Basel III in Africa: Making It Work

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Abstract

Basel III is a framework to protect the global banking system. This article provides a policy discussion on Basel III in Africa. The significance of Basel III is discussed, and some ideas to consider when implementing Basel III to make it work in Africa, are provided. Under Basel III, the African banking industry should expect better capital quality, higher capital levels, minimum liquidity requirement for banks, reduced systemic risk, and differences in Basel III transitional arrangements. This article also emphasizes that (i) there should be enough time for the transition to Basel III in Africa, (ii) a combination of micro and macro-prudential regulations is needed; and (iii) the need to repair the balance sheets of banks, in preparation for Basel III. The discussions in this article will benefit policymakers, academics and other stakeholders interested in financial regulation in Africa such as the World bank and the International Monetary Fund (IMF).

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1. Introduction

This paper presents some policy discussion on Basel III in Africa and how to make it work. Promoting financial stability in Africa is important and would require a broad micro- and macro-financial policy framework. Basel III in Africa will form a key part of the wider agenda coordinated by bank regulators around the world to build a safer financial system and ensure its resilience to financial crises and economic recessions. In 2010, the Basel committee reached an agreement to strengthen financial regulation by introducing a global liquidity standard, and by increasing the global minimum capital standards for commercial banks which is known as the Basel III standards. In addition to capital regulation, Basel III require bank regulators to consider the role of macroeconomic policies, both monetary and fiscal, in promoting financial system stability in their respective banking systems.

Many developed countries particularly European countries have fully implemented Basel III while many developing countries have not adopted Basel III and are still in the process of implementing Basel II. Developing economies feel obliged to adopt and implement Basel III standards, even though Basel III standards may not fit the needs and circumstances of their banking systems (Beck et al, 2019). In Africa, some analysts predict that most African countries will not adopt Basel III now, but will adopt Basel III in the next decade, for different reasons. One notable reason is that African bank regulators need some time to study the monetary policy requirements needed to cater for Basel III. Other reasons include (i) the argument that unsophisticated banking systems - such as those in Africa, do not need sophisticated banking regulations like Basel III, (ii) the reluctance to adopt foreign regulations due to preference for local banking regulations in order to preserve national identity - for instance in Ethiopia, (iii) some African countries have few or no internationally active banks which puts them under little or no pressure to adopt Basel III. Nonetheless, bank regulators in some African countries have begun implementing some aspects of Basel capital accords because they recognize the need to strengthen the resilience of their banking systems to adverse shocks, even though the rate of implementation is slow in some African countries.

The viewpoints expressed in this article makes two contributions to the literature. First, the discussions in this article contribute to the policy debates on how Basel III regulation can repair or impair the financial system (see Laas and Siegel, 2017; Tsingou, 2010; Ozili, 2015, 2017; Brunnermeier et al 2009, etc). Secondly, the viewpoints contribute to the literature that analyse how banking supervision and regulation works in developing economies (see Klomp and De Haan, 2015; Triki et al 2017; Bascom, 2016). Extending the debate to Africa, it is needful to explore how regulation and supervision can work in African countries given their imperfect financial markets, weak enforcement, political interference in banking regulation, limited sources of information and shallow capital markets. Thirdly, it contributes to the literature that examine the possible effect of regulation and supervision on bank behavior and risk-taking (see Laeven and Levine, 2009; Buch and DeLong, 2008; Ozili, 2019). The literature argue that strict regulation and supervision can reduce excessive risk-taking in banks and can improve the stability of banks during stressed times, which is what bank regulators want.

The rest of the article is organized as follows. Section 2 discuss the objective, importance and progress of Basel III in Africa. Section III discuss how to make Basel III work in Africa. Section 4 discuss the challenges of Basel III adoption and how to minimize them. Section 5 present some recommendations, and Section 6 concludes.

2. Basel III: Objective, Importance and Progress in Africa

The Basel III accord was developed by the Basel Committee on Banking Supervision (BCBS) due to the impact of the global financial crisis on banks. Basel III builds on the previous accords, Basel I and II, and is part of a continuous process to enhance regulation in the banking industry. There are three (3) key principles of Basel III. The first principle is ‘minimum capital requirements’. The Basel III accord increased the minimum capital requirements for banks from 2% in Basel II to 4.5% of common equity, as a percentage of the bank’s risk-weighted assets. There is also an additional 2.5% buffer capital requirement that will bring the total equity to 7%. The second principle is the ‘leverage ratio’. Basel III introduced a non-risk based leverage ratio which require banks to hold at least a 3% leverage ratio. The non-risk based leverage ratio is calculated by dividing Tier 1 capital by the average total consolidated assets of a bank. The third principle is ‘liquidity requirements’. Basel III introduced two liquidity ratios - the ‘liquidity coverage ratio’ and the ‘net stable funding ratio’ (NSFR). The liquidity coverage ratio requires banks to hold sufficient high-liquid assets that can withstand a 30-day stressed funding scenario as specified by the bank supervisor. On the other hand, the ‘net stable funding ratio’ require banks to maintain stable funding above the required amount of stable funding for a period of one year of extended stress. The NSFR is designed to address liquidity mismatch in banks.

Basel III is important because it will strengthen regulation, supervision, and risk management within the banking industry. Basel III will prevent banks from taking excessive risks that can hurt the economy. It will improve banks’ ability to withstand abnormal shocks. Basel III will also strengthen transparency and disclosure in Banks. Under Basel III, the banking industry should expect better capital quality, higher capital levels, minimum liquidity requirement for banks, reduced systemic risk, and differences in Basel III transitional arrangements.

Currently, the implementation of Basel III in African countries is slow due to heterogeneous adoption of Basel standards in terms of scope and technicality across African countries (Beck et al, 2019). Only South Africa has fully implemented Basel III standards. Majority of African countries like Egypt, Tanzania, Kenya, Senegal, Cameroon, Uganda, Nigeria and Ghana are still at the Basel II implementation stage. Bank regulators in these African countries prefer to slowly integrate some aspects of Basel III into their Basel II regulatory frameworks and discard other aspects of Basel III that is not well suited for their country’s banking system. Some African countries are still at the Basel I implementation stage while other African countries are yet to adopt Basel I either because they do not have the capacity and resources to adopt Basel standards (GSP-WG, 2018), or because of the need to preserve national identity by rejecting foreign regulations in preference for local regulations (Beck et al, 2019).

3. Basel III in Africa: Making It Work

3.1. What African banks can do themselves

African Banks can do at least six (6) things in preparation to adopt Basel III standards.

Firstly, the top management of African banks should show support towards complying with Basel III standards. Top management of banks can show their support, and show their seriousness in complying with Basel III standards by: (i) providing extensive trainings on Basel III standards to their risk management and compliance staff, (ii) promoting a strong risk culture across all levels of the organization, (iii) ensuring there is a two-step authorization process before approving credit lines or trade deals above a certain threshold in order to reduce the bank's exposure to abnormal credit risk and market risk, (iv) ensuring that members of the Board Risk Committee are competent in risk management and regulation.

Secondly, there should be process ownership for Basel III adoption in banks. Banks in African countries should appoint a Chief Risk Officer (CRO) who will be responsible for implementing Basel III standards in the bank. The CRO should become the process owner for Basel III adoption within the bank. The CRO should be competent and should have experience in the financial services, banking or regulatory industry.

Thirdly, African banks should appoint a Chief Compliance Officer (CCO) who will be responsible to ensure that the bank comply with Basel III regulations and all existing local laws and regulations that affect the bank's activities. The CCO should be the process owner for Basel III compliance within the bank. The CCO should be competent and should have experience in the legal, banking or regulatory industry.

Also, African banks should increase their holdings of high-quality capital and decrease the amount of low-quality capital and hybrid capital in their capital structure. Hybrid capital are low-quality capital instruments because these instruments have the properties of equity but already have a claim on them, making such instruments unavailable to absorb losses in banks. Common equity has the highest quality of capital, therefore, African banks may need to go to the capital market to obtain high-quality capital.

Also, banks should recruit competent staff for its risk management function. Careful recruitment of risk management staff should be a top priority because recruiting incompetent risk management staff could lead to human errors, non-compliance issues, process errors, risk modelling mistakes, avoidable losses, and violation of regulations which may attract heavy fines to banks.

Furthermore, banks in Africa should reduce their exposure to speculative risks. African banks should review their overall risk exposures prior to Basel III adoption, and should reduce risk by eliminating risks that do not add value to shareholders' wealth particularly speculative risks in their trading books. This will help to reduce the regulatory capital for market risk.

3.2. The Role of regulators

Bank regulators should oversee the transition period from Basel II to Basel III in African countries. Regulators may extend the transition period to 6 months, 2 or 5 years if necessary. African bank regulators should also consider how long it will take to translate Basel III standards into a national macro-prudential policy framework.

Secondly, bank regulators in African countries should decide whether they will modify Basel III standards or adopt off-the-shelf Basel III standards. Basel III standards can be modified in three ways, either (i) adopt off-the-shelf Basel III without any changes; (ii) impose higher requirements above Basel III standards, or (iii) impose lower requirements below Basel III standards. If the regulator chooses to modify Basel III standards, such modification to Basel III should be done in a way that harness the benefits of global banking standards while at the same time reducing the risks or cost that adopting off-the-shelf Basel III brings (Beck et al, 2019).

Thirdly, bank regulators should ensure that bank examiners understand the Basel III requirements so that they can conduct effective bank examination and supervision of banks under Basel III standards. Bank examiners are responsible for conducting risk-based or compliance-based regulatory audits of the financial statements, processes and governance structure of regulated banks and other financial institutions. These audits or examinations are either risk-based or compliance-based.

Also, regulators in each African country should notify bank examiners of any local modification made to Basel III during its implementation. Bank examiners should understand any changes to Basel III, and how such changes will affect the way they conduct regulatory audits for supervisory purposes. If necessary, additional training should be provided to bank examiners to explain the reasons for such modifications and to guide bank examiners on how to conduct regulatory audit under the new changes.

Furthermore, regulators should ensure that there is no ambiguity in Basel III implementation process for the compliance teams of banks. Bank regulators should ensure that the compliance managers (or teams) of banks fully understand the requirements of Basel III. Regulators should hold several meetings with the compliance teams of banks to explain the regulatory and compliance expectations of Basel III. Such meetings will give the compliance teams the opportunity to ask questions on areas they do not understand regarding Basel III rules. This approach is desirable and cheaper for banks compared to the cost of hiring some consultant to explain the compliance process of Basel III to banks, and paying huge consulting fees for such services.

Finally, regulators should seek the help of the government if they believe that new laws need to be made to support the Basel III regulatory framework in the African country.

3.3. The Role of Government

The government can do three (3) things to support the Basel III adoption process. The government should provide full support to the Central bank or to the resident bank regulator in the African country throughout the Basel III implementation process. Secondly, the government in African countries should understand the purpose of Basel III standards, the benefits and the potential consequences of adopting Basel III standards. The government can set up a senate committee to oversee the Basel III adoption process. The committee should communicate with the bank regulator, to ensure that the government is well-informed about Basel III objectives and implementation plans, so that any future fall-out from Basel III or other negative externalities to the banking system will be well-anticipated. Thirdly, the legislative arm of government should be willing to enact new laws or establish new institutions at the request of the regulator if such new laws or institutions are needed to support the banking system in the Basel III era. And finally, the government should have a crisis resolution plan, contingency liquidity provision or other extraordinary measures to rescue the financial system from unforeseen events especially financial crises.

4. Challenges to Basel III adoption and how to minimize them

There are challenges to implementing Basel III in Africa.

For instance, domestic banks that have limited cross-border exposure may show little enthusiasm to embrace Basel III standards in their risk culture. To minimize this problem, regulators can allow domestic banks to gradually adopt Basel III at their own pace within a defined transition period. But, allowing domestic banks to adopt Basel III in their own convenient time could signal regulatory bias and favoritism towards some domestic banks, it can signal that regulators lack the power to impose Basel III standards on all banks, or it can also lead to complacency by banks.

Another challenge to implementing Basel III is that regulators in African countries are often selective adopters. They choose some aspects of Basel standards to adopt and choose the aspects to ignore. It is difficult to minimize the selective adoption problem because most African countries are not members of the Basel Committee for Banking Supervision (BCBS), and are therefore not under any obligation to adopt off-the-shelf Basel III standards.

Another challenge is political interference in banking regulation and supervision in African countries. Politicians often take legislative actions to prevent a Central bank from implementing specific regulations which they feel will put weaker local banks in jeopardy, or which they feel might affect the banks that politicians are commercially-affiliated with. The level of political interference is high in some African countries such as Ethiopia, and lower in other African countries such as South Africa, Nigeria, Mauritius and Kenya. To minimize the political interference problem, the governors of African central banks should seek presidential endorsement and support for Basel III adoption in the country, and should also seek legal support for Basel III implementation to help prevent interference from other politicians.

Another challenge is increased cost of capital. African banks will be required to hold higher capital buffers and this will significantly reduce the availability of credit to small and medium-sized enterprises. To address this problem, the government while implementing Basel III, should consider providing a generous lending window or credit schemes to small businesses and individual borrowers preferably at single-digit interest rate so that individuals and businesses can access affordable credit during the transition period and in the Basel III era.

5. Recommendations

African bank regulators should enforce strict market discipline under Basel II in preparation for Basel III.

Secondly, effective bank supervision is needed to ensure that the activities of banks comply with micro and macro-prudential policies and regulations.

Thirdly, there should be international cooperation and peer engagement with other bank regulators in areas of common interest for effective adoption of Basel III standards.

Regulators should have a contingency plan to reassure the public of the safety of their deposits in bad times.

The timetable for the introduction of Basel III's new minimum capital and liquidity ratios should be flexible to give banks enough time to transit to Basel III requirements.

Bank regulators should have emergency liquidity solutions to support the financial system during troubled times. When liquidity solutions are available, bank regulators should carefully review the quality of such emergency funds, and should review the timing of the withdrawal of emergency liquidity facilities in order to create a soft landing for the most affected financial institutions in the event of a crisis.

Finally, bank regulators in African countries may need to carefully review the definition of the assets eligible to meet the liquidity requirements of Basel III.

6. Concluding Remarks

New banking regulations will increase in the coming years. For this reason, it is important to ensure that banks in African countries have sufficient capital above the minimum levels at all times, depending on their risk profile, business models and prevailing economic conditions. Bank regulators may impose a more stringent capital base for banks in their countries, and may speed-up the implementation of Basel standards, and this will be a recurring element in subsequent Basel regulations particularly in Basel 3.5 and Basel 4.

Five points to remember include the following. Basel III regulation will bring more regulations, transparency and more clarity to the banking system in African countries. Secondly, Basel III regulation will combine both micro- and the macro-prudential approach to financial system regulation. Thirdly, Basel III will also introduce a macro-prudential framework which will promote stability in the financial system, reduce procyclicality in the financial system and to deal with systemic risk. Furthermore, bank regulators may opt for a long transition period because Basel III will be a learning process for some African countries. Finally, bank regulators in African countries should intensify their effort to help their banks recover from the effect of past or current crises, in preparation for Basel III implementation.

The viewpoints in this article have implications for academics and for future research in Africa. The effect of Basel III on the performance of African banks is unknown. Future research should investigate the effect of Basel III on African banks. Academics and policy researchers interested in banking research should identify the African countries that have adopted Basel III such as South Africa, and check whether banks in these African countries are more profitable or less risky in the Basel III era. The findings from such analyses can provide feedback to bank regulators in their assessment of the impact of Basel III standards on bank behavior and bank performance. Secondly, Basel III's stringent capital regime can reduce excessive risk taking in banks and can reduce the level of nonperforming loans in banks. In line with this argument, future research can investigate whether African banks have more or fewer nonperforming loans in the Basel III era, compared to the Basel II era.

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