CHAPTER 7

REGULATIONS TO SUPPORT FINANCING IN AFRICA

Although innovative finance has received a lot of attention in this report, the banking sector remains the most important source of capital for loans and funding to the private sector in most African countries. Banks are also the way most savers hold deposits and financial assets, including government securities. The banking sector remains the most important intermediary of Africa's households' savings, to which Africa's private sector needs access.

So, African countries need to regulate their bank sector to limit the possible harm from banking crises or from more general system-wide misallocation of resources. For the sake of private sector development, the regulation of banks and other sources of capital for funding private industry—such as equity and debt capital markets and digital platforms—needs to be strengthened.

The development of well-functioning financial systems requires not only sound regulatory rules but also supervisory mechanisms applicable to banking, capital markets and other financial services. In African countries the central bank is at the heart of regulation for the financial services sector. Most of the central banks are mandated to provide the regulatory framework for economic transactions and monetary policy, helping to channel public and private savings into investment and so leading to growth. Two different approaches characterize analysis of how the development of financial regulation affects inclusion and growth. The "growth-enhancing governance" approach seeks direct evidence of financial regulation's impact on development outcomes. A less direct approach studies how regulations contribute to resource mobilization and allocating supporting investments, promoting inclusive development (ECA, 2019).

Economic shocks and financial crises test the strength of financial systems, the appropriateness of regulatory systems and the frameworks put in place. For instance, the importance of financial regulation and supervision became clearer in the wake of the 2008–2009 financial crisis due to the volatility of cross-border capital flows, which dropped to $2 trillion in 2008 from a record high of $12 trillion in 2007 (IMF Statistics). The experience led to more stringent financial regulation and to growing economic nationalism, especially among advanced economies.

Most African countries were resilient to the financial crisis, mainly because their linkages with global banks and investment services were limited. Yet, they must continue to improve the regulation of the financial service sector and support innovative financing in the private sector. The current debate on adopting the Basel III regulatory guidelines gives African countries a chance to decide whether those guidelines fit the supervision and oversight of the financial sector across Africa.

Appropriate, effective and enabling regulatory frameworks for all financial intermediaries operating in Africa will give confidence to a new breed of fit and proper entrepreneurs. The frameworks will introduce new financial service platforms and innovative products, whose competitive arena will become more transparent and will open up to new players. Regulation according to best practices can enable Africa's financial service sector to stimulate growth and encourage the entry of innovative financial products. The example of financial regulation in Kenya and the emergence of M-Pesa is important in this context and will be discussed below.

This chapter examines issues policymakers should consider in evaluating the options for better regulating the financial service sector in Africa, so the sector can play its role in allocating resources and stimulating private sector development and economic growth. In addition to banking sector regulation, the chapter describes the regulation of other types of bank and non-bank financial intermediaries—equity and debt capital markets, digital platforms and microfinance companies—so they can promote resource allocation and investment opportunities and reduce costs and risks for financing private sector growth and sustainable development in Africa.

OVERVIEW OF FINANCIAL REGULATION IN AFRICA

BANKING REGULATIONS

Financial sector reform has had three distinct phases across Africa, and the evolution of the sector has shown a number of key trends (Murinde, 2012). First, in the pre-1960 colonial phase, before African countries established central banks, banking regulation was assigned to colonial administrators. Regulation was driven not by a desire to see the financial sector improve the colony's resource allocation and economic growth, but by overall colonial policy, which in some countries prohibited the local ownership of banks and in others actively encouraged lending only to foreign firms (Austin and Uche, 2007). During the colonial phase, the aims ascribed to financial services did not drive regulation or the design of financial sector policy.

The second phase (as identified by Murinde) took place between independence and the 1970s—this chapter extends that phase to the 1980s, calling it the pre-Basel phase. In it, central banks replaced currency boards. Countries modelled the new central banks primarily on the Bank of England, despite early warnings not to. The new central banks were responsible for bank regulation and supervision, as well as for normal central bank functions—issuing currency, overseeing monetary policy and acting as bankers to governments. New financial institutions were established to remedy the perceived failure of the financial markets to provide capital to local entrepreneurs. Alternative lending institutions, such as agricultural and industrial development banks, cooperative banks and several state-owned banks, were created to address the market failure. At times, state-owned banks were created through the nationalization of foreign banks. In the main, these state-driven institutions aimed to address the shortcomings of the market and its credit rationing.

The third phase is what Murinde refers to as "the Basel regime." It runs from when the Basel Committee initiated the Accords on Capital Adequacy in 1988, establishing the Basel guidelines (the so-called Basel Capital Accord that sets minimum capital standards for internationally active banks, known as Basel I) to the onset of the global financial crisis in 2008. In introducing Basel I, the Basel Committee was primarily concerned with managing credit risk in banks, so the initial discussions centred on capital adequacy and were originally designed for internationally active banks. Other concerns included making a level playing field for international banks operating across borders and creating regulations to support the financial service sector's contribution to economic development—specifically, regulations to incentivize financial systems to stimulate economic growth.

Critics saw Basel I as limited in scope and hoped that revisions would cast a wider net. But an updated set of guidelines, Basel II, circulated in mid-2006, again focused narrowly on cross-border banking. It had three pillars. Pillar I dealt with the minimum capital requirements for credit risk. Pillar II concerned the supervisory review of capital adequacy. Pillar III improved market discipline by requiring that investors be given accurate and transparent information on the oversight of banks' risk management. Basel II has been criticized for encouraging strong supervision, and questions were raised about whether its capital requirements and internal controls would constrict certain aspects of financing in developing countries. To date, only a few African countries have implemented the Basel II standards, including Cameroon, Egypt, Ghana, Kenya, Nigeria, Senegal, United Republic of Tanzania and Uganda (Ozili, 2019).

During the transition to Basel III, legislation introduced in several financial centres improves the prospect for private monitoring of financial intermediaries, which should be used to shape a new set of policy prescriptions on regulatory reform in Africa. This phase introduces macroprudential regulations in the Organisation for Economic Co-operation and Development (OECD) and in several African countries. Its approach to international financial regulation, which emphasizes private monitoring and other considerations, has direct lessons for African countries and other countries anxious to stimulate economic growth by providing capital to long-term and high-risk projects.

Basel III went beyond improving capital adequacy measures to emphasize building buffers to help banks recover from financial and macroeconomic shocks. Basel III also introduced specific macroprudential measures to address threats to systemic stability through a countercyclical capital buffer (Kasekende, 2015). When Basel III was launched in 2004, its aim was to increase the total capital ratio from 8 to 10.5 per cent in 2019 and the Tier 1 capital ratio from 4.5 to 6 per cent, as a new measure strengthening capital requirements. Other Basel III additions included goals to strengthen microprudential regulation to avoid systemic crisis.

But Basel III is, in turn, subject to criticism. The size of the equity buffer is debated, though its purpose is agreed: to reduce the probability of a banking crisis by capitalizing banks better. Even if a crisis occurred, it would do less damage since banks were holding more equity (Vickers, 2016). The mechanism for determining a bank's equity capital in emerging African economies is of great interest because the equity buffer is fundamental to a country's financial stability, particularly given concerns with commodity shocks and the levels of finance needed for small and medium enterprises (SMEs) and other forms of high-risk, long-term finance. Many African countries faced challenges implementing earlier capital and liquidity requirements, and the excessive complexity of the standards were ill-suited to less developed financial markets (Jones and Knaack, 2019). To date, South Africa is the only African country that has fully implemented the Basel III standards.

MACROPRUDENTIAL REGULATIONS

Although many African countries tried to adopt financial standards (such as Basel's) and financial stability policy regimes, the efforts were slow. Murinde (2012, p. 23) remarks, "African central banks have not fully adopted macroprudential supervision responsibilities, which involve supervision at systemic level (financial stability) to complement the supervision of institutions."

Several African countries are tackling these shortcomings. Some have introduced financial stability boards and oversight committees as part of their regulatory architecture. The member countries of the Global Financial Stability Board's Regional Consultative Group for Africa are Angola, Botswana, Ghana, Kenya, Mauritius, Namibia, Nigeria, South Africa, United Republic of Tanzania, Uganda and Zambia as well as the Central Bank of West African States (BCEAO) and the Bank of Central African States (BEAC). The regional consultative group is co-chaired by Lesetja Kganyago, governor, South African Reserve Bank, and Moses Pelaelo, governor, Bank of Botswana. Further, the Community of African Banking Supervisors (CABS), a subsidiary of the Association of African Central Banks (AACB), was established to contribute to ongoing efforts to strengthen banking regulatory and supervisory frameworks in Africa. The continent thus recognizes the importance of macroprudential supervision.

By emphasizing collective behaviour, macroprudential regulation can tighten the link between prudential regulation and development policy. As one study points out, in many African countries economic activity is concentrated in a few sectors—typically producers of specific cash crops or extractive industries such as oil, gas, metals and mining. Bank lending tends to concentrate on these sectors, raising the macroeconomic risk associated with lending portfolios. Macroeconomic risks of financial stability tend to be high because commodity downturns easily cause systemic risks and can be more important than risks to individual banks.

Macroprudential policy can boost economic growth to enhance the financial sector's contribution to a country's development. Economists and central bankers expect macroprudential policy to evaluate the risks associated with various failures, particularly the effect that the failure of an institution would have on the economy due to size, for example, or customer markets. But does a macroprudential framework make a major contribution to enabling or hindering the financial system in promoting growth (**BOX 7.1**)?

BOX 7.1 MACROPRUDENTIAL POLICY ASSESSMENT IN AFRICA

Four essential indicators are relevant to macroprudential analysis in Africa for explaining and predicting the build-up of systemic risk through the financial sector:

- *Ratio of broad money supply to GDP.* Historically, broad money supply has been largely expansionary and volatile in Africa. Although the ratio of the broad money supply to GDP has consistently risen over the past two years, it has done so more slowly than over the long term. The current annual growth rate is 0.06 per cent, while the long-run growth rate is 1.39 per cent. The current trend indicates a negative growth rate, hence a lower likelihood of systemic shocks through the broad money supply.

- *Ratio of domestic credit to the private sector by banks (percentage of GDP).* The ratio of domestic private sector credit to GDP in the continent has been falling consistently since 2016. For instance, in 2019, the credit-to-GDP gap for South Africa was set at −2.1 per cent (Bank for International Settlements database), indicating a fairly stable environment and low probability of systemic risk build-up.

- *Ratio of bank non-performing loans to total gross loans (per cent).* Surprisingly, non-performing loan management has been outstanding in Africa, with the ratio falling 25 per cent over 2005–2015. In Nigeria for instance, the 2019 non-performing loan to total gross loans ratio of 6.03 per cent is below its 10-year average (2008–2018) of 11.32 per cent (World Bank data).

- *Portfolio equity, net inflows (current $ millions).* GDP growth, market volatility, global oil price shocks and other structural vulnerabilities and instability have been largely responsible for the high volatility in portfolio equity flow. For instance in Egypt portfolio equity flows had great volatility in the aftermath of the 2011 Arab Spring, with net flows falling negative between 2011 and 2013; −$711.3 million in 2011, −$983.4 million in 2012 and −$431.4 million in 2013 (World Bank data).

African countries need to develop a robust foreign reserves policy, especially for build-up of reserves for external shocks.

The adequate provision of essential services and facilities in Africa will enhance social well-being and further economic growth by providing an enabling environment and support for businesses. This support will address two challenges to financial stability: it will reduce the inflationary impact of the excessive money supply, and it will advance economic diversification. The excess money supply will be diverted and absorbed by latent productive capacity rather than feed into the prices of goods and assets, which would eventually lead to inflation and financial shocks. And shifting an African economy from a single foreign exchange income source towards multiple sources through exports will reduce the severity of financial shocks through devaluation. Increasing access to financial services, especially to capital market products, will both improve access to credit and enhance monetary policy effectiveness and transmission channels.

THE ROLE OF REGULATORY AUTHORITIES

CENTRAL BANKS

Central banks are critical to efficient and well-regulated capital markets, since the banks' financial stability objectives are affected by the markets' depth and liquidity. African central banks, like those elsewhere, have an important role in developing and marketing domestic government debt. They work closely with their ministries of finance to do so. Central banks also typically oversee the local payment infrastructure as part of their supervisory role in the local banking sector. The interest rate policies and prudential policies pursued by central banks are important drivers of the local debt and equity market.

Policy recommendations will be considered later in this chapter for creating an enabling environment for financial market development across institutions—banks, microfinance institutions (MFIs) and the capital market. Regulators and monetary authorities are well advised to create an environment that promotes low and stable inflation and sustainable debt and fiscal management strategies, for these will stimulate economic growth and reduce uncertainty, thus contributing to the development of capital markets by lowering the cost of raising capital.

Like other emerging markets, many African countries have taken steps to liberalize financial markets, including removing caps on interest rates and stopping the allocation of credit directly from central government departments. Governments also increased their reliance on securities auctions to determine the price of government debt and to raise funding. And they strengthened the legislation that supports the growth and functioning of domestic corporate securities markets. All these steps promoted the development of capital markets.

Funds raised through capital markets are secured on an arm's length basis. For this reason, these markets depend on a supportive legal framework whereby financial transactions are settled efficiently and financial transactions and contracts are enforced in a way seen as fair. A robust legal framework with strong disclosure rules is necessary so holders of securities can monitor a company's performance and if necessary, take action to keep company managers and controlling shareholders from using company resources for their own personal benefit. In addition, market regulations must be seen to protect creditors' rights, particularly during corporate failures. That is when efficient and predictable insolvency regimes reassure creditors that outstanding debts will be paid in full and on time, and when the losses incurred by equity holders will be minimized.

MARKET REGULATORS

African countries also need sound and appropriate regulatory environments and frameworks to enable the development of stable and resilient capital markets. All countries with established securities markets or stock exchanges have appropriate rules, regulations and regulatory bodies. The capital market regulatory authorities are then responsible for governing and monitoring the overall regulation of the activities of the stock market, protecting the rights of investors, ensuring the safety of the investments, preventing malpractice and fraudulent activities and developing a code of conduct for such intermediaries as dealers, investment funds, brokerage firms, securities exchanges and investment advisors. Developed capital markets in advanced economies and emerging markets are regulated by securities and exchange commissions or boards, which ensure that investors and savers are offered diversified opportunities to invest in projects in viable sectors capable of generating high rates of return. For instance, the United States established its first market regulatory authority—the Securities and Exchange Commission (SEC)—in 1934, responsible for protecting investors, maintaining fair and orderly functioning of the securities markets and facilitating capital formation.

In Africa, several countries have established either a capital market authority (CMA), as in Egypt, Kenya, Rwanda, Tunisia and Uganda, or a securities and exchange commission, as in Ghana and Nigeria. The CMA is a market-regulating body

> "Like other emerging markets, many African countries have taken steps to liberalize financial markets"

responsible for supervising, licensing and monitoring the activities of market intermediaries, including the stock exchange, the central depository and settlement system and all the other persons licensed under the Capital Markets Act.

Kenya established its capital markets authority in 1989, charged with the prime responsibility to regulate and supervise the Kenyan capital markets industry and facilitate the mobilization and allocation of capital resources to finance long-term productive investments. The Kenyan CMA also introduced the "regulatory sandbox"—a regulatory framework to support innovation in the capital markets (**BOX 7.2**).

Nigeria's securities and exchange commission was established in 1962, at first as an ad hoc consultative and advisory body. It was mandated to examine applications from companies seeking to raise capital from the capital market and to recommend the timing of such issuances to prevent them from clustering and overstretching the market's capacity. That advisory body was made an SEC in 1980 with the full functions of regulating, supervising and monitoring the Nigerian capital markets (Nigeria SEC website).

In South Africa, the Financial Sector Conduct Authority (FSCA), formerly known as the Financial Services Board, regulates the financial market. FSCA is a market conduct regulator of financial institutions aiming to enhance and support the efficiency and integrity of financial markets and to protect financial customers by promoting their fair treatment by the financial institutions licensed under financial sector law. The licensed institutions include banks, insurers, retirement funds and administrators, and market infrastructure (FSCA, n.d.).

Because stock exchanges have the potential to finance high-risk and high-return projects requiring long-term capital commitments, they are valuable in Africa's arsenal of financial services. They must be regulated with that potential in mind. But many exchanges in Africa operate under weak regulatory environments, which have contributed to dismal stock exchange activity and shrinking foreign investor participation (CFA Institute, 2019). To develop and deepen exchanges to become significant drivers of economic and societal transformation in Africa, 26 stock exchanges created the African Securities Exchanges Association (ASEA) in 1993. The ASEA provides members opportunities to enhance their effectiveness through exchange integration as a means of deepening the markets and enhancing their liquidity. It offers capacity-building initiatives that equip members with skills and cultivates close liaisons with market stakeholders to develop an investor-ready environment (CFA Institute, 2019).

FINANCIAL INNOVATION AND REGULATORY CHALLENGES

Sound regulation of a financial system encourages the development of the financial sector in ways that aid and support inclusive and sustainable growth. The relationship between finance and economic development has been widely debated and analysed. Research by Barth, Caprio and Levine (2012) describes and analyses the mechanisms through which financial intermediaries and markets stimulate and are affected by economic growth and development. Regulating financial markets in ways that stimulate, or at least do not impede, growth should be a policy objective in all African economies, particularly those with low incomes.

> "The recent growth of technological innovation in the financial service sector has the potential to spur economic growth and sustainable development, emanating mostly from emerging and developing markets"

Since commercial banks are the dominant financial service institutions in Africa, much financial regulation in African countries comprises banking regulations. The regulation of other intermediaries and institutions (such as stock markets, digital finance platforms and microfinance institutions) is also relevant, since the growth of these alternative forms of finance is necessary if the system is to function as a whole. Currently, mobile money providers and platforms, the second most important financial service institutions in Africa, are regulated under banking legislation and so are required to place deposits in custody or trust with commercial banks. Capital markets and non-bank financial institutions such as microfinance firms and savings and loan companies play a role in African economies but are not as systemically significant as commercial banks. Stock markets in most African countries are neither large nor highly liquid and so are rarely central to discussions of financial markets on the continent.

The evolution of financial services and the sophistication of financial products, particularly in developing countries, are shifting the dynamics around the institutions and international standards that define the global financial architecture. The key players in setting international financial standards are mostly advanced countries such as the European Union member states, Japan and the United States. They set standards reflecting their own economies' state of development. But now that China and other fast-growing developing countries are becoming more important in the global financial system, efforts to mainstream them have begun in key financial standard-setting bodies.

The 2008 economic and financial crisis was a wakeup call for the global financial system, with direct and indirect impact on developing countries. It demonstrated their close interconnectedness with the financial core, making them more vulnerable to financial crises and to regulatory changes in other jurisdictions. As a result, Basel Committee membership was extended to all G20 members. For the first time, developing countries such as Argentina, Brazil, China, India and South Africa will join the discussions and participate in decisions on international financial regulation and supervision.

The recent growth of technological innovation in the financial service sector has the potential to spur economic growth and sustainable development, emanating mostly from emerging and developing markets. In response, the global financial system will once again go through a series of reforms and adaptations. From simple technologies such as mobile money to more sophisticated ones such as big data analytics and blockchain, such innovations can break new ground in enhancing financial inclusion. But current international financial regulations and supervision, focused mostly on financial stability, may not be appropriate for the new financial products and services pouring into the markets. And regulations that concern the banking sector alone may be insufficient to safeguard the financial system against some of the risks fintech services pose, such as data privacy, money laundering, mismatched risk and return, and systemic risk. These new risks call for financial regulation to be reviewed to provide a flexible environment for fintech to develop that is strict enough to limit the risks. Regulators and financial-standard setting bodies must also break down their own sectoral and geographical silos and put the protection and fair use of customer data at the top of their agenda.

MOBILE MONEY AND REGULATORY CHALLENGES

The single most revolutionary change to the financial services landscape in Africa after the introduction of ATM machines has been the introduction of mobile money, which is the name of a range of financial transaction services accessed through mobile phone applications. As mobile money has spread across urban and rural communities, it has changed household cash management and the use of banking services. Access to banking services through digital finance platforms is improving in Africa. In 2018 almost half the world's 866 million mobile money users were in Africa (GSMA Intelligence, 2019). The region contributed about 65 per cent of the global value of mobile money transactions in 2018 ($41 billion) (Techpoint Africa, 2019). In West Africa, mobile technologies and services generated $52 billion in economic value in 2018, representing about 8.7 per cent of the region's GDP (GSMA Intelligence, 2019). In Uganda, it is reported that $34 million moves through an intricate digital highway every day (Mawejje and Lakuma, 2019). The Central Bank of Kenya (2018) reported that Kenya's mobile financial structures had $38 billion in transactions, a large share coming from M-Pesa, the country's mobile payment system.

The use of mobile payment systems is growing, helping to fill the vacuum in the unbanked segment of communities across Africa. Domestic transfers through mobile payment platforms pay for a wide range of services, from school fees and rent to utility bills and wages. The importance and extent of the financial services provided through mobile platforms should not be underestimated. The highest uses of digital platforms in Africa are credit (29 per cent), payments (25 per cent), mobile banking (15 per cent) and group savings (12 per cent) (Vidal, 2017). Group savings and other forms of savings are held with commercial banks.

> "The single most revolutionary change to the financial services landscape in Africa . . . has been the introduction of mobile money"

The commercial banks hold custodian accounts on behalf of the mobile payment operators. In this context, regulators may need to determine what types of assets the deposits can be invested in to ensure that they are not exposed to high risk. Regulators may also want to determine which banks are eligible to take deposits and could impose diversification requirements on mobile network operators to ensure that deposits are spread over several commercial banks. The mobile network operators whose platforms are used to provide these services are forbidden by current banking laws to intermediate the funds received from customers; they must transfer the funds that they receive to the commercial banks with which they partner.

Through the mobile money platforms cash from Africa's informal economy, including from people who are unbanked, can be pooled into bank accounts in the formal banking sector through partnerships between mobile network operators and traditional commercial banks. This activity benefits the economy as a whole and should be encouraged by regulators as a monetary policy so more of society's cash can be held in the formal banking sector. Digital money platforms have a positive capacity to bring currency into the formal banking sector and act as a mechanism for pooling a country's savings.

The pooled funds can be lent by custodial banks in the normal manner. So, the activity creates credit and, if banks allocate the capital efficiently, could improve capital allocation across the economy.

Further, the presence of mobile money platforms can increase remittances and so lead to the inflow of new money that was previously outside a country's economy. And if mobile money platforms are enabled to build customers' financial histories, enhanced credit scoring for those customers can start, which can lead to greater lending to the historically unbanked. All these benefits are deemed to have implications for monetary policy. Because customer deposits tend to be secured against liquid or near-liquid deposits at custodial banks, non-bank mobile platforms are expected to create little systemic risk.

No research so far has conclusively evaluated the impact of mobile money on financial stability or monetary policy (Kipkemboi and Bahia, 2019). Recent research is theoretically ambiguous, and the evidence is mixed. But central banks must be clear about the requirements for safeguarding the funds of companies and households. Central banks need to enhance their effectiveness where mobile money penetration is high and where more cash enters the formal banking sector through mobile money platforms. The role of digital platforms in encouraging pooled savings should not be underestimated, and regulators ought to pursue supervisory and oversight mandates to encourage this segment of financial services to grow. To date, 14 African countries (Democratic Republic of the Congo, Ghana, Kenya, Lesotho, Liberia, Malawi, Namibia, Nigeria, Rwanda, Sierra Leone, United Republic of Tanzania, Uganda, Zambia and Zimbabwe) have enacted regulatory frameworks or guidelines for regulating and supervising their mobile money markets (see **BOX 7.2** for the case of Kenya).

As mentioned in **CHAPTER 6**, an Africa-wide approach could usher in more coherent and streamlined regulation as a common digital trade market advances in the AfCFTA. Countries could cooperate to create regulation to govern the digital realm of mobile money and electronic payment and transfer systems, assigning rights and obligations to digital platform operators at the continental level while addressing critical related issues, such as taxation, competition, cybersecurity and digital identity.

BOX 7.2 REGULATORY SANDBOX IN KENYA

Kenya is applying a "regulatory sandbox" approach to financial service innovations under which certain regulations are relaxed while the innovations are tested. Once the regulator can see the innovations in operation, the relaxed regulations can be re-introduced, modified or removed. This approach allowed Kenya's flourishing mobile money sector to develop, leading to a substantial reduction in poverty and a boost in financial inclusion.

In general, the regulatory sandbox approach seems to support innovation and could improve the financial service sector's ability to meet client needs. But regulators must closely supervise financial products or providers benefitting from the regulatory sandbox to prevent financial instability, weak consumer protection and illicit finance risks and to re-impose regulations quickly if particular innovations turn out undesirable.

Source: ECA, 2019.

THE FUTURE OF FINANCIAL REGULATION AND NEED TO SUPPORT PRIVATE SECTOR DEVELOPMENT IN AFRICA

Africa needs to rethink its financial services regulation so that innovation is fully functional, the environment enables (rather than stifles) innovation, transparency is enhanced (through reduced information asymmetry, adverse selection and moral hazard), and financing for private sector development is delivered (**BOX 7.3**). The current discussions around the Basel III and global regulatory frameworks do not address several areas related to the oversight of Africa's financial markets.

As African countries seek financial service sector stability, inclusion and efficiency, their financial regulation and supervision priorities differ substantially from those put forward by the Basel Committee on Banking Supervision (BCBS), according to many practitioners and researchers. Any recommendations on Africa must take into account the narrow resources African countries provide or are committed to providing for regulation, which limit its technical and human capacity.

Improving stress-testing capacity in banks operating in Africa and in African supervisory bodies is necessary for introducing "living wills" for banks, also known as bank resolution plans. This procedure requires financial institutions to provide credible plans to regulators detailing how the institutions, if materially financially distressed, would be wound up quickly and neatly under national bankruptcy laws or other applicable insolvency regimes (**BOX 7.4**).

African banking crises have sometimes extended to the broad financial service sector. They occurred primarily because of corporate governance failures in banks and broader corporate governance failures.

For example, in Ghana's recent banking and financial sector crisis, the number of banks in the country fell from 36 to 23. Some 53 fund managers lost their licences to operate. And 23 savings and loan companies and 347 MFIs and non-bank financial institutions were deemed insolvent and closed. Two years into the crisis the government funded bailouts in local currency amounting to the equivalent of $2.9 billion (about 5 per cent of the country's GDP). By contrast two years after

BOX 7.3 IMPACT OF REGULATIONS ON SMALL AND MEDIUM ENTERPRISE FUNDING

Lending to small and medium enterprises (SMEs) has been considerably affected by regulations. African countries, like other emerging markets, rely on SMEs to generate incomes, employment and growth. Yet, SMEs are seen in emerging economies as risky asset classes since their lack of long track records and reliable, audited financial information hampers assessing their credit risk. In emerging economies SMEs face the most pronounced credit rationing due to market failure.

Several initiatives try to counter the difficulties SMEs experience in seeking credit. Sinha (2012) highlights a number of these. Well over 2,000 SME credit guarantee schemes have been adopted in almost 100 countries—more than half the world's countries. The guarantee schemes usually target a sector, a group of firms, a region or a group of individuals who ordinarily find it hard to access capital. In addition other instruments can boost SME financing, including interest rate ceilings and directed lending by government-backed banks and institutions.

BOX 7.4 THE IMPORTANCE OF LIVING WILLS

The introduction of resolution plans or "living wills" for banks is an important step in ensuring bank viability and stability in Africa. These plans tell regulators how the institutions, if financially distressed, could shut down quickly under national bankruptcy laws or other insolvency rules.

A regulator that determines a target financial institution's plan is not credible should take steps to strengthen the institution's prospect of recovery from any future financial distress. A regulator could, for instance, require an institution to divest certain operations or assets. In Africa, Namibia and South Africa have progressed the furthest in introducing bank resolution plans, but most other countries' banking regulations do not assign the central bank explicit responsibility and accountability for implementing such plans and are unclear about resolution objectives. This situation needs to be evaluated.

Living will legislation should be introduced at the same time deposit insurance is strengthened. But in poorly regulated African markets with weak institutions and limited supervisory capacity, deposit insurance is likely to have distortionary and destabilizing effects. All deposit insurance schemes across Africa should be made explicit and should be introduced (or re-introduced) alongside toolkits strengthening overall supervision and specifying that the schemes are available only to banks that pass stress tests and have resolution plans acceptable to regulators.

the start of the last global financial crisis, analysts estimated that the direct cost to taxpayers of bailouts in most OECD countries was less than 1 per cent of GDP. Direct fiscal costs in the United States were unlikely to exceed an estimated 2 per cent and those in Germany, 1 per cent, while banking sector bailouts in the United States and France returned a net gain to their treasuries. The high cost to taxpayers of bailing out failing banks shows why African countries need to use regulation to incentivize financial institutions to adopt better governance, or else need to find ways of quickly identifying poorly governed institutions.

IMPROVING THE MANAGEMENT OF MACROECONOMIC SHOCKS

As mentioned earlier, many African economies are dominated by a small number of sectors, normally the producers of cash crops or natural resources, such as oil and gas. Bank lending tends to concentrate on firms and households in those sectors, so great macroeconomic risks are associated with lending portfolios vulnerable to commodity risk. Commodity downturns easily lead to systemic financial risks. African central bank governors take seriously the need for central banks to be able to execute macroprudential mandates in the face of such commodity shocks—for example, this topic was the subject of discussion during the 2013 Association of African Central Banks (AACB) annual meetings.

Global commodity prices, determined in global markets outside the control of most exporters, are volatile. Countries depending on commodity exports face price shocks from time to time and need to consider this volatility when implementing financial sector policies. African central banks can, for example, vary capital adequacy requirements with commodity cycles and introduce provisioning that brings forward the capital costs of lending decisions. And they can insist that when commodity prices are high, banks build adequate buffers to protect themselves when commodity prices fall and the financial system undergoes greater stress (Cohen and Edwards, 2017). African central banks are challenged to enact regulations that take commodity price cycles into account.

> "Regulations to avoid the spread of financial instability should include minimal capital requirements, early warning systems and central bank mechanisms that monitor and oversee financial markets

The regulator's selection of an instrument or combination of instruments depends on circumstances (**TABLE 6.1**). A cross-country study by the International Monetary Fund (IMF) concluded that a combination often works best. But that is just one of the choices a regulator makes (Masson, 2014). The regulator must also decide whether to take a broad-based or a targeted approach, whether a rule-based or a discretionary application of policies is preferable and whether or not the instruments' use should be coordinated with other policies, such as monetary and fiscal policies.

Furthermore, with AfCFTA services trade negotiations frontloading financial service liberalization, accompanying measures to ensure financial markets function should include macroprudential regulation (see **CHAPTER 4**). Regulations to avoid the spread of financial instability should include minimal capital requirements, early warning systems and central bank mechanisms that monitor and oversee financial markets. In this regard the West African Capital Markets Integration Council (WACMIC), discussed in **CHAPTER 4**, offers an interesting regional institution experience.

Beyond these efforts, countries liberalizing their commitments will have to review existing banking regulations to learn what reforms may be required. A healthy balance between safeguarding the economy from financial contagion and allowing financial operators to conduct their business will require carefully tuning and sequencing macroprudential measures. African central banks and academic economists must study which macroprudential instruments can combat the harm caused by shocks, and what circumstances call for particular instruments (**TABLE 7.1**).

CENTRAL BANKS AND THE PROMOTION OF EFFICIENT CAPITAL MARKETS

As noted earlier, well-functioning equity and debt capital markets are widely recognized as playing an important role in funding the growth and expansion of private sector development in Africa and other emerging markets. The capital markets help allocate risk, transmit monetary policy and thus promote financial system stability and stimulate economic growth.

In October 2019, the Bank for International Settlements published the recommendations of a working group it had established on improving the functioning of capital markets (Acharya and Bo, 2019). Regulators in Africa should adopt

TABLE 7.1 EXAMPLES OF INSTRUMENTS SERVING PRUDENTIAL AIMS

RULES GOVERNINGFINANCIAL SERVICES	MEASURES
Bank loans	▪ Caps on the ratio of loan to value for mortgages ▪ Caps on the ratio of debt service to household income ▪ Rules on the reference interest rate used for mortgage lending ▪ Rules on currency mismatches of borrowers ▪ Ceilings on credit growth (aggregate or by sector)
Bank balance sheets	▪ Countercyclical capital ratios (possibly including additional capital charges for any rapid increase in bank lending). Dynamic provisioning ▪ Adjustment to asset risk weights ▪ Rules on loan loss provisioning ▪ Caps on loan-to-deposit ratios, core funding ratios and other liquidity requirements ▪ Bank reserves deposited with the central bank ▪ Limits on interbank exposures (domestic or cross-border) ▪ Capital surcharges for systemically important institutions
Collateral used in wholesale funding	▪ Prevention of procyclical variation in minimum margins or haircuts (or making such variation countercyclical)

Source: Turner, 2012.

the report's recommendations, which are:

- Promoting greater respect for market autonomy.
- Strengthening legal and judicial systems.
- Enhancing regulatory independence and effectiveness.
- Deepening the domestic institutional investor base.
- Pursuing two-way openings to international participation while preparing for spill-overs.
- Developing complementary markets and market infrastructures.

The report points out that its recommendations are to be implemented within the context of a given economy. Some are outside the scope of a country's central bank. But since an efficient capital market can help a central bank meet its objectives, central banks must have a seat at the table in implementing the recommendations.

REGULATION OF DIGITAL FINANCIAL PLATFORMS

Mobile payment systems have expanded across Africa on the back of mobile telephone penetration. Given their wide reach expanding financial inclusion, their regulation is urgently required for both customer protection and monetary stability. In this context, regulations to promote a level playing field, regulations to protect customer accounts, and the revision of interest rate policies warrant attention.

REGULATION TO PROMOTE A LEVEL PLAYING FIELD FOR FINANCIAL SERVICE PROVIDERS

Ensuring a level playing field for digital platforms and other forms of financial intermediation should be of highest concern to regulators. Mobile money expands in an economy when regulations permit both traditional banks and mobile network operators to provide mobile money services. Where the playing field is level, accounts opened at mobile network operators outnumber bank accounts. In Africa, some countries have followed Bank for International Settlements advice to put regulations in place distinguishing providers by type of service, not by the entity providing the service. In this way in the number of countries that have levelled the playing field and permitted competition between mobile network operators and commercial banks for customer deposits has increased.

Perhaps AfCFTA services trade liberalization offers the most tangible opportunity for a blanket approach to regulation levelling the playing field for financial service providers. Financial service liberalization is being frontloaded in the AfCFTA as one of five service sectors being prioritized (see **CHAPTER 3** and **CHAPTER 4** for discussion). Together with the existing Protocol on Trade in Services, which sets outs common rules for a continental market where services are to circulate freely, financial service liberalization will dismantle today's barriers keeping financial service providers from operating across borders.

Liberalization commitments under the AfCFTA focus on eliminating measures that restrict the service provision in a particular sector, not necessarily on the actual service provider. So, the AfCFTA will not only offer opportunities to existing traditional financial operators that, despite barriers, were already operating across borders, it will also open opportunities for other operators not traditionally categorized as financial institutions, such as those providing digital financial services. As new operators offer services complementing and diversifying those of traditional financial institutions, opportunities for financial deepening and greater financial development of African financial markets will grow.

So, regulating activities rather than types of providers will be necessary. Many regulatory and oversight approaches will need to be revised, and more countries in Africa need to adopt this approach.

The basic service of pooling capital and holding it in safe financial instruments can get poorer communities onto the first rung of financial benefits, as described above. Regulators, by ensuring a level playing field for providers, will encourage the emergence of service platforms as major parts of Africa's financial architecture.

REGULATION TO PROTECT CUSTOMER ACCOUNTS

Regulation must ensure that customers can redeem mobile units for cash on demand in order to build confidence and protect customers using mobile money platforms. Regulators should determine the types of asset deposits can be invested in or ensure that deposits are invested in low-risk instruments. They could also determine a list of banks eligible to take deposits from mobile network operator platforms and could require mobile network operators to diversify the banks holding those deposits. If the eligible commercial banks are subject to the country's standard prudential regulation, the mobile money system will also be fully protected under umbrella of that regulation.

REVISION TO INTEREST RATE POLICIES

Across Africa, mobile money deposits do not earn interest. So, although mobile money units are a store of value for many households, the users of these platforms earn no returns on their savings. Regulators should seek to reclassify mobile units as stores of value on which interest can be earned. The introduction of partnership models, such as M-KESHO in Kenya, promotes the role of mobile money in savings. A joint product of the mobile network operator Safaricom and the local commercial bank Equity Bank, M-KESHO pays interest to M-Pesa users and provides health insurance to its members. M-KESHO is seen as expensive since customers pay fees to transfer funds from the M-KESHO account at Equity Bank to the M-Pesa account and also to withdraw cash from M-Pesa—the two transaction fees largely cancel out any interest.

EXTENSION OF DEPOSIT INSURANCE SCHEMES

In the event of bank failure, mobile deposits do not qualify under domestic deposit insurance schemes. Most deposit insurance schemes cover only single amounts, whose limit is often lower than the sums in mobile deposit schemes, placing customers of non-bank platforms at a disadvantage. Regulators evaluating the introduction or extension of deposit insurance schemes should determine whether or not to extend these schemes to mobile money customers across Africa as a direct or indirect safety net.

AFRICA'S FINANCIAL POLICY RESPONSES TO THE COVID-19 CRISIS

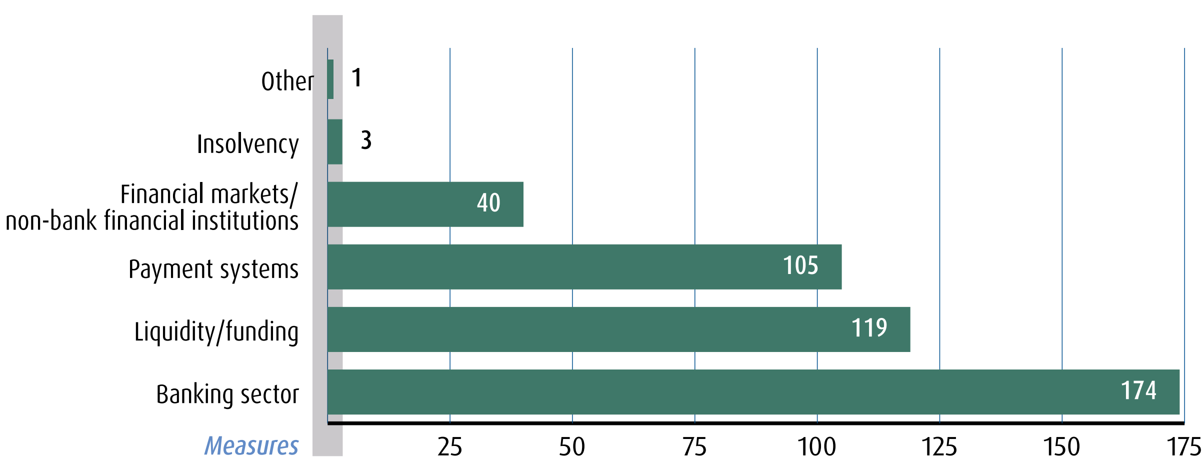
Even though the COVID-19 outbreak has hit Africa slightly later than other regions, it has interrupted economic growth, eroded improvements in macroeconomic and debt sustainability and created devastating human and social cost. Many African governments responded rapidly by adopting targeted policy interventions or stimulus packages to reinvigorate growth, boost productivity and employment and offset the negative socioeconomic impact of the crisis.

Some African countries have limited fiscal space and international reserves and thus lack the necessary resources to implement COVID-19 responses. While financial assistance from advanced economies and international financial institutions remains crucial, domestic efforts to cushion the impact of the crisis have gained more traction among policymakers. African governments introduced various new fiscal, monetary and financial sector measures to increase fiscal space and reserves, raise additional capital and facilitate access to credit for firms and households.

African governments have incurred major revenue losses due to commodity price shocks and economic disruptions, which constrain their ability to finance public health expenditures to contain the virus or to finance stimulus packages to protect affected people and businesses. According to IMF data, African countries will record fiscal deficits averaging 5.8 per cent in 2020 and 4.4 per cent in 2021, compared with 3 per cent in 2019. Their debt-to-GDP ratios will increase, with about 29 countries projected to record debt-to-GDP ratios above the 60 per cent threshold set by the African Monetary Co-operation Program (AMCP) as comfortable for developing countries, signalling a risk of debt unsustainability and negative impacts on growth. To address the deteriorating fiscal space and vulnerable debt positions, most African countries enacted emergency measures to provide liquidity, support domestic financial institutions, manage financial stability and reduce the risks of systemic failure in banking systems.

According to the World Bank dashboard on financial sector measures, 45 African countries have adopted a combined 442 measures to inject liquidity, ease monetary conditions, support the banking sector and its borrowers, stabilize financial markets, support non-bank financial institutions and underpin payments systems (**FIGURE 7.1**). Of the 45, 28 approved a combined 174 measures targeting the banking sector. Regulators and supervisors in those countries took prudential measures to temporarily relax key regulatory and supervisory requirements and support critical economic sectors and solvent borrowers facing the supply and demand shocks induced by the COVID-19 lockdowns. The measures include credit repayment moratoria, supporting or facilitating loan restructuring, relaxing the classification or provisioning of non-performing assets and releasing or deferring existing capital buffers (Mora, 2020).

FIGURE 7.1 FINANCIAL SECTOR SUPPORT MEASURES PUT IN PLACE BY AFRICAN COUNTRIES IN RESPONSE TO COVID-19



Source: ECA, based on World Bank data (2020).

CONCLUSION

This chapter has examined why effective and enabling oversight of the financial sector is important. Pooling a country's savings for investment, creating markets so those with unused productive financial assets can exchange them for financial instruments, making unused productive assets available to entrepreneurs through intermediaries and boosting firms' ability to raise funding through monitoring and improvement of governance standards are all ways Africa's financial service sector can stimulate economic growth. For this sector to provide capital to the continent's private sector effectively, oversee its productive firms and guard its savings and financial assets, financial intermediaries must be properly regulated.

This chapter has made several recommendations. In some countries, public policymakers (including central banks) might resist amending banking and financial services legislation. The process could lead to lobbying, opening for debate a range of banking and financial service issues that many regulators would prefer to consider settled. But avoiding new regulation would be a mistake, and the current Basel III debate provides an opportunity to pursue it.

The Basel III guidelines, like Basel I and II, have been driven by the OECD countries, with input from larger emerging markets such as India and China but little input from smaller emerging economies with underdeveloped capital markets, many of which are in Africa. But African institutions can work on detailed country studies of aspects of regulation to determine what works best in each country's context and subregion, given the different stages of capital market development across Africa. The possibilities include digital platform regulation, macroprudential tools for managing risks associated with commodity booms and strengthened regulation to enable capital markets to be more effective in resource allocation and monetary policy.

Some strategic proposals cover areas of regulation to shift from looking only at the safety of financial intermediaries towards introducing incentives to improve overall governance and disclosure, covering the private firms that raise funding from the intermediaries. Improved governance and disclosure standards and the right incentives should amplify the financial service sector's role in allocating resources across Africa. Using regulation in this way will lay the foundation for further innovative financing of private sector development.

> "African policymakers' and regulators' experience with the 2008–2009 financial crisis and use of various measures to cushion its impact give them an advantage in rapidly responding to the COVID-19 crisis"

African policymakers' and regulators' experience with the 2008–2009 financial crisis and use of various measures to cushion its impact give them an advantage in rapidly responding to the COVID-19 crisis. They can put in place emergency policy measures to manage financial stability and create a sound pathway towards economic recovery. The measures include prudent macroeconomic policies, fiscal stimulus packages, expansionary monetary policies, targeted sectoral assistance and new regulations to support financial institutions, firms and households (such as lowering the base rate, lowering bank cash reserve ratios and undertaking government bond buying programmes and a debt moratorium). But at the time of writing this report, the end of the COVID-19 pandemic is uncertain, so it is premature to claim the success of these policy measures in stabilizing the financial system and enabling efficient and sound economic recovery. It thus remains critical to continue increasing African government capacity, strengthening financial sector resilience and supporting all financial innovations that could help mitigate the negative impact of the crisis.

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