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ANNUAL MEETINGS OF THE ASSOCIATION OF AFRICAN CENTRAL BANKS (AACB)

(Windhoek, Namibia, August 18, 2006)

DRAFT REPORT OF THE 2005 SYMPOSIUM

On

" RISK-BASED BANKING SUPERVISON AND THE IMPLICATIONS OF BASLE II "

(Accra, Ghana, 28 July 2005)

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1. The Association of African Central Banks (AACB) organised a symposium on "Risk-Based Banking Supervision and the Implication of Basle II" on July 28, 2005 at the La Palm Royal Beach Hotel, Accra, Ghana. The symposium preceded the 29th Ordinary Session of the Association, also held in Accra on the 29th July 2005, and was organised to increase understanding and implications of the new Capital Accord Framework, commonly referred to as Basle II.

2. The opening ceremony of the symposium was marked by the welcoming address delivered by Dr. Paul A. Acquah, Governor of the Bank of Ghana, followed by an opening statement by Mr. Jean-Félix Mamalepot, Governor of the Bank of Central African States (BEAC) and Chairman of the Association.

3. Delivering his address, Governor Acquah first welcomed the participants. He then thanked Ms. Elisabeth Roberts of the Financial Stability Institute of the Bank for International Settlements (BIS), who had agreed to make a presentation on the Principles of Basle II.

4. Dr. Acquah indicated that the Symposium was being held in a context marked by an improved economic environment in Africa, with relative stability of exchange rates and increased growth, in comparison with the recent experience. Financial stability and the application of standard international practices to that end constituted the ultimate objective of improving the statutory framework and that explained why the Governors attached so much importance to the Seminar.

5. The Basle II Agreement, a vital mechanism for financial stability, is reputed to offer a more integrated framework for managing risks and enhancing the security and stability of the financial system. That being the case, in the course of their discussions, the participants were expected to assess whether the current status of the banking system, as well as the trend, management and control of risks in the affiliated Central Banks facilitate the transition towards the adoption of the principles of the Basle II Agreement.

6. From this viewpoint, Governor Acquah emphasised the need to address:

   - The obstacles to the adoption of the Basle II Agreement;
   - The conditions required for the enforcement of Basle II;
   - The effects on training and the cost-benefit analysis of resource utilisation; and
   - The types of legal, technological and institutional infrastructures required.

7. In view of these concerns, Governor Acquah warned that norms alone did not suffice so the banks of developing countries are likely to face serious problems in implementing the Agreement, because of the lack of technical skills, the embryonic nature of the financial markets as well as some structural rigidities and inadequacy of the legal systems.

8. Governor Acquah ended his statement by expressing the hope that by the end of the symposium, the participants would have a better understanding of the principles of Basle II and that the countries that had made progress would share their experience with those entering into that process.

9. On his part, the Chairman of AACB, Governor Mamalepot, on behalf of the participants, thanked Governor Acquah and the staff of the Bank of Ghana as well as the Authorities and the people of Ghana, for the warm and fraternal welcome they enjoyed since their arrival in Accra.

10. He indicated that the theme chosen for the Symposium was intended to shed more light on the principles of the new Agreement and the advantages it offered to Central Banks for a better mastery of the banking systems. It would also help in assessing the measures taken or envisaged by African Banks in that framework.

11. Having cited some advantages of the Basle II Agreement, which would enhance the sensitivity of capital adequacy requirements in relation to risks and induce the banks to adopt the most advanced systems of evaluation and management, Governor Mamalepot pointed to some uncertainties associated with the new Agreement because of its complexity:

    - The transition from Basle I to Basle II Agreement would necessitate amendments to the legislation and regulation in force whose scope would be determined by the quality of the existing legal framework as well as the specific characteristics of each country.

    - The implementation of Basle II would also be contingent on a structure as well as human and technical resources adapted to the related requirements such as competence, specialisation and data processing.

    - The current state of human and technical resources available at the level of the supervisory authorities and banks constitutes a real obstacle that is hardly surmountable in the short term because of the huge investments to be made.

    - As regards the measurement of the credit risk, the recourse to external organisations for the evaluation of credits also poses a problem in the implementation of this approach since a large number of banks in the African countries do not operate on the world scale and have no culture of performance evaluation, not forgetting the lack of credible local evaluation bodies.

12. Governor Mamalepot ended his speech by indicating that the implementation of the Basle II Agreement posed formidable challenges to African Banks. It was therefore up to the participants to discuss them, draw lessons and make the necessary recommendations to enhance the development of our different banking systems.

13. In her presentation on *the Principles of Basle II*, Ms Roberts said Basle I was issued in 1988 but became fully operational in internationally active banks in the G-10 countries in 1992. Key features of Basle I include, uniform definition of capital, risk weights applied to category of assets based on perceived four-tier risk scale (0,20,50 & 100 percent), conversion of off-balance sheet exposures to on-balance sheet by applying appropriate risk weights, and a minimum of 8 percent capital adequacy ratio. Basle I was amended in 1996 to incorporate market risks.

14. Basle I has led to substantial increase in capital adequacy ratios of banks. It is relatively simple in structure leading to its worldwide adoption. It has engendered increased competitive equality among international banks, instilled greater discipline in managing capital and serve as benchmark for assessment by market participants. Weaknesses of Basle I include its limitation in the differentiation of credit in relation to a bank's risk profile and its failure to explicitly recognize operational and other risks. Besides, Basle I does not provide proper incentives for credit risk mitigation techniques. Rather, it creates room for regulatory arbitrage by banks through instruments such as securitization to avoid certain capital charges. It is these weaknesses associated with Basle I that have necessitated the introduction of Basle II.

15. The new Capital Adequacy Framework commonly referred to as Basle II, which seeks to address perceived deficiencies in Basle I, was finalized and released in June 2004 after extensive consultative process that began in 1998. Basle II consists of three pillars namely:

    - Pillar 1 – minimum capital requirements
    - Pillar 2 – supervisory review process and
    - Pillar 3 – market discipline

Pillar 1 – Minimum capital requirements

16. Pillar 1 of Basle II broadens the scope of capital adequacy assessment of banks to include operational risk, in addition to credit and market risks as per Basle I. It further gives recognition to banks' own models or methodologies for measuring and managing risks. This pillar allows transiting banks to adopt any of these three progressively complex approaches namely standardized approach, foundations internal risk based (IRB) approach and advance internal ratings-based (IRB) approach for assessing and making capital provision for credit risks.

17. The standardized approach is the simplest of the three approaches. It involves slotting of exposures into risk-weight buckets based on broad distinctions of risk determined by supervisors. The risk weights are more sensitive to inherent risks and are based on external credit assessments as well as more refined treatment of credit risk mitigation.

18. The foundations IRB and advance IRB approaches for assessing credit risks, are largely bank-determined methodologies. They rely on banks' own assessment of risk factors based on risk components such as probability of default, loss-driven default, exposure at default, maturity, and risk weight functions as well as minimum requirements. They involve separate approaches for each portfolio of assets and are subject to supervisory validation and approval.

19. As with credit risk, Pillar 1 also envisages three different approaches with respect to assessment and capital provision for operational risk. These are the Basic Indicator approach which is similar to the standardized approach under credit risk, Standardized approach and the Advanced Measurement approach which are also IRB approaches. Again the IRB approaches involve quantitative risk modelling, stress testing and are subject to supervisory validation and approval.

20. Thus Pillar 1 has retained aspects of the old capital accord while making radical changes to measurement and coverage of risks. Pillar 1 also recognises credit risk mitigating techniques and has a large menu of options to accommodate the variety and level of sophistication in banks.

Pillar 2 – Supervisory review process

21. The Supervisory review process requires that banks regularly assess the adequacy of their capital positions vis-à-vis the risk assumed and also that supervisors review these positions and take necessary action in response to these reviews. It therefore calls for supervisory capacity building to enable the supervisor validate the various bank methodologies for assessing and managing risks.

Pillar 3 – Market discipline

22. Market discipline imposes a set of disclosure requirements for banks to allow market participants to assess key information as such the application of capital and risk exposures, risk assessment procedures and capital adequacy of the banking institution. Basle II thus requires banks to make adequate disclosure on their operations to both supervisors and the general public.

Time frame for Implementation

23. Basle II framework will replace Basle I for internationally competitive banks in the G10 countries by December 2006 but countries outside the G10 have the option to determine whether and when to implement Basle II. The International Monetary Fund has issued a written statement to the effect that its FSAP assessments on banking supervision would not be based on the Basle II Capital Accord Framework.

24. African bank supervisors may assess the strength of Banking Systems on whether and when to accede to Basle II and in the process confer with Supervisory Authorities elsewhere. There may be the need to amend existing Banking Laws, build capacities in supervisory department, banks and institutions. Basle II committees and sub-committees on the different areas of preparation may be set up.

25. In his contribution, the first discussant and Deputy Governor of the Central Bank of Nigeria, Mr. Tundi Lemo, posed a number of questions. Whether or not Basle II is desirable for developing economies? How prepared are African Banking Systems for Basle II? Whether the necessary infrastructure and capacity are in place for implementation of Basle II? Will validation of banks models for measuring and managing risks by supervisors not expose them to litigations when validated models fail to bring the desired results?

26. African banks, and bank supervisory authorities are in transition and may not be in the position to commit resources to undertake the sophisticated techniques required under Basle II. Bank Supervisors in Africa were yet to develop adequate capacities to enable them validate banks risk assessment and management models in their varying degrees of sophistications. The absence of credible credit rating agencies in many African countries may hamper the smooth implementation of Basle II. The market discipline pillar of Basle II requires the publication of very detailed financial statements by the banks. However, the level of literacy in Africa is very low and most people will not appreciate and make use of such detailed financial statements.

27. Mr. Lemo advised African banks to work towards full compliance with the Basle Core Principles and adoption of risk-based supervision as a first step towards transiting to Basle II. Meanwhile, African supervisors could raise the capital adequacy ratio to take care of all other risks that are currently not covered under Basle I. Africans may give themselves a ten-year time frame from now to transit to Basle II.

28. In his contribution, the second discussant and Governor of the Bank of Kenya, Dr. Andrew K. Mullei highlighted the principal features of Basle II before citing the conditions essential for its implementation and the challenges that the African countries had to meet.

29. These conditions were enumerated as follows:

- Wholesale application of Basle I before the adoption of Basle II, since the countries that adopted Basle I did not necessarily take account of financial charges for market-related risks.

- Establishment of risk management systems by the banks to help them determine, measure and control the risks facing them within the Basle II framework.

- Compulsory adoption of the fundamental principles of bank supervision, as defined by the Basle Committee, before the enforcement of Basle II.

- The crucial importance of supervision based on the risks for the supervisory authorities fulfilling their obligations regarding prudent supervision under Basle II: this is contingent on a continuous evaluation rather than occasional evaluation and therefore constitutes an indispensable condition for the enforcement of Basle II.

- Capacity building for the authorities responsible for bank regulation: Basle II offers new approaches and methods that require skills in areas such as statistics and modelling. Apart from human capital, the regulatory organs and the banks will need some information facilities for the storage and analysis of data envisaged in the Basle II framework.

30. The challenges consisted in:

- Amending the laws of the States and implementing initiatives such as risk-based supervision and collective supervision. However, because of conflicts of priorities and concurrent demands for resources intended for supervision, the enforcement of Basle II could be accorded secondary importance.
- Building capacity for the African countries that do not have adequate human resources to do so (specialised training in the various components of Basle II or retraining courses for supervisory staff).
- Improving the quality of data and ensuring their availability. The elaborate modelling methods require adequate chronological data for developing models as well as the engagement of human resources and establishment of a sizeable information structure by the banks and supervisory authorities.
- The legal challenge relates to the requirement of Pillar II that supervisors ensure that the banks maintain a volume of capital consistent with their risk financing profile. This, if enforced, may induce banks to maintain a volume of capital greater than the minimum required. However, many supervisory authorities may not have jurisdiction to oblige the banks to maintain a volume of capital exceeding the minimum required.

31. To facilitate implementation of Basle II, Dr. Mullei made the following proposals:

- Each country should prepare its road map for Basle II while taking account of its national priorities and the status of its preparation in view of the prerequisites for the implementation of Basle II; this opinion was supported by the Basle Committee which felt that the time frame for the ultimate adoption of Basle II should be determined by the situation of each country, even if it is in the interest of all the countries to engage in this process.

- A strong infrastructure for supervision should be established at first and the approach consisting in "adopting Basle II at all costs" should be avoided. According to IMF and the World Bank, future evaluations covering the financial sector will not be conducted on the basis of the revised framework for conformity to the sector if a country decides not to apply it. They will rather be carried out on the basis of regulatory/supervisory standards adopted by the different countries concerned and their results in relation to the selected standards.

32. In conclusion, Governor Mullei underscored the fact that this symposium offered participants the opportunity to learn from one another, to exchange their ideas and opinions about the stability of their financial sectors. The road to Basle II is full of pitfalls that no one can overcome single-handedly, hence the need for collective reflection and exchange of experiences periodically.

General Discussions

33. The discussions were focused mainly on the expediency of developing countries implementing the Basle II Agreement, constraints inherent in the implementation of the Agreement and relevance of the 2007 deadline set for its implementation. In general, participants recognised the need to enforce the principles of Basle II in so far as they help in strengthening the status of the banks in addition to enhancing the viability and stability of the international financial system.

34. Discussing the constraints inherent in the implementation of Basel II by African countries, the participants pointed to the inadequacy of infrastructure, the ongoing bank restructuring process, lack of national performance rating agencies, the need for staff capacity building and the revision of legislation. On the particular concern over capacity building, the participants expressed the hope that the IMF and the World Bank would assist in training African bank supervisors.

35. Concerning the deadline for implementation of Basle II, the participants tendered their preference for a gradual approach. In this regard, they underscored the need to ensure an effective application of the twenty-five (25) fundamental principles of Basle I before any attempts to embark on the process of implementation of the Basle II Agreement. Meanwhile, seminars would be organised between the Central Banks and commercial banks to better define the features of this new Agreement and contribute to its smooth implementation. Some of the Governors recommended the establishment of working groups for some in-depth reflection on the conditions required for a satisfactory implementation of the Basle II Agreement.

36. In summary, the exchanges enabled the participants to reassert the need to adopt new principles for enhanced banking supervision as a means of preserving the viability and stability of the international financial system. However, the Governors felt that the twenty-five (25) basic principles of Basle I should be applied before the implementation of these new principles. At any rate, the African countries could be allowed some time to observe the outcome of the implementation of the Basle II Agreement by member countries of G1O, since there is no provision obliging them to implement it precisely by 2007.