Caleb M Fundanga: Measures to improve financial regulation and supervision of the financial system in Zambia

Remarks by Mr Caleb M Fundanga, Governor of the Bank of Zambia, at the United Nations Working group meeting on the world financial and economic crisis, New York, 3 May 2010.

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The Co-Chairpersons of the Ad hoc Open Ended Working Group on the World Financial and Economic Crisis
Distinguished Delegates
Ladies and Gentlemen

It is a great honour for me to address this important meeting on the impact and ramifications of the global financial crisis on economies across the globe. I am particularly encouraged by the fact that the discussions pay particular focus on the issues of financial sector reform and how we can best ensure that the financial sector plays its rightful role in facilitating innovation, enterprise, growth and development.

Chairperson, although the worst effects of the economic recession appear to be behind us, the negative effects are still being felt, particularly in the advanced economies where unemployment is likely to remain stubbornly high. According to the most recent forecasts by the IMF, the global economy is projected to record positive growth of 3.9% in 2010, after contracting by 0.8% in 2009. However, these growth rates mask significant differences in economic growth across the world, with emerging and developing countries on the whole posting much stronger growth rates than the developed or advanced economies. It is obvious that there will be need to rebalance fiscal and monetary policies in these economies once growth becomes more broad-based and entrenched to avoid a build up of inflationary pressures. As the crisis was mainly a result of weak regulatory framework and poor supervisory oversight in advanced economies, there is also need to continue undertaking measures to reform the financial systems and enhance global standards for the supervision of the financial sector.

Zambia weathered the crisis relatively well, with growth in 2009 actually increasing to 6.3% from 5.7% in 2008. This growth was largely driven by increased output in the mining and quarrying, construction, agriculture, and energy sectors. Although the Zambia's financial sector was not directly exposed to toxic assets, the financial crisis and the global recession that it triggered did impact Zambia's macroeconomic environment. The Zambian economy suffered reversal of short term capital flows and a slowing down of foreign direct investment, which had an adverse impact on the exchange rate of the Kwacha against the major currencies. The collapse in commodity prices as global demand contracted also impacted on Zambia's mining sector and its related support industries, leading to losses in output and employment that fed back into the deterioration in the loan book of commercial banks. Non-performing loans in the banking sector, for example, rose from around 6% in June 2008 to 12.6% at the end of 2009.

Distinguished delegates, part of the reason for the resilience of Zambia's financial sector were the comprehensive financial sector reforms that have been systematically undertaken after the banking sector collapse in the second half of the 1990s. These reforms were promulgated under a Financial Sector Development Plan (FSDP) that was implemented to address weaknesses in the financial sector, identified in a Financial Sector Assessment Programme (FSAP) conducted by the International Monetary Fund (IMF) and the World Bank in 2002.

Zambia's reforms included the following: the increase in capital requirements for banks; consolidation of the supervision of bank and non-bank financial institutions under the Bank of

Zambia; legislative reform that gave the Bank of Zambia powers to deal with failing institutions; and the promulgation of corporate governance guidelines including the conduct of outreach programmes on good corporate governance practices for the financial sector and the introduction of credit reference services. The Bank of Zambia is continuing with its work to improve the financial sector and enhance the role of the financial sector in the development of the country through the implementation of the second phase of the Financial sector Development Plan, FSDP II. The FSDP II will focus more narrowly on issues of competition within the financial sector and extending financial inclusion. However, the fallout from the crisis has brought to the fore the need to further enhance the regulatory framework by adopting and fortifying supervisory and regulatory practices which ensure prompt and effective policy responses to developments in the financial system.

Ladies and Gentlemen, the introduction of credit reference services in Zambia was necessitated by the poor credit culture, which was identified as one of the weaknesses in the financial sector, under the FSDP. Bank of Zambia licensed the first ever credit reference bureau, in 2006, following the introduction of the Credit Reference Services (Licensing) Guidelines and Credit Data (Privacy Code) 2006. The substantive operations of the CRB commenced in the fourth quarter of 2008 after a Directive was issued by the Bank of Zambia on 10 December 2008 mandating all credit providers to use the services of a credit reference agency before issuing any loan and to provide credit data to a credit reference agency. However in spite of these efforts, the credit reference system still faces problems, largely relating to the coverage of sectors, as the current legislation is limited to the financial sector. In view of this, the Bank of Zambia is currently developing a comprehensive credit reference law that, amongst other things, will have jurisdiction over all credit providers and data sources and will provide for the treatment of credit data.

Chairperson, allow me to share with you some of the key regulatory and supervisory issues that the Bank of Zambia is addressing with regards to the regulation of the financial system in Zambia and the need to address the supervisory challenges posed by the global financial crisis. These issues include: the adoption of a risk based supervision (RBS), enhancing the legislative framework, the determination of capital adequacy, the introduction of a deposit insurance scheme, the enhancement of our lender of last resort regime, and the enhancement of cross-border cooperation through consolidated supervision of financial institutions.

Risk based supervision is a structured, forward-looking process designed to identify key risk factors to which individual banks are exposed. This approach entails closer interaction with banks and allows early identification of risks as well as close monitoring of the nature and direction of risks as they emerge. The banking industry has recorded notable rapid growth in the last ten years. This growth comes with heightened risk levels. The RBS provides robust mechanisms to ensure that banks have adequate risk management systems to mitigate risks. RBS systematically considers all key functional activities (business lines and operational areas) and, within each key functional area, evaluates the level of risk, quality of risk management, and direction of risk. The resulting risk profile of the bank, which is dynamic, will therefore change during the supervisory cycle. This paradigm shift in supervisory approaches requires a permissive legal and regulatory framework.

In order to ensure timely and credible information for the effective supervision of banks and other financial institutions, the Bank of Zambia has been playing a key role in developing the Bank Supervision Application System (BSA), which is a Southern African Development Community (SADC) region initiative. The BSA is a standardized tool designed for capturing supervisory information, financial and risk analysis and provides a workflow mechanism for communicating the different aspects of the supervisory process.

Distinguished delegates, the legal and regulatory framework governing the supervision of the financial sector must provide for a fast and flexible way of adapting the banking system to the constantly changing financial landscape. The legal and regulatory frameworks in Zambia comprise of the Banking and Financial Services Act, Chapter 387 of the Laws of Zambia; the Bank of Zambia Act, Chapter 360 of the Laws of Zambia; the National Payment Systems Act; the Prohibition and Prevention of Money Laundering Act; the Bank of Zambia Anti-Money Laundering Directives; and the Bank of Zambia Corporate Governance Guidelines. The speed at which changes to these regulatory frameworks can be made is a crucial element of the reform process in regulatory and supervisory arrangements as it improves policy responsiveness. A number of challenges exist in this area including the need to update some of the Statutory Instruments (SIs) in order to reflect the dynamics presently characterizing the financial markets. In some cases, new guidelines are altogether needed for regulating new products and innovations such as mobile banking, internet banking and Islamic banking. The need for quick and appropriate responses to market developments and innovations while important also need to be balanced by a well designed regulatory framework that ensures the maintenance of a stable and sound financial system.

Chairperson, the stability and soundness of the financial system is in turn, heavily dependent on the adequacy of capital. It is essential for the right balance to be struck between the need for banks to hold adequate capital to absorb losses and the need to ensure that capital requirements do not unduly constrain from lending to the real economy. It is also important that banks are not so highly leveraged relative to common equity as to create incentives for excessive risk taking. The required capital ratios should therefore be viewed in the context of the high quality capital – Core Tier 1 and Tier II definitions and should exclude subordinated debt as providing relevant support.

Distinguished delegates, Basel II provides a pragmatic approach to determining overall capital levels. It introduced a new approach to the definition of relative capital requirements to be held against specific asset categories. The challenge in this approach is in deciding what an optimal level of capital is especially in light of massive scale of economic losses now being suffered as a result of the banking system collapse. However, any theory of optimal capital level will have to strike a balance between the increased cost of financial intermediation which result from higher capital requirements and the benefits of the decreased probability of bank failure and economic harm which will be achieved. Recent developments have established a prima facie case for higher minimum capital requirements. The challenge will be for supervisors to manage the transition to higher capital requirements in a phased approach and take into account the need to avoid procyclical pressure on bank capital adequacy under conditions of economic downturn. Zambia has adopted Basel II for implementation although work is still on-going in this area.

The enhanced approaches to capital that I have just described have the potential to significantly minimize the probability of bank failure. They may also assist in reducing the extent to which strains on bank capital and liquidity result in an impaired ability to extend credit to the real economy. But the probability of bank failure cannot be reduced to zero. The system of bank regulation and supervision therefore needs to be buttressed by arrangements for deposit insurance (for protecting depositors in the event of default) and for bank resolution (to ensure orderly wind up and avoid knock-on effects to the rest of the banking system). In this regard, an effective deposit protection scheme becomes an important aspect of the financial safety net especially in crisis times. Although Zambia did not experience bank failures during the current global crisis, work on the establishment of the deposit protection scheme is currently in progress. Quick bank resolution is also an essential element that inspires confidence in the financial system. In Zambia, for instance, work on liquidations has been going on for some time in some cases. The establishment of an effective depositor protection scheme should assist in early bank resolutions while providing protection to the most vulnerable depositors.

Chairperson, although the Bank of Zambia has exercised the function of lender of last resort (LOLR) in the past during the banking crisis in the 1990s, there was no clear LOLR policy framework in place. There has been renewed concern that the economic slowdown, if prolonged, could create liquidity pressures in the banking system in Zambia. Past experiences and current global slowdown build a strong case for a clearly designed LOLR framework in which the central bank can exercise this function. The challenge in the regulatory and supervisory arrangements is that of operationalising the lender of last resort. Lender of last resort should be seen in light of its role in promoting wider public good and systemic financial stability and ultimately, the wider economic stability. It plays an important role in the economy to avoid the social cost of a bank failure. Some bank failures may lead to contagion effect on other banks which has the potential to transmit to the entire economy. Lender of last resort should be an essential element of the wider institutional framework for governments and central banks for dealing with banking crises in addition to prompt corrective action, bank resolution and deposit insurance among others.

Distinguished delegates, the speed with which the crisis spread across the globe highlights the global nature of financial markets and the importance of cross border supervision. The risk posed by cross-border operations by financial institutions is clearly significant if not properly supervised. Over the years, many financial organisations worldwide have adopted more flexible and complex structures through the establishment of a wide range of subsidiaries and affiliates that are engaged in business lines different from the core business of the parent financial institution. The emergence of financial conglomerates has seen banking activities, asset management or insurance activities that previously were conducted on a stand-alone basis now being provided within one financial group. Some of these financial groups operate businesses across borders. The main economic and financial benefit which encourages the formation of such groups is the enhanced ability to achieve economies of scale and capture synergies across complementary financial services business lines. These synergies result in improved operational efficiency and effectiveness due to lower costs, reduced prices, and improved innovation in products and services. At the same time, the emergence of such groups has brought complex linkages and relationships among economic agents. Consequently, they have also necessitated a paradigm shift in supervisory approaches in order to identify, manage and monitor risks both within and across borders.

Distinguished delegates, previously, supervision of cross-border banks placed significant reliance on the ultimate home country supervisor to ensure the soundness of the overall institution. This implied that other regulatory authorities could only provide input to the supervisory process in the home country. Hence, it was considered appropriate for global firms to gain the benefits of global approaches to the management of their business and had significant flexibility in the use of legal entities to book transactions and to manage liquidity globally. Therefore, the global inter-connectedness made it very difficult for individual national entities to survive group failure even though they are subsidiaries, given the huge importance of confidence factors in funding markets. The challenge is how to develop regulatory and supervisory approaches which will minimize the likelihood of cross-border failures and to reduce the severity of that impact in the event of a failure materializing. It would appear that an appropriate response would have to combine both greater coordination among supervisors and actions aimed at specifically addressing national concerns. On its part, the Bank of Zambia is currently settling Memoranda of Understanding with various central banks for effective supervision of entities with cross-border operations. This is also necessary for enhancing cooperation among the various regulatory authorities in the financial system in Zambia such as the Pensions and Insurance Authority and the Securities and Exchange Commission.

Chairperson, in the wake of the financial crisis, there has been renewed interest in macroprudential supervision. In many countries or economic areas, the institutional framework for financial stability is being strengthened in the light of the lessons learnt from the crisis, and incorporates new supervisory tasks and bodies responsible for the macro-prudential regulation of systemic risk and Zambia is no exception. Overall, the current crisis has revealed that microprudential supervision in many cases proved inadequate to identify, in a timely manner, the nature and size of accumulating risks and to impose appropriate remedial action; and that there is therefore, a need to strengthen both the macroprudential and microprudential supervision of the financial system.

The Bank of Zambia with the help of the World Bank is currently conducting pilot tests of the World Bank developed Financial Projection Model (FPM) on a number of financial institutions. Among many other things, the FPM is a tool designed to simulate the effect of internal and external events upon financial institutions' solvency and profitability to implement stress scenarios in a dynamic fashion. The Bank of Zambia is also developing a financial sector contingency plan to address problems of a systemic nature and enhance practical tools for effectively managing financial distress and potential systemic crisis.

Chairperson, let me conclude by stating that in the wake of the global financial crisis, Governments around the world and the international community acting together, have an important opportunity to address some of the structural weaknesses in our domestic economies and in the global financial system that were laid bare by the crisis. I have already outlined the broad changes that are being considered. It is, however, important to emphasize that for the emerging and developing economies, particularly those in SSA, these measures to reform the international financial architecture need to be carefully considered to ensure that they build on the strong foundation for economic growth that has been laid over the past decade.

I thank you for your attention.