FOCUS OF SUPERVISORY ACTIVITIES

The CBN/NDIC during bank supervision and examination focus on the main aspects of banking operations. These include capital requirement, loan concentration, liquidity ratio, provisioning, internal control and management among others.

CAPITAL REQUIRMENT

Adequate capital is very important for any business, and banking is not an exception. The importance of adequate capital in banking stems from the following functions being performed by capital, viz: capital provides a cushion for absorbing operational losses; it provides a measure of shareholders' confidence and stake in the bank; it reveals the bank's ability to finance its capital expenditure and fixed assets; and it provides protection to depositors' funds, among others. It is therefore necessary to have enough capital so that depositors' risks could be minimized.

Government, on the advice of the monetary authorities, prescribes the minimum paid-up capital for banks. Recently the CBN consolidated the banks by raising the Shareholders fund to ₦25 billion.

A bank's capital adequacy is based on the capital ratio which involves the weighting of a bank's capital base against the portfolio of risk assets carried. A minimum of 10 percent of the total risk-weighted assets of a bank is required to be maintained as capital funds. Similarly, it is required that not less than 50 percent of a bank's capital must be Tier 1 or primary capital (that is, paid-up capital plus reserves). In addition, the ratio of adjusted capital to loan assets of the bank should be a maximum of 1:10. In other words, a Naira capital should support not more than ₦10 of loans.

Using banks' total risk-weighted assets ratio for example, the supervisory authorities classify banks as adequately capitalized, marginally under-capitalized, significantly under-capitalised, critically under-capitalised or technically insolvent, depending on the value of their risk-weighted asset ratios. While a bank with risk-weighted asset ratio of 10 percent and above is classified as adequately capitalized, a bank with a negative risk-weighted assets ratio is classified as technically insolvent. This classification is an attempt at establishing bench-marks for prompt supervisory intervention.

LOAN CONCENTRATION

Considering the fact that it is risky for a bank to concentrate its lending operations in a single sector or borrower, the regulatory authorities usually direct banks to diversify their lending activities. Also, banks are required to report large borrowings to the CBN in the statutory returns.

LIQUIDITY RATIO

Banks are required to maintain a minimum liquidity requirement by ensuring that the level of cash flows is matched by expected receipts so that they can meet their obligations as they fall due. Liquidity is achieved through effective fund management. Given the critical role of liquidity in banks' operations, it is essential for banks to provide for both the expected as well as the unexpected fluctuations in their businesses as reflected in their balance sheets and to provide funds for growth.

A bank suffers from illiquidity when its obligations to others mature faster than the obligations from others. This leads to assets/liabilities mismatch as well as gaps between its receipts and payments. When illiquidity occurs, it portends that the bank can no longer accommodate decreases in deposits or meet its obligations to its depositors. In such situations, the affected bank would not be able to grow and would be forced to acquire additional liabilities under adverse market conditions at excessively high rates. This would worsen the already illiquid position of the affected banks and may result in insolvency.

PROVIONING

There is the need for banks to make provisions for non-performing credit facilities. The provisioning should be adequate so as not to mislead the depositors and the general public on the true state of affairs of the bank. These provisions are made on the basis of perceived risk of default on specific credit facilities. The provisioning is also applicable to performing loans because these loans also carry some elements of risk loss, no matter how small.

INTERNAL CONTROL

Good internal control is very essential in order to minimize fraud and other malpractices which can lead to loss of assets. It also helps in ensuring compliance with laid down rules and regulations on banking business by the operators. These reasons explain why bank examiners focus on the internal control systems of banks.

MANAGEMENT

The CBN is responsible for approving the board and changes on the boards of banks in the country. Parameters such as competence, experience and integrity of the person or group of persons involved are considered to ensure that only qualified and responsible people are put on the boards of banks in order to safeguard depositors' fund and enhance public confidence in the banking system. Good management in banks is a must as the quality of management has been found to be the primary determinant of success or failure of a bank the world over.

OFF-BALANCE SHEET ENGAGEMENT

Off-Balance Sheet (OBS) activities or transactions refer to the financial transactions or activities that are not recorded in the bank's balance sheet but still have potential impact on its financial position and performance. They are reported below the lines as OBS assets or liabilities. The activities include items such as letters of credit (LC), loan commitment, bank guarantees (performance guarantees, bid bonds), derivatives etc.

A Letter of Credit (LC) is a mode of payment used in international trade. It is a written undertaking given by a bank (issuing bank) at the request of its customer (applicant), in which the bank obligates itself to pay the exporter (seller/beneficiary) up to a stated amount within a prescribed time frame upon presentation of stipulated documents that conform to the terms and conditions of the documentary credit.

Loan commitment is a written agreement, signed by the borrower and bank, detailing the terms and conditions under which the bank will fund a loan. Commitments can be drawn upon by bank's customers at any time within the tenor specified in the loan agreement. It is usually in form of a revolving working capital overdraft that can be used to fund customer's operating expenses.

A bank guarantee is a financial backstop offered by banks promising to cover a financial obligation of customer, if the customer fails to honor a contract obligation with a third party. Bank guarantee enables customers to acquire goods, bid for contract, buy equipment, or perform international trade. An example of such guarantee is a bid or performance bond issued by bank to its customer as a performance undertaking usually required by the principal from a contractor (a bank customer) as security for the customer's performance.

The use of OBS activities may improve bank's earnings or income, profitability and capital because commissions and fees are charged from the activities. OBS are also used to manage risks and enhance financial flexibility. Although OBS activities can have benefits for banks, they also pose significant risks to them and even the overall financial market. Banks are exposed to credit risk (risk of default), foreign exchange risk etc. This is because OBS may give rise to a corresponding increase in bank assets or liabilities when they convert into actual assets or liabilities. For example, if a guaranteed customer failed to perform under the contract, liability may crystalize for the bank.

Consequently, banks are required to ensure transparency, caution and accountability in their OBS activities. The Corporation review the risks and controls associated with OBS activities during its off-sight surveillance and onsite examinations. The review considers the adequacy of the bank's policies, practices, internal controls, board oversights, conformance with regulations, credit quality and collectability of OBS credits in event of crystallization. The review also includes adequacy of provision for losses or impairment on OBS to ascertain if they reflect the credit risks thereon. Banks are required to also hold a certain amount of capital to support their OBS activities to mitigate any unexpected losses. This is done by applying credit conversion factors on the notional amount of the OBS items in line with the CBN's Guidance Notes on Regulatory Capital.