**Chapter 5**

**Safeguarding Financial Systems**

**Introduction**

The global financial crisis has put financial stability back onto government agendas around the world. The crisis has exposed weaknesses in the way national and international financial markets and national and crossborder banks are regulated and supervised, and the international community has responded through concerted efforts to strengthen international supervisory and regulatory standards. Many of these efforts have repercussions in Africa. Their adoption across the continent should be guided by the different needs of individual African financial systems relative to systems in industrialized and advanced emerging markets.

The themes of this chapter are closely linked to the main messages in chapters 3 and 4. We stress the importance of competition in the banking system and the financial system at large. However, this also poses additional challenges for regulators and supervisors. The recent Nigerian experience of widespread and systemic fragility linked to (though not necessarily caused by) rapid changes in market structure and the capital structure of banks shows that regulators and supervisors have to develop the capacity to follow such changes carefully. It also shows that increased competition has to be accompanied by improvements in governance. Similarly, expanding financial service provision beyond banking poses additional challenges to regulators and supervisors. This means not only the challenges in the supervision of insurance companies and pension funds, but also the coordination between bank and telecommunications regulators, a topic we touch upon in chapter 3. It also requires an open and flexible regulatory and supervisory approach that balances the need for financial innovation with the need to be alert to the emergence of fragility in new forms. Finally, to the same extent that addressing demand-side constraints is important in expanding outreach toward the access possibilities
frontier, demand-side constraints have to be dealt with to keep the financial system from moving beyond the sustainable frontier and to avoid overindebtedness and abuse on the individual level and financial fragility on the aggregate level.

This chapter takes a fresh look at the challenges represented by the need to safeguard finance in Africa and is informed by the recent crisis experience, but also Africa’s own experience with fragility and by solutions adopted across the continent and in other developing and emerging markets. Overall, our approach is guided by the principle that finance should be safeguarded for the ultimate users. Thus, our goal is not to resolve the problems of banks for the sake of banks and not to foster the regulation of exchanges to prevent the failure of brokers and dealers. Rather, our goal is to protect the ultimate beneficiaries, that is, investors and customers. In the case of sophisticated investors, we follow the recommendation by Honohan and Beck (2007), who adopt a caveat emptor approach. For the bottom-of-the-pyramid users of financial services, we stress the need for more effective consumer protection. As the objectives of deeper and broader financial systems are being realized, appropriate regulation and supervision are becoming more important.

This chapter is organized to reflect the three main messages of the book. After discussing the stability of the financial system, we turn to the challenges in bank regulation and supervision in a rapidly changing environment of increased competition and a continuing trend toward globalization, but also toward crossborder banking within the region and the reform discussion in the context of the G20 process. We then discuss the expansion of the regulatory perimeter beyond banking in light of our discussion on expanding the financial system beyond banking. The regulation of insurance companies, pension funds, and capital markets has traditionally been weak, while the regulation and supervision of microfinance institutions (MFIs) have undergone significant changes in large parts of the continent in recent years. We argue for a risk-based approach that focuses on more rigorous regulation of those segments that manage the savings of unsophisticated savers. Finally, we turn to the users of financial services, especially small savers, and advocate an increased focus on consumer protection.

Stability: We Have Come a Long Way

African financial systems have come a long way in terms of financial stability. The 1980s and 1990s saw a series of costly banking crises, both systemic and nonsystemic. In 1994, at the height of widespread bank fragility, countries in Africa, from the Arab Republic of Egypt to South Africa and from Cameroon to Kenya, were suffering systemic or nonsystemic banking crises. Beginning in 2000, this fragility subsided across the continent. Between 2000 and 2007, Laeven and Valencia (2008) report no single systemic crisis in Africa (figure 5.1). As Honohan and Beck (2007) discuss, African banking crises of the late 20th century were distinct from banking crises outside Africa because they were mostly caused by governance problems at the bank level and at the regulatory level or simply by bad banking practices. This
is true of countries in which the banking systems were dominated by government-owned banks, but also of countries with predominantly private banking systems, no matter if these were local banks or foreign banks (for example, Meridien BIAO and the Bank of Credit and Commerce International).

Governance continues to be a major challenge in banks and regulatory entities in some countries, though important steps have been taken in most. In some instances, privatization has helped by reducing the conflicts of interest that public authorities face because they are owners and supervisors of the same institutions, though, in other instances, the process was not smooth and, at first, exacerbated misgovernance and fragility and, subsequently, had to be renegotiated. The privatization process in Mozambique, Tanzania, and Uganda in the 1990s, for example, was undermined by governance challenges leading to insider lending and looting, often by politically connected insiders, which forced the respective governments to renationalize the institutions before a successful second round of privatization could be undertaken. In Nigeria, internal bank governance deficiencies were at the core of the recent crisis, as we discuss in chapter 2.

Improving asset quality and capitalization are the two dimensions in which African banking systems have made the greatest progress over the past two decades. It is partly because of this progress that Africa has weathered the recent crisis. The traumatic experience with bank fragility in the 1980s and 1990s explains the rather conservative bias of bank regulators and supervisors across the continent toward stability. Today, most African banking systems are stable and well capitalized. They also have a good level of liquidity. (Indeed, sometimes, the liquidity is excessive to a degree that undermines the ability of the systems to intermediate efficiently.)
Nonetheless, there is still hidden or silent fragility in several Central and West African countries. Among the smaller financial systems, Togo has several banks with a high level of nonperforming loans and insufficient capital-asset ratios, and 50 percent of the banking system is effectively in distress, a result of governance deficiencies and political and economic turmoil over the past two decades. The banking crisis in Togo illustrates how banking systems may suffer from a deterioration in public finance. Similarly, there are undercapitalized banks in the Democratic Republic of Congo, a consequence of political and economic turmoil. In Côte d’Ivoire, a large number of banks, mostly local or regional, faced difficulty in 2008, generally related to the accumulation of public sector arrears, loans to risky sectors, and governance problems. The government took control of three banks and recapitalized them. In Ghana, systemic distress is concentrated in state-owned banks and a number of small, locally owned banks that face liquidity problems because of their dependence on the public sector and wholesale funding. Similarly, in the West African Economic and Monetary Union (UEMOA), many banks do not comply with prudential norms and are subject to potential shocks stemming from the heavy involvement of the governments in economies throughout West Africa. In addition to governance weaknesses, the lack of an appropriate bank resolution framework prolongs the distress and exacerbates the overall costs, a point to which we return below.

Figure 5.2 shows the significant capitalization of African banks. Even in their unweighted version, capital-asset ratios are well above 8 percent. The ratio of regulatory capital to risk-weighted assets is more than double the 8 percent given by the Basel capital adequacy ratio and has even increased during the recent crisis. Raw capitalization ratios and risk-weighted capitalization ratios are thus highly conservative. Given the characteristics of African banks and their host economies that we discuss in previous chapters, especially the high volatility African lenders face, it might be argued that a conservative bias in capitalization is appropriate.

A comparison of the liquidity of African banks over time shows similar trends, as we discuss in chapter 2. In general, African finance is liquid, with limited maturity risk. There has been limited exposure to derivative products and securities with high price volatility on bank balance sheets, partly because of the lack of well-developed financial markets and partly because of the conservative approach of African regulators. The simplicity and conservative bias of bank balance sheets minimized contagion during the crisis. This is symptomatic of the low level of financial development, which also, however, prevents the financial system from fulfilling a growth-enhancing role.

The stability focus is on banking because of the vulnerability of banking based on the maturity mismatch and because of the dominant role of banking within the financial systems of Africa. Nonetheless, it is worthwhile to discuss other segments of finance as well. The insurance sector is characterized across the continent by undercapitalized institutions, poor governance structures, poor payout records, and a weak regulatory framework. In countries where they exist, pension funds are
often underfunded, have poor governance structures, and are poorly regulated, as we discuss in chapter 4. While this is a different kind of fragility given that, with a pension fund, there is no implication of the risk of a run, the fragility of pension funds has a direct impact on long-term growth because the resources of the pension funds are not being allocated to the most effective use, as we discuss in chapter 4. While there is no immediate risk for the overall financial system and the economy at large, the misallocation creates long-term, contingent fiscal liabilities.

**Bank Regulation and Supervision: New Challenges in a Changing Environment**

Although we advocate the expansion of the financial system beyond banking, this sector is and will continue to be the most important part of financial systems across Africa for many years to come. In addition, the regulatory and supervisory focus is on banking rather than on other segments of the financial system. This is so because of the sector’s vulnerability to runs given the maturity mismatch between assets and liabilities, because of the close interconnection through the interbank market and payment system and the consequent risk that a single bank failure could spark systemic distress, and because of the role of banks as the creators of private information about borrowers in the economy. For the overall financial sys-
tem and the real economy, these externalities make bank failures much more damaging than fragility in other parts of the financial system.

However, the environment in which banks are operating is changing, even in Africa. First, there is increased competition from within and from outside the banking sector. As we discuss above, increased competition has many advantages; however, it also implies greater uncertainty and risks, which have to be properly managed. This puts a premium on improved governance in the banking system (as in the financial system at large; see below), as well as on supervisory upgrades. Second, in an increasingly global financial system and given the prominent and still increasing presence of multinational banks, but, recently, also regional banks, Africa’s financial systems and economies will become more interconnected and subject to more external shocks that have to be properly managed. Third, the international regulatory reforms put forth by the Financial Stability Board and the Basel Committee have direct and indirect repercussions for Africa. Africa needs to be careful to manage the process of adopting similar standards for its own markets, a subject to which we return in chapter 6.

From a regulatory to a supervisory upgrade

Over the past decade or so, there has been a significant strengthening of the regulatory framework in various African jurisdictions. Reviews and subsequent reforms of banking sector legislation have been undertaken in a number of countries. Many countries have complemented legislative reforms with an overhaul of the corresponding regulations. However, there are still deficiencies in the regulatory framework, especially as regards the independence of supervisors, risk management, and the resolution capacity of supervisors, as we discuss below.2

One way to measure the adequacy of the regulatory and supervisory framework is the Basel Core Principles for Effective Banking Supervision (BCPs). These cover 30 areas of bank regulation and supervision on which countries are being assessed by their peers in other countries, often in the context of joint International Monetary Fund–World Bank financial sector assessment missions. One should bear in mind that different assessors apply different grading principles; nonetheless, it has been reported that, on average, the 16 African countries for which the BCPs have been assessed were largely or fully compliant with only 20 of the 30 principles. Among the important principles that pose a challenge in the effort at compliance are BCP 1.2 (the independence, accountability, and transparency of bank supervisors), BCP 7 (the risk management process in bank supervision), BCP 18 (the abuse of financial services), and BCP 23 (the corrective and remedial powers of supervisors) (BCBS 2006). The median ratings for these were materially noncompliant (figure 5.3). Looking beyond banking to other segments of the financial sector, we see that there is still a striking lack of a sound, best practice regulatory framework in the insurance and pension fund industries in most African countries.

Focusing on compliance with international best practices is an important part of the modernist agenda for building financial markets. How important is the
adoption of these principles in explaining the stability of the financial systems in the region? Cross-country comparisons have shed doubt on the usefulness of the BCPs in predicting stability across countries. Demirgüç-Kunt, Detragiache, and Tressel (2008) find no significant relationship between most of these principles and banking system stability, with the notable exception of BCP 21, which measures the quality of supervisory reporting. Countries in which banks have to report their financial data regularly and accurately to regulators and market participants have banks showing greater financial strength. None of the other BCPs is significantly associated with bank stability. This does not mean that peer review of the regulatory and supervisory framework is not important. Rather, it means that one has to look beyond adherence to the principles to the actual implementation and functioning of bank supervision. One also has to consider the root causes of widespread financial fragility in the 1980s and 1990s, which, as pointed out by Honohan and Beck (2007), lie mostly in governance failures in the public sector and in the private sector. These failures led to credit boom-and-bust cycles. The most recent example, Nigeria, also points to weak governance within financial institutions and markets as a core cause of fragility.

**Weak supervisory capacity and the lack of regulatory independence**
Pervasively weak supervisory capacity and the lack of regulatory independence are at least as important as gaps in the regulatory framework in explaining fragility. In many countries, licensing and closure decisions are still vested with ministries of

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**Figure 5.3 The Median Basel Core Principle Assessment across Africa**

![Graph showing the median Basel Core Principle Assessment across 16 African countries](source: Fuchs, Losse-Müller, and Witte (2010).)
finance rather than bank regulators, which gives rise to a risk of political interference in these critical decisions, as well as delays in early intervention in the case of fragile and weak banks. In most African countries, supervisory resources are limited, including qualified staff and the availability of analytical tools and skills. Supervisory processes focus on compliance with regulatory standards, but are not set up to identify and manage the changing risks in banking systems. In addition, the ability to monitor risk at the institutional and systemic level is hampered by insufficient quality in data and reporting processes. These deficiencies weigh even more heavily in an increasingly globalized world, in which most African countries host banks from developed countries, but also from other African countries.

The UEMOA Banking Commission, for example, lacks sufficient power to enforce corrective measures in cases of noncompliance with regulations, a situation that political authorities have only recently started to address. Ill-suited regulations, such as the regulation on preapproval of loan applications, are often ignored, which undermines supervisory discipline. To ensure certainty and supervisory discipline, one would prefer that such outdated regulations be dropped and the focus be shifted to the consistent enforcement of meaningful regulations.

While most supervisory authorities still use the Basel I capital regime (with notable exceptions, such as Mauritius and South Africa), the large majority plans on implementing the Basel II capital requirements. In the recent Making Finance Work for Africa survey, all responding countries across Africa, except Angola, Eritrea, and Lesotho, indicated their intention to implement, though many have not yet set a date. Given the complexity of Basel II, it is surprising that its adoption is so high on the agenda of regulators in Africa. African regulators offer a variety of reasons why they want to adopt Basel II, although adoption is not mandatory outside the member states of the Basel Committee on Banking Supervision. Specifically, they are concerned that Basel I is beginning to be perceived as an inferior standard by international investors and that African markets may be penalized by international market participants or that African banks will eventually be denied access to foreign markets if they do not comply with the latest Basel standards. According to a Financial Stability Institute study (FSI 2004), the main driver among nonmember countries of the Basel Committee on Banking Supervision to move toward Basel II is the fact that foreign-controlled banks or local subsidiaries of foreign banks operating under Basel II expect regulators in low-income countries to adopt the framework as well. Whether or not these concerns are justified, they have accelerated the diffusion of the Basel accords not only in Africa, but across the developing world.

South Africa was one of the first countries on the continent to introduce the full-fledged version of Basel II, pillar 1, in 2008, leaving it up to banks to decide which approach to use for capital calculation, though their choice is subject to approval by the supervisor. Even so, most domestic banks opted for the standardized approach, in addition to the minimum Tier 1 capital ratio of 7.0 percent and the minimum total capital ratio of 9.5 percent. The latter includes a 1.5 percent systemic requirement on top of the internationally agreed minimum capital ratio of
8.0 percent that was imposed to adjust international capital standards to an emerging market environment.

Implementing the full-fledged version of Basel II beyond the simplified standardized approach carries significant costs for banks and regulators alike. However, even choosing the standardized approach can be problematic because of the low penetration of credit ratings across the continent and the disadvantages unrated companies (typically small or informal sector companies) would face in accessing credit at affordable terms. Building up supervisory capacity (including staff training), new processes, and the substantial investments in information technology infrastructure is beyond the budgetary scope of many regulators in low-income African countries. The development of their own internal rating systems might be easy for subsidiaries of larger international banks, but it is a steep hurdle for smaller domestic banks, thus creating an additional competitive barrier. Importantly, as long as supervisory capacity remains low, Basel II does not provide an adequate framework for enhancing financial stability in African countries. Because of the lack of preparedness among authorities to supervise the use by banks of highly sophisticated risk models effectively, moving beyond the simplified standardized approach could result in a de facto loss of supervisory power and would therefore be counterproductive.

The crisis and new international reform proposals offer a valuable opportunity to revisit the regulatory and supervisory landscape in Africa and to look at the priorities for the continent. Caution is called for, however. In defining the regulatory and supervisory reform agenda in Africa, policy makers need to assess carefully the costs and benefits of implementing international standards. Rather than applying the standards wholesale, a more successful alternative might be appropriate sequencing and cherry-picking among the building blocks that correspond to the regional implementation environment and risks.4

The new Basel III standards developed by the Basel Committee on Banking Supervision are meant to incorporate lessons learned from the financial crisis. Most of the proposed measures are of limited immediate relevance to African banking sectors because the weaknesses they address are largely a result of regulatory philosophies and market practice in developed markets. This does not signify that they are irrelevant in the effort to enhance the regulatory framework in the future, but it does signify that they are of limited practical application today. First, Basel III outlines various measures to raise the quality, consistency, and transparency of the regulatory capital base and focuses largely on the definition of Tier 1 capital. In most African countries, bank capital structures are a relatively straightforward composition of common shares and retained earnings and, thus, already fulfill Basel III quality requirements. Second, measures to improve the risk coverage of the capital framework for counterparty credit risk will have little immediate impact because African bank activity in derivatives, repurchase agreements, and securities financing is limited. However, they should be included in the regulatory approach of African jurisdictions going forward because they might become relevant as financial markets deepen. Third, given the high levels of liquidity in most African
markets, global minimum liquidity standards imply little change for African banks. However, given the lack of data quality and the system constraints in Africa, more basic approaches, such as the simple ratio of customer loans to deposits seen in some low-income countries, appear more appropriate and easier to implement. Care would need to be exercised to balance prudent liquidity controls with the risk of excessively constraining loan growth and the consequent economic development. Finally, a leverage ratio, currently under supervisory monitoring, may offer an important safeguard for all low-income jurisdictions, especially those that are in the process of introducing Basel II. However, in practice, the leverage of African banks is significantly less than the suggested standards.

Finally, the addition of a layer of macroprudential regulation, as proposed in the Basel III framework, is viewed by most regulators in Africa as a key challenge. Macroprudential oversight is meant to address systemic risk as opposed to bank-level idiosyncratic risk, the focus of microprudential regulation. Perhaps the most prominent example is the cyclical provisioning for loans. As attractive as these cyclical requirements are from a theoretical viewpoint, they seem much more difficult to implement in low-income or even most middle-income countries than in countries of the Organisation for Economic Co-operation and Development. They are technically challenging, and, if regulators get them wrong, capital adequacy levels become out of tune with risk. With the exception of a few countries, the development of macroprudential supervisory capacity is in its infancy. Most central banks do not have dedicated financial stability units. The additional resource demands are considerable, particularly in skills, training, modeling, technology, and data. In addition, macroprudential supervision requires a cultural shift from a passive rules-based supervisory approach to active risk management. Regulators may lack the legal authority for intervening on the basis of macroprudential factors (rather than institution-specific factors). Regulators need to work with governments to determine how far they are prepared to intervene in the event of a buildup of systemic risk.

Despite these difficulties and independent of the need to adhere to new international standards, the development of a macroprudential supervisory capacity is crucial to most African supervisors. It is generally agreed that macroprudential supervision is a function that all regulators must address, but it imposes a range of new demands that many regulators are unable to meet. It requires new cross-cutting skills combining macroeconomic analysis and regulation, new modeling techniques, data collection and analysis, and practical criteria for triggers and interventions. The development of international standards on tools and measures to monitor macroprudential risks could inform similar exercises by African regulators that are adjusted to the existing resource and data constraints.

**Minimum capital requirements**

Throughout the book, we discuss the diseconomies of scale arising among small banks in terms of expanding outreach and lengthening contracts. An additional
In chapters 3 and 4, we emphasize the positive impact that competition can have on deepening and broadening. However, more competition can certainly also bring about more fragility. What have the academic literature and recent examples taught us about the relationship between competition and stability?

Theoretical models have made contrasting predictions about the relationship among bank concentration, competition, and stability. On the one hand, bank concentration may enhance market power and result in high profits, which provide a buffer against adverse shocks and increase the franchise value of a bank, thus reducing the incentives for bankers to take excessive risk (Marcus 1984; Keeley 1990). On the other hand, proponents of the concentration-fragility view argue that market power might result in higher interest rates, which, in turn, provide incentives to borrowers to take higher risks (Boyd and de Nicoló 2005).

Closely linked to the market structure and fragility debate is the issue of bank size. On the one hand, larger banks can diversify more readily so that banking systems characterized by a few large banks tend to be less fragile than banking systems with many small banks (Allen and Gale 2004). Furthermore, a few large banks might be easier to monitor than many small banks. On the other hand, policy makers are more concerned about bank failures if there are only a few large banks. Larger banks in a concentrated banking system could also increase the risk of contagion, thus creating a positive link between concentration and systemic fragility.

Cross-country evidence shows that more concentrated banking systems are less likely to suffer systemic fragility; at the same time, competition also contributes to greater stability (Beck, Demirgüç-Kunt, and Levine 2006; Schaeck, Čihák, and Wolfe 2009). Bank-level evidence provides conflicting evidence on the impact of competition and concentration on stability. This emphasizes that market structure is not the same as competition and that idiosyncratic bank fragility and systemic distress are far from perfectly correlated. However, there also seems to be significant cross-country variation in the relationship between competition and stability; the effect of competition depends on the regulatory framework, the market structure, and the potential herding behavior by banks (Beck, De Jonghe, and Schepens 2011). This puts the emphasis back on the regulatory and supervisory framework.

In summary, competition is not detrimental per se for bank stability, nor does a more concentrated banking system necessarily imply less competition and more stability. It is critical, however, to adjust the regulatory and supervisory framework to changing market structures. The governance of financial institutions is as important, including ownership structures and cash-flow rights, as well as the accountability of senior management for risk decisions and the financial statements to which they agree (Caprio, Laeven, and Levine 2007; Schaeck et al., forthcoming; Beltratti and Stulz 2009).

dimension is whether concentrated banking systems with larger banks can also be considered more stable. Box 5.1 discusses the evidence. Nigeria dramatically increased minimum capital requirements a few years ago to create larger banks (see chapter 2, box 2.3) and other countries are following this trend. The evidence discussed in box 5.1 and in previous chapters points to potential gains in the efficiency and stability of the financial system from such a consolidation. However, consolida-
tion can result in more aggressive risk taking by the banks that have now become larger and are seeking to exploit their too-big-to-fail status; in any case, their failure will exert more stress than the failure of small banks on the resolution framework. In addition, the consolidation process might have a negative impact on access, especially for customers of small niche banks. Meanwhile, the impact of consolidation on efficiency, stability, and access will depend on the implications for competition of a more concentrated banking system. At higher concentration, it is even more important to have an open, contestable financial system that allows for competition from outside the banking system, including from nonbank financial institutions such as leasing companies, equity funds, and also mobile phone companies.

Thus, consolidation can create important scale economies in African financial systems. However, the consolidation process has to be accompanied by the necessary changes in the regulatory and supervisory framework, and greater contestability through the nonbank provision of financial services has to be assured.

**Bank resolution: the missing component**

The weakest point in the financial safety net in most countries across the developing and developed world continues to be the lack of effective resolution systems, crisis management tools, and implementation, where this is present at all. Effective resolution systems rely on the capacity to intervene in a failing bank in time to prevent economic damage and contagion. Effective crisis management tools rely on the capacity to coordinate a response to a crisis when it occurs. The recent crisis and the often bungled attempts of the countries of the Organisation for Economic Co-operation and Development to deal with their failing banks have put this issue high on the agenda. There are two main dimensions to the problem: one on the domestic level and one on the regional or international level.

Few countries in Africa have a separate bank resolution framework, and, in most countries, either supervisors or courts can intervene in banks. Even in South Africa, supervisors have to obtain approval from the minister of finance to intervene in a bank. Immediate intervention is not possible: there is a delay of 30 days, during which time the bank can argue against intervention. This hinders supervisors in intervening decisively, expeditiously, and effectively. In Tanzania, meanwhile, regulators can intervene in a failing or noncompliant bank without the involvement of the policy sphere or courts. The resolution framework includes a prompt corrective action procedure and provides for a large number of options, including private solutions and the possibility of mergers and acquisitions supported by the regulator. In Ghana and Kenya, the central bank has the power of intervention, but the legislation does not include provisions for specific resolution techniques. The lack of legal clarity in terms of the power of intervention and, more critically, the lack of a clear framework for resolving weak banks undermine not only market discipline, but also supervisory independence with respect to banks.

The banking crisis in Togo illustrates this point. The slow resolution of the crisis points to the ineffectiveness of the mechanism for managing banking crises within
UEMOA. The UEMOA Banking Commission does not have the necessary powers to intervene in failing banks and shares many of its responsibilities with national ministries of finance, which is of special concern given the increasing dominance of regional banks. Specifically, the banking law authorizes the chairman of the commission to call for market solidarity or to request shareholder assistance in the event of a banking crisis. The provisions of the law, however, are not binding on shareholders, and any action is thus based on the chairman’s power of persuasion. The national ministries of finance have the power to appoint a temporary administrator and to lodge an appeal with the UEMOA Council of Ministers against any license revocation decision. The appeal suspends action until the council reaches a decision.

The main challenges in the domestic agenda thus include the lack of an appropriate legal framework to deal with failing banks. Dealing with failing banks can often only be accomplished under the provisions of the general bankruptcy law, which, as discussed in box 5.2 in more depth, is not sufficient. A common feature of the special resolution regimes is that, provided certain trigger conditions are met, they allow the supervisor to overrule shareholders during the preinsolvency stage. In turn, this allows for good-bank–bad-bank solutions, whereby a set of liabilities and a corresponding set of high-quality assets are transferred to an acquiring bank (a purchase of assets and an assumption of liabilities if this occurs directly; otherwise, a bridge bank is used). This permits a transfer of the systemically relevant parts of the bank, while the remainder can be liquidated. It also allows for continuity. The advantage relative to a scenario in which no special bank resolution regime is in place is that the decision for the authorities to intervene is no longer a binary one (that is, save the entire institution, or do not intervene). It thereby serves the public interest of financial stability at minimum overall cost to taxpayers.

Related to the more general point on supervisory capacity above, many African countries also lack the capacity to deal with failing banks. This concerns not only supervisory skills, but also the financial resources that might be needed to fill potential capital shortfalls. This has often led to regulatory forbearance, which deepens fragility. As we discuss below, this problem can be exacerbated by the presence of subsidiaries of large multinational banks and the fact that many regulators are not independent of ministers of finance or other government institutions in their decision making. Moreover, the legal framework often limits regulatory discretion in two important regulatory decisions: licensing and the corrective and remedial powers of supervisors to intervene in failing banks.

The recent Nigerian experience in responding to bank failures and several self-assessments by other African countries have highlighted the need to establish and rehearse effective crisis response mechanisms and bank resolution procedures before such events occur. Several countries in the region have undertaken holistic reviews of the crisis management and bank resolution framework, such as Malawi, Mozambique, and Zambia. They have strengthened the resolution framework through the adoption of prompt corrective action mechanisms, the development
The three basic functions of banks in any market economy are to (1) provide payment services; (2) pool society’s savings, thereby transforming short-term liquidity into long-term investment; and (3) screen and monitor borrowers and investment projects. These three functions result in (1) the need to belong to a network of financial institutions, (2) the risk of a maturity mismatch and liquidity shortages in the case of shocks such as bank runs, and (3) the creation of private information. The failure of a financial institution results in negative externalities beyond the private costs of the failure to shareholders, management, employees, depositors, and borrowers. It also imposes external costs on other financial institutions and the economy at large. This gap between the private and the social cost of bank insolvency by itself justifies the establishment of a special insolvency regime for banks. Specifically, the three characteristics discussed above can be mapped to three problems that lead to the external social costs arising from bank failure, as follows: (1) the domino problem that is created because banks belong to a network: the failure of one institution can easily result in the failure of other institutions despite the sound fundamentals of these other banks; (2) the hostage problem that results from the maturity mismatch and the incapacity of banks to satisfy the liquidity needs of all its customers in the case of a bank run, which, in turn, might lead to contagion effects throughout the financial system; and (3) the refrigeration problem that results from the deterioration in lender-borrower relationships occurring because of the loss of information after the institution fails. These problems require swift attention, which cannot be provided through the regular insolvency regimes for corporate insolvencies. Such a special framework with clearly defined rules is also necessary to avoid a classical time inconsistency problem among regulators: while it is optimal ex ante to deny the possibility of a bailout so as to instill market discipline, it is optimal ex post to focus on reducing the social costs of bank failure.

In the absence of a proper bank resolution framework, authorities are often left with two ways to deal with failing banks: make them undergo regular bankruptcy procedures or bail them out. Implementation of the first option exacerbates the problems described above because it can lead to bank runs, contagion, and the destruction of private information. Implementation of the second option creates perverse incentives for banks to take aggressive risks. Any gains realized from this risk taking accrue to the banks, and any losses are socialized through the bailouts. The objective of a bank resolution framework is to create options so that bank regulators can minimize the costs imposed by bank failures on the rest of the system, while reducing moral hazard because bankers are encouraged to be too aggressive in the face of risks. Such options may include a supervisory-driven merger of a weak bank with a strong bank or a purchase-and-assumption technique, where the good part of a failing bank’s assets (the purchase portion), together with some of the liabilities (the assumption portion), is transferred to another bank, while the remainder of the assets, together with residual liabilities, is sent through the liquidation process. If such options are not available because of the absence of purchasers or because the failing bank is too large, a bridge-bank option may be considered. This involves establishing a temporary bank to administer the deposits and liabilities of the failed bank.

However, bank regulators do not operate in a vacuum. They are part of an overall institutional and political framework. Their objectives might not coincide with those of taxpayers,
Box 5.2  Bank Resolution (continued)

who ultimately have to pay the bill for bank failures. Imposing certain rules on supervisors in terms of when and how to intervene (in the form of a framework for prompt corrective action) and certain rules on which resolution option to choose (for example, the least cost rule in the United States) can help structure the bank resolution framework in a way that the incentives of supervisors become better aligned with the incentives of taxpayers and the objectives of an effective and sound financial system.

of crisis management plans for large, systemically important banks, and the introduction of coordination mechanisms within central banks and ministries of finance. Proper procedures need to be established by African authorities to define efficient information-sharing, analysis, decision-making, and internal and external communications processes, as well as appropriate mechanisms to fund bank resolution. The various responsibilities can be described in detail in interagency memorandums of understanding (MOUs) on crisis management, which should contribute to preventing coordination failures, facilitating timely exchanges of key information, ensuring coordinated communications among institutions, markets, and the public, and, in general, strengthening overall contingency planning for financial crises. Acute time pressures and severe shortages of information are common during banking crises.

One size does not fit all. In some financial systems, for instance in West Africa, a current task is the restructuring and possible privatization of weak or failing government-owned banks, while other countries should focus on implementing a structure to deal effectively with potential failures of private banks.

A dimension in which quick progress could be made is fire drills, simulation exercises, and contingency plans. Fire drills can hone the necessary capacities of supervisory staff. They can also help expose shortcomings in the current legal bank insolvency framework and thus influence reform in the bank resolution system. Fire drills can also highlight the need to prepare contingency plans for major bank failures or a systemic banking crisis. A contingency plan should include previsions for the necessary human resources; the legal background; the lines of communication with other institutions, government authorities, and foreign supervisors; and action plans for the response to major bank failures or a systemic crisis. Contingency planning should include all relevant national authorities, including the supervisor, deposit insurance authorities, and finance ministries, as well as other relevant agencies (such as international agencies, foreign supervisory authorities, and so on). Scenarios such as a takeover by competitors inside or outside the domestic banking system should also be part of contingency planning. Well-prepared and realistic contingency plans allow regulatory authorities to be proactive rather than reactive in a crisis. Simulation exercises can be used to test the adequacy of contingency plans.
Contingency planning is especially important in countries with a history of exercising forbearance, whether because the owners of distressed banks have been politically influential or because governments have shown fear that bank closures and the attendant job losses and disruptions among bank customers would be politically and economically unpopular. In addition to economic forbearance and political forbearance, Maimbo (2001) argues that, in some cases, a third kind of forbearance—bureaucratically institutionalized regulatory forbearance—may be more prevalent. In a study of the regulatory and supervisory process in Zambia, he finds that this type of forbearance was not only embedded in the formal and informal administrative policies and procedures for effecting legislative and supervisory sanctions, but also appeared to be part of the organizational culture of decision making within the regulatory agency.

The efficient resolution of failing subsidiaries of foreign banks is often both more challenging and more critical, especially in many smaller economies in Africa, where such banks often have a dominating position. It is more challenging because bank supervisors in host countries often lack the necessary information to be sufficiently prepared for a failure event. In addition, given the nature of bank balance sheets, the asset-liability composition and, thus, the liquidity and equity positions of banks can be changed within hours in favor of the parent and at the expense of the subsidiary. While the idea of stand-alone subsidiaries has been offered as an option against these risks, such firewalling would also take away the advantages of multinational banks in terms of scale economies and the use of joint platforms. Bank of Africa, Ecobank, First Rand, and Standard Bank, four important regional banks throughout the continent, have centralized their group functions for treasury and liquidity management, group audit, large credit authorization, and electronic data processing (Lukonga 2010). Contingency plans can thus be especially useful in the context of subsidiaries of multinational banks. Such plans would also entail making the corporate structures of these banks more transparent. In an additional phase, it might even be worthwhile to require subsidiaries of multinational banks to undertake their own contingency plans, that is, plans on resolving the subsidiaries on a stand-alone basis if the need arises. This is similar to the idea of instituting living wills that has been floated in Europe and North America for large, systemically important financial institutions.

A role for deposit insurance?

A critical issue in a bank resolution framework is access to the necessary resources to resolve failing banks. Recent reforms in the bank resolution framework in Latin America have put deposit insurance at the center of the resolution of weak banks to align incentives across the financial safety net and provide resolution authorities with appropriate resources. Can the Latin American experience be transplanted to Africa? Most countries in Africa currently have no deposit insurance scheme, and, over the past decade or so, more and more empirical evidence has pointed to the pitfalls of moral hazard associated with deposit insurance (Demirgüç-Kunt and
Kane 2002). Thus, by reducing the incentives for bank depositors and creditors to monitor and discipline banks (although one has to remain skeptical of the ability of small-scale depositors to assess the risk profile of banks in the first place) and by institutionalizing the liability of governments, banks are more likely to follow their natural instinct of taking an aggressive stance toward risk (given that they only participate in the upside but not the downside of this risk), especially in the presence of a weak supervisory framework. The argument that an explicit deposit insurance is better than an implicit guarantee because it limits this guarantee does not necessarily hold in reality, as the case of Bolivia has shown. Bolivia’s financial system is small and not well developed, somewhat similar to many African financial systems, and the introduction of explicit deposit insurance led to increased risk taking by banks (Ioannidou and Penas 2010). However, there is much anecdotal and practitioner evidence that the existence of a deposit insurance scheme can help in the reform or establishment of a proper and incentive-compatible bank resolution scheme; Bolivia is, again, the example (see Bolzico, Mascaro, and Granata 2007). There thus seems to be a trade-off between ex ante and ex post efficiency in the use of deposit insurance as part of the financial safety net: it raises the incentives for aggressive risk taking, but serves as an effective instrument in resolving failing banks. There also seems to be path dependence in the sense that, where certain institutions and structures already exist, it is best to maximize their usefulness, while, in countries in which they do not exist, it is easier to start afresh with optimal structures.

Would the introduction of deposit insurance to improve the efficiency of bank resolution be practical in the context of small, low-income African countries? Given the limited number of banks and the often limited human resources, it seems that the introduction of a deposit insurance scheme with the primary purpose of establishing an incentive-compatible bank resolution scheme would be costly. Also, bank runs are much less common in Africa than elsewhere. The failure of a single bank, not even the largest, would exhaust the fund, and diverting staff to the establishment and administration of a deposit insurance scheme might draw necessary resources from bank supervision. However, where deposit insurance already exists, transforming it from a pay-box scheme into an integral part of failure resolution, as is happening in Kenya and Uganda, might enhance efficiency and crisis preparedness. This might include assigning regulatory powers to the deposit insurer, along with access to supervisory information, the right to require additional and intensive on-site and off-site supervision, and participation in the intervention decision. It would help align incentives because deposit insurers would then have the incentives, but also the tools to minimize the losses of the insurance fund. As with so many other discussions throughout the book, we see that one size does not fit all: the structure of the ideal financial safety net is a function of the development, structure, and size of the relevant banking system.

Alternatives to deposit insurance are available. Given the significant liquidity of most banks in Africa, the investment of liquidity in the central bank or government
papers, earmarked to reimburse small depositors in the case of failure, could be useful. Most banking systems in Africa impose high liquidity requirements on banks, plus high reserve requirements; so, such an arrangement would be easy to implement.

Another lesson from the European crisis is that crossborder issues of deposit insurance must be addressed. This is especially the case with respect to branches because these are supervised by the respective home countries and may or may not be covered by the deposit insurance schemes of these countries. Such arrangements have led to problems within Europe, as the case of Iceland has shown. Almost half the countries in Africa that responded to the recent Making Finance Work for Africa survey on the regulatory framework (see elsewhere above) allow foreign banks to enter through branches. In reality, however, foreign bank entry through branches is rare in Africa because most multinational or regional banks establish subsidiaries. Even where the regional integration of bank supervision might facilitate a regional resolution framework, such as in West Africa and Central Africa, bank regulators insist that foreign banks must enter each country through subsidiaries rather than branches.

**Regional crossborder supervisory cooperation**

Another important dimension in bank resolution is the crossborder dimension, an area where the recent European experience can be insightful. Crossborder supervisory issues are increasingly important among African regulators, especially in light of the fact that, by the end of 2009, there were at least 20 banks of African origin with crossborder operations in four or more countries (Lukonga 2010). The home countries ranged from Morocco to Mauritius, Nigeria and South Africa. The effective supervision of crossborder financial institutions requires close cooperation between the respective supervisors in the home countries of the institutions and in the host countries of the subsidiaries. This is also a key issue in advancing consolidated supervision.

Recent reforms in the international supervisory architecture have focused on the constitution of colleges of supervisors for all banks with international operations. The representation of African supervisors in these supervisory colleges remains a weak point given the current asymmetry of the size of operations of large international banks in developed markets and in most African markets. For example, the activities of an international banking group in Africa may make up only a small part of the total balance sheet of the group, but they may be of disproportionate systemic importance in African countries. This asymmetry introduces an inherent complication in the design of college arrangements, namely, that African supervisors have a great interest in being included in the supervisory college, but may be overlooked by the home supervisors under a biased view of efficiency and effectiveness. To these issues may be added the substantial money and time costs required for relatively scarce qualified senior personnel in low-income countries to travel to and attend meetings in distant locations.
Closer to home, the emergence of regional banks headquartered in African jurisdictions requires close cooperation among banking supervisors across the region. African home supervisors have begun championing regional college agreements and bilateral MOUs to facilitate the cooperation process. Restrictions on the sharing of banking information to protect confidentiality need to be loosened to enable proper communication among regulators.

The recent European experience suggests, however, that colleges of supervisors and MOUs are necessary, but not sufficient tools for coordination in cases of idiosyncratic or systemic fragility. MOUs are legally nonbinding documents, and, even within a college of supervisors, it is the home country supervisor who makes the final decision. MOUs are therefore not as crisis proof as is commonly assumed prior to a crisis. Moreover, given the asymmetries in information and capacity, the position of African supervisors will be weak with respect to home country supervisors in Asia or Europe. Closer to home in the case of regional banks, there might be more room for cooperation given the relative size of host and home country operations, and there might be more balance in capacity and skills. More political will might be necessary, however, in pursuing regional financial integration in the regulatory framework and in achieving supervisory cooperation so as to avoid the mistakes of Europe.

How can the limitations of the traditional crossborder bank resolution framework be overcome? As discussed above, the major challenge is the gap between the ex ante and ex post objectives of the resolution framework, the objectives of reducing aggressive risk taking ex ante and of avoiding the negative repercussions of bank failure ex post. A complicating factor in crossborder bank resolution is that costs have to be distributed in an incentive-compatible way, which is almost impossible ex post because decisions have to be made quickly (Goodhart and Schoenmaker 2009). Ultimately, this points to living wills, an idea that is being increasingly adopted across developed financial markets. Living wills are drawn up by the banks themselves and lay out how to wind down large crossborder banks. Combined with international contingency plans and ex ante binding resolution cost-sharing plans, living wills can create, ex ante, adequate incentives against excessive bank risk taking, but also provide a blueprint for dealing with large failing crossborder banks in the region.

And market discipline?

Allow us one quick remark on the debate on market discipline versus supervisory discipline. The obvious failure of market discipline during the recent crisis can be attributed to the moral hazard generated by the Bernanke-Greenspan put, although other explanations such as mood swings or externalities have also been put forward (de la Torre and Ize 2009). In addition, the absence of markets in many low-income countries leads observers to the conclusion that there is no room for market discipline in the financial systems of these countries. As Caprio and Honohan (2004) do, we argue that there is sufficient room for market discipline because of the pres-
ence of large depositors (often expatriate or donor accounts) and the limited resources of governments to bail out large banks (even if the latter may be small in global comparisons). In addition, the relatively small business community and the less-sophisticated banking business in Africa make monitoring and information collection and dissemination easier. While strengthening supervisory capacity and discipline seems important, fostering market discipline, where possible, can be critical. One option would be a greater role for equity markets where they exist. Encouraging large and listed banks to float a greater share of their equity can lead to share prices that reflect the risk taking of management more accurately. Another instrument is the strengthening of auditing standards so that auditors are liable for the financial statements they have agreed to and ensure accountability with regard to shareholders and supervisors.

Market discipline is essential in addressing the challenges of governance. The discussions throughout the book, but especially in the context of recent banking crises across Africa, point out the severe governance challenges at the core of fragility. Corporate governance in banks is especially important, given that many previous crises in Africa have been caused by governance challenges. Moreover, the expansion of Africa’s financial systems can only be achieved if the governance challenges in nonbank financial institutions, including MFIs and cooperative institutions, are also addressed.

Governance is as much an issue of legal rules as it is an issue of enforcement. Most of the bank regulators that responded to the Making Finance Work for Africa survey reported that they have regulations on related party lending and disclosure requirements of directors and controlling shareholders about their business interests involving related party relationships or potential conflicts of interest with banks. This begs the question about the enforceability and enforcement of these rules. Similarly, as discussed in chapter 3, many cooperative institutions suffer from weak governance structures.

Entrenched political elites tend to use financial systems for their own financing purposes. However, the problem in governance goes beyond direct government ownership. It involves cross-ownership between the financial and the nonfinancial corporate sector and, most importantly, connections among politicians, regulators, and financial institutions that result in noncommercial lending decisions associated with high risks and, thus, contingent and, often, realized losses. Privatization is not a panacea in this context, but only a first step, as the experience in several countries in East Africa and southern Africa mentioned above has shown.

One method is to induce more competition into the system. Certainly, one size does not fit all. Advances in governance through competition and the media is more easily achieved in larger and middle-income countries than in smaller or low-income countries. Encouraging openness and competition is widely seen as effective in dealing with this type of governance challenge. Foreign bank entry and strategic private foreign management can be effective in tackling problems associ-
Equally important is ensuring that there is a measure of effective self-discipline within institutions. Self-regulation, whereby a bank voluntarily monitors its own adherence to legal and ethical standards, is far preferable to enforcement of these standards by outside regulators. To this end, there has been a lot of governance work aimed at making boards of directors more effective. The reports of the King Committee on corporate governance in South Africa, led by former High Court Judge Mervyn King, have been influential in setting the direction of codes of corporate practice and conduct in Africa. The latest report, King III, builds on the spirit of the December 1992 Cadbury Report, which was published in the United Kingdom and which was the first in-depth statement on corporate governance and a model for sound practice worldwide for dealing with the division of responsibilities among top management to ensure that the decision-making power is not delegated to one person alone (IODSA 2009). On governance, King III is based on principles and accepts that there is no one size fits all in the solutions to corporate governance issues. Instead, it encourages firms to tailor standard corporate governance principles as appropriate to the size, nature, and complexity of their organizations. For banks in Africa, this message is especially relevant given the diversity of strategies for overcoming Africa’s unique challenges.

Looking beyond Banks: How to Regulate Which Segments of the Financial System

**Contractual savings institutions and capital markets**

The regulation of insurance companies and pension funds has often been neglected, especially when financial sector supervision has been housed in ministries of finance with small staffs, a weak regulatory framework, and no supervisory powers. As we argue in chapter 4, the lack of proper regulation and supervision is an important, though not necessarily the decisive factor in explaining the underdevelopment of these segments of financial systems across most of Africa. Similarly, severe governance challenges plague these segments. As important as capital and governance regulations are, consumer protection regulations seem especially conducive to increasing the public’s trust in these institutions. Fortunately, this has recently started to improve. Regulatory and supervisory functions have been moved to central banks or to dedicated nonbank regulatory agencies, as in the case of Botswana and Zambia.

The lack of proper regulation and supervision can be a drain on the development of capital markets. As we discuss in chapter 4, however, in the case of Africa, it is, overly burdensome licensing and issuing requirements that seem to be holding back the development of the market. As shown in a broad cross-country sample of countries, transparency and disclosure standards are more important
than the existence of strong supervisory entities (La Porta, Lopez-de-Silanes and Shleifer 2006).

Another reform suggestion in the recent postcrisis debate has been the idea of extending the regulatory boundary, that is, extending financial sector regulation and supervision to nonbank financial corporations such as private equity funds. This reform push has been influenced by the recent crisis experience that brought to light the large shadow-banking sectors outside regulatory oversight in many developed financial markets. This has led to recommendations that capital funds be supervised and that market oversight be more stringent, including requiring standard products to be traded over the counter on organized exchanges. The purpose of such a step would be to supply supervisors with better information and early-warning signals, as well as to throw sand into the gears of rapidly moving global financial markets by increasing trading costs. Would the implementation of such recommendations fit the African reality?

The trend toward the extension of the regulatory perimeter conflicts with the lack of the necessary human and financial resources in many low-income countries, but also with the transaction costs that the expansion of regulation would generate in the emerging components of the financial system, such as certain over-the-counter markets and capital funds. More generally, the decision to regulate and supervise a segment of the financial system has to take promissory intensity into account. This is determined by (1) the likelihood that a financial contract cannot be honored, (2) the problems faced by consumers in assessing the creditworthiness of a financial service provider, and (3) the impact of the breach of a contract (Quintyn and Taylor 2007). This promissory intensity, in turn, has to be balanced with the costs of regulation for users, providers, and the economy at large, and the systemic risks must be weighed against the long-term benefits of the development of these segments of the financial system (Honohan and Beck 2007). A caveat emptor approach, whereby the weight of the responsibility for monitoring lies on sophisticated investors rather than supervisors, might therefore be more adequate for segments of the financial system that are being used by such investors.

This caveat against expanding the regulatory boundary indiscriminately certainly does not exclude strengthening the regulation and supervision of the insurance and pension fund sectors, which are still rudimentary in many countries of Africa, or the risk-based expansion of regulation and supervision to MFIs or savings and credit cooperatives (SACCOs). In a nutshell, expanding the regulatory net to include nonbank financial institutions that serve households with less financial exposure might be more important than expanding it toward products and markets mostly used by more educated and sophisticated segments of the population.

**The bottom of the pyramid: prudential regulation where appropriate**

One of the areas experiencing the most rapid changes over the past decade or so has been the regulation of institutions that serve the bottom of the pyramid. Many African countries have introduced some kind of special regulatory framework for
MFI or are in the process of doing so. In a third of the countries in Africa, meanwhile, MFI still either fall implicitly or explicitly under the banking or nonbank financial institution regulatory framework or are left out completely.

One important issue is the failure of nonregulated or poorly regulated bottom-of-the-pyramid institutions, such as SACCOs. As we have seen across the world (for example, in Albania and Colombia), the failure of such institutions can lead to bank runs and the loss of trust in all financial institutions among large parts of the population, but also to social and political unrest. On a more general level, the failure of an MFI has potentially an even bigger impact on people’s lives than a bank failure. While concerns about a domino effect are usually unjustified because MFI and SACCO feature only limited interconnectedness and size, the number of savers affected by a failure can be considerable.

A question many countries across the continent have been struggling with is whether microfinance or cooperative institutions should be regulated and supervised to the same extent as banks. A global consensus has developed around the idea of extending prudential regulation and supervision only to deposit-taking institutions, while avoiding “burdensome prudential regulation for nonprudential purposes, that is, purposes other than protecting depositors’ safety and the soundness of the financial sector as whole” (Christen, Lyman, and Rosenberg 2003, 3). While, for a long time, deposit taking was limited to banks, more and more countries have loosened this restriction and created a regulatory framework for deposit-taking MFI or community banks. In some cases, regulation has followed reality because many SACCOs in East Africa are already taking deposits not only from their members (as they are allowed to do), but also the broader public through front-office facilities. This creates serious concerns if the broader public does not understand the difference between banks and such bank-like financial institutions, expecting the same regulatory oversight and protection. Introducing a formal regulatory framework for such institutions, however, without complementing this by the necessary supervisory structure can backfire. This can be exacerbated if a deposit insurance scheme for such institutions is introduced before their financial situation and viability have been assessed, resulting in potentially high fiscal liability and, even worse, a loss of trust in bank supervision if the authorities do not follow up on their commitments.

Deposit-taking MFI can certainly benefit from reporting requirements and absolute minimum capital standards that are less strict than those applying to banks; however, they may need more stringent requirements in terms of capital and liquidity ratios. An argument can be made that higher capital-adequacy ratios should be required among MFI because their loan portfolios are typically more geographically and sectorally concentrated and, for this reason, tend to be more volatile. Rules, such as limits on unsecured lending as a ratio of equity, should not be imposed on MFI because most, if not all microlending is uncollateralized. It is important not to impose overburdening activity or geographical restrictions on such institutions because this might undermine their viability. Similarly, the regu-
lation of MFIs is expensive for supervisory agencies, given the fixed costs. There is thus a trade-off between the goal of inclusion and the goal of stability. However, there are ways to alleviate this trade-off. Unnecessary regulatory burdens, such as excessive loan documentation or excessive branching requirements, should give way to simpler reporting requirements and ownership diversification rules that do not represent barriers to investment in MFIs by nongovernmental organizations. Member-based financial institutions, such as cooperatives, might also benefit from reduced supervision, especially if the supervisory authorities can rely on well-run, well-governed, and appropriately regulated and supervised apex institutions. A separate question is whether a special regime is needed for deposit-taking MFIs. The example of Uganda, which introduced a regulatory framework for deposit-taking MFIs a few years ago, might be rather depressing because there are currently only two institutions under this regime. However, such an assessment does not take into account the contestability aspect of this option with regard to a growing MFI or a new entrant.

The transition process from credit-only to deposit-taking institution is a tricky one. Allowing credit institutions to start collecting deposits requires that the new institutions first submit to a careful process of vetting and screening. Are they sufficiently viable and profitable? Do they have the proper management information systems? Can they bear the regulatory burden? Does a license to take deposits entail a certain promise from regulators? It is therefore important to be open toward the public about the implications of such a license in terms of security and guarantees.

MFI regulation can be both restraining and enabling and can help low-end financial institutions push toward the access possibilities frontier. Yet, regulation that is too lax can also provide perverse incentives to move beyond the frontier by allowing too many unqualified providers into the market or by giving support to disreputable providers.

**The supervisory structure: two is a party; three is a crowd?**

An important discussion in recent years has revolved around the organizational structure of financial sector supervision. Across the world, the advantages and shortcomings of various models—separate supervisors for each segment, unified supervisory agencies, or a functional approach involving separate prudential supervision and supervision of business conduct—have been discussed. Traditionally, bank supervision has been carried out by central banks, with the exception of UEMOA, the Economic and Monetary Community of Central Africa, and other francophone countries in which bank supervision is housed in a separate entity. The supervision of other financial institutions and markets, including capital market supervision and insurance and pension fund supervision, has often been carried out through ministries of finance. Even today, countries as diverse as Algeria, Madagascar, and Mauritania supervise insurance companies through the ministries of finance. The latter arrangement, however, has often been plagued by the limited skill base and the lack of independence. Several countries have therefore
undertaken the establishment of specialized insurance and capital market supervisors in recent years. Specifically, Egypt, Mauritius, and South Africa have introduced financial service boards for nonbank financial service providers to streamline rules regulating these industries and supervise institutions with multiple financial nonbanking activities, while Ghana and Kenya have separate insurance supervisors. Another discussion concerns the issue of who should supervise deposit-taking microfinance and cooperative institutions. The majority of countries rely on supervision by the same institutions that supervise banks, though not necessarily under the same regulatory framework. In Kenya, deposit-taking MFIs are supervised by the Central Bank, which also supervises banks, while SACCOs are supervised by a separate entity.

In each of these cases (insurance companies and capital markets, as well as MFIs), there are arguments in favor and arguments against using the same entity to supervise nonbank financial institutions and banks. On the one hand, bank supervisors have accumulated the necessary supervisory expertise and skills, as well as the necessary reputation, which might be especially critical in the early stages of the supervision of a new segment of the financial system. This might be particularly important in countries with a limited skill base. On the other hand, the supervision of nonbank financial institutions and markets often requires a separate skill set. This also applies to MFIs. Moreover, there are concerns about competition because bank supervisors might dominate other types of supervisors and favor the banking segment of the financial system over other segments.

While the concerns about the separate skills needed and about competition might be valid in the case of insurance and capital market supervision, they appear less valid in the case of the supervision of deposit-taking microfinance and cooperative institutions because the required technical skills are similar. Furthermore, given the often vague boundary between traditional banks and deposit-taking MFIs or cooperatives in the eye of the general public, it might be helpful to have one set of regulators for such deposit-taking institutions so as to avoid regulatory arbitrage. It is certainly important that financial cooperatives not be supervised by the general cooperative authority, but by specialized supervisors. There are also political considerations, as well as concerns about the power of bank supervisors and about whether bank supervisors might focus too much attention on stability and not sufficient attention on outreach. A compromise might involve the secondment of staff to a new authority that supervises nonbank deposit-taking institutions.

Another important question revolves around the location of the authority responsible for market development and expansion. While currently often housed in central banks, this raises the issue of a conflict of interest with the prudential task of bank regulators. Yet, the central bank is, in most countries across the region, still the institution with the highest concentration of skills outside financial institutions and often the entity with the best reputation and greatest autonomy.

There has been a recent trend toward a regional regulatory framework. The francophone countries of West and Central Africa are farther ahead in this context,
having joint bank regulatory authorities for the two currency unions and one joint insurance regulator and supervisor (the Inter-African Conference on Insurance Markets), though these entities exist more in form than in substance. The authority to license banks is housed with the ministries of finance in these countries, and there is no consolidated supervision, at least not in the UEMOA region. Such regional arrangements can have critical advantages over national supervisors because they are able to address the scale challenge and the governance challenge. By joining forces regionally, bank regulators can create scale economies and build the necessary skills and capacities, while gaining independence from the political sphere and the regulated entities by functioning on the regional level rather than the national level. Attempts to harmonize regulations and supervisory practices, as currently undertaken in other parts of the continent, such as the Southern African Development Community, is an important first step toward the establishment of such regional structures.

**From the supply side to the demand side**

On a more local level, the risk of overindebtedness among households has been raising concerns since before the microfinance crisis in Andhra Pradesh, India. Initiatives that focus on responsible finance, such as those encouraged by the Consultative Group to Assist the Poor and the International Finance Corporation, commit MFIs to certain minimum standards of individual consumer protection against overindebtedness, including disclosure and transparency standards, but also incentive structures that do not create a bias in favor of lending too much to one client. This refers especially to salary loans, which are considered troublesome especially because of the ease with which creditors can gain access to the salary payments of borrowers.

If voluntary initiatives are not sufficient, more formal structures of consumer protection must be examined. We discuss these in the following.

**Focusing on Users: Consumer Protection**

Throughout the book, we stress the importance of extending the focus from supply-side constraints to demand-side constraints. This is as important in the area of financial stability as in the areas of expanding access and lengthening contracts. Parallel to financial literacy in the attempt to include a larger part of the population in the financial system, we have to focus on consumer protection to protect current and newly banked segments of the population.

Unlike in the case of capital markets and equity funds, where we advocate a caveat emptor approach to avoid suppressing these nascent segments of the financial system, a caveat venditor approach is called for in the case of bottom-of-the-pyramid financial services. Consumer protection has gained increasing importance throughout the world. Across industrialized countries, the aftermath of the global crisis has seen a reemphasis on protecting the unsophisticated consumers of finan-
cial services from buying products they do not need or that expose their livelihoods to extreme risk. This focus on consumer protection relates to savings and investment and to credit products, as well as to payment services, such as remittances. It is closely related to the theme of financial literacy discussed elsewhere above, but focuses more on the market-harnessing role of regulation and imposes restrictions on financial service suppliers rather than focusing on (potential) consumers.

Consumer protection can help competition and, thus ultimately, outreach. Better informed customers are able and more likely to shop around, thus incentivizing financial service providers to compete on price and product features. By the same token, marketing tools, including deceptive advertising, can have a major impact on consumer decisions, as a recent study in South Africa shows (Bertrand et al. 2010). Loan offers were mailed to some 50,000 customers. The loans were associated with randomized interest rates and advertising material containing numerous variants on common advertising devices. The researchers found that loan demand was sensitive to the quoted interest rates, but also to several features of the advertising. For example, including a photograph of a woman in the accompanying literature (as opposed to a man) was, in terms of the influence on loan take-up, equivalent to lowering the rate of interest by over 4 percentage points per month.

Effective consumer protection in financial services focuses on four key areas: (1) consumer disclosure that is clear, simple, easy to understand, and comparable; (2) prohibitions on business practices that are unfair, abusive, or deceptive; (3) efficient and easy-to-use recourse mechanisms; and (4) financial education that gives consumers the knowledge, skills, and confidence to understand and evaluate the financial information they receive (Rutledge 2010). Consumer protection sets clear rules of engagement between financial firms and retail customers. It helps narrow the knowledge gap between consumers and their financial institutions and increases the ability of consumers to make informed decisions about financial products. Thus, effective financial consumer protection is delivered through regulation (government regulation and self-regulation) and programs of financial education.

No internationally agreed methodology has been developed to assess the quality of a financial consumer protection framework. Nonetheless, the legal, regulatory, and institutional framework is generally stronger in high-income countries than in Africa.

What are the instruments of consumer protection? In line with the motto that transparency is the best disinfectant, disclosure requirements are one of the most basic and important tools. Advising consumers about the returns and the risks of investment products should be the foundation of any sales process in financial services. Providing customers with a clear indication of the monthly costs of credit, including interest, principal, and fee payments, over the complete lifetime of the credit should be a minimum requirement. According to the Making Finance Work for Africa survey (see elsewhere above), most countries require banks, by law, to inform customers about the fees for products before account opening and, subsequently, about any changes to these fees. This is the hallmark of any decent busi-
ness conduct, and these are rules that can be easily put in place. Consumer protection should also be an integral part of any credit reference bureau, including mechanisms for data disclosure and an appeal process, as in the case of South Africa (box 5.3).12

A step up from minimum consumer disclosure rules (which can be enforced by bank supervisors or on a self-regulatory industry-wide basis by the banking association) are government regulations that prohibit financial institutions from selling specific products to all but sophisticated clients (such as corporate clients or high-wealth individuals) and government regulations that impose affordability

### Box 5.3 The Consumer Protection Framework in South Africa

A distinct feature of the South African financial system is the presence of the National Credit Act, credit bureaus, the national credit regulator, the Office of the Credit Information Ombud, and the National Consumer Tribunal, which became operational on June 1, 2006.

- **National Credit Act 34 of 2005:** The purpose of the act is to promote and advance the social and economic welfare of South Africans; promote a fair, transparent, competitive, sustainable, responsible, efficient, and accessible credit market and industry; and protect consumers. Specifically, this includes (1) promoting black empowerment and ownership within the consumer credit industry; (2) prohibiting unfair credit and credit-marketing practices; (3) promoting responsible credit granting and use and, for that purpose, to prohibit reckless credit granting; to regulate credit information; to provide for the registration of credit bureaus, credit providers, and debt counseling services; (4) establishing norms and standards relating to consumer credit; and (5) promoting a consistent enforcement framework.

- **National credit regulator:** The national credit regulator is responsible for the regulation of the South African credit industry and has the responsibility to (1) implement education campaigns, (2) conduct research and develop policies, (3) investigate complaints, and (4) ensure compliance with the act. It also has the responsibility to register and regulate credit providers, credit bureaus, and debt counselors.

- **Credit bureaus:** The National Credit Act (1) stipulates that credit bureaus are required to register with the national credit regulator to conduct business legally, (2) sets out the purposes for which consumer credit information may be used and the companies to which the credit bureaus may provide the information, (3) sets out the standards for data accuracy, and (4) ensures that consumers have the right to check their records.

- **Office of the National Credit Ombud:** To resolve disputes between consumers and credit bureau providers, the Office of the Credit Information Ombud was established and is operating.

- **National Consumer Tribunal:** The tribunal hears cases on noncompliance with the act, issues fines, and provides redress to consumers. Consumers and credit providers may appeal any decision of the national credit regulator to the tribunal.

Collectively, the South African consumer protection framework is designed to ensure that, among other protections, (1) the language in credit agreements is simple and understandable;
(2) quotes are given on all credit agreements and are binding for five days; (3) advertising and marketing contains prescribed information on the cost of credit; (4) credit sales at a person’s home and workplace are strictly limited; (5) reasons are provided if credit is declined; (6) automatic increases in credit limits are regulated; (7) reckless lending is prohibited; (8) interest and fees are regulated on agreements, including microloans; (9) credit bureaus are regulated, and consumers have the right to free credit bureau records; and (10) overly indebted consumers have access to debt counseling to enable the restructuring of debt.

Although largely applauded for their restrictions on abusive lending practices, the debt restructuring processes embedded in the National Credit Act have attracted criticism from the financial sector. The court-enshrined process has been criticized as too slow. Banks cite the 9,000 cases being submitted to the courts monthly and the resultant backlog as a source of major concern for the industry. Their efforts to establish a national debt mediation association to increase the flow of negotiated interventions for overly indebted consumers is seen as a positive, yet insufficient initiative. It is argued that as few as 5 percent of the estimated 150,000 applications made by consumers since July 2003 have been finalized by the courts.

To create an effective consumer protection framework, the effort must be complemented by an equally effective financial literacy program. The government is determined to raise the level of financial awareness and improve the financial behavior of consumers so that they can make informed financial decisions according to their specific economic and social circumstances. Only a financially literate population will use consumer protection systems. Improving financial literacy strengthens the knowledge, understanding, skills, attitudes, and, especially, behavior that people need to make sound personal finance decisions and that allow people to become more attractive as potential borrowers. The government has to use multiple channels to deliver financial literacy programs, including financial institutions, the education system (financial education in school curricula), the media (newspapers, radio, television, Internet), social marketing (road shows, street theater, targeted entrainment programs), institutional services (debt counseling, mentoring), and other methods.

In South Africa, the Banking Association of South Africa has made representations to the parliamentary portfolio committee on basic education on reforms to the national curriculum on matters of economic management science, including an individual’s economic cycle, sustainable growth and development, and managerial, consumer, financial, and entrepreneurial knowledge and skills. Financial literacy programs in the early formative years are accepted as an essential aspect of efforts to improve South Africa’s low savings rate of only 15 percent, but also as an essential element of the national empowerment for citizens. The proposed reforms are intended to build on the ongoing Teach Children to Save South Africa Program launched in July 2008, which enables financial sector professionals to share their work-based knowledge and expertise by giving one-hour lessons on savings to grades 4 to 7 learners nationwide. Supported by the Department of Basic Education and integrated in the economic science learning area of the school curriculum, the program has thus far attracted participation from 13 banks and 27 financial sector institutions.


Box 5.3. The Consumer Protection Framework in South Africa (continued)
tests on financial institutions before credit may be extended. However, such regulations impose regulatory compliance costs on financial institutions, might prevent the broadening of the financial system, and require additional institutional capacity among the relevant authorities. South Africa adopted this approach in 2007 through the passage of the National Credit Act and the establishment of the national credit regulator, who is responsible for consumer protection in the area of consumer credits, whether they are extended by banks or by nonbank financial institutions, an experience discussed in box 5.3.

A final set of rules imposes certain minima or maxima on the costs of financial services, including usury interest rates. Such interest rate ceilings (in the case of credit) or floors (in the case of savings products) can, however, easily turn into a restrictive tool that reduces access to services by riskier customers and customers who need smaller transactions and who are thus costlier for financial institutions. According to the Making Finance Work for Africa survey, a third of countries in Africa still have usury ceilings in place, and a fourth impose deposit interest rate floors. This high rate is driven by UEMOA, which caps lending rates at 18 percent for banks and 27 percent for nonbank financial institutions and MFIs, regardless of the purpose or recipient of the loans. Yet, few countries impose limits on fees. This obviously makes interest rate ceilings and floors less effective because fees are a popular escape route for banks facing restrictions on interest rates.

In consumer protection, one size does not fit all. Middle-income countries such as South Africa can afford sophisticated institutional structures. Given the rapid increase in reliance on consumer credit, there is also a stronger need for protection mechanisms in these economies. In the specific case of South Africa, this has also to be seen in the context of the consumer credit boom the country experienced in the early 2000s. Small and low-income countries, in contrast, might not have the necessary resources and capacities to implement such a system and have to rely more on disclosure standards and self-regulatory initiatives. In large and middle-income countries, additional emphasis might have to be put on detecting pyramid schemes in the formal and informal financial services sector.

In terms of institutional structures for simplicity and accountability, it is best to have only one institution to which consumers can submit complaints about financial services (Rutledge 2010). In line with the motto that one size does not fit all, this could be part of an industry association, the regulatory authority, or a separate entity. Dealing effectively with complaints is critical in this context because it is through the complaint process that most consumers will have direct contact with the consumer protection agency, and dealing ineffectively with complaints can lead to cynicism and a general aversion for financial services. However, there might also be a useful link with financial literacy programs, as they can teach (potential) consumers of pitfalls, possible abuse, and remedial opportunities.

Accountability among financial service providers for the products and the information they supply and for the sales processes they rely on is paramount in the protection of consumers. This includes prohibiting unfair and deceptive practices.
Simplicity is key. Disclosure requirements can accomplish much; however, they must be clear and easy to understand and enable users to compare similar products and services. Providing key fact statements, with a summary of the most important terms and conditions written in plain language, and developing standardized contracts can be helpful. It is essential to offer comparable, standardized information about the services provided by financial institutions, for example, the costs of opening, maintaining, and using bank accounts for typical user groups. Financial institutions should also offer contact points where consumers can present complaints.

In terms of consumer protection, all financial institutions should be covered by business conduct regulations, independent of whether they are subject to prudential regulations or not. Obviously, conduct of business regulations and supervision are not as extensive as prudential regulations, so that more emphasis has to be placed on the initial registration process and on following up closely on any complaint. Such a registration process should focus on the integrity and qualifications of the provider. However, there is a trade-off between protecting consumers through a regulatory framework on business conduct and imposing unnecessary regulatory burdens on financial service providers. One has to distinguish among different target groups. Specifically, institutions aiming for the low end of the market certainly deserve closer scrutiny than providers for the high end of sophisticated investors. Put bluntly, caveat venditor should apply to low-end financial institutions, caveat emptor for the high end. Pyramid schemes pop up on a regular basis throughout the developed world and the developing world; continuous monitoring by regulators is therefore required.

Consumer protection is also a critical element in the design of financial infrastructure components such as credit registries. Consumers and businesses need an easy and inexpensive way to verify the positive and negative information that is being collected about them in credit registries, as well as a transparent and swift process to contest information that they think is in error.

Conclusions

The three main messages we discuss in previous chapters also apply to this chapter, though from a somewhat different perspective. In the previous chapters, we advocate for a greater reliance on competition within and across different segments of the financial system so as to reap the benefits of financial innovation. This should not imply that regulators should not follow developments closely and step in when risks to financial stability arise. Allowing competition exerts strain on the regulatory framework and requires more flexibility and more ability in adapting to changing market structures.

While recognizing the potential trade-off between stability and innovation in the financial system, this book advocates a preference for the latter. This also implies, however, that more competition will impose a greater burden on regulators and supervisors. Looking beyond existing institutions and markets to service pro-
vision is also important in safeguarding finance. Deposit-taking institutions should be subject to prudential regulations and supervision, no matter whether they call themselves banks or not, though the exact nature of the regulatory framework can vary; it must not cause regulatory arbitrage, however. Finally, addressing demand constraints through a greater focus on consumer protection is important in safeguarding finance because this helps expand access and lengthen contracts.

Different countries have different priorities. Countries with more developed financial systems are more likely to have more capacity, but also more need and therefore more motivation to follow closely the regulatory and supervisory upgrades proposed in the G20 reform process and to expand the regulatory perimeter beyond banking. Low-income countries have more immediate needs in regular bank supervision. Consumer protection is important across all countries, though the institutional possibilities and options vary significantly, as we argue. As Africa’s financial systems develop, the regulatory and supervisory framework has to adapt to changing circumstances and requirements.

Notes

1. “In a systemic banking crisis,” according to Laeven and Valencia (2008, 5), “a country’s corporate and financial sectors experience a large number of defaults and financial institutions and corporations face great difficulties repaying contracts on time. As a result, nonperforming loans increase sharply and all or most of the aggregate banking system capital is exhausted. This situation may be accompanied by depressed asset prices (such as equity and real estate prices) on the heels of run-ups before the crisis, sharp increases in real interest rates, and a slowdown or reversal in capital flows. In some cases, the crisis is triggered by depositor runs on banks, though, in most cases, it is a general realization that systemically important financial institutions are in distress.” A nonsystemic crisis, meanwhile, affects only (large) financial institutions, without additional negative repercussions on the rest of the financial system.

2. For the following discussion, see Fuchs, Hands, and Jaeggi (2010); Fuchs, Losse-Müller, and Witte (2010).


4. In addition to the direct implications of the regulatory reform debate for regulation and supervision in Africa, there are also indirect repercussions. One implication of the Basel reforms described above is that, because smaller banks and banks from developing countries are, on average, less likely to possess sophisticated risk management systems, they will already face a competitive disadvantage in crossborder markets in this respect and will be confronted by higher capital charges as they transition to Basel II and, ultimately, Basel III. Therefore, the Basel capital requirement reforms essentially raise the cost of international bank financing for developing countries and may also reduce their access to external financing.

5. At high cost, Mozambique, Tanzania, and Uganda had to renationalize previously privatized banks because the respective purchasers—various multinational banks—turned out to be too weak (World Bank 2001).

6. Lukonga (2010) documents trends in and the characteristics of large African conglomerate financial institutions and analyzes the stability risks that these pose. As the ex-
ample of Europe shows, a rapid expansion of large, conglomerate financial institutions throughout the continent can raise a number of risks for regional stability that are not adequately mitigated by the current practice in regulatory oversight. These risks mainly arise from (a) the nontransparency of corporate structures, which creates the potential for the unnoticed buildup of group risks and for financial contagion to other banks stemming from problems in separate parts of the corporate group; (b) inadequacies in the risk management of the vulnerabilities inherent in banking and other operations; and (c) potential exogenous shocks from the economic and political environment in which the corporate group operates. The effectiveness of overall supervision is undermined by the inconsistencies in prudential regulation and the lack of supervisory coordination that create opportunities for regulatory arbitrage, by weaknesses in accounting infrastructure, and by the absence of a crisis management framework, an absence that, in the resolution process, could raise the costs of failure.

7. It is important to expand the regulation and supervision of previously unregulated segments of the financial system, such as MFIs and SACCOs, in an incentive-compatible order, that is, first licensing and regulation, before expanding any deposit guarantees to these segments, which could result in large fiscal contingencies and aggressive risk taking.

8. For a discussion relating directly to Africa, see Quintyn and Taylor (2007).

9. In contrast to the caveat emptor approach, the caveat venditor approach (let the seller beware) implies that the seller of the financial product is liable for negative consequences and has to check the financial capacity of buyers.

10. For the following, see the discussion in Rutledge (2010).


12. Detailed diagnostic work has been done on the status of consumer protection in several African countries; see Engels (2011).