Basel III in Nigeria: making it work

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Abstract

Basel III is a framework to preserve the stability of the international banking system. Nigeria adopts Basel capital framework for capital regulation in the banking sector. This article is a policy discussion on how to make Basel III work in Nigeria. The significance of Basel III is discussed, and some ideas to consider when implementing Basel III to make it work in Nigeria, are provided. Under Basel III, the Nigerian banking system should expect better capital quality, higher levels of capital, the imposition of minimum liquidity requirement for banks, reduced systemic risk, and a transitional arrangement for transitioning across Basel I and II. This article also emphasizes that (i) there should be enough time for the transition to Basel III in Nigeria, (ii) a combination of micro- and macro- prudential regulations is needed; and (iii) the need to repair the balance sheets of banks, in preparation for Basel III. The study recommends that the Nigerian regulator should enforce strict market discipline and ensure effective supervision under the Basel framework. There should be international cooperation between the domestic bank regulator and bank regulators in other countries. The regulator should have a contingency plan to reassure the public of the safety of their deposits, and there should be emergency liquidity solutions to support the financial system in bad times.

JEL codes: E44, G21, G28

Keywords: Basel III, Bank Business Models, Bank Performance, Financial Stability, Capital Regulation, Bank Regulation, Nigeria

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1. Introduction

This article presents a discussion on Basel III in Nigeria and how to make it work.

In 2010, the Basel committee reached an agreement to strengthen financial regulation by introducing a global liquidity standard, and by increasing the global minimum capital standards for commercial banks which is known as the Basel III capital accord. In addition to capital regulation, Basel III require bank supervisors to consider the role of macroeconomic policies, both monetary and fiscal, in promoting stability in their respective banking systems. Many developed countries particularly European countries have fully implemented Basel III while many African countries, including Nigeria, have not fully adopted Basel III and are still in the process of implementing Basel II.

Some Central Banks feel obliged to adopt and implement Basel III standards, even though Basel III standards may not meet the needs and circumstances of their banking systems (Ozili, 2019a&b). Other African bank supervisors plan to adopt Basel III at a later period because they feel they need enough time to study the monetary policy requirements needed to cater for Basel III. Some argue that Basel III only applies to sophisticated banking systems - such as those in Europe, and that African banking systems are not sophisticated and therefore do not need sophisticated banking regulations like Basel III. On the political level, some bank supervisors have opposed and rejected Basel III recommendations because they want to preserve the country's national identity – they feel that adopting foreign laws or regulations will lead to loss of national identity, Ethiopia is a classic example.

Other African bank supervisors understand the need to strengthen the resilience of their banking systems to adverse shocks, and Nigeria is one of them. Promoting banking stability in Nigeria is important and would require a broad micro- and macro- financial policy framework. Basel III in Nigeria will form a key part of the wider agenda coordinated by the Central bank to build a safer financial system and ensure its resilience to financial crises and economic recessions.

The study makes two contributions to the literature. First, the discussions in this article contribute to the policy debates on the effect of Basel III regulation on the banking system of developing and developed countries (see Blundell-Wignall and Atkinson, 2010; Kalloub et al, 2018; Yan et al, 2012; etc). Secondly, the discussion contributes to the literature that analyse how banking supervision and regulation works in African economies (see Van Vuuren, 2012; Adesina, 2019; Ozili, 2019b). Extending the debate to Nigeria, it is important to explore how regulation and supervision can work in Nigeria given the financial market imperfections, weak enforcement, political interference in banking regulation, limited sources of information and shallow capital markets. Thirdly, it contributes to the literature that examine the possible effect of regulation and supervision on bank behavior and risk-taking (see Laeven and Levine, 2009; Lall, 2009, Ozili, 2019a). This literature argue that strict regulation and supervision can reduce excessive risk-taking in banks and can improve the stability of banks in stressed times, which is what bank regulators want.

The rest of the article is organized as follows. Section 2 discuss the objective, importance and progress of Basel III in Africa. Section III discuss how to make Basel III work in Nigeria. Section 4 discuss the challenges of Basel III adoption and how to minimize them. Section 5 present some recommendations, and Section 6 concludes.

2. Basel III: Objective, Importance and Progress in Nigeria

Basel accord is a framework to preserve the stability of the international banking system, and Nigeria adopts Basel capital framework for capital regulation in the banking sector. The purpose of the Basel accords is to design a framework to preserve the stability of the international banking system.

Basel 1 was the first set of capital accords issued by the Basel Committee for Banking Supervision (BCBS). Basel 1 was issued in 1988. Basel 1 was designed to enhance understanding of key supervisory issues and improve the quality of banking supervision across countries. In 1997, the BCBS issued the "Core Principles for Effective Banking Supervision", which provided a comprehensive framework for effective banking supervision.

Basel II accord primarily focused on financial soundness. It was designed to enhance capital regulation by introducing risk weights, aligning bank regulation with best practices in risk management, and provide banks with incentives to enhance risk measurement and management capabilities. Basel II was initially issued in 1999. The BCBS issued a first, second, third and fourth consultative papers for Basel II in 1999, 2001, 2003 and 2004 respectively. Basel II accord was amended in 2005 and 2006, and a final version approved in 2008.

The Basel III accord was developed by the BCBS due to the impact of the global financial crisis on banks. Basel III places great importance on liquidity and impact of economic cycles on financial system risks. Basel III builds on the previous accords, Basel I and II, and is part of a continuous process to enhance regulation in the banking industry (see table 1). There are three (3) key principles of Basel III. The first principle is the ‘minimum capital requirements’. The Basel III accord increased the minimum capital requirements for banks from 2% in Basel II to 4.5% of common equity, as a percentage of the bank’s risk-weighted assets. There is also an additional 2.5% buffer capital requirement that will bring the common equity to 7%. The second principle is the ‘leverage ratio’. Basel III introduced a non-risk based leverage ratio which require banks to hold at least a 3% leverage ratio. The non-risk based leverage ratio is calculated by dividing Tier 1 capital by the average total consolidated assets of a bank. The third principle is ‘liquidity requirements’. Basel III introduced two liquidity ratios - the ‘liquidity coverage ratio’ and the ‘net stable funding ratio’ (NSFR). The liquidity coverage ratio requires banks to hold sufficient high-liquid assets that can withstand a 30-day stressed funding scenario as specified by the bank supervisor. On the other hand, the ‘net stable funding ratio’ require banks to maintain stable funding above the required amount of stable funding for a period of one year of extended stress. The NSFR is designed to address liquidity mismatch in banks.

Basel III is important because it will strengthen regulation, supervision, and risk management within the banking industry. Basel III will prevent banks from taking excessive risks that can hurt the economy. It will improve banks’ ability to withstand abnormal shocks. Basel III will also strengthen transparency and disclosure in banks. Under Basel III, the banking industry should expect better capital quality, higher capital levels, minimum liquidity requirement for banks, reduced systemic risk, and differences in Basel III transitional arrangements.

Table 1: Basel Transition				
Pillar 1			Pillar 2	Pillar 3
Capital	Risk coverage	Containing coverage	Risk management and supervision	Market discipline
Summary of specific provisions				Global liquidity standard & supervisory monitoring

3. Basel III in Nigeria: Making It Work

3.1. What Nigerian banks can do themselves

Nigerian banks can do at least six (6) things in preparation to adopt Basel III standards.

Firstly, the senior management of Nigerian banks should show support towards complying with Basel III standards. Senior management of banks can show their support, and show their seriousness in complying with Basel III standards by: (i) providing extensive trainings on Basel III standards to their risk management and compliance staff, (ii) promoting a strong risk culture across all levels of the organization, (iii) ensuring there is a two-step authorization process before approving credit lines, or trade deals above a certain threshold in order to reduce the bank's exposure to abnormal credit risk and market risk, (iv) ensuring that members of the Board Risk Committee are competent in risk management and regulation.

Secondly, there should be process ownership for Basel III adoption in banks. Banks in Nigeria should appoint a Chief Risk Officer (CRO) who will be responsible for implementing Basel III standards in the bank. The CRO should become the process owner for Basel III adoption within the bank. The CRO should be competent and should have experience in the financial services, banking or regulatory industry.

Thirdly, Nigerian banks should appoint a Chief Compliance Officer (CCO) who will be responsible to ensure that the bank comply with Basel III regulations and all existing local laws and regulations that affect the bank's activities. The CCO should be the process owner for Basel III compliance within the bank. The CCO should be competent and should have experience in the legal, banking or regulatory industry.

Also, Nigerian banks should increase their holdings of high-quality capital and decrease the amount of low-quality capital and hybrid capital in their capital structure. Hybrid capital are low-quality capital instruments because these instruments have the properties of equity but already have a claim on them, making such instruments unavailable to absorb losses in banks. Common equity has the highest quality of capital, therefore, Nigerian banks may need to go to the capital market to obtain high-quality equity capital.

Also, banks should recruit competent staff for its risk management function. Careful recruitment of risk management staff should be a top priority because recruiting incompetent risk management staff could lead to human errors, non-compliance issues, process errors, risk modelling mistakes, avoidable losses, and violation of regulations which may attract heavy fines to banks.

Furthermore, banks in Nigeria should reduce their exposure to speculative risks. Nigerian banks should review their overall risk exposures prior to Basel III adoption, and should reduce risk by eliminating risks that do not add value to shareholders' wealth particularly speculative risks in their trading books. This will help to reduce the regulatory capital for market risk.

3.2. The Role of the bank regulator/supervisor

The bank regulator should oversee the transition period from Basel II to Basel III in Nigeria. The regulator may extend the transition period to 6 months, 2 or 5 years if necessary. The bank regulator may also consider how long it will take to translate Basel III standards into a national macro-prudential policy framework.

Secondly, the bank regulator in Nigeria should decide whether they will modify Basel III standards or adopt off-the-shelf Basel III standards. Basel III standards can be modified in three ways, either (i) adopt off-the-shelf Basel III without any changes; (ii) impose higher requirements above Basel III standards, or (iii) impose lower requirements below Basel III standards. If the regulator chooses to modify Basel III standards, such modification to Basel III should be done in a way that harness the benefits of global banking standards while at the same time reducing the risks or cost that adopting off-the-shelf Basel III brings (Beck et al, 2019).

Thirdly, the bank regulator supervisor should ensure that bank examiners understand the Basel III requirements so that they can conduct effective bank examination and supervision of banks under Basel III standards. Bank examiners are responsible for conducting risk-based or compliance-based regulatory audits of the financial statements, processes and governance structure of regulated banks and other financial institutions. These audits or examinations are either risk-based or compliance-based.

Also, the bank regulator should notify bank examiners of any local modification made to Basel III during its implementation. Bank examiners should understand any changes to Basel III, and how such changes will affect the way they conduct regulatory audits for supervisory purposes. If necessary, additional training should be provided to bank examiners to explain the reasons for such modifications and to guide bank examiners on how to conduct regulatory audit under the new changes.

Furthermore, the bank regulator should ensure that there is no ambiguity in Basel III implementation process for the compliance teams of banks. The bank regulator should ensure that the compliance managers (or teams) of banks fully understand the requirements of Basel III. The regulator should hold several meetings with the compliance teams of banks to explain the regulatory and compliance expectations of Basel III. Such meetings will give the compliance teams the opportunity to ask questions on areas they do not understand regarding Basel III rules. This approach is desirable and cheaper for banks compared to the cost of hiring some consultant to explain the compliance process of Basel III to banks, and paying huge consulting fees for such services.

Finally, the regulator should seek the help of the government if they believe that new laws need to be made to support the Basel III regulatory framework in Nigeria.

3.3. The Role of Government

The government can do three (3) things to support the Basel III adoption process. The government should provide full support to the Central bank throughout the Basel III implementation process. Secondly, the government should understand the purpose of Basel III standards, the benefits and the potential consequences of adopting Basel III standards especially the procyclicality of Basel III capital requirements. The government can set up a senate committee to oversee the Basel III adoption process. The committee should communicate with the bank regulator, to ensure that the government is well-informed about Basel III objectives and implementation plans, so that any future fall-out from Basel III or other negative externalities to the banking system will be well-anticipated. Thirdly, the legislative arm of government should be willing to enact new laws or establish new institutions at the request of the regulator if such new laws or institutions are needed to support the banking system in the Basel III era. And finally, the government should have a crisis resolution plan, contingency liquidity provision or other extraordinary measures to rescue the financial system from unforeseen events especially financial crises.

4. Challenges to Basel III adoption and how to minimize them

There are challenges to implementing Basel III in Nigeria.

For instance, domestic banks that have limited cross-border exposure may show little enthusiasm to embrace Basel III standards in their risk culture. To minimize this problem, the bank regulator can allow domestic banks to gradually adopt Basel III at their own pace within a defined transition period. But, allowing domestic banks to adopt Basel III in their own convenient time could signal regulatory bias and favoritism towards some domestic banks, it may signal that there is regulatory complacency towards small domestic banks.

Another challenge to implementing Basel III is that the regulator may become selective in adopting the full aspects of Basel III. The regulator may choose some aspects of Basel standards to adopt and choose the aspects to ignore. It is difficult to minimize the selective adoption problem because Nigeria is not a full member of the Basel Committee for Banking Supervision (BCBS), and is therefore not under any obligation to adopt off-the-shelf (or full) Basel III standards.

Another challenge is political interference in banking regulation and supervision. Politicians can take legislative actions to prevent a Central bank from implementing specific regulations which they feel will put weaker local banks in jeopardy, or for other reasons. To minimize the political interference problem, the Central bank may seek presidential endorsement and support for Basel III adoption in the country, and the Central bank may seek legal support for Basel III implementation.

Another challenge is the increase in cost of capital. Nigerian banks will be required to hold higher capital buffers and this may reduce the availability of credit to small and medium-sized enterprises. To address this problem, the government while implementing Basel III can consider providing a generous lending window or credit schemes to small businesses and individual borrowers preferably at single-digit interest rate so that individuals and businesses can have access to affordable credit during the transition period and in the Basel III era.

5. Recommendations

1. Nigerian bank regulator should enforce strict market discipline under Basel II in preparation for Basel III.

2. Effective bank supervision is needed to ensure that the activities of banks comply with micro and macro-prudential policies and regulations.

3. There should be international cooperation and peer engagement between the domestic bank regulator and bank regulators in other countries in areas of common interest for effective adoption of Basel III standards.

4. The regulator should have a contingency plan to reassure the public of the safety of their deposits in bad times.

5. The timetable for the introduction of Basel III's new minimum capital and liquidity ratios should be flexible to give banks enough time to transit to Basel III requirements.

6. The bank regulator should have emergency liquidity solutions to support the financial system during troubled times. When liquidity solutions are available, the bank regulator should carefully review the quality of such emergency funds, and review the timing of the withdrawal of emergency liquidity facilities in order to create a soft landing for the most affected financial institutions in the event of a crisis.

7. Finally, the bank regulator in Nigeria may need to carefully review the definition of the assets eligible to meet the liquidity requirements of Basel III.

6. Concluding Remarks

It is certain that new banking regulations will increase in the coming years. For this reason, it is important to ensure that banks in Nigeria have sufficient capital above the minimum levels at all times, depending on their risk profile, business models and bank-specific conditions. The bank regulator may impose a more stringent capital base for banks, and may speed-up the implementation of Basel standards, and this will be a recurring element in subsequent Basel regulations particularly in Basel 3.5 and Basel 4.

Five points to remember include the following. Basel III regulation will bring more regulations, transparency and more clarity to the banking system in Nigeria. Secondly, Basel III regulation will combine both micro- and the macro-prudential approach to financial system regulation. Thirdly, Basel III will introduce a macro-prudential framework that will promote stability in the financial system, reduce procyclicality in the financial system and to deal with systemic risk. Furthermore, the bank regulator may opt for a long transition period because Basel III will be a learning process for some banks. Finally, the bank regulator can intensify their effort to help banks recover from the effect of past or current crises, in preparation for Basel III implementation.

The effect of Basel III on the performance of Nigerian banks is still unknown. Future research can investigate the effect of Basel III on Nigerian banks using available data. Academics and policy researchers interested in banking research can examine the impact of Basel III on bank performance. The findings from such analyses can provide feedback to the bank regulator in their assessment of the impact of Basel III standards on bank behavior and bank performance. Secondly, Basel III's stringent capital regime can reduce excessive risk taking in banks and can reduce the level of nonperforming loans in banks. In line with this argument, future research can investigate whether Nigeria banks have more or fewer nonperforming loans in the Basel III era, compared to the Basel II era.

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