Making Finance Work for Africa

Workshop

The African approach to the implementation of international standards for banking supervision and the Basel capital framework

April 28-29, 2011

Kampala, Uganda

FINAL REPORT

CONTENTS

EXECUTIVE SUMMARY

The Partnership for Making Finance Work for Africa (MFW4A), in collaboration with the Association of African Central Banks (AACB) and the Bank of Uganda, organized a policy workshop on "The African Approach to the Implementation of International Standards for Banking Supervision and the Basel Capital Framework", in Kampala, Uganda from April 28th - 29th, 2011.

Most African banking systems showed remarkable resilience to the global financial crisis, reflecting not only their low exposure to risks emanating from the subprime crisis but also the major improvements in the quality of banking regulation and supervision over the past two decades. This was manifested in high capital ratios, strong profitability, and high liquidity. Nevertheless, some banking systems experienced pressures and risks, notably from the threat of cross-border contagion (from financial institutions with regional and international operations), operational risks (as innovation and the use of technology-based products increases), and the fragmentation of regulatory and supervisory frameworks will increase as African financial systems grow and integrate more with the global financial system. Access to finance also remains a challenge.

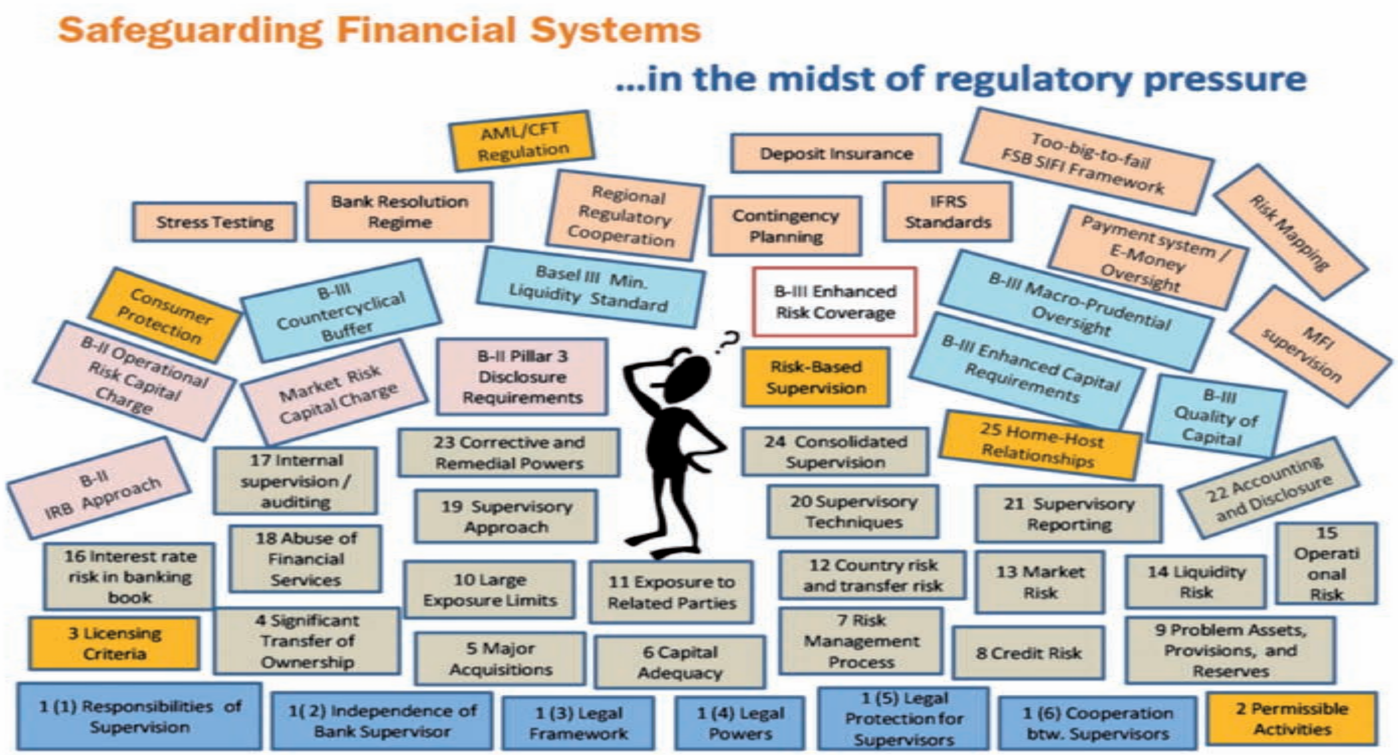
In this environment several important trends are taking place. These include a move towards regional harmonisation of regulatory frameworks, the emergence of African Large and Complex Financial Institutions, a renewed focus on financial sector systemic stability issues, and the rapidly changing international regulatory environment (Basel II & III, and related FSB initiatives).

One of the major issues facing African regulators is how to pursue the regulatory reform agenda, given limited resources, and the identification of priorities and appropriate sequencing. The fact that Africa avoided the worst of the global financial crisis is not an excuse for complacency, and the further upgrading of regulatory standards and supervisory capacity in Africa remains essential.

While there is considerable expectation internationally that countries should follow the Basel II/III route, African priorities in financial regulation may differ substantially from the international agenda. For instance, higher capital requirements as envisioned in Basel III are not a priority in most African countries because capital adequacy ratios are already comparatively high - the focus should rather be on building regulatory capacity. Key challenges include moving to risk-based supervision; skills development and retention; improved financial sector disclosure and governance; developing capacity in consolidated supervision; improved supervision of cross-border financial institutions; regional co-operation between regulators; establishing regulatory frameworks for non-bank financial institutions and new products such as mobile banking; modernisation of financial system infrastructure; contingency plans for financial sector crises, resolution regimes; and developing the capacity for macro-prudential supervision. Rather than using Basel II/III as a blueprint, there is a strong case for African regulators to select those specific components of the international reform agenda that are most relevant in their country context and treat Basel II/III as a long-term objective. But in many cases, improving compliance with the Basel Core Principles (BCPs) is a more immediate priority.

Importantly, the reform agenda needs to reflect the institutional and economic specificities of each country. Given the lack of guidance on part of the standard-setting bodies there is merit in conducting country-level diagnostics and developing regulatory reform road maps that reflect priorities and resources in individual countries and regions.

The workshop participants proposed to establish a "Community of African Banking Supervisors" (CABS) to identify common issues, assist with capacity building and give African regulators greater voice in international fora. An action plan for the regulatory reform agenda was developed, including initiatives to establish the CABS; promote the collective voice of African regulators; strengthen cross-border supervisory co-operation and establish regional supervisory colleges; strengthen capacity-building and BCP compliance assessments; undertake country-level roadmap diagnostics to prioritize reforms and develop regulatory reform roadmaps; and leveraging the experience of central banks in Africa that have implemented Basel II.



Safeguarding Financial Systems
...in the midst of regulatory pressure
AML/CFT Regulation
Deposit Insurance
Too-big-to-fail FSB SIFI Framework
Stress Testing
Bank Resolution Regime
Regional Regulatory Cooperation
Contingency Planning
IFRS Standards
Risk Mapping
Payment system / E-Money Oversight
Consumer Protection
B-III Countercyclical Buffer
Basel III Min. Liquidity Standard
B-III Enhanced Risk Coverage
B-III Macro-Prudential Oversight
MFI supervision
B-II Operational Risk Capital Charge
Market Risk Capital Charge
B-II Pillar 3 Disclosure Requirements
Risk-Based Supervision
B-III Enhanced Capital Requirements
B-III Quality of Capital
B-II IRB Approach
17 Internal supervision / auditing
23 Corrective and Remedial Powers
24 Consolidated Supervision
25 Home-Host Relationships
22 Accounting and Disclosure
19 Supervisory Approach
20 Supervisory Techniques
21 Supervisory Reporting
16 Interest rate risk in banking book
18 Abuse of Financial Services
10 Large Exposure Limits
11 Exposure to Related Parties
12 Country risk and transfer risk
13 Market Risk
14 Liquidity Risk
15 Operational Risk
3 Licensing Criteria
4 Significant Transfer of Ownership
5 Major Acquisitions
6 Capital Adequacy
7 Risk Management Process
8 Credit Risk
9 Problem Assets, Provisions, and Reserves
1 (1) Responsibilities of Supervision
1(2) Independence of Bank Supervisor
1 (3) Legal Framework
1 (4) Legal Powers
1 (5) Legal Protection for Supervisors
1 (6) Cooperation btw. Supervisors
2 Permissible Activities

1. INTRODUCTION

In collaboration with the Secretariat of the Association of African Central Banks (AACB), the Partnership for Making Finance Work for Africa (MFW4A) organized a policy workshop on "The African Approach to the Implementation of International Standards for Banking Supervision and the Basel Capital Framework". The Bank of Uganda (BoU) hosted the workshop from April 28th-29th 2011 in Kampala, Uganda.

The workshop aimed to discuss issues that are crucial to African countries in their efforts to align their regulation and supervision of banking systems with international standards and best practices, while addressing country-specific needs and circumstances.
It brought together African central banks to discuss the relevance of these international standards in the regional context and build an African consensus around reform priorities and adequate sequencing.

The workshop drew from the work of MFW4A Partners (the African Development Bank, the World Bank and the International Monetary Fund), the Financial Stability Board and practical experiences of various African central banks and international regulators (BAFIN). The German Ministry for Economic Cooperation and Development (BMZ) also provided technical and financial support.

This brief report summarises the proceedings of the workshop, and is divided into three sections. The first outlines the main conclusions regarding developments and emerging issues in banking and regulation in Africa. The second highlights issues around upgrading regulatory and supervisory frameworks in Africa, and the final section suggests an action plan to follow up on the workshop conclusions and put ideas into action.

2. DEVELOPMENTS AND EMERGING ISSUES IN BANKING REGULATION AND SUPERVISION IN AFRICA

African regulators have made considerable progress in reforming banking regulation and supervision in the past two decades, and these improvements are one reason for the resilience of African banking systems during the global crisis. Still, there is a need to advance reforms even further due to both global developments and the rapid evolution of African financial systems.

RECENT DEVELOPMENTS

It is widely acknowledged that most African banking systems showed remarkable resilience to the global crisis. This reflected a number of characteristics, including high capital ratios, strong profitability and high liquidity.

Nevertheless, some banking sectors have experienced stress due to the interaction of external developments and internal weaknesses. Some risks have arisen from the structure of financial systems, notably from cross-border contagion. In some countries credit risk has been apparent, especially those with high concentration of lending in specific sectors, and this is often reinforced by weaknesses in legal regimes. Operational risk is becoming more prominent, especially with the increased use of technology-based products. Although widespread reliance on retail deposits tended to mean that liquidity risk was low, in some countries dependence on large institutional depositors meant that this was a potential problem.

Regulatory and supervisory frameworks in Africa tend to be fragmented, and in general the focus has been on the regulation and supervision of banks rather than non-banks. Even within banking supervision, full compliance with international standards is still to be achieved in many countries, supervisory capacity has not kept pace with changing risks and shortcomings have been identified in supervisory and resolution processes.
A number of important changes are taking place in African banking systems that have implications for regulation and supervision. African financial sectors are becoming more integrated with global markets, innovation is leading to the adoption of more sophisticated financial products, and the importance of non-bank financial services is accelerating.
As a result, banks are likely to be subject to more volatile capital flows, heightened credit risk, and liquidity risk.

Access to finance also remains a challenge throughout much of the continent, causing a classic "dilemma" for regulators: supporting innovation that can help improve financial sector efficiency and extend access to low-income groups, while understanding and managing emerging risks. The emergence of technological solutions and new business models is helping to extend access, but poses new regulatory challenges: an increased prominence for managing operational risk, the entry of non-banks (such as telcos) and the blurring of traditional distinctions between payments and banking activities. Developing an appropriate regulatory response - including appropriate Anti-Money Laundering (AML) regulations - in a fast changing environment, is a challenge faced by all regulators across the continent.

EMERGING ISSUES IN BANK REGULATION

An important trend in banking regulation in some parts of Africa is the beginning of regional harmonization of regulatory frameworks. This may involve moving towards a single financial market through having similar or the same legislation across countries, or allowing passporting (a single licence and cross-border branching); introducing resolution procedures for cross-border financial institutions; and regional depositor protection. One example of such regional harmonisation is in the East African Community, which includes cross-border supervisory MoUs, joint examination of regional financial institutions, and upgrading and harmonization of prudential regulations. Challenges are posed by overlapping memberships (countries being members of more than one regional economic community), which can lead to inconsistent or conflicting regulations, lack of resources given competing demands and divergence in banking supervision approaches; lack of technical skills; weak enforcement/compliance; and political issues. Lessons from Europe and elsewhere suggest that the logical outcome of regional regulatory harmonisation is the establishment of regional regulators, which also helps to address some of the conflicts and constraints.

Another important emerging trend is the emergence of African Large and Complex Financial Institutions (LCFIs), which have grown rapidly in recent years. Regulation and supervision has not kept pace with cross-border and cross sector expansion, resulting in supervisory gaps and regulatory inconsistencies. Effective supervision is also impeded by opaque ownership structures, and this is compounded by weak risk management in some groups. Although LCFIs offer potential benefits to the region, they pose risks that need to be monitored and mitigated through a mixture of legal reforms, improved supervision, and crisis management arrangements.

Case studies based on the experiences of African central banks reveal a mixture of common and diverging experiences. Most central banks have not had to deal with banking sector crises, but are nevertheless grappling with the challenges of upgrading their supervisory frameworks. This includes implementing Basel II, or planning for it. Some central banks, however, are giving priority to improving their compliance with Basel Core Principles (BCPs), rather than the rapid adoption of Basel II itself.

Planning the adoption of Basel II has major implications. Typical preparatory measures taken include revision of banking and other legislation, re-organisation of Banking Supervision Departments (BSDs) and building supervisory capacity, the adoption of risk-based supervision, the introduction of online reporting by the banks, and requiring banks to adopt IFRS. Key challenges include re-orientating BSD staff from a compliance-based to a risk-based approach, the (in) adequacy of risk-related skills, financial and resource implications, the need to upgrade risk management capacity at supervised banks, and the challenges of consolidated groups and conglomerates.

Where Basel II has been adopted successfully, advantages include more transparency in supervision and regulation and more of a “common language” with the banks. However, moving from the simplified standardised to the advanced approach may be hindered by the lack of quality data (e.g. on credit ratings and defaults). There are also problems of staff retention, as many of the banks recruit supervisory staff from central banks.
Essential requirements for making a successful transition to Basel II include understanding the importance of dialogue with the banks, the fact that it is a long process, and the importance of appropriate preparation. *A key conclusion from the workshop was that the benefits from implementing Basel II need to be assessed carefully against the costs of implementation. In many African jurisdictions Basel II is likely not to be a priority*.

Central banks are also dealing with financial sector systemic stability issues. Key challenges for central banks include establishing systems for macro-prudential supervision, and preparing contingency plans for financial sector distress and crisis resolution.

3. UPGRADING REGULATORY AND SUPERVISORY FRAMEWORKS IN AFRICA

One of the major issues discussed during the workshop was how African central banks should pursue the regulatory reform agenda, given limited resources: which are the priorities for the continent and what would be an appropriate sequencing schedule?

A PRESSING AGENDA

The international reform agenda comprises many aspects, including Basel II (more sophisticated risk weighting for capital requirements, supervisory review, public disclosure), Basel III (higher minimum capital requirements, higher quality capital, capital buffers, leverage ratio, liquidity standards, etc.). In addition, work is being undertaken by the Financial Stability Board (FSB) on a broad range of issues including Systemically Important Financial Institutions (SIFIs), Credit Rating Agencies, and macro-prudential tools and policy frameworks.

Although the continent has generally avoided the worst problems that have emerged in developed countries, this is not an excuse for complacency. The upgrading of regulatory and supervisory standards and capacity in Africa is a key requirement and there are many emerging risks that need to be understood. In particular, regulators have to move beyond the national focus that have traditionally characterised bank regulation and supervision, to deal with cross-border issues and consolidated supervision.

REFORM PRIORITIES

African priorities in financial regulation and supervision differ substantially from the Basel II/III route being discussed internationally. For instance, higher capital requirements as envisioned in Basel III are not a priority in most African countries because capital adequacy ratios are already comparatively high. Research suggests that there would only be a marginal benefit from increases in capital requirements, in part because capital requirements are already high in most African countries, and that the priorities are elsewhere. On the other hand, building regulatory capacity is a big priority across the region.

As a general principle, the adoption of Basel II and III in Africa should not be rushed, but should be seen as a longer-term objective. Basel II and III can provide a reference framework to provide orientation as systems develop, but not all Basel and FSB standards are of immediate relevance for developing countries, and they do not necessarily provide a blueprint to guide reforms, especially in low-income countries. For many African countries, enhanced compliance with the Basel Core Principles (BCPs) is a general priority that would put supervisors in a stronger position to deal with the changing risks in their financial systems. But even among the BCPs some may be more urgent than others. Countries should identify and focus scarce resources on those elements of the reform agenda that are most relevant in their specific context. Hence the need for country diagnostics to prioritise building blocks of reform and develop regulatory roadmaps.

Going forward, there is considerable scope for regional and collective efforts, given that many countries face similar challenges and could benefit from sharing their experiences. Furthermore there is scope to leverage economies of scale in capacity building that could be provided on a regional basis.

Workshop participants identified a number of elements in the Basel II and III frameworks that would be useful in their jurisdictions: the general move towards risk-based supervision was seen as important, but for most African countries the Simplified Standardised Approach of Basel II is most relevant given the difficulties of measuring operational, market and credit risk with the required degree of certainty. The disclosure and corporate governance elements of Basel II were also seen as important. Under Basel III, the incorporation of macro prudential supervision was considered to be more relevant and urgent than other components such as raising capital requirements, countercyclical capital buffers, leverage ratios and liquidity standards.

4. THE WAY FORWARD

Given the distinct features and stages of development of banking systems across the African continent, there can be no one-size-fits-all solution. The relevance and applicability of international regulatory and supervisory standards needs to be assessed on a case-by-case basis. Roadmaps for reform should prioritise regulatory building blocks based on an assessment of the specific risk profile of the banking sector and the economy, factor in the institutional capacity and resource limitations for reform and tailor design and sequencing schedules to individual country needs.

PRIORITY AREAS

Workshop participants had the opportunity to identify key ongoing and anticipated future priorities. While the exact priorities vary from country to country, the following were identified as the key issues across the region (with the most important ones in italics):

- **Upgrading of regulatory and supervisory frameworks**

- *Developing capacity for macro-prudential supervision;*
- *Establishing regulatory frameworks for mobile banking, other forms of branchless banking services etc*;
- Upgrading regulatory frameworks and supervisory capacity for non-bank financial institutions (pensions, insurance, securities etc.);
- Conducting BCP reviews and enhancing compliance; and
- Development of consolidated supervision of diversified financial conglomerates, legal reforms and modernisation.

- **Building supervisory capacity and tools**

- *Developing capacity for risk-based supervision, including modernisation of techniques for both off-site and on-site supervision;*
- *Enhancing IT capacity (notably for risk-based off-site supervision);*
- *Staff recruitment measures to develop and retain skills;*
- Drawing up contingency plans for financial sector crises and institution-specific problems, including resolution regimes, especially for SIFIs; and
- Developing MoUs between bank and non-bank regulators.

- **Regional / cross-border issues**

- *Developing capacity for supervision of cross-border entities, including the establishment of supervisory colleges;*
- Regional harmonisation of regulatory frameworks; and
- Enhanced co-operation between supervisors (e.g. cross-border MoUs).

- **Reporting and Accounting Standards**

- *Application of IFRS standards; and*
- Upgrading bank reporting requirements and formats.

- **Modernisation of financial infrastructure**

- *Introducing deposit insurance;*
- Payment, clearing and settlement systems; and
- Credit information registries.

It is striking that many items on the reform agenda that supervisors are currently working on (e.g. deposit insurance, e-money) are not being driven by the Basel agenda but reflect domestic priorities.

PROPOSED INITIATIVES

A number of initiatives can play a role in taking the regulatory reform agenda forward. **Setting up a "Community of African Banking Supervisors" (CABS)**, under the auspices of the Association of African Central Banks (AACB) and Making Finance Work for Africa (MFW4A). This has been agreed in principle at the Kampala workshop. The initial focus of the CABS would be on information-sharing and peer learning (exchange of views and experiences) and preference shall be given to virtual interaction rather than face-to-face meetings. CABS will also help communication between existing regional organisations of supervisors and foster channels for formulating collective views for input to other fora.

Action items

- Endorsement by AACB Assembly of Governors;
- Elaboration of the Terms of Reference of the CABS (MFW4A/AACB Secretariats).

Collective Voice. African countries are generally not represented in fora such as the G-20 and the FSB (South Africa is the continent's sole representative). However there is a need for the voice of the continent to be heard and for the international regulatory reform process to have inputs from a wide range of developing countries. The Community (CABS) can help to co-ordinate the views and needs of African supervisors and channel these to the C-10/G-20/FSB fora.

Action items

- Establish link to C-10;
- Establish link to FSB Regional Consultative Group for SSA (via South Africa);
- Consider whether link to FSB expert groups for Emerging Markets and Developing Economies (EMDEs) is necessary (management of capital flows and foreign exchange risks; home-host supervisory issues; regulation and supervision of NBFIs; domestic capital markets development; and application of international standards and policies); and
- Seek clarification from international standards setters (BCBS/FSB/IMF/WB) as to their expectations regarding the applicability of standards and policies in low-income countries.

Strengthen cross-border supervisory co-operation and establish supervisory colleges. The growth of large African financial institutions operating in a number of countries indicates a need to establish supervisory colleges, involving regulators from all of the countries in which a specific institution operates. There is also a need to enhance and formalise cross-border co-operation between supervisors.

Action items

- Encourage formalised co-operation between supervisors, e.g. MoUs and harmonisation of regulations;
- Leverage the experience of regulatory authorities in other parts of the world (such as the German regulator BaFIN, which has extensive experience of supervisory colleges in Europe) to help establish the operational modalities of such colleges in Africa. The Community (CABS) could offer a platform for valuing on knowledge resources available through these experiences; and
- Work through existing regional economic communities that already involve collaboration between banking regulators (e.g. SADC, EAC etc.).

Capacity Building. Many central banks face major capacity building needs, reflecting the move to risk-based supervision, the need to develop macro-prudential supervision, the demands of cross-border oversight and consolidated supervision, and the adoption of (parts of) Basel II (and/or Basel III).

Action items

- Determine demand for capacity building among central banks;
- Establish priorities and areas of similar demand across countries;
- Consider scope for regional activities;
- Lodge appropriate requests with IMF/World Bank/FIRST Initiative/AfDB; and
- Mobilise resources, e.g. FIRST Initiative, AFRITACs, EADIs.

FSAPs and BCP Compliance Assessments can play a crucial role in identifying weaknesses and priorities for attention and upgrading of regulatory and supervisory capacity. At the same time, the demand for FSAPs has increased, not least because developed countries are seeking assessments of their financial systems in the aftermath of the global financial crisis.

Action items

- Encourage countries to have updated FSAPs and assessments of BCP compliance;
- Lodge appropriate requests with IMF/World Bank; and
- IMF/World Bank to mobilise necessary resources.

Country-level diagnostics, prioritisation and regulatory road-maps.
While there is a need to increase resources for FSAPs in African countries development partners should also develop new tools such as diagnostic assessments to guide the development of developing country roadmaps for regulatory/supervisory upgrading.

Action items

- Design diagnostic instruments that assist policymakers in prioritising and sequencing reforms; and
- Draw up country-specific regulatory roadmaps for regulatory and supervisory reforms.

Leveraging the experiences of central banks in the region: two central banks in Africa - from Morocco and South Africa - have already moved to Basel II. Others have outlined programmes for the adoption of Basel II, some with specific timescales. Countries planning Basel II/III adoption need to carefully consider resource needs and have a realistic timescale.

The experiences of these two central banks should be disseminated to other central banks in Africa. This dissemination could cover the practical issues around preparations for Basel II/III adoption, realistic timescales and the resources required. The South African and Moroccan experiences can also be useful in respect of key general topics such as introducing risk-based supervision, macro-prudential regulation etc. Dissemination of lessons learned could be on a regional basis (e.g. Morocco for North Africa and Francophone countries, SA for Anglophone and Lusophone countries).

This could be realized through regional workshops, ideally facilitated through MFW4A and the AACB in the framework of the Community of African Banking Supervisors.

Action items

- Request South Africa and Morocco to share their experiences and facilitate peer learning, in modernising regulation and supervision and issues around Basel I/II/III; and
- Organisation of regional workshops.

ANNEX 1: POTENTIAL FOCUS AREAS

Setting up a “Community of African Banking Supervisors” (CABS[1])
Endorsement by AACB Assembly of Governors
Elaboration of the Terms of References of the CABs

Collective Voice
CABS to inform C-10’s work
CABS to inform FSB Regional Consultative Group for SSA
(Leverage the relationship between South African National Treasury and World Bank)
Seek clarification from international standards setters (BCBS/FSB/IMF/WB) as to their expectations regarding the applicability in low-income countries

Capacity Building
Determine demand for capacity building among central banks
Establish priorities and areas of similar demand across countries and consider scope for regional activities
Lodge appropriate requests with IMF/World Bank/FIRST Initiative/AfDB / /AFRITACs/EADIs
Strengthen cross-border supervisory co-operation
Leverage the experience of regulatory authorities in other parts of the world with regard to the establishment of supervisory colleges
Encourage formalised co-operation between supervisors, e.g. MoUs and harmonisation of regulations
Work through existing regional economic communities that already involve collaboration between banking regulators

Leveraging Basel II experiences
Encourage South Africa and Morocco to share their experiences with the adoption of Basel II/III, the introduction of risk-based supervision, macro-prudential regulation etc.
Organisation of regional workshops
Diagnostics, Prioritisation and Regulatory Road-maps
Design diagnostic instruments that assist policymakers in prioritising and sequencing reforms and develop roadmaps of reform
Draw up country-specific regulatory roadmaps for regulatory and supervisory reforms

FSAPs and BCP Compliance
Encourage countries to have updated FSAPs and assessments of BCP compliance and readiness
Lodge appropriate requests with IMF/World Bank

ANNEX 2: PARTICIPATING CENTRAL BANKS (25)

Banque d'Algérie
Banco Nacional de Angola
Bank of Botswana
Banque de la République du Burundi
Banque Centrale du Congo
National Bank of Ethiopia
Banque Centrale de la République de Guinée
Bank of Ghana
Central Bank of Kenya
Central Bank of Liberia
Banque Centrale de Madagascar
Reserve Bank of Malawi
Bank of Mauritius
Bank Al-Maghrib (Morocco)
Banco de Mozambique
Central Bank of Nigeria
Banque Nationale du Rwanda
Central Bank Sao Tome and Principe
Banque Centrale des Etats de l'Afrique de l'Ouest (BCEAO)
Central Bank of Somali
Central Bank of Swaziland
Bank of Tanzania
Bank of Uganda (Host)
Bank of Zambia
Reserve Bank of Zimbabwe

ASSOCIATION OF AFRICAN CENTRAL BANKS WORKSHOP
28TH-29TH APRIL 2011 SERENA HOTEL
KAMPALA,UGANDA