The Relevance of Global Reform of Bank Regulation: A Perspective from Africa

Louis A. Kasekende

Abstract

The global financial crisis exposed fundamental weaknesses in the financial regulation, prompting ongoing efforts to strengthen the regulatory framework. The key features of the global reforms are: higher mandatory minimum capital adequacy ratios, together with improvements in the quality of capital; introduction of minimum liquidity requirements; introduction of macro-prudential tools; proposals for the resolution of globally systemically important banks. The international character of banking provides a clear rationale for global minimum regulatory standards, especially to avoid regulatory arbitrage, whereby banks locate in the jurisdictions with the least onerous regulations, spurring a race to the regulatory bottom. Hence key regulatory innovations have been drawn up at the global level and most governments around the world, including those in Africa, have incorporated them into their own national banking regulations. The aim of this paper is to assess the implications of the global regulatory reforms for bank regulation in Africa and, in particular, whether the specific reforms are likely to be helpful or counterproductive for banking system stability in Africa. The paper aims to help fill a gap in the literature on the latest global reforms to bank regulation; relatively little of which has assessed these issues from the standpoint of developing countries.

Introduction

The global financial crisis, which erupted in 2008, exposed fundamental weaknesses in financial regulation, prompting ongoing efforts, led by the Basel Committee on Banking Supervision (BCBS), to strengthen the regulatory framework. The main thrust of the global reforms pertaining to the banking system is the following:

1. Higher mandatory minimum capital adequacy ratios, together with improvements in the quality of capital;
2. The introduction of minimum liquidity requirements;
3. The introduction of macro-prudential tools;
4. Proposals for the resolution of globally systemically important banks.

The first three sets of reforms comprise the main components of what is known as Basel III (Basel Committee on Banking Supervision, 2010A, 2011). Most of them were agreed by the G20 in 2010. They are motivated by an analysis of the financial crisis which views excessive leverage, inadequate and low quality capital and insufficient liquidity buffers as the main prudential weaknesses in the banking sector. The proposed reforms for the resolution of globally systemically important banks have not yet been finalised.

Banking is an international business. Finance flows across borders and in many countries, including most African countries, cross border banks hold a prominent share of the banking market. The international character of banking provides a clear rationale for global minimum regulatory standards, especially to avoid regulatory arbitrage, whereby banks locate in the jurisdictions with the least onerous regulations, spurring a race to the regulatory bottom. Hence key regulatory innovations – notably the Basel Capital Accords – have been drawn up at the global level (by the BCBS) and most governments around the world, including those in Africa, have incorporated them into their own national banking regulations. The Basel Accords are designed primarily to apply to internationally active banks from advanced economies, and African bank regulators have had little influence in shaping them. Nevertheless, they are regarded as a global minimum standard which should be adopted by all countries, although national authorities can impose stricter standards if they see fit to do so.

The aim of this paper is to assess the implications of the global regulatory reforms for bank regulation in Africa and, in particular, whether the specific reforms are likely to be helpful or counterproductive for banking system stability in Africa. The paper aims to help fill a gap in the literature on the latest global reforms to bank regulation; relatively little of which has assessed these issues from the standpoint of developing countries. The paper is organised around the four sets of reforms noted above: section 2 discusses the increased capital requirements; section 3 the liquidity requirements, section 4 the macro-prudential measures and section 5 the proposals for resolving globally systemically important banks. Section 6 provides a conclusion.

The Basel III Capital Adequacy Reforms

Basel III will raise the minimum requirement for tier 1 capital for banks from the current level of 4 percent of risk weighted assets (RWA) to 6 percent. It will also raise the requirement for common equity capital (a component of tier 1 capital) from 2 percent to 4.5 percent of RWA. In addition there will be more stringent definitions of common equity capital and tier 1 capital; for example banks will have to deduct intangible assets from common equity and tier 1 capital. Minimum total capital will remain at 8 percent of RWA. Banks will also be required to hold a capital conservation buffer, composed of common equity, of 2.5 percent of RWA. They will be allowed to run down this buffer in periods of stress but if they do so

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1 The BCBS’s membership comprises 27 countries but the only African country which is a member is South Africa.
2 The BCBS has established the Basel Consultative Group (BCG), comprising non BCBS members, which prepared a report in 2014 highlighting aspects of the Basel framework which are of concern for emerging markets, developing and small economies (Basel Committee on Banking Supervision, 2014).
3 Beck and Cull (2013), provide a survey of the characteristics of African banking systems.
they will face restrictions on earnings distributions, designed to preserve capital. Basel III will, therefore, raise the minimum requirements, inclusive of the capital conservation buffer, for common equity, tier 1 and total capital to 7 percent, 8.5 percent and 10.5 percent of RWA respectively. In addition, banks will face higher capital charges for the market risk in their trading books, exposures to off balance sheet vehicles and derivatives and for the credit risk of trading counterparties. With the exception of the capital conservation buffer, these reforms are essentially micro-prudential in nature; i.e. they are intended to strengthen the financial resilience of individual banks.

The reforms to the capital adequacy requirements will be supplemented by a non risk based leverage ratio defined as tier 1 capital to total assets. An initial minimum leverage requirement of 3 percent was set on a test basis in 2013. The motivation for the leverage ratio is both micro-prudential and macro-prudential; it is intended to provide a safeguard against errors in measurement and modelling risk pertaining to the risk based capital requirement and to constrain the build-up of leverage during booms, and hence the risk of a subsequent de-leveraging.

The global standards for bank regulation place great emphasis on capital adequacy requirements as the primary regulatory instrument. At a theoretical level, capital requirements are justified as a micro-prudential instrument because of the incentives this gives to the owners of a bank to avoid taking excessive risks which would jeopardise the value of the claims of its debt holders, such as its depositors (Dewatripont and Tirole, 1993).

To evaluate the minimum level at which the CAR should be set, the BCBS used several approaches, including empirical analysis of the volatility of the rate of return of RWA as a measure of the potential losses a bank might incur, estimates of losses incurred by banks during the recent financial crisis and stress tests (Basel Committee on Banking Supervision, 2010B). Cecchetti (2010) defends the Basel III increases in capital adequacy requirements by noting that the losses incurred by 99 percent of globally active banks during the recent financial crisis were less than, or equal to, 5 percent of their RWA. Hence if banks were to hold equity capital of 7 percent of RWA, as required under Basel III, inclusive of the capital conservation buffer, 99 percent of globally active banks would remain solvent if there was a repeat of the losses incurred during the 2007-09 financial crisis.

Table 1 Minimum Capital Adequacy Ratio, Actual Capital Ratios and Non-Performing Loan to Total Loan Ratios in African Countries

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<tr>
<td>Minimum core capital/RWA ratio (%)</td>
<td>Minimum total capital/RWA ratio (%)</td>
<td>Regulatory Tier1 capital to Risk Weighted Assets ratio (%)</td>
<td>Regulatory capital to Risk Weighted Assets ratio (%)</td>
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<tr>
<td>Burundi</td>
<td>8</td>
<td>18.4</td>
<td>21.4</td>
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<tr>
<td>Kenya</td>
<td>8</td>
<td>12</td>
<td>18.2</td>
</tr>
<tr>
<td>Lesotho</td>
<td>4</td>
<td>8</td>
<td>15.2</td>
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<tr>
<td>Mauritius</td>
<td>8</td>
<td>10</td>
<td>14.6</td>
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<tr>
<td>Namibia</td>
<td>7</td>
<td>10</td>
<td>11.2</td>
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<tr>
<td>Nigeria</td>
<td>10</td>
<td>10</td>
<td>12.8</td>
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<tr>
<td>Rwanda</td>
<td>10</td>
<td>15</td>
<td>21.6</td>
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<tr>
<td>Swaziland</td>
<td>4</td>
<td>8</td>
<td>18.7</td>
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Table 1  (continued)

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<tbody>
<tr>
<td>Regulatory Tier1</td>
<td></td>
<td></td>
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<tr>
<td>Minimum core capital/RWA</td>
<td>8</td>
<td>12</td>
<td>17.5</td>
</tr>
<tr>
<td>capital/RWA ratio (%)</td>
<td></td>
<td></td>
<td></td>
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<tr>
<td>Minimum total capital/RWA</td>
<td>10</td>
<td>12</td>
<td>19.1</td>
</tr>
<tr>
<td>capital/RWA ratio (%)</td>
<td></td>
<td></td>
<td></td>
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<tr>
<td>Regulatory capital to Risk</td>
<td>5</td>
<td>10</td>
<td>19.5</td>
</tr>
<tr>
<td>Weighted Assets ratio (%)</td>
<td></td>
<td></td>
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<tr>
<td>Non Performing Loans to Total Loans (%)</td>
<td></td>
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<td>6.4</td>
</tr>
</tbody>
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Tanzania 8 12 17.5 Na 6.4
Uganda 8 12 19.1 21.7 3.9
Zambia 5 10 19.5 21.9 9.7

Sources: IMF Financial Soundness Indicators data portal; 2012 World Bank Survey of Bank Regulation and Supervision.

How relevant are the proposed changes to the level and composition of bank capital requirements to Africa? This is a complex question to answer, but a number of considerations are pertinent.

First, banks in Africa operate in a much riskier economic and institutional environment than banks in advanced economies and as such, are vulnerable to much larger losses in relation to the size of their balance sheets. African economies are less diversified and hence banks’ loan portfolios are less diversified sectorally (Narain et al, 2003), and weaknesses in the legal system impede banks’ ability to recover loans and foreclose on loan security. The non performing loans of banks in the countries shown in table 1 averaged 5.5 percent of their total loans during 2011-2014, which is higher than in advanced economies. Banks in developing countries face potential losses of a different order of magnitude than banks in the advanced economies. This provides a rationale for regulators in Africa to impose higher minimum capital ratios than those stipulated in the Basel Accords. This is the principle adopted by bank regulators in the five member states of the East African Community (EAC), who have agreed to adopt Basel III and to maintain a buffer of four percentage points above the Basel III minimum requirements (see table 2 below).

Table 2  Planned Minimum Capital Adequacy Ratios in the East African Community

<table>
<thead>
<tr>
<th>Percent of risk weighted assets</th>
<th>Basel III</th>
<th>EAC</th>
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<tbody>
<tr>
<td>Core capital</td>
<td>6</td>
<td>10</td>
</tr>
<tr>
<td>Total capital</td>
<td>8</td>
<td>12</td>
</tr>
<tr>
<td>Capital conservation buffer</td>
<td>2.5</td>
<td>2.5</td>
</tr>
<tr>
<td>Capital surcharge for SIBs</td>
<td>1-3.5</td>
<td>1-3.5</td>
</tr>
<tr>
<td>Total with buffers for a non SIB</td>
<td>10.5</td>
<td>14.5</td>
</tr>
<tr>
<td>Total with buffers for a SIB</td>
<td>11.5-14</td>
<td>15.5-18</td>
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Second, most banks in Africa already hold capital well in excess of minimum regulatory levels. The banking systems of many of the countries shown in table 1 hold capital, in aggregate,

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5 Majnoni and Powell (2005) estimated the unexpected credit losses which would be incurred by banks in Argentina, Brazil and Mexico, using a simulated distribution of credit losses. To cover 99 percent of the distribution of unexpected losses, banks would need to hold capital equivalent to about 15 percent of their risk assets.
which comfortably exceeds the minimum requirements under Basel III, inclusive of the capital conservation buffer, and would still exceed the minimum even if a premium of up to four percentage points were to be applied (although all individual banks within these countries might not be in compliance). Why banks should hold capital in excess of the regulatory requirements is not well understood, but it is a long term, rather than a temporary cyclical, phenomenon which suggests that the banks themselves regard high capital holdings as desirable from a business perspective, as a buffer against perceived risk. A lack of loanable projects in which to invest their resources, or a reluctance to expand lending because of the perceived risk involved, cannot adequately explain the excess capital holdings, because if this were the case banks could have reduced their capital holdings over time through larger dividend payments.

Given the existing excess capital held by banks, raising capital adequacy requirements might not bind for many banks in Africa and thus might have little impact on actual bank capital holdings. Nevertheless, it might still be valuable for regulators to put a higher floor under bank capital levels to ensure that they are not reduced in the future. Banks might want to reduce capital adequacy ratios to protect returns for their shareholders if greater competition in banking markets depresses returns on bank assets.

Third, there are inevitably some trade-offs between keeping the banking system safe through higher capital requirements and other important objectives, such as the availability of bank credit, which might affect economic growth. This trade-off is explored by Caggiano and Calice (2011) who compare the impact of higher capital bank requirements on the lower probability of the occurrence of a future banking crisis with the costs arising from wider interest rate spreads and find that higher capital requirements have modest net benefits in terms of higher GDP over the long term.

Fourth, even if banks in Africa are induced by the application of higher statutory minimum capital adequacy ratios to hold more capital, will they be less vulnerable to financial distress as a result? Unfortunately, it is doubtful if statutory minimum capital adequacy requirements alone, even if set at higher levels than the minimum global standards, can provide adequate protection for banks in a very volatile environment where potential losses are very high. In such circumstances, the minimum capital requirements should be supplemented with regulations to curb the riskiness of banks’ assets portfolios, such as restrictions on large loan concentrations, on insider lending and on foreign exchange exposures.

**Basel III liquidity requirements**

Basel III includes two new liquidity requirements for banks. The Liquidity Coverage Ratio (LCR) stipulates that banks should hold sufficient liquid assets to meet all potential demands for liquidity over a 30 day period under stressed conditions. The Net Stable Funding Ratio (NSFR) aims to curtail liquidity mismatches over the longer term by ensuring that banks use stable sources of funding. This is the first time that liquidity standards for banks have been established at the global level.

Many African bank regulations already include a statutory liquid asset requirement, usually defined in terms of eligible liquid assets as a minimum percentage of deposits. The rationale for this liquid asset requirement is that the main source of liquidity pressures facing a bank is withdrawals of customer deposits. The LCR in Basel III is more comprehensive and sophisticated in that it requires banks to hold sufficient high quality liquid assets to cover all possible sources of liquidity pressures over a 30 day period, under stressed conditions; including a partial withdrawal of deposits, a loss of unsecured wholesale funding and calls on committed credit facilities. Banks will have to hold much more liquid assets to cover wholesale liabilities.
maturing within 30 days than retail deposits, because wholesale liabilities are a much less stable source of funds than retail deposits.

African countries could usefully adopt the LCR into their own banking legislations. Banks in Africa have mostly relied on retail deposits to fund their assets, but this is likely to change in the future. As domestic money and capital markets develop and African financial systems become more globally integrated, banks are likely to make greater use of wholesale funds, from domestic or foreign sources, especially if they want to fund rapid growth without having to establish large branch networks. For banks which mobilise wholesale funds, a liquid asset requirement based on retail deposits provides inadequate protection against liquidity pressures, whereas the LCR takes explicit account of the need to hold sufficient liquidity to protect against a withdrawal of wholesale funding.

**Macro-prudential Policy Measures**

Basel III introduces, for the first time in global bank regulatory standards, a specific macro-prudential measure, designed to address threats to systemic stability; the countercyclical capital buffer. This is intended to moderate the amplitude of the credit cycle and especially to avoid sharp contractions of credit during cyclical downswings which can be highly damaging for the real economy. National regulators will have the discretion to impose a countercyclical capital buffer of 2.5 percent of RWA, on top of the minimum capital adequacy requirement inclusive of the capital conservation buffer, in periods when bank credit growth is deemed excessive. By imposing a higher capital requirement during the upswing of the credit cycle, the countercyclical capital buffer aims to constrain credit growth. When the credit cycle turns down, the countercyclical buffer will be removed to reduce the pressure on the banks to shed assets in order to remain in compliance with their capital adequacy requirements.

Almost all African countries have at least one, and often several, systemically important banks (SIBs). Systemically important financial institutions are defined as institutions “whose disorderly failure, because of their size, complexity and interconnectedness, would cause significant disruption to the wider financial system and economic activity” (Financial Stability Board, 2010: 1). To address the specific risks posed by SIBs, the BCBS has proposed levying a capital surcharge of between 1 and 3.5 percent of RWAs on SIBs. The BCBS has also proposed a methodology for identifying SIBs and determining how large the capital surcharge should be (Basel Committee on Banking Supervision, 2011). The methodology incorporates measures of a bank’s size, the substitutability of its services, its interconnectedness and its complexity. The rationale for the capital surcharge is that, given that the closure of a SIB would be (by definition) very disruptive for the economy, it should have to hold more capital than a non SIB to lessen the probability that it will ever suffer distress and thus risk failing. The imposition of a capital surcharge, on a progressive basis depending on the degree of systemic importance, could also give the SIB an incentive to make itself less systemically important (e.g. by becoming smaller).

Specifically macro-prudential measures such as the countercyclical capital buffer are motivated by the recognition that systemic risks to the financial system are not simply the aggregation of the risks facing each individual bank in the banking system; instead the actions of individual banks to protect themselves from distress can collectively have negative externalities which create or exacerbate systemic risks to the financial system (Caruana, 2010A). However, the structure of financial systems and the nature of systemic risks in Africa are not identical to those in advanced economies; therefore how relevant are the Basel III macroprudential policy measures for Africa?
Threats to systemic stability in Africa probably arise from four main sources. The first is contagion arising from financial shocks emanating from outside of the domestic economy, such as volatile external capital flows or financial distress in cross border banks which have subsidiaries in Africa. The second is the pro-cyclical characteristics of financial intermediation which can amplify the economic cycle, through rapid credit growth during economic upturns and credit contraction during downturns. The third entails common exposures of the financial system, such as credit exposures. In less diversified economies, the constraints on diversification mean that all banks may face similar credit concentrations; hence a shock to a dominant sector of the economy poses a potential systemic risk to the banking system (Narain et al, 2003). The fourth involves the financial distress of a SIB. These four sources of systemic risk may be connected. For example, external capital inflows can fuel a credit boom and a reversal of capital flows can force a credit contraction, while many of the SIBs in Africa are subsidiaries of international or regional banks.

The countercyclical capital buffer is intended to counter the time dimension of systemic risk by moderating the amplitude of the credit cycle. Credit booms have been relatively common in Africa in recent years, hence measures to moderate the credit cycle might be relevant for Africa. However, given that rapid intermediation growth is a feature of economies undergoing financial development and is, to some extent, optimal for development, it is not straightforward for regulators to determine when credit growth is excessive in the sense that it poses a threat to financial stability (Basel Committee on Banking Supervision, 2014). Furthermore, in periods when rapid credit growth is considered excessive, imposing the countercyclical buffer may not be an effective tool to dampen the credit cycle, because a countercyclical capital buffer of 2.5 percent of RWA is likely to be too low to bind as a constraint to credit growth in African banking systems. This is because banking systems in many African countries hold capital which is well in excess of the statutory minimum capital requirements (see table 1).

To restrain excessive credit growth, regulators in Africa may have to employ other tools which impose a more direct constraint on the ability of banks to expand their loan portfolios. For example, regulators could impose direct controls on aggregate lending by each bank or on lending to specific sectors which are regarded as posing most risk to systemic stability, such as loans for real estate. With such measures, there are no standard international benchmarks which can be applied, because what constitutes an excessively risky rate of credit growth or volume of credit depends on the prevailing circumstances. Imposing regulatory caps on loan to value ratios for real estate lending may also be useful. Both direct credit curbs and loan to value ratio caps have been used by bank regulators in East Asia to dampen the procyclicality of credit (Caruana, 2010B).

Basel III does not address, in a comprehensive manner, two of the potential sources of systemic risk discussed above, volatile short term external funding intermediated through the banking system, which is vulnerable to “sudden stops” and the cross sectional risk arising from common exposures, such as lending to a dominant sector of the economy. Hence regulators may need to consider additional policy tools to mitigate these risks.

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6 Iossifov and Khamis (2009) identify 13 SSA countries which experienced rapid credit growth during 2003-07, defined as annual average real growth of bank credit to the private sector of over 20 percent in this period.

7 One of the reasons why loans for real estate might be regarded as posing a greater threat to systemic stability than loans to other sectors is that the former stimulates demand for real estate, which pushes up prices, given that supply is finite. In turn the higher real estate prices raise the value of collateral for lending and may stimulate further demand if investors expect to make capital gains in a rising market. Hence real estate lending can generate a self reinforcing spiral of rising asset prices and a credit boom.
Regulators could discourage banks from mobilising short term foreign liabilities by imposing an unremunerated cash reserve requirement with a minimum stay period. The rate at which the reserve requirement is applied need not be constant over time to achieve macro-prudential goals; instead it could be applied at higher rates during periods when external capital inflows are very strong. Regulators should also consider imposing restrictions on banks’ foreign currency derivatives because these could be used to circumvent controls on foreign currency liabilities. To address the credit risk emanating from bank lending in foreign currency to domestic residents, stricter prudential requirements, such as higher capital charges and/or loan loss provisions could be imposed. Moreno (2011) discusses a range of policy measures which regulators could use to mitigate the risks arising from banks’ foreign currency denominated transactions; these include limits on the net open positions of financial institutions, defined as a ratio of their capital, more stringent requirements for lending in foreign currency than in domestic currency and higher liquid asset requirements on short term foreign liabilities than on domestic liabilities. Some of these measures, especially the limits on net foreign exchange exposure, are already in force in many African countries although the motive for their imposition is primarily micro-prudential.

One of the sources of cross sectional risk, that arising from potential fragility of SIBs, is being addressed through the capital surcharge for SIBs proposed by the BCBS, and this measure could usefully be adopted by African regulators. To counter the risks from common exposures in undiversified economies, regulators may need to craft regulations which can restrict exposures to single sectors, rather than just individual borrowers, if they potentially threaten systemic risk.

The supervision and resolution of cross border banks

The supervision of cross border banks and especially their resolution in the event that they incur financial distress are very difficult challenges for regulators but ones which are very pertinent for Africa given that cross border banks have a prominent share of the banking market in many African countries. Cross border banks held a market share by assets in African banking markets of about 55 percent in 2009 (Beck et al, 2014: 29). These banks include large international banks, such as Société Générale and Standard Chartered Bank, and also banks from other developing countries including African countries. The market share of foreign owned banks varies widely across Africa: in several smaller economies it is between 80 and 100 percent, whereas in some of the larger economies it is less than 40 percent.

Effective supervision of cross border banks must be done on a consolidated basis. Even if their operations in individual countries are set up as separately capitalised subsidiaries, they have many financial and operational links with other entities in their banking group and could still be subject to contagion from problems elsewhere in the group; hence supervision at a purely national level is not optimal. Consolidated supervision is undertaken by the cross border bank’s home regulator. Supervisory colleges for cross border banks have been set up to coordinate supervision and share information between the home and host regulators, in which African supervisors are participating. Under the Basel Core Principles (BCPs), the home country regulator has clear responsibilities to the host country regulators to provide information about the consolidated operation of the banking group, including the extent to which the subsidiaries could rely on the parent banking group for financial support and arrangements for crisis management. But because the subsidiaries in small countries are often unimportant in terms of the health of the overall banking group, home country regulators do not always comply with their responsibilities to the host regulators. African bank regulators
should demand better cooperation from the host regulators of international banks, in line with the latter’s responsibilities under the BCPs.

Cross border banks headquartered in African countries have expanded their market share in Africa in the last few years and are systemically important in some countries. Beck et al (2014) lists 10 banks which are headquartered in Africa and which each have operations in nine or more African countries, the largest of which include Ecobank (headquartered in Togo) Stanbic Bank (South Africa) and United Bank for Africa (Nigeria). Most of the cross border expansion of African banks has taken place since 2000. The regulatory treatment of these banks should be the same as that applied to other cross border banks of similar systemic importance. In terms of regulatory challenges, the main issue of concern pertains to consolidated supervision by the home country regulator which is deficient in some cases. In addition, supervision of the non-banking activities of these banks is not adequate, outside of South Africa, and cooperation between home and host country regulators is weak (Lukonga, 2010). However, cooperation between home and host country regulators within Africa is being strengthened, especially within the context of regional bodies such as the East African Community (EAC). The five central banks in the EAC have signed memoranda of understanding to share information about the operations of cross border banks, to cooperate in undertaking on-site inspections of these banks and to establish supervisory colleges for the banks which are headquartered in the EAC.

The Financial Stability Board has published proposals for resolving globally systemically important banks (GSIBs) in a manner which is intended to minimise threats to financial stability, preserve the critical functions of the GSIB and avoid exposing taxpayers to losses (Financial Stability Board, 2014). The proposals involve two components. First, the material subsidiaries of a GSIB will be grouped together into a resolution group, along with a “resolution entity” (in many cases, the resolution entity will be the parent bank or holding company of the GSIB). Regulatory interventions to resolve distress in any of the individual entities within the resolution group will take place through the resolution entity and will be led by the regulator of that entity. If there are losses in a material subsidiary which may cause it to fail, capital will be passed down from the resolution entity to the distressed subsidiary to prevent its failure. As such a material subsidiary need not be subject to resolution by its host regulator, in the event it suffers financial distress.

To ensure that sufficient resources will be available to cover potential losses, the resolution entity will have to hold liabilities of sufficient magnitude which can absorb losses without triggering the bankruptcy of the GSIB. These liabilities are referred to as total loss absorbing capital (TLAC). In addition to regulatory capital, subordinated debt which can be written down or converted to equity can also qualify as TLAC. Capital buffers such as the capital conservation buffer will not be included in TLAC. The FSB proposes that the TLAC for a resolution group should be set at between 16 and 20 percent of its RWA. Consequently a GSIB will have to hold TLAC of between 8 and 12 percent of RWA, on top of the Basel III minimum capital requirements, and also hold the capital conservation buffer and the capital surcharge for SIBs.

The FSB proposals have merit in that they offer a way to resolve a distressed cross border bank in a manner which is not dependent on coordinated actions being taken by numerous different bank regulators, which would be very difficult in practise to achieve in an optimal manner. Under the FSB proposals, the host regulators do not need to apply resolution actions to the subsidiaries of GSIBs in their own jurisdictions, because these subsidiaries will be
protected by the TLAC of the applicable resolution group. Therefore the African hosts of subsidiaries of GSIBs should have greater protection from the failure of these subsidiaries than would be the case if they were purely stand-alone entities. Given the importance of the subsidiaries of GSIBs in African financial systems, the protection afforded under the FSB proposals should make African banking systems less vulnerable to systemic risk.

The host regulators will, however, need to have confidence that the home regulator of the GSIB’s resolution entity has the competence to carry out a resolution to achieve the objectives of the FSB noted above and that the resolution entity really does have sufficient TLAC to cover all of the potential losses in the resolution group. This confidence will only be generated if there are well functioning crisis management groups (CMG) for each GSIB which include all of the host regulators and if there are resolution action plans for each GSIB prepared in consultation with all of the members of the CMG. Unfortunately, the FSB proposals set minimum size criteria for the definition of a “material subsidiary” that would exclude most of the subsidiaries of GSIBs in Africa, which implies that these subsidiaries would be left out of the relevant resolution group and not enjoy the protection of the group’s TLAC. African regulators should take a strong stance against any subsidiaries of GSIBs being excluded from resolution groups even if they are small in relation to the size of the consolidated GSIB and should also insist on being included in the relevant CMGs.

Conclusions

Basel III provides a new set of global minimum regulatory standards for banks, primarily pertaining to their capital adequacy. The reforms have been formulated to deal with the deficiencies of financial regulation as they are perceived in developed countries. They are less relevant for African economies, whose banking systems have different characteristics and face different challenges. Nevertheless, raising capital adequacy requirements and introducing the capital conservation buffer and the capital surcharge for SIBs could help to make African banking systems safer in the long run. Although African banking systems in aggregate already hold substantial capital in excess of the statutory regulatory requirements, raising minimum capital adequacy requirements will establish a higher floor under banks’ capital adequacy ratios. Furthermore, African bank regulators should consider imposing capital adequacy ratios which are higher than the global minimums in the Basel Accords, to take account of the greater risk facing banks in their economies, as is the case with the five member states of the EAC.

Introducing the Basel III liquidity coverage ratio (LCR) in Africa should also be useful because it provides a more comprehensive safeguard against liquidity risk than the existing liquidity regulations in Africa, which are focussed primarily on the liquidity risk arising from runs on deposits. The LCR takes account of the liquidity risk from all components of the balance sheet and off balance sheet items, some of which, such as wholesale funding, may constitute a much greater source of liquidity risk than deposits.

Basel III places too much emphasis on capital adequacy requirements as a regulatory tool to ensure the resilience of banks. Capital is important, but in banking systems in which asset values are very volatile, capital requirements cannot realistically shoulder the entire burden of prudential regulation. Instead it is necessary to regulate the asset side of the bank’s balance sheet, to control excessive risk taking and improve the quality and accurate valuation of bank assets and the associated provisioning for losses. From the standpoint of micro-prudential regulation in Africa, the most serious lacunae in Basel III is the omission of global standards to regulate bank assets. Many African countries already impose a range of regulations to curb risk in bank asset portfolios, such as loan concentration limits and limits on foreign currency
exposures. These regulations should remain in place, but they need to be amended and updated to keep pace with the evolving nature of banking in Africa. Bank regulation also needs to be backed up by stronger, more intrusive bank supervision: hence strengthening supervisory capacities and supervisory methodologies should be accorded priority by African regulators (Briault, 2009). Stronger supervision will probably contribute more to safeguarding bank soundness in Africa than strengthening the bank regulations.

The macro-prudential policy measures in Basel III fall short of what Africa needs to prevent systemic risks to the financial system. Basel III includes a countercyclical capital buffer of 2.5 percent of RWA, to be imposed at the discretion of the national regulator, and a leverage ratio of 3 percent of total assets. Neither is likely to be large enough to provide an effective constraint to excessive asset growth during economic booms, which could generate systemic vulnerabilities. Furthermore, Basel III includes no macro-prudential measures to tackle what is likely to be a major source of systemic risk for African financial systems in the future, the intermediation of short term external capital flows through the banking system, which can entail exchange rate, credit and liquidity risks. Consequently, an effective macro-prudential policy toolkit must include a much wider range of instruments than those included in Basel III, including possible curbs on banks’ use of short term foreign exchange liabilities and derivatives.

The merit of the proposals of the Financial Stability Board for the resolution of GSIBs is that they do not depend on multiple different regulators taking coordinated and mutually optimal resolution actions during a banking crisis, which would be very difficult to achieve in practise. However, if Africa is to benefit from these proposals, the African subsidiaries of GSIBs must be included in the applicable resolution groups of the GSIBs and African host regulators should be members of the relevant crisis management groups.

References

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