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Preventing a Credit Crunch in Africa: The Role of Financial Regulation

African Development Bank

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AFRICAN DEVELOPMENT BANK GROUP

Preventing a Credit Crunch in Africa : The Role of Financial Regulation

Meeting of the Committee of Finance Ministers and Central Bank Governors

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1. Introduction

The current financial crisis has highlighted the critical role of efficient regulation for financial stability. Government interventions to bail out banks and non-bank institutions have sought to restore bank liquidity and allow adequate level of bank lending. These measures are symptomatic. They do not address the underlying causes of the problem. Preventing such crises in the future requires commitment to regulatory review at the national and global level.

This briefing note highlights key regulatory principles and goals to guide policy debates; analyses the regulatory status quo in Africa; and defines key strategies required to preserve financial stability and prevent a credit crunch in African economies.

2. Financial regulation – key principles and objectives

The current crisis is an opportunity to recast debates over the regulatory framework, in support of developmental outcomes, for developing countries, in general, and Africa, in particular. Two principles, in particular, must be at the center of the debate around appropriate reforms of the regulatory framework: the mitigation of procyclicality; and comprehensiveness.

Mitigating procyclicality

The current regulation and supervision frameworks produce substantial procyclicality in banking activity, especially lending. During economic booms, expectations of higher return on investment are high and economic agents are solvent. As a result, assets are easily overvalued. In turn, risk is perceived to be low across the spectrum of asset types and capital requirements are not adjusted over the business cycle. Thus, the expansionary pressure feeds of higher capacity and increased incentives for banks to lend. In this context, bank lending can outpace growth of real income. This means that the borrowing appetite of private sector agents easily exceeds the real value created by leveraging additional capital. During economic downturns, a reverse trend is observed and asset portfolios are downgraded. Capital becomes harder to raise. Banks are forced to disproportionately cut lending, leading to a credit crunch which deepens the economic downturn.
Responding to the challenges of a fast evolving global economy will require *more flexible and dynamic regulatory frameworks* at the national, regional and global level.

Comprehensiveness

Over the past years, with tremendous financial instruments and innovation, the creation of bank holding companies, and weaker regulation of non-bank activities, the financial system has become significantly more exposed to risk and contagion than in the past. African countries can learn from the regulatory failures experienced in developed economies:

- The regulatory environment must preserve the *special role of banks* and protect them from exposure to risk associated with non-bank financial operations. Banks must remain separate from investment institutions and banks' dealings with the latter must be clearly monitored and supervised.

- Non-bank activities must be adequately regulated and this becomes critical as banks begin to engage in both banking and non-banking activities. For African countries, adapting ongoing regulatory framework reforms to firms that have emulated the Western model of the investment banks is a critical challenge. Are African SECs and other regulatory bodies adequately equipped to regulate this section of the financial system?

- Regulators must carefully consider off-balance sheet operations. In modern financial systems, financial assets and operations controlled by banks represent a small fraction in the sector. In the United States, banks represent only a quarter of total financial assets. Conversely, banks in Africa represent the largest share of assets (over 90 percent). This is bound to evolve with financial development and innovation. Adequate financial regulatory frameworks need to be established to keep pace with financial innovations. The emphasis should be on improving risk analysis, proper disclosure of financial operations and diligent regulatory oversight.

3. Regulation and credit in African systems – Salient features

Salient features at the national level

Regulation affects and relates to specific dimensions of the African financial systems: African financial systems are dominated by banks, which remain the primary channel for savings and investment. Other instruments, insurance and pension funds are undeveloped. Insufficient diversification of instruments undermines intermediation in general and constrains intergenerational wealth transfer. It also constitutes a constraint on maturity transformation, limiting the supply of long-term finance. Beyond protecting bank solvency, regulatory reform on the continent will need to establish an enabling environment for the development of the non-bank sector to increase financial depth.

African financial systems are also highly monopolistic. This allows banks to enjoy high interest rate margins (6% average for the continent against 4% in the rest of the world) and high profit rates (twice the returns on assets as those enjoyed in the rest of the world). Accordingly, they have limited incentive to innovate.

Foreign bank presence varies widely across countries in Africa, representing over 60 percent in more than 15 countries while banks are fully locally-owned in the majority of the countries. On the continent, banks have generally been conservative and avoided exposure to risky securitized assets in the international markets. As a result, contagion through foreign bank presence has been limited even in countries where banks are completely foreign-owned (e.g., Botswana, Lesotho, and Madagascar).

Regulation in African countries has been quite prudent in the areas of *domestic debt markets and capital account transactions*. To some extent, prudential regulation and limited global integration of African financial markets shielded African economies from first round effects of the current financial crisis. Banks were also helped by the strict capital adequacy framework followed by the country, especially after the adoption of Basel II. However, there are countries such as Uganda, Zambia, and Kenya with a highly liberalized capital account. These countries have recently played host to speculative flows, especially in the domestic bond markets, taking advantage of high interest rates.

Banks tend to be highly risk-averse, preferring cash holdings to private lending. Bank credit to deposits ratio is 67 percent in Africa, compared to 100 percent worldwide. This constitutes a major constraint to private sector development as many productive investment projects lack adequate funding. Without adequate risk mitigation guarantee mechanisms and strong institutional capacity, there is a dearth of risk/venture/long term capital. In many African countries, early attempts to establish loan guarantees failed due to moral hazard problems largely attributable to poor management of loan guarantee institutions. From a regulator's perspective, this situation poses a critical challenge: how to establish incentives for bank lending while at the same time preserving stability by minimizing defaults.

Regulation at the regional level

Since the 1990s, cross-border banking has been increasing in Africa, taking advantage of liberalization within the context of regional economic communities (RECs) and even reaching beyond the RECs. South African and Nigerian Banks have adopted aggressive regional and continental strategies while the Kenya

Commercial Bank is spreading its wings in East Africa. This trend has opened opportunities for market expansion for banks, technological spillover, and increased private investment. Critically, expansion in cross-border banking is moving ahead of regulation.

Regional regulatory frameworks are in place in only two regions of Africa, that is, Bank of Central African States (BEAC) and the Central Bank of West African States (BCEAO). National regulatory frameworks are disparate and hinder regional financial investments and integration. Harmonization is therefore urgently needed to help banks broaden the scope of financial intermediation and national governments to attract investment and encourage competition in financial services. Currently, disparities across different national regulatory frameworks tend to dissuade regional financial investments and deter the process of regional integration.

Moreover, regulatory frameworks need to be extended to other areas of the financial services sector, such as insurance and other non-bank financial institutions. There are positive steps in this direction, such as the East African Insurance Supervisory Association which vets new players, issues licenses and supervises the operations of all players in the sector. These examples need to be emulated in other regions and scaled up where they already exist.

Harmonization of the regulatory framework at the regional level is needed for greater integration of financial systems in the continent. The lack of harmonization is likely to create distortionary regulation that gives unfair comparative advantage to some market players and countries. The objective is to establish a level playing field that opens opportunities for existing market leaders as well as potential new comers. Fair competition in banking is a critical ingredient for efficiency in financial intermediation.

Efforts at the national and regional levels need to be complemented by greater African participation in reforms at the global level, especially at the IMF (see Briefing Note on Voice and Representation for more detailed discussion). The IMF-Africa dialogue provides a useful forum for Africa to articulate its expectations and advance its interests in this area.

4. Areas of focus going forward

Role of global institutions

Regulating the global financial system must enable a sustainable flow of financing for African countries and prevent financial instability. Effective regulation of the global system requires a clear definition of the respective roles to be played by the key global institutions, especially the BIS and the IMF. These and other bodies will need to be more proactive and enhance interaction with all stakeholders, ensuring that the needs and special circumstances of developing countries are properly taken into account. Efforts should be focused on *aligning the mandates* of these institutions with the realities of today's global economy, and improving the way these institutions implement these mandates, rather than creating new institutions. Also of crucial importance is close engagement of African countries with these global institutions through effective representation on relevant decision-making bodies.

Basel II and low income African countries

The current crisis has refocused attention on the international frameworks of banking regulation and supervision, especially the Basel II accord. Important weaknesses have been pointed out in the Basel II framework, especially the implied pro-cyclicality of bank credit and issues of off-balance sheet activities. There are already plans to address these weaknesses at the Basel Committee. However, the application of the Basel II accords poses particular challenges that are specific to African countries, especially low income countries. The first challenges relate to capacity, specifically technical capacity to design, validate, and monitor the use of the complex models that full implementation of Basel II entails. The alternative of adopting the *standard (simpler)* approach also faces challenges, especially due to the lack of reliable credit rating agencies to determine the risk level of various categories of borrowers.

The second challenge arises from the presence of foreign banks, which face pressure to adopt more sophisticated models which will be in line with the requirements in their home countries. However, adopting sophisticated models by foreign banks, while local banks would, at best, afford the standard approach will (1) give a competitive edge to foreign banks, (2) induce foreign banks to focus their lending operations on the higher end of the market, and (3) result in credit rationing for low-end customers, the majority of which are small and medium enterprises. The concentration of lending whereby foreign banks operate in "safer" market segments while local banks are forced to operate in the riskier ones creates two equally undesirable outcomes: ***concentration of risk*** that exposes banks to shocks; and serious ***equity issues*** associated with the competitive edge accruing to foreign banks.

What are the options for African low-income countries? Given the severe capacity constraints faced by most African countries, it appears that the *gradual approach* is the only viable option. This will allow countries to build capacity to fully appreciate the scope and complexity of the Basel II framework and take advantage of learning by doing as well as lessons from middle income countries that are likely to move faster to full implementation of the framework (as South Africa has already done). In the meantime, African countries will need support in the form of technical assistance to accelerate capacity building. Moreover, regulators in African countries with a large foreign bank presence need to establish and strengthen communication and information exchange with their counterparts in the homes of foreign banks to address issues of divergent regulatory regimes. To date, there appears to be little communication and collaboration on this front.

Transparency, disclosure, and comprehensiveness

Efficient regulation and supervision of the financial sector requires adequate quality and flow of information on key market players and operations. National regulatory bodies need to enforce full and regular disclosure of activities by banks and non-bank financial institutions to allow continuous assessment of risk. Regulation should be ***comprehensive*** and should cover all types of financial institutions as well as all categories of financial transactions. The *financial sector assessments* by the IMF and the World Bank, as well as the AfDB's work on the financial sector will be useful in this regard. These assessments should be ***comprehensive*** and disclosure should cover all institutions as well as all transactions, including on-balance and off-balance sheet items. On their part, African countries should enforce periodic reporting by commercial banks and non-bank financial institutions. Emphasis should be on detailed credit reporting in order to properly monitor risk taken by institution and sector of activity.

Mitigating pro-cyclicality

The pro-cyclical nature of bank lending can amplify the effects of shocks, resulting in larger swings in economic activity over the business cycle. Inappropriate regulation worsens the pro-cyclicality of bank lending, especially for countries moving to adopt the risk-sensitive models of the Basel framework (IRB approach). Even as African countries explore ways of improving the regulatory framework, they must not lose sight of the core objective of financial regulation which is to preserve financial stability so as to achieve stable economic growth.

Independence of the regulator

Effective regulation of the financial sector requires a high degree of independence of the regulatory bodies, allowing them to freely enforce the rules of the game. Regulators are like referees, and are called to ensure fair competition by systematically applying the rules. This requires setting limits to political interference as well as lobbying influence by major players in the market. African countries are called upon to examine the structures and legal measures that can guarantee the maximum autonomy and independence of regulatory institutions to achieve efficient financial regulation.

Role of MDBs and other partners

Multilateral Development Banks (MDBs) need to play a more prominent role in strengthening financial sector regulation on the continent as a means of promoting financial development, in general, and preventing a credit crunch in the wake of the current financial crisis, in particular, (see the Briefing Note on Voice and Representation for more detail). In line with their core mandates, the primary area of intervention of MDBs should be the provision of liquidity to the private sector in the form of lines of credit, especially trade finance. This intervention will need to be targeted in line with national development goals, giving priority to areas that are traditionally credit constrained such as infrastructure and other large scale long-term investment projects. This will help offset the *procyclicality of bank credit*. Another area of intervention is in capacity building to equip African countries with the appropriate skills and institutional prerequisites for effective financial sector regulation.

With declining access to private lending, MDBs are called upon to play a major role in filling the growing financing gap faced by African countries in the wake of the financial crisis. However, given that resources are limited, the key guiding principle should be selectivity in line with national development agenda and country-specific needs. In this context, MDBs should expand and strengthen their products to address weaknesses in financial systems, low technical capacity and scarce capital or liquidity for supply-side development activities such as infrastructure development.

On the part of other development partners in general, especially G20 countries, actions should focus on (1) restoring access to financing for African countries; and (2) reducing the continent's exposure to systemic risks, especially regarding increased cross-border banking. Some options include:

- Establish incentives in these countries for banks to lend and invest in African countries, while pursuing support to banks in developed countries;

- Encourage banks to accumulate capital during good times to minimize the liquidity dry- up in periods of crisis, and avoid the need to cut off credit lines to African financial institutions;

- Channel aid to Africa through MDBs;

- Establish special initiatives for liquidity support to African countries to ensure solvency;

- Establish and strengthen support programs targeting access to credit, especially trade financing and financing for infrastructure in Africa.

- Support financial regulation capacity building programs at the national and regional levels;

- ensure adequate regulatory requirements for capital and liquidity;

- ensure that transparency in financial markets keeps pace with future financial innovations; in particular,

  - o assessing whether steps that are underway to strengthen regulatory capital and accounting rules for off-balance sheet exposures should be supplemented with actions to enhance transparency, including strengthening direct regulatory oversight of the shadow banking sector;

  - o assessing private sector proposals for unified best practices for private pools of capital and hedge funds;

  - o assessing whether the differentiated nature of regulation in the banking, securities and insurance sectors creates regulatory arbitrage incentives for firms; and

  - o assessing the range of policy options to mitigate pro-cyclicality in the financial system.

Other Publications in the Series

N° 1/2008 : The Current Financial Crisis: Impact on African Economies, November 2008.

N- 1/2009 : Impact of the Financial Crisis on African Economies - An Interim Assessment, January 2009.

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