

# **Lessons of Financial Sector Regulatory Reforms and Challenges of Real Sector Financing: A Regional Perspective**

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## **I. Introduction**

**F**inancial intermediation and financial services industries have undergone many changes in the past two decades due to deregulation, technological advances and globalization. The changes included consolidation within and across markets, greater cross-border financial services provision, the emergence of new financial products and alternative wholesale markets and trading systems, a redefinition of the role of traditional financial services providers, and the use of new distribution channels, including e-finance. These changes have been triggered by regulatory changes/reforms notably by: liberalization (locally, regionally, and globally), market forces, and technological advances. In turn, these changes have led to new regulatory reforms as well as challenges particularly in developing countries such as Nigeria.

The framework for regulating financial activities has also seen many changes, with approaches to adapting to new challenges arising from both regional and global economy. Developing countries, like Nigeria were not spared from the effects of the global economic recession brought about by: the exit of portfolio investors that led to a sharp depreciation in the value of quoted stocks in the Nigerian Stock Exchange Market, reduction of export earnings, lower foreign direct investment (FDI) inflows, among others. In response to these, the Nigerian government adopted new regulations to ensure efficient and sound financial intermediation as well as to address the demand of the changes affecting financial sector and to address the lessons learnt from the financial crisis.

Since after the turmoil, phrases such as systemic risk, oversight and macro-prudential regulation have become the new touchstones for a repaired regulatory framework in many countries. These developments call for renewed efforts to redefine the regulatory philosophy and principles around a different mould at national, regional and global financial systems. While it is understood that to bring out any paradigm shift would require an equally weighty intellectual case for an alternative model, it would, however, be imprudent to ignore the

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basic lessons of the financial crisis, which is that the existing framework before the crisis had severe pitfalls justifying substantial reforms. This is why efforts to strengthen and develop the country's financial system require an assessment of the financial services required by Nigeria as it moves towards the desired new economy under Vision 20:2020. This in addition entails an assessment of the implications of the forces of change in the global, regional and domestic environments. While opportunities have emerged in these new environments, threats of the regional and global marketplaces are becoming more intensive, as both regional and global players as well as technology advancements the world over are having an unprecedented impact on the approach of providing banking and other financial businesses.

It is understood that the likely positive impact of financial liberalization include: (a) capital flowing from capital – rich developed countries to capital – deficient ones, directing savings towards productive investments, (b) increased competition among economies as they strive to offer better opportunities for savers as well as lower costs to borrowers; (c) development of new financial instruments such as derivatives (futures, swaps and options); (d) the markets would provide a healthy discipline for governments in terms of fiscal discipline, better economic policies and performance; and (e) the long – run result would be higher investment and growth in the liberalized economies (McKinsey and Company, 2007).

These five positive views are somewhat clouded by the possibility of marked increase in financial fragility explained earlier. Consequently, the benefits of financial liberalization must be weighed against the costs of increased financial fragility. This of course is why some economists have argued that some degree of financial regulatory reforms is still inevitable and in fact preferable to premature liberalization in developing countries (Schnabl, 2008). The purpose of this paper is to review both the general regulatory challenges as well as the specific issues facing Nigeria in terms of adapting to the various financial sector regulatory reforms both within the financial services industries in national and regional environment as well as coming from international regulatory norms. The remainder of the paper is, thus, structured into five parts. Part II examines the changes in financial systems of today that make regulatory reforms inevitable. In Part III, an attempt is made at addressing issues and challenges of financial regulatory reforms in developing countries. A brief analysis of challenges facing the Nigerian economy in its financial regulatory reforms with emphasises on the real sector is made in Part IV. Part V of the presentation addresses the issues of regional financial regulatory reforms under the Economic Community of West

African States (ECOWAS) with particular reference to the regional payments system of ECOWAS Commission and part VI concludes.

## **II. Changes in the Financial Sector**

In theory, the arguments for financial reforms towards liberalization appear uncontroversial because based on exacting assumptions, financial globalization has the potential to raise economic growth and lower consumption volatility. In addition, it could exert some level of international disciplinary effects on the conduct of national macroeconomic policies particularly: (a) if international capital flows become more important for national economic development; and (b) if the capital flows respond negatively to bad monetary and fiscal policies. However, what is theoretically sound and logically possible may be impracticable, particularly when the credits assigned to financial liberalization are premised on economic assumptions as usual. One thing that is clear is that with the recent financial crisis, the benefits of capital account liberalization to the recipient economy are inconclusive as some economies seem to experience a **costly boom-bust cycle** after liberalization. In particular, economies that are less able to control domestic agency problems, like in most developing countries appear to have a higher likelihood of crisis.

Therefore, what we observe is a pattern of a boom-bust cycle in investment, asset prices, and output preceded by financial liberalization. This is why a survey of some key changes in financial systems as well as financial services; in addition to what is driving the changes is examined below.

### **II.1 Deregulation**

The last two decades had witnessed dramatic changes in the financial landscape in which market forces, due to globalization and supported by inevitable regulatory changes as well as technological advances have led to substantial changes in the operational modalities of most financial systems of the world. These changes have, to a large extent been triggered by the removal of controls over financial sector activities and institutions in all countries of the world including the Nigerian economy. The progressive elimination of barriers between different types of financial services providers in the country, the removal of barriers of entry and the elimination of product restrictions has led to more competition in financial services of the economy. In addition, the establishment of cross-border activities of Nigerian banks in member states of the Economic Community of West African States (ECOWAS) as well as to other parts of the world had compelled these banks to be competitive.

The consequent broadened markets, within and outside the economy to other ECOWAS countries have triggered large changes in market structures of Nigerian banks. In addition, the bank consolidation exercise in the country, with its waves of merger and acquisitions, allowed the banks to take advantage of larger markets to reap the economies of scale advantages and/or positioned them against a more intense threat of competition domestically and across borders. Furthermore, inter-industry changes have occurred in the Nigerian financial system under universal banking which abolishes the legal separations between commercial banking, insurance and investment banking activities.

## **II.2 Technology**

Changes within the Nigerian financial system were not confined to deregulation alone. The changes have been due to rapid information, communication and technological (ICT) innovation within the financial services industries, with deregulation catching up. It is not just that technology today provides an increased ability to engage in high-level financing (e.g., credit derivatives), but it also allows cheaper production and better mainstreaming of financial services for households and smaller size firms in Nigeria. In turn, cost advantages have been passed to consumers in the form of lower margins and better quality services. Technology has equally allowed for financial institutions in the country to deliver their services at greater distance, through **on-line services**. The development in ICT is making cross-border provision of financial services easier and cheaper, e.g., improvements in ease and costs of international remittances over the last few years.

Besides the costs gains for consumers and firms, technology has allowed for the emergence of new financial markets and trading systems (such as the various stock trading systems), and complete new forms of financial products. Technology has also affected market structures in many ways, directly and indirectly. The direct effects are many, such as the entry of new financial services providers, e.g., those providing aggregation services putting multiple account information and transaction capacity in one place. Technology is further facilitating the blurring of financial services as financial products can more easily be created, adjusted to user preferences, and delivered. Technological advances have also enhanced the ability of Central Bank of Nigeria (CBN) to better monitor Nigerian banks. With better supervision helped in part by technological advances, freeing up banks without inducing instability has become easier for the CBN as the regulator of the industry.

The combination of the deregulation and technological changes is leading to many institutional changes, besides changes in market structures. For instance, new forms of financial services providers have emerged, such as e-brokers and aggregators, and the breadth of financial services available for firms, households, and specialized groups such as lower net-wealth investors, has increased. Deregulation and technology have led to more complexity and new risks. Many large banks have become risk managers, rather than traditional providers of financing and liquidity services. New products have been introduced for which risk management systems are still lacking or only being introduced late even as markets are already large, e.g., credit derivatives. Other new risks come up on a regular basis. For example, in settlement and clearing systems due to greater cross-border trade with associated legal uncertainties, new risks have arisen. All of these have led to **new challenges** for the design and implementation of financial regulatory reforms and supervision in many countries including Nigeria.

### **III. Challenges for Financial Regulation Reforms**

Changes in financial services sector have generally led to improved outcomes in terms of more efficient financial services provision, greater diversity of financial services, and greater access to diversities of financial services. Yet, these developments are also simultaneously leading to new challenges facing financial sector regulators such as the CBN as well as other policymakers. These challenges relate in large part to financial stability as new systemic risks arise. In addition to this are other emerging issues in terms of how to make the financial markets function properly, in the sense of delivering the best possible financial services at the lowest cost to different consumers.

For both stability and efficiency purposes, there has consequently been a parallel trend to adapt existing regulations and adopt new regulations in some areas ("re-regulation") to ensure well-functioning financial systems and markets. The design and applicability of these new regulations have been subject to many discussions. Issues arising have been various, but include: the overall approach to financial sector regulation and supervision in the light of changes in the special nature of banks; competition policy in financial intermediation; consumer protection; the costs of regulation; and further harmonization of rules and practices at regional and multilateral levels.

#### **III.1 Overall Approach and the Emerging (Special) Role of Banks**

It is now clear that financial liberalization meant that banks and other financial institutions have moved from being under close control of the monetary authority with little competition to a different terrain where **they only need to satisfy**

**minimum prudential standards of the monetary authorities** with more general supervisory oversight and enforcement of good internal risk management practices. Recall that in the late 1980s to 1990s, in both developed and developing countries, financial liberalization led to vulnerabilities and even in some cases financial crises at national and regional levels. This was understandable as due to markets' participants (banks and non-banks financial institutions) and supervisors (in case of Nigeria, the CBN) who were just learning slowly issues in the new world of financial liberalization as well as due to ill-designed financial liberalization efforts at national and regional levels. The disturbance of early 1990s in the Nigerian financial system could be traceable to this fact that while in most developed countries, banks and other financial institutions were able to withstand the shocks relatively unscathed, it was not the same in the Nigerian context.

Apart from the fact that financial markets' participants as well as the supervisors in the economy were slowly "learning" the new world of financial liberalization, many of the problems were due to ill-designed financial liberalization efforts at national level. For instance, some financial crises were triggered by failures of non-bank financial institutions that engaged in financial transactions outside their core functions, a replica of the 1993 episode in Nigeria.

No doubt, each crisis in Nigeria has taught the CBN new lessons as well as triggered adaptations to better financial regulations. In spite of these, however, thinking ahead of what new risks may arise and how to prevent serious impact remains nevertheless a challenge for the regulatory authority (just like in any economy of the world). This is why the full set of issues of financial stability and related implications for financial regulation and supervision are beyond this paper. However, there are clearly some general trends underlying the recent changes that require adaptation of approaches at the level of the CBN, the level of the overall financial system of the country and at the international level. Many of these changes relate especially to the emerging role of banks as they affect the real sector of our economy under the dynamic circumstances constantly facing them.

Though the role of banks has expanded in recent decades, at the same time, banks have simultaneously shed some of their more traditional forms of financial intermediation. For instance, today banks are becoming more risk managers rather than straightforward financial intermediation. In addition, financial institutions most often organized around "banks" are now engaged in a broad range of complex financial transactions and operate in various markets- banking,

insurance, and capital markets- to take on and lay off risks on behalf of their customers. Under these new roles banks underwrite complex financial transactions, provide specialized over-the-counter hedging and risk management products, and are engaged in highly-leveraged financing operations. They equally help to place financial instruments with other, nonbank financial institutions, such as institutional investors, and take on many advisory roles. The increased roles of banks as risk managers suggest a market response and the exploitation of natural comparative advantages. These recent changes in financial services provision calls for continuous innovation of the central bank monitoring techniques.

These developments call for new regulatory issues for the central banks all over the world. For one thing, the degree and nature of spillovers among financial institutions and through financial markets has become much more complex to predict measure and manage by the central banks. In the past, spillovers of a financial institution running into financial distress on other financial institutions might have been easy to predict by regulatory authority, as the bank engaged with a limited number of clients in a significant way. However, today in many financial markets, spillovers are much harder to predict. Even the relatively straightforward analysis of predicting how turbulences get transmitted through the interbank market activities has become quite complex because of the activities of making actors and agents. Exposures have become so much more complex in the Nigerian economy. The broader issue of how liquidity shocks get passed on through various financial markets has become even harder to analyze as the transmission mechanisms are so much more complex today.

This development justifies the recent CBN initiative to review the **Universal Banking** framework by emerging with **cylinder approach**. This approach involves treating commercial and investment banks, insurance companies and securities markets intermediaries as separate institutions with their own set of regulations and separate forms of oversight. While the CBN is right to some extent on this reversion, the close congruence between commercial and investment banks in most financial systems of the world as well as the close links between insurance corporations and commercial banks suggests, however, that risks from one area of the system may not necessarily be possible to be isolated to one type of financial institution. Consequently applying standards and supervision by separate types of financial institution has its own problems these days. Instead of a cylinders-approach, therefore, a more general risk management approach will be needed, at the micro and macro levels. What appears desirable because of the increasingly complex ways through which financial risks are being managed

by banking, insurance, and securities firms is a cross-sectoral approach and not a water-tight separated regulation.

Given how difficult it is to anticipate the ways in which risks get transmitted in the financial system, it is hard to determine how to make the system more robust and how to prioritize interventions. It is probably the case that there will be a greater need for the CBN to concentrate more at protecting the basic elements of a financial system such as the: payments system, clearing and settlement, and the basic provision of liquidity while cooperating with other regulatory institutions on a cross-sectoral basis in the management of the systemic issues in the entire financial system. For this reason, much effort would have to be invested in strengthening these basic elements of the institutional infrastructure, at national, regional and international levels.

### **III.2 Competitive Policy**

Since the beginning of globalization, competition has been an important driver of financial sector improvements. It has equally made the financial systems more open and contestable, thus, leading to greater product differentiation, lower cost of financial intermediation, more access to financial services, and enhanced stability. As globalization, technology and de-regulation further progress, the gains of competition can be expected to become even more wide-spread across and within countries. However, it is difficult to ascertain the potential gains from competition brought about by financial liberalization. Nevertheless, elements that have to be considered in analyzing competitive policy issues include the following:

**First**, the national as well as regional institutional arrangements for competition policy will need to change. For one, there is much more need for the ECOWAS member states to coordinate better, and preferably bring together, competition policy functions now often dispersed among various agencies within countries (e.g., separate for banking and non-bank financial institutions, or with prudential regulators, or among both specialized and general competition policy agencies). The changing nature of financial services provision also means that many other actors and aspects affect the competitive environment for financial services provision (e.g., telecommunications as it may affect the market structure for e-finance). Obviously, there is a much greater need today for international cooperation among various national agencies in the application of competition policy on regional basis. However, such related regional competition policy needs to be separated more clearly from prudential oversight of the regional central banks.

**Second**, the new forms of financial services provision suggests that approaches to competition issues on national and regional levels need to be adjusted. The kind of adjustments may resemble those used in other network industries, such as telecommunications, energy, and water. This would mean that the various inputs required for the production and distribution of financial services, including network services, need to be available to all interested in using them, in which they will be fairly and uniformly priced, as well as efficiently provided.

**Third**, in addition to corresponding changes in financial services industries, the tools for identifying and addressing competition issues need to be adjusted accordingly. As at now, the measures typically used to date for measuring lack of competition are quite limited. Yet, the more sophisticated analytical and empirical tools developed for measuring competition in other industries are hard to apply to financial services industries given the unclear production function for financial services, the tendency to produce and sell bundles of financial services, the weaker and more volatile data, the presence of network properties, etc. For example, it has been difficult to measure effectively competition in Nigerian banking industry using known tools from the traditional industrial organization. However, some information on the competitive structure may still be possible by focusing on price setting for specific products or financial functions, e.g., what are the fees being charged for consumer retail products or for processing individual payments to customers. In addition, more focus can be given to the pricing and availability of inputs necessary to produce the various financial services.

### III.3 Consumer Protection

The increased diversity of financial instruments and larger number of financial institutions operating in Nigerian financial markets has led to some important questions with respect to consumers of financial services. The more diverse and complex products and the numerous changes in the markets have made it more complicated to assure that consumers benefit from this diversity. For one thing the delivery channels of the various financial products have changed quite a lot and many new players have emerged, making it harder for consumers to choose on a well-informed basis.

Though the bankers' tariff as well as other monetary policy responses by the CBN was motivated by concerns over consumer treatments in the Nigerian financial system, yet these measures are not primarily aimed at what is traditionally called **consumer protection**. Consequently, since the dividing lines between consumer protection, competition policy and assuring properly and integrally functioning

financial markets that allocate resources efficiently can be somewhat arbitrary, we divide the issues here into: ensuring markets work better for all final consumers (what is sometimes called assuring a proper business conduct); protecting individual consumers; and ensuring consumers obtain the greatest benefits from financial services provision through proper information and education.

### **III.3.1 Ensuring a Proper Business Conduct**

The policy goal of ensuring proper business conduct is especially more applicable to capital market. Recent happenings from the global financial crisis had revealed that many changes in stock markets, banks derivatives and other formal trading markets, including ownership and governance structures, can make self-regulation to work poorer, and raise issues of oversight and conflict of interests. More generally, and also in the light of the recent lapses in governance and capital market conduct (in even the most developed countries), there has been a perception that on a systematic basis financial markets have not been functioning for the interests of all final consumers.

Following many scandals in the Nigerian capital market which affected the entire financial system, stricter accounting and auditing regulatory oversight structures that moves away sharply from self-regulation of the market by the Security and Exchange Commission (SEC) had been put in place. More generally, SEC has stepped up its oversight function to ensure, among others, fair consumer treatment. Disclosure requirements on conflict of interests and liability of all types of financial services providers have consequently increased.

### **III.3.2 Protecting Individual Consumers**

Since the global financial crisis which equally affected the Nigerian economy in no small dimension, financial institutions in the country have had to comply with greater responsibility of truth in advertising and providing more information about their various products to consumers. Yet, the legal policy of **buyer beware** has shown to be of limited effectiveness in protecting consumers. This is because providing more information to customers is necessary but not a sufficient condition to fully answer the question of assuring that products are of fair value and match consumers' knowledge, preferences and abilities. At the same time, a more liberal environment by definition cannot have the CBN checking individual products for fair value or other consumer attributes.

Thus, it is increasingly recognized that financial services users themselves need to be equipped with the legal and administrative tools to take action against misuse of the information passed to them by the financial institutions they are dealing

with. This approach would imply, *inter alia*, that consumers can more easily sue financial intermediaries, that class-action suits are allowed, that specialized courts or institutions exist to handle small financial services claims, that more material information is provided on a routine basis, that conflict of interests are more clearly revealed, etc. In collaboration with the Nigerian judicial system, I believe we should be moving towards this direction. However, the existing judicial systems have to develop the expertise to deal with these (complex) financial cases to be effective.

### **III.3.3. Ensuring that Consumers Obtain the Greatest Benefits**

The bewildering choices of financial instruments make it hard to compare the true all-in costs, risks and fits of an instrument with the individual consumer's needs and preferences. The less-educated in the Nigerian society patronising the financial intermediary institutions in the country may be easily misguided, and more so than in the past, about the gains of new financial instruments they are accessing in the financial markets. While consumers of financial services may have access to relevant information, they often do not read or understand the materials provided or choose to ignore it, especially when induced by the latest adverts which appear rather tempting to ignore from the financial market operators. Such mis-information and **herding effects** are becoming easier in an internet and mass-communication world of today. Because it is especially the less-educated who stand to suffer most with the increased complexity, increasing financial literacy is an obvious policy prescription for CBN to promote on this issue.

### **III.3.4 Evaluating the Costs of Regulation**

Just as in other areas of economic activity, ensuring the right balance between the private (and public) costs and the public (and private) benefits of regulation and supervision is essential. With the many new regulations and regulatory changes in recent decades arising from global, regional or national initiatives, new costs have been imposed on financial services industries as well as the national central banks. These costs have come in the form of direct expenditures on compliance, increased reporting, further internal system development and supervisory functions, etc.

Since over-regulation can equally be counter-productive, the CBN need to avoid over-regulation and ensure that the existing regulations do not impose too high compliance costs on actors in the financial services industry. To achieve this goal, the CBN has to regularly conduct the impact assessments of any new or modified regulation as well as perform consistently rigorous costs-benefits trade-offs. Also,

the CBN can create greater consultation and transparency in their rule-making processes so as to allow a better reflection of financial services industry's views.

Such assessments and consultations should be part of the standard rule making processes not only nationally by the CBN, but increasingly regionally by relevant ECOWAS institutions. To be useful, the consultative process has to be broad enough to include all stakeholders, including consumers and businesses, not just financial institutions. This requires balancing the powers of various interest groups properly and may require proactive measures. Because, consumers in the financial markets of the Nigerian economy are typically poorly organized they may need to be equipped with resources and expertise to play their role effectively.

### **III.3.5 Achieving Greater Harmonization**

Apart from the need to evaluate the costs and benefits of regulation, there is also need for greater harmonization of regulatory approaches across sectors and products and the elimination or reduction of barriers impeding the efficient production and provision of financial services in the Nigerian economy and in the ECOWAS region. Harmonization is needed both among financial services providers (banks, insurance companies, pension funds, asset management, etc.) and between different, but functionally equivalent types of products (whether banking, insurance, or capital markets products) in the country as well as in the region.

Harmonization across sectors and products is needed to: avoid regulatory arbitrage, provide level playing field, increase competition, and reduce differences in the overall regulatory burden of products in the country and in the regional economic integrated ECOWAS community. The increased ability to create complex financial products and unbundle risks, straddling in the process various markets and institutions, makes the need for a common regulatory approach necessary. Harmonization should be that, within markets, products are not regulated differently depending on what type of financial institution that provides the service.

Regionally and globally, harmonization issues are further compounded. This is because harmonization across markets or countries is a very complex undertaking (particularly in ECOWAS countries) because of its inconsistencies with national rules and laws of member states. In any economic integration agenda, this area (monetary integration is the highest level). For this reason, regional harmonization of financial systems in an economic community demands that the

region must have passed through free trade area (FTA), customs union (CU), common market (CM) and then economic union (EU). The passing through of these phases demands that other policy areas need to be adjusted, which takes much time and effort. The European Union (EU) and other regional experiences show not only how difficult financial harmonization is in practice, but also that conceptually difficult questions arise. For example, liquidity support and lender-of-last resort facilities in the EU are still national, but this can create inconsistencies with policies for dealing with financial insolvency as it is currently occurring in Greece and Ireland.

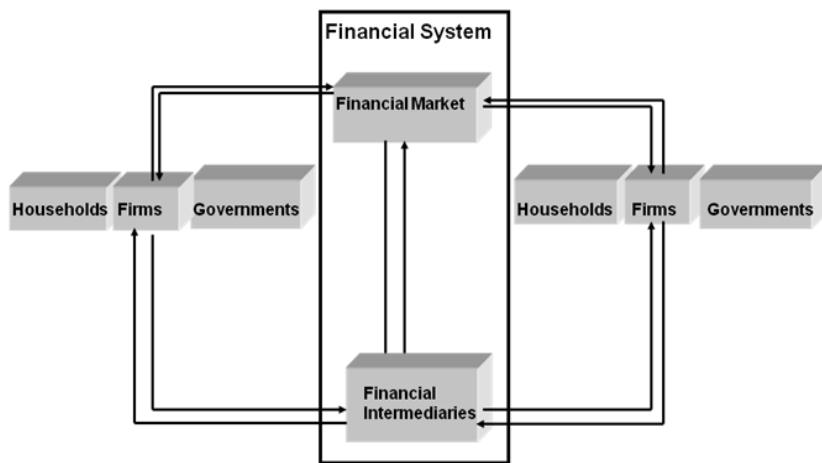
#### **IV. Challenges Facing Nigerian Economy in its Financial Regulatory Reforms: Implications for the Real Sector**

The challenges facing the CBN as well as the entire financial system arise from the global financial liberalization and efforts to insert appropriate regulatory reforms to cope at national, regional and multilateral levels. On one hand, Nigeria like other developing countries, is rapidly integrating with the global financial markets. But in the application of international regulations and best practice supervision, it is clear, however, that for most developing countries the globally common approaches may be difficult to implement without substantially injuring the real sector.

Financial system provides effective financial intermediation between the surplus and deficit units of an economy by issuing claims on borrowers directly to savers. Under a financial system, savers (or lenders) provide funds to borrowers in return for promises of repayment in addition to extra charge for using the funds at a later date. The promises of the borrowers are financial liabilities for the borrowers but assets to the savers. Financial system is comprised of: financial market, financial intermediaries and financial regulators.

##### **IV.1 Financial Market**

A financial market provides structures through which the deficit and surplus units interact and matches savers and borrowers as well as allowing them to share risks in financial intermediation – savers can diversify the risks via capital or money market instruments; financial markets allow both savers and borrowers liquidity opportunity; and financial markets provides effective communication opportunities to savers and borrowers – collect information from savers and borrowers and in return provide the information to borrowers and savers. Financial market is made up of capital and money markets.



#### IV.2 Financial Intermediaries

Financial intermediaries are: financial institutions (i.e. banks and non-bank financial institutions) that operate in the financial markets. They engage in trade financing by raising funds through the financial market instruments from savers and investing them in debt and equity claims of borrowers. They equally provide risk-sharing, liquidity and information services.

#### IV.3 Financial Regulators

Financial regulators perform three main functions: ensures all participants in the financial systems have access to essential information that the financial intermediaries give savers and borrowers, and that the information is accurate and timely; regulates the financial markets and the intermediaries to ensure financial stability of the system; and government can advance economic policy through intervention policies of the regulators into the financial system.

Perhaps, among the most important lessons learnt from the financial crisis is that the leverage and interconnectedness of firms in the financial services sector, and the critical role that financial intermediaries play in modern economies, mean that a malfunction in the financial industry can immediately and profoundly harm the entire **real sector of any economy**. For instance, crisis in the financial sector filtered through to the real economy, resulting in a reduction in access to credit, massive layoffs and higher unemployment figures, reduction in demand and consumption and a global economic recession (which are all real sector problems).

The real sector of any economy uses the financial market as the source for the required financial demand. With the liberalization of the financial sector and activities of financial regulators, the implications of these developments are transmitted to the real sector that uses the services of the financial markets. The various areas where national economies need to understand so as to evolve appropriate regulatory reforms to ensure that the real sector is not negatively affected involve the following

#### **IV.3.1 International Financial Integration**

Gross capital flows (inflows and outflows), not necessarily net flows and other forms of cross-border financial services provision such as equity listing and trading on international stock markets, have increased sharply for many developing countries in recent decades, albeit for some countries from low bases. Such flows come in the form of both **de jure** financial integration as well as from **de facto** financial integration. The former relates to government policies on capital account liberalization that permit the actual capital flow while the later relates to capital flows between countries irrespective of government liberalized or restrictive measures. In essence while the de jure financial integration is the 'normative' aspect of capital flows based on the capital account liberalization, de facto financial integration considers the 'positive' aspect of the capital flows (Aremu, 2004). The consequence rapid financial integration could force many adjustments in a short period of time on the regulatory authority. At the same time, the monetary regulatory authority may face great difficulties: while they need rapid institutional capacity building.

#### **IV.3.2 Application and Adaptation of International Regulatory Reform Standards**

It is clear that adopting international financial sector standards can be challenging for developing countries such as Nigeria. While standards need adaptation, as there is not a one- size that fits all countries, in their design, by default, standards have a bias towards the circumstances of current developed countries where these standards are fashioned. Developing countries like Nigeria are further from the paradigm reflected in these standards. Consequently, regulatory reforms based on these standards are often too sophisticated for many developing countries as they assume too much in terms of the supporting institutional infrastructure. To a large extent, overcoming or alleviating these problems requires the following actions in developing countries: better laws and regulations and institutional capacity building, supported by technical assistance, etc. This will take much time, however, and in the meantime inefficiencies from using the wrong standards may be considerable and new risks may even arise.

Trying to adopt all standards in their entirety is surely inefficient for almost all developing countries. Some parts of the financial system may not yet be developed (e.g., stock markets) and as such some standards may be meaningless when adopted; and, depending on the country, some elements of the standards will be more important than others. Better prioritization, in which elements of the regulatory reforms standards are more relevant for the circumstances of specific developing countries, and which would need to be implemented first would be useful. While it is recognized that adaptation of the application of standards and the regulatory reform model to the circumstances of developing countries can be necessary, to date developing countries have had a small stake in the global standard setting bodies and their debates. Emerging financial markets' participation in global forums like the Financial Stability Forum, Basel Committee and other such groups, is still small, making the influence of developing countries in the formulation of the various regulatory reform standards in financial intermediation still limited.

#### **IV.3.4 Political Economy**

Financial regulatory reform needs to consider the political economy of the country in question. One clear aspect involving political economy factors is enforcement, which is an issue in many developing countries like Nigeria. Overarching concern for developing countries with respect to the financial regulatory reform standards will be their enforcement. It is important to say that the institutional constraints and limited scope for enhancing capacity are not just a matter of national laws and technical implementation, but also of enforcement. Over the years weak enforcement has been a symptom of development, and this is why some say development is all about enforcement. As such, enforcement will take some time to achieve and balancing public enforcement with other means (such as relying on private enforcement mechanisms) will be efficient. Often some of the constraints regarding enforcement run much deeper than just lack of capacity, to the lack of political will, lack of accountability, and plain corruption.

### **V. Regional Financial Regulatory Reforms in ECOWAS**

Most discussions on financial system activities concentrate at the national level. In ECOWAS Commission, there is an on-going regional financial integration community to remove/minimize restrictions that impede the flow of capital, and harmonize all financial rules, regulations and taxes between member countries. The Commission expects two types of benefits from this initiative:

- ❖ **Economies of scale** arising in larger financial markets will generally drive a number of benefits, notably that costs should decline thereby providing scope for better consumer value. If this is associated with greater competition, sound regulation, good governance and banking consolidation and higher capital levels, then the benefits multiply; more availability of financial products and services, more consumer choice, more pressure for efficiency and effectiveness, lower prices, etc. In the ECOWAS, with a total population of around 275 million, taking cross-border barriers down is very important.
- ❖ **Cross-border financial services would also become more efficient** (faster, cheaper) in the region if there is more financial integration, since it will permit all forms of payments e.g. direct inter-bank transfers, plastic card payments, mobile banking and trade finance, and cross-border financial transactions where customers living in one country 'buy' their financial services in another country. This will particularly boost trade – a crucial dimension of the dialogue in the ECOWAS integration agenda.

### **V.1 Regional financial market integration**

Regional financial market integration is a process leading to the removal of the relevant frictions and obstacles within an economic integrated community. In this sense, a market for a given set of financial instruments or services is fully integrated if all potential market participants bearing the same relevant characteristics such as facing a single set of rules when they decide to deal with those instruments and services, having equal access to the above mentioned set of instruments or services, and being treated equally when they are active in the market. Economists have identified three consequences of financial market integration: when financial markets are fully integrated, prices for similar assets in different regions are the same (except for trivial transaction costs); agents in different regions have access to and use financial assets from different regions to save, borrow, invest, and insure; and local saving and local investment decisions should be independent, and the capital account position should smoothly adjust to offset desired current account positions. It should be stressed that both goods and financial markets integration are necessary for full economic integration, as any desired current account position entails the simultaneous exchange of financial assets. Consequently, if local people prefer to exchange financial instruments with other local people rather than with outsiders, goods market flows will be impeded.

An integrated financial system under ECOWAS Common Investment Market (ECIM) will be of benefit to individuals and businesses by:

- providing finance for individuals, households, business and governments in any part of the community;
- helping business and households to manage their risks effectively;
- allowing the entire ECOWAS society to accumulate wealth and manage risk; and
- providing mechanisms such as payments systems through which businesses and households in the region will carry out transactions quickly, cheaply and reliably.

In addition, a well-functioning integrated regional financial market makes monetary and fiscal responses operate more effectively, helping to minimise economic and social costs when different economies in the region face shocks and ensuring that shocks to certain industries or countries can be more easily absorbed by other economies opportunities.

## **V.2 ECOWAS Regional Capital Market Development**

ECOWAS regional capital market integration means that investors can buy and sell securities in any West African stock market without restriction. All types of participants in capital markets can offer their services throughout the region without restriction. It equally means that identical securities are traded at essentially the same price across markets after adjustment for foreign exchange. Categories of regional participants include retail and institutional investors, securities regulators, corporations and governments.

Capital market regulators within the region have signed formal Memorandum of Understanding (MOU) among themselves towards the commencement of regional capital market integration. Furthermore, the ECOWAS Commission is recognizing and collaborating with the West African Stock Exchanges Association (WASEA) and efforts are now in place to facilitate its operations. Since an integrated securities market requires an integrated regulatory and enforcement approach, increased dialogue and cooperation between member states as well as stakeholders in the regional capital markets, as provided by the Supplementary Act on Common Investment Rules, will lead to improved securities regulation and the promotion of vibrant capital markets in the region. In

this regard, harmonization of listing regulations among ECOWAS stock exchange markets is being embarked upon as an important step towards a vibrant regional capital market development

### **V.3 ECOWAS Regional Payments System**

Until now, ECOWAS payments system infrastructure and outreach for payment services are generally not the same across countries, further constraining systematic regional integration. Compounding the problems of the inadequate infrastructure are the numerous rules and regulations affecting both domestic and cross-border payments that are not currently harmonized and may further complicate clearing and settlement on a regional basis. Establishing a clear institutional framework for the flow of financial resources on a cross-border basis will serve as useful input in the design of an effective ECOWAS cross-border payment system. ECOWAS Commission is being assisted by the World Bank at emerging with the regional payment system.

Regional payment agreements are mechanisms designed to facilitate payments between residents of the participating countries in an economic integration arrangement like ECOWAS. Such a payment system would consist of a large central bank/interbank payment and messaging networks that offer payment services by various kinds of institutions including banks and non-bank financial institutions, as well as all interbank obligations resulting from retail payments such as checks and electronic funds transfers that are cleared on a regional/multilateral net basis by the established Automated Clearing House (ACH).

The obvious advantage of the regional payment system to ECOWAS member states is that it would reduce costs associated with regional transactions and, thus, enhancing international trade among member states if the regional payment system would provide a significant boost to trade among ECOWAS countries. This in turn would increase economic growth, and result in higher incomes and welfare for member countries.

At regional level, Accounting Bodies of West Africa (ABWA) had decided to partner with the ECOWAS Commission on harmonization of national accountancy standards of its member states in line with the ECIM initiative of the Commission. This will help put in place the necessary arrangements for the mutual recognition of certificates and credentials among ECOWAS accounting professionals. It is also to harmonize accounting qualifications and training across

the region so as to permit the flow of skilled labour among member states of the region.

## **VI. Conclusion**

The future landscape of the ECOWAS financial system will be developed against the backdrop of an increasingly integrated regional and multilateral economic environment and within the context of the appropriateness of the national financial markets to cope. Such future lies in its ability to create a dynamic set of financial players, which are able to provide support to the domestic economy, and more importantly, that are increasingly more efficient, competitive, sound and stable to equally register its presence in the current competitive regional and multilateral environment. The task facing the monetary authorities under the new order is, therefore, to develop a more resilient, competitive and dynamic financial system with best practices, that supports and contributes positively to the growth of the economy through the economic cycle, and has a core of strong and forward-looking domestic financial institutions that are more technology-driven and ready to face the challenges of globalisation from regional and multilateral environments.

However, new issues that have arisen globally from the financial crisis include the overall approach towards ensuring a stable and efficient financial system taking into account the changing special role of banks; the approach towards competition policy; how to assure consumer protection effectively and efficiently; evaluating the costs of regulations; and the harmonization of rules across products within markets. In the application of these international and other regulatory reforms, a number of specific issues have come up for developing countries, for which the globally-developed aspects of them can be more difficult to adopt. This is the core of the challenges facing the real economy from the regulatory reforms of the financial sector.

Consequently, there have been many changes in the financial systems around the world over the past two decades. Many lessons, sometimes costly, have been learned as to what regulatory approaches work in terms of promoting sound and efficient financial intermediation. We have discovered that as the financial services industries are undergoing continuous changes in all countries of the world, new issues keep coming up. Thus, as the boundaries between financial activities get blurred, it makes sense for the boundaries between regulators to also get blurred, and eventually, for the supervision of financial services to be consolidated.

Because of the linkage effects of the financial markets to the rest of the economy, **restructuring of the financial sector is often a mirror reflection of reforms in the real sector**, including trade and parastatal reforms. Furthermore, efficient cleaning of banks' balance sheets often entails substantial reorganization of claims over the corporate sector and can prove costly to government and the public. Accordingly, while financial reforms are necessary in the country, their design and implementation has to take due cognizance of the **links with the real sector**, of their implications on borrowers' net worth and, ultimately, their effects on the portfolios of banks and the general institutional health of the financial system.

The success of financial sector reforms calls for a pragmatic approach which takes into consideration not only the current state of the financial sector, but also of the real sector. Moving too fast to improve balance sheets of financial institutions and recapitalizing banks in an environment where the main borrowers (the Government and public enterprises) are financially-distressed and the institutional capacity is weak could engender serious systematic risks to a country's financial system and vice versa.

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