



# **HIGH-LEVEL ROUNDTABLE ON AFRICA AND NEW GLOBAL FINANCE: MACROECONOMIC POLICY AND REGULATORY RESPONSES**

May 2015

## Foreword

### **Christopher Adam, Emily Jones, and Ngaire Woods**

Finance in Africa is undergoing a rapid transformation, changing the architecture of domestic financial systems and redefining their links with global markets. Many African governments have borrowed from international financial markets for the first time; there are signs that foreign direct investment is diversifying away from natural resources; pan-African banks are becoming an important presence in many countries on the continent, often replacing long-standing European banks; and mobile banking is having a substantial impact on financial inclusion. At the same time, on a less positive note, African countries are having to navigate the end of the commodity supercycle; concerns are being raised about the sustainability of new sovereign debt issuances; and global financial standards are having unintended adverse effects, including on remittances.

How are African regulators responding to these developments? How can they best manage cross-border capital flows? What opportunities and challenges do the rapid growth of cross-border and mobile banking pose? What have been the tangible impacts of global financial standards? To explore these questions, GEG and PEFM convened a small, high-level group of experts from national regulators, academia, the private sector, and global financial organizations on 17 March 2015 to critically examine the economics and political economy of these new developments and their implications for regulatory design.

Six themes emerged particularly strongly from our discussions. First, African countries need to build up the local investor base in order to limit the impacts of volatile international capital flows. Second, while accessing global financial markets has provided governments with new forms of finance, greater attention needs to be paid to the structuring of sovereign debt issuances to help manage the sustainability of growing debt burdens. Third, the expansion of pan-African banks appears to be increasing the availability of longer-term financing. Yet there are very substantial weaknesses in the regulation of these banks, which are systematically important in a good number of countries, and greater cooperation is needed among African supervisors. Fourth, where mobile banking has grown, it is often down to the regulatory approach taken: more needs to be understood about how to regulate this sector effectively for the twin aims of financial inclusion and stability. Fifth, the burden of complying with international standards on anti-money laundering and combatting financing of terrorism is leading to a withdrawal of correspondent banking and having a dampening effect on remittances. Changes to these standards could be made to avoid these adverse effects, without undermining their aims. Finally, global banking standards need to be carefully customized to suit specific contexts yet African regulators may be encouraged, or may come under pressure, to implement standards too quickly or in ways they consider suboptimal.

This report presents an overview of the discussions in the workshop, and also brings together the short thought-pieces that several participants submitted prior to the meeting. We are enormously grateful to the Ford Foundation and to the Political Economy of Financial Markets project at St Antony's College, whose support made this meeting possible. We are indebted to Alexandra Zeitz, Ivaylo Iaydjiev, Emma Burnett, and Reija Fanous for their outstanding job organizing the meeting and writing up the report.

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## PLEASE NOTE

All memos represent the authors' personal views, and should not be interpreted as representing the policy or views of their respective organisations.

## SUMMARY

New Global Finance:  
What Opportunities and  
Challenges for African  
Countries?

**Christopher Adam**  
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**Alexandra Zeitz**

The financial landscape in Africa is changing rapidly. Following a decade of strong growth in cross-border foreign direct investment (FDI) flows, recent years have seen a sharp increase in non-FDI cross-border capital flows, to both the public and the private sector. As well as the wave of high-profile sovereign Eurobond issues by African governments, recent years have seen rapidly increasing short-term portfolio flows, primarily into domestic government debt instruments. This has been accompanied by a surge in pan-African banks and the explosion of mobile banking in some countries.

These changes pose new regulatory challenges and call for new thinking. How should regulators in African countries respond to these changes? How can new forms of finance be harnessed to support financial stability and economic development? What are the regulatory priorities at the domestic, regional, and global levels? Drawing on the expert opinions shared at a high-level roundtable convened at the University of Oxford on 17 March, this piece highlights the most salient changes in the financial landscape in Africa and distils the opportunities and challenges these pose for African regulators.

Below we consider these questions in five key areas:

1. Large-scale capital inflows to Africa;
2. Rapid growth of regional and pan-African banks;
3. Expansion of mobile banking in some African countries;
4. Impact of global initiatives on anti-money-laundering and combating the financing of terrorism;
5. Relevance and implications of Basel global banking standards.

## 1. CAPITAL ACCOUNT OPENNESS: OPPORTUNITIES, CHALLENGES AND REGULATORY RESPONSES

In the last 15 years, Africa has seen large-scale capital inflows that have far outstripped bilateral and multilateral aid flows. This increasing financial integration has come especially through a surge in short-term portfolio and cross-border bank flows, though longer-term foreign direct investment (FDI) flows continue to dominate cross-border flows to Africa.

### DRIVERS OF CAPITAL FLOWS: IMPROVING FUNDAMENTALS OR SEARCH FOR YIELD?

Understanding the drivers of the capital inflow is crucial for designing the right policy response, as **Giulia Pellegrini** argues in her memo. An optimistic reading among some participants was that such inflows are a response to an improvement in the economic fundamentals across much of the continent. The fact that investors are in fact differentiating between sovereign borrowers, with some countries experiencing a greater spread in yields than others, would suggest they do discriminate on the basis of fundamentals.

However, a more worrying possibility is that capital inflows are the product of advanced economy investors' search for yield and are susceptible to 'sudden stop' and reversal, for instance when interest rates in the US begin to normalize. The impact of the 'taper tantrum' in May 2013 on capital flows to emerging and frontier markets lends credence to this argument.

### SHORT-TERM MEASURES: DO CAPITAL CONTROLS AND MACROPRUDENTIAL REGULATION WORK?

As **Governor Linah Mohohlo's** brief indicates, reaping the benefits of capital account openness often requires macro-economic adjustments in recipient countries. Yet, as **Mthuli Ncube** shows in his contribution, there is a live debate about the role capital controls might continue to play in mitigating volatility and contagion during a crisis. The Roundtable discussion noted that controls on outflows, especially if imposed after a crisis, can have negative reputational and economic costs, harming investor perception and possibly leading to exclusion from key indices. By contrast, targeted measures intended to place 'speedbumps' in the path of short-run inflows have been associated with positive investor perceptions.

Counter-cyclical macroprudential measures can be used to address potentially excessive credit growth driven by large capital inflows, as **Alain Nkontchou's** memo discusses. Despite the increasing popularity of these measures in advanced economies, however, there are worries about their effectiveness in low-income countries, where it can be difficult to secure reliable data on countries' positions in generally more volatile and harder-to-assess credit cycles.

## LONG-TERM STRATEGIES: DOMESTIC MARKET DEVELOPMENT

Beyond short-term tools, there was a strong consensus among participants that building up the local investor base is key to limiting the consequences of volatility in international capital markets. Domestic institutional investors, in particular pension funds, can act as a “shield” to reversals in short-term capital flows by providing much needed longer-term financing.

## SOVEREIGN DEBT: OPPORTUNITIES AND RISKS

Investor enthusiasm about Africa, whether as part of a search for yield or a ‘new normal,’ has also given African countries growing access to bond markets. According to **Brett House**, since 2006, 12 sub-Saharan African countries have issued a cumulative US\$ 17 billion in external debt. Given that several African borrowers have already undergone restructuring, there are mounting concerns about debt sustainability.

In his memo, he lays out possible steps African governments can take to mitigate the risks of these growing debt burdens, especially when sovereign bonds are structured as ‘bullet repayments’ rather than amortizing debt. Governments should consider setting aside escrow funds for the possibility that loans cannot be rolled over and support efforts towards an international sovereign debt restructuring mechanism. House also recommends that governments consider linking their future debt to economic performance, for instance in the form of GDP-linked bonds.

While some participants expressed enthusiasm about the potential of GDP-linked bonds, others pointed out that these debt instruments would likely be too expensive to provide a sustainable source of financing. Creditors are likely to demand much higher returns in compensation for the downside risk protection that debtors would enjoy with GDP-linked bonds.

## REDUCING THE “AFRICA PREMIUM”

Many African countries continue to experience an ‘Africa premium’ i.e. high interest rates associated with investing on the continent. In part this is due to weaknesses of legal structures and institutions. Addressing governance issues through regulatory and other legislative intervention remains a priority in order to reduce this premium.

However, participants noted that even if governance concerns were addressed, an ‘Africa premium’ would remain. Investors may continue to lack information about the true risk of investing, so risk perceptions may be higher than actual risk. Investors are also concerned by a range of factors (e.g. market size, limited liquidity, inelastic supply of savings, degree of co-movement of risks) that are not directly under regulatory control.

## 2. CROSS-BORDER BANKING: THE RISE OF PAN-AFRICAN BANKS

A highly visible aspect of financial integration in Africa is the rise of pan-African banks. Over the last 10 years, regional banks have expanded rapidly, becoming systemically important in many African countries and, in some countries, outstripping European and American banks that have traditionally dominated the market. This unprecedented growth presents opportunities to increase financial depth, banking efficiency, and trade integration, but also carries a number of risks, including creating an additional channel for contagion in case of crises.

### ARE PAN-AFRICAN BANKS SPECIAL?

Experiences suggest that pan-African banks bring advantages that other banks do not, since they have better local information and thus are able to assess risk more accurately. In the wake of the global financial crisis they provided the majority of syndicated loans for infrastructure, cushioning the effect of the deleveraging of European banks, as demonstrated by **Mauro Mecagni’s** contribution to this report. European banks remain present in Africa but have reoriented towards other instruments, such as private equity or mezzanine funds.

However the extent to which pan-African banks have a fundamentally different lending model from foreign banks remained unclear. Some participants highlighted that a substantial proportion of long-term lending by PABs originates from multilateral donors, such as the African Development Bank and the International Finance Corporation, which are opting to use these banks to channel loans.

### REGULATORY CHALLENGES: BUILDING SUPERVISION AND COOPERATION

The regional nature of pan-African banks raises considerable regulatory challenges because supervisory practices in most African countries remain national, as **Thorsten Beck** explains in his piece. For a range of capacity and political economy reasons, some pan-African banks with regional systemic importance are not subject to consolidated supervision at home and do not have cross-border supervision arrangements, such as supervisory colleges, that could bring together the various regulatory agencies responsible for the banking group.

A related challenge is home-host cooperation between supervisors. Such cooperation is essential given the regional nature of the pan-African Banks, but is still underdeveloped in Africa. Difficulties with home-host cooperation may be even more severe with large foreign banks. Incentives are likely to be in conflict, particularly when a local subsidiary is systemic to the host country but small relative to the banking group being overseen by the home regulator. Some of these challenges could be addressed greater regional coordination over supervision of global banks. For instance, African regulators may wish to pursue regional or sub-regional representation in the colleges of supervisors of globally systemically important banks (G-SIBs).

#### REGULATORY RESPONSES: SUBSIDIARIZATION AND THE RESOLUTION ENDGAME

Regulators have relied heavily on subsidiarization to protect national financial stability and have also made use of traditional tools such as Memoranda of Understanding (MoU). There remain regionally-specific challenges given relative degrees of regional integration, as explained by **Seydou Ouedraogo** for the West African Economic and Monetary Union, and **Radha Upadhyaya** for the East African community.

In times of stress these structures of MoUs and subsidiarization are likely to be of limited use, as demonstrated in Europe during the financial crisis. Roundtable participants questioned the legal robustness of existing MoUs, especially since large foreign banks may resist formally concluding the agreements. Therefore, participants highlighted the need for better ex-ante resolution frameworks that can ensure the orderly winding down of a regional financial institution, avoiding the politicization and break-down in cooperation associated with ex-post solutions.

#### REGIONAL SIBS: GLOBAL RULES FOR REGIONAL BANKS?

The post-crisis global regulatory agenda has paid a lot of attention to banks that are systemically important at the domestic or global level (D-SIBs and G-SIBs respectively) and has formulated specific regulatory requirements for them. However, it was noted during the roundtable that there is no separate concept of regional systemically important bank (R-SIB). Developing such a concept would draw attention to the growing importance of R-SIBs and the systemic risks they can pose and could lead to regulatory recommendations on their supervision and resolution.

### 3. MOBILE BANKING: BANKING INNOVATION IN AFRICA

Many Africans now access banking services without ever setting foot in a bank, instead using the mobile banking services that have exploded in certain countries, including Kenya. Mobile banking services are significantly advancing financial inclusion, extending banking to the unbanked by providing a secure means of storing money, making payments and saving.

Participants noted that mobile banking services provide a formal alternative to the informal solutions customers previously relied on, thereby helping to formalise the economy and widen access to financial services. These services also produce electronic records of transactions that previously would have occurred without oversight, records that can lay the foundation for credit assessments, allowing banking intermediation services to be built on the back of the mobile money payments system.

#### REGULATORY DECISIONS: BANKING PRODUCTS OR PAYMENTS SYSTEMS?

When mobile banking services were first introduced, it was unclear how they should be categorized and regulated. Regulators in Africa continue to take different approaches,

some seeing them as banking products and others as payment and settlement systems. One approach that has allowed mobile banking services to expand is to regulate them primarily as payments systems. Customers' funds are not held by the mobile services provider, but rather by a trust, protecting customers in the case of bankruptcy of the telecommunications company.

#### REGULATORY CONCERNS: SYSTEMIC RISK AND MONEY LAUNDERING?

Some participants expressed concerns that the trust structure may not be sufficient to protect mobile customers and raised questions about the systemic risk associated with the growth in mobile banking. As the tool has become central to several African economies, it has taken on systemic importance and may need to be regulated more closely. A question was raised as to whether these products facilitate money laundering and criminal transactions. However, given that transactions are recorded electronically, mobile banking platforms can in fact provide investigators with greater information about money laundering than the informal financial arrangements they largely replace.

#### THE POLITICAL ECONOMY OF EXPANSION: CHALLENGING ESTABLISHED PLAYERS

The expansion of mobile banking, with its associated benefits for financial inclusion, has faced resistance from established actors in the sector. While traditional banks were initially the greatest critics, many banks now see mobile products as a means of expanding their client base. Internationally, mobile banking poses the greatest disruptive challenge to established payment and settlements systems, such as the SWIFT network, or those operated by Mastercard and Visa. Participants suggested that opposition by these actors could hinder the further expansion of mobile banking into cross-border transactions.

#### SPREADING BEYOND THE INITIAL BASE: FACILITATING FURTHER EXPANSION

Given the enthusiasm about mobile banking from champions of financial inclusion and its rapid expansion in certain markets, why has it not spread across Africa to other markets? Participants noted that the approach of the regulator is key: in order to facilitate expansion, regulators will have to take experimental and innovative approaches, while also addressing genuine concerns about protecting customers and systemic risk.

### 4. THE AML/CFT REGIME: GLOBAL STANDARDS AND DOMESTIC NEEDS

The international anti-money laundering and combating the financing of terrorism (AML/CFT) regime is central in the interface between African financial regulators, the economies they oversee, and global markets. Participants in the roundtable, while supportive of the aims of these initiatives, expressed concern about their unintended adverse consequences on financial flows to the continent. Moreover,

participants questioned the effectiveness of the current AML/CFT regime in fulfilling its aim of deterring, detecting, investigating and prosecuting crime and terrorism.

#### REGULATORY REQUIREMENTS: THE AML/CFT REGIME

The requirements of the AML/CFT regime, as set out by the Financial Action Task Force (FATF), place very substantial costs on African governments and banks operating in the region. Participants noted that failure on the part of African governments to comply with the obligations for domestic legislation, establishment of local financial intelligence units and AML/CFT risk assessments can have serious consequences: countries included on the FATF's 'grey list' suffer reputational costs in capital markets and may experience the withdrawal of international banks. Some global banks have indicated that slow compliance with FATF standards is inhibiting their expansion into African markets.

#### ADVERSE EFFECTS: HIGH COST OF REMITTANCES AND WITHDRAWAL OF CORRESPONDENT BANKING

These compliance burdens are passed on to domestic banks, which can translate into higher costs for consumers, harming the ultimate goal of financial inclusion. Compliance costs are having a tangible impact on remittances. As **Dilip Ratha's** article in this conference report outlines, remittances are a powerful tool for development, but compliance with the AML/CFT regime means that costs of remittances remain high.

The unintended adverse effects of the AML/CFT regime also operate through global banks. Several international banks are withdrawing correspondent banking services to African counterparts, citing the legal risks of potential AML breaches. Participants expressed concern that as international firms stop conducting what they now see as 'high-risk-low-margin' business, particular jurisdictions in Africa may become 'under-banked' or 'unbanked'.

#### REGULATORY ADJUSTMENTS: A THRESHOLD AND CLEAR GUIDANCE FROM DEVELOPED COUNTRY REGULATORS

To reduce the adverse effects of the global AML/CFT regime on remittances, participants suggested a threshold under which AML/CFT reporting requirements do not apply. Given that most remittances are small amounts unlikely to be used for money laundering or the financing of terrorism, setting a lower bound for these standards could be very effective. For instance, all international transfers under \$1000 could be exempt. Or, thresholds could be set specifically for particular corridors, e.g. UK to Nigeria.

To address the withdrawal of correspondent banking, developed country financial regulators could similarly issue guidance stipulating that banks will not face legal consequences for AML breaches associated with small transfers, such as those under \$1000. Clear guidance from developed country regulators is important, since global banks are in many cases withdrawing correspondent banking due to a perceived risk of potential legal consequences, rather than observable breaches in AML standards.

## 5. BASEL: GLOBAL STANDARDS AND DOMESTIC NEEDS

In interfacing with global markets, African regulators face a further set of global standards: the Basel banking standards. Participants recognised the vital role that stronger global financial standards have to play in improving financial stability in the global economy. However, as discussed in the piece by **Emily Jones, Ngaire Woods** and **Alexandra Zeitz**, there are concerns that the new standards respond to causes of instability in advanced financial markets and are, in some cases, ill-suited to African economies at a different stage of financial development.

#### THE SHORT-TERM: CUSTOMIZING THE BASEL APPROACH

Given the varying degrees of financial sector development across the continent, there was consensus at the Roundtable that African regulators need to 'customize' their implementation of the Basel standards, selecting those elements that are most appropriate to their regulatory needs, and adapting them to suit their specific circumstances. For instance, capital requirements set by national regulators are, quite appropriately, often higher than required by Basel, reflecting the country's particular risk profile. Measures addressing counterparty credit risk in derivatives markets are not yet relevant for most African economies.

In customizing the standards, participants noted that regulators should coordinate with and seek advice from others within the sub-region. The timeline for 'phasing in' the international standards must be responsive to both the state of the domestic financial sector and the technical capacity of the regulator.

#### DRIVERS OF ADOPTION: ENCOURAGEMENTS AND PRESSURE

While recognising the need for a customised approach to Basel standards, participants noted that regulators may be encouraged, or may come under pressure, to adopt Basel standards more quickly than they consider optimal.

Three 'drivers' of adoption were noted. In some instances, cross-border banks have exerted pressure on both home and host regulators for regulatory convergence to international best practice to facilitate their cross-border operations. Second, the IMF's Financial Sector Assessment Programs (FSAP) provides incentives to adopt Basel standards, as it highlights states' shortcomings with respect to international best practices. This said, participants noted that experiences with the FSAPs differs across countries, since the process is closely shaped by the approach of particular evaluators, and the FSAP does appear to have become less rigid over time. Finally, credit ratings agencies use adoption of Basel standards as a means of assessing the riskiness and credit-worthiness of sovereigns. This provides an incentive for governments to adopt Basel standards to facilitate access to international capital markets.

#### INTERNATIONAL SUPPORT: CAPACITY BUILDING OR OVERWHELMING INFORMATION?

African regulators can seek information from the Bank for International Settlements and the Basel Committee, which are emphasizing capacity-building in order to ease the process of adoption. And yet, the volume of data and information from these international standard-setters can also overwhelm over-stretched African regulators seeking to chart an independent and locally-suited path.

#### THE LONG-TERM: TWO SPEEDS OR GRADUAL HARMONIZATION?

The 'end game' with respect to these global standards remained an open question. Should low-income countries push for adjustments of the standards, calling for exemptions along the lines of 'special and differentiated treatment'? Or should they aim at eventual, if gradual, convergence? Several participants stressed the benefits of a global minimum standard. Aiming at convergence to this standard is important for reputational reasons as well: avoiding regulatory harmonization will carry market costs and may undercut efforts to position African markets as no different from other emerging or frontier markets. Yet, there is clearly also scope for global recognition and clearer guidelines on the need for countries to gradually phase in different elements of the standards.

#### CONCLUSIONS

The developments in African finance are varied and complex. In the Roundtable discussions on the current state of affairs, several clear conclusions emerged.

- While it may be unclear whether capital inflows are an indicator of a lasting 'new normal' or a more temporary product of global conditions, African regulators must respond to surges in cross-border capital flows. In so doing, they must weigh the possible short-term benefits of capital controls against longer-term reputational costs, and evaluate whether they hold the necessary data to apply macroprudential tools effectively.
- Pan-African banks are changing the face of banking in Africa. To reap the benefits without risking stability, regulators must substantially strengthen cross-border supervision of these new systemically important actors. Cultivating the necessary trust for cooperation and coordination must be a part of subregional integration initiatives.
- Innovations and expansions in mobile banking in Africa have already substantially advanced financial inclusion. To encourage further expansion, regulators must ensure the appropriate legal frameworks are in place so that consumers are protected and systemic risks are avoided.
- The global AML/CFT regime is imposing unintended adverse consequences on African economies. To address these impacts, clear steps can be taken. Firstly, introducing thresholds for remittances that are exempt from AML/CFT. Secondly, clear guidance from regulators on the AML/CFT legal risks for global banks to allay the fears that are undermining correspondent banking.
- Basel standards will have to be customized to African financial sectors. Regulators will need supportive capacity-building that recognizes differences in regulatory needs. Accountability mechanisms that ensure African voices are heard in the process of further refining standards are essential to ensure the legitimacy of global standards.





# Futureproofing Africa's external bond issuance

## Brett House<sup>1</sup>

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### INTRODUCTION

The recent boom in sub-Saharan African (SSA) countries' external bond issuance,<sup>2</sup> while a canny strategic move to take advantage of historically low interest rates, should be viewed as an incipient vulnerability rather than an ongoing structural source of financing. When global yields normalize, demand for these bonds is likely to dry up and, on maturity, it will be difficult to roll them over on affordable terms. SSA countries should take action now on four fronts to insulate themselves against future financing challenges: (1) set up structures and initiatives to ensure these debts can be repaid; (2) make existing and future external bond issuance easier to restructure; (3) intensify efforts to develop domestic capital markets; and (4) press the G7, G20, and IFIs for support of these and related initiatives.

### CONTEXT

Issuance of external bonds has long been seen as an important step in a country's financial maturation. Over the last few years, a host of SSA countries have made their d but international issues, mainly through the London Eurobond market. Until 2006, South Africa was the only SSA country that had issued an external sovereign bond: since then, 12 sub-Saharan African countries, all rebranded as 'frontier' markets, have issued some US\$17bn in external bond debt, of which over US\$2bn was issued as part of debt restructurings, as detailed in Table 1. Three more countries have made private external placements during time: Mozambique and Angola (2012), and Tanzania (2013).

It would be a mistake to see this new market access as the by-product of a sudden embrace of Africa's frontier markets as the next economic miracles. This new (or in some cases renewed) access to international capital comes partially in response to two decades of high growth and improved macroeconomic management, and, until recently, relatively strong demand and high prices for major commodity exports. But more importantly, investors are simply scrambling for yield given that industrialized-country interest rates have

been pinned near zero for several years. Investor interest in these bonds also reflects an expectation that, if these countries encounter financial problems, bondholders will likely be bailed out with public money from the international financial institutions (IFIs) or bondholders will be able to litigate successfully for repayment.

It's difficult to make sense of the extent of investor interest in SSA's external bonds based on macroeconomic and financial fundamentals. For instance, in 2006, the Seychelles was able to issue d but external bonds worth \$200mn, some 29 per cent of GDP; it defaulted in 2008, restructured in 2010 and defaulted again in 2011. Yields on Ethiopia's 2014 d but issue were lower than US treasury yields in 2000; yields on Rwanda's 2013 first external bond issue were at the same levels as Spain in 2012; Ghana went ahead with an oversubscribed US\$1bn issue priced at 8.125 per cent in September 2014, one month after its decision to seek help from the IMF. This looks worryingly similar to the mispricing of risk on Greece's bonds after it joined the euro zone in 2003. Creditors appear to think their holdings of SSA external bonds are more or less protected against possible default.

Table 1: Sub-Saharan African Eurobond Issuance (excl. private placements)

	Yield, %	Years	Size, USD mn
<b>2006</b> Seychelles	9.467	5	200
<b>2007</b> Gabon	8.250	10	1,000
DR Congo	8.770	22	480
Ghana	8.500	10	750
<b>2009</b> Senegal	9.473	5	200
<b>2010</b> Seychelles 1/ Ivory Coast 1/	8.690	16	168
	5.625	22	2,300
<b>2011</b> Nigeria	7.126	10	500
Senegal	9.125	10	500
Namibia	5.835	10	500
<b>2012</b> Zambia	5.625	10	750
<b>2013</b> Rwanda	6.746	10	400
Nigeria	5.750	5	500
Nigeria	6.625	10	500
Ghana	7.875	10	750
Gabon	6.375	11	1,500
<b>2014</b> Zambia	8.625	10	1,000
Kenya	5.875	5	500
Kenya	6.875	10	1,500
Ivory Coast	5.625	10	750
Senegal	6.625	10	500
Ghana	8.125	12	1,000
Ethiopia	6.625	10	1,000

Source: Bloomberg.

1/ Issued as part of a debt exchange within a post-default restructuring.

<sup>1</sup> Brett House tweets on @BrettEHouse; his contact email is: brett.house@jeannesauve.org

<sup>2</sup> "External" here refers to bonds issued under foreign law, most of which, historically, have been issued under English law, with smaller shares of issuance under New York, Japanese, Swiss, and Luxemburgish law. These foreign-law bonds have largely been denominated in US dollars, with smaller shares in British pounds, Euros, yen, and Swiss francs. Eurobonds refer only to those bonds denominated in the currency of a jurisdiction other than the one in which they are issued, e.g., US dollar-denominated bonds issued under English law in London.

This isn't unique to SSA: yield-driven investors have piled into and out of external bonds across emerging and frontier markets. Even Ecuador, which defaulted in 2008 and 2009 on debt it deemed "illegitimate", was able to return to international bond markets in 2014 with a US\$2bn 10-year issue that, at a 7.95 per cent yield, was oversubscribed.

The fact that international bond market debuts have followed so closely on the heels of debt restructurings implies a deep case of amnesia amongst policymakers, investors, and market cheerleaders. Eight of SSA's countries that recently made foreign bond issues or private placements emerged from debt write-offs only a few years before under the Heavily Indebted Poor Countries (HIPC) and Multilateral Debt Relief Initiative (MDRI) debt relief programmes. Those write-offs were a recognition that even over a very long horizon, deeply concessional loans were too expensive for these countries to manage sustainably. Between 1996 and 2007, donor governments and multilateral financial institutions agreed to write off approximately US\$75bn in debt owed by 36 poor countries around the world. Each country received a clean slate to invest in development. Just a few years of fresh borrowing at historically low rates has already pushed many low-income countries back into trouble. The IMF estimates that some 40 poor developing countries are in medium to severe debt distress. The next debt crisis is already brewing. In short, poor countries should not try to borrow their way to development.

The remainder of this note lays out steps that SSA countries can take to "futureproof" their debt against payment problems and make themselves more resilient to sovereign debt distress.

## I. PREPARE FOR THE WORST

SSA's external bond issuers should begin hedging their foreign currency exposure and building sinking escrow funds into which they make regular, budgeted payments to ensure that sufficient resources will be available to retire a substantial share of these bond series in the event they cannot be rolled over on affordable terms at maturity. As the data in Table 1 show, the tenors on most recent SSA external bonds are not long enough, in the context of weak commodity demand, to allow SSA's borrowing countries to generate easily the surpluses needed to cover the principal amounts coming due on maturity: the weighted average maturity at issue was 11.8 years; the weighted remaining residual maturity on these bonds is currently only 9.2 years. Most SSA issuers will try to rollover their bonds on maturity, but their creditworthiness could look weaker in a period of reduced commodity demand, normalizing developed-market yields, and a stronger US dollar. Rollover may be either prohibitively expensive or impossible when the time comes.

Rather than issuing more external bonds, low- and middle-income SSA countries should seek external grants and long-dated deeply concessional loans to finance future productivity enhancing development projects. They may even consider using such financing to buy-back some portion of their outstanding external bonds during market sell-offs. Active liability management and improved public debt management units should precede any additional external bond issuance.

Finally, SSA countries should join the BRICS, the Gulf states, and other newly emerging economies to press for changes to make more inclusive the "soft law" infrastructure by which sovereign debt restructurings are conducted. A venue that includes established creditors, new creditors, debtor countries, private creditors, implicit creditors (i.e., public pension holders, public servants, *et al.*) should be created along the lines of the Sovereign Debt Forum (SDF) proposed by Gitlin and House (2014) to provide a more effective discussion, negotiation, and research centre for improving the ways the world deals with instances of sovereign debt distress.

## II. SWAP EXISTING EXTERNAL BONDS AND CHANGE THE WAY FUTURE DEBT IS ISSUED

SSA countries that have issued external bonds should consider launching swaps to replace this paper with bonds bearing the more robust contractual language recently published by the International Capital Markets Association (ICMA) and endorsed by the International Monetary Fund (IMF). In August 2014, the International Capital Markets Association (ICMA) published improved model contractual language (ICMA 2014) for collective actions clauses (CACs) that enables cross-series aggregation, along with additional recommended language that provides for reasonable and consistent thresholds on acceleration, commitments on information transparency, structured engagement with bondholders through creditor committees, and proscription of the ratable payments interpretation of standard *pari passu* clauses, the very problem that has allowed creditors holding bonds that were not included in the 2005 and 2010 Argentina debt restructurings to pursue the government in Buenos Aires through the New York courts. With the exception of partial inclusion of these terms in recent issues by Ghana (*pari passu*) and Ethiopia (CACs and *pari passu*), no SSA external bonds include the full spirit or letter of the ICMA model language. In October 2014, the IMF (2014) endorsed most of the ICMA proposals, with the exception of the provisions on debtor support for creditor committees. While most SSA external bonds were issued under English law and, therefore, are subject to CAC provisions, the relatively small size of these series make them vulnerable to blocking minorities of creditors in the event of an attempted restructuring. Such minorities prevented the activation of CACs in about half of Greece's English-law external bonds in 2012; the bonds were not restructured and creditors have been paid in full using IMF and European institutions' funds. SSA external bond issuers should act now to avoid a similar possible fate.

Future bond issues should be structured to make the payments due on these bonds contingent on the issuing country's economic performance. SSA countries' macroeconomic indicators are closely tied to commodity prices and are, therefore, particularly volatile. Tying principal and interest payments on external bonds to key macro variables would provide for automatic standstills during difficult periods and compensation to creditors in good times. This could be

achieved through two types of bonds: (1) sovereign “cocos” (that is, contingent convertibles), bonds that automatically wger linked to a liquidity crisis. Martin Brooke *et al.* (2013) propose tying activation of a sovereign bond’s coco provisions to initiation of an IMF-supported program, but other triggers more removed from the sovereign’s discretion, such as ratings downgrades, increased collateral requirements on a sovereign’s debt, or violation of a pre-specified floor on official foreign-exchange reserves, would make more sense; and (2) GDP-linked bonds with provisions that tie principal and/or interest payments to a country’s GDP. They could also be linked to global or regional growth, key commodity prices, global interest rate indices, or other major aggregates that materially affect the financial health of the sovereign, but are outside the government’s discretion

SSA external bond issuers should also move away from the standard practice of issuing bullet bonds and move toward bond structures that amortize gradually over time. It makes little sense, particularly in relatively volatile, resource-dominated economies, to assume that the funds necessary will be available to repay the entire amount of a medium- or long-term bond on a single, specific day some ten years in the future.

### III. DEVELOP DOMESTIC MARKETS

While domestic borrowing is by no means a panacea for the financing needs of SSA countries’ governments (Panizza 2007), a great deal more should be done to develop SSA domestic capital markets before further recourse is made to external borrowing. More SSA countries should follow the example of Uganda, which consciously chose in August 2014 to focus on local market development and issuance rather than rush prematurely into external bond markets.

SSA countries should work with the World Bank, International Finance Corporation (IFC), the African Development Bank (AfDB), and other multilaterals to increase their bond issuance under local SSA law and denominated in a wider variety of SSA currencies.<sup>3</sup> This is a particularly effective way to build a benchmark local yield curve while also generating efficiently priced financing for these institutions. Preparing for such issuance provides a natural and compelling opportunity to enlist these organizations’ technical assistance in improving local capital market legislation, regulation, institutional structures, and depth. Rather than causing crowding out, the experience of several emerging markets in the 1990s, such as Greece and South Africa, implies that such issuance attracts substantial foreign capital and expertise to domestic markets.

<sup>3</sup> The World Bank, for instance, has issued in Botswanan pula, Ghanaian cedi, Nigerian naira, South African rand, Ugandan shilling and Zambian kwacha; the IFC in CFA francs and Rwandan francs, as well as naira and shillings.

### IV. PRESS THE G7, G20, AND IFIS TO SUPPORT CHANGE

Every one of these suggestions could be accomplished more easily with enabling support from the G7, G20, and the IFIs. Debt swaps and buy-backs; moves to issue amortizing and state-contingent bonds; creation of a Sovereign Debt Forum; and domestic capital market development would all advance more quickly if SSA countries could pursue these goals in the wake of leadership and precedent provided by the G7 and G20 countries. G7 and G20 countries should also be pressed to refine further lending and borrowing codes drafted by the Institute of International Finance (IIF, 2012) and UNCTAD (2012) to ensure they provide symmetric expectations of both creditors and debtors, while at the same time receiving wider endorsement from a diverse range of stakeholders. They should also be pressed to immunize further their payment systems from attachment by holdout creditors and make certain the dispute-settlement mechanisms under investment and trade treaties cannot be used to pursue debtor governments that attempt to restructure their debt (St John and Woods 2014). Obviously, completion of the 2010 package of IMF reforms would also help all countries to futureproof themselves sovereign debt distress.

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# Capital account openness and macroeconomic management

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The scale (both levels and rate of growth) of international capital flows is truly immense. Total private non-resident capital flows to emerging markets in 2014 have been estimated at USD1.1 trillion<sup>1</sup>. This is slightly below the all-time high of USD1.35 trillion in 2013, but compares to only USD200 billion in the year 2000. This represents compound nominal annual growth of 12.5 per cent, increasing the share of capital flows relative to emerging market GDP from about 1.5 per cent to over 7 per cent. Of course, much of this total is accounted for by major emerging markets/countries, notably China. But the smaller economies are also seeing the benefits and possible costs of greater integration into global capital markets. In sub-Saharan Africa (SSA), this is most clearly indicated in the range of countries that are now benefiting from access to international bond markets.

In Botswana, there has been de jure capital account openness since 1999, when the process of removing all foreign exchange controls was finally completed<sup>2</sup>. In taking this step, the authorities' confidence was bolstered by substantial foreign exchange reserves that, at the time, amounted to more than 100 per cent of GDP, limiting any vulnerability to external shocks. But the decision was also made in clear recognition of the tremendous potential advantages arising from the free movement of capital. This is not just in terms of attracting foreign funds for domestic investment, but also expanding the opportunities available for domestic savers. On the latter, a major development in the subsequent period has been the growth of pension funds in Botswana, with the freedom to invest as much as 70 per cent of assets offshore.

The uncertainty and, at times, turbulence that have characterized global financial markets in recent years have understandably been a matter of concern to developing economies. The opportunities arising from the "search for yield" on a global basis have been accompanied by the risks of a subsequent "flight to quality". At the same time as developments in information and communications technologies make money and capital markets evermore interconnected, major central banks have resorted to large-scale quantitative easing (QE).

This has obviously been based on the needs of their domestic economies, with little consideration of the wider consequences. Thus, in mid-2013, the so-called "taper tantrum", as the Federal Reserve Bank prepared to conclude its last round of QE, led to volatility in several major emerging markets (EMs); more recently, the announcement of a new QE programme by the European Central Bank (ECB) has had consequences for monetary policy in other European countries. If the finely tuned machine that is the Swiss National Bank can be challenged by such developments, the concern among other policymakers is understandable.

There are two possible responses to greater de facto openness of capital flows. One is to try and limit this trend by introducing more effective capital controls; the other is to accept the reality of the changed environment and adopt policy options accordingly. Of these, the latter is clearly to be preferred. A major reason for the increased integration of sub-Saharan African countries into global capital markets (and their reduced dependence on bilateral aid and the Bretton Wood Institutions for support<sup>3</sup>) is their own recent track record of success. These countries cannot expect to bask in the reflected glory of the so-called "Africa rising" and then pick and choose from the consequences. In the long run, this would serve only to retard future development.

This is not to say that all countries should immediately remove all capital controls or that new or strengthened controls should never be considered in any circumstances. But the process towards increasing liberalization should not, in general, be resisted.

A respectable argument in support of tougher capital controls might be the need to counter the effects of "contagion"; that is, the destabilization arising from indiscriminate capital inflows and outflows. This is certainly not something to be ignored, especially, perhaps, in Africa, where "guilt by association" remains a recurring hazard. This was clearly seen in the recent Ebola outbreak, where tourism across Africa was adversely affected, regardless of countries' proximity to the disease. Similarly, herd-like responses in financial markets are a reality, and policymakers in advanced economies should not be absolved from the potential for collateral damage arising from their actions. But risks of contagion are also easily overstated, perhaps sometimes deliberately so as a distraction from more fundamental shortcomings of domestic policy. Indeed the recent research on the "Taper Tantrum" concluded that:

*"Eventual differentiation in market pressure during the taper talk phase was mostly based on fundamentals in EMs. Although market reaction was indiscriminate during the initial*

<sup>1</sup> Institute of International Finance (IIF), Capital Flows to Emerging Markets, 14 January 2015, available at: <https://www.iif.com/file/7774/download?token=8otRZndV>

<sup>2</sup> However, some degree of de facto friction in cross-border capital flows remained. Notably, exchange controls remain in place to this day in neighbouring South Africa, which dominates the regional economy.

<sup>3</sup> For 2014, it is estimated that non-resident capital inflows to Africa and the Middle East totalled USD100 billion. Of this, only USD6 billion was due to official inflows.

*bout of volatility in May-June 2013, these reactions were short-lived. Market differentiation occurred during the subsequent bouts of volatility. Investors focused particularly on countries with larger external financing needs and macroeconomic imbalances.”<sup>4</sup>*

The clear lesson from this is that, first and foremost, EMs should concentrate on getting the basics of policy right, including any adjustments that need to be made in light of the greater openness of their economies<sup>5</sup>. If macroeconomic policy is designed and implemented on a sound basis, then capital flows will respond favourably to the resulting stability. A further need is to ensure that adequate buffers are accumulated, sufficient to counter short-term volatilities.<sup>6</sup>

A particular challenge, relevant to an increasing number of countries in SSA, is to frame appropriate policies (fiscal policy in particular) in terms that are relevant for the exploitation of non-renewable natural resources. The focus should be on effective intergenerational budgeting, with a strong emphasis on credible mechanisms and institutions (sovereign wealth funds, for example). This is to counter the temptation to spend future revenues before they are realized; the impact on some countries of the recent slump in international oil prices provides a clear warning of the dangers of such an approach.

Similarly, if microeconomic policies prioritize the creation of a conducive environment for promoting investment, then the risks of over-reliance on short-term portfolio flows should be mitigated. In this respect, a further disadvantage of more intrusive capital controls is that they can be undermined by administrative inefficiencies that have a variety of corrosive effects, both undermining the effectiveness of the controls, while, at the same time, impacting negatively on the general business environment. In addition, capital controls are also vulnerable to regulatory capture and rent-seeking by those (sometimes including governments) who seek to access a cheap, “captive”, source of finance. Policies to restrict the options for offshore investment by domestic savers may be particularly at risk in this regard.

Regarding macro-prudential policies, these remain very much in their infancy, with both practitioners and academics divided over their usefulness. For emerging markets, with relatively undeveloped, “vanilla” financial sectors, the emphasis should again be on doing the basics well. In this regard, the more

explicit prioritization in many countries of financial stability as a matter of concern for monetary authorities is an unequivocally welcome development. Development of effective capacity in this area should go a long way toward instilling the necessary confidence. While interventions at the macro level cannot be ruled out, they are not a substitute for effective micro-prudential supervision, encompassing both banks and non-bank financial institutions.

<sup>4</sup> Emerging Market Volatility: Lessons from the Taper Tantrum”, IMF Staff Discussion Note 14/09, October 2014.

<sup>5</sup> This would include recognizing the increasing relevance of the “Impossible Trinity”, thus limiting the possibilities for operating independent monetary and exchange rate policies.

<sup>6</sup> For this reason, in Botswana the emphasis of fiscal policy is currently on running budget surpluses to strengthen the government’s net financial position following an unprecedented series of deficits from 2008/09 to 2011/12.

# Capital account policy experience – learning and growth in Africa<sup>1</sup>

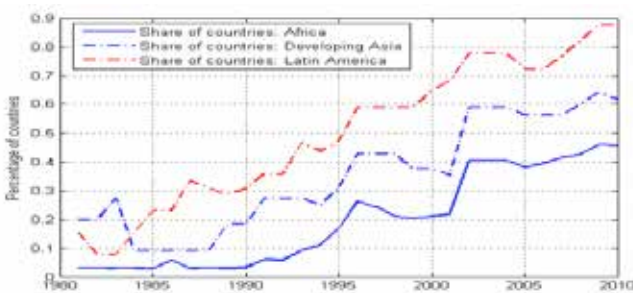
**Mthuli Ncube**

Blavatnik School of Government, University of Oxford

## I. BACKGROUND

Africa, like other developing regions, has experienced a surge in private capital inflows since the early 2000s<sup>2</sup>. Net private capital inflows to Africa exceeded official flows several times over. Over time, developing regions (Africa, Latin America and developing Asia) increased capital account openness not only in *de facto* (flows) but also *de jure* (regulations) terms (Figure 1). With the low savings rates and substantial investment needs that characterize many African economies, capital inflows are an indispensable source of financing in Africa (and Latin America), in contrast to developing Asia (Figure 2).

**FIGURE 1. EVOLUTION OF THE REGIONAL SHARE OF CAPITAL**



## ACCOUNT LIBERALIZATION

While larger capital inflows can stimulate higher growth, they often also bring macroeconomic challenges such as high inflation and real exchange rate appreciation. Their sudden reversals have led to growth collapse and major exchange rate volatility, or even crises.<sup>3</sup> Until recently, relatively stable foreign direct investment accounted for most of capital inflows to Africa. Managing volatile capital flows has not yet created a major policy challenge in Africa, not even during the global financial crisis.<sup>4</sup> Yet with deeper financial integration, Africa's frontier markets are becoming vulnerable to global financial shocks and portfolio outflows<sup>5</sup> Effective management of the financial integration and volatile capital flows is becoming an important policy priority.

<sup>1</sup> Drawn from analysis in Z.Bicaba, Z.Brixiova, and M.Ncube(2015), Capital Account Policies, IMF programs and Growth in Developing Regions, African Development Bank and William Davidson Institute Working paper 1085, University of Michigan.

<sup>2</sup> See African Economic Outlook 2014, AfDB, OECD, UNECA, UNDP

<sup>3</sup> Ncube, M.; Ndou, E., and Gumata, N. (2012), 'How are the US Financial Shocks Transmitted into South Africa? Structural VAR evidence,' AfDB Working Paper 157.

<sup>4</sup> See Brixova and Ndikumana (2013), The Global Financial Crisis and Africa: the Effects and Responses, in handbook of Political Economy of Financial Crises (edited J.Epstein and M. Wolfson, OUP)

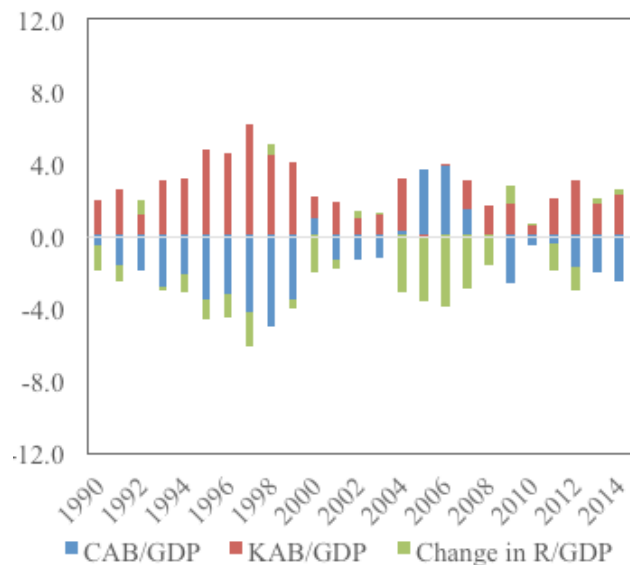
<sup>5</sup> International Monetary Fund (2013), 'Managing Volatile Capital Flows: Experiences and Lessons for Sub-Saharan African Frontier Markets', IMF Regional Outlook for sub-Saharan Africa 2013 (October), IMF: Washington, DC

Against this background, how can African policymakers optimize the growth benefits of capital inflows while mitigating their cost? Has the move towards greater capital account liberalization been beneficial in terms of growth? The impact of capital account policies on growth has long been the subject of policy controversy. Policymakers in different countries and institutions have had different views on the growth impact of capital account liberalization, and the trade-offs between growth level and volatility. These views change over time based on experiences:

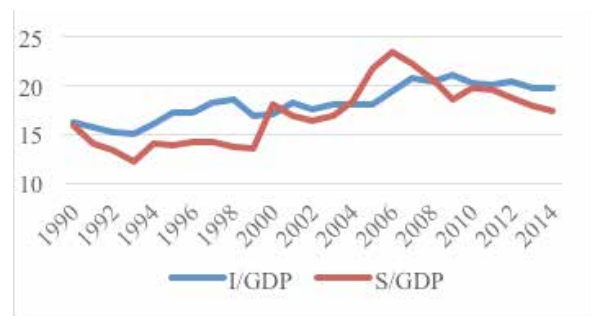
*'...The IMF once advocated the removal of all controls on outflows and inflows in the hey-days of the Washington Consensus in the 1990s. The Asian Crisis of 1997-1998, however, initiated a slow process of conversion that culminated with the IMF's recent decision to explicitly and openly support the imposition of controls on capital inflows....'* (Jinjarak et al., 2012)

**FIGURE 2. CAPITAL FLOWS, RESERVES AND SAVINGS-INVESTMENT GAP (% OF GDP), 1990 - 2014**

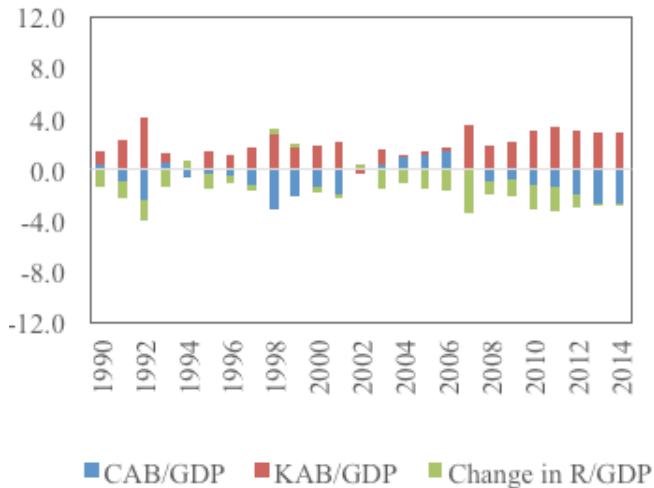
### 2a. Africa – capital flows



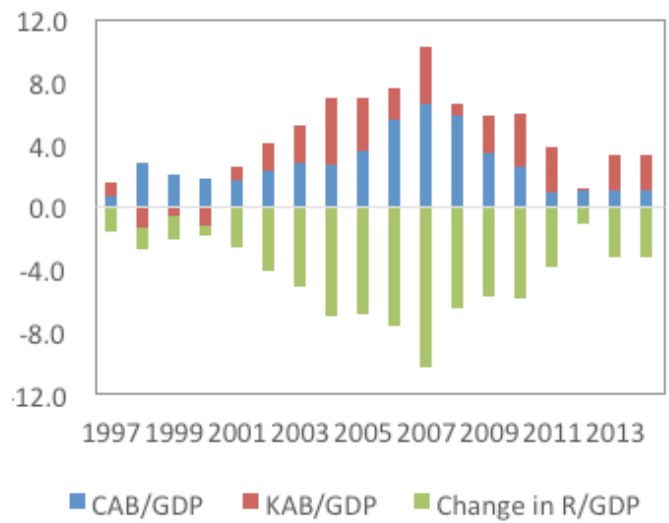
### 2b. Africa – savings-investment



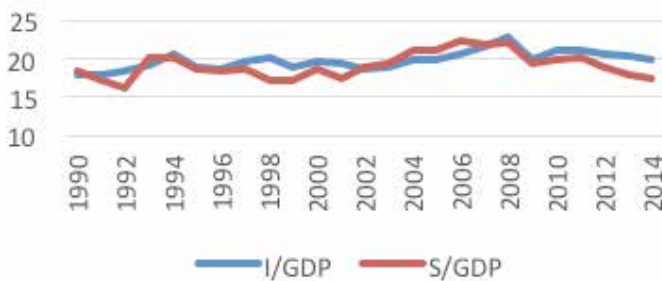
2c. Latin America – capital flows



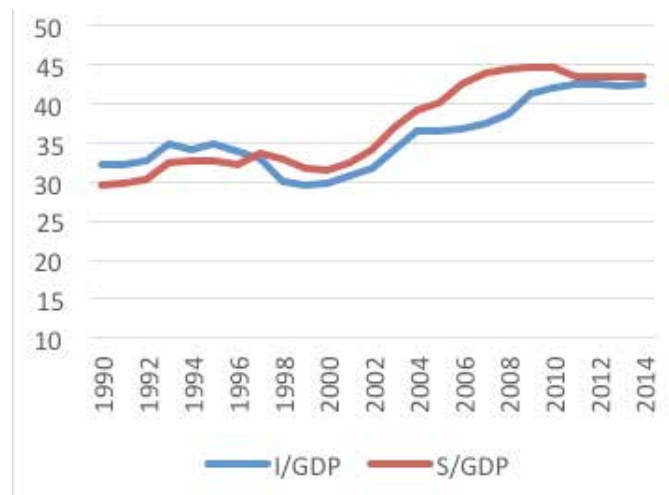
2e. Developing Asia – capital flows



2d. Latin America – savings- investment



2f. Developing Asia – savings - investment



Source: Authors' calculations based on the IMF WEO database.

Over time, policymakers' views on capital account policies have evolved from favouring liberalization under the Washington Consensus to recognizing the usefulness of capital flow restrictions in specific circumstances. The global financial crisis reinforced the message that full capital account liberalization may not be the right goal for all countries at all times. In fact, in 2013 the IMF acknowledged the usefulness of capital account controls during a financial crisis or when the crisis is imminent (IMF 2013b). Studies show that whether capital controls or liberalization are optimal depends on the shocks received.<sup>6</sup>

II. KEY ISSUES

In a forthcoming paper with Zorobabel Bicaba and Zuzana Brixiova we examine the uncertain impact of capital account policies on growth using an *adaptive learning* framework,<sup>7</sup> drawing on the models of Bicaba and Coricelli (2014) and Buera *et al* (2011). In this framework, policymakers choose capital account policies (liberalization or controls) to maximize growth. Their choices are constrained by the 'Mundell's trilemma' – the ability to reach only two goals among financial liberalization, fixed exchange rate and monetary autonomy. In addition to past growth outcomes, policymakers'

6 Farhi, E. and Werning, E. (2012), 'Dealing with the Trilemma: Optimal Capital Controls with Fixed Exchange Rates,' NBER Working Paper No. 18199.

7 Bicaba, Z. T. and Coricelli, F. (2014), 'Learning to open up: capital account liberalization in the post-Bretton Woods era', CEPR Working Paper. &

Buera, F. J., A. Monge-Naranjo, and G. E. Primiceri (2011), 'Learning the wealth of nations,' *Econometrica*, 79, 1-45.



policy choices have also been influenced by IMF programs. The model is calibrated to data from Africa, Latin America and developing Asia for policymakers' initial beliefs about the impact of capital account policies on growth. These beliefs are updated each period based on policies undertaken, presence of the IMF programs, and the growth outcomes.

Capital account policies raise uncertainty about growth and other macroeconomic outcomes for several reasons. First, they alter the overall economic environment, but the precise impact on incentives and outcomes will be known only with time. Second, capital flows raise the exposure of the economy to external shocks. Third, due to their pro-cyclicality, capital flows exacerbate negative shocks to the domestic economy. The adaptive learning framework is particularly suitable for developing countries, where policymakers face a greater uncertainty than those in advanced economies regarding the impact of policies on growth.

Reflecting these and other uncertainties we seek to answer the following questions using the *adaptive learning* framework:

- i Does an *adaptive learning* approach capture the paths of capital account policies in developing regions, including the delayed liberalization in Africa?
- ii How do IMF programs impact countries' learning about capital account policies?
- iii Under what conditions might countries with liberalized capital accounts introduce capital controls?
- iv What capital account regimes should African countries adopt?

### III. EVIDENCE AND POLICY IMPLICATIONS

Empirical analysis of key stylized facts pertaining to capital flows, IMF programs, and growth reveals that African economies seem to face greater uncertainty regarding growth outcomes of policies. This is shown, for example, in the discrepancy between the forecast and actual growth in 1990 – 2011 (Table 1). Such uncertainty makes the learning framework relevant for Africa and developing countries in general.

**TABLE 1.** ESTIMATES OF BIAS FORECASTS OF GDP

	1990 - 2011	1990 - 2011 (without outliers) (percentage points)
Advanced Economies	0.07	0.10
Africa	-0.77	-0.43
Developing Asia	-0.02	0.18
Latin America	-0.24	-0.12

**Source:** Genberg and Martinez (2014).

Regarding the impact of IMF programmes on capital account policy choices, we do not find the programs to be systematically associated with capital account liberalization. Analysis of specific IMF programs shows that some types of programmes (Stand-By Arrangement (SBA) and Extended Fund Facility (EFF)) in fact had a negative (and statistically significant) impact on capital account openness in Africa (Table 2). This confirms findings in the literature about IMF programmes and capital account liberalization.<sup>8</sup> It is still an open question whether the capital account policy choices undertaken under IMF program result in better and more accurate (expected) growth outcomes.

<sup>8</sup> Joyce, J. P. and Noy, I. (2008), 'The IMF and the Liberalization of Capital Flows', *Review of International Economics*, 16(3), 413–430

**TABLE 2. IMF PROGRAMS AND CAPITAL ACCOUNT OPENNESS**

	Africa			Latin America			Developing Asia		
	(1)	(2)	(3)	(1)	(2)	(3)	(1)	(2)	(3)
Stand-By Arrangement (SBA5)	-0.176*** (0.0180)			-0.151*** (0.0417)			-0.224*** (0.0470)		
Poverty Reduction and Growth Facility (PRGF5)		0.0848*** (0.0210)			0.280*** (0.0624)			0.106** (0.0531)	
Extended Fund Facility (EFF5)			-0.148*** (0.0298)			-0.133*** (0.0456)			-0.0746 (0.0618)
Observations	1,352	1,352	1,352	589	589	589	391	391	391
N	44	44	44	19	19	19	13	13	13
Fixed effects and constant	YES	YES	YES	YES	YES	YES	YES	YES	

Note: Standard errors in parentheses, \*\*\* p<0.01, \*\* p<0.05, \* p<0.1. This table shows the results of a linear probability model linking capital account openness and IMF programs. This model controls for individual effects. SBA5 is a dummy variable for IMF Stand-by-Arrangement in effect for at least 5 months in a particular year. PRGF5 is a dummy variable for IMF Poverty Reduction and Growth Facility Arrangement in effect for at least 5 months in a particular year. EFF5 is a dummy variable for IMF Extended Fund Facility Arrangement in effect for at least 5 months in a particular year.

Further, applying the *adaptive learning* approach, we find that the framework reflects capital account liberalization paths relatively well, including Africa's delay in liberalization relative to other regions.<sup>9</sup> The accuracy of policymakers' beliefs about the impacts of capital account policies on growth has also improved over time. One of the findings is that even countries with a liberalized account can revert to capital controls in the presence of particularly large output shocks. Further, the outcomes of capital account switches are closer to policymakers' expectations in countries with the IMF programs. However, this may also be attributable to the number of policy measures contained in IMF programmes besides changes in capital account regimes, pointing to the need for complementarity of policies. Capital account policies in Africa tend to change more often than in other regions, creating policy uncertainty for economic agents. This underscores the importance of building stronger policymaking institutions and rules in the region to mitigate this high volatility.

Regarding capital account policies, generalizations for a continent as diverse as Africa are clearly likely to be simplistic or even unsuitable, as no single capital account regime can be appropriate for all countries at all times. Still, several points are worth highlighting.

- First, capital flows to Africa have so far not reached levels needed to close the savings–investment gaps. Hence attracting private capital flows is a key policy objective for the majority of African countries.
- Second, as Africa becomes more integrated into the global financial markets, the issue of capital flows management will gain even more attention. A flexible macroeconomic framework can help to mitigate possible negative consequences of large capital flows. Such flexibility can be achieved through building fiscal buffers and foreign exchange reserves during booms. Where suitable, more flexible exchange rate regimes would also help in managing macroeconomic impacts of capital flows.
- Third, even if macroeconomic frameworks and policies are sound, large surges in capital flows can result 'sudden stops' due to changes in investors' sentiments. In such cases, targeted controls especially at short-term inflows could be considered. However, it is not clear how quickly temporary capital controls can be imposed relative to other measures, and to what extent they may become semi-permanent. The large disparities between the *de jure* and the *de facto* capital controls suggest that capital controls lose their effectiveness over time as agents learn to bypass them. Even if capital controls are the right option, the timing of their introduction matters. For example, Blanchard and Ostry (2012) suggest that capital controls should be introduced after other measures have already been applied.<sup>10</sup>

9 Other factors, such as limited capacity to establish conditions for capital account liberalization, played a role.

10 Blanchard, O. and Ostry, J.D. (2012), 'The multilateral approach to capital controls', Vox Working Paper, December 2012, <http://voxeu.org/article/multilateral-approach-capital-controls>

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# Capital account openness and macroeconomic management

## Alain Nkontchou

Enko Capital

The increase in cross-border capital flows across Africa is directly linked to the spread of capital account openness. The positive experience of industrial countries that opened up to international capital flows since the early 1980s and the boom in emerging market economies during the first half of the 1990s bolstered the argument that an open capital account promotes development and growth.

Capital account openness has become an important policy choice in an increasingly integrated global economy. Indeed, theoretical and empirical evidence suggest that capital account liberalization:

- Promotes a more efficient global allocation of capital, as the flow of resources reduces cost of capital in the liberalizing/recipient countries, thereby increasing investment and raising economic output.
- Enables African countries to cushion fluctuations in national incomes and smooth out consumption levels.
- Facilitates the transfer of technological and managerial know-how, encourages competition and financial development.

However, openness to international capital flows can be especially dangerous if the appropriate controls, regulatory apparatus and macroeconomic frameworks are not in place. This suggests the need to carefully manage and sequence liberalization in order to minimize risks.

From a macroeconomic standpoint, capital account openness signals a country's commitment to credible fiscal and economic policies, since deterioration in the policy environment could lead to capital flight and economic imbalance.

In that respect, capital account liberalization provides a strong incentive to policy makers to adopt and maintain sound macroeconomic policies with obvious benefits for long-term growth.

## EFFECTS OF CAPITAL ACCOUNT OPENNESS ON CENTRAL BANKS' MONETARY POLICY

From a monetary policy perspective, capital account openness in many African countries has de facto led monetary policy to target the exchange rate as an essential mean to achieve stable inflation.

Indeed, most central banks in African countries where the capital account is liberalized have an implicit exchange rate target in their monetary policy, due to the high component of imported goods in the CPI (Consumer Price Index). In order to ensure continuous capital inflows to fund the current account, they tend to keep high real rates at the front end of the yield curve.

Hence the monetary policy in African countries with an open capital account tends to be more restrictive in order to allow for a stable currency. Yet, the impact on economic growth of this high real yield is relatively muted due to the low level of debt creation in most African economies.

## REAL YIELDS ACROSS AFRICAN ECONOMIES, COMPARED WITH EURO AND US YIELDS

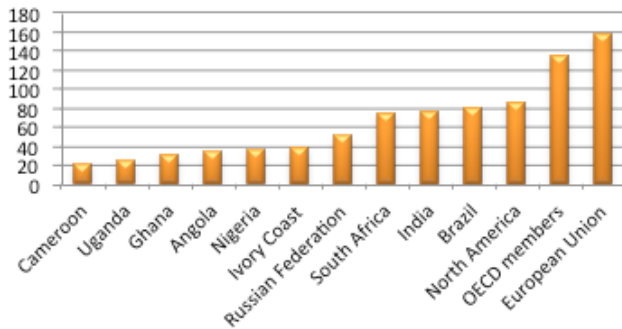
	Real Interest Rates	3 Month Rates
Country		
Euro	0.65%	0.04%
US	0.14%	0.26%
Egypt	3.6%	11.8%
Ghana	10%	25%
Kenya	2.3%	8.3%
Nigeria	6%	14%
Rwanda	3.7%	4%
South Africa	0.8%	6.1%
Uganda	3.4%	10.2%

## LOW DEBT FORMATION IN AFRICA

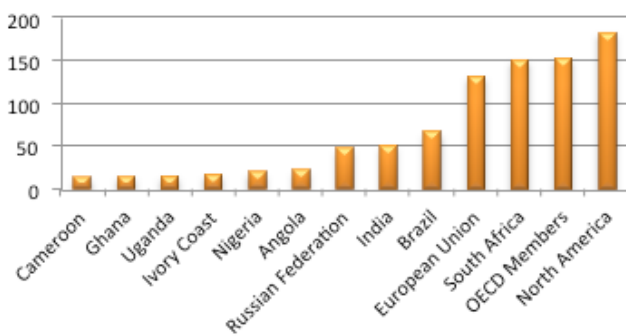
Low credit formation in Africa, especially in the sub-Saharan region, due to:

- Lack of efficient collateral recovery
  - Lack of centralized and regular credit information
  - Limited access to long term funding
  - Asset based lending
- Low level of financial intermediation has created a severe shortage of private sector credit. As a result, non-bank lending is increasing.

**Money and quasi money  
(M2) as % of GDP (2012)**



**Domestic Credit to Private Sector  
(% of GDP, 2012)**



### WHAT LESSONS CAN BE LEARNT ABOUT THE DESIGN OF RELEVANT MACRO-PRUDENTIAL MEASURES FOR AFRICAN ECONOMIES?

African countries could learn a great deal from recent experiences of the Global Financial Crisis and also from the 1990s crises in emerging markets.

- Global shocks can affect countries with an open capital account with a larger magnitude even when they may not be part of the original cause of the crisis. As the financial crisis of 2008 has shown, in such an environment there are few macro policies that could cushion such external shocks.
- African and other emerging economies have not yet been able to properly leverage financial market flows, since capital flows into these economies are clearly pro-cyclical. Indeed international investors tend to be keen to lend in 'good times,' only to retreat in 'bad times' and thereby exacerbate macroeconomic imbalances.

### MACRO-PRUDENTIAL MEASURES

- For countries where there is a significant positive relationship between capital liberalization and economic growth, it is advisable that capital account liberalization should happen in stages. Essentially, long-term flows should be liberalized before short-term flows.
- Trade policy should be complementary to account liberalization efforts.
- Market depth, financial system architecture and managerial infrastructure should be reinforced in order to reap the benefits of liberalization and ensure the economy's resilience.
- Macro policy (fiscal and monetary) has to be sound and credible in order to win markets' and investors' confidence over the long term.
- Sound fiscal policy (cyclically adjusted budget deficit cap) and credible monetary policy (stable inflation) have to be enshrined in macro policy.
- Whenever there are conflicting choices between domestic interest and external environment, the domestic interest has to prevail over the long term.
- Sound counter-cyclical macro policies to strengthen macro stability and support growth should be implemented. This was demonstrated in 2008, as African economies were for the first time able to stimulate their economies to cushion the effect of the Global Financial Crisis.
- A minimal tax on capital flows could limit the volume of outflows in periods of high pressure, contain currency depreciation, and support counter-cyclical policies.

# Capital account openness and macroeconomic management

## Giulia Pellegrini

JP Morgan

### THE EMERGENCE OF A NEW ASSET CLASS – FRONTIER MARKETS

In recent years, the macroeconomic dynamics of so-called Frontier Markets (FMs) have increasingly been driven by capital account phenomena. This has become evident also in sub-Saharan Africa. African FMs have seen a surge in interest. Some observers have attributed this to a structural shift – a “new normal” – that sees African FMs as in the process of turning into a more mainstream investment destination. This structural change has been the result of better macro management and still wide growth differentials with Developed Markets (DMs). Others point out that the surge in capital inflows into FMs has been contingent on DMs’ Quantitative Easing programs, hence the need to brace for upcoming policy normalization, at least in some DMs.

Either way, over the past decade capital account openness has increased de facto in sub-Saharan Africa. Capitalizing on strong growth, a cleaner balance sheet after a wave of debt relief programs, interesting demographics, and the global search for yield, many African countries have made their debut on the international capital markets, moving the spotlight onto previously less renowned investment opportunities. We have also seen foreign investors positioning in African FMs’ domestic debt and equities markets. Finally, some timid signs have emerged of FDI flows into the continent diversifying away from the resource sector, while official development assistance has been declining as a portion of capital inflows as countries’ income levels rise. Since 2010, all these trends have been taking shape with renewed impetus, but concomitantly we have also witnessed deterioration in certain sovereign balance sheets amid expansionary fiscal stances that have led in some cases to the rebuilding of debt stocks. African FMs are now facing the challenge of the end of the commodity super cycle against the backdrop of weaker balance sheets. Whether international investors’ interest in Africa is, indeed, the “new normal” or whether countries will be left to manage the pitfalls of a sustained reversal in capital flows is an open question. While there is no doubt that this emerging asset class has become more established, the answer to that question will also depend on countries’ policy responses.

### CAPITAL FLOWS IN THEORY...

Capital flows can facilitate more efficient savings mobilization for productive investment, which is especially important in Africa considering the continent’s infrastructure gap.

This productive investment provides a boost to the recipient’s economic growth (Quinn & Toyoda, 2008) and helps consumption smoothing in capital-exporters. Higher capital account openness has also been linked to more competitive financial sectors (Klein & Olivei, 2008). However, it comes with risks that can be magnified, especially at times of stress, by shortcomings in countries’ financial sector and, more generally, institutional infrastructure. Indeed, critics of capital account liberalization have pointed out that liberalization is more beneficial if countries have already reached certain levels of financial and institutional development (Rodrik, 2008; Eichengreen, 2001) as surges or rapid outflows of capital, particularly if of a short-term nature, can result in policy challenges that may be especially difficult to manage in FMs. Sharp exchange rate movements and financial stability issues often arise in countries that experience significant capital outflows, especially over a short period of time. Debt sustainability issues may also result, especially if appropriate policy adjustments are not made to deal with changing capital flow dynamics in the medium-term. Appropriate policy responses to capital flow reversals include sound macroeconomic management; careful financial supervision and macro prudential measures; and, in some cases, capital flow management measures. As African FMs have become more integrated with the global financial system, more attention will need to be paid to macro management and macro prudential measures within the context of enhanced cross-border coordination, in such a way as to minimize the need to make recourse to capital controls in order to manage any vulnerabilities arising from sudden capital flow reversals. Challenges such as limited policy space and lower levels of local capacity and institutional development complicate such efforts.

### CAPITAL FLOWS TO AFRICAN FMS – SOME HIGHLIGHTS

From 2010 to 2012, average net private flows into African FMs rose five-fold – albeit from a lower base – to around US\$26bn, when compared to 2000–2007 (source: IMF). Although FDI contributed to this surge, cross-border bank flows and portfolio flows rose noticeably.

Since 2010, the largest African FM recipients of portfolio inflows have been Nigeria, Ghana, and Zambia (on a % of GDP basis). More generally, net portfolio flows to African FMs have been twice as large as those to EMs and DMs, at around 2% of GDP and 1% of GDP respectively (source: IMF). The picture has become somewhat more diversified since mid-2013 when first the “Taper Tantrum” caused a global sell-off (somewhat less pronounced in African FMs) and, more recently, the drop in commodities prices has resulted in a significant reversal of portfolio flows. This has been so especially from countries such as Nigeria and Zambia, which have been more significantly impacted by the commodity prices fall.

Cross-border bank lending to African FMs has risen by 4.5 times since 2010 but deposits in foreign banks have also

grown steadily so that these economies have remained net lenders vis-à-vis their foreign counterparts. FDI into sub-Saharan Africa has been rising too, since 2010. It was up by 5% year-on-year (y/y) last year, to a provisional US\$34.6bn. The increase was mainly driven by Southern (97%y/y) and Eastern Africa (15%y/y), while Central (-18%y/y) and West Africa (-14%y/y) saw net outflows. Most FDI went to oil and gas but investment is increasingly going also to business services, utilities, transport and manufacturing. Notably, intra-Africa investments have been rising, albeit modestly. They increased to US\$12bn in 2013, making up 18% of greenfield FDI on the continent, up from 10% in 2004-2009.

These higher capital inflows have been accompanied by more expansionary fiscal policies across the continent as bond yields declined until mid-2013. They have often gone hand-in-hand also with a surge in local liquidity, which policymakers have responded to via larger Open Market Operations and/or higher cash reserve requirements. Yet private credit growth has remained modest in most African FMs, while some countries have taken advantage of rising inflows to rebuild their foreign exchange (FX) reserve buffers. Nigeria saw FX reserves rising by 34% (US\$12.3bn) from August 2012 to May 2013, as the country gained entry to two international banks' bond indexes.

## DRIVERS OF CAPITAL FLOWS TO AFRICAN FMS

The recent surge in capital flows to African FMs has likely been driven by a combination of healthier economic fundamentals (compared to the 1990s) and poorer returns prospects in DMs and more established EMs. Higher returns in a global low-yield environment, lower correlation to DMs, shallower liquidity and portfolio diversification issues undoubtedly helped support Africa FMs story. J.P. Morgan's NEXGEM Index — a subgroup of frontier markets within the more widely used EMBIG Index — returned 10.6% in 2014, coming second only to the S&P 500 (11.6%) and outperforming Euro High Grade and GBI-EM Local (both at 8.2%). EMBIG/Div-Africa returned 9.7% in 2014 and 2015 has started strong with a 2.3% return to date. Lower correlation with EMs and shallower liquidity also helped cushion African FMs through the mid-2013 sell-off. NEXGEM was one of only three J.P. Morgan-managed indexes closing 2013 in positive territory, at +5.1%, with EMBIG returning -6.6% and GBI-EM Global Div. returning -9.0%. Since J.P. Morgan began tracking the asset class in 2002, NEXGEM has seen only one year of negative returns: 2008.

Yet as the growth differential with DMs narrows and more questions arise around the sustainability of EMs' growth amid recent disappointments; as commodity prices take a plunge and resource nationalization talks or slower legislative progress hinder commodity production on the continent; and as African FM's sovereign balance sheets deteriorate, it is important to maintain sound macro management practices. This will allow African FMs to further capitalize on the

wave of interest by foreign investors amid the latter's need to diversify risk under management. Indeed, recent experience shows that international investors are becoming somewhat more discerning as they become more acquainted with the asset class. This could impact some African FMs' ability to roll over liabilities at manageable interest rates in the future. With foreign investors also increasing their holdings of African domestic debt since 2010, another significant risk is the need to support any outflows amid often-modest FX reserves levels. The experiences of Ghana, Nigeria and Zambia show how foreign investors' appetite for local debt can result in significant swings in portfolio flows. Foreign positioning in Ghana would be around 25% of total domestic debt. However, when considering the 3-5 year portion of the yield curve, foreign ownership rises to around 80%. Foreign ownership of Nigerian domestic debt likely peaked around 20% in mid-2013. Our client survey — tracking institutional investors and corporates with exposure to EMs with assets under management of about US\$1.15tn — shows positioning in Nigerian FX and rates at its lowest since we began tracking that market three years ago. In Zambia, foreign ownership surged last year from virtually zero to around 15% of total domestic debt at end-2014. These levels compare to 18% in Brazil, 22% in Turkey, and 47% in Malaysia.

## MANAGING GREATER DE FACTO CAPITAL ACCOUNT OPENNESS AND CAPITAL FLOWS

The recent drop in commodity prices and the expected start of the Federal Reserve and Bank of England hiking cycles have brought to the fore once again the important question of how to manage capital flows in the context of de facto greater capital account openness in African FMs. Doing so typically requires a mix of macroeconomic policy adjustment — via fiscal, monetary and exchange rate levers; macroprudential measures, especially to contain financial stability risks; and capital flow management measures. The latter are often the most controversial portion of the mix and are generally advisable only for a temporary period. The exact combination of the three depends on the broader context of prevailing economic conditions; the drivers behind capital movements, local capacity, and institutional strength, etc.

Macroeconomic policy adjustment should be the first port of call. This includes assessing foreign exchange reserve adequacy and need to realign the exchange rate with fundamentals; the country's position in the business cycle; and the risks to local banks and corporates' balance sheets. For example, using FX reserves to intervene to stabilize the exchange rate may be appropriate if the driver behind an episode of outflows is of a temporary nature. In the case of a more permanent exogenous shock, a realignment of the exchange rate with economic fundamentals may be warranted. More generally, using the exchange rate as an adjustment valve may be preferable — perhaps containing volatility via direct intervention — before considering measures such as capital controls. The example of Nigeria comes in handy in this context.

In early 2014, the short-lived episode of portfolio outflows that occurred on the back of rising political risk, following the news of former Governor Sanusi's suspension, was appropriately responded to via direct intervention in the FX market to support the naira. The more recent oil price drop appears a more permanent exogenous shock, given the poor outlook for oil prices, and has resulted in a significant readjustment in the USDNGN exchange rate from 155 in October to the current 198.

In 2013 Ghana, with much lower FX reserves and large twin deficits, preferred to delay the adoption of a tighter monetary stance and a currency adjustment, postponing the latter until the following year. The currency depreciated by 65% against the US dollar in the first eight months of 2014. In the meantime, the country looked to attract more capital inflows to support the cedi, boost its FX reserves, and meet the high hard-currency needs of a corporate sector operating in a fast growing economy via the issuance of Eurobonds and domestic bonds available to foreign investors. In Zambia, looser liquidity conditions as a result of an expansionary fiscal policy in 2013, limited appetite to tighten monetary policy, and copper production issues resulted in the kwacha depreciating by 27% in the first five months of 2013. More disciplined public spending and strong policy action by the BOZ in the spring of 2014 helped the currency retrace nearly half of its losses by year-end.

From a policy perspective, the development of a local institutional investor base also warrants attention. Although not a perfect substitute for macroprudential or capital control measures, the ability to tap into an established and deep local investors' base can help to some extent to mitigate the impact of a rapid reversal in portfolio flows. Nigeria's US\$25bn pension industry has helped contain the sell-off in domestic bonds witnessed since 4Q14, while also helping to boost market liquidity more broadly in recent years. A few other African FMs are working on supporting the growth of their pension and insurance industries.

Capital flows may heighten financial stability risks if they spur excessive credit growth, resulting in asset/liability mismatches or fuelling asset price bubbles. In most African FMs, this has hardly been the case since the Nigerian banking crisis of 2009. By and large, non-performing loans are low compared to similarly rated peers, capital adequacy ratios exceed prescribed thresholds, and credit growth has been roughly in line with GDP growth with a couple of exceptions. Central banks have also been proactive via adjustments in capital requirements, reductions in net open positions, limits on foreign currency lending, etc. With African financial institutions becoming more integrated in the international financial system and expanding their operations across African jurisdictions, regulators will have to pay increasing attention to the risks associated with capital movements. In this context, tackling persisting challenges such as weaknesses in local capacity and institutional strength to improve supervision is key.

Finally, capital flow management measures can also be employed to manage changes in capital flows. Considering that evidence on the impact of capital flows is not conclusive, limiting a rapid surge or a sharp outflow of capital may be warranted at times, especially when macroeconomic policy space is limited or concerns for financial sector stability are significant. Yet viewing capital flow management measures as a perfect substitute for macroeconomic policy adjustment may be a missed opportunity for enhancing a country's competitiveness and ensuring medium/long-term macro stability. It may also have a negative impact on international investors' confidence. Finally, it may mean that the country cannot tap the opportunities afforded by capital flows if such measures prevent it from being eligible for inclusion in major bond or equity indexes. For example, any explicit capital control would prevent the inclusion of a country's bonds into J.P. Morgan's GBI-EM Global/Div. Index. Restrictions on foreign investors' entry/exit in Angola, Ghana, Senegal, and Tanzania make their local bonds ineligible for the GBI-EM Global/Div. at present. With over US\$250bn in assets under management benchmarked against the index globally, inclusion allows a country's bond market to enjoy considerable investor sponsorship. Nigeria is currently the only African FM included in the GBI-EM Global/Div. Index. While authorities have not imposed any capital controls, recently introduced macroprudential and administrative measures have gone hand-in-hand with a fall in FX market liquidity – another index requirement. This has rendered index replicability more challenging for investors and has resulted in the country being placed on negative watch.

The emergence of the Frontier Markets asset class has seen the spotlight turning onto a number of African markets. These have made their debut with Eurobond issues and welcomed more foreign investors into their local debt and equities markets. The ensuing inflow of private capital has by and large had a relatively mild effect on African exchange rates, with some central banks taking this also as an opportunity to accumulate FX reserves. However, in other countries such capital inflows have amplified the impact of lower fiscal discipline on FX reserves and current accounts. Now that some capital flow reversal has begun taking place on the back of the drop in commodity prices the challenge for African FMs is to appropriately select and sequence macro policy adjustments, macroprudential measures and, if warranted, capital controls, in such a way as to minimize any disruptions from these changing flow dynamics while maintaining investors' confidence.



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# Cross-border banking in Africa: facts, challenges and opportunities

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Cross-border banking has become an increasingly important feature of African financial systems, in a trend that has accelerated in the past decade. African banks have not only substantially increased their geographic footprints on the continent but have also become economically significant beyond their home countries and of systemic importance in a number of jurisdictions. This growth and expansion of African banks has in recent years reduced the relative importance of traditional, mostly European, banks on the continent and has shifted the onus of managing the risks and the reaping benefits of cross-border banking from the traditional home countries in Europe towards African policy makers. The increasing importance of regional banks within Africa also puts a new light on the whole discussion on the relevance of international regulatory standards for Africa.

While cross-border banking brings a lot of benefits for host economies, regional financial integration also entails new potential sources of risks. New channels of contagion will and are indeed already developing, as national banking systems and financial markets become increasingly interwoven, allowing for the transmission of shocks across borders. These new potential risks underscore the importance – both for banks and their supervisors – of having in place adequate provisions for risk management and mitigation. They also call for a greater commitment and adherence to common “rules-of-the-game”, as embodied in internationally accepted standards and practices, to foster greater confidence in the financial sectors on the continent. Given the serious repercussions both for financial stability and financial deepening associated with bank fragility, particularly when it concerns larger pan-African banking groups, both banks and authorities have a mutual interest in upgrading bank oversight and cross-border supervisory cooperation.

Potential stability risks emerging from cross-border banking often need to be addressed collaboratively rather than by individual home or host country supervisors. The rapid expansion especially of pan-African banks therefore requires both a significant upgrade of domestic oversight and an adjustment of the current toolbox of cross-border regulatory cooperation. Consolidated supervision of a bank’s activities through all its affiliates, across sectors and jurisdictions, Memoranda

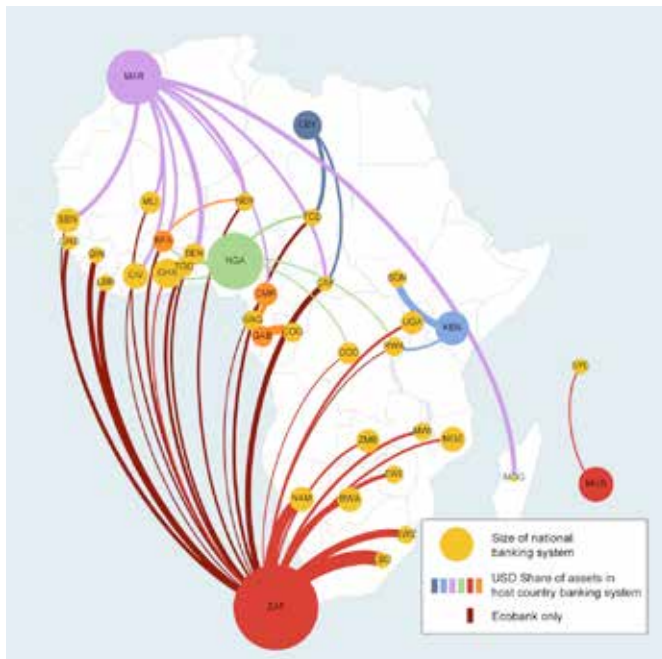
of Understanding between home and host supervisors and Colleges of Supervisors for individual cross-border financial institutions are the basis for effective cross-border regulatory cooperation. However, as the recent Global Financial Crisis demonstrated, these tools are not sufficient to safeguard financial stability. Greater efforts are necessary to develop cross-border frameworks for crisis management and bank resolution (thus building on domestic efforts in this area), not only as a means to collaboratively deal with financial sector fragility and failed banks, but also to set the appropriate ex ante incentives to reduce the probability of systemic banking crises. Addressing this agenda requires authorities to carefully assess country and region specific circumstances, as the scope and intensity of cross-border regulatory cooperation should be in proportion to the strength of the cross-border linkages between home and host country banking systems.

Countries across Africa have made progress in upgrading their regulatory frameworks, including elements applied to cross-border banking, but significant gaps remain. Few African countries have effective systems of consolidated supervision in place. This is especially a concern relating to the supervision of a few large African cross-border financial institutions that are active across the continent and systemically important in a number of countries but are neither under consolidated, nor under effective solo (home or host) country supervision. Moreover, only a small but increasing share of cross-border linkages across the continent is covered by proper arrangements for home-host supervisory cooperation, such as Memoranda of Understanding and Colleges of Supervisors. Yet even where such arrangements are in place, considerable efforts are required to implement them effectively and enable regular and trustful exchange of relevant information on a bilateral or multilateral basis.

In view of the multiple demands posed by the intensification of cross-border banking and limited supervisory resources regulatory authorities in Africa face an important trade-off. On the one hand they are faced with the more traditional task of safeguarding their financial institutions and banking systems, taking into consideration the risks associated with the growth of cross-border activity in recent years. On the other hand, they are faced with the challenge of reaping the significant gains associated with cross-border banking in the form of more efficient intermediation and deepening of financial markets, which will also contribute to greater resilience and thereby support a virtuous cycle in support of financial system stability and robustness.

<sup>1</sup> This note is based on the Executive Summary of Beck, Fuchs, Singer and Witte (2014): Making Cross-Border Banking Work for Africa.

FIGURE 1: GROWING INTRA-AFRICAN BANKING CONNECTIONS



Sources: World Bank, GIZ, IMF, Central Bank websites, annual reports of banking groups, Claessens/Van Horen database

## REAPING THE BENEFITS OF CROSS-BORDER BANKING

If Africa takes advantage of the efficiency gains and innovations cross-border banks can provide, the continent stands to benefit substantially in terms of financial deepening and increased outreach to previously unbanked parts of the population. Despite increasing financial integration, the impact of cross-border banking on banking efficiency and financial outreach has so far been limited. One of the constraining factors in that regard is the often still-rudimentary financial infrastructure. It is therefore a priority to **strengthen financial infrastructure** in a consistent manner across countries, particularly those that share strong cross-border linkages. In the context of cross-border banking the focus would be on improving the comparability of credit information across countries, enhancing the efficiency of payment systems particularly as regards cross-border retail payments and the servicing of migrant flows, strengthening mutual recognition of procedures for registration of property and collateral rights and mechanisms for foreclosure on collateral, as well as improving financial literacy and the availability of comparable information on the cost of financial services. Such upgrades might be best undertaken in a coordinated manner within sub-regions, as is already the case in some Regional Economic Communities.

Authorities could also consider a move towards **more integrated banking models** predicated by a sound framework for consolidated supervision, clearly established and functioning channels of information exchange between home and host country supervisors, and effective cross-border resolution frameworks. Banks expanding across borders in

Africa are almost universally required to establish not only self-standing subsidiaries, but also to establish local IT functions, to use predominantly local labor, and to establish independent, local management functions. This ‘fortress banking’ runs directly counter to reaping the potential economic gains from cross-border banking. In particular, more integrated banking models would provide the opportunity for significant cost-savings in a traditionally high-cost industry and could make it cost-efficient and therefore attractive to provide financial services to a broader set of clients. Policies fostering more integrated banking models could, for example, include reducing the complexity and length of the licensing process, reducing initial capital requirements as applied to bank subsidiaries (with requirements designed to grow in line with the foreign bank’s business engagement and risk exposures), reducing or doing away with requirements as to establishing new branches where these exist (leaving decisions as regards the structure and security of bank premises etc. up to the banks), encouraging full mobility in the use of labor (skills transfer), and encouraging usage of centralized, common IT platforms (both as regards the banks’ internal operations and in the provision of clients services, such as ATMs, card services and internet banking), audit and risk management systems. A move away from stand-alone subsidiaries towards more integrated subsidiaries and eventually even branching – if certain pre-conditions are met – could be especially considered in formally integrated regulatory areas such as the Central and West African currency unions.

In addition, **regulatory harmonization could contribute to greater certainty as regards predictability and consistency in implementation, a significant reduction in compliance costs** across the region, as well as raising standards in more challenged environments. Regulatory harmonization is a huge undertaking and care will need to be taken that efforts to promote convergence are focused on key concerns, especially in environments with severe capacity constraints. Prioritization and sequencing are crucial, and the focus needs to be on those policy areas where harmonization is essential to the integration agenda. For example, in an environment where credit risk is the key risk factor prioritization might suggest a focus on loan loss classification criteria and provisioning requirements.

## SAFEGUARDING STABILITY OF CROSS-BORDER BANKING IN NORMAL TIMES

Consolidated supervision is a critical component of overseeing cross-border banks, yet most African home country supervisors still lack adequate frameworks, implementation capacity and consolidated accounting data. **Establishing or improving frameworks of consolidated supervision** and their effective implementation is therefore a high priority in safeguarding financial stability in Africa.

To effectively carry out consolidated supervision, authorities require sufficient data on the activities of banks. Available information about the size and nature of cross-border

banking activities in Africa is currently difficult to come by or unavailable. A key immediate task facing African authorities is to **improve the availability and regular exchange of relevant information**. To make this task manageable, it is strongly recommended that a smaller group of African home supervisory authorities take the lead in developing the required formats as well as a platform enabling regular information exchange on a basic set of data among African supervisors. This dataset should include information on (i) basic qualitative and quantitative characteristics of cross-border banks, (ii) supervisory data as it relates to performance, (iii) qualitative information on regulatory frameworks and definitions underlying supervisory data, and (iv) market intelligence. Making such data publicly available will allow for overseeing and monitoring on-going developments in cross-border banking and could serve as the basis for a risk-based approach to strengthening banking supervision. At the same time, timely exchange of more detailed, institution-specific information based on Memoranda of Understanding among supervisors and as input to supervisory colleges is also necessary for effective cross-border supervision and an early detection of financial fragility.

Effective consolidated supervision will also depend on building **trust between home and host supervisory authorities**, which is essential to the quality and frequency of information exchange, particularly when it relates to more detailed, institution-specific information. Formal arrangements can be instrumental in building trust and anchoring expectations. Improvements in supervisory cooperation – through signing of appropriate Memoranda of Understanding and formation of properly structured Colleges of Supervisors, joint inspections of cross-border banks, and peer learning and capacity building events – is thus an important area of action on both bi-lateral but also sub-regional levels.

Moreover, the fact that there are **large African cross-border banks** that are not subject to consolidated supervision from their respective home country supervisors needs to be addressed. Given the large geographic footprint of these institutions, coordination on the pan-African level is urgently called for. Given the potential reputational and stability risks associated with unreported or undisclosed risks of cross-border banks and conglomerates, authorities and banks have an important common social responsibility in seeing that regulatory gaps are addressed. A private/public partnership could play an important role in advancing this agenda to ensure a level playing field for banks. At the same time, the Community of African Banking Supervisors (CABS) or the Financial Stability Board's Regional Consultative Group for sub-Saharan Africa might serve as a coordination forum to identify systemically important institutions and how best to coordinate policy action and monitor implementation of consolidated supervision for systemically important African cross-border banks.

The CABS may also become a permanent forum for discussing issues related to cross-border cooperation. While such an exchange can play a decisive role in shaping the regional policy dialogue and capacity building agenda, day-to-day cooperation will have to be implemented on either a bilateral level or within smaller groups focusing on specific cross-border institutions. The CABS can, however, serve as an important forum for exchanging ideas and experiences and driving convergence towards a common set of international standards while at the same time facilitating the development of Africa-appropriate regulatory frameworks and providing the entry point for more detailed cooperation between individual countries or on individual banks.

### PREPARING FOR CROSS-BORDER REPERCUSSIONS OF BANK FRAGILITY

Preparing for the cross-border repercussions of bank fragility clearly requires a solid foundation for safeguarding the stability of banking in normal times. However, being prepared for times of distress also requires authorities to be equipped with sound **resolution frameworks** on a national level so that resolution proceedings can be initiated in a timely manner, with clearly assigned responsibilities among relevant authorities, and with sufficient powers as regards transfer of assets and liabilities, and implementing bank restructuring. Aside from planning for the eventualities of bank failure, resolution frameworks are also a preventive measure in that they affect the incentives of banks with regard to risk-taking even in normal times. Overall, there is a considerable outstanding agenda in many African countries relating to respecting the hierarchy of creditors in bank resolution and preventing legal actions that constrain the implementation of resolution measures.

Cross-border regulatory cooperation also has to look beyond information exchange during normal times towards **preparation for cross-border repercussions of idiosyncratic and systemic bank failures**. Joint crisis simulation exercises could be used as the foundation for joint crisis management plans. Where relevant, this could also involve extending supervisory colleges towards including resolution authorities such as ministries of finance in so-called Crisis Management Groups.

Given the complexity of orderly resolution of cross-border groups every effort should be made to take **precautionary measures to avoid the emergence of non-transparent, strongly interwoven international financial groups** through strict monitoring, limits on intragroup exposures and enhanced business continuity planning. While consolidated supervision is the basis for such measures, such a precautionary approach goes beyond collecting the necessary information towards a more active involvement of supervisors, as currently done for several systemically important financial institutions in the U.S. and Europe in the context of recovery and resolution plans.

# Africa: Financial Inclusion and Regulation—a Difficult Balancing Act in an Under-Banked Region

**Adam Bennett**

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The low level of financial inclusion in sub-Saharan Africa (SSA) is well known. World Bank data (see Table 1 below) suggest that less than a quarter of the adult population in the region had (as of 2011) an account at a financial institution. Only 10 per cent of the population used such accounts to receive their wages. For those that did have an account, it appears that the primary motive was to use the account as a (safe) store for their savings. Very few (only 5 per cent) borrowed from their bank (relying instead on the informal market or family members) and electronic debit cards were held by only 15 per cent of the adult population. Other things being equal, it tends to be the more remote rural communities that are least well served by financial institutions, and this is also where the highest levels of poverty are often recorded. Financial inclusion in the most advanced country in SSA, South Africa, was about double that of SSA as a whole. While this shows that there is considerable potential to improve the metrics of SSA, South Africa still scores no better than the average for developing countries in Europe and Central Asia. By contrast, 88 per cent of the adult population in the USA have accounts with financial institutions, and all the other metrics are correspondingly higher, except for reliance on family members for loans, which is (as one would expect) much lower. In the United Kingdom, financial inclusion is even higher, with 97 per cent of the adult population having a bank (or similar) account. The target of a fourfold increase in financial inclusion in SSA would therefore seem (in the long run) entirely reasonable.

The positive correlation between financial inclusion and economic development, as well as the negative correlation with poverty, is also well known.<sup>1</sup> While the direction of causation can be disputed, there is a strong case for believing that increasing access to bank accounts and to financial institutions generally in SSA would lead to higher prosperity in that region. The converse of this argument is the philosophy behind the bailouts of banks “too big to fail”, and the logic of deposit insurance and lenders of last resort. If we did not believe that

financial systems generate prosperity for those who have access to it (and even for those who don't), why would we bother to protect it at such vast expense? If we believe that this link between financial inclusion and prosperity, including for the lower income groups, is genuine, then there is a good case for a major push for further financial deepening in Africa. Rising prosperity for lower income groups linked to financial inclusion should not only help reduce poverty, but should also promote the middle class in Africa, with a stake in financial stability and good governance.

TABLE 1: FINANCIAL INCLUSION: SUB-SAHARAN AFRICA COMPARED WITH REST OF THE WORLD (PERCENTAGE OF POPULATION OVER 15 YEARS OLD HOLDING BANK ACCOUNTS, 2011)

	Bank account	Wages paid into bank	Saved at a bank in past year	Bank loan in past year	Family loan in past year	Debit card
sub-Saharan Africa	24	10	14	5	40	15
South Africa	54	23	22	9	34	45
Emerging Europe & Central Asia	45	27	7	8	28	36
USA	88	51	50	20	17	72

Source: Demircug-Kunt and Klapper, World Bank, 2012, “Measuring Financial Inclusion: The Global Findex Database”

So what factors influence access to financial services? Evidence suggests that the proximity of bank branches is only one factor. Financial exclusion can still be a problem even in urban areas where the distance of households from bank branches cannot fully explain the relative lack of access to financial services of poor urban households.<sup>2</sup> Financial literacy, as well as familiarity, may also be a key factor. The World Bank has argued that there is a correlation between education and access to bank accounts, although here again the direction of causation is ambiguous. Nevertheless, it would seem *prima facie* obvious that improving financial literacy would likely lead to greater willingness to seek access to financial services where they are available. In addition to lack of familiarity with finance, the evidence suggests that potential recruits can be put off by the perceived cost of bank charges, and also by know-your-customer (KYC) rules which can seem intrusive and intimidating in an environment where financial governance (along

<sup>1</sup> See for example Finance for All? Policies and Pitfalls in Expanding Access, World Bank Policy Research Report. Washington, D.C., World Bank, 2008. Much of the analysis has been in terms of the relationship between financial depth and prosperity, where the data is easier to obtain and which tends to disproportionately reflect the financial habits of the richer members of society, but more recent analyses of financial access has tended to confirm the hypothesis that access to banks accounts and financial services also benefits the poorer and lower income groups.

<sup>2</sup> In Indonesia, for example, where there are large urban conurbations in addition to extensive rural island communities, access to bank branches was not seen as an impediment to opening accounts except in the most remote rural areas. See Improving Access to Financial Services in Indonesia, World Bank, April 2010. One of the more surprising findings of this World Bank study was that “not having enough money” was given as a common reason for not opening bank accounts by all income groups. This suggests that it is financial literacy—not income—that is the constraining factor. If so, adequate financial education could unlock savings at all levels, including from the most disadvantaged low-income groups.

with political governance generally) is not always trusted. The reporting requirements of KYC rules could be a particular deterrent to rural customers. If a tax payer identification number is required, this could inhibit low-income households, micro-businesses, and some small businesses. KYC rules that require prospective customers to be interviewed in bank branches may also hinder the banks' ability to garner such clients in rural areas.

One way to strengthen financial inclusion might be to extend mobile banking services using mobile phones. Mobile phone banking has proved popular in many developing countries and the technology is tried and tested. Mobile phone banking can either be bank-based or non-bank based. In bank-based mobile banking, users of the service must have a prior bank account with a commercial bank. In non-bank based systems, users essentially use their balance in the phone as their bank account. Under both systems, users can top up their balances with cash deposits, as well as withdraw cash (with suitable ID), in a wide range of retail outlets, making the service much more convenient for people living in more remote areas where bank branches are scarce. Other transactions require only that a mobile phone signal be available. However, non-bank based systems are more limited than bank-based systems in the services that they can provide, and for the most part amount to little more than an alternative (and safer) means of holding cash. Moreover, any effort to expand such services would likely require their incorporation into banking law and regulation, including KYC rules. Bank-based systems, of course, require a pre-existing bank account, so such systems do not address the critical first step in overcoming low levels of financial inclusion—the opening of a bank account by the unbanked.

Another powerful incentive to draw the unbanked into the formal financial system is the incorporation of prize elements within investments and other savings instruments.<sup>3</sup> Prize-linked products are likely to be especially attractive to low-income households, for whom traditional methods of saving may appear unlikely under any realistic scenario to substantively alter their welfare for the better. This is precisely the segment of households that needs to be drawn into the financial system in Africa. In the United Kingdom, for example, Premium Bonds (whose running return is afforded entirely by the possibility of prizes) have proven much more attractive to lower income households than other forms of investment like stocks and shares. If the sale of such prize-linked products can be used to garner such information as would satisfy (at least part of) the KYC requirements, the next step of entering a bank and opening an account would seem less daunting to the customer.<sup>4</sup> Alternatively, the

opening of a bank account could be combined with a prize-linked product. In South Africa, in 2005, the First National Bank of South Africa (FNB) launched the Million a Month Account (MaMA), where account holders were automatically entered into a lottery with monthly prizes of 1 million rand. Within three years, FNB had over one million MaMA accounts, or 7 per cent of all accounts in the financial system. What is not clear is the extent to which these accounts were substituted out of existing accounts.<sup>5</sup> But they were certainly popular. Similar experiments have been tried in Gambia, Malawi, Nigeria, Tanzania, and Zambia.

Of course, as we know from recent experience, engagement with financial systems brings risks as well as rewards. Robust systems for the regulation, supervision, and safeguarding of financial systems is essential. The development of this architecture will need to balance the benefits of financial inclusion and risks of financial exclusion, such as unmonitored informal money transfers and the more general consequences for social cohesion of impaired economic development, along with the burden and deterrent effect that some of these safeguards might exert on wary potential depositors as well as on the banks offering them their services. The burden of KYC and anti-money-laundering measures applied to certain countries in Africa by the United States has all but eliminated access to global financial services, an effect that is particularly evident in Somalia, and one which can only perpetuate the failure of the most vulnerable states.

Africa needs to significantly expand and strengthen its domestic intra-regional financial intermediation. With its wide spectrum of nations at various stages of development and with differing investment needs and savings capacity, a deeper financial system should enable the continent to finance a greater share of its own development and lessen its dependence on external financial flows. Such a realignment of the continent's financial systems would require a careful balancing between modernization of the regulatory framework and broadening the reach of the region's financial systems.

<sup>3</sup> See, for example, Tufano et al., *Making Savers Winners, an Overview of Prize-Linked Savings Products*, NBER Working Paper No. 16433, 2010; Tufano notes, *inter alia*, that interest in prize-linked savings is likely to be greatest among those who do not have regular saving habits and who have little actual savings.

<sup>4</sup> Moreover, once the unbanked have been persuaded by the purchase of prize-linked products to go through the KYC process and open bank accounts, the potential for mobile banking via e-money mobile

phone-linked bank accounts could increase dramatically. This process of drawing such purchasers into the banking system is consistent with recently fashionable so-called "Nudge Theory" that is influencing thinkers in policymaking. See C. Sunstein and R. Thaler, *Preferences, Paternalism, and Liberty*, Royal Institute of Philosophy Supplements, Volume 81, Supplement 59, pp. 233–64, December 2006.

<sup>5</sup> These accounts were declared illegal in 2008 by the South African lottery board, so this experiment ended then. Nevertheless, it may have contributed to a permanent improvement in financial inclusion, as once in the financial system, users of such accounts will be likely to discover and exploit other financial services.

# Pan-African banks: Opportunities and challenges for cross-border oversight<sup>1</sup>

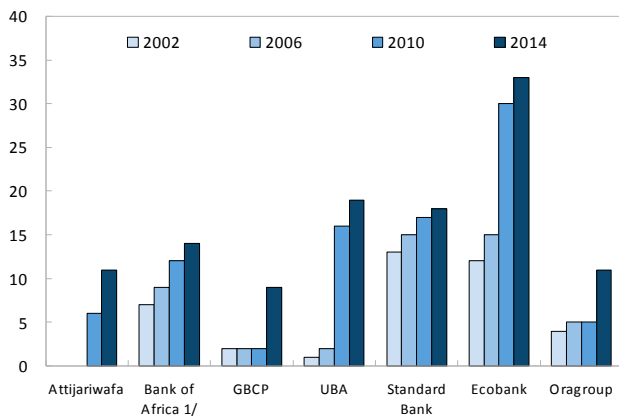
**Mauro Mecagni**

IMF

Pan-African banking groups (PABs) have expanded rapidly across sub-Saharan Africa (SSA) in recent years. This phenomenon is a major change in the African banking landscape, and reflects a number of converging push and pull factors. These include improved political and macroeconomic stability; increasing trade linkages and economic integration, with incentives for banks to follow their customers abroad; and diversification opportunities in markets with large unbanked populations relative to more saturated home markets.

Seven major PABs dominate the landscape in terms of geographic footprint, with a presence in at least ten African countries (Fig.1 and 2). Three of these groups are headquartered in Morocco, two in Togo, and one each in Nigeria and South Africa. Additional banks, primarily from Kenya, Nigeria and South Africa, have more of a regional presence, with operations in at least five countries. PABs have expanded mainly through subsidiaries, although with quite different strategies and resulting structures. They have a systemic presence in around 36 SSA countries, and are now more important on the continent than the long-established European and American banks (Fig. 3, 4, 5).

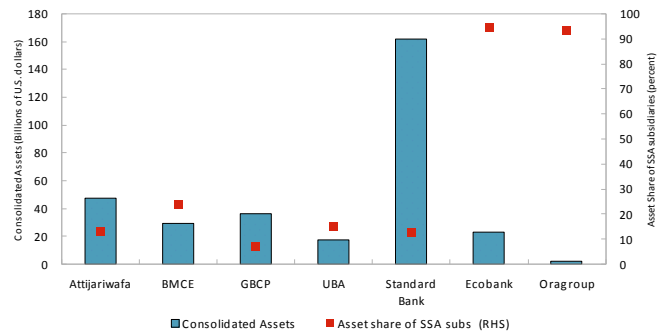
FIGURE 1. MAJOR PABS: CROSS-BORDER EXPANSION, 2002–14 (Number of subsidiaries in SSA)



Sources: Bank websites and annual reports.  
1/ BMCE is a majority owner of Bank of Africa Group since 2010.

<sup>1</sup> This note is based on a report prepared by a staff team of the IMF African Department and Monetary and Capital Markets Department. The team was led by Charles Enoch, Paul Mathieu and myself, and included Jorge Ivan Canales Krijlenko, Sandra Donnally, Cheikh Gueye, Herve' Joly, Christian Josz, Pilar Garcia Martinez, Suliman Aljabrin, Rachid Awad, Kay Chung, Alexandra Peter, Mamoru Yanase, Bruno Flanchec and Dirk Grolleman. The report is under publication as IMF African Department Paper.

FIGURE 2. MAJOR PABS: SIZE AND SHARE OF CROSS-BORDER SUBSIDIARIES, 2013 (Billions of U.S. dollars and percent)

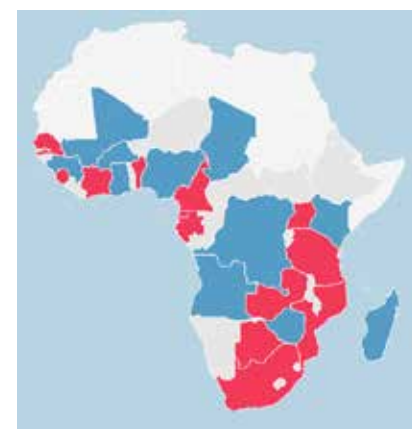


Sources: Annual reports, Bankscope, and IMF staff calculations.

FIGURE 3. SELECTED PABS AND FOREIGN BANKS: SYSTEMIC IMPORTANCE BY COUNTRY, 2013

## Major PABS

### Selected Foreign Banks

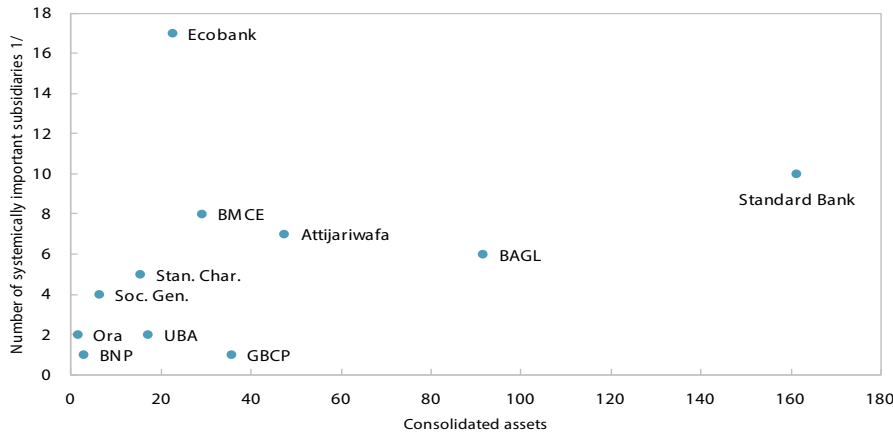


No presence  
Systemically important presence  
Non-systemically important presence

Sources: Annual reports, Bankscope and IMF staff calculations.

Note: Systemically important presence includes parents in their home countries and subsidiaries with a deposit share of more than ten percent of banking system deposits

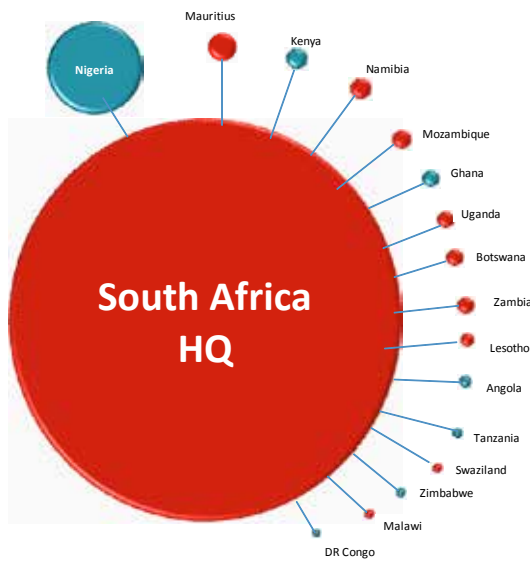
FIGURE 4. SELECTED PABS AND FOREIGN BANKS: SIZE AND SYSTEMICALLY IMPORTANT OPERATIONS, 2013 (Billions of U.S. dollars)



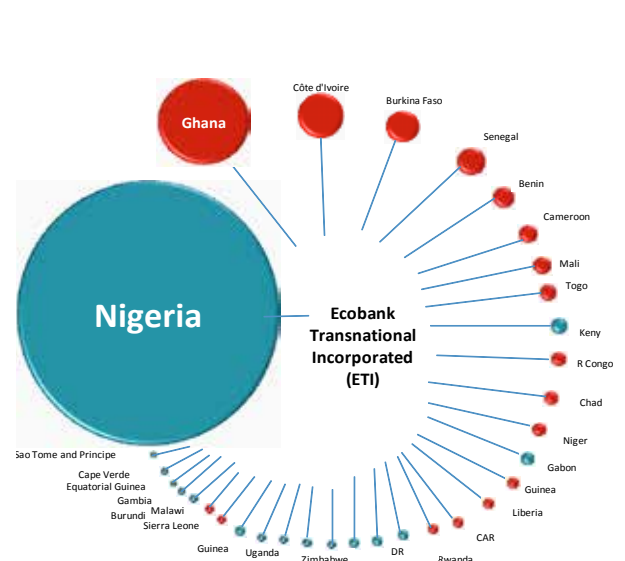
Sources: Annual reports, Bankscope, and IMF staff calculations.  
 1/ A systemically important subsidiary is defined as having a deposit share exceeding 10 percent.  
 This chart shows the seven major pan-African Banking groups plus four selected foreign banking groups (sum of assets of SSA subsidiaries) for comparison.

FIGURE 5. CONTRASTING PAN-AFRICAN BANK STRUCTURES: DOMINANT HOME VERSUS DOMINANT NETWORK

**Standard Bank**



**Ecobank**



Sources: Annual reports, Bankscope, and IMF staff calculations.

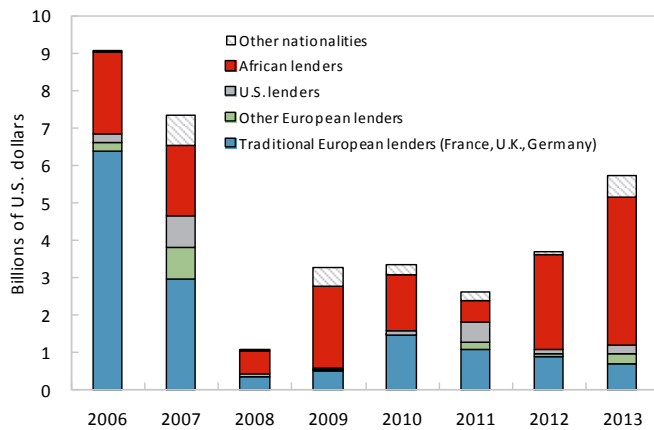
Note: The size of the ball indicates the asset share in consolidated assets of that subsidiary. A red ball represents a systemically important presence with a deposit share exceeding ten percent of banking system deposits.

The growth of PABs offers a number of opportunities and benefits, as these institutions are playing a key role in driving financial innovation and development. The expansion of these banks is contributing to improved competition, supporting financial inclusion, and giving rise to greater economies of scale. In addition, it is important to note that these institutions have become the lead arrangers of syndicated loans for SSA infrastructure financing, filling the gap recently left by European banks (Fig 6). Reflecting more advanced regulatory practices in Morocco, South Africa, and to a degree in Kenya and Nigeria, the PABs based there and their home regulators are also inducing host authorities to upgrade supervisory and accounting norms.



FIGURE 6. SSA: NEW SYNDICATED AND LARGE BILATERAL LOANS FOR INFRASTRUCTURE BY LENDER NATIONALITY, 2006–13

Source: IMF, 2014 (Dealogic Analytics; and IMF staff calculations).

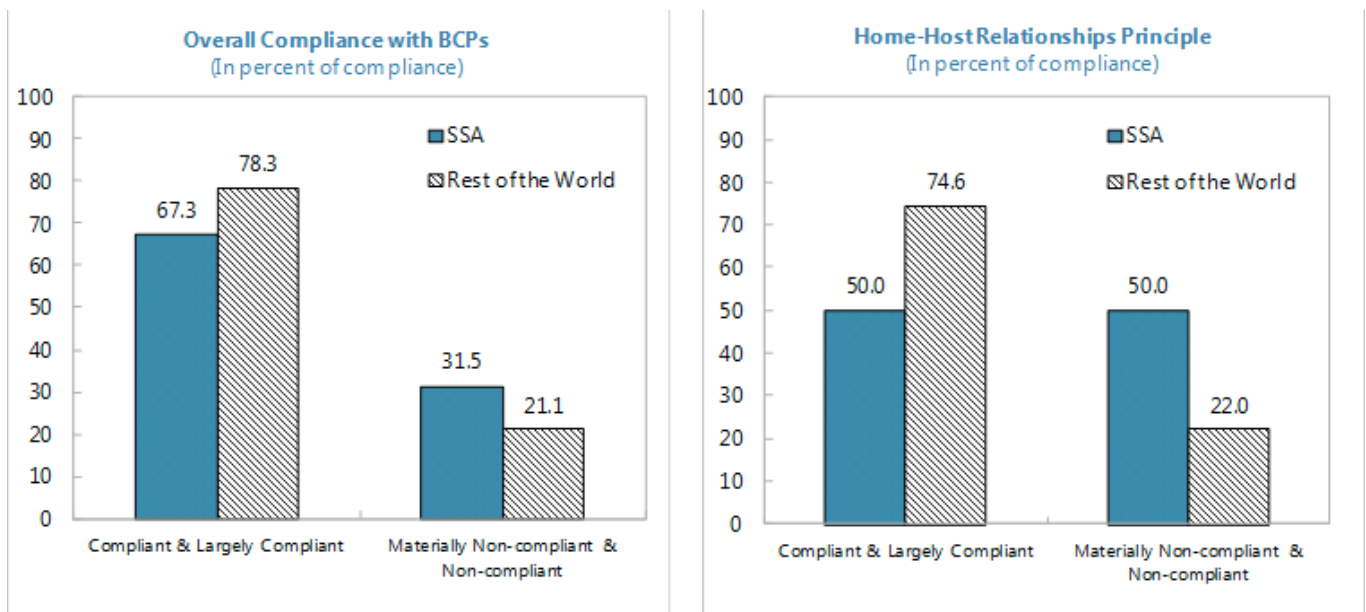


At the same time, the rapid expansion of PABs and their systemic importance in a large number of SSA countries poses new oversight challenges, which if left unaddressed could raise systemic risks. Greater integration has benefits, but interconnectedness also means that countries are more exposed to spillovers from cross-border shocks. The spread of PABs could act as channel of contagion across African countries, in case a parent bank or important subsidiaries were to be subject to financial distress<sup>2</sup>. Difficulties in a bank's operations in one country may lead to problems in other countries or for the group as a whole, particularly if governance is a concern. And PABs may be more vulnerable because they operate under supervisors that may have weak capacity and/or limited interaction with home supervisors.

For host authorities where PABs are systemic, risks may also arise when home authorities or parent institutions take unilateral or uncoordinated actions with implications for financial stability in the host jurisdiction.<sup>3</sup>

Supervisory capacity is limited and under-resourced in most of Africa, particularly in the area of cross-border oversight (Fig.7). PABs on the other hand raise the importance of transparency and disclosure, good governance and a legal and regulatory framework that supports effective consolidated supervision and crisis management, particularly in countries that are homes to major PABs. Consolidated supervision and cross-border cooperation are key to getting a full picture of a PAB's financial conditions.

FIGURE 7. SSA: COMPLIANCE WITH BASEL CORE PRINCIPLES



Source: Standards and Codes Database.

Note: The figures are based on assessments against the 2006 Basel Core Principles methodology undertaken as part of FSAPs during 2007-12. It includes 75 countries, of which 16 are African countries.

2 The subsidiary model may reflect the regulators' wish to minimize contagion risks. But while requiring separately capitalized subsidiaries reduces the extent of possible contagion, it does not eliminate it--subsidiaries may well have exposures to their parents or to other bank or nonbank entities within the same group

3 The experience of several Central and East European countries with large foreign banks during the global financial crisis is instructive. The greater the asymmetry in economic size between home and host, other things equal, the greater the likelihood that an overall strategy for a bank will not take account of the host country, and the more likely that financial stability will be jeopardized in the host country if problems emerge in the home country.

A number of challenges need to be addressed if PABs are to support continued growth with financial stability in Africa. Among the most urgent gaps to fill are the lack of formal regulatory oversight of bank holding companies in the WAEMU and their supervision on a consolidated basis. In fact, at least two large PABs incorporated there are currently operating as unregulated holding companies. Moreover, fitness and propriety of owners and shareholders of PABs is not always fully assessed and ownership structures in some cases are opaque. Data availability in many countries is also limited, and exchange of data constrained by national secrecy laws. In particular, limited information on cross-border exposures within a PAB makes it hard for supervisors to get a firm understanding of potential spillover risks. The lack of a single accounting standard across the continent further complicates the assessment of the banks' overall situation. And an effort is needed to harmonize regulatory norms across Africa, including in PABs' jurisdictions.

Cooperation on cross-border supervision has started, but efforts to strengthen consolidated oversight need to be intensified. The Central Bank of Nigeria (CBN) requires a Memorandum of Understanding (MOU) with home regulators before allowing a bank to be established in its jurisdiction. Quarterly meetings of the West African Monetary Institute include discussions of PAB issues. In Kenya and the EAC, several joint inspections have taken place and supervisory colleges established for a few PABs, and others are planned. Nonetheless, home authorities should establish supervisory colleges—regarded as the optimal way for supervisors to exchange information, despite some problems emerged during the recent crisis—for all systemic PABs. These supervisory colleges should meet at senior level at least once a year, and be organized to ensure a focused discussion of core risks and issues facing PABs. MOUs that ensure full exchange of information are needed between all homes and hosts' authorities. And vulnerabilities from spillovers associated with PABs should be assessed periodically, including through stress tests.

Sustained efforts are also needed to address cross-border resolution issues. So far little attention has been paid to preparing for an eventual need to resolve a PAB, while the global financial crisis amply demonstrated the costs of not having a workable cross-border operational framework in place, as well as the difficulty of constructing one, particularly at times of financial distress. Resolving a complex bank with operations in many countries is a very challenging task, and would benefit from early agreement on fiscal burden sharing and agreements on creditor hierarchies. National fiscal authorities will likely have domestic interests in mind, unless there is a robust pre-commitment to a cost-sharing formula for any public support for a cross-border bank. While some countries have been seeking to address problems of spillover costs through ring-fencing, this does not obviate the need

for cross-border cooperation. Thus, the issue of establishing recovery and resolution plans for systemically important PABs may prove particularly difficult, because ex-ante understandings are needed across different jurisdictions regarding respective responsibilities in the event of difficulties.

Regional currency unions, such as the West African Monetary Union (WAMU), face particular challenges on the interface of responsibilities between regional and national authorities. WAMU operates as a single regional monetary and supervisory authority, but with a licensing and resolution role for national authorities. Bank licenses are issued by the national Minister of Finance after the binding opinion by the Banking Commission and are revoked by the national Minister of Finance upon decision of the Banking Commission. However, the national Minister of Finance has the right to appeal at the WAMU Council of Ministers. National responsibility for bank resolution while supervision is conducted at the regional level can seriously complicate the handling of bank problems. Given that WAMU is home to two major PABs and host to many others, developing appropriate arrangements to reconcile regional and national interests is paramount. As seen in the euro area, the problems that emerge in crisis situations indicate a need to clarify regional responsibilities, powers, and institutions. Regional groupings that are homes or hosts of major PABs should examine the scope for establishing a single resolution mechanism.

The agenda is formidable and many of the recommendations put forward here require efforts to strengthen capacity. It is of mutual interest for PABs' homes and hosts that oversight capacity is strengthened as quickly as possible. In this regard, strategic collaboration between the home regulators and central banks of the major PABs could drive the cooperation and harmonization agenda, for instance by including host country supervisors in the training they conduct for their own supervisors (e.g., Kenya, Nigeria); using joint inspections and meetings of colleges to share their knowledge with their host country colleagues; and taking the lead in promoting staff exchanges and other peer learning initiatives with supervisors from jurisdictions that have been facing similar challenges.

Pursuing the reform agenda expeditiously will nonetheless require extensive technical assistance. The IMF is prepared to continue to provide assistance in its areas of responsibility and to liaise with other multilaterals and national providers to prioritize a comprehensive program to enhance capacity to supervise the PABs. Such a program is urgent, in view of the many institutional development challenges posed by the PABs. It could have a substantial payoff for financial stability of individual African nations, regional groups, and Africa as a whole.

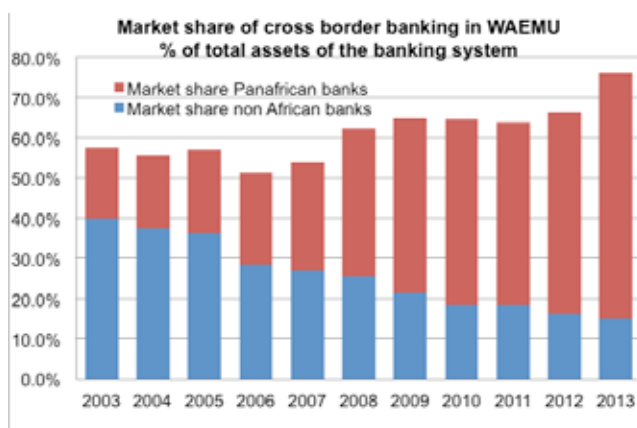
# Cross-border banking in the West African Economic and Monetary Union: Regulatory opportunities and challenges

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## THE EXPANSION OF PAN-AFRICAN BANKS IN WAEMU

As in other African regions, the West African Economic and Monetary Union (WAEMU) has seen an expansion of cross-border banking (CBB) over the last decade. The number of banks operating in more than one country doubled between 2003 and 2013, from 31 to 67. The market share of these banking groups has increased from 57.6% of the total banking sector assets in 2003 to 76% in 2013. There are two major actors: pan-African banks (PAB) and non-African banks, which are mainly French. The increase of the total market share of banking groups has occurred in parallel with a redistribution of the competitive positions of the two actors. Indeed, European banks' share decreased from 39.9% in 2003 to 14.9% in 2013. Société Générale and BNP Paribas are the two remaining European banking groups in WAEMU. This situation is different from the period of Western bank dominance that was referred to as a 'cartel of French banks'. The present expansion of the pan-African groups has marked the second phase of cross-border banking in WAEMU. The market share of PAB has increased from 17.7% in 2003 to 61.1% in 2013.



Source: Data are from different reports of the Commission bancaire, BCEAO.

The main PAB groups operating in WAEMU are Ecobank Transnational Incorporated (ETI) and Bank Of Africa (BOA), and also Nigerian groups (United Bank for Africa (UBA), Diamond Bank) and Moroccan ones (Attijariwafabank, Atlantic Business International (ABI)).

This expansion of CBB in WAEMU comes with opportunities, but also induces significant challenges for regulators.

## (POTENTIAL) BENEFITS AND OPPORTUNITIES OF CBB FOR WAEMU

Although WAEMU has seen an important expansion in CBB in the last decade, the assessment of its economic impact still remains to be investigated. Case studies are important, since the economic literature is still ambivalent in this domain. Economic theory indicates several benefits from cross-border banking. CBB expansion can increase financial intermediation, innovation and efficiency. Because of constraints in access to banking credit,<sup>1</sup> this is particularly important for economic development. The new cross-border cash flow can enhance the volume of mobilized resources made available to local economies. Alade (2014) affirmed that the Nigerian banks mobilized resources in their domestic market for the West African Monetary Zone (WAMZ) countries in which they have opened subsidiaries. The presence of CBB can spur competition by increasing the number of firms in the market and innovation in the sector by improving efficiency. The entering banks can also bring more efficient risk management system (FSB, IMF, and World Bank, 2011).

CBB expansion can also contribute to deepening the integration of financial markets and promote trade and economic integration. "The recent cross-border expansion of PABs has been partly influenced by increasing trade flows and expansion of companies into new markets" (IMF, 2013). If regional trading induces the development of cross-border banking activities, then it is conceivable that these could also reinforce trading. The intra-zone trade is very low in WAEMU and the economic integration in West Africa still under-developed. CBB could drive trade expansion further.

Risk diversification and better profit opportunities are important goals for the parent company. This is particularly relevant for WAEMU countries as their economies are very small, poorly diversified and subject to several shocks. Cross-border investment makes the bank less exposed to these domestic shocks. "When a domestic bank invests abroad, it becomes less exposed to domestic shocks. As long as business cycles are not perfectly synchronized across countries, expanding beyond the home market allows banks to diversify macro-economic risk. Similarly, countries with diversified banking systems – made up of both domestic banks and foreign banks from different origin countries that are not subject to synchronized funding shocks – provide risk diversification for local users of banking services" (Beck and al. 2014).

Because of low financial development and narrow financial markets in African economies, many of the expected benefits from CBB could be important. But to realize these benefits requires an adequate regulation of CBB, in particular a good management of the challenges that regulators face.

<sup>1</sup> Enterprises surveys conducted by World Bank indicates that access to finance is the major obstacle to firms development in many countries of WAEMU.

The economic literature also reveals costs associated with CBB. CBB expansion can impose a cost on domestic banks in host countries by inducing more risk-taking with adverse consequences for the stability of the banking sector. This could include patterns such as potential adverse selection of clients for domestic banks due to the migration of less risky clients to foreign banks who offer new and innovative products and services (Alade, 2014). Under adverse economic conditions across the region, CBB groups could become a channel for cross-border contagion unless regional supervisory frameworks are strengthened (IMF, 2012). Regional financial integration entails new potential sources of risks. These new potential risks underscore the importance of having in place adequate provisions for risk management and mitigation (Beck and al. 2014).

### CHALLENGES OF CBB AND REGULATORY RESPONSES

CBB poses three main challenges: (i) the upgrading of regulation for an adequate management of banking groups and a harmonization of rules; (ii) the reinforcement of cooperation between different supervision authorities and (iii) implementation of proper mechanisms for resolving banking crisis.

Concerning the upgrading of rules in banking regulation, it is important to draw a particular attention to the vacuum that prevails in WAEMU with respect to regulating bank holding companies. In fact, neither the prudential rules put in place in 2000 inspired by Basel I nor the Banking Law of 2010 provide specific rules for bank groups. So “Bank holding companies are not formally regulated, but are supervised by the Commission bancaire (CB) on the basis of a WAEMU council minister’s decision of 1991 on Ecobank (ETI). Thus far, the CB has conducted several onsite visits to ETI” (IMF, 2015). The supervisory authority should require the holdings to provide quarterly reports on their activities such as governance and risk management, profitability and solvency of bank groups.

Concerning harmonization of laws, the joint authority of regulation, The Commission bancaire (CB), is an asset in responding to the challenges posed by CBB. But sharing responsibilities between the CB and national authorities of supervision, in particular ministries of finance, poses coordination problems. Administrative burdens have caused problems in the past, for instance in the processing of the CB opinions by the ministries of finance. Moreover, the ministries may be less rigorous and objective with local banks.

Like many other regulators, the CB is considering the adoption of certain Basel II and Basel III standards. This is expected to open the way for consolidation of cooperation between supervisors. The CB has signed agreements with regulatory authorities from Morocco, Nigeria and France. These allow the organization of joint supervision. This implies sharing of information on financial situation of subsidiaries and headquarters of banks. “Information about a PAB can be maximized through joint inspections, with the home country participating in

inspections in host locations” and “Home authorities should establish supervisory colleges for all systemic PAB, which should meet at a senior level at least once a year. The functioning of supervisory colleges should be organized to ensure a focused discussion of core risks and issues facing PAB and supervisors representation should be enhanced to warrant a better implementation of college decisions and recommendations” (IMF, 2015).

Another major challenge is the consolidated monitoring of different components of financial sector. In WAEMU, a committee for financial stability is located at the central bank and combines different regulators. Except for two annual meetings, the committee has few activities. At the same time, a guarantee fund for bank deposits is under implementation for management of banking crisis. But the mechanism is rudimentary and perspectives of cooperation with countries outside WAEMU could be considered.

In conclusion, facing many challenges, WAEMU regulation and supervision authorities need to build technical capacities and carry out an internal reflection on bank regulation policy in line with the development objectives of member countries. The technical assistance of IMF and other partners should not prevent a real ownership of banking and financial policy.

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# Cross-border banking in the East African Community: Regulatory opportunities and challenges

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## INTRODUCTION

This memo will focus on cross border regulation of banking in the East African Community (EAC). It will provide a background of the nature and growth of cross border banking in the region, discuss some of the responses regulators have taken and then list some of the key challenges. Since all EAC member countries' financial sectors are dominated by banking, this note focuses on banking rather than the regulation of capital markets.

## BACKGROUND

EAC member countries are Kenya, Tanzania, Uganda, Rwanda and Burundi. However this paper will focus on the 3 largest of these – Kenya, Uganda, and Tanzania. Over the last ten years, all EAC countries, in particular Kenya, have experienced an increased depth of banking sectors, but efficiency gains measured in terms of a reduction in interest rate spreads have not been achieved (Upadhyaya & Johnson, 2015 (forthcoming)).

Inter-regional trade within the EAC has increased following the establishment of a Customs Union in 2005 and a Common Market in 2010. EAC member states have agreed to move towards full monetary union with the signing of the East African Monetary Union (EAMU) protocol in November 2013. The Government of Tanzania ratified the EAMU Protocol in June 2014, followed by Rwanda and Burundi, then Kenya. Uganda ratified most recently in February 2015. Besides a common currency and East African Central Bank by 2024, the monetary union also envisages common principles for regulation and supervision of the financial system (Central Bank of Kenya, 2013).

Cross border banking has increased as a response to both EAC regional integration and other market forces, including the search for opportunities by banks. Cross border banking can provide valuable opportunities for finance to contribute to development by reducing the costs of doing trade within EAC. However there are also risks, as the supervision of cross border banking is by its nature complicated. Within cross border banking in the EAC there are two key developments: the growth of regional banks and the establishment of the East African Payments System.

Kenyan banks in particular have expanded into other markets. As of December 2013, eleven Kenyan banks had subsidiaries

operating a total of 288 branches in the EAC and South Sudan (Central Bank of Kenya, 2013). Some of the Kenyan banks, like Equity Bank and KCB, have replicated their innovative business models which focus on financial inclusion in the regional markets (Beck, Fuchs, Singer, & Witte, 2014). Others have focused on lending to Kenyan firms in regional markets.

The table below shows the regional footprint of Kenyan banks.

	Uganda	Tanzania	Rwanda	Burundi	South Sudan	TOTAL
KCB	14	12	11	1	21	59
Diamond Trust	28	19	-	4	-	51
CBA	1	11	-	-	-	12
Bank of Africa	28	19	-	-	-	47
Guaranty Trust Bank (formerly Fina Bank)	7	-	18	-	-	25
Equity Bank	38	6	8	-	9	61
I&M Bank	-	6	13	-	-	19
Imperial Bank	4	-	-	-	-	4
ABC Bank	2	-	-	-	-	2
NIC Bank	1	6	-	-	-	7
The Co-operative Bank of Kenya					1	1
<b>Total</b>	<b>123</b>	<b>79</b>	<b>50</b>	<b>5</b>	<b>31</b>	<b>288</b>

Source: Central Bank of Kenya (2013)

While there are West African banks that have a presence in Kenya, there are no Ugandan- or Tanzanian-owned banks that have subsidiaries in Kenya.

The East African Payments System (EAPS) went live in November 2013. It was officially launched in May 2014. The EAPS led to integration between the Real Time Gross Settlement Systems (RTGS) of 3 countries, reducing cheque clearance time from 22 days to 1 day. Between November 2013 and May 2014 a volume of 1,106 transactions were processed through EAPS, with the following value processed in the three EAC currencies: Ksh. 1.6B, Ugx. 9.9B and Tzs .2.5B. On average 10 EAPS transactions are processed per day (Ndungu, 2014). Rwanda joined the EAPS in December 2014 (Rwangombwa, 2014). However there is no regional switch to allow bank-to-bank transactions. This prevents a deepening of cross border transactions.

Central Banks in EAC have undertaken several initiatives to enable better regulation of cross border banking and eventual monetary union. These include:

- 1 Monetary Affairs Committee of East African Community (MAC). At a meeting in October 2013, member states agreed to adopt the proposal of the G20 and Basel committee on a post crisis regulatory framework.
- 2 Financial System Stability Assessment Framework SHIELDS rating system adopted by Common Market for Eastern and Southern Africa (COMESA) members. SHIELDS refers

<sup>1</sup> Not for citation

to Solvency conditions, Liquidity conditions, Default conditions, and Systemic loss.

- 3 The Central Bank of Kenya (CBK) has set up supervisory colleges with other member states to monitor regional banks.

However each of the member states are at different stages of implementation of the regulations and it is still unclear how well regional supervision is working.

## CHALLENGES

### STRUCTURAL CHALLENGES

- a Political differences between EAC member states is delaying EAC trade integration with impact on all other areas of integration. Tensions between Rwanda and Tanzania over conflict in the DRC in 2013 highlighted fragility of EAC as a single political unit.

**Challenge** – What protocols can be established to resolve disputes within the EAC?

- b Different levels of financial depth, breadth and efficiency of each of the member states raises challenges. Aggressive expansion of Kenyan banks is often perceived as an anti-competitiveness issue in other member states. There are also differing regulations of non-bank financial providers including mobile network operators (MNOs) that are used to transfer funds. Furthermore, there are differing levels of supervisory capacity in each of the member states.

**Challenge** – How can a ‘level playing field’ be designed to ensure that banks from stronger national markets do not engage in anti-competitive behaviour?

**Challenge** – How can the differences in regulation for MNOs in each of the member states be resolved to ensure a ‘level playing field’ between banks and non-banks and also between MNOs across between different member states?

**Challenge** – How can supervision capacity of all member states be improved to ensure that there is no regulatory arbitrage?

### REGULATORY CHALLENGES

- a There is a debate on the appropriateness of the parent–subsidiary model vs. branch model. Regional banks in EAC follow a parent–subsidiary model. It has been argued that setting up of subsidiaries is quite expensive (particularly in terms of minimum capital requirements) and this may prevent smaller banks from exploiting opportunities in regional markets. However this author believes the parent–subsidiary model is a more prudent regulatory approach.

**Challenge** – How can Central Banks make the process of establishing regional banks less cumbersome while maintaining regulatory oversight?

- b Alignment of home and host country supervision. It has been highlighted that while the interests of the home and host country supervisors align in normal times – if (a) the parent bank is of systemic importance in the home country, (b) the subsidiary is of systemic importance for the parent bank, and (c) the subsidiary is of systemic importance in the host country – there can be conflicts of interest when the financial situation of the bank deteriorates.

**Challenge** – What is the appropriate design of home–host country supervision, particularly in situations of financial distress?

**Data challenges** – It is difficult to get full information on extent of financial flows for both trade and banking within EAC. Data challenges pose a constraint for regulators making decisions and also for analysts attempting to understand cross border banking in EAC.

**Challenge** – How can a user–friendly data portal that combines data on EAC flows be developed?

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# Global banking standards in Africa: How are African governments responding, and why?

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In this memo we set out a major element of a new 3-year research project, led by Ngaire Woods, Thorsten Beck and Emily Jones, which looks at the adoption of Basel standards by African countries.

Global financial standards are described as offering opportunities for global regulatory harmonization and for increasing stability. Yet they have been set by bodies that are not representative of African economies and may not be responsive to the needs of African financial sectors. African regulators face important and pressing questions about how to respond to these new global financial standards and their decisions are impeded by the relative weakness of the evidence base. There is a paucity of credible evidence on the precise impact that global banking standards are likely to have on different African economies, we do not have a complete picture of the rates of implementation across African countries, and we have little understanding of the conditions under which African regulators decide to adopt global standards.

Our project has three specific policy-relevant aims:

- To identify the opportunities and constraints for African regulators afforded by global standards, in combination with other international economic and geo-strategic pressures;
- To establish a compelling evidence base about the ways African countries can adapt global regulations to their specific national and regional regulatory contexts to support an inclusive financial system and growth;
- To identify effective strategies for African countries to ensure global standard-setting permits them to adopt regulation which best reflects their interests and capacities.

We hope that our initial review, set out below, will foster discussion, particularly on the following questions:

- **How relevant are Basel standards for African countries?** To what extent should African countries engage with global banking standards and why? Should the scope of our research be widened to other aspects of global financial regulation? If so, which?
- **What is the best way to access high-quality information** about levels of adoption and implementation of global standards by African governments? How reliable

are surveys conducted by the Financial Stability Institute, reviews by the IMF?

- **What, in your experience, are the reasons for variation in the adoption of Basel standards** across African countries? Have these changed over time, in particular, after the global financial crisis?

## BASEL STANDARDS: DESIGNED PRIMARILY FOR HIGH-INCOME JURISDICTIONS

In the wake of the recent financial crisis, greater emphasis is being placed on creating global financial standards to reduce collective vulnerability to financial crises. As part of this regulatory initiative, all countries are being encouraged to adopt the global banking standards developed under the auspices of the Basel Committee on Banking Standards. While African countries have an interest in a stronger and more robust global financial system, they are under-represented on the Committee. Of the 27 countries represented on the Committee, South Africa is the only African country.

Reflecting the Committee membership and given that the recent set of Basel standards was designed specifically in response to the crisis arising out of advanced financial economies, Basel standards are geared primarily towards countries with relatively deep and sophisticated financial markets. So far only a few studies examine in detail the suitability of standards for African countries and those that do, raise some concerns. These are summarized below.

## IMPLEMENTATION CHALLENGES FOR AFRICAN COUNTRIES<sup>1</sup>

Implementation challenges arising from regulatory weaknesses and gaps in financial infrastructure are a very substantial challenge for many African countries seeking to adopt Basel standards. These are particularly acute for implementing the more advanced approaches to risk assessment in Basel II and the macro-prudential elements of Basel III. Studies highlight five implementation challenges:

- 1 *Human and Financial Resource Constraints.* The shift from compliance-based supervision in Basel I to risk-based supervision in Basel II often poses a major challenge. The transition carries very significant costs for domestic banks

<sup>1</sup> This section draws on Emily Jones, "Global Banking Standards and Low Income Countries: Helping or Hindering Effective Regulation?," in Global Economic Governance Programme Working Paper (2014).

Main sources include: Thorsten Beck, Michael Fuchs, and Marilou Uly, "Finance in Africa: Achievements and Challenges," in Policy Research Working Paper (Washington, D.C.: World Bank, 2009). Thorsten Beck et al., *Financing Africa: Through the Crisis and Beyond* (Washington, D.C.: World Bank, 2011); FSB, IMF, and WB, "Financial Stability Issues in Emerging Market and Developing Economies: Report to the G20 Finance Ministers and Central Bank Governors," (2011). Michael Fuchs, Thomas Losse-Mueller, and Makaio Witte, "The Reform Agenda for Financial Regulation and Supervision in Africa," in *Financial Sector Development in Africa: Opportunities and Challenges*, ed. Thorsten Beck and Samuel Munzele Maimbo (Washington, D.C.: World Bank, 2013); Victor Murinde and Kupukile Mlambo, "Development-Oriented Financial Regulation," (University of Birmingham, African Economic Research Consortium, African Development Bank, 2010).

and regulators, as it requires staff training, new processes, and substantial investments in information technology infrastructure. Although the new emphasis on macro-prudential regulation in Basel III is widely welcomed, macro-prudential supervisory capacity is in its infancy in most African countries.

- 2 *Insufficient Information.* Basel standards require high levels of information that are often lacking. To implement risk-based supervision under Basel II, notably the A-IRB approach, regulators require information on each bank's internal risk management practices, its exposure to risks, its funding structure, and its overall risk profile. It is often extremely difficult for host country regulators to access this information from multinational banks operating in their jurisdictions. Basel III imposes further information requirements, as regulators need to monitor systemic risks.
- 3 *Weaknesses in Institutional Governance* In many countries, central banks and regulatory authorities do not have the requisite political and operational independence and enforcement powers. Notably, A-IRB approaches under Basel II rely on highly skilled regulators using judgment and discretion and thus place even more onus on regulators being independent, immune from lawsuits, and willing to challenge the well-connected. Implementing Basel III often requires expanding the reach of regulatory institutions to provide regulators with the legal authority for intervening on the basis of macro-prudential factors (rather than institution-specific factors).
- 4 *Insufficient Cross-Government Coordination* (National and Regional). Basel III and related initiatives seek to strengthen national and regional mechanisms for crisis management. This requires coordination, including between central banks, ministries of finance, deposit insurers, court judges, and tax authorities. In many African countries, the lack of effective resolution systems and crisis management tools is one of the weakest points in the financial safety net. As cross-border banking is substantial, greater cooperation is required between African regulators.
- 5 *Infrastructure Gaps.* Macro-prudential regulation in Basel III requires a sound financial infrastructure, particularly credit reporting institutions, payment and settlement systems, and the legal framework governing financial transactions. Yet this infrastructure is very weak in many countries. The limited coverage of credit reporting institutions is especially problematic, given that these provide essential information on interconnected risks in the financial sector.

## DESIGN FLAWS AND GAPS IN BASEL II AND III<sup>2</sup>

Some elements of Basel standards are widely welcomed. These include the emphasis on strengthening the regulatory infrastructure and on improving the public oversight in Basel II (Pillar 2 and Pillar 3), and the emphasis on systemic sources of risk in Basel III. However specific aspects of Basel standards have been criticized for having, or being expected to have, adverse consequences in developing countries. They have also been criticized for neglecting issues of major concern to Africa regulators.

Thus, even if African governments are able to overcome the institutional weaknesses and gaps in financial infrastructure noted above, they would still face questions to how to best tailor Basel standards to a their jurisdiction.

Seven criticisms of Basel II and III stand out from the studies:

- 1 *Adopting A-IRB approaches under Basel II may favour international banks over smaller domestic banks, increasing bank concentration.* While large internationally active banks can readily move to A-IRB approaches under Basel II, these approaches can be a formidable hurdle for small domestic banks. The latter therefore must continue to operate under the higher capital requirements of the standardized approach, creating an uneven playing field.
- 2 *New capital adequacy ratios in Basel III may lead to a reduction in finance in priority areas, such as SME financing.* Banks in developing countries are generally thought to hold sufficient capital to comply relatively easily with the new capital requirements (there are few Africa-specific studies). However, the quality of core capital held by banks varies and some banks may need to substantially adjust their portfolios, reallocating capital in ways that are detrimental to growth and development (e.g. from relatively risky SME financing towards less risky government securities).
- 3 *New liquidity standards in Basel III may reduce long-term finance.* Some reports suggest that African banks will face no problems meeting the new liquidity standards.

<sup>2</sup> Main sources as in footnote 1, plus: FSB, "Identifying the Effects of Regulatory Reforms on Emerging Markets and Developing Economies: A Review of the Potential Unintended Consequences. Report to the G20 Finance Ministers and Central Bank Governors. Financial Stability Board," (2012); FSB, "Financial Regulatory Factors Affecting the Availability of Long-Term Investment Finance: Report to the G20 Finance Ministers and Central Bank Governors Financial Stability Board," (2013). FSB, "Monitoring the effects of agreed regulatory reforms on emerging markets and developing economies (EMDEs). Financial Stability Board," (2013). World Bank, "Global Financial Development Report 2013: Rethinking the Role of the State in Finance.," (Washington D.C.: World Bank, 2012). Ricardo Gottschalk, *The Basel capital accords in developing countries: challenges for development finance* (Basingstoke: Palgrave Macmillan, 2010). Louis Kasekende, Justine Bagyenda, and Martin Brownbridge, "Basel III and the Global Reform of Financial Regulation: How Should Africa Respond? A Bank Regulator's Perspective.," (2011). Pietro Calice, "A Preliminary Assessment of the Implications of Financial Regulatory Reform for African Countries," in *Policy Briefs on the Financial Crisis* (African Development Bank, 2010).



Yet others suggest that banks may in fact face challenges meeting quality requirements. In cases where banks need to adjust their portfolios to meet the Liquidity Coverage Ratio (LCR) (requiring them to hold sufficient high quality liquid assets (HQLA) to survive 30 days of acute stress) they may struggle to do so because of a limited supply of government or highly-rated corporate bonds. This may reduce the turnover and liquidity of bond markets driving up the cost of finance. Compliance with the Net Stable Funding Ratio (NSFR) (the longer-term structural ratio that addresses liquidity mismatches and provides incentives for banks to use stable sources to fund their activities) may result in banks reducing longer-term financing.

- 4 *The Basel III counter-cyclical buffer is poorly designed and is likely to be ineffective.* Given that many African banks hold levels of capital in excess of the Basel III minimum, the introduction of a 2.5 percent countercyclical capital buffer is unlikely to be high enough to be effective. As designed, the counter-cyclical buffer is based on trend deviations of private sector credit as a percentage of GDP (a credit-to-GDP ratio). This is inappropriate for countries with large swings in credit and growth cycles, as this measure is unlikely to detect significant build-up of risk. Thus the countercyclical buffer needs substantial modification to work in a developing country context.
- 5 *Basel III does not address the systemic risks arising from the banking system's reliance on foreign currency denominated liabilities.* The build-up of currency mismatches on bank and borrower balance sheets, combined with sharp currency fluctuations, can heighten credit and liquidity risks. This is a major source of systemic risk in many developing countries, and their regulators use a variety of prudential and administrative measures to limit currency mismatches. Yet measures to address this source of systemic risk are absent from the Basel III framework.
- 6 *Basel III doesn't solve bank resolution challenges for most African countries.* Basel III sets up resolution mechanisms for globally systemically important banks (G-SIBs), but it is still unclear how effective home-host cooperation will be in resolution cases where a subsidiary is systemically important in the host country but not systemically important to the home regulatory or parent bank. Further, the international banks that are systemically important in most African countries are regional banks and are not classified as G-SIBs. Thus effective regional institutional arrangements for cooperation on bank resolution are urgently needed.
- 7 *Basel III may distort the regulatory agenda.* Small-scale non-bank institutions such as savings and credit cooperatives and micro-finance institutions are growing rapidly in many African countries and in many cases are inadequately regulated. Prioritizing the adoption and implementation of Basel standards could divert scarce resources away from the regulation and supervision of the non-bank financial sector.

## HOW ARE AFRICAN REGULATORS RESPONDING TO BASEL II AND III?

The data we have is patchy. The most recent available data (2014) covers only 21 African countries and is gleaned from government officials' responses to voluntary Financial Stability Institute (FSI) surveys. Indeed, a first step in our project will be to improve the coverage and quality of data on the uptake of global banking standards across Africa.

The survey data enables us to compare the adoption of Basel II, 2.5 and III across countries (Table 1). In our scoring, we follow the survey, which breaks the Basel standards into their constituent parts and asks respondents to indicate the state of implementation of each element on the following scale: not applicable (0), draft regulation exists but not published (1), draft regulation published (2), final rule published (3), and final rule in force (4). Basel II and Basel III are sub-divided into eight parts, so the maximum implementation score for each is 32, while Basel 2.5 is sub-divided into four parts, with a maximum score of 16.

Overall, we can identify three broad responses taken by regulators. The first is to *not to adopt any elements* of the relevant standard. Only two countries (Ghana and Angola) have yet to adopt any element of the Basel standards, although there is substantial variation across the standards, with 5 countries yet to adopt any element of Basel II; 13 countries yet to adopt any element of Basel 2.5; and 5 countries yet to adopt any element of Basel III.

The second response is to *make initial moves* to adopt some elements of Basel standards, by drafting regulations, but not (yet) proceeding to publish and implement them (i.e. maximum scores of 1 or 2 on some elements of Basel). This is a common approach, adopted by seven countries on Basel II, five countries on Basel 2.5, and eleven countries on Basel III. While most countries have initiated the process of drafting regulations on only a few elements, some countries have started drafting legislation on all elements of Basel II, 2.5 and III (Tanzania, Zambia and Gambia).

The third response is to *adopt and implement elements of Basel standards* (i.e. maximum scores of 3 or 4 on some elements of Basel). Eight countries have adopted and/or are implementing elements of Basel II; two countries have adopted and/or are implementing elements of Basel 2.5; and five countries have adopted and/or are implementing elements of Basel III. As might be expected, South Africa, the only African member of the Basel Committee, has the highest overall levels of adoption: it is fully implementing Basel II and 2.5, and has proceeded to adopt and/or implement all elements of Basel III. Other relatively high adopters include Zimbabwe, Mauritius, Namibia and Kenya.

Scrutinizing the specific elements of Basel standards, the trends are broadly as we might expect given the implementation challenges and criticisms noted above. Under Basel II, Pillar 2 on supervisory review and Pillar 3 on disclosure standards for banks have been adopted more frequently than

the more contentious aspects of Pillar 1 on minimum capital requirements. Notably, while thirteen countries have taken steps to adopt and/or implement the standardized approach to credit risk, only five of these countries have taken steps to adopt the A-IRB approach and, of these, only one country (South Africa) is implementing the A-IRB approach.

On Basel III, regulators have most frequently taken steps to adopt and/or implement provisions on the definition of capital, the leverage ratio, capital conservation buffer, and liquidity standards. This suggests that some African countries

are able to comply relatively easily with capital and liquidity standards, raising questions about the validity of concerns in the literature on adverse impacts of adopting these standards on lending to SMEs and long-term projects. The counter-cyclical buffer shows lower levels of take-up, supporting the suggestion that it might not be appropriately designed for a developing country context. Relatively few countries have taken steps to adopt provisions on risk coverage (counterparty credit risk), which is to be expected given the low levels of trading in derivatives and repurchase agreements.

TABLE 1: ADOPTION OF BASEL II, 2.5 AND III BY AFRICAN COUNTRIES

	Basel II (score out of 32)	Basel 2.5 (score out of 16)	Basel III (score out of 32)	Cumulative (score out of 80)
Group 1 (no implementation)	Angola (0), Congo DRC (0), Ghana (0), Madagascar (0),	Angola (0), Botswana (0), Congo DRC (0), Ghana (0), Guinea (0), Lesotho (0), Liberia (0), Madagascar (0), Malawi (0), Mauritius (0), Mozambique (0), Nigeria (0), Uganda (0)	Angola (0), Ghana (0), Guinea (0), Mozambique (0), Seychelles (0)	Angola (0), Ghana (0)
Group 2 (initial moves to implement)	Botswana (10), Gambia (8), Lesotho (4), Nigeria (13), Tanzania (8), Uganda (4), Zambia (8)	Gambia (4), Namibia (4), Seychelles (4), Tanzania (4), Zambia (4), Zimbabwe (4)	Botswana (3), Congo DRC (5), Gambia (8), Lesotho (1), Madagascar (2), Malawi (3), Mauritius (10), Nigeria (8), Tanzania (8), Uganda (14), Zambia (8)	Botswana (13), Congo DRC (5), Gambia (20), Guinea (3), Lesotho (5), Madagascar (2), Nigeria (21), Tanzania (20), Uganda (18), Zambia (20)
Group 3 (adopt and implement)	Guinea (3), Kenya (12), Liberia (12), Malawi (20), Mauritius (24), Mozambique (20), Namibia (16), Seychelles (4), South Africa* (32), Zimbabwe (21)	Kenya (4), South Africa* (16)	Kenya (16), Liberia (12), Namibia (10), South Africa* (25), Zimbabwe (20)	Kenya (32), Liberia (24), Malawi (23), Mauritius (34), Mozambique (20), Namibia (30), Seychelles (7), South Africa* (73), Zimbabwe (45)

\*As a member of the Basel Committee for Banking Standards, South Africa undergoes implementation monitoring rather than completing the voluntary FSI survey. The format of reporting is slightly different to that of non-BCBS states.

Source: Financial Stability Institute Survey: Basel II, 2.5 and III implementation, July 2014.

## SIX POSSIBLE EXPLANATIONS FOR VARIATION IN BASEL ADOPTION

Once our project has established a more comprehensive and reliable database of adoption and implementation across African countries, we will seek to explain variation in the uptake of Basel standards. Academic and policy research provides us with six possible explanations for this variation and our research will test their relevance and explanatory power.

### HYPOTHESIS 1: FINANCIAL DEVELOPMENT.

A first and obvious possible explanation is that patterns of adoption reflect the varying development of financial markets across Africa. If indeed Basel standards are more appropriate for countries with deeper and more sophisticated financial markets, it is reasonable to expect that regulators in countries with relatively deep financial markets will be more likely to adopt Basel standards than their counterparts in countries with shallower financial markets.

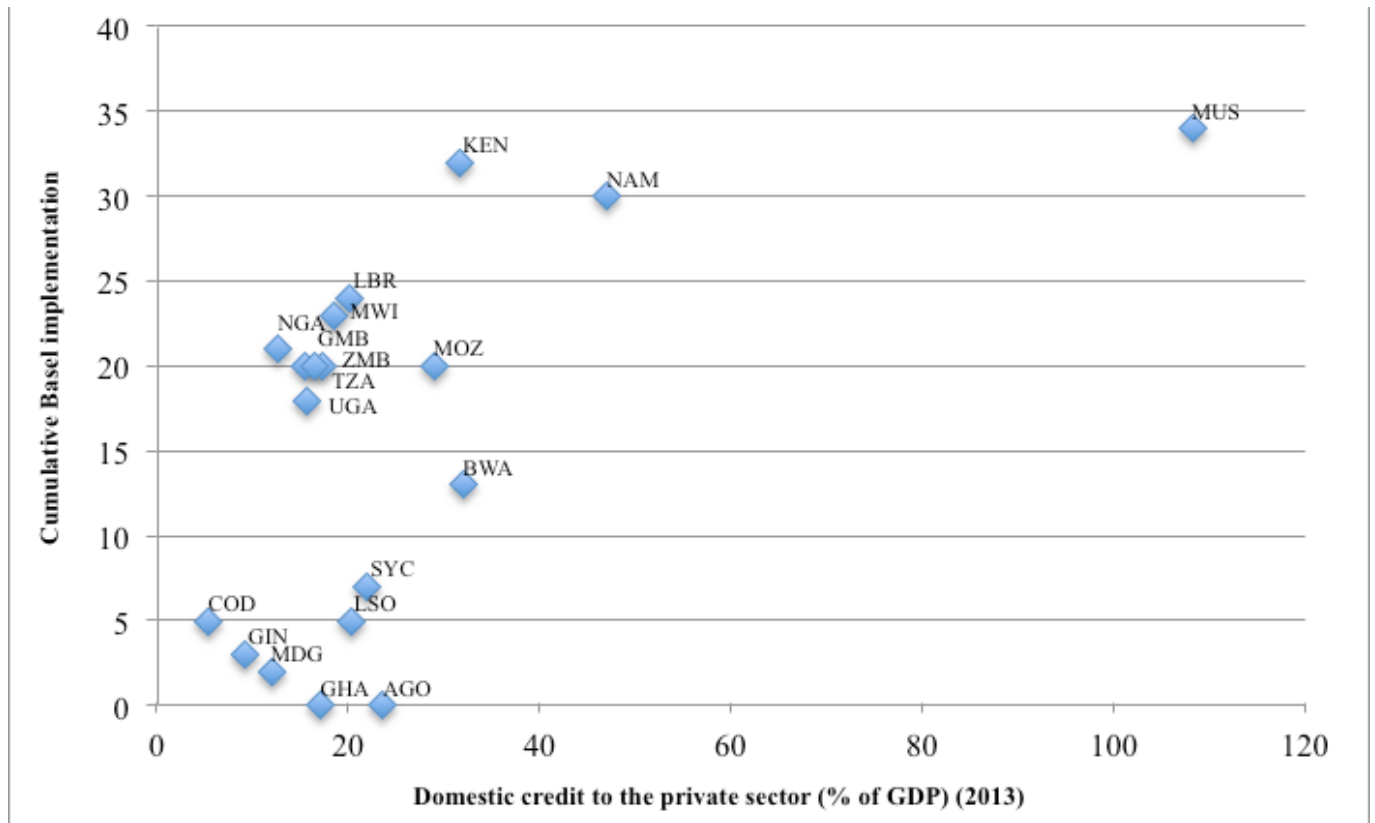
A quick ‘back-of-the-envelope’ inspection of the data suggests that financial development may be able to explain some, although not all, of the variation. Using domestic credit to the private sector (measured as a percentage of GDP) as

a proxy for financial sector development<sup>3</sup> we find a positive correlation with the implementation of Basel standards (Figure 1). At one extreme is South Africa (not visually represented as it has far higher values on both axes), which has by far the deepest financial sector and has implemented nearly all aspects of Basel II, 2.5 and III (cumulative score of 73). Similarly, Mauritius and Namibia have relatively deep financial sectors and have relatively high cumulative scores (34 and 30 respectively).<sup>4</sup> At the other end of the spectrum, Congo DRC has a low level of financial depth and, as we might expect, has only begun to adopt a few some elements of Basel standards. However we also see countries that have adopted Basel standards to a greater degree than we might expect given their financial depth (including Kenya, Liberia, Malawi, Nigeria, Gambia, Zambia, Tanzania), and countries that have adopted standards to a more limited degree than we might expect (including Ghana and Angola).

<sup>3</sup> We are aware of efforts to diversify the measures of financial development, e.g. the World Bank’s Global Financial Development Database, but we find that credit to the private sector remains a useful, if crude, proxy for financial depth.

<sup>4</sup> Note that data on the ratio of domestic credit to GDP was not available for Zimbabwe.

FIGURE 1: CORRELATION BETWEEN FINANCIAL DEPTH AND BASEL ADOPTION



Sources: Financial Stability Institute Survey, Basel II, 2.5 and III implementation, July 2014; World Bank, World Development Indicators, 2013.

What, aside from financial sector development, might explain this variation?

### Domestic Factors

#### HYPOTHESIS 2: TECHNICAL AND INSTITUTIONAL FIT.

We noted above that many African countries face major implementation challenges when they adopt Basel II and III. These range from inadequate human and financial resources, to inadequate information, to weak governance of regulatory institutions. It is therefore plausible that the degree of adoption and implementation of Basel standards reflects the ‘goodness of fit’, the complementarity between international standards and domestic regulatory institutions and resources.<sup>5</sup> If this were the case, we would expect to see relatively low levels of adoption where governments are particularly resource-constrained (this is particularly likely to be the case for more sophisticated and resource-intensive forms of regulation such as A-IRB and macro-prudential elements of Basel III). We may also observe regional patterns, where countries harmonizing regulatory approaches and institutions adopt a common approach to Basel standards.

#### HYPOTHESIS 3: REGULATORY CAPTURE.

Regulation is inherently political, as it creates winners and losers. Many scholars find evidence that governments design and implement regulation in response to pressure from organized interest groups. This may result in ‘regulatory capture’: the control of the regulatory process by those whom it is supposed to regulate or by a narrow subset of those affected, with the consequence that regulatory outcomes favour the narrow ‘few’ at the expense of society as a whole.<sup>6</sup> In the case of Basel standards, we saw above that domestic banks may be at a competitive disadvantage vis-à-vis international banks from the adoption of A-IRB approaches. It is plausible that regulators are more likely to adopt A-IRB approaches where international banks are a relatively more powerful lobby group than in countries where domestic banks are a relatively more powerful lobby group. Indeed one study of Basel II in 150 countries found a significant correlation between the presence of foreign subsidiaries whose parent bank was already implementing Basel II and the adoption and implementation of Basel II in the host jurisdiction.<sup>7</sup>

<sup>5</sup> This is in a similar vein to Tim Büthe and Walter Mattli, *The new global rulers: the privatization of regulation in the world economy* (Princeton, NJ: Princeton University Press, 2011).

<sup>6</sup> See Walter Mattli and Ngaire Woods, *The politics of global regulation* (Princeton, NJ ; Oxford: Princeton University Press, 2009).

<sup>7</sup> Young Bong Cho, “Why do countries implement Basel II? An analysis of the global diffusion of Basel II implementation.” (London School of Economics, 2013).

## International Factors

### HYPOTHESIS 4: DIFFUSION THROUGH EXPERT NETWORKS.

There is some evidence that international economic regulations spread through networks of experts. According to this literature, the norm of adopting and implementing these standards as ‘best practice’ diffuses through technical, professional networks.<sup>8</sup> If this were the case, we would expect to see higher adoption and implementation of Basel standards in those African countries where regulators are closely integrated into international professional networks that promulgate the implementation of Basel standards. For instance, where countries are active members of the FSB’s regional consultative groups. Alternatively, it is plausible that Basel standards are advocated by providers of technical advice, including international consultancy firms, which would lead us to expect higher uptake of standards in countries with substantial technical assistance programmes.

### HYPOTHESIS 5: SIGNALLING TO INTERNATIONAL FINANCIAL MARKETS.

Regulators may adopt international standards in order to signal competence, stability and sophistication to bond markets and international investors. For instance, there is evidence that countries adopted the IMF’s Special Data Dissemination Standards (SDDS) primarily as a market-signalling device.<sup>9</sup> Given the global standing of the Basel standards, and their position as international ‘best practice’ in financial regulation, it is plausible that their implementation can be used to communicate the competence and reliability of regulators. In fact, various assessments of business climates in African countries use the implementation of Basel as an indicator.<sup>10</sup> As credit ratings agencies factor in countries’ adherence to Basel standards when making assessments, it is plausible that regulators adopt standards in order to improve their country’s credit rating and thereby increase their access to international financial markets.

### HYPOTHESIS 6: RESPONSE TO COERCIVE PRESSURE.

The adoption and implementation of Basel standards might be the consequence of pressure from (i) foreign banks, (ii) foreign governments, or (iii) international financial institutions. In other areas of international political economy, threats to withdraw trade preferences have been made to secure trade-related regulatory changes from preference-dependent African countries. For instance, in the case of Basel standards, it is plausible that foreign banks exert coercive pressure

in order to secure regulatory convergence by threatening to withdraw from African economies if there is no regulatory change.

## CONCLUSION

An investigation of African responses to global financial standards is pertinent and timely. African regulators are likely to come under increasing pressure to adhere to the standards. The FSB is a key driving force, taking steps to ensure worldwide adoption and adherence to key financial standards. It is monitoring compliance in around 60 countries – both FSB members and other jurisdictions that rank highly in financial importance – including three African countries (South Africa, Mauritius and, since 2015, Nigeria). The scope of this monitoring exercise will increase over time. Importantly, the FSB has identified a ‘toolbox’ of measures to ensure compliance, ranging from positive measures (such as policy dialogue and technical assistance) to negative measures intended to ‘apply additional pressure’ (such as public advisement to financial institutions exercise caution in conducting business with the non-compliant jurisdiction).

At the same time, there is growing recognition that global standards may need adjusting for developing countries, and that developing countries need to be better represented at the FSB. Indeed these changes are vital to preserve the FSB’s legitimacy and to ensure that global standards are welcomed and implemented by all jurisdictions. Since the G20 in Brisbane, the FSB is allowing non-member jurisdictions to be involved in its various committees and working groups, and to attend Plenary meetings. These changes provide African regulators with new opportunities to shape global standards.

<sup>8</sup> On Basel, in particular, see: *ibid.*; Ranjit Lall, “Timing as a source of regulatory influence: A technical elite network analysis of global finance,” *Regulation & Governance* (2014)

On epistemic diffusion, in general see: Peter M Haas, “Epistemic Communities and International Policy Coordination,” *International Organization* 46, no. 1 (1992); Zachary Elkins and Beth Simmons, “On Waves, Clusters, and Diffusion: A Conceptual Framework,” *The ANNALS of the American Academy of Political and Social Science* 598, no. 1 (2005).

<sup>9</sup> Layna Mosley, “Attempting global standards: national governments, international finance, and the IMF’s data regime,” *Review of International Political Economy* 10, no. 2 (2003).

<sup>10</sup> Beck et al., *Financing Africa: Through the Crisis and Beyond*.

# It's time to repeal the remittances "Super Tax" on Africa

**Dilip Ratha**

World Bank, with

**Dame Tessa Jowell**

London Labour MP

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Remittances are the shining light of development policy. While debate rages in austerity-hit Western capitals about spending on aid, remittances cost tax-payers nothing. Remittances to developing countries are worth nearly half a trillion dollars – that's three times the level of aid – and they're rising fast, quadrupling since the turn of the century. And remittances work. It's hard to imagine a more efficient targeting system than people sending money home to their own families and the facts bear that out; remittances are linked to improved economic, health and education outcomes. And as if those benefits weren't enough, remittances are a huge driver of financial inclusion, acting as a gateway to banking for the people sending and receiving them.

But people sending money home to many parts of the world, particularly sub-Saharan Africa, are paying far too much. They face what is, in effect, a remittances 'super tax'. A worker sending \$200 from London to Lagos can pay fees of over 13%, more than fifty percent above the global average. And within Africa it's even worse, sending money from South Africa to Malawi could cost upwards of 20%. Of course we all expect some fees for financial transactions but there is strong evidence that these costs are excessive and are restricting the poverty-zapping remittances that reach poorer countries. Reducing fees for sub-Saharan Africa to the global average for instance would mean an extra \$1.3 billion reaching families in the region.

And we're not moving nearly fast enough to reduce fees on remittances. We've known about the issue for a while; the G8 committed in 2009 to the '5x5 goal' of reducing the global average fee for remittances to 5% within 5 years. But despite some progress, we're still at close to 8% globally and 12% for sub-Saharan Africa. Indeed, if the cost of sending remittances could be reduced by just 5 percentage points relative to the value sent, remittance receipts in developing countries would receive over \$20 billion dollars more each year than they do now. That amount of money could educate 18 million children and buy enough vaccines to prevent 8 million children dying from diseases like malaria.

To fix this situation, we need action on three fronts.

First and foremost, we need to increase competition in the global remittance market and empower migrants by helping them make informed choices about the services they use. This is probably the most effective way to drive down costs and will require action at all levels and in countries that are net senders and net recipients of remittances.

Regulation of international money transfers is complex, and has been tightened in some areas because of understandable concerns over illicit flows of money from criminals and terrorists. But there are things we can do while maintaining those safeguards. One is to require higher standards of transparency from money transfer companies on how they charge – on exchange rates, fees and taxes for both sender and recipient – so that it's easier for consumers to shop around and know what they're getting. Another is for governments to unpick exclusivity agreements which tie particular banks to particular money transfer companies. And a third way to boost competition is to reduce restrictions which prevent post offices and micro-finance institutions, which are much more accessible in many rural parts of the world than mainstream banks, from performing money transfers. None of these actions alone will reduce fees overnight, but together they would increase choice and help push costs down over time.

Second, we need to encourage technological innovation. Mobile money is already transforming the financial sector in many countries: you can now use your phone to buy a round of drinks in Nairobi, or pay Ebola health workers in Sierra Leone, or give farmers access to weather insurance in Tanzania. Emerging technologies have the power to extend direct person-to-person, phone-to-phone money transfers across national and currency borders, lowering costs at the same time. We need to back these innovations and let the best thrive. Again, it's about striking the right balance of protecting consumers while letting new technologies emerge, and it might take some creativity on the part of regulators to get it right.

Third, we need to keep up the political pressure for reform. We know that remittances are a large and growing part of the development landscape. And we know what we have to do to make them even more effective. Reducing the cost of remittances comes down to political will – this is a global issue and it needs a collective global response.

And we're seeing early signs that when the case is made strongly the money transfer companies listen. For example, in London a group of companies are committing to a first ever World Remittance Day where they will commit to a day with 'no fees, no margins' on all transfers as a signal of intent to lowering costs in the future. This is accompanied by financial education and inclusion for Londoners; in a city where around one in three are foreign born, the potential impact is huge.

That's the really good news: we know what we need to do. If we can unite on this issue we can repeal the super-tax on remittances and improve the lives of millions of families around the world.



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