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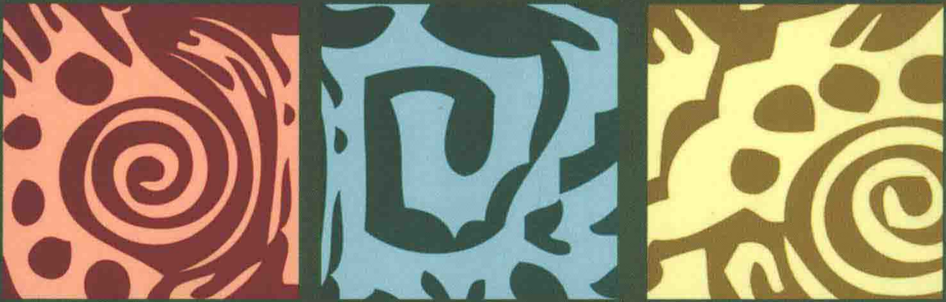
Bank Regulatory Reforms in Africa



Edited by Victor Murinde

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Foreword

This book is based on papers that were presented at the Twelfth Senior Policy Seminar (SPS XII) of the African Economic Research Consortium (AERC), which took place in Mombasa, Kenya, on 22–24 March 2010. Leading public policymakers, monetary and financial economists, professional bankers and advisors from central banks across Africa gathered for sober reflection on one topical subject – bank regulatory reforms in Africa. The seminar was opened by the Hon. Wycliffe Ambetsa Oparanya, Minister for Planning and National Development, Government of Kenya. Professor Njuguna Ndungu, Governor of the Central Bank of Kenya, delivered the opening keynote address.

The three days of intense discussions focused on how to enhance bank competition and intermediation efficiency across Africa. This regionwide meeting brought together 71 economic policymakers and advisors drawn from the highest levels of government and representing 22 countries in the continent.

In the wake of the recent financial crisis, which has created enormous regulatory risks, some changes in the content of banking regulation are crucial and any positive transformations are likely to produce encouraging results. The regulatory system in many African countries has evolved in the recent past, notably through progressively more detailed capital requirements and increasing demands that banking organizations enhance their own risk-management systems. However, with respect to the structure of the implementation of bank supervision and regulation, major changes are still in the works that will probably rearrange and consolidate financial oversight and extend the powers of African central banks.

The AERC Senior Policy Seminar in Mombasa provided a structure for the honest exchange of experiences. The arrangement turned on syntheses of relevant research findings presented by senior scholars. Each session then featured a brief summary of the presentation and a floor discussion by the policymakers themselves.

Wrapping up the debates was a working session in which participants identified additional key areas of research to generate findings that they would like to utilize in policy formulation. This atmosphere generated spirited interaction among the participants and helped the policymakers to fine-tune their own approaches as they applied the lessons and details of AERC-supported economic policy research from elsewhere in the continent. Besides this specific immediate result, the seminar improved the prospects for cooperative policy research between policymakers and researchers. The outcomes of the consultations served as inputs for AERC's policy research agenda and helped with the identification of structures and methods intended to promote collaboration among policymakers and researchers, both within individual countries and across the continent.

The media coverage was impressive. The seminar elicited significant interest from the local, regional and international media organizations, which covered the event very well. In Kenya they included the *Daily Nation*, Nation Television (NTV), the *Standard*, Kenya Broadcasting Corporation (KBC) and FM stations like Kiss FM, as well as Xinhua, a Chinese international media organization. At the meeting, journalists were also involved in long interviews with the key presenters and participants, and they too were given extensive coverage in the local newspapers. Ahead of the meeting, a piece on the seminar and about AERC was published in the *Daily Nation*, the *Standard* and the *East African*. These are high-profile media outlets with extensive readership and circulation that covers the East African region. Other promotional materials prepared for the seminar included an AERC documentary, which was screened at the AERC publications desk and distributed to some of the participants.

Let me thank the contributors, who carried out thorough research work to sustain the debate on bank regulation in Africa. Also, I wish to thank all colleagues inside and outside the AERC, resource staff as well as participants, and importantly the Office of the Chief Economist of the African Development Bank, which made SPS XII and this book possible. It is my hope that this volume and the knowledge it contains will generate serious interest in Basel III and associated issues of bank regulation in Africa.

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Contents

Figures

Tables

1
Keynote: Progress with Bank Regulation Reforms in Kenya

Njuguna Ndungu

1.1 Introduction

I am delighted to be with all of you here in Mombasa and to speak on 'Bank Regulatory Reforms in Africa: Enhancing Bank Competition and Intermediation'. But before I make my remarks, let me take this opportunity to thank the African Economic Research Consortium (AERC) for their invitation to give the keynote address at this seminar. This is indeed a timely topic as we continue to assess the effects of the global financial crisis and find long-term solutions to mitigate and prevent recurrence. I am informed that approximately 70 senior policymakers from more than 20 countries in Sub-Saharan Africa (SSA) are in attendance. This signals the importance of this seminar and the policy spin-offs it will generate.

At the outset, I would like to recognize the important role that the AERC has played in strengthening local capacity for managing economies within SSA. The AERC has contributed to advanced policy research and graduate training in economics. Most institutions of policy in SSA today are led by AERC alumni. I am happy to be part of this group myself.

This seminar is taking place at a time when countries in Africa are taking stock of the second- and third-round effects of the global financial crisis. You will agree with me that the crisis, which initially hit African countries with stronger financial linkages to international capital markets, significant trade relations with the Western world and rich natural resources, set the stage for challenging times in policy making and implementation.

Africa's prospects in the post-crisis period are contingent on the behaviour of policymakers. Indeed, there is need for better regulation that can readily identify emerging vulnerabilities, properly price risks and strengthen incentives for prudent behaviour. It is tempting after the crisis to call for more regulation *but we should emphasize better regulation*. Second, we should emphasize building strong institutions. Globally, the remedial actions taken by governments to deal with the crisis have borne fruit and the green shoots of recovery are beginning to sprout.

For us here in Kenya, we remain committed to fostering a stable market-based financial system as mandated by law. An efficient financial system collects and collates deposits from micro-savers and channels them to investors. This is the intermediation process. This process allows economic agents to evaluate the risks and prices in the market and align their investment portfolio and investment gestation.

The Kenyan case is both interesting and a policy strategy challenge. It reflects an example of segmented markets. But the cost of credit and interest rates spread remains high. The spread is a major challenge in the banking sector because it acts as an impediment to expansion of credit and development of financial intermediation and signals inefficiency in the sector.

The challenge for a policymaker is to develop a financial sector that answers to the challenges of the economy. In order to address market inefficiencies, the Central Bank and other stakeholders have undertaken significant reforms for the banking sector. These reforms include the operationalization of the credit reference bureaux, payment systems improvements, opening of new currency centres, automation of trading system for treasury bonds and the activation of horizontal repos. I wish to highlight these initiatives.

1.2 Operationalization of credit referencing mechanism

The Banking (Credit Reference Bureau) Regulations were operationalized on 2 February 2009. This will facilitate the sharing of credit information by institutions licensed under the Banking Act. This link will allow the industry to build information capital that is critical in the credit market. It will also enhance access to credit by SMEs and individuals that have been constrained by lack of physical collateral.

Further, the Banking Sector will be able to address the problem of non-performing loans at the origination point as credit history of applicants will be taken into account during the credit appraisal process.

1.3 Licensing of deposit-taking microfinance institutions

The Microfinance Act was operationalized effective May 2008. Currently, one institution has been licensed and eight applications for licences are being processed. With the unique business models of microfinance institutions mainly targeted at the lower end of the market, bringing them under the purview of the Central Bank will not only give them a legal basis in dealing with depositors but will also boost access to formal financial services by the populace. Deposit-taking microfinance institutions are free to be community-based or nationwide.

1.4 The National Payments System

The National Payments System sits at the centre of the financial system. It is imperative that payments systems are secure and efficient. The Central Bank continues with its initiatives to modernize the national payments system. Accordingly, from 1 October 2009, value capping was effected with all payments above Ksh.1 million being made through the Real Time Gross Settlement System (RTGS). This initiative enhanced the security and efficiency of high value payments.

1.5 MPESA[1]

The celebrated MPESA falls under this category of reforms. As we have seen this market unfolding, MPESA account holders have soared to nine million, total transactions surpassed Ksh.48 billion a month (or averaging Ksh.1.6 billion a day) and agents increased to 17,000 in the last three years.

1.6 Monetary policy

On the monetary policy front, the Central Bank of Kenya has observed that, despite signalling efforts by the Monetary Policy Committee to bring down the rates of interest by lowering the Central Bank Rate (CBR), banks have not responded accordingly. Further, the failure of the banking system to extend the maturity of their loan products is a consequence of the characteristic nature of not only their deposits, which are largely short term, but also their assessment and pricing of risk.

To support economic development, there is need for the development of banking products that support long-term lending. These development banking products will play a significant role in influencing a downward trend in commercial banks lending rates. The Central Bank will therefore explore how development banking products can be introduced into the market to enhance the monetary policy transmission mechanism and lengthen the maturity profile of commercial bank term loans.

1.7 Developments in the bond market

The Central Bank has successfully raised funds for infrastructure development for the Government through infrastructure bonds. These infrastructure bonds have not only facilitated financing of the Government's infrastructure programme but also set the pace for the issuance of similar bonds by corporate entities such as KENGEN and Safaricom. This, coupled with automated trading in the Nairobi Stock Exchange, will be important for a vibrant bond market. In addition, to deepen and widen the bond market, the Central Bank implemented the following measures:

- *Issuance of benchmark bonds*: The Bank together with Market Leaders Forum adopted 2, 5, 10, 15 and 20 year maturities as benchmark bonds. This move has not only firmed up the yield curve, but has improved pricing, reflected through improved secondary market trading.
- *Reopening of benchmark bonds*: This has increased trading activities in the secondary market.
- *The shape and position of the Yield*: The vibrant bond market has led to a downward shift in the Yield Curve with an upward gentle slope reflecting stability. This has created reliable pricing benchmark for corporates, many of which raised required capital via issuance of corporate bonds in 2009/10. It is also a useful tool in pricing credit facilities as it signals the direction of interest rates.

You will recall that the Central Bank of Kenya (CBK), the Nairobi Stock Exchange (NSE) and the Capital Markets Authority collaborated in the automation of trading of Treasury Bonds through the NSE. The main objective of this initiative was to make bonds trading secure and efficient, and to create a vibrant market. The expected improvement in market activity will also improve market liquidity and encourage more investors to participate in the bond market.