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NO40

RISK MANAGEMENT IN FINANCIAL SERVICE INDUSTRY

Isa Audu

MONETARY POLICY DEPARTMENT
10TH
Anniversary
Commemorative
Edition

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Aims and Scope

Understanding Monetary Policy Series are designed to improve monetary policy communication as well as economic literacy. The series attempt to bring the technical aspects of monetary policy closer to the critical stakeholders who may not have had formal training in Monetary Management. The contents of the publication are therefore, intended for general information only. While necessary care was taken to ensure the inclusion of information in the publication to aid proper understanding of the monetary policy process and concepts, the Bank would not be liable for the interpretation or application of any piece of information contained herein.

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Central Bank of Nigeria

Mandate

- Ensure monetary and price stability
- Issue legal tender currency in Nigeria
- Maintain external reserves to safeguard the international value of the legal tender currency
- Promote a sound financial system in Nigeria
- Act as banker and provide economic and financial advice to the Federal Government

Vision

"By 2015, be the model Central Bank delivering Price and Financial System Stability and promoting Sustainable Economic Development"

Mission Statement

"To be proactive in providing a stable framework for the economic development of Nigeria through the effective, efficient and transparent implementation of monetary and exchange rate policy and management of the financial sector"

Core Values

- Meritocracy
- Leadership
- Learning
- Customer-Focus

MONETARY POLICY DEPARTMENT

Mandate

To Facilitate the Conceptualization and Design of Monetary Policy of the Central Bank of Nigeria

Vision

To be Efficient and Effective in Promoting the Attainment and Sustenance of Monetary and Price Stability Objective of the Central Bank of Nigeria

Mission

To Provide a Dynamic Evidence-based Analytical Framework for the Formulation and Implementation of Monetary Policy for Optimal Economic Growth

FOREWORD

The understanding monetary policy series is designed to support the communication of monetary policy by the Central Bank of Nigeria (CBN). The series therefore, provides a platform for explaining the basic concepts/operations, required to effectively understand the monetary policy of the Bank.

Monetary policy remains a very vague subject area to the vast majority of people; in spite of the abundance of literature available on the subject matter, most of which tend to adopt a formal and rigorous professional approach, typical of macroeconomic analysis. However, most public analysts tend to pontificate on what direction monetary policy should be, and are quick to identify when in their opinion, the Central Bank has taken a wrong turn in its monetary policy, often however, wrongly because they do not have the data for such back of the envelope analysis.

In this series, public policy makers, policy analysts, businessmen, politicians, public sector administrators and other professionals, who are keen to learn the basic concepts of monetary policy and some technical aspects of central banking and their applications, would be treated to a menu of key monetary policy subject areas and may also have an opportunity to enrich their knowledge base of the key issues.
In order to achieve the primary objective of the series therefore, our target audience include people with little or no knowledge of macroeconomics and the science of central banking and yet are keen to follow the debate on monetary policy issues, and have a vision to extract beneficial information from the process, and the audience for whom decisions of the central bank makes them crucial stakeholders. The series will therefore, be useful not only to policy makers, businessmen, academicians and investors, but to a wide range of people from all walks of life.

As a central bank, we hope that this series will help improve the level of literacy in monetary policy as well as demystify the general idea surrounding monetary policy formulation. We welcome insights from the public as we look forward to delivering content that directly address the requirements of our readers and to ensure that the series are constantly updated as well as being widely and readily available to the stakeholders.

Moses K. Tule
Director, Monetary Policy Department
Central Bank of Nigeria

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Isa Audu [2]

SECTION ONE

Introduction

The financial service industry is dynamic as new ideas, new products and new ways of doing business are its unique features. Indeed, the businesses of financial services have changed noticeably over the years, and expanded. Amidst all this innovation, it is important to know and be able to measure the risks that new products and new ways of doing business bring. An important consequence of this shift has been an increase in the exposure to the risks associated with financial markets. The unmitigated exposure owing to expanded activities could be catastrophic for the financial system and have general spill-over (contagion) effect. The necessary complement to the development has been an increasing focus on risk management. Thus, an enterprise must understand and articulate its risk appetite, not only for managing risk, but also for improving general business performance.

Normally, risk is regarded as a threat to a bank's steady flow of income. The rational approach to risk therefore, is at the very least to restrict exposure to it, ideally to avoid it all together. Risk avoidance may appear as solution to every risks, but evading risk may also deny an organization the prospective gain that accepting (retaining) such risk might have permitted. This paper aims at discussing risk management in financial services industry.

Following the introduction, section 2 reviews concept of risk and risk management, while section 3 discusses strategies for risk management in financial services industry. Section 4 contains the overview of risk-management

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[1]This publication is not a product of vigorous empirical research. It is designed specifically as an educational material for enlightenment on the monetary policy of the Bank. Consequently, the Central Bank of Nigeria (CBN) does not take responsibility for the accuracy of the contents of this publication as it does not represent the official views or position of the Bank on the subject matter.

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practices in the Nigerian banking industry, while section 5 reviews risk management and bank regulation. Section 6 concludes the paper.

SECTION TWO

Concept of Risk and Risk Management

Risk is the possibility, likelihood or chance that something unpleasant or unwelcomed will happen that is capable of damaging an asset, or all of the original investment or the possibility of financial loss. More precisely, risk is the possibility of damage or any other negative occurrence that is caused by external or internal vulnerabilities, which may be avoided through preemptive action. Risk is commonly associated with uncertainty, as the event may or may not happen. It is an essential part of business, because enterprises cannot function without taking risks as business grows through risk taking. Hence, risk is related with opportunities and threat, which may harmfully affect an action or expected outcome.

Risk management is, thus, the identification, assessment, and prioritization of these risks followed by coordinated and effective application of resources to reduce, monitor, and control the probability and/or impact of disastrous events (Wikipedia 2008). It is also the process by which managers identify key risks, obtain consistent, understandable, mitigating measures, choosing which risks to avoid or reduce and by what means, and establishing procedures to monitor the resulting risk position. The essence of risk management is to detect prospective problems before they become actual problem, and the implementation of an enterprises wide strategy to manage those risks. Thus, an ideal risk management program assists an enterprise to steer clear of potential risks before they occur throughout the life of the product or project. A risk management design includes tools or methods of analysis that allows an organization to reduce, delay or avoid likely risks.

In its broadest sense, the risk management strategy of financial service operators is to ensure that exposure to either financial loss or loss of reputation is contained. In some areas, the objective is not to eliminate risk entirely, since it is usually necessary to take risk in order to obtain a financial return.

Thus, risk management is a continuous, progressive procedure that is applied to risks that may negatively impact on a project, and there must be a balance on each project in terms of overall risk management ownership and implementation to mitigate the adverse effects of loss.

Risk management should address issues that could endanger the achievement of critical objectives. Risks can emanate from several ways e.g. financial markets, letdowns in project, counter party default risk, accidents, natural causes, etc. Risk and risk management cut across all sectors of the economy. Risk management does not eliminate risks, but manage risks associated with firms' operations, thereby exploiting opportunities and reducing threats. It also means introducing techniques to reduce the possibility of these negative events occurring, without incurring excessive costs or hampering the initiative and entrepreneurial flair of an enterprise. Hence, loss exposure is what risk management is all about, not only the ones that can be underwritten. In that regard, insurance is a method to finance some loss exposures and, thus, a part of the larger concept of managing risk.

The overall purpose of the management of risk process is to help a decision-maker understand a situation, along with the likely outcomes. Specifically, it helps to:

- Identify the various risk elements inherent in a given system;
- Prevent undue exposure to both internal (circumstances or events within an organization), or external (those in the wider business arena) risk elements that can undermine the continuous existence of a given system;
- Prevent systemic failure by given early signals on any threat;
- Access the quality and effectiveness of the risk management strategies already deployed to mitigate the identified risk elements in the system;
- Support better decision making by providing Management with the nature of risks that may impede the organizations overall strategies and objectives; and
- Develop effective strategies to manage performances and results, reinforce transparency and accountability.

2.1 Principles of Risk Management

The International Organization for Standardization (ISO) identifies the following principles of risk management.

- Risk management should create value.

Risk management should be integrated into the organizational processes.

- Risk management should be part of decision making.
- Risk management should explicitly address uncertainty.
- Risk management should be systematic and structured.
- Risk management should be based on the best available information.
- Risk management should be tailored to the specific needs of an organization.
- Risk management should take into account human factors.

- Risk management should be transparent and inclusive.
- Risk management should be dynamic, interactive and responsive to change.
- Risk management should be capable of continuous improvement and enhancement.

2.2 Ideal Risk Management

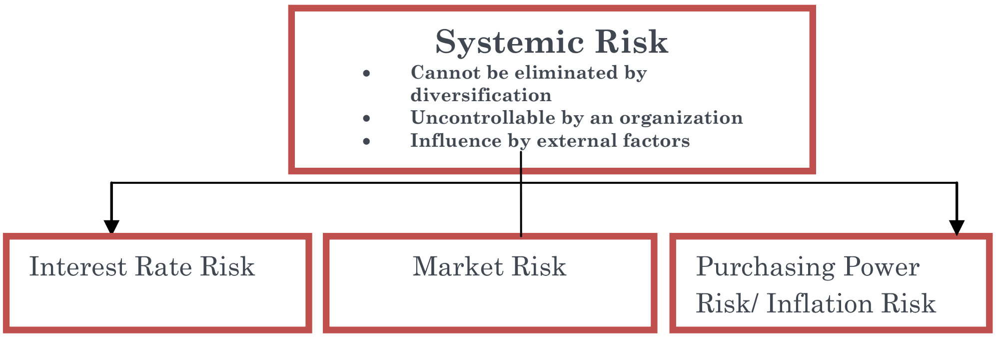
In sound risk management practices, an ordering process is pursued, whereby those risks with the highest loss and the highest likelihood of occurring are brought under control first, and those with lesser possibility of happening and lesser loss are controlled in descending order. In practice, the process can be very challenging and balancing between these probabilities can always be mismanaged. Ideal risk management can help to reduce spending as well as the adverse effects of risks.

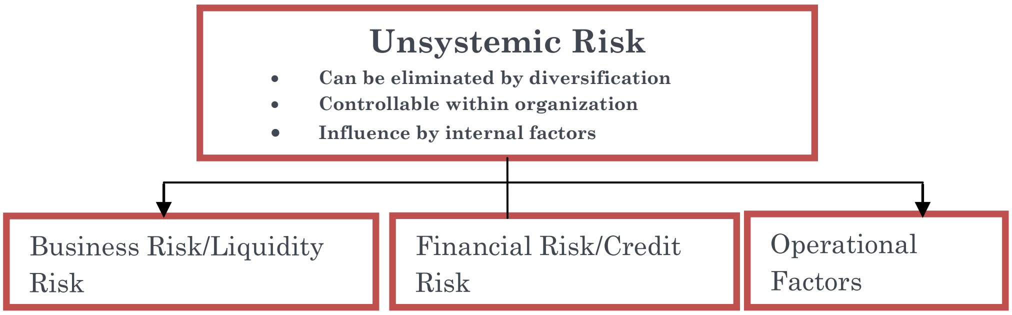
2.3 Broad Categories/Types of Risk

In financial parlance, risk can be categorized into two main groups, viz., *Systemic (Non-Diversifiable) and Un-systemic (Diversifiable) risk)* as depicted below:

a) **Systemic Risk/Non-diversifiable** - Systemic risk is also known as un-diversified or market risk. It can be defined as risk that cannot be eliminated or avoided by diversification; it can only be mitigated through hedging. This type of risk is uncontrollable and it is virtually impossible for any organization to protect itself from this type of risk. It cannot be planned for, as it normally arises due to the influence of external factor on enterprises. Systemic risk is also macro in nature as it affects a large number of firms. Systemic risk influences a large number of assets. Interest rates, recession, war or any important political event, for example, could affect several assets in a portfolio.

b) **Unsystemic Risk/Diversifiable** - This is the risk other than systemic risk, and sometimes referred to as "specific risk" or diversified risk. Diversifiable risk is the risk that can be eliminated by diversification. Unlike systemic risk, unsystemic risk can occur mostly as a result of internal factors prevalent in an organization. This type of risk is controllable; as such it can be planned. In effect, it is micro in nature as it affects only a particular organization. Thus, to protect business from un-systemic risk, diversification is the only solution. This class of risk affects a very small group of assets. Examples of this category of risk includes: operational risk, business risk, financial risk and liquidity risk, and as depicted below:





c) **Relevant Risk:** Since systemic risk is beyond the control of people working in the market, it is irrelevant risk. It is irrelevant in the sense that it is practically difficult to safeguard businesses against this type of risk and is not controllable. Thus, unsystemic risk is the relevant risk, because it is under the control of the investor to decide in which security to invest or not, and can be controlled or eliminated through diversification.

2.3.1 Specific Types of Financial Services Risks

The nature of financial services is strongly related to the management and control of risks. Hence, banks in the process of providing financial services undertake several kinds of financial risks, which constitute a threat to such bank's steady flow of income and the achievement of financial stability. Typically, the key risks identified for the Nigerian financial services industry can be broken down into nine generic types as discussed below.

2.3.1.1 Strategic Risk

Firms in the financial service industry in the course of fulfilling their goals are confronted with strategic risk, which could considerably affect their ability to survive. This type of risk might emanate from poor execution of business plan, inadequate resource allocation, and poor business decisions or from inability to response well to changes in the business environment. Strategic risks are critical to the growth and performance of any organization and are influenced by Board decisions about the goals and direction of the organization.

2.3.1.2 Market Risk/Volatility Risk

Market risk refers to the risk of loss emanating from the erratic valuation in the price of assets due to the adverse movements in market prices. More precisely, market risk may occur due to reasons that disturb the general performance of the financial markets; mostly external factors. These factors include: interest rate risk, currency risk , equity risk and commodity risk. Market risk is also known as *systemic risk*, it is uncontrollable and cannot be avoided through diversification, but it can be hedged by financial services firms, particularly banks. For instance, larger chunks of deposit money banks (DMBs) resources are invested in instruments that have higher risk in the markets; this category of risk constitute the source of the problems of a great number of DMBs.

2.3.1.3 Credit Risk/Default Risk/Financial Risk

Credit risk occurs when a debtor defaults on a loan or other line of credit. It may also arise from a change in the credit quality of a counterparty resulting from a market-base revaluation; perhaps following a rating agency downgrade, or from actual default. This type of risk is largely that of the financier and includes the loss of principal and interest, and the loss may be complete or partial. Credit risks can result in the erosion of a bank's capital. For instance, the recent experience in the Nigerian credit market, where provisioning caused from losses by banks on margin loans threatened their capital.

2.3.1.4 Liquidity Risk

This is the risk that cash cannot be realized in a timely and economic fashion in order to meet any and all forecast and unpredictable flows. This type of risk arises from the type and nature of the asset/liability mix or bank liquidity. In the financial sector, DMBs routinely experience mismatch between their asset and liabilities during intermediation. This occurs when banks take funds on short-term deposit (liabilities), pool them together, and lend them on longer maturity (loans). The risk here is the lack of certainty concerning a bank's capacity to meet its commitments as they occur.

Liquidity risk can also emanate from conditions in which an assets holder wants to sell his assets, but is unable to do so, because he cannot get buyer on those assets. More precisely, this type of risk stems from the lack of marketability of an asset that cannot be purchased or sold fast enough to prevent or minimize a loss. Poor liquidity management could cause a condition where a financial service company though apparently solvent, may be unable to meets due obligations.

2.3.1.5 Operational Risk

This is the risk that stems from the failure of people and process within an organization. It arises as a result of the breakdown of internal procedures, people, policies and system. In another words, operational risk could result from insufficient or botched systems, processes, and people as well as from external developments. It is a consequential risk – that is, it arises when another, specific risk develops. These specific risks include human error; system failure or the possible break down of computer system; lack of back-up or disaster recovery plan and external events. Example of operational risk includes frauds related to ATM and internet frauds, etc. Operational risk is difficult to measure and is often seen as "residual" risk after all the other risks have been identified. It is a source of worry for both banks and monetary authorities. For instance, scam, weak IT infrastructure and corporate governance, among others, constitute serious challenges to DMBs in Nigeria.

2.3.1.6 Reputational Risk

This is the risk that one cannot be trusted. All the aforementioned risks if not properly managed, could adversely affect the image, credibility and reputation of a financial service firm and could lead to the loss of reputation. It is an important aspect of strategic risk. For instance, the business of banking is exclusively reliant on trust of the client that the money kept at the bank could be retrieved any time it is needed or at maturity of the deposit. Waning of that trust could result in a run on banks. The likelihood of injury to the client's self-assurance in the bank is referred to reputational risk.

2.3.1.7 Counterparty Risk:

Counterparty risk is basically related to the phenomenon where an entity in a contract will not live up to its contractual obligations. Counterparty risk is normally associated with the non-performance of a trading partner. In most financial contracts, counterparty risk is also known as "default risk". This type of risk gained prominence in the wake of the global financial crisis (GFC).

2.3.1.8 Legal Risk/Regulatory Risk

Legal risks stems from the contractual agreements that financial services firms undertake. These consist of the risk that loan agreement may not be enforceable under the relevant law and that the nature of the product/service may render the financial service company exposed to litigation. This risk could also emanate when governments suddenly amend laws in a way that negatively affects an investor's position. Legal risk could also occur through lawsuits or adverse court judgments that can disrupt or negatively affect the conditions of the business entity.

2.3.1.9 Solvency Risk

Solvency risk can result when an individual or organization can no longer meets its financial obligations or unable to satisfy its debt. Solvency risk is also known as bankruptcy risk. Solvency risk is greater when the individual or firm has little or no cash flow, to cover losses generated by all types of risks.

SECTION THREE

Strategies for Risk Management in Financial Services Industry

In its broadest sense, the strategy to manage risk is to ensure that exposure to either financial loss or loss of reputation is controlled. In some areas, the goal is not to eliminate risk entirely, since in profit oriented activities such as banking it is usually necessary to take risk in order to obtain a financial return. Typically, risk management strategies include shifting the risk to another person, evading the risk altogether, minimizing the adverse effect of the risk or even accepting some or all of the potential or a particular risk.

3.1 The Risk Management Process

As a result of the large range of risks that the financial institutions undertake, there are no approved or agreed risk management technique that works for everyone. Every financial organization is expected to adopt a risk management plan that meets it requirements and circumstances. However, it is suggested that organizations should examine the best risk management practices in the area. Irrespective of the risk management strategy, each plan should cover the following:

3.1.1 Risk Identification

Risk identification is the first step in preemptive risk management practice. Recognizing risks, as well as their likelihood and overall impact, can help a risk expert to provide recommendations that enable corporations to develop an efficient risk management plan. Risks are about events that, when triggered, cause problems. It provides the indicators and information that permits organization to identify major risks before they negatively affect operations and hence the business. Thus, risk identification could begin with the origin of the problems, or with the problem itself.

Source analysis Risk sources may be within or outside the system, and this is the target of risk management. Categories of potential risks includes: bank customers, workers of a corporation, technical, cost, contractual, climate conditions etc. **Problem analysis:** Risks are related to identified threats e.g. fear of losing money in the case of default, threat of accident and casualties as well as abuse of privacy information. The threats may occur from several units, most especially with customers, investors, and legislative bodies. As soon as the sources of the problems are identified, the events that may trigger or lead to a problem can be examined and tackled by the organization.

3.1.2 Risk Assessment/Evaluation

Risk assessment/evaluation is the next phase in the risk management process. Once a potential hazard has been identified, they must then be evaluated based on the potential severity of loss and the probability that the risk will occur. Risks are not equal, some risk events are more likely to occur than other, and the cost of each risk event can vary greatly. Thus, it is important for the risk management strategist in an organization to guess correctly in order to appropriately prioritize the execution of the risk management design. Moreover, an assessment of risk is generally conducted as part of the needs assessment and service planning process.

Risk evaluation offers a tool for ascertaining which risks denote probable opportunities and which denote impending pitfalls. Risk evaluation gives establishments a clear view of variables to which they may be unprotected, whether internal or external, retrospective or forward-looking. A strong risk valuation method, applied constantly throughout the corporation, enables the management to better recognize, appraise, and exploit the right risks for their business, while keeping proper control to guarantee efficient operations and supervisory compliance.

For risk evaluation to produce the desired results, certain key values must be considered. For instance, a risk assessment should begin and end with specific business objectives that are anchored in key value drivers. Also, governance over the assessment process should be clearly established to foster a holistic approach and a portfolio view. Lastly, capturing leading indicators boosts the capacity to anticipate likely risks and opportunities before they occur. With these foundational principles in mind, the risk assessment process can be periodically refreshed to deliver the best possible insights.

The major challenge in risk assessment is determining the rate of occurrence due to the lack of statistical information on all kinds of historical occurrences. In addition, measuring the effect is always problematic for intangible assets such as image, as asset valuation also needs to be tackled. Nonetheless, risk valuation should offer evidence for management that makes essential risks easy to comprehend, and risk management decision simple to rank.

3.1.3 Risk Mitigation

Once the critical set of risk has been thoroughly identified and assessed, then the risk strategists are in a better position to determine the best course of action to mitigate those risks. Hence, the strategies and actions to manage the risk could be subsumed into one or more of these four major categories which include: risk avoidance, risk reduction, risk transfer and risk retention. Each of these techniques could serve as effective instrument in minimizing individual risk and the risk profile of the scheme.

3.1.3.1 Avoidance (eliminate)

This involves the elimination of risk at any cost. This also connotes refusing to undertake any task that could bring risk. For instance, when a bank refuses to grant loan to an enterprise in the real sector for the fear of the loan default risk that is associated with it. Avoidance may seem aggressive and effective and the answer to all risks, however, it is not practical, since it is necessary for banks to take risks in order to obtain financial return.

3.1.3.2 Reduction (mitigate)

Risk reduction involves techniques that minimizes the probability of the loss from occurring through investment of funds. For instance, an international business corporation could hedge foreign currency in order to reduce the risk associated with foreign currency fluctuations. Another example is when companies invest in sprinklers, which are intended to extinguish a fire in order to minimize the risk of loss by fire. Thus, corporations should correctly use risk reduction techniques to minimize their risk. These include the use of letters of credits, collateralization of transactions, netting arrangements etc.

3.1.3.3 Transfer (outsource or insure)

Risk transfer is a risk mitigation approach that includes contractually transferring risk from one party to another. For instance, purchasing insurance policy is the most common form of transferring risk from the entity to another party. The risk is transferred from the project to the insurer issuing the policy. In effect, the insurance may be labelled more correctly as a post-event compensatory mechanism. A bank may purchase fire or robbery insurance that would cover the risk of loss by fire or loss of money due to arm robbery. The purchase of insurance is usually outside the control of the corporations. Risk transfer tactics are important element of a risk management plan, because they enable a unit to reduce its risks of taking on another entity's liability unknowingly, or from being exposed to additional liabilities due to the actions of others.

3.1.3.4 Retention (accept and budget)

Risk retention is a form of self-funding of losses and the most common risk financing technique, especially when the loss values are relatively low. Indeed, this technique remains a viable strategy for small risks. It is employed as a way of keeping a portion of financial or operating risk as against transferring or hedging. Corporations employ this technique, after determining that the cost of shifting risk to an insurance corporation is higher over time than the cost of absorbing the risk, thereby paying for losses out of their own reserve fund. In effect, it means accepting the loss when it occurs. The merit of adopting this strategy is to incentivize corporations to adopt loss prevention projects, thereby minimizing the total cost of risk.

SECTION FOUR

Overview of Risk-Management Practices in the Nigerian Banking Industry

The banking industry, which occupies a central position in the Nigerian financial system, is in the business of managing risks to generate profits by accepting deposits, granting loans and trading portfolios. Commercial entities, private customers, corporate organizations and authorities deposit their funds with DMBs based on trust and self-assurance that such a DMB will manage the money, and other funds at its disposal, without exposing them to undue risk of loss. Such deposits are usually short term, legally repayable in full to the depositors on demand. The banks invest the money received and provide returns to their shareholders in line with the accepted risk profile. Consequently, unmitigated exposure by banks owing to their activities could be catastrophic for the financial system through general spill over/contagion effect.

Ongoing reforms of the banking industry had revealed weaknesses in the Nigerian financial service industry. The financial service industry was characterized by poor risk management practices, due to the absence of basic control measures, as boards and managements of banks failed to observe established controls by the CBN. There was near total absence of corporate governance in most of banks, blatant and excessive exposure to the stock market, petroleum industry, and lack of adequate disclosure and transparency about the accurate financial positions of banks. The developments that triggered crisis of confidence and brought the Nigeria banking system into discredit includes: huge non-performing loans, inter-bank indebtedness, contravention of supervisory and regulatory provision, weak internal control, inside abuse, huge exposure to single or few obligors, macroeconomic instability, etc.

Other element of the crisis in the Nigerian financial service industry can be attributed to poor operating environment, stiff competitions, and lack of dependable consumer credit report on corporate bodies and prospective borrowers. In effect, no ideal operating policy exist that could guide bank lending as expected of modern banking. This resulted in the DMBs concentrating on few sectors and activities that seem lucrative like the oil sector, information technology, margin loans, product importation and preference for few big ticket clienteles than lending to small scale and mid-sized firms or lending for long-term projects.

Before 2006, the regulatory authorities relied heavily on the rules and compliance supervisory framework, as the main strand for managing financial market risks in line with the provision of the Basel 1 Accord. Usually, the rules were communicated through the issuance of supervisory circulars and guidelines, with the expectations of full compliance by financial market operators. Prominent in this regard, is the Monetary and Credit Policy Circulars and the periodic issuance of the Prudential Guidelines to operators. The rule and compliance approach place reliance on transaction testing, such as evaluating the adequacy of credit administration process, assessing the quality of loans and ensuring the adequacy of provisioning for loan losses. Thus, risk management in bank focused primarily on qualifying the problems, correcting the systems and minimizing the risks in individual institution.

The emergence of distress in the financial service industry in the 1990s exposed the inadequacy of the rule and compliance based supervision, due to the obvious fact that the risks being taken by market operators were ineffectively evaluated. It was realized that the adoption of one-size-fits-all technique in respect of all institutions without regards for variation in size, business mix as well as the individual penchant for risk was inadequate and inefficient.

SECTION FIVE

Review of Risk Management and Bank Regulation

Risk management has been a matter of real interest to financial regulators in two quite distinct senses: the use of risk management theory and practice by banks in running their business; and the recognition by regulators that they need to manage the risks they face in carrying out their responsibilities. Failure to sufficiently manage these risks exposes DMBs not only to losses, but may also threaten their survival as business entities, thereby jeopardizing the stability of the financial system. Because bank regulators stand in the place of the depositors and investors, whose interest they are to protect, they take a close interest in the kinds of risks that banks undertake and in the policies and techniques that they adopt in managing them.

Regulatory authorities are apprehensive that some DMBs may not have the capacity to effectively manage the risks they confront in their obsessive and uncoordinated expansion programs. The condition is exacerbated by the weak corporate governance, over-aggressive lending practices and risk tolerances that were hazardous in the banks. This counts against instituting a risk-conscious environment in the financial service industry. With insecure markets for commercial assets, falling incomes and changing economic thinking, each firm has to efficiently manage the resultant risks in the rapidly changing environment. Thus, effective risk management to ensure the stability of the financial system is a major challenge to the regulatory authorities. This is because the insolvency of any operator would disrupts the financial system and have broader economic ramification within the economy and beyond.

The surveillance roles of the supervisory authorities are important to ensuring the safety, soundness and efficiency of financial institutions, in order to build up confidence and stability of the system, and to save the country from avoidable crisis. The role of the CBN in the economy lies in the effective regulation and supervision of the banking sector, as well as critical developmental initiatives of the Bank. The Bank ensures that the DMBs have adequate levels of capital, which is one of the first levels of defense, which a central bank has against banking system crisis. But if a bank does get into trouble, the central bank has to make judgment about how much support it should give to such institution and balance the benefits of providing support against the risks of moral hazard. Making such judgment is what Alan Greenspan has called the "essence of central banking". The central bank therefore, plays an important part, directly and indirectly, in deciding the division of risk in the financial system as a whole between the public sector and private sector.

Although the DMBs strive to keep pace with the rapid changes in the operating and regulatory environment, the regulatory authorities also strive to cope with their workload and effectively supervise the banks. This implies that banks tend to receive less supervision and assessment from regulators, with the potential for more problems, resulting in an overall increase in bank failures.

Notwithstanding, the CBN recently announced reforms measures to address certain weaknesses in the Nigerian financial service industry in response to the devastating impact of the GFC. The Bank adopted strategic medium to long-term measures aimed at strengthening the capacity of the banks to contribute to an all-inclusive growth. Thus, the CBN in 2009 launched a reform agenda focused on four pillars, which included the quality of banks, ensuring financial stability, enabling healthy financial sector evolution, and ensuring that the financial sector contributes to the development and growth of the real sector.

In order to promote provisioning policies, which are consistent with sound risk management practices, the CBN recently reviewed the Prudential Guidelines for DMBs based on forward-looking capital provisioning, driven by stress test. The guidelines address wide-ranging areas of risk management, corporate governance, know your customer (KYC) and anti-money laundering, loans loss provisioning, and financing to different sectors. The objective of the new prudential guidelines among others, is to ensure that the provisioning guidelines reflect gestation periods of the various types of loans and to provide framework for "Haircuts" adjustment for lost facilities.

Some of the key issues addressed by the guideline are highlighted below: Section 3.17 under the Risk Management section made provision for a tolerable limit of non-performing loan to total loans. Item (a) allows a 10.0 per cent tolerable limit of ratio of non-performing loans to gross loans (NPL ratio) and further discloses sanctions by the CBN in cases "where the ratio of non-performing credits to total credits is 20.0 per cent above tolerable limit of 10.0 per cent and/or 25.0 per cent of non-performing credits are insiders related.

"Sections 3.24 and 3.25 of the guideline make provisions for expectations on "credit rating of counter party/obligor and sectors" and "credit rating of banks", respectively. Section 3.9 on the Risk Management provisions gave minimum conditions, which must be met before taking exposures. Item (d) is of relevance to credit information reporting and it states: "All banks must obtain credit report from at least two (2) credit bureaus before granting any facility to their customers. In addition, compliance with the CBN circular BSD/DIR/GEN/CIR/04/014 issued on 30 April 2010 is mandatory."

It further stated: "Sequel to the provisions of this Guideline, the CBN issued a circular (CBN circular BSD/DIR/GEN/CIR/04/014) to further strengthen credit appraisal procedures towards improving quality of credit and responsive credit behavior in the nation's banking industry. The circular mandated banks and other financial institutions under the purview of the CBN to comply with Sections 5.4.3 and 5.45 of the Guidelines on Licensing, Operations and Regulations of Credit Bureaus in Nigeria. It also mandated submission of quarterly credit reports for all previous loans/facilities granted to enable the determination of the borrowers' current exposure to the financial system. Failure to comply will attract appropriate sanctions by the regulatory body. Section 4.0 of the Guideline addresses some corporate governance issues not specifically addressed in the initial code to include tenure of CEOs, eligibility, amongst others.

In line with the global best practice of effective risk management and control system, the Bank has implemented a risk-based technique in the supervision of the institutions under its purview, commensurate with the scope of their operations in line with New Capital Accord (Basel II). A major feature of the new strategy is the precondition that financial institutions should strongly manage the risks that confront them. Banks are anticipated to put measures in place to identify and control those risks, while the CBN has provided the best-practice guidance in the form of the Guidelines for Developing Risk Management Frameworks. This is to enable banks to develop their respective strategy for evolving efficient risk management system. The Risk-Based Supervision represents a shift away from the rigid rules, of the transaction and compliance based rules to a more risk-sensitive framework, which seeks to encourage DMBs to continuously update their internal risk management system commensurate with scope of their operations.

The CBN also followed up these reforms with the establishment of the Asset Management Corporation of Nigeria (AMCON), following the promulgation of its enabling Act by the National Assembly in 2010. AMCON is a broad resolution strategy aimed at addressing the problem of non-performing loans, including capital adequacy and liquidity of the banks. In line with its mandate, AMCON has acquired the non-performing risk assets of some banks worth more than N1.4 trillion, to boost liquidity as well as enhance the safety and soundness of the banks. With the intervention of AMCON, banks' ratio of non-performing loans to total credit has dropped significantly to less than 5.0 per cent at the end-August, 2014 from 34.4 per cent in end-November, 2010. The ratio is expected to further drop against the backdrop of the continuous intervention of AMCON in the loan recovery efforts of banks.

Furthermore, in order to address increasing non-performing loans in DMBs, it became imperative for the financial system to create a central data base, which consolidates credit information on borrowers. The CBN Credit Risk Management System (CRMS) or Credit Bureau was therefore, established to enhance credit risk management system and given legal backing by the CBN Act No. 24 of 1991. The enabling legislation empowered the CBN to obtain credit information from banks for compilation and disseminating status report to any interested party (i.e. operators or regulators). The data base provided avenue for identifying predatory debtors, whose techniques involved abandoning debt obligations in some banks, and proceeding to contract new debts in another bank.

The CBN also embarked on the transformation of its internal structure and processes in order to deliver on its core mandate. For instance, the Bank reorganized and streamline it structure by creating new departments namely; Banking and Payments System (B&PS), Reserve Management (REM) and Financial Market Risk Management (RM) Departments. To achieve the highest standard of risk management, the Bank also ensures the establishment of internal risk management specialist function to develop the Nigerian Capital Adequacy and Enterprises Risk Assessment Process Guidelines. All these reforms are intended to ensure and enhance the capacity of the Bank to supervise and monitor the financial service industry efficiently for enhance delivery.

Specifically, the Bank established two new departments, the Consumer Protection (CP) and Financial Policy and Regulations (FP&R) Departments within the Financial System Stability (FSS) Directorate to focus mainly on financial stability and macro-prudential issues. The Consumer Protection Department (CPD) is to provide the platform through which consumers can seek redress as well as enable regulators to enforce discipline in the market. The Bank also strengthened the Financial System Stability Committee (FSC) - to stem the incidence of regulatory arbitrage and enhance inter-agency cooperation in the regulation of the financial service industry.

Other measures were the strengthening of the inter-agency coordinating framework through the Financial Services Regulation Coordinating Committee (FSRCC; issuance of the Code of Corporate Governance to engender sound governance practices in the financial sector, conducting own-risk assessment and relying less on classification by rating agencies; regulating the tenor of banks chief executives to maximum of two terms of 5.0 years each; timely regulation and supervision of the financial sector; rigorous demand for transparency in the financial sector; and, transparency in structured credit instrument to be improved upon for easy assessment of associated risk. In addition, the Bank in collaboration with the Securities and Exchange Commission (SEC) developed a framework for the harmonization of rule on margin loans as well as the rules governing margin trading. Of significance, is the issuance of guidelines on mandatory disclosure by banks preparatory to the adoption of the International Financial Reporting Standards (IFRS) 2012, for transparency and global competitiveness as well as the announcement of the adoption of common accounting year end by the Bank, to improve comparability of developments for policy analysis and for transparency.

Finally, by creating a risk-conscious environment in the financial institutions, the Bank has been able to mitigate the adverse effect of the general weakness in the financial system through various policy measures it adopted. These measures have also improved the risk management practices in banks in the country, and further develop the capability of these organizations to survive under severe economic climate.. The combined impact of these and other reform measures taken by the CBN since 2006 have led to significant improvement in corporate governance practice in the Nigerian banking industry as well as bank balance sheet. Moreover, the CBN was committed to sustaining and consolidating the gains.

SECTION SIX

Conclusion

This brief had shown that risk management has been an age-long affair in the financial service industry and other business activities. Financial market operators, by and large, face a considerable number of risks and this underscored the need for effective risk management to ensure the stability of the financial system. The stability of the financial system is a major challenge to the regulatory authorities, given the implication of its disruption on account of the insolvency of any operator on the economy and beyond. The CBN, mindful of the challenges posed, has reorganized/streamline its internal structure to boost service delivery and enhanced its capacity to better supervise the industry. Nonetheless, image management is indispensable for the financial service industry, since it defines how others relate to the bank, as well as how much faith and trust savers and other stakeholders will place on a bank. Like attitude, the reputation of a bank – one of its priceless assets - is most at risk if a bank suffers a material loss through bad risk management.

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