothesis eight (Ho_8)

The result in table 4.6.8 showed that the calculated χ^2-value of 16.91 is greater than the critical χ^2- value of 7.82 at 3df and 0.05 levels of significance. This result shows that the null hypothesis is rejected, while the alternate hypothesis which states that the present management capacity of most banks need to be overhauled and re-invigorated with directors and managers that possess the inert qualities of good banking experience before Basel 2 can successfully be implemented is accepted.

This observation was supported by the computed mean response value of 3.15 which fell within the four-point likert scale of agreement with the statement in table 4.4 which states that

The present management capacity of most banks have to be overhauled and re-invigorated with directors and managers that possess the inert qualities of good banking experience before Basel 2 can successfully be implemented in Nigeria.

Proof for Null hypothesis Nine (Ho_9)

From the table 4.6.9, the calculated χ^2-value of 289.52 is greater than the critical χ^2-value of 7.82 at 3df and 0.05 levels of significance. This shows that the null hypothesis is rejected, while the alternate hypothesis is accepted. This therefore implies that a robust risk management need to be in place before Basel 2 can successfully be implemented. This observation was supported by the computed mean response value of 3.55 in table 4.4 which confirms a high degree of agreement with the statement which states that '*a robust risk management should be in place in Nigeria before Basel 2 can successfully be implemented.*

Proof for Null hypothesis Ten (Ho_{10})

The result in table 4.6.10 showed that the calculated χ^2-value of 8.63 was found to be greater than the critical χ^2- value of 7.82 at 3df and 0.05 levels of significance. This result shows that the null hypothesis is rejected, while the alternate hypothesis which states that the issue of resurgence of high level malpractices such as round-tripping of forex, falsification of records, insider- abuses etc need to be addressed before Basel 2 can successfully be implemented. This observation was supported by the observed view on the computed mean response value of 2.65 which was found to fall with the four- point likert scale of agreement with the statement in table 4.4 from which the hypothesis was framed.

Proof for Null hypothesis Eleven (Ho_{11})

From the result in table 4.6.11, the calculated χ^2-value of 90.33 was found to be greater than the critical χ^2- value of 7.82 at 3df and 0.05 levels of significance. This shows that the null hypothesis is rejected, while the alternate hypothesis is accepted. This therefore implies that the problems associated with rendition of false returns, continued concealment need to be addressed before Basel 2 can successfully be implemented. This observation is also in conformity with the observed view based on the computed mean response value of 3.10 which was found to be high based on the statement in table 4.4 addressing the hypothesis

Proof for Null hypothesis Twelve (Ho_{12})

The result in table 4.6.12 showed that the calculated χ^2-value of 111.18 is greater than the critical χ^2- value of 7.82 at 3df and 0.05 levels of significance while the computed mean response value of 3.05 in table 4.4 for the statement which states that the Inadequate operational and financial control of most banks in Nigeria must strictly be addressed before Basel 2 can successfully be implemented from which the hypothesis is formulated is high and fell within the four-point likert scale for those who agreed with the statement supports the hypothesis. However the calculated value of 111.18 was found to be greater than the critical χ^2- value of 7.82 and as such shows that the null hypothesis is rejected, while the alternate hypothesis which states that inadequate operational and financial control of most banks must strictly be addressed before Basel 2 can successfully be implemented is accepted.

Proof for Null hypothesis Thirteen (Ho_{13})

From the result in table 4.6.13, the calculated χ^2-value of 327.97 is greater than the critical χ^2- value of 7.82 at 3df and 0.05 levels of significance. This shows that the null hypothesis is rejected, while the alternate hypothesis is accepted. When the computed mean score of 3.05 from the statement in table 4.4 from which the hypothesis was framed was assessed it was found to fall within the four-point scale of agreement. This therefore implies that Nigerian banks need to go beyond their present transparency level and always adequately disclose information (e.g. risk management strategies, risk concentration, performance measures e.t.c) to the stakeholders before Basel 2 can successfully be implemented.

Proof for Null hypothesis Fourteen (Ho_{14})

The result in table 4.6.14 showed that the calculated χ^2-value of 26.11 is greater than the critical χ^2- value of 7.82 at 3df and 0.05 levels of significance. This result shows that the null hypothesis is rejected, while the alternate hypothesis which states that Nigerian banks need to fully comply with the comprehensive risk management framework as spelt out by the Basel 2 recommendation before Basel 2 can successfully be implemented. When the computed mean response value of 2.24 in table 4.4 was used to proof the hypothesis, this value was found to be low and falls within the likert point scale for those who disagreed with the hypothesis. However when used to assess the hypothesis it ran contrary to the observed view of the respondents.

Proof for Null hypothesis Fifteen (Ho_{15})

From the result in table 4.6.15, the calculated χ^2-value of 3.75 is less than the critical χ^2- value of 7.82 at 3df and 0.05 levels of significance. This shows that the null hypothesis is accepted, while the alternate hypothesis is rejected. This therefore implies that Nigerian bank's risk management framework need not capture all the risks the banks are likely to encounter before Basel 2 can successfully be implemented. When the calculated mean response value of 2.48 in table 4.4 was used to assess the hypothesis it was found to be low and fell within the likert point-scale for those who disagreed with the statement. This observation supports the postulated hypothesis.

Proof for Null hypothesis Sixteen (Ho_{16})

The result in table 4.6.16 showed that the calculated χ^2-value of 108.02 is greater than the critical χ^2- value of 7.82 at 3df and 0.05 levels of significance. This result shows that the null hypothesis is rejected, while the alternate hypothesis, which states that the credit ratings of Nigerian Banks need to essentially meet up with that of Basel's 2 recommendations before Basel 2 can successfully be implemented is accepted. The calculated mean response value of 2.05 was found to be low from the statement from which the hypothesis was framed, showing that the respondents disagreed with the statement which states that "The credit ratings of Nigerian Banks have to essentially meet up with that of Basel 2 Accord recommendations before Basel 2 can successfully be implemented." This result however is at variance with the observation made from the calculated χ^2-value.

As a matter of fact the rating of Nigeria as a Very High Risk country as shown in this research makes it one of the Less Developed Economies that the Basel Accords are being expected to prevent G10/OECD countries from lending to through the imposition of regulatory capital on any attempted accommodation by their banks.

The low rating of the country even by FitchIBCA will make lending to it expensive to the banks and its bonds a hard sell.

As shown in this research many institutional and structural changes must take place in the Nigerian banking industry before Basel 2 Accord can be successfully implemented.

CHAPTER VI

SUMMARY OF FINDINGS

INTRODUCTION

This chapter highlights the summary, conclusion and the recommendations of the research study after finding answers to the research questions and testing the hypotheses postulated for the study.

5.1 SUMMARY OF FINDINGS

The following findings were made after analyzing the research questions and the hypotheses formulated for the study:

The technical competence of the board and management of all the banks need to be fine-tuned before Basel 2 Accord can be successfully implemented. This is

because the challenges posed by the Basel 2 Accord requires individual with superb technical know-how. It was recorded that there is need for Nigerian banks to be able shoulder Nigeria's debt rescheduling strategies before Basel 2 Accord can successfully be implemented. Further finding revealed that the high ownership concentration of certain board of some banks needs to be decentralized in order to remove hitches of one-man or key-man dominance before Basel 2 Accord can successfully be implemented in Nigeria.

It was also revealed that the issue of knowledge gaps in the competence of the Board of management, the harmonized role and salary structure of staff with an improved working environment need to be met before Basel 2 Accord can successfully be implemented.

Nigeria also needs to evolve a stable political climate for any meaningful banking practice to take place even before Basel 2 Accord can successfully be implemented.

The finding also showed that the present merging process of aligning different entities of mergers will need to be integrated and in line with Basel 2 Accord guidelines before Basel 2 Accord can successfully be implemented. Nigerian banks need to go beyond their present level of information technology systems which have to be integrated with their accounting systems and record before Basel 2 Accord can successfully be implemented. Similarly the present management capacity of most banks need to be overhauled and re-invigorated with directors and managers that possess the inert qualities of good banking experience before Basel 2 Accord can successfully be implemented. On the issue of risk management it was observed that a robust risk management needs to be in place before Basel 2 Accord can successfully be implemented.

The issue of resurgence of high-level malpractices such as round tripping of forex, falsification of records, insider- abuses etc also need to be addressed before Basel 2 Accord can successfully be implemented. The finding of this research also revealed that the problems associated with rendition of false returns, continued concealment need to be addressed before Basel 2 Accord can successfully be implemented. It was also recorded thatinadequate operational and financial control of most banks must strictly be addressed before Basel 2 Accord can successfully be implemented.

Nigerian banks need to go beyond their present transparency level and always adequately disclose information (e.g. risk management strategies, risk concentration, performance measures e.t.c) to the stakeholders before Basel 2 Accord can successfully be implemented. Further result showed that Nigerian

banks need to fully comply with the comprehensive risk management framework as spelt out by the Basel 2 recommendation before Basel 2 Accord can successfully be implemented. However it was observed that Nigerian bank's risk management framework need not capture all the risks the banks are likely to encounter before Basel 2 can successfully be implemented. Finally the credit ratings of Nigerian Banks need to essentially meet up with that of Basel's 2 recommendations before Basel 2 Accord can successfully be implemented.

CONCLUSION

Part of what this research has brought to focus is the relevance of the central banks in financial intermediation between a commercial bank and its customer. The scenario is something like this:

A commercial bank as a CBN licensed private initiative opens its doors for business like any other organisation. A customer comes in and deposits his money based on his belief that the CBN / NDIC control the activities of the bank. As soon as he turned his back the bank lends this money to any one based on their judgement. Neither the CBN nor the NDIC would be part of this decision; they also need not to be informed until the debt goes bad. Should many of such debts go bad in a bank enough to render it insolvent the CBN has the duty to order it closed without any forewarning to the bank's account holding customers. Once the bank has been closed the NDIC comes in to marshal the assets and liabilities of the bank with a promise to pay a maximum amount to owners of insured deposits at a future date. A bank failure had occurred and the helpless depositors will bear the brunt. The bank would come up with all the reasons for the failure of the bank except their own bad judgement. The shareholders would have recouped their investment many times over and would have little if anything to lose. It is the depositor that loses everything. The question becomes whether the CBN actually controls the banks apart from adjusting rates, which actually ought to be a function of market forces.

Bank failures are what Basel 2 Accord is being expected to prevent and the Third Pillar is on Market Discipline, which recognises the depositor as a stakeholder that is entitled to information on what the bank is doing with his money. As proved in this research many structural and institutional changes must take place in the Nigerian banking industry before the Basel 2 Accord can be successfully implemented.

RECOMMENDATIONS

(1) The role of the CBN must be redefined as to whether it should continue to perform all the original functions including the supervision of commercial banks. This author recommends that the CBN should be stripped of its role as the supervisors of commercial banks in the light of continuous failure of banks in the country and the civil service structure of the apex bank.

(2) The role of the NDIC should also be redefined as to whether the protection it purports to offer depositors is the type actually needed in the light of its status as a one hundred percent government owned corporation like the CBN. This author recommends that there should be an enabling law allowing the formation of Non Governmental Organisations to provide additional protection outside these two government controlled organizations.

(3) Both the boards of the CBN and the NDIC should have representatives of commercial banks on their boards as members to enlighten them on many issues the regulatory authorities could be taking for granted because of the present command and control structure of bank supervision.

(4) The Basel 1 Accord requirement of 8% ratio of weighted risk asset to capital should be carried out as stipulated in the Accord especially the deduction of the amount from a bank's profit. The Accounting Standards Board should see to the creation of Loan Loss Reserve as part of a bank's capital and this is where the regulatory capital of 8% should go. The regulatory authorities should further require commercial banks to stress test their performance with a view to recognising potential future losses and provisioning for them. The outcome of this exercises would be a leaner

profit that could translate into lower dividend if any, but ultimately resulting into stronger capital bases for the banks, less taxes, reduced strain on the banks' resources and capital appreciation for the shareholders. The ability of the banks to withstand future shocks and economic downturns would be greatly enhanced and bank failures could be drastically reduced.

(5) Banks in Nigeria should take the pains to recognize the risks peculiar to the country's banking industry and address them instead of copying foreign versions of risks and pretending they are applicable to Nigeria.

(6) All lending by banks in Nigeria should be by way of loans instead of overdrafts as being done presently. This is because loans are repayable in instalments over an agreed period of time and a default could easily be ascertained more quickly than in the cases of overdrafts that may never be repaid because there would never have been such agreement.

7) Increase Financial Transparency and Enforcement of Accounting Standards

8) Create credible alternative channels for capital formation through equity and debt markets.

APPENDICE

THE BASEL 2 ACCORD

QUESTIONNAIRE ON PILLAR 1 – MINIMUM CAPITAL REQUIREMENT

(1) Pillar 1 of the Basel 2 Accord is on minimum regulatory capital requirements for internationally active banks in G10/OECD countries and significant banks in other economies. Internationally active banks are very large international banks doing cross-border lending to sovereigns and corporate bodies within them, while significant banks are those banks big enough to upset the economies of their countries should they become insolvent.

Would you consider your bank a significant bank in Nigeria?

(a) Yes

(b) No

(c)

(d) I Don't Know.

(e)

(2) The Regulatory Capital of a bank is as prescribed by the Central Bank of Nigeria (CBN) and other Supervisory bodies like the Nigeria Deposit Insurance Corporation (NDIC), etc. Other types of Capitals are Economic capital and Available capital. The idea behind the Basel 2 Accord is that once regulatory capital was strong and kept strong consistently, it could act as a buffer to a commercial bank during economic downturns.

Do you agree with this idea?

(a) Yes

a.

(b) No

Please give reasons.

(3) A major requirement under the Accord is external ratings of sovereigns and corporates within them by an internationally recognized credit rating agency the likes of Standard and Poor's, Moody's Investor Services, and FitchIBCA.

Do you think Nigeria has such?

(a) Yes

(b) No

If yes, please name them.)

(4) Are there internal rating systems for your customers?

(a) Yes

(b) No

(5) Are you aware of your bank's foreign currency denominated lending to the government of a foreign country, its Central Bank, corporate or banks in it or its Public Sector Entities (PSE)?

(a) Yes

(b) No

If yes, please state the amount in the foreign currency denomination and if possible, the counterparty.

(6) Are you aware of any your bank's foreign currency lending secured by commercial or residential real estates outside the shores of Nigeria?

(a) Yes

(b) No

If yes, please state the value and the counterparty.

(7) If your answer to either question 5 or 6 is yes, are you aware of the credit ratings of the sovereign or counterparty offshore prior to the approval of the facility?

(a) Yes

(b) No

If yes, what were they?

(8) What is Asset Securitization?

(a) Security for a facility

(b) A bank's group of identical assets and funds flow sold as security to a third party.

© None of the above.

(9) Operational Risk is being defined under the Basel 2 Accord as the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events. A minimum regulatory capital of 8% is to be set aside for every exposure under this heading.

Do you consider this risk as relevant to the Nigerian banking industry?

(a) Yes

(b) No

© I don't know

(10) Do you keep a permanent record in your Branch or Department of periods and duration of host failures?

(a) Yes

(b) No

(11) Do you keep a permanent record of all Branch errors and defalcations as to the date and amount involved?

(a) Yes

(b) No

(12) Do you keep a permanent record of all natural disasters that impacted negatively on Branch or Department's operations?

(a) Yes

i.

(b) No

(13) Do you keep a permanent record of all the bad debts created by accounts domiciled in your Branch within the past three (3) years at least?

(a) Yes

(b) No

OPTIONAL

Name: Department:
Status:

THE BASEL 2 ACCORD

QUESTIONNAIRE ON PILLAR 2 – SUPERVISORY REVIEW PROCESS

The Pillar 2 of the Basel 2 Accord is on the Supervisory Review Process, and it has more to do with the CBN / NDIC as supervisors / regulators of the Nigerian banking industry than the commercial banks themselves directly.

(1) As supervisors, would you say commercial banks in Nigeria have enough loss data internally that could help the CBN/NDIC to review the adequacy of the risk measures they could use in assessing their internal capital adequacy?

(a) Yes

(b) No

(2) If the answer to No 1 is 'Yes', to what extent would you say they should use this loss data operationally in setting limits, evaluating business line performance and controlling risk generally in line with the Basel 2 Accord?

(a) Small

(b) Reasonable

(c) Large

(3) If the answer to No. 1 is 'No', what source would you say they should depend on for the loss data they would need to assess their capital adequacy in line with Basel 2 Accord?

(a) The CBN Credit Risk Management System

(b) External credit rating Agency

© All of the above

(d) None of the above

(4) Would it be correct to say that the guideline of risk-based supervision being adopted by the CBN as contained in the publication "Framework for Risk-based Supervision of Banks in Nigeria" dated December 13, 2005 was patterned after that of the Financial Services Authority (FSA) of the United Kingdom instead of those contained in the Basel Committee's publication titled "Core Principles for Effective Banking Supervision"?

(a) Yes

(b)
No

(5) If the answer to No 4 is 'Yes', which of the following reasons would be more appropriate to justify the preference?

(a) The Nigerian banking industry has more in common with the British banking industry than with the Americans.

(b) The banking industry in Nigeria does not have the capacity yet to meet the requirements of the Basel Committee's recommendation as contained in their publication "Core Principles for Effective Banking Supervision".

© The Basel Committee's recommendations as contained in their publication are too complicated for the Nigerian banking industry to implement.

(6) If the answer to No. 4 is 'No', would you say the Nigerian banking industry has fulfilled the Basel Committee's five preconditions for assessing effective banking supervision environment? These are:

(i) Sound and sustainable macro-economic policies;

(a)

Yes

(b)

No

(ii) A well-developed public infrastructure;

(a) Yes

(b)

No

(iii) Effective market discipline;

(a)

Yes

(b)

No

(iv) Procedures for efficient resolution of problem in banks;

(a)

Yes

(b)

No

(v) Mechanisms for providing an appropriate level of systemic protection (or public safety net)

(a) Yes

(b)

No

(7) According to the Banking Supervision Annual Report 2004 of the CBN, Nigeria has fully complied with 10 out of the 25 Basel Committee's Core Principles for Effective Banking Supervision (BCP) as at that year.

What is the level of compliance now with each of the remaining 15 listed below as they relate to Externally Assisted Assessment?

BCP 1.1 Responsibilities and objectives

(a)

C

(b)

LC

			(c)
			MNC
			(d)
			NC
“		1.2	
		Independence and resources	
			(a)
			C
			(b)
			LC
			(c)
			MNC
			(d)
			NC
“	1.3	Legal framework	
			(a)
			C
			(b)
			LC
			(c)
			MNC
			(d)
			NC
“	1.5	Legal protection	
			(a)
			C
			(b)

			LC
			(C)
			MNC
			(d)
			NC
“	1.6	Information sharing	
			(a)
			C
			(b)
			LC
			(C)
			MNC
			(d)
			NC
“	6.0	Capital adequacy	
			(a)
			C
			(b)
			LC
			(C)
			MNC
			(d)
			NC
“	7.0	Credit policies	
			(a)
			C
			(b)

			LC
			(C)
			MNC
			(d)
			NC
“	8.0	Loan Evaluation and Loss provision	**(a)**
			C
			(b)
			LC
			(C)
			MNC
			(d)
			NC
“	9.0	Large exposure limits	**(a)**
			C
			(b)
			LC
			(C)
			MNC
			(d)
			NC
“	10.0	Connected lending	**(a)**
			C
			(b)

			LC
			(C)
			MNC
			(d)
			NC
“	11.0	Country Risk	
			(a)
			C
			(b)
			LC
			(C)
			MNC
			(d)
			NC
“	12.0	Market risks	
			(a)
			C
			(b)
			LC
			(C)
			MNC
			(d)
			NC
“	13.0	Other risks	
			(a)
			C
			(b)

			LC
			(C)
			MNC
			(d)
			NC
“	14.0	Internal control and Audit	**(a)**
			C
			(b)
			LC
			(C)
			MNC
			(d)
			NC
“	20.0	Consolidated supervision	**(a)**
			C
			(b)
			LC
			(C)
			MNC
			(d)
			NC
“	21.0	Accounting and disclosure	**(a)**
			C
			(b)

			LC
			(C)
			MNC
			(d)
			NC
“	22.0	Remedial Measures	
			(a)
			C
			(b)
			LC
			(C)
			MNC
			(d)
			NC
“	23.0	Global Consolidated Supervision	
			(a)
			C
			(b)
			LC
			(C)
			MNC
			(d)
			NC
“	24.0	Host Country Supervision	
			(a)
			C
			(b)

			LC
			(C)
			MNC
			(d)
			NC
“	25.0	Supervision of foreign banks	**(a)**
			C
			(b)
			LC
			(C)
			MNC
			(d)
			NC
NOTE:			**(a)**
			C
			=
			Compliant
	(b)		LC
			=
			Largely Compliant
	©		MNC
			=
	Materially		Noncompliant

(D) NC = Noncompliant

(8) How soon do you think Nigeria would be able to be compliant with the Basel 2 Accord?

(a)Three years

(b)More than three years

© Less than three years

OPTIONAL

NAME:……

POSITION HELD:……

THE BASEL 2 ACCORD

QUESTIONNAIRE ON PILLAR 3 – MARKET DISCIPLINE

(1) Should banks disclose their Tier 1 and total capital adequacy ratios, and their components to the public on a quarterly basis?

(a) Yes

(b) No

© I don't know.

(2) Should a bank provide a general summary of its risk management objectives and policies, reporting systems and definition to the public on an annual basis?

(a) Yes

(b) No

© I don't know.

(3) Do you agree that the following should be disclosed to the public?

(i) Summary information on the terms and conditions of the main features of all capital instruments.

(a) Yes

(b) No

© I don't know.

(ii) The amount of Tier 1 capital with separate disclosure of the component.

(a) Yes

(b) No

© I don't know.

(iii) The total amount of Tier 2 and Tier 3 capital.

(a) Yes

(b) No

(c) I don't know.

(iv) Deductions from Tier 1 and Tier 2 capital.

(a) Yes

(b) No

© I don't know.

(v) Total eligible capital.

(a) Yes

(b) No

© I don't know.

(vi) A summary discussion of the bank's approach to assessing the adequacy of its capital to support current and future activities.

(a)
Yes

(b) No

© I don’t know.

(vii) Capital requirements for credit risk.

(a) Yes

(b) No

© I don’t know.

(viii) Capital requirements for market risk.

(a) Yes

(b) No

© I don’t know.

(ix) Capital requirements for operational risk.

(a) Yes

(b) No

© I don’t know.

(x) Total and Tier 1 capital ratio.

(a) Yes

(b) No

© I don't know.

(4) For each separate risk area (e.g. credit, market, operational, equity) the Basel 2 Accord is requiring banks to describe and disclose their risk management objectives and policies including:

- Strategies and processes;
- The structure and organization of relevant risk management function;
- The scope and nature of risk reporting and/or measurement systems;
- Policies for hedging and/or mitigating risk and strategies and processes for monitoring the continuing effectiveness of hedges/mitigants?

Do you agree that these should be disclosed?

(a) Yes

(b) No

© I don't know.

(i) Definition of past due and impaired loans for accounting purposes.

(a) Yes

(b) No

© I don't know.

(ii) Description of approaches followed for specific and general allowances and statistical methods.

(a) Yes

(b) No

© I don't know.

(iii) Discussion of the bank's credit risk management policy.

(a) Yes

(b) No

© I don't know.

(iv) Total gross credit risk exposures broken down in significant areas by major types of credit exposure.

(a) Yes

(b) No

© I don't know.

(v) Geographical distribution of exposures, broken down in significant areas by major types of credit exposures.

(a) Yes

(b) No

© I don't know.

(vi) Industry or counterparty type distribution of exposures, broken down by major types of credit exposure.

(a) Yes

(b) No

© I don't know.

(vii) Residual contractual maturity breakdown of the whole portfolio broken down by major types of credit exposure.

(a) Yes

(b) No

© I don't know.

(5) Counterparty type by major industry for:

- Amount of past due / impaired loans
- Specific and general allowances; and
- Charges for specific allowances and charges-offs during the period.

DO YOU AGREE THAT THESE SHOULD BE DISCLOSED?

(a) Yes

(b) No

© I don't know.

(i) Reconciliation of changes in the allowances for loan impairments.

(a) Yes

(b) No

© I don't know.

OPTIONAL

Name

Department:

Status:

SECTION D

The following items are designed to seek your candid opinion on some structural and institutional factors likely to influence the successful implementation of the Basel 2 Accord in Nigerian Banks.

	SA	A	D	SD
1. *The technical competence of the board and management of all the banks in Nigeria need to be redefined or restructured before Basel 2 Accord can be*				

successfully implemented.				
2. *The high ownership concentration of certain board of directors of some banks have to be decentralised in order to remove hitches of one-man or key-man dominance before Basel 2 can successfully be implemented.*				
3. *Basel 2 Accord cannot be successfully be implemented if Nigerian banks cannot shoulder Nigeria's debt rescheduling strategies.*				
4. *The Nigerian political climate must be stable for any meaningful banking practice to take place before Basel 2 can successfully be implemented.*				
5. *There is need for the issue of knowledge gaps in the competence of the Board of management, the harmonised role and salary structure of Bank staffers with an improved working environment for Basel 2 to be successfully implemented in Nigeria.*				
6. *Banks in Nigeria need to go beyond their present level of information technology development before Basel 2 can successfully be implemented.*				
7. *The present merging process of aligning different entities of mergers will have to be properly integrated and should be in line with Basel 2 guidelines before Basel 2 Accord can successfully be implemented.*				
8. *The present management capacity of most banks have to be overhauled and re-invigorated with directors and managers that possess the inert qualities of good banking experience before Basel 2 can successfully be implemented in Nigeria.*				
9. *A robust risk management should be in place in Nigeria before Basel 2 can successfully be implemented.*				
10. *The issue of resurgence of high level malpractices such as round-tripping of forex, falsification of records, insider- abuses etc have to be addressed among banks in Nigeria.*				
11. *Inadequate operational and financial control of most banks in Nigeria must strictly be addressed before Basel 2 can successfully be implemented.*				
12. *The problems associated with rendition of false returns, continued concealment should be addressed before Basel 2 can successfully be implemented.*				
13. *Nigerian banks have to fully comply with the comprehensive risk management framework as spelt*				

out by the Basel 2 Accord recommendations before Basel 2 can successfully be implemented.				
14. *Nigerian banks have to go beyond their present transparency level and always adequately disclose information (e.g. risk management strategies, risk concentration, performance measures e.t.c) to the stakeholders before Basel 2 can successfully be implemented.*				
15. *Nigerian bank's risk management framework have to capture all the risks Nigeria banks are likely to encounter before Basel 2 can successfully be implemented.*				
16. *The credit ratings of Nigerian Banks have to essentially meet up with that of Basel 2 Accord recommendations before Basel 2 can successfully be implemented.*				