Policy Briefs on the Financial Crisis

N^{O} 3/ 2010

A Preliminary Assessment of the Implications of Financial Regulatory Reform for African Countries

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* with inputs from EDRE, the World Bank, GTZ, the South African Reserve Bank and South Africa's National Treasury

African Development Bank

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A Preliminary Assessment of the Implications of Financial Regulatory Reform for African Countries

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1. Introduction

Africa has weathered the global financial and economic crisis reasonably well so far. Yet tighter global financial conditions negatively impacted trade, capital flows, remittances, and ultimately economic growth both in 2008 and 2009. While the outlook for 2010 is more positive, with the continent set to grow by about 4 percent, this is well-below pre-crisis levels and those needed to achieve the Millennium Development Goals.

One reason for the region's resilience has been the cushion provided by the financial sector, particularly by the banking sector. Banks' capital adequacy ratios across the continent averaged 19 percent in 2008. Nonperforming loans have decreased over the last few years in most countries, reaching an average of 6 percent of total loans in 2008 for the continent, though the trend seems to have reversed recently.[1] Further, African banks have not generally been exposed to subprime-related structured credit products and other toxic assets, given their limited degree of integration in international financial markets and capital account controls in many countries. Overall, the impact of the crisis on the regional financial sector has been limited.

The relative resilience of the financial sector is the result of the structural reforms implemented by many countries over the past decade within a context of sound macroeconomic policies. Most countries have improved the regulatory framework for supervision, bolstering prudential requirements and supervisory rules. Many countries, especially oil exporting countries, have recorded improved fiscal space, lower debt levels and higher reserves. Central banks have controlled inflationary pressures relatively well, anchoring expectations and stabilizing the exchange rate. With stronger financial and macroeconomic policies, many countries in the region have been by and large able to limit adverse feedback effects of financial shocks on the real sector.

Building on this progress, Africa needs to push further and improve its financial sector reform agenda. The main tenets of the current agenda—developing institutional and legal underpinnings for financial stability and promoting access to financial services—remain valid. However, in the future Africa's agenda for financial sector reform will be strongly influenced by the ongoing global debate focused on structural reforms needed to improve the regulatory framework to avoid a repetition of a major crisis.

The debate has developed primarily in advanced economies, which have been hit hardest by the crisis.[2] African countries' participation in the consultation process has been limited at best. The financial sector in most African countries differs substantially from those in industrialized countries, with much smaller banking systems and less developed capital markets. Accordingly, African interests and needs are generally different, and this should be adequately taken into account in the global reform agenda. This is so especially given that the outcome of the ongoing debate will have major implications for supervisory practices and financing availability for the continent. African

[1] Figures are based on BankScope database.
[2] See, for example, Brunnermeier et al (2009); de Larosiere Group (2009); Group of Thirty (2009); Turner Review (2009); and Warwick Commission (2009).

countries have no other option but to adapt to the shift in global standards for financial regulation and supervision as incentives to comply are strong, and include official sector and market discipline, market access requirements and reputation. Going forward, it is therefore imperative that African interests are adequately represented in this important debate. In this regard, some suggestions are provided further below in this note.

The debate has already led to a set of recommendations. The G20, the Financial Stability Board (FSB) and the Basel Committee on Banking Supervision (BCBS) have developed specific proposals to reform the financial regulatory infrastructure, reflecting an emerging consensus that regulation has to be comprehensive and deal *inter alia* with pro-cyclicality issues.[3] In the area of financial regulation, agreements have been reached on proposals to enhance micro-prudential regulation. However, the most important development is the introduction of a macro-prudential framework that focuses on systemic risk, or those factors which affect the stability of the entire financial system. Key regulatory developments include:

- Strengthening the quality of regulatory capital, widening the risk coverage, limiting leverage and introducing minimum liquidity requirements to raise the resilience of individual banking institutions;

- Introducing measures to reduce procyclicality in the regulatory system; and

- Expanding the regulatory perimeter to capture all systemically important financial institutions and improving cross-functional and cross-border regulation and cooperation.

The purpose of this paper is to assess the implications of the proposed changes in the regulatory framework for Africa and to discuss some options for policymakers as they advance their financial sector reform agenda. Specifically, the objective of the paper is threefold: 1) to identify possible spillover effects of implementation of regulatory reforms in industrialized countries on African economies; 2) to discuss direct implications of implementation for African banking systems and supervisors; and 3) to suggest a set of policy responses.

The paper is organized as follows. The next section looks at the measures proposed to strengthen Basel II, especially Pillar 1. Section 3 focuses on measured aimed at reducing procyclicality. Section 4 discusses actions to expand the regulatory perimeter. Section 5 offers some concluding remarks.

2. Strengthening Basel II

The financial crisis has exposed the relative inadequacy of the current micro-prudential regulatory framework. Prior to the crisis, banks had built up excessive leverage levels, both on- and off-balance sheet. When systemic trading and credit losses materialized, the banking sector in some systemically important advanced economies proved unable to absorb the shock due to the inadequate levels and quality of its capital base and

[3] See G20 (2009); FSB (2009); and Bank for International Settlements (2009a; 2009b).

insufficient liquidity buffers. As a result, a first lesson of the financial crisis is the need to strengthen the prudential focus on individual institutions. In particular, the crisis has intensified the debate over the adequacy of Basel II, particularly its reliance on external ratings and banks' internal risk models. Nonetheless, regulatory authorities in many countries remain committed to implement the Basel II framework.

To address the weaknesses revealed by the crisis, proposals have been advanced on measures to strengthen Pillar 1 of Basel II. These include raising the quality and consistency of Tier 1 capital to bring it into closer alignment with "tangible common equity", a measure of capital which excludes hybrid forms of capital such as "trust preferred", which during the crisis demonstrated less ability to absorb losses on an operating basis. Other proposals focus on enhancing the regulatory capital treatment of counterparty credit risk arising from exposures to derivatives, repurchase agreements and securities lending. Another component of the micro-prudential reform package is the introduction of a non risk-based leverage ratio as a supplementary measure to the risk-adjusted capital ratio. Finally, a framework for measuring and managing liquidity risk has been suggested. These substantial reforms follow minor adjustments proposed to Pillar 2 and Pillar 3 to guide banks and supervisors in better identifying and managing risks and improving market disclosure in the securitization business.

2.1 Indirect implications

By significantly reducing leverage in the banking system of advanced economies, and by pushing international banks, especially European banks, to replace hybrid capital with common equity, the proposed reforms might reinforce the possible negative bias of Basel II against developing economies, in particular by reducing cross-border lending to African countries. This would buttress an old criticism to Basel II that, as regulatory capital becomes more correlated with risk, it might lead to a portfolio reallocation from low-rated borrowers to high-rated ones.[4] Because of the perceived riskiness of Africa-based counterparties, both public and private, lending will attract higher capital requirements, ultimately reducing capital flows to the continent. For example, the recent dramatic shrinking in trade financing for emerging market countries, including countries in the region, may be partly associated with the adoption of Basel II in developed countries.

In addition to a general reduction of cross-border lending to Africa, the reforms could increase selectivity in lending. The five African countries with an investment-grade rating accounted for two-thirds of total cross-border lending to the region in the past five years.[5] This trend might be reinforced by the suggested reforms under Basel II.

2.2 Direct implications

In the vast majority of African countries, the micro-prudential regulatory framework is still largely based on Basel I, with the notable exceptions of Morocco and South Africa,

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[4] See, for example, Claessens et al (2004) and Griffith-Jones et al (2004).

[5] These countries are: Botswana, Egypt, Morocco, South Africa and Tunisia. Figures based on BIS Consolidated Banking Statistics, various years.

which have already adopted Basel II. However, many countries have expressed their intention to adopt the new capital framework in the medium-term. On balance, the proposals advanced to strengthen Basel II are not expected to have a major direct impact on the region in the near future. Credit risk remains the main concern for African banking systems, while exposures to other risks such as trading risk remain marginal. African banks are relatively well capitalized and, more importantly, the quality of the core capital base is high due to the absence of hybrid instruments. Non risk-adjusted leverage is limited—total assets were 7.3 times the equity base on average in 2008—though the relevant accounting framework can affect the outcome of the proposal for introducing a leverage ratio. Finally, the liquidity profile of African banks is generally good, with liquid assets accounting for half of retail deposits and short-term borrowing.[6] Therefore the direct implications for the region are more generally related to the whole architecture of Basel II and its underlying philosophy. This attracted several criticisms during the consultation phase, which have not been taken into account.[7]

A first challenge is the dearth of relevant information in the region. Pillar 1 of Basel II relies extensively on external ratings or, in the case of the most advanced approaches, on banks' internal models. Related to this is the cost of implementing the new framework, given the significant investment required to upgrade the IT infrastructure and the need for training for both bankers and supervisors. Moreover, the shift from a supervisory environment that is traditionally compliance-driven to a more discretionary and judgmental framework will stretch scarce supervisory resources. African countries will need to recruit additional specialized staff, and provide extensive training to existing staff.

Another problem is the impact on the composition of domestic lending and, implicitly, on access to credit for various sectors of the economy. By remodelling risk-weighted assets, Basel II is likely to influence how credit will be allocated to the real economy. For example, while a lower risk weighting for residential mortgage lending provides an incentive to expand housing finance—provided banks can raise long-term finance—financing for small and medium-sized enterprises (SMEs) and for project finance are likely to become more costly given their higher risk weight, and therefore sectors that are key drivers of economic growth and employment might be severely hampered. This might be especially the case where foreign banks dominate the banking system, given their traditional focus on large corporate borrowers. These negative implications for access to finance might be eased by the use of a wide range of risk-mitigating techniques under existing Pillar 1, including financial and physical collateral and third-party guarantees.

2.3 Policy options

While the new capital regulation framework can benefit the continent by contributing to strengthening the robustness of the financial sector and improving supervision, these gains have to be weighed against the costs that it entails. African countries might want

[6] Ratios based on BankScope database.
[7] See, for example, Gottschalk and Griffith-Jones (2006).

to proceed cautiously and sequentially in implementing Basel II. A strong supervisory foundation as well as internationally accepted accounting standards is fundamental preconditions for Basel II implementation. In countries with relatively weak banking supervision, it would be advisable to implement selected dimensions of Pillar 2 and Pillar 3 before embarking in the adoption of Pillar 1. Pillar 2 identifies key principles of supervisory review which complement those outlined in the Basel Core Principles for Effective Banking Supervision (BCPs). Therefore, as countries continue in their process of implementing the BCPs, this would help ensure compliance with Pillar 2. Pillar 3 focuses largely on appropriate disclosure of bank capital adequacy and other financial data, with the aim to improve the effective use of market discipline to encourage sound banking practices. Enhanced disclosure of information could facilitate supervision and improve market discipline in the region.

In developing or refining a roadmap for Basel II implementation, African countries might want to focus on capacity building programmes and coordinate with donors for technical assistance. International financial institutions and training institutes can assist supervisors in developing tailored training programs for their staff. With regard to more technical details of Basel II implementation, expertise might have to be recruited from outside in the short run. Given the resource constraints faced by African countries, their development partners would need to scale up assistance. One option would be to pool resources in a dedicated fund for technical assistance in this area.

The key priorities in many African countries are strengthening financial stability and creating opportunities for access to finance. Regulators might need to carefully assess the broader implications of different approaches to Basel II on credit creation, its cyclicality and distribution, and on competitiveness, so as to strike an acceptable balance between banking stability on the one hand and financial inclusion and growth on the other hand. Further studies are therefore needed, and the C10 offers an appropriate framework for facilitating continued debate on these issues.

Finally, African countries need to continue their efforts to strengthen the legal system. As mentioned, Pillar 1 of Basel II takes account of the different risk mitigating techniques available to banks to minimize their exposure. Conditional upon a sound legal framework for collateral, which includes an effective enforcement system, these instruments can offer capital relief opportunities to banks, therefore raising their incentives to support the real economy.

3. Dealing with procyclicality

The most important regulatory change that has emerged from the crisis is the development of a macro-prudential framework, which will look at how the different components of the financial system change and interact with the real economy. A first or “time” dimension of the macro-prudential approach to regulation stems from the business cycle and refers to how systemic risk evolves over time. The nature of banking is inherently procyclical. Credit and debt levels rise in an upturn, with lenders and investors becoming increasingly vulnerable to the same shock owing to common exposures. In the downturn, this process goes into reverse. The unfolding of the recent

crisis has followed a similar pattern. Not only is existing bank regulation unable to prevent harmful feedback effects from financial excesses; it also exacerbates the swings of the cycle. Some accounting principles such as the "fair value" approach amplify the procyclicality of the financial system.

This has called for a need to introduce measures to curb the procyclicality of the current regulation and possibly to make it more countercyclical. Concrete proposals focus on measures that would strengthen the current micro-prudential regulatory framework through (i) developing mechanisms to reduce the cyclicality of minimum capital requirements; (ii) promoting a loan loss provisioning approach based on expected losses rather than incurred losses; and (iii) establishing "capital conservation standards" which would restrict the discretion of banks with insufficient capital buffers to declare dividends and dispose of earnings. A complementary proposal is to introduce a separate regime which could be used by supervisors to increase the capital buffer of the banking sector as a whole when there are signs of excessive credit growth.

3.1 Indirect implications

The majority of advanced economies, with the notable exception of the US, have implemented Basel II in recent years. The implications of the new capital accord for cross-border lending are twofold. First, capital allocation will be associated with the business cycle of the recipient country, emphasizing its boom and bust pattern. Second, as negative shocks to home economies threaten capital adequacy, banks might cut back foreign lending, thereby transferring credit contraction overseas. To the extent that the implementation of recommended reforms in this area would contribute to smooth the procyclicality of cross-border credit supply, their impact on African economies is expected to be largely positive.

3.2 Direct implications

The regulatory system in Africa displays features that do give rise to procyclicality. As discussed, capital adequacy standards throughout the region largely conform to Basel I, whose guidelines rely on fixed risk-weights that are stable through the cycle. However, the very principle of having a minimum capital ratio could induce procyclicality in a downturn as banks curtail lending to meet minimum capital requirements.[8] This may not be a substantial issue in the region, where the average capital ratio is well above the minimum. Yet some countries may want to move forward with their adoption of Basel II and would benefit from adopting reforms now to reduce the procyclicality of the current system.

In African countries loan loss provisions are generally linked to loan quality and past payment history. In the same vein, lending tends to be based on collateral, whose value fluctuates sharply during the cycle, compounded by the thin secondary markets for most types of collateral. Fair value accounting is not widely adopted, though in many countries there is a well established trend towards adoption of the International

[8] For a discussion on the procyclical features of Basel I see Goodhart et al (2004).

Financial Reporting Standards (IFRS), which are based on the principle that price of assets on banks' books be marked to market to reflect their "true" value.[9] These countries could also benefit from implementing the countercyclical proposals under discussion.

3.3 Policy options

African countries can mitigate the procyclicality of capital requirements by introducing a mechanism for cyclical adjustments of the regulatory capital ratio. A possible option would be to have two levels of regulatory capital: a publicly disclosed minimum requirement enforced at all times, and an extra cushion to be raised during periods of sustained growth and reduced during downturns. Such a cyclical adjustment would be based on clear rules so as to promote transparency, enhance credibility and protect supervisors from political and lobbying pressures.

Another option to smooth procyclicality would be to introduce a dynamic provisioning system such as the one adopted by Spain and some Latin American countries. The principle here is to introduce a supplementary countercyclical provision to act as a buffer. This would be based on banks' internal risk models, based on data spanning at least an entire economic cycle, or established by the regulator based on the loan classification. A challenge in the implementation of this option could be the dearth of expertise in this area.

Finally, African countries can mitigate the effects of marking to market by applying more conservative valuations for collateral. To limit volatility in the prices of assets used as collateral, countries can set collateral valuations at historical averages instead of current market values. Alternatively they can introduce higher haircuts.

4. Broadening the regulatory perimeter and improving consolidated supervision

A second, or "cross-sectional", dimension of the macro-prudential approach to regulation focuses on how the various components of the system interact and how risk is distributed within the financial system at a particular point in time. Because the risk of the whole system can be greater than the sum of its parts due to externalities, a consensus has emerged on the need to develop a systemic view of financial risks.

As a result of these developments, policy makers and standard setters have called for measures to address systemic risk originating from the size, illiquidity, leverage and interconnectedness of financial institutions, instruments and markets. In particular, there is a call to (i) widen the regulatory perimeter to include all systemically important financial institutions; and (ii) consolidate supervision to capture the links between different types of institutions and instruments (cross-functional) and among financial institutions across countries (cross-border).

[9] For example, South Africa adopted the IFRS in 2005.

4.1 Indirect implications

The changes in supervisory rules applying to the parent bank in advanced economies will affect the supervisory frameworks in those African countries where international banks have a significant presence.[10] Currently, local subsidiaries of foreign banks must comply with regulations of the host country to ensure that the playing field is levelled among all banks in the host country. However, the new proposals call for more effective consolidated supervision of international banks which are deemed to pose systemic risks, essentially to avoid regulatory arbitrage. The proposals also call for the establishment of supervisory colleges in the countries where global banks operate to share information, harmonize norms and define responsibilities.

It is still premature to draw conclusions on the indirect impact of these proposals on the region. In any event, foreign subsidiaries of systemically important banks will continue to comply with the host country regulatory framework. It is therefore important that cooperation and information exchange work properly. The needed reforms towards convergence of rules will put pressure on supervisory resources and structures in the region.

4.2 Direct implications

With an increased focus on systemic institutions, Africa could benefit by putting in place a strengthened regulatory framework to ensure more effective cross-functional supervision. The strongest supervision applies to banks, which normally are the only institutions entitled to access central banks' liquidity facilities. The remaining institutions are typically subject to less stringent supervision, even though they may have potential systemic implications.

Broadening the scope of financial regulation is a more pressing issue for those few emerging market countries in the region with a growing non-bank financial sector—of microfinance institutions, and insurance, pension and other contractual savings institutions—and with relatively developed domestic capital markets. However, countries with less developed non-bank financial institutions may also face potential risks from outside the banking sector as their financial systems deepen and might therefore benefit from reconsidering the regulatory perimeter

The implementation of a macro-prudential framework will require supervisors and central banks to improve their methodological and analytical toolkit for assessing systemic risk, probably relying less on market discipline and more on regulatory discipline and policy instruments, with increased discretionary powers and greater exercise of judgment. It will also be necessary to rethink the institutional framework for supervision and to establish appropriate linkages between financial and macroeconomic conditions, with implications for the conduct of monetary policy. Close coordination

[10] Countries where foreign banks hold more than 60 percent of total banking system assets include: Botswana, Cape Verde, Central African Republic, Chad, Côte d'Ivoire, Equatorial Guinea, Gambia, Guinea-Bissau, Guinea, Lesotho, Liberia, Madagascar, Malawi, Mozambique, Namibia, Niger, Seychelles, Swaziland, Tanzania, Uganda and Zambia (Honohan and Beck, 2006).

between supervisors and the central bank is key. Where the supervisors are located within the central bank, arrangements will have to be put in place to ensure that the "micro" and the "macro" dimension of risk analysis are integrated to allow adequate regulation and mitigation of system-wide risks.

4.3 Policy options

African countries could implement and strengthen as appropriate the legal framework for consolidated supervision. BCP 25 defines cross-border consolidated supervision based on the principle that host regulators should require the local operations of foreign banks to adhere to local standards, and requires a regular exchange of information and collaboration among home and host supervisors. However, few African countries are compliant with this requirement. Countries might benefit from full implementation of this principle, by signing to memoranda of understanding (MOUs) through which clear responsibilities and operational rules covering information sharing and supervisory authorities are be spelled out. For example, countries of the West African Monetary Zone have already taken positive steps towards this direction. Building on the C10 mechanism, pan-African cooperation and information sharing should be institutionalized by setting up regular technical meetings among supervisors and creating an African college of supervisors. Regional financial integration might be enhanced, particularly in the area of financial regulation. African supervisors need to be adequately represented and get formal feedback in the new supervisory colleges for international banks, when activities of international banks are systemically relevant in African markets.

In line with the Group of Thirty recommendations, national supervisors should set broad guidelines for determining systemic importance.[11] The definition of systemically important institutions would include any large institution potentially able to threaten the stability of the system, but also small financial institutions that can pose a collective threat through herding behaviour.

Cross-functional supervision could be reinforced as well. Countries with a sizeable non-bank financial sector rely in general on multiple functional supervisors. Therefore, ensuring cooperation is fundamental. Cross-functional supervision might benefit from implementing the FSB Framework for Strengthening Adherence to International Standards, which, in addition to the BCPs, include the IAIS Insurance Core Principles and the IOSCO Objectives and Principles of Securities Regulation.[12] In this regard, it is important that African countries define an adequate implementation framework and set sensible timelines in complying with the framework requirements.

To cope with the demanding pressure on a more proactive and judgment-based supervisory approach, countries should continue their efforts to modernize supervision

[11] Group of Thirty (2009).

[12] More recently, the Basel Committee has issued a Consultative Document on Microfinance, spelling out core principles for supervision. Given the importance of the microfinance sector in the region, it would important for African supervisors to monitor developments in this area and provide feedback based on the experience accumulated (see Bank for International Settlements, 2010).

and regulation. However, this process will take some time to reach fruition and will require intensive technical assistance to build capacity.

5. Concluding remarks

The financial sector in Africa, particularly the banking sector, has increased its resilience over the past decade, mainly as a result of improved financial regulation and supervision and stronger macroeconomic policies. These gains must be consolidated and preserved; and any reform efforts must be geared to achieving this goal. It is in this perspective that discussions of adoption of the proposed regulatory reforms must be envisaged.

As noted in this paper, the proposals to strengthen Basel II in developed countries might exacerbate the possible negative impact on aggregate cross-border lending to the region. At the same time, implementation of Basel II in African countries is likely to be hampered by the lack of critical capacity and dearth of relevant information. The composition and distribution of credit to the real economy might also be affected, with access to finance for SMEs and project finance made it more difficult. Possible national policy responses include a cautious and sequential approach to Basel II, with roadmaps emphasizing the need for capacity building. International financial institutions could help scaling up resources for technical assistance in an increasingly coordinated approach. The C10 can help in facilitating and coordinating further debates in this area to improve knowledge on the consequences of Basel II on the continent.

The development of a countercyclical mechanism within the regulatory framework will be beneficial for the region, as it will smooth the cycle of international lending. With the exception of Morocco and South Africa, most African countries apply the Basel I prudential framework, which also presents some features which amplify the procyclicality of the financial system. These are mitigated by the relatively large capital base of African banks. However, provisioning requirements tend to be backward looking, and lending tends to be based on collateral. Shifting to countercyclical capital adequacy requirements and introducing dynamic provisioning may also help curb procyclicality. Finally, as countries move towards the formal adoption of IFRS, they can consider applying more conservative collateral valuations.

Finally, the proposals to broaden the regulatory perimeter with a focus on systemically important institutions might especially impact those countries in the region with a large presence of international banks. Countries might benefit from a re-evaluation of the regulatory coverage which would include non-bank financial institutions deemed to be systemic. However, these benefits should be weighed against the implied pressure on supervisory structures and capacity. Information sharing and cooperation need to be enhanced; the C10 can play a key facilitation role in this area.

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