1 Bank Regulation in Africa at a Crossroads

In many African countries, capital markets remain peripheral as vehicles for raising capital. However, with banking systems expanding over the past few decades, and offering an increasingly wider range of financial instruments, the continent has found itself at a crossroads. How should bank supervision and regulation adapt to prevent crisis in the future, in a context marked by the failure of conventional regulatory frameworks?

Historically, the regulation of banks in Africa has evolved through several overlapping phases. In the pre-independence phase,

African colonies and territories were served by colonial currency boards (precursors of central banks) which were barely able to address market failure. In the 1960s and 1970s, national central banks replaced currency boards and assumed limited bank regulation, mostly to direct credit to local entrepreneurs through state-owned development banks. However, African countries experienced many difficulties, notably due to principal-agent problems, given that many managers were political protégés. Credit was largely allocated through political peddling, and in a number of cases, bank crises were prevented because of government guarantee.

When Basel I regulatory framework was initiated in 1988, the emphasis was on a...
set of minimum capital requirements for banks in order to address credit risk. African countries adopted the principles prescribed in this framework, but its enforcement varied considerably. Massive Bank failures in the 1990s led to the adoption of the Basel II framework with new procedures for computing minimum capital requirements for market and operational risks; new rules for supervisory review of capital adequacy; and new policies that force banks to disclose accurate, transparent information, among other innovations. The recent financial crisis has, however, dramatically exposed the limitations of Basel I and II, as capital adequacy rules provided for by these frameworks proved inadequate to prevent it. While this has resulted in increased calls for the adoption of Basel III, there is still considerable debate about its ability to prevent future crises.

- Proponents of Basel III argue that the framework will be effective, thanks to the substantial increase in the quality of capital; significant improvement in the coverage of risks; requirement of much higher levels of capital; introduction of a global liquidity standard to supplement the capital regulation; and the introduction of stronger supervision, risk management and disclosure standards.

- Critics, however, argue that strengthening capital standards or empowering supervisors does not boost bank efficiency, reduce corruption in lending, or lower banking system fragility. They are of the view that what is more promising is introducing reforms that place far more emphasis on policies that promote market discipline. These include disclosure requirements and transparency in the banking sector, as well as better private-sector monitoring of banks.3

It is now imperative to provide evidence as to why and how the above dilemma would be best addressed. As African governments are invited to adopt Basel III bank regulatory framework, the Continent has to address multifaceted challenges before a clear picture of the potential gains of such a move can be obtained. In this regard, Africa is still faced with several key questions, whose answers are likely to help chart the way forward.

2 Important Questions Are Still Open

The first key question is whether the supervisory function should be assigned to the central banks or not. As shown in Table 1, there are three main models of bank supervision in Africa: the model where the central bank is the only regulatory and supervisory authority; that in which there are multiple bank supervisors, including the central bank; and the group where the supervisory authority is a quasi-autonomous agency, not the central bank.

Globally, bank regulation has become just one more component of financial services regulation, with a range of regulatory functions, hitherto performed by self-regulating agencies, now nationalized and performed by public agencies. The main issue, to be considered in an attempt to answer the above question, is whether the greater power of enforcement that comes from the authority of the public agency offsets the informational disadvantage experienced by an external regulator4.

3 See Barth et al., 2006; Barth et al., 2004; and Beck et al., 2006.

4 See Kay, 2009.
The global crisis occurred during the transition from Basel I to Basel II for many African countries, thus complicating the transition and raising a number of questions: Should African central banks jettison the encumbering supervisory function or recast it? Does Basel III suit the present-day needs of African banks? More importantly, can the regulator effectively supervise banks without jeopardizing monetary policy independence? In this regard, it is interesting to note that the group of countries where central banks do not supervise banks is dominated by CFA zones countries, where neither central banks nor governments have full monetary authority.

Equally important is the question raised by transnational regulation issues arising from cross-border supervision, especially in cases of non-convergence between national and international regulations. How can Africa reduce information asymmetry and non-convergence of national and international regulations, especially where large foreign banks are heavily involved in small, poor economies? This requires the redefinition of Africa’s role in sharing information for transnational regulation, given that Africa cannot effectively regulate foreign bank subsidiaries without strong information sharing internationally?

The requirements arising from African banking systems’ increasing international exposure also spill over to the risk-weighting systems. The financial crisis exposed the unreliability of risk weights produced by key rating agencies as a market-discipline component of bank regulation. Overall, bank risk was undervalued, and weights for specific risks were inappropriately set. A key unresolved issue is how to measure and assign risk weights to the mix of banking services, given that specifically for Africa, regulation must allow for flexibility in re-modeling risk-weighted assets, especially where foreign banks dominate.

3 Lessons of Experience in Building Capacity for Banking System’s Resilience to Adverse Shocks

Recent experience of capacity strengthening for enhanced stability of banking systems in Africa illustrates the need to resort to a whole series of instruments that have proven their effectiveness in capacity development. These range from organizational capacity to institutional capacity—notably through the reinforcement of accountability systems; the alignment of incentives; redefinition of roles; coordination and sequencing; and capacity for policy dialogue, to mention a few.

Private credit bureaus have been established in a number of African countries,
as a means of strengthening the organizational capacity for reducing asymmetric information, moral hazard and adverse selection problems between borrowers and lenders. The bureaus have effectively reduced credit risk, supported access to credit and improved credit repayments. The relevance and effectiveness of the measures proposed by Basel III to meet this objective and the decision to move to Basel III must be examined in full awareness of this proven role of private credit bureaus in addressing credit market information imperfections.

Past experience has also shown that strengthening the discretionary powers of prudential supervisors in countries with weak institutional capacity and particularly inadequate systems of incentives leads to lower level of bank development, greater corruption in lending, and banks that are less safe and sound. The message to African policy makers is that ‘best practices’ for advanced countries may not work for developing ones, and the suggestion is that contextualized ‘best fit’ solutions will do better than quick fixes inspired by ‘best practices’ in developed countries.

Defining roles, with a view to reducing systemic risk, in such a way to achieve the micro prudential role mainly through market discipline, while assigning the macro prudential role of financial stability to a quasi-government agency should be abandoned to adopt a regulatory regime that encompasses both roles.

In any case, it will be necessary to make sure that the framework that is retained is in line with the human capacity available. In this regard, there is a growing consensus among experts that Africa may not need complex models such as Basel III, with its value at risk (VaR) models for which it cannot collect data, let alone run the model competently.

It is also necessary to reinforce African countries’ capacity for policy dialogue, with a view to strengthening Africa’s voice in post-crisis bank regulatory fora. Adequate definition of roles and appropriate sequencing will be crucial. In the short term, the African Development Bank, as the secretariat of the African Committee of 10 (C-10) which represents African finance ministers and central bank governors needs to catalyze Africa’s contribution in discussions on banking regulation reforms being coordinated by the Financial Stability Board (FSB) and the Basel Committee. At the same time, robust and sustained efforts to equip African governments with the required capacity for negotiation through appropriate training and knowledge generation and sharing would seek to ensure a more active role of governments in the medium term.

Last but not the least, enhanced coordination efforts should aim to reinforce the interbank market in the Continent. This market provides the market discipline component of regulation, in addition to its role in managing liquidity and hence, monetary policy. Therefore, bank regulatory policies that enable markets to better monitor banks, and that encourage private actors to “discipline” banks are associated with desirable outcomes.

“Prudential supervision in countries with particularly weak institutional capacity and inadequate incentives requires contextualized ‘best fit’ solutions, than quick fixes inspired by ‘best practices’ in developed countries.”

“The adoption of a regulatory regime with self-regulated payment systems and which encompasses both micro and macro prudent roles should be encouraged.”

“Given African countries’ inability to finance large bailout plans in the event of major bank failures, introducing a financial transaction tax on bank balance sheets to build a fund against such risks should be considered”

“To strengthen Africa’s voice in bank regulatory fora, enhancing capacity for policy dialogue is needed. The African Development Bank could assume a catalytic role in the short term, and devolve responsibilities to African countries progressively.”

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5 See Murinde, 2010; and Mylenko, 2007.
6 See Barth, Caprio and Levine, 2006
4 Conclusion

Many African countries have transitioned their regulation from Basel I to Basel II, but post-crisis, these countries are stuck at a crossroads. Going back to Basel I is not an option; meanwhile, Basel II has been ineffective in preventing the financial crisis. African countries must therefore move towards Basel III, albeit cautiously. In addition to Basel III not being a case of ‘one size fits all’ fix, quite a number of the emerging themes for the framework are merely tangential to the concerns of African economies. Therefore, there is need to:

- Review Basel III recommendations to decide on the key aspects that need to be incorporated into African banks’ regulatory frameworks;
- Develop risk management frameworks for identifying, measuring and mitigating potential risks; and
- Go beyond market risk concerns to represent development-enabling regulation.

All these requirements will be met only if Africa has the required human and institutional capacity to manage the process adequately. Hence, the success of the move toward Basel III will depend on how significant and sustained the effort to enhance such capacity, harness an enabling environment, as well as generate and share the relevant knowledge will be.

Cited References


