BANK OF UGANDA

Remarks by Dr Louis Kasekende at the two-day programme "*Integrating Financial Reform & Public Policy Goals*"

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Public Policy Goals and Development Context

What areas of financial regulation are critical in the development context?

The framework for financial regulation promoted by international institutions such as the Basel Committee for Banking Supervision (BCBS) and the Financial Stability Board (FSB), reflects for the most part the public policy priorities of the advanced economies. In discussing the relevance of financial regulation, or of different areas of financial regulation, for developing economies, two questions need to be addressed.

The first, and most fundamental question, is whether the basic framework of financial regulation promoted by the global institutions is compatible with the strategic objectives of development? More specifically, are there trade-offs between the objectives of financial regulation underlying the global framework and the strategic objectives of development?

The second question is whether, even if the same basic approach to regulation is warranted, given that there are substantial differences between advanced and developing economies in the structure of their financial systems, should developing economies place greater

emphasis on those aspects of the regulatory framework which are most relevant for their own financial systems, and vice versa?

Do the strategic objectives of development warrant any fundamental differences in the approach to financial regulation in developing economies?

The framework of financial regulation promoted by the global institutions has at its core the Basel Capital Accords and the Base Core Principles for Effective Banking Supervision (BCPs). The Basel Capital Accords, of which the latest manifestation is Base III, and the BCPs are being implemented very widely in advanced and developing economies. The primary motivation for this regulatory framework is prudential; to protect the interests of bank depositors and to avert systemic financial crises. That the framework demonstrably failed to prevent the global financial crisis of 2007-09 has prompted the latest rounds of reform.

The priority accorded to prudential objectives means that financial regulations aim to restrain risk taking by banks; for example by requiring them to hold capital against risk assets and to make provisions for non performing loans. The argument is sometimes made that economic development requires banks to take risks, for example by extending loans to inherently risky borrowers such as farmers or small and medium scale enterprises. As such, financial

regulations which prioritize prudential objections will constrain banks from maximizing their contribution to development. If so, there would be a trade-off between developmental and prudential objectives, with developing economies naturally placing greater emphasis on the former.

I don't think that there are trade-offs between prudential and developmental objectives in practice and, if anything, the opposite is the case: stronger prudential regulation may benefit development. This is for three reasons. First, relaxing prudential regulations may allow banks to expand risky lending but is likely to be counterproductive in the long run if this leads to financial distress in the banks which would then force them to curtail their lending even if they do not collapse under the weight of bad debt. Furthermore, extending bank credit to risky enterprises is not necessarily the best way to support their sustainable growth if these enterprises face more binding constraints in other areas, such as access to markets or lack of business skills.

Second, there is empirical evidence that the economic costs, in terms of lost output and costs to taxpayers, of banking crises in developing economies are much greater as a share of GDP than those of banking crises in advanced economies. This would warrant developing economies placing more emphasis on averting banking crises.

Third, the risks facing banks in developing economies are generally greater than in advanced economies because the former are more volatile and less diversified and have weaker institutional structures which makes the recovery of loans by banks much more costly and uncertain. As such many developing countries, including Uganda, have chosen to impose higher minimum capital requirements than those stipulated in the Basel Accords and also to impose stricter restrictions than most advanced economies on the permissible activities of banks and the composition of their risk assets.

Finally I would like to highlight the findings of some research by one of my former colleagues at the African Development Bank who estimated the long term costs and benefits to real output in Africa arising from the Basel III increases in the minimum capital requirements. Giovanni Caggiano and Pietro Calice found that raising minimum capital requirements generates modest long term net benefits for Africa, essentially because the benefits from a lower probability of a banking crisis outweigh costs arising from wider interest rate spreads.

Should developing economies prioritize different aspects of the regulatory framework than advanced economies?

Although the basic global framework of financial regulation is as relevant for developing economies as advanced economies, I want to

highlight four areas of the regulatory framework where the priorities of the former might differ from those of the latter.

Basel I or Basel II

The Basel I Capital accord and Pillar 1 of Basel II offer alternative methodologies for computing the minimum capital requirements of banks. Basel I has been widely adopted in Africa and is relatively straightforward to implement and enforce. It has contributed to the strengthening of bank capital in Africa, which is one of the reasons why the incidence of banking crises on the continent has fallen markedly since the 1980s.

Implementing pillar 1 of Basel II is more challenging than Basel I and only three Africa countries have, to date, adopted the former. Basel II offers several different options for computing bank capital requirements, from the relatively simple to the more complicated. However the simplest approaches offer few advantages over Basel I because they rely on the credit ratings by credit rating agencies to determine the risk weights of corporate borrowers, yet very few corporates have credit ratings in Africa. The more complex approaches to determining risk weights, which rely on banks' own internal models, are unlikely to be feasible in Africa because neither the supervisors nor most of the banks themselves have the technical expertise to operationalize these models. As such,

replacing Basel I with pillar I of Basel II should not be a priority for African regulators.

Macro-prudential measures

Basel III introduces, for the first time in the global regulatory framework, specific macro-prudential measures - the capital conservation buffer and the countercyclical capital buffer – which are intended to mitigate the time dimension of systemic risks; i.e. risks related to volatile financial and economic cycles. The motivation for these measures is the recognition that the risk of a systemic financial crisis is not simply the aggregation of the risks facing each individual financial institution in the system, but that systemic risks can build up – for example through credit and asset price booms – even when individual financial institutions appear to be in a sound financial condition and are complying with all micro-prudential regulations.

Although the introduction of macro-prudential measures is a welcome step in principle, the Basel III measures appear inadequate to address systemic risks in developing economies, for two reasons. First, given that many banks in developing economies already hold capital in excess of the regulatory minimum, it is difficult to envisage that imposing a countercyclical capital buffer of 2.5 percent of risk weighted assets, as proposed under Basel III, will

really act as a constraint to a credit boom. To properly mitigate these risks it may be necessary for regulators to impose more direct controls on bank lending during a credit boom, or on loan to value ratios, as has been done in some south East Asian countries.

Second, Basel III does not address one of the most important sources of systemic risk for developing economies; that of volatile short term external capital flows intermediated through the domestic financial system. This may require controls on banks' short term external liabilities or minimum stay requirements on external capital inflows.

The resolution of distressed cross border banks

How to resolve a failed cross border bank in an orderly manner is probably the most difficult challenge facing financial regulators. The Financial Stability Board has developed a set of "Key Attributes" for the resolution of cross border banks. The Key Attributes include the setting up of Crisis Management Groups (CMGs) for each cross border bank, comprising the home regulator and host regulators of "materially significant subsidiaries". In addition, there should be an Institution Specific Cross Border Cooperation Agreement (COAG) which specifies the processes of cooperation and information sharing among the home and host regulators.

These are potentially important innovations. It is imperative to have close cooperation between the home and host regulators if a distressed cross border bank is to be resolved in an optimal manner, which minimizes the losses to creditors or taxpayers. However, developing economy host regulators of cross border banks should not be excluded from the CMGs simply because the relevant subsidiary has a small share of the global bank's assets. Many of these subsidiaries are of systemic importance in the host economy. It is crucial that developing country interests are properly taken into account when resolution plans are prepared, which will only happen if developing country host regulators are properly represented on the relevant CMGs.

Unintended consequences of anti-money laundering legislation

Around the world, banks have to comply with increasingly strict anti-money laundering and combating the financing of terrorism laws. Banks which fail to comply face very large fines. Unfortunately the huge size of the penalties involved and indiscriminate manner in which they have been applied has made banks very risk averse in conducting any transactions with countries afflicted with terrorism. Somalia is the most tragic example of the consequences of this risk aversion. Its population rely heavily on remittances from Somalis living broad, but because banks have no way of distinguishing innocent money transfers from the tiny minority of transfers which might be linked to terrorism,

banks in Britain, the United States and Australia now refuse to do business with money transfer companies which send remittances to Somalia, which is severely impeding the flow of remittances to that country. Even in terms of fighting terrorism this is shortsighted and counterproductive because by intensifying poverty it will contribute to more people joining terrorist groups.