

A KEY NOTE ADDRESS

at

THE FOURTH AFRICAN FINANCE AND INVESTMENT CONFERENCE IN STELLENBOSCH, SOUTH AFRICA

on

REGULATION, SUPERVISION AND CORPORATE GOVERNANCE IN THE FINANCIAL SECTOR

by

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October 24, 2002

I am most grateful for the opportunity to be a part of this, the fourth conference on Finance and Investment in Africa. It was indeed a pleasure for me to accept the invitation to give keynote remarks to this distinguished audience, and I wish to commend the conveners of this conference for choosing a timely and pertinent subject. The theme of the conference is very important as Africa needs to keep pace with international developments in banking and finance, and of course there is a need for the continent to continuously attract investment in the interests of sustainable development and economic growth, if poverty is to be reduced with its deleterious effects on society.

I have chosen to share with you some perspectives on a topic that I believe is close to the heart of both academics and practitioners in the financial sector. The topic is, "Regulation, Supervision and Corporate Governance in the Financial Sector", and I will speak from a central bank perspective, given its role of regulator and supervisor of financial institutions. You will agree that effective regulation and supervision of the financial sector is an essential component of sustainable development. The topic is also relevant to initiatives being undertaken within the ambit of the New Partnership for Africa's Development (NEPAD) and the African Union. As you know, NEPAD focuses on the principles of good political governance and the pursuit of transparent and sound macroeconomic policies at national, regional and continental levels, as a precondition for Africa's renewal.

No doubt globalisation has affected the environment within which the regulation and supervision of financial systems takes place. Globalisation has brought with it reduced barriers between national financial markets and increasing cross-border activity for financial institutions, which is facilitated by the rapid pace of technological innovation. At the same time, there is a trend towards a consolidation of financial institutions and the emergence of financial conglomerates which provide a range of financial services.

These developments mean that the risks facing financial institutions are becoming increasingly complex and difficult to evaluate and assess, thus posing serious challenges for regulators and supervisors, particularly in view of an increasing complexity and range of products, as well as the global reach of financial activities. Regulators whose remit was purely national in the past are now engaged in cross-border supervision, with all the associated demands on human resources and the required expertise. The initiatives against money laundering and the financing of terrorism (which have been intensifying since the unfortunate events of September 11, 2001 in the USA), in collaboration with other enforcement agencies, pose additional challenges on regulators and supervisors. There is no doubt, therefore, that there is an urgent need for enhanced supervisory capacity.

There is also a need for clearly defined and appropriate regulatory policies; both the regulator and the regulated need to understand their respective obligations. In the interests of transparency, it is essential that all concerned should adopt international regulatory standards. In particular, there is need to adhere to the Core Principles for Effective Supervision which have been established by the Basel Committee as a benchmark for assessing the efficacy and effectiveness of national regulatory practices and standards. This approach will, in turn, facilitate effective international collaboration among regulators/supervisors, which is increasingly important in a globalised environment. Adherence to these international standards also facilitates a general upgrading and strengthening of supervisory capacity.

As we all know, stability and soundness of the financial sector does not only depend on rules and regulations. It also depends on the broader issues of sound macroeconomic environment or a lack of it. It is, therefore, encouraging that even in the area of macroeconomic and financial management, there is a shift from the codification of principles to formal assessments of countries against those principles. This is a step in the right direction. There are two vehicles for these assessments. The first are the Reports on the Observance of Standards and Codes (ROSCs) and the second is the Financial Stability Assessment Programme (FSAP) of the International Monetary Fund (IMF). These formal assessment programmes assist in identifying financial sector weaknesses, assessing financial sector stability, and prioritising policy responses. Many IMF member countries have undertaken the exercise while many more have expressed interest in going through the exercise in future participation.

Experience has proved that financial stability and monetary stability are inextricably linked. This means that regulation and supervision of financial institutions will be most effective in an environment of macroeconomic stability. A consistent and sound macroeconomic policy environment, with complementary monetary, fiscal and exchange rate policies, is essential. Otherwise the opposite could lead to an increase in economic and financial risks, to the point where the financial system itself becomes vulnerable. At the same time, the absence of a well functioning financial system would no doubt make the achievement of macroeconomic stability more difficult.

In addition to the stability of the macroeconomic and financial environment, effective regulation and supervision of the financial sector is predicated on the supposition that corporate governance for financial institutions is of the highest standards, and that specialist service providers, such as accountants, auditors and lawyers, adhere to equally high professional standards and code of business ethics. You will agree that if accounting and auditing standards are weak or perverted, then effective banking regulation and supervision will be seriously compromised. Recent accounting scandals in the United States of America reinforce the need for vigilance on corporate governance and adherence to sound and transparent accounting practices, as well as the maintenance of sound business ethics by all concerned.

Let me share with you some recent trends and improvements in the supervision of financial institutions. There has recently been a move towards risk-based supervision. This approach focuses on identification of risks encountered with specific assets, instead of the traditional approach of requiring banks to adhere to pre-specified measures and ratios at specific points in time. The risk-based approach is concerned with assessing the adequacy of each bank's risk management systems, with the aim of ensuring that there is effective measurement, monitoring and controlling of risk in a timely manner.

Another supervisory trend has emerged due to the changing structure of the financial sector. Specifically, the structures of supervision are increasingly required to conform to the diversification of the financial sector especially with the increased move towards the stability of structured bond markets. As you are aware, most sub-Saharan African countries have financial systems that are dominated by what could be referred to as "plain vanilla" financial institutions. However, in many of these countries, there is a move towards the development of capital markets, specifically stock and bond markets, in order to diversify sources of finance for investment and the range of financial instruments available to savers. The development of such markets calls for new and relevant supervisory infrastructures. At the same time, other financial service providers, such as pension funds, asset managers, insurance companies, unit trusts, brokers and investment advisors, are proliferating, and they need to operate within an appropriate

regulatory framework. There is no doubt, therefore, that in many countries a redesign and modernisation of supervisory structures is long overdue.

The increased diversification of the financial markets presents both a challenge and an opportunity for supervision. The challenge is to ensure that the regulation of these emerging structures adhere to international best practice, while the opportunity to be derived relates to the benefits associated with the highest standards of supervision and corporate governance. Success in this direction will, in turn, reduce the inherent risks and contribute towards attracting the much needed capital inflows that have an important role in economic development, a point which is made in the NEPAD initiative on financial markets.

Furthermore, as we make progress in developing and modernising our respective financial markets, it is important to put in place an appropriate institutional infrastructure for financial sector regulation and supervision which includes international collaboration. However, it should be pointed out that there is no unique supervisory structure for all countries as the situation differs from country to country. The size and behaviour of financial markets, the availability of resources, as well as the economic environment should provide guidance in this respect.

Countries can adopt a structure of multiple regulatory agencies, each dealing with a sub-set of the financial sector. The alternative is to place the entire sector under a single regulator, akin to the Financial Services Authority of the United Kingdom. There is then the question of the role of the central bank in each of these arrangements. I am aware that this has recently become an issue in South Africa, with questions being raised about whether the existing dual regulatory structure is appropriate, effective and efficient. For many of the countries in sub-Saharan Africa, the situation is somewhat different in that supervisory capacity for securities markets and other non-bank activities is more or less non-existent, and the issue then becomes the type of structure that should be developed.

There are good arguments in favour of a single regulator, covering all financial markets and institutions. The benefits from economies of scale can be substantial, as can be the cost savings in avoiding unnecessary overlap and duplication of regulatory agencies. A single agency can facilitate an effective regulation and supervision of financial institutions with complex structures; it can also optimise the use of scarce human resources and enable certainty over lines of accountability.

However, the single regulator model is a relatively recent development and still has to be “put to the test” in order to determine how well it deals with different types of financial crises. In view of the enormous power that a single regulator can command, it is important to ensure that inefficiencies do not creep in, such as excessive bureaucracy and related slowness in responding to the needs of stakeholders.

If a single regulator approach is chosen, there are strong arguments for a close relationship with the central bank. This arrangement tends to facilitate information flow as well as the coordination of monetary policy and supervisory policy actions and, in the event of an emerging crisis, it would enable a faster assessment of and response to systemic risk.

In developing countries, however, there is a case for central banks to retain responsibility for prudential supervision. This is so because central banks are often the gravitational centre for technical and professional expertise in economic policy analysis and implementation, and have closer contact with market participants than other parts of the official sector. Engagement by central banks in this area of policy can greatly enhance financial stability. Central banks must, therefore, ensure that there is complementarity between their core responsibility of monetary policy and that of regulating and supervising their respective financial sectors.

Obviously, central banks should not be overburdened with responsibility for regulating and supervising non-bank financial institutions and markets. It is my view that appropriate regulatory bodies, such as a capital markets authority, should be established to oversee the other segments of the wider financial

sector. The coordination of different regulatory agencies, including the central bank, can be achieved through a committee of regulators in which the government (Ministry of Finance) would play a pivotal role.

Once an appropriate regulatory and supervisory structure is established, it is important to address capacity building issues, against the background of a dearth of relevant human resource skills in Africa. This constraint is compounded by the increasing demand on regulators and supervisors in the light of the move to risk-based supervision, the need for international collaboration in supervision, and the demands imposed by the initiatives on anti-money laundering and the prevention of the financing of terrorism. Therefore, there has to be a continuous staff development programme which will equip the supervisors with appropriate professional and technical competence.

One way of developing supervisory capacity is to expose staff to international standards of risk management techniques. While these standards can be demanding, especially the challenges posed for regulators and banks by the new Basel Accord, there are many advantages to be gained from a consistency of standards across countries. Cross-border supervision can be simplified if different national authorities commit to adhere to common standards. There would also be beneficial effects in that a regional or international body of experts could emerge in countries where similar or the same standards are being applied. For instance, the numerous vulnerability assessments that have been conducted against the Basel Core Principles can provide more hands-on experience in crisis prevention. Thus regional financial assessment peer reviews can be carried out, which again is central to NEPAD.

As a related matter, it is essential that regulators and supervisors should be concerned with issues of consumer protection, particularly with respect to capital markets. However, I believe that there should be a separation of responsibilities. Supervisors of securities markets, insurance companies, pension funds and similar entities, should ensure that the purchasers of financial instruments and products are not misled or exploited by service providers, since unsound practices are likely to retard the development of embryonic capital markets.

The primary task of bank supervisors is to guard against systemic instability; hence their concern should be with the risks taken by banks, in order to minimise the chances of depositors losing their money due to possible bank