



FINAFRIQUE RESEARCH

ENTRY INTO FORCE OF THE BASEL 2 AND BASEL 3 REFORMS IN UEMOA

THE LIMITS AND KEY POINTS OF THE NEW PRUDENTIAL FRAMEWORK



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SUMMARY

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- Regional/local rating agencies are not mentioned
- No specific treatment in the SME credit risk assessment
- Towards a strengthening of the capital structure

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FOREWORD

Since 1 January 2018, the Basel 2 and Basel 3 prudential standards have come into force in the UEMOA¹ monetary area and to a lesser extent in the CEMAC² zone.

This document presents the highlights of this new framework and some challenges for all stakeholders in the financial environment: Subject Banks and Credit Institutions, Regulators, Investors, Financial Markets etc.

¹ West African Monetary Union.

² The Economic and Monetary Community of Central Africa.



GOING BEYOND OPERATIONAL RISK MEASUREMENT

THE INTEGRATION OF OPERATIONNEL³ RISK INTO THE REQUIREMENTS OF THE PRUDENTIAL FRAMEWORK IS ONE OF THE NOTABLE DEVELOPMENTS IN THE PROCESS OF SUPERVISING CREDIT INSTITUTIONS.

Indeed, the severity of the losses that have occurred in the banking market over the past 5 years (WAEMU and CEMAC⁴) and related only to fraud⁵ confirm the need to prudently manage operational risks. In this regard, the banking commission proposes to institutions 2 approaches for evaluating operational risks based on weightings applied to the institution's Net Bank Product (GNP).

THESE WEIGHTINGS ARE IDENTICAL TO THOSE DEFINED BY THE COMMITTEE ON BALE, NAMELY 15% FOR THE BASIC APPROACH AND A LEVEL VARYING BETWEEN 12% AND 18% FOR THE STANDARD APPROACH.

Table 15 : Distribution of lines of business according to the standard approach.

Job Lines	Weighting coefficient
Business Financing	18.00%
Market Activities	18.00%
Retail Banking	12.00%
Commercial Bank	15.00%
Payments and Settlements	18.00%
Money Function	15.00%
Asset Management	12.00%
Retail Brokerage	12.00%

Source : Annex prudential framework

Among other things, it requires institutions wishing to use the standard approach to set up an operational risk management function with strong involvement of the executive body that defines the roles and responsibilities of each stakeholder.

TO MOVE BEYOND IN THE MEASUREMENT OF OPERATIONAL RISK, INSTITUTIONS COULD INTEGRATE INTO THEIR RISK MAPS ELEMENTS RELATED TO THE LOCAL CONTEXT AND DIRECTLY IMPACTING THEIR RESULTS AND OWN FUNDS. THESE ARE THE « SCENARIO » OF MAJOR RISKS AS DEFINED UNDER PILLAR 1 OF THE BASEL 2 ADVANCED APPROACH OR THE « RESISTANCE TESTS » REQUIRED IN PILLAR 2 (SURVEILLANCE PRUDENTIELLE).

Some examples of risk scenarios, some of which have already occurred on the place :

- ▲ The departure or disappearance of a key resource in the organization,
- ▲ The EBOLA epidemic,
- ▲ The management of the risk of skills disruption related to human capital management, which was recently discussed by a major banking group in Central Africa at its annual meeting.

Finally, the standard approach weights should be subject to a thorough review by the Banking Commission on the basis of available data, possibly after the transitional phase, to assess their relevance to the local context and in the light of changes in the banking and financial sector.

³ The risk of losses resulting from inadequacies or failures attributable to processes, people, internal systems or external events.

⁴ The Economic and Monetary Community of Central Africa.

⁵ The most recent event being the bank card fraud foiled by the BGFI Bank Group for an estimated amount of 1.9 Billion FCFA.



AS AN EXAMPLE, THE 15% WEIGHTING ATTRIBUTED TO THE COMMERCIAL BANK ACTIVITY LINE MAY NOT BE SUFFICIENTLY PRUDENT IN THE UEMOA AREA, BECAUSE THIS ACTIVITY LINE REPRESENTS ON AVERAGE MORE THAN 80% OF THE RESULT OF BANKING INSTITUTIONS

REGIONAL/LOCAL RATING AGENCIES ARE NOT MENTIONED

Within the scope of credit risk and under the standard approach, the precise assessment of risk essentially relies on the counterparty weightings set by the Banking Commission.

These weightings depend on the rating established by External Credit Assessment Organizations (ECAOs) or Rating Agencies, which differ in 2 ways:

- International Rating Agencies:** The UEMOA Banking Commission authorises 4 agencies whose Big Three (Standard & Poor's - S&P, Moody's Investors Service, Fitch Rating Services) and Dominion Bond Rating Service (DBRS).
- Regional/Local Rating Agencies:** Unfortunately the list is not yet published, neither on the BCEAO website nor on the site of the regulator in charge of financial markets (the Regional Council for Public Savings and Financial Markets - CREPMF), contrary to article 173:

« ARTICLE 173. AN EXTERNAL ASSESSMENT OF THE CREDIT FOR OEEC OTHER THAN THOSE LISTED IN PARAGRAPH 172 MAY ONLY BE USED TO DEFINE THE RISK WEIGHT APPLICABLE TO AN EXHIBITION IF THE OEEC IS AGREED BY THE BCEAO. THE LIST OF OEEC RECOGNIZED IN WAEMU IS DRAWN UP BY THE BCEAO AND PUBLISHED ON ITS WEBSITE. »

Source : Annexe dispositif prudentiel, Article 173

Gold, 2 Regional/Local Rating Agencies are approved by the CREPMF (Bloomfield Investment Corporation and West Africa Rating Agency) and have been involved for several years in the WAEMU zone. Unlike the 4 international rating agencies mentioned above, these two regional/local rating agencies issue ratings on the financial health of several African companies including certain SMEs defined within the meaning of the commission (turnover less than 1 Billion).

The official publication of these Regional/Local Rating Agencies directly in the texts and in the same way as the 4 International Rating Agencies, would advocate for transparency under Pillar 36 of Basel 2. It would also be part of the promotion of financial rating, a key element in the credit risk assessment and mitigation scheme as illustrated in paragraph II.

NO SPECIFIC TREATMENT IN THE RISK ASSESSMENT CREDIT PME

According to the Banking Commission, an SME is defined as an autonomous company producing goods and/or commercial services, registered in the trade register, whose annual turnover excluding taxes does not exceed one billion (1,000,000,000) FCFA.

With the standard approach proposed in the new text, credit risk is assessed by the client's exposure to which a weighting between 0% and 150% is applied and which depends on the external rating of the counterparty. Thus, a loan of 100 million FCFA granted to an SME that is rated "A - " will benefit from the same weighting as a large enterprise (more than 1 billion in turnover) which is also rated BBB +: 50% according to the grid presented below.

Table 8 : Grid for weighting exposure on businesses

Rating	AAA to AA-	A+ à A-	BBB+ à BBB-	Below BB-	No rating
Weighting	20%	50%	100%	150%	100%

Source : Annexe dispositif prudentiel

In reality, the weighting of SMEs operating in the UEMOA zone would be maximal (100%) because very few are still rated by regional rating agencies and even fewer by international agencies. For better discrimination of the credit quality of borrowers, especially SME clients, institutions must use internal rating models, a more relevant tool in risk assessment. However, the criteria for transposing this evaluation system are not yet defined in the texts. This system provides for SME customers, for example, an increasing weighting with a company's turnover up to a certain threshold, as shown in the table below:

Between €5M and €50M in turnover (definition of an SME within the meaning of Basel 2), the weighting increases with turnover, and beyond €50M, turnover no longer influences the weighting.

Simulation of the credit risk weighting in an internal rating method

CA (M€)	CA (Mds FCFA)	Weighting (%)	Equity (€)	Equity (CFA)
5	3 278	61,56%	34 742	22 775 683
10	6 556	63,91%	36 071	23 646 938
15	9 833	65,88%	37 184	24 376 304
20	13 111	67,86%	38 301	25 108 756
25	16 389	69,85%	39 423	25 844 352
30	19 667	71,85%	40 550	26 583 145
35	22 945	73,85%	41 682	27 325 184
50	32 778	75,87%	42 819	28 070 512
55	36 056	79,92%	45 108	29 571 202
60	39 334	79,92%	45 108	29 571 202

Source : FinAfrique Research

Nevertheless, the Institutions have the possibility to use credit risk mitigation techniques under certain conditions set by the banking commission. The general principle is as follows;

- ▲ If the client's exposure is fully covered by an eligible collateral or guarantee, then the risk is assessed by the client's exposure to which the guarantor's weighting is applied;
- ▲ If the exposure is partially hedged, then the hedged part benefits from the guarantor's weighting and the unhedged part from the client's;

Thus, the loan of 100 million FCFA granted to the SME rated "A-" but now guaranteed at 50% (or 50 million FCFA) by a financial institution such as the African Guarantee Fund (AGF) will benefit from the weighting of the African Guarantee Fund up to 50%. In the present case, AGF being rated "AA-" by the agency Fitch Ratings, 50 million FCFA are weighted at 20% (or 10 million FCFA) and the other 50 million FCFA are weighted at 50%, **is a final risk of 35 million against 50 million in the absence of a guarantee.**

Table 6 : Weighting grid for exposures > 3 months to financial institutions

Rating	AAA to AA-	A+ to A-	BBB+ to BBB-	BB+to B-	Below B-	No rating
Weighting	20%	50%	50%	100%	150%	50%



TOWARDS A STRENGTHENING OF THE CAPITAL STRUCTURE

The new prudential framework introduces several changes based on the requirements of both Basel 2 and Basel 3 with a view to gradual implementation by 2022. Among the major changes, we note **le renforcement du capital de base** mobilised by the Banks in respect of Pillar 1 requirements (minimum requirements in own funds).

Indeed, Banks must hold a level of **core capital** hard or Common Equity Tiers 1, CET1⁶ corresponding to a **minimum threshold of 5%** the amount of their exposure to credit, market and operational risks against a level of **4,5% in Europe and 8% in Kenya**.

This ratio is reinforced by the introduction of **conservation cushion**, additional capital cushion to preserve core capital during periods of crisis: the conservation buffer is set at a **maximum level of 2,5%** of the bank's total exposure to risk in accordance with the threshold defined by Basel 3.

Table 22 : Transitional provisions on minimum capital requirements

Minimum Requirements	2018	2019	2020	2021	2022
Minimum ratio for common equity tier 1 capital (CET 1)	5%	5%	5%	5%	5%
Capital Conservation Buffer	0,625%	1,25%	1,875%	2,5%	2,5%

Source : Annex Prudential Framework

Two other cousins are added to complete the overall capital structure: the equity buffer to counter the effects of the economic cycle on loan activity or **counter-cyclical buffer** set at 2,5% and the **systemic buffer** aimed at regional systemically important banking institutions whose threshold is set by the Banking Commission.

Ratio	Balle II		Europe	UMOA	Kenya
Common Equity Tier 1 (CET 1)	2%		4,5%	5,0%	8,0%
Tier 1 (incluant CET1)	4%		6%	6%	8%
Tier 2	4%		2%	2%	4%
conservation buffer			2,5%	2,5%	2,5%
Counter-cyclical buffer			0% - 2,5%	0% - 2,5%	
Systemic risk buffer			0% - 5%	Fixé par la CB	
Minimum own fund = Tier 1 + Tier 2 + Conservation cousin (Basel 3)	8%		10,5%	11,5%	14,5%

BASEL III

Core Tier 1	Action, Reserves, Certain minority interests
Tier 1	preference shares Titres super subordonnés
Tier 2	Certain subordinated securities (maturity > 5 years)

Source : FinAfrique Research

⁶ CET1 is composed of the following elements: Capital, Premiums, intermediate profits, reserves, etc.

Ultimately, the banks of the WAEMU zone will have to mobilize at the end of 2018 a minimum level of own funds of 8.625% of their weighted risks including 5% dedicated to the basic own fund (CET1) and 0.625% of conservation cushion with a target of 11.5% by 2022. In Sub-Saharan Africa, this threshold oscillates between 8% and 15% depending on the currency area and in some English-speaking African countries such as Nigeria, it takes into account the origin of the financial institution (National Bank, Sub-Regional or subsidiary of International Bank). The principle being to apply a higher level of own funds requirement to a foreign-funded institution compared to a local bank.

At the end of December 2016, the 113 banks in the WAEMU zone held an equity level corresponding to 11% of their risks, which is higher than the expected overall threshold of 8%.

Table 12 : Distribution of banks according to the level of the risk coverage ratio

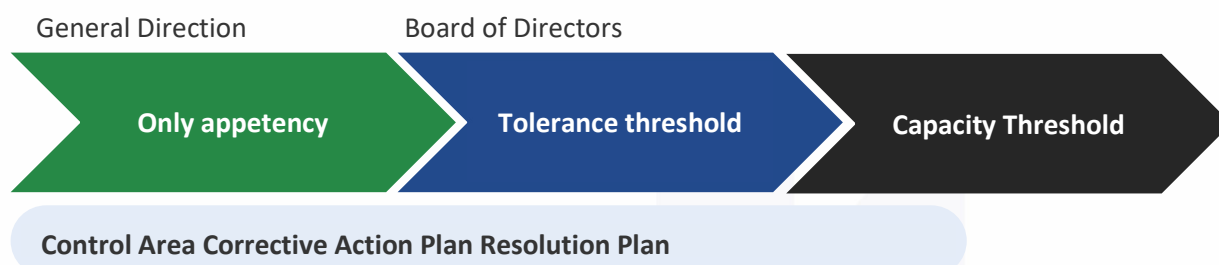
slices	number of credit institutions	Weight in terms of total assets	Weight in terms of weighted risks
<8%	12	8,6%	8,0%
>8%	101	91,4%	92,0%
TOTAL	113	100,0%	100,0%

Source : Annual Report UEMOA Banking Commission 2016

WHAT ARE THE IMPLICATIONS OF THESE NEW RATIOS FOR ESTABLISHMENTS THAT MUST MEET BOTH SOLVENCY REQUIREMENTS AND ACHIEVE PROFITABILITY OBJECTIVES ?

- Develop a better understanding of the capital structure (the components of the CET1 ratio numerator) to optimize the own funds. It is particularly about the composition of the basic own funds that must represent at least 5% of weighted risks. As an example, an establishment could decide on an increase of his capital and not pay dividends despite strong commercial performance to strengthen its own funds.
- Strengthen the risk management system (better manage the denominator of the ratio) involves the establishment of a relevant system for at least assessing credit risk, market risk, and operational risk. This translates into compliance with procedures and credit limits, the formalization of the bank's risk appetite in line with its development strategy, and the strengthening of its human capital, etc.

Illustration of the framework of risk appetite levels for an Establishment



Source : FinAfrique Research



CONCLUSION

The prudential framework has taken into account, in a normative manner, the developments of the Basel 2 and Basel 3 agreements, including the integration of operational risk in the calculation of capital requirements. However, reading the main developments raises some questions about the practical transposition and operational implementation of certain key elements within the WAEMU space institutions. These elements concern the levels of weightings affected in the risk assessment, the banking and economic environment with the credit risk assessment of SMEs and the positioning of local rating agencies.

