



FINAFRIQUE RESEARCH

THE IMPACT OF INTERNATIONAL BASEL I, II & III REGULATIONS ON THE AFRICAN BANKING SYSTEM



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FOREWORD

Since the financial crisis of autumn 2008, banking regulation has become more and more complex at an international level with a much increased level of vigilance both at the regulator's level and within banks in terms of risk surveillance. This regulation has notably materialised in numerous changes over the last 20 years: after the implementation of Basel I and Basel II respectively in 1994 and 2008, European banks have been subject to the Basel III standard since the end of December 2014. Moreover, since 04 November 2014 they have begun the transition to a single European supervisor (the European Central Bank) in place of local regulators (ACPR for France).

Faced with these numerous changes, the banking environment in Africa and particularly in francophone sub-Saharan Africa has been marked by strong growth in its activity over the past 3 years. At the end of 2013, the GNP (Net banking product = income) of the 127 banks in the WAEMU zone amounted to 1,197 billion FCFA compared with 973 billion FCFA in 2011, an increase of 23%.

In addition, the total balance sheet of the 45 banks in the CEMAC zone also increased by 20.7%, from 7,584 billion FCFA at the end of 2010 to 9,151 billion FCFA at the end of 2011. This sector is also characterized by strong competition between local banks (pan-African banks, multi-regional and regional banks) and subsidiaries of foreign banks. As such, at the end of 2011 it recorded the presence of 7 pan-African banking groups including the Ecobank ETI group established in more than 32 countries.

To maintain the stability of this African banking system and especially to preserve the savings of depositors and therefore avoid the massive bankruptcies observed in the 90s in West and Central Africa, local regulators must constantly adapt their monitoring and banking risk control systems **at the new international regulations**.

What are these new international regulations Basel I, II, III?

How are they transposed by African regulators at the regional level?

What are the impacts of these regulations on the activities of banks and credit institutions?

To answer these questions, this study focuses on three main areas:

- ▲ The fundamentals of Basel I, II & III,
- ▲ The link with the regulations in force in Africa and
- ▲ The impacts of these regulations on banking activity.



WHAT BASEL I/II/III ?

ONE OF THE MAIN ACTIVITIES OF A COMMERCIAL BANK OR FINANCIAL INSTITUTION IS TO GRANT CREDIT AND THUS CONTRIBUTE TO THE FINANCING OF THE ECONOMY. HOWEVER, THESE ACTIVITIES ARE GENERATORS OF VARIED RISKS WHICH ARE PARTICULARLY ACUTE DUE TO THE TRANSFORMATIONS AFFECTING THE FINANCIAL ECONOMY (INCREASED COMPETITION, COMPLEXIFICATION AND SOPHISTICATION OF PRODUCTS TO MEET CUSTOMER REQUIREMENTS, TECHNOLOGICAL INNOVATIONS...). IN ORDER TO IDENTIFY, MEASURE AND CONTROL THESE DIFFERENT RISKS AND TO PROTECT THE STABILITY OF THE BANKING SYSTEM, THE BANKING COMMITTEE HAS GRADUALLY PUT IN PLACE A CONTROL AND RISK MONITORING SYSTEM FOR COMMON BANKING INSTITUTIONS CALLED BASEL I, BASEL II ET BASEL III.

THE ORIGINS OF BASEL

The Basel Committee was born in 1974 under the aegis of the G10 countries with a desire for the Central Banks of the countries that make it up to improve the stability of the international banking system, the dissemination and promotion of best banking and supervisory practices and the promotion of international cooperation in prudential supervision. In this regard, it issues recommendations based on bank reference practices and proposes minimum standards. These recommendations are incorporated into the European regulations in the form of directives and then transposed into the local regulations of each country.

BASEL I AND THE RATIO COOK

In 1988, the Basel Committee introduced the Cook ratio through the Capital Adequacy Directive by requiring a minimum of 8% equity to cover credit risk. This translates into the fact that when a bank lends €100 to a client, it must have at least €8 of own funds and use a maximum of €92 from its other sources of financing such as deposits, loans, interbank financing, etc. The agreement defined the regulatory capital and all credit commitments with a ratio broken down as follows:

The numerator of the ratio consists of regulatory capital in the broad sense. In addition to capital and reserves (core capital), additional own funds considered as "quasi-capital" may be included in regulatory own funds, subordinated debts (debts whose repayment only comes after that of all other debts).

The denominator contains the Bank's credit commitments to which are applied for some of the weightings set between 0% and 100%, depending on the nature or type of credit or counterparty. Thus, some loans are weighted at 50% (loans secured by a mortgage), or 20% (bank counterparty, international organization or non-OECD state) or even 0% (OECD state counterparty).

UNFORTUNATELY, THE VERY FAST WEIGHTING SYSTEM SHOWS ITS LIMITS BECAUSE THE WEIGHTING OF COMMITMENTS WAS INSUFFICIENTLY DIFFERENTIATED TO TAKE INTO ACCOUNT THE DIFFERENT ACTUAL LEVELS OF CREDIT RISK OF THE CLIENT.



In addition, the emergence of the derivatives market in the 1990s with the emergence of "off-balance sheet" risks led the Committee to revise the 1988 directive. Thus, the 1996 directives introduce market risk in the Cook ratio with the possibility for some banks to use internal rating systems to better assess the client's credit risk.

BASEL II / CAPITAL REQUIREMENT DIRECTIVES (CRD)

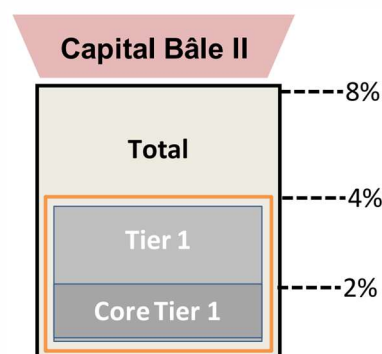
In continuation of the 1996 amendments, new capital directives called Capital Requirement Directives (CRD) are introduced by the Basel Committee in 2004 for a better risk assessment through the implementation of a prudential supervision and transparency mechanism. This system, which entered into force in France in 2007 via the decree of February 20, is based on 3 fundamental pillars namely:

- 1_ **Minimum capital requirements of 8%** defined by the Mc Donough ratio which takes into account a new type of risk, operational risk in addition to credit and market risk, and imposes a risk management system according to different assessment methods.

Capital

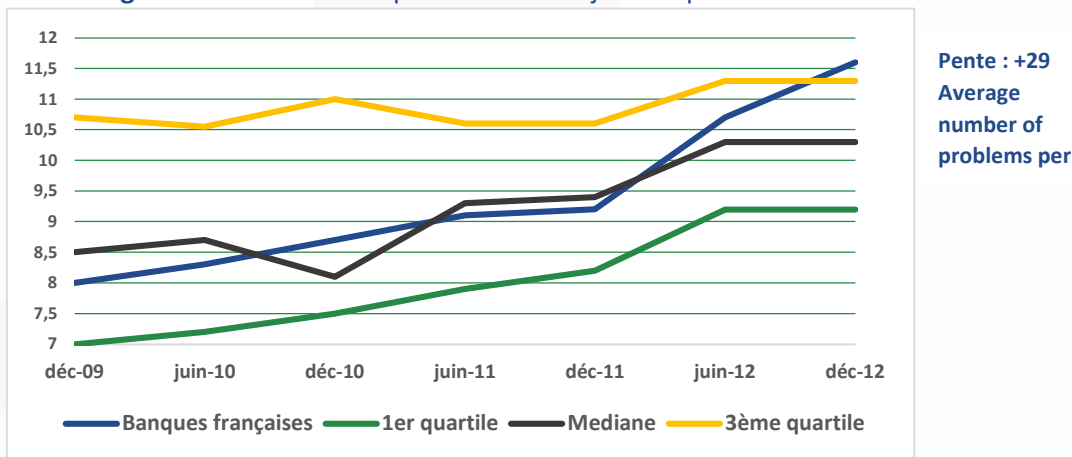
Credit risk	+ Market Risk *	+ ★ Operational Risk *
Weighted Credit Risk Exposure	12,5 'Capital Requirements for Market Risk Instruments'	12,5 * Capital Requirements for Operational Risk Exposures
↓	↓	↓
3 Calculation Methods: ▲ Standard Method, ▲ IRB Fondation Method (IRBF), ▲ Advance IRB Method (IRBA).	2 calculation Methods : ▲ Standard Method, ▲ Internal-model approach	3 Calculation Methods: ▲ Basic indicator approach, ▲ Standardized Approach, ▲ Advanced Measurement Approach (AMA).

The new ratio of 8% is broken down into two parts: a so-called «Tier 1» ratio representing 4% of the capital where the capital is supposed to be «real» capital (i.e. without risk) and another «Tier 2» ratio for which the constraints are less strong with a level of 4%. Tier 1 is also broken down into two parts: the Core Tier 1 of a level of 2% for which only the shares and profits of the bank reinvested are taken into account, and the other part of Tier 1 (2%) including hybrid securities (such as convertible bonds).



For example, the aggregate Core tier 1 ratio of the main French banks (BNP Paribas, Société Générale, Crédit Agricole Group, BPCE Group, Crédit Mutuel Group (GCM) and La Banque Postale (LBP)) is estimated at between 8% and 11% between the end of 2009 and the end of 2011, be well below the required threshold. This shows the desire for these banks to have a capital cousin above regulatory minimums.

Figure 22: Core Tier 1 Capital Ratio of Major European Banks



Source : FINREP et EBA (KRI 3) – Scope: main European banks

Comments : For this comparison between European banks, Core Tier capital is defined as Tier 1 capital less outstanding hybrid instruments

Source : Prudential Supervisory Authority (ACPR)

2_ Enhanced prudential supervision of banks. The objective of the second pillar of Basel II is to ensure that banks apply sound internal procedures to determine the adequacy of their capital in relation to their risk profile on the basis of a thorough risk assessment. This involves, in particular, taking into account certain risks not covered by Pillar 1 (concentration risk) and integrating factors external to the bank into risk management (stress testing scenarios, macroeconomic environment). This pillar also formalizes the implementation of effective risk management governance requiring strong involvement from senior management.

3_ A market discipline in term of transparency and communication of informations between different banking institutions and the regulator. The communicated information, both Qualitative and quantitative must allow the establishment of the institution's risk profile.

S Pillar 1 : What are the fundamental differences with Basel I in risk assessment?

The transition to Basel 2 requires banks to implement an internal mechanism specifically dedicated to risk assessment (credit risk, market risk and operational risk) :

- An internal rating system for the credit risk assessment (IRB) consisting of estimating 3 parameters for the calculation of equity: the probability of default of the client (PD), the loss in case of default of the client (Loss Given Default, LGD) and the client's exposure at the time of the default (Exposure at Default, EAD). If the requirements of Basel 1 are very focused on measuring the client's exposure to credit risk regardless of their risk profile, this system offers the advantage of distinguishing good payers from bad payers through internal rating and also allows to determine the quality of the credit granted to the client. However, the implementation of this system requires banks to invest in building internal models which, before their entry into force, must be validated by the supervisor.

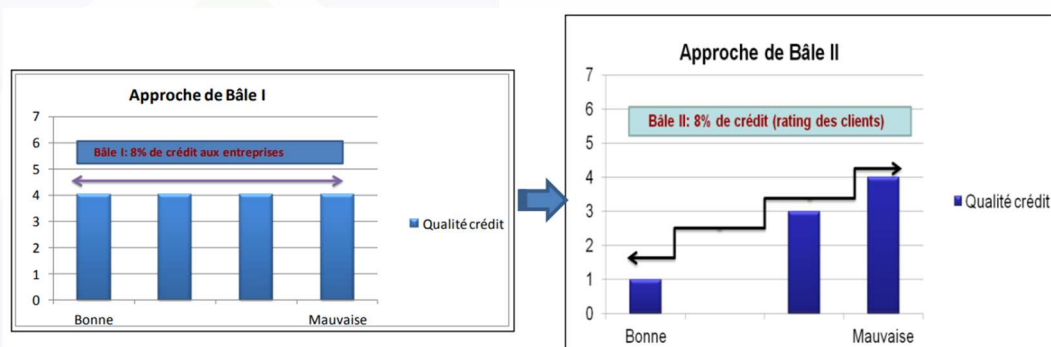
Some details on the standard, foundation and advanced approaches:

In the standard approach, the amount of regulatory capital is calculated using fixed weightings assigned to the types of credit (0%, 20%, 50%,).

Example : *Commercial mortgages are weighted with a risk factor of 100%. It should be noted that the weightings used for sovereign borrowers depend on the rating (external rating determined by rating agencies) of the sovereign state. A weighting of 20% is given to sovereign borrowers with a rating between « A+ » et « A- ».*

When establishing its capital base, the Bank must estimate the probability of default of customers for each type of credit/asset class in order to calculate its capital requirements using internal models.

In the advanced method, the three parameters PD, LGD, and EAD are calculated in advance in each risk category for the calculation of capital. Each parameter is calibrated using a statistical methodology that requires high-quality internal data with a minimum historical depth of 3 to 5 years.



Source : FinAfrique Research

A market risk assessment system using two approaches: a standard approach based on flat weightings assigned to risk portfolios (foreign exchange, commodities, currencies, etc.) and an internal rating approach defined by a Value-at-Risk model. The latter approach provides a more accurate estimate of the level of risk to which the bank is exposed.

FOR A BANK WITH A HIGHLY DIVERSIFIED BUSINESS, THE DIFFERENCE BETWEEN THE STANDARD METHOD AND THE ADVANCED METHOD CAN BE VERY SIGNIFICANT (BETWEEN 5 AND 10 TIMES MORE IMPORTANT).

A system of operational risk assessment defines according to 3 approaches: a basic approach, a standard approach, and an advanced approach. If the first 2 approaches are based on a principle of weighting assigned to the GNP (Net Banking Product => revenues) of the bank (one directly based on consolidated GNP and the other based on lines of activity making up the GNP), the advanced approach requires the implementation of a risk assessment system integrating 4 elements:

- Internal data,*
- External data,*
- The analyses of scenarios*
- The Bank's internal control environment.*

It includes, for example, the implementation of a base for collecting operational losses, the creation of a risk mapping, the execution of crisis scenario simulations (disappearance of a key loss in the Bank), the implementation of a business continuity plan, etc.



Illustration basic approach

RESULT ACCOUNT	2010	2009	2008	2007	2006
Net banking income	32 184 882	29 735 574	24 939 309	17 862 409	16 479 680
Results before tax	10 044 080	10 343 410	8 347 920	6 627 542	6 593 106
After-tax results	7 732 872	8 255 817	6 818 771	5 191 318	5 213 300
Dividends	6 572 542	7 017 341	5 804 721	4 412 328	4 412 328
in thousands of FCFA					
Own funds requirements	15%*(Average income over the last 3 years)				

15%
average
income

Source : FinAfrique Research

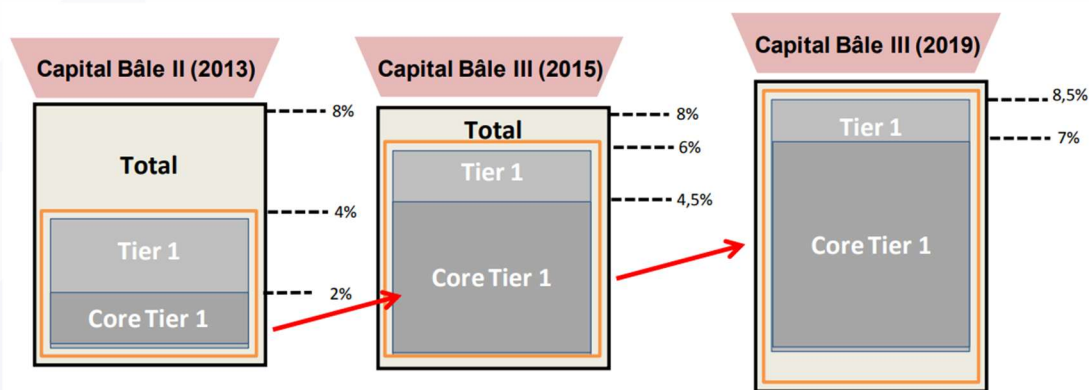
BASEL III/CRD IV

The financial crisis of 2008 revealed some weaknesses in the Basel II framework mainly related to the procyclicality of the new Mc Donough ratio, and the failure to take liquidity risk into account in the assessment of equity capital, to the roles of rating agencies in risk assessment (independence of agencies) and a delay in new banking practices.

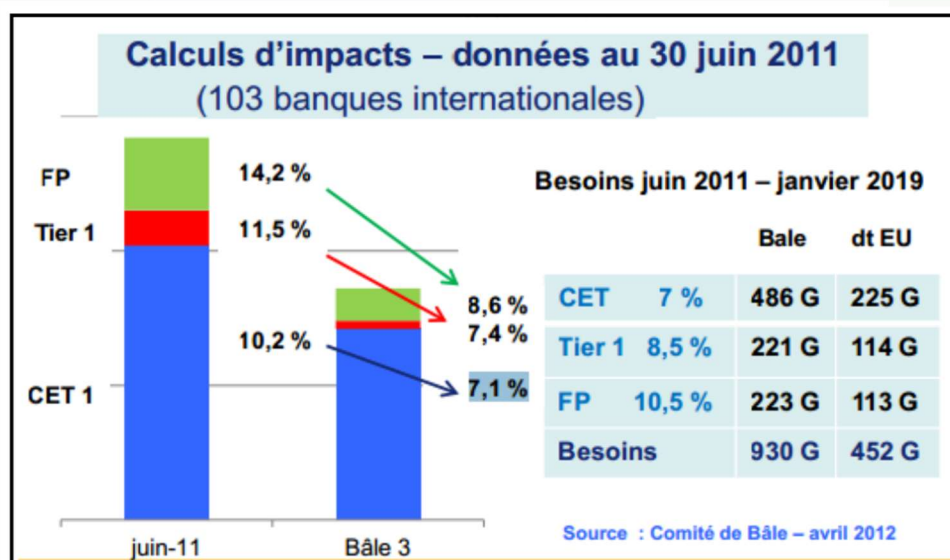
These shortcomings led the Basel Committee to implement a series of reforms whose main axes are:

- 1_ Strengthening the measurement of market risk (counterparty risk on market operations), the review of treatments to be applied in re/securitisation operations in the calculation of own funds and the framework for the remuneration policy of the bank's executives with a view to limiting excessive risk taking in a favorable economic environment. These reforms adopted in November 2010 are framed under the CRD III Directive or Basel 2.5.
- 2_ The strengthening of the solvency structure, of the measurement of banks' liquidity risk by the CRD IV Directive (or Basel III) for application from the beginning of 2014 for solvency. The points covered are:

a.- The strengthening of the solvency ratio: The Core Tier 1 ratio increases from 2% (Basel 2) to 4.5% (Basel 3) starting in 2015, reaching a level of 7% by 2019.



In an impact study carried out by the Prudential Control Authority (ACPR, French supervisor) in June 2012, the Core Tier 1 ratio target Basel 3 is reached for 103 international banks. It is established at a level of 7.1% against 7% required in 2019.



Source : Autorité de contrôle prudentiel (ACPR)

b.- The introduction of a new ratio to limit banks' leverage (leverage ratio) on loans granted to customers in relation to the level of equity capital. It consists of Tier 1 capital as the numerator and



adjusted total assets (including off-balance sheet items, derivatives, goodwill, etc.) as the denominator, etc.). **The threshold of the ratio is set at a level of 3%**

- c.- *The introduction of a counter-cyclical cushion to capture the effect of the economic situation not taken into account by the Basel ratio 2. The objective is to impose the creation of capital cushions in a favorable economic environment, allowing banks to have reserves during periods of recession to absorb potential losses.* **The cushion level varies between 0% and 2.5%**
- d.- *The introduction of two liquidity ratios in response to the liquidity difficulties encountered by several banks during the 2008 financial crisis: a short-term liquidity ratio (1 month), Liquidity Coverage Ratio or LCR, and a long-term liquidity ratio (1 year), Net Stable Funding Ratio or NSFR. These two ratios are defined as follows:* **Stable funding available/Stable funding required > 100%.**

ARE THESE REFORMS APPLICABLE IN AFRICA?

With assets of US\$1.28 trillion and average return on equity exceeding 12% at end-2010 (28% in Central Africa), the banking sector in sub-Saharan Africa is growing rapidly. This growth is accompanied by a change in the regulatory framework with a desire from local regulators to gradually establish a supervisory system for banking institutions aligned with international practices in order to preserve the stability of the financial system. If the Basel I and II reforms could not avoid the 2008 financial crisis in Europe and the United States, they allowed banks to implement a real risk management system involving all resources including top management. Are these reforms applicable to the African banking sector?

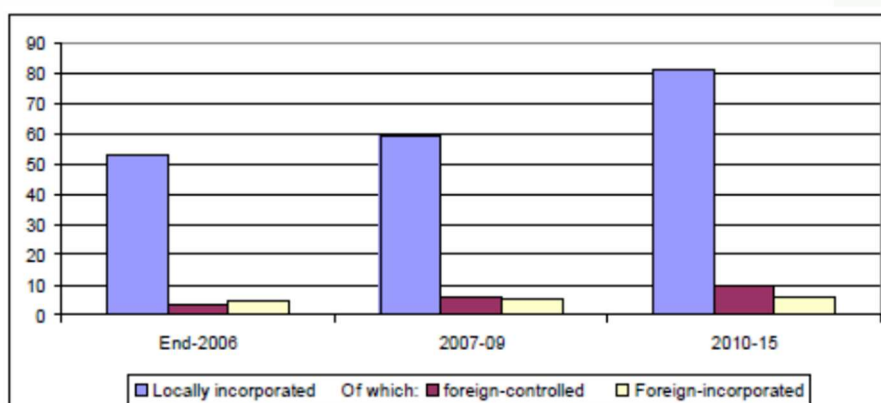
BASEL II EN AFRICA

During the implementation of Basel II in Europe in 2004, the Bank for International Settlements (BIS) administered a questionnaire to 25 local African regulators to probe their interests on the implementation of the system within their respective banking environments. Among the requested regulators are the West African and CEMAC Zone Banking Commissions, the Central Bank of Nigeria, the Central Bank of Ghana, and that of Kenya which will be the subject of specific monitoring in the continuation of this study.

Out of the 25 jurisdictions solicited, 22 responded to the questionnaire, with 16 in favor of transitioning to the Basel 2 standard within a 2006-2009 timeframe, 5 undecided and expressing a desire to reflect on the optimal implementation strategy to adopt, and 1 institution not interested in transitioning to the framework in the near future. In summary, the vast majority (72% of respondents) recognized the benefits of Basel 2 on their financial systems with a desire for gradual implementation, first at the level of local banks and then on foreign banks and banks with shared ownership.

As shown in the graph below, 58% of the assets of local banks were to migrate to Basel 2 starting from the end of 2006, compared to less than 10% for the other two types of banks. By 2010-2015, the thresholds were estimated at 80% of the assets of local banks, 10% for foreign banks, and around 8% for other banks

Bank adopting basel II by percentage of total banking assets (weighted average)



Source : Banque des Règlements Internationaux (BIS)

3 Transposition of the 3 pillars of Basel 2 in Africa

- Regarding the implementation of Pillar 1 (minimum capital requirements), jurisdictions mostly opted for the use of the internal rating method for credit risk modeling (42% of the total assets of all banks)

and the standard method for operational risk (35% of the total assets of banks) starting from the end of 2006.

- Regarding prudential supervision (pillar 2), local regulators have prioritized convergence towards a risk-based supervisory approach (*case today of the WAEMU zone*) in the absence of adequate resources and skills to efficiently control procedures and rating models. The implementation of these models requires a reliable information system and a relatively sufficient internal data history with a minimum depth estimated at 3 years.
- Finally, the transposition of pillar 3 is of minor importance vis-à-vis local jurisdictions compared to the first 2 pillars due to the absence of a strong institution capable of monitoring the quality of information to be published on the place (reporting and financial statements). It was also found that due to the high concentration of banks in the area (Sub-Saharan Africa and Maghreb), the communication of certain information would expose the growth strategy of a small minority of large banks that would be in a situation of unfair competition.

CURRENT STATE OF REGULATION IN AFRICA

In this section, we will present the regulatory standards in force in Sub-Saharan Africa related to the Basel I, II, III reforms. The scope will be restricted to the WAEMU zone, the CEMAC zone, Ghana, Nigeria and Kenya due to their participation in the survey conducted by the Bank for International Settlements in 2004. The objective being to evaluate the quality of the prudential system and to review the existing one in relation to the projections made in these areas during the survey.

Prudential framework (Zone WAEMU and CEMAC zone) : a slow adaptation ...

Within the WAEMU zone and the CEMAC area, the respective supervisory authorities (West African Banking Commission and Central African Banking Commission) have defined a monitoring system based on risk-based supervision via:

- The instruction N°2000/01/RB on the procedures for applying the prudential framework applicable to banks and financial institutions in the WAEMU zone.
- The COBAC Regulation R-2010 on risk coverage for credit institutions
- These two instructions are strongly inspired by the Basel I agreements with an 8% capital ratio. The minimum capital requirement is 5 Mds CFA francs for banks, with a projected increase to 10 Mds CFA francs.

LIBELLE	UEMOA	UMAC	BALE II
Equity	Exisants	Exisants	Exisants + nécessaires
Composition	Base + complementary (tier 1, tier 2)	Base + complémentaire (tier 1, tier 2)	Base + additional + additional (tier 1, tier 2, tier 3)+ necessary
Social Capital	5 Billion FCFA	Billion FCFA	3,2 Billion FCFA (5 M€)
Institutions	Banks, financial institutions, mutual institutions.		
Ratio solvabilité	8%	8%	8%
Risk	Credit	Credit	Credit, Market, and Operational

Source : FinAfrique Research



If the transition to Basel 2 is still being studied in these 2 areas, some initiatives have however been taken by the regulators to facilitate the management of credit risk, promote the granting of credit and significantly improve a still low banking rate (around 10%). Among them, there is the creation of credit bureaus and free banking services in the WAEMU zone (in 2014).

S Ghana : toward Basel 2.

The Central Bank of Ghana had envisaged the transition to Basel 2 by June 2012 but to date the texts in force (Banking Act, 2004, n° 673) are aligned with the Basel I standards amended by the following points :

- ▲ The equity ratio is set at a level of 10%,
- ▲ The minimum share capital of the Banks is 120 M Cedis (about 20 Mds FCFA) since 2013.

S Nigeria initiate the transition to Basel 2

Since June 2014, banks operating in Nigeria are subject to the Basel 2 agreements transposed according to the rules set by the Central Bank of Nigeria in December 2013 (BSD/DIR/CIR/GEN/LAB/06/053).

These rules require banks to:

- ▲ A minimum equity ratio set at 10% for local banks and 15% for foreign banks
- ▲ An assessment of credit and market risks using the standard approach and operational risks using the basic approach. The objective is a gradual deployment with a transition to an internal rating approach starting from 2015.



S Kenya : a prudential framework shared between Basel I, Basel II, and Basel III

Since January 2013, the Central Bank of Kenya has required banks, mortgage lenders, and financial institutions to implement a risk management system that complies with Basel I, Basel II, and Basel III standards (Prudential Guidelines, 2013).

This system should enable the assessment of the 3 main risks identified by the Basel II and Basel III agreements, as well as other risks such as reputational risks, strategic risks, and, above all, risks related to the rapidly growing information and communication technology sectors in the country (Mobile Banking).

In summary, banks must:

- ▲ Hold a total capital ratio of 12%, of which 8% is for core capital (equivalent to the Basel 2 Core Tier 1 ratio)
- ▲ Assess risks using the following approaches:
 - ▼ *Credit risk according to a weighting-based approach (similar to Basel I),*
 - ▼ *Market risks in the standard approach and internal methodology for banks with appropriate resources,*
 - ▼ *Operational risks according to the 3 Basel II approaches, strongly encouraging banks that wish to do so to use the advanced method.*

This mechanism also draws inspiration from Basel 3 requirements by introducing a conservation buffer to absorb losses related to economic cycle fluctuations, set at 2.5% and bringing the overall ratio to 14.5%.

Core Capital (Tier1) to RWA		Total Capital (Tier 2) to RWA
Minimum Ratio	8.0%	12.0%
Conservation Buffer	2.5%	2.5%
Minimum plus Conservation Buffer	10.5%	14.5%

Source : Banque Centrale du Kenya Prudential Guideline

The Basel 3 liquidity ratios (LCR and NSFR) are also required at a level of 100%.

S Assessment of prudential supervision in Africa?

Local regulators are mostly in favor of strengthening their existing framework by gradually migrating to the international standards Basel 2 and Basel 3. The current standards generally govern the measurement of credit risk (and to a lesser extent that of market risk and operational risk) more dominant in the African banking environment.

Are the international standards Basel 2, Basel 3 applicable to the African context? Yes, the question to ask is rather to know **how to optimally adapt them to the African context?** The case of Kenya is a good example to follow in terms of implementation approach: taking into account certain risks specific to the African environment such as those related to information and communication technologies in connection with the expansion of Mobile Banking, the creation of an information and credit office operational since 2010 which is led by the Professional Association of Banks (Kenya Banker of Association, KBA). It should be noted that the KBA has positioned itself as a major player in the development and promotion of the financial industry in Kenya by, for



example, integrating into its organizational structure a sub-committee dedicated to credit with the participation of all local banks (43 banks). This forum allows banks to share best practices and challenges to address credit risk management and also other types of specific risks such as security, fraud, and legal.

In the WAEMU zone, the CEMAC zone and Ghana, the pace of transition to these reforms is much slower than that observed in Kenya or Nigeria.

This slowness can be explained by several reasons:

- ▲ **A high cost of the device:** the implementation of these reforms raises numerous budget, time and resource constraints that require banks and regulators to make significant investments. As an example, the cost of implementing Basel 3 (cost of transformation and compliance across the entire French sector) was estimated by a European firm at 960 million Euros, including 540 million Euros for the eight largest banking players in the French market (BNP Paribas, Crédit Agricole, BPCE, Société Générale, Crédit Mutuel-CIC, Dexia, La Banque Postale, HSBC France). This estimate extends over 5 years (until the end of 2015).
- ▲ **The lack of expertise adapted to the African market:** The implementation of these regulations also requires a human resources system (see next page) involving specific levels of expertise not sufficiently provided by the African banking market:

Statistical engineers with a good knowledge of local regulations and Basel II standards for the implementation of internal rating models.

Computer engineers with a good knowledge of databases and banking operations for the design of information systems and the collection of internal data.

Auditors with quantitative, IT and banking expertise for the validation and supervision of internal rating models, information system or procedures and operating modes.

Lawyers with a good knowledge of banking and financial markets to facilitate the understanding and interpretation of standards.

Experts in the fields impacting the bank's own funds for the design and validation of major risk scenarios as part of advanced operational risk methods. For example, a medical specialist in the Ebola virus could contribute alongside the operational risk managers of a bank, to measuring the impact of a possible spread of the virus on the bank's own funds and to setting up the business continuity plan.

- ▲ **The low presence of structures such as rating agencies** at the regional level for the rating (adapted to the local environment) of banking counterparties and sovereign states. Until 2006, no regional rating agency still existed in the WAEMU zone and the CEMAC zone. The arrival of the rating agencies Bloomfield Investment Corporation and West Africa Rating Agency (WARA) in these two areas will significantly improve the evaluation system of interbank and sovereign counterparties for banks wishing to use the Basel 2 standard method.
- ▲ **The low level of communication and awareness among the various stakeholders regarding Basel 2 and Basel 3 standards:** Central banks, credit institutions and finance ministries which are generally responsible for the transposition of these regulations in African countries (this is the case in the WAEMU space) are unfortunately not yet sufficiently aware of these standards and their impacts on the African banking environment. The regular training of these actors, including professional banking associations that play an intermediary and information relay role, could speed up the implementation of these regulation.





WHAT IMPACTS ON BANK ACTIVITY ?

THE TRANSITION TO THE BASEL II AND BASEL III STANDARDS, AS DESIRED BY REGULATORS IN SUB-SAHARAN AFRICA, IS TAKING PLACE GRADUALLY BUT AT A MUCH SLOWER PACE THAN THAT DRIVEN BY EUROPEAN BANKS. WHILE THE REGULATORS OF SOME COUNTRIES SUCH AS NIGERIA AND KENYA HAVE RECENTLY ADAPTED THE SYSTEM IN RELATION TO THE LOCAL ENVIRONMENT, THOSE OF THE WAEMU ZONE, THE CEMAC ZONE AND GHANA ARE STILL IN THE PREPARATION PHASE FOR A CHANGE ENVISAGED IN THE NEAR FUTURE. IN ANTICIPATION OF THE TRANSITION TO THESE REFORMS, WHAT SHOULD BANKS DO? WHAT ARE THE IMPACTS OF ADAPTING THESE INTERNATIONAL STANDARDS ON THEIR ACTIVITIES?

ADAPT BANK GOUVERNANCE

The protection of depositors' savings, the reduction of information asymmetry toward the client to maintain a climate of trust, the obligations to comply with toward shareholders, and adherence to regulatory standards are all elements that force banks operating in Africa to constantly adapt their governance structure to avoid crisis situations.

The banking failures of the 80s and 90s in West and Central Africa clearly demonstrated the importance of good corporate governance, including **in terms of risk control and monitoring**. If banks increasingly integrate this dimension into their activity to comply with the requirements of the prudential framework, the transition to international standards (Basel 2) requires a higher level of vigilance in this area. It particularly requires the **implementation of principles of good governance and transparency** defining the roles and responsibilities of each actor/management within the bank.

In this regard, the Basel Committee addressed in 2006 to all regulators and financial institutions worldwide 8 major principles of good corporate governance, including:

- ▲ The need for bank directors to possess the qualifications required for the exercise of their mission with the presence for large banks of an audit committee,
- ▲ The effective use by the Board of Directors and the general management of internal audit, external auditors and internal control functions. By way of example, he must ensure **the independence of the head of Internal Audit with an audit committee that reports to the Board of Directors**.

Beyond compliance with regulatory standards, these principles of good governance will above all enable banks to continue their contribution to the development of African economies in a sustainable manner (*the contribution of the banking sector in West Africa represents 31% of regional GDP at end 2011, 19% in Central Africa and 75% in Southern Africa over the same period*).

STRENGTHEN THE HUMAN RESOURCES MANAGEMENT SYSTEM

The transition to Basel 2 has a strong impact on the management of the Bank's human resources. In this case, it requires a strong mobilization of resources (depending on the size of the Bank) for the functions of Risk and Control and requires specific expertise for each type of risk.

Example : The implementation of internal models for the advanced credit risk method involves mobilizing a team of statistical engineers for model design, consulting with credit analysts to define rating scales, of an IT team for the development of the information system for the collection of internal data...

Furthermore, all the bank's employees must be made aware of the fundamentals of risk management and changes in regulatory standards.



Thus the recruitment policy of Banks and Financial Institutions must integrate this dimension by emphasizing on:

- ▲ The training of employees, including the bank's Top Management,
- ▲ The regular communication of best practices in risk management,
- ▲ The establishment of a risk culture within the Bank.

BETTER MANAGE CREDIT RISK AND OPERATIONAL RISK

Credit risk management must be strengthened in banks through the use of rating (internal or external) in order to better appreciate the quality of the borrower's credit but also to facilitate access to financing for African banks wishing to mobilize funds internationally (sovereign bond issuance). Faced with an increasingly growing development of new technologies (Digital Banking, Mobile Banking) and risks related to the information system (hacking of bank accounts), it is also important to integrate **operational risk as a specific component in the Bank's capital assessment through tools such as risk mapping.**

WHAT ARE THE ONGOING DEVELOPMENTS IN EUROPE ?

After monetary union, the European Council decided in June 2012 to create a Banking Union, which should constitute the new pillar of banking supervision in the Eurozone.

The purpose of the latter is:

- ▲ To ensure optimal effectiveness of monetary policy and put an end to the fragmentation of the money market in the euro area,
- ▲ Ensure effective supervision of the most important banks by removing national tropisms,
- ▲ Avoid moral hazard and reduce the cost of a rescue for the taxpayer.



The Banking Union is organized around three pillars essential to its effectiveness:

- ▲ **The unique supervision**, under the leadership of the European Central Bank (ECB), assisted by national supervisory authorities. Thus, since 4 November 2014, European banks have been subject to a single supervisor, the European Banking Authority within the European Central Bank (equivalent of the Banking Commission of the UEMOA Zone in West Africa). Its mission is to ensure the exercise of a **strong and independent state supervision**, prerequisite to the 2008 financial crisis resolution mechanism. It is also about harmonising prudential practices in the euro area to avoid prudential arbitrage that exacerbated the consequences of the 2008 financial crisis.
- ▲ **A single resolution mechanism**, measure voted in April 2014, which is due to enter into force in January 2016. The latter provides for the prior mobilisation of all private actors in the event of a crisis, in accordance with the principle of internal bail-in. A Single Resolution Board will be created to manage the liquidation of banks, in a matter of a weekend if necessary. It will be backed by a common resolution fund, to be funded by the banking sector, which is expected to be worth EUR 55 billion by 2025.
- ▲ **Deposit guarantee**, adopted by the European Parliament on 15 April 2014 and due to be transposed into European law in July 2015, provided that savers' deposits would be protected in the event of a bank failure up to a maximum of EUR 100,000. This latest text further strengthens the protection of depositors, ensuring that they can recover their savings within a shorter timeframe of seven working days.

Prior to taking on this new role of single supervisor, the ECB carried out an Asset Quality Review (AQR) followed by a stress test to better gauge the funding needs of the banks to be supervised.

If the majority of banks passed the test (25 banks failed out of 130), the exercise allowed some banking institutions to identify the areas of weakness in their internal risk management system and to implement preventive measures.

The establishment of the Banking Union should significantly simplify the supervision of banks. From this perspective, the Eurozone will eventually be considered as a single country, promoting cross-border bank mergers within the Eurozone.

In addition, the banking union must be reflected in the lifting of liquidity restrictions in the countries of the zone. Thus, a bank will be able to use its excess liquidity in a country A to finance its activities in a country B.



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