

CHAPTER FOUR

CROSS-BORDER ISSUES AND REGIONAL INTEGRATION IN FINANCIAL REGULATION

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4.1 INTRODUCTION

Cross-border banking services by African banks within Africa have been on the rise since the last decade. As these services are provided predominantly by complex financial institutions and involve operating within a number of African financial systems, effective regulation of such entities can be challenging. The challenges are two-fold: regulating complex financial institutions on a consolidated basis and achieving effective supervisory cooperation between home and host country regulators of these banking entities, which is critical given the cross-border nature of the services they provide. Regulation is particularly significant due to the linkages of all financial systems involved in the operation of cross-border banking services and also the ease and speed with which a crisis can spread from one jurisdiction to another - as the last global financial crisis revealed.

This chapter, as such, assesses the legal and regulatory challenges inherent in the delivery of cross-border services by African banks within Africa and proposes solutions for making the operation of such services safer. Section one considers the reasons for the rise of African cross-border banks and their effect on African banking systems. Section two considers the legal and regulatory challenges inherent in their operations. Section three provides a critical appraisal of solutions for the legal and regulatory challenges by assessing the extent to which consolidated supervision, memorandums of understanding and the operation of colleges of supervisors, mitigate these challenges. Section four considers proposals for making cross-border banking services in Africa viable and section 5 concludes.

4.2 CROSS-BORDER BANKS IN AFRICA AND REASONS FOR THEIR INCREASE IN AFRICA

The operation of cross-border banking services in Africa, for many decades was dominated by foreign banks until almost a decade ago when the operation of cross-border financial services by African banks began to emerge.¹ Cross-border African banks have increased ten times in the past twenty years since 1990, with strong growth seen especially over the last six (6) years.

The African banks that have contributed to this growth trend include: Bank of Africa (Mali), which grew from two (2) countries to ten (10) in the same period; Ecobank (Togo), which grew from five (5) countries to thirty (30); Standard Bank (South Africa),

¹ The international banks, notably Stanbic, Standard Chartered and Barclays, already have operations in most of these countries

which increased its countries of operation from four (4) in 1990 to thirty-three (33) in 2010; United Bank of Africa (Nigeria), which grew from two (2) countries to twenty (20). It has to be mentioned that despite the increase of cross-border services by African banks, financial systems in most African states are still underdeveloped and lacking significantly in financial infrastructure needed to support financial market development and cross-border services in Africa. Aspects of financial systems development that would greatly support cross-border services include building and, where necessary, developing payment, clearing and settlement and credit registry systems.²

It would appear that African cross-border banks are more prevalent in countries with more advanced banking and financial sectors and hence countries including Morocco, Nigeria, South Africa and Kenya are home to most cross-border African banks and as such have a low amount of foreign banks operating in their banking system. Others with not as advanced banking sectors as countries referred to above such as Botswana, Chad, Cote d'Ivoire, Guinea-Bissau, Mali, Mauritania, Namibia, Niger, and Senegal have a very strong foreign bank presence.³ Countries such as Benin, Burkina Faso, Lesotho, Madagascar, Mozambique, and Zambia with some evidence of financial sector development although small, are almost completely dominated by foreign banks. While countries with poor financial systems development, such as Ethiopia and Eritrea, are completely closed to foreign capital and are neither investment destinations of African and foreign cross-border banks.

It has to be mentioned that the increase of cross-border banking operations in Africa both by African and foreign banks has occurred against the backdrop of financial sector liberalization in Africa in the 80s and 90s. After independence, African countries embraced interventionist financial sector policies, which inhibited cross-border banking services in Africa. But with the introduction of financial liberalisation policies, it became easier for banks to expand cross-border. Nonetheless, specific reasons for the increase of cross-border operations by African banks include, amongst other things: the desire of banks to follow their large corporate clients as they develop their businesses abroad; the keenness of banks to participate in the growth prospects of Africa and technological advances that make possible the delivery of new products, which are relevant to African markets such as mobile money and village banking.

The operation of cross-border banks within host state countries is also known to have some benefits. It is believed that cross-border banking services can enhance the development of financial systems particularly if such banks operate within a much more advanced banking system than the host state. Cross-border banks are also known to improve banking services by increasing the degree of competition among banks since both domestic and foreign banks would now be competing for the banking space and market and since such competition would ensure that domestic banks improve and enhance their services to customers in order to stay in the market. Another benefit associated with cross-border banks is their improvement of banking expertise and

² Overall, payments services, particularly at the retail level, remain fragmented and costly and only a few African countries have effective credit information systems, be they private credit bureaus or public credit registries

³ See I Salami, 'African Financial Markets – Going Global or Staying at Home?' (2011) 26 (11) *Journal of International Banking Law and Regulation* 35 – 44

supervisory skill since their operation would require an increase in the number of skilled staff required to operate sophisticated banking products provided by foreign banks, which would also necessitate that bank supervisors upgrade their supervisory skills to be able to effectively supervise such banking activities. Cross-border banking services are also believed to enhance financial stability in both the home and host states of the foreign bank. As long as, the economies of the home and host governments are not synchronized, risk diversification is achieved as the foreign bank operates within another jurisdiction away from any economic crisis that may occur in its home country and vice versa with respect to host countries. The operation of foreign banks is also known to promote the independence of the regulator as foreign banks are more removed from host states politics which sometimes lead to regulatory capture and thus undermine effective regulation needed for a stable banking system.

Nonetheless, despite the potential benefits of improved services and expertise gained from the operation of cross-border/ foreign banks in Africa, the extent of these benefits is called into question when weighed against the potential drawbacks that could occur from their presence in African jurisdictions. One of the strongest drawbacks of the operation of foreign banks in Africa is that they can crowd out local banks that offer existing services to the local community. So the trade-off between financial deepening derived from the operation of foreign banks in Africa (which of course has economic benefits to such banks as their operations in Africa is profitable to their businesses) and the development of domestic banks, is one to be carefully considered by African authorities. The former, relating to achieving financial deepening within the host state, would appear to be the prevailing choice in the context of African development.

4.3 LEGAL AND REGULATORY CHALLENGES AND RISKS OF CROSS-BORDER BANKING IN AFRICA

While there are numerous benefits of cross-border banking within Africa even by African banks, these cross-border banking services have introduced new challenges in banking supervision and through this, have increased the risk of financial instability across the continent.

Despite the underdeveloped state of a good number of African banking systems, most of these banking systems are quite stable due to the introduction of banking reforms in the past two decades, which saw, as in the case of Nigeria, an increase in bank capitalization and liquidity levels. This also explains the reason for the relative stability of financial systems in Africa in the past two decades. However, the increase of cross-border banking services particularly by African banks, presents a different set of challenges for which regulation would necessarily play a vital role.

Regulatory Challenges

The regulatory challenges of cross-border services by African banks is accentuated by the fact that most African banks are members of conglomerates with operations in other sectors including banking, capital markets, insurance, microfinance, pensions,

money transfer, leasing and non-financial sectors. This makes for complex corporate structures with multiple holding companies, diverse shareholding structures, opaque ownership, non-disclosure tendencies, and other practices, which complicate regulation. In order to cater for potential group risks and the potential systemic effect of the failure of such conglomerates and there is a need for strong regulatory oversight and surveillance of these financial groups / conglomerates. Nonetheless, in the context of Africa, to achieve this status quo is challenging for the reasons assessed below.

Different Regulatory Regimes across African Countries and Poor Financial Integration

A key challenge in regulating cross-border banking services is that as these services cut across various banking systems, with different legal and financial structures and laws and regulations, the coordination of banking regulation is particularly challenging.⁴ What is also challenging for banks is that the different regulatory requirements in jurisdictions where they operate make compliance cumbersome. As an example, cross-border banks need to comply with reporting requirements for the different jurisdictions they operate within due to lack of regulatory coordination. So, for example, Ecobank operates in several countries, each with its own set of rules and regulations. As capital adequacy requirements differ from country to country, one of its subsidiaries may need to recapitalize if new legislations is introduced, thus resulting in some subsidiary companies being cash rich while others require fresh capital. Ecobank, or indeed any African cross-border bank, can hardly maximize its opportunities to make profits by operating under these circumstances and would need to deliver economies of scale to drive higher profit growth and generate value for shareholders.

Another example arising from the differences in regulatory requirements is the different tax regimes that exist in different countries, which makes the overall supervision of different branches difficult. Other issues are regulatory inconsistencies in the different countries. This necessarily calls for the integration of financial regulatory regimes or banking/financial harmonization among African states.

Countries such as Kenya, Tanzania and Uganda have made progress in the area of financial integration. They have began a process to integrate their real time gross settlement systems (RTGS), with Rwanda and Burundi starting down the same path.⁵ The harmonization of banking/financial regulation, sub-regionally or regionally, would significantly enhance banking business. Such harmonization at its ultimate could result possibly in the operation of a single licensing requirement across Africa or across sub-regions in Africa, which would significantly ease the operation of cross- border banking services. But suffice to say that this is an extremely ambitious statement and even in Europe - that has successfully operated a monetary union project which only recently was tried and tested but passed – achieving a banking union has not been a walk in the park.

⁴For extensive coverage of this see, I Salami, *Financial Regulation in Africa: An Assessment of Financial Integration Arrangements in Emerging and Frontier Market* (Ashgate, 2012)

⁵Ibid

Contagion/Regional Risk

Another challenge presented by the operation of African cross-border banks is the ease in which contagion and regional risk can spread across the continent. This is perhaps the most pertinent risk in cross-border banking in Africa particularly as it involves the regulation of large complex groups. This is the risk that a branch in one country that faces an economic crisis could infect the entire group/institution and the exposure of other institutions in other African jurisdictions to this group could result in a regional crisis. As a result, it is pivotal that the consolidated supervision of group structures are sound and supervisory cooperation exists between both home and host country regulators to prevent the transfer of risk from one jurisdiction to another.

Regulatory Arbitrage

Banks would generally gravitate to jurisdictions with lighter regulation as this is more cost effective for their business and such jurisdictions benefit from an inflow of banking business. This can, however, have grave consequences if and when lighter regulation leads to bank fragility or failure. Altogether, circumvention of supervisory oversight due to regulatory arbitrage – e.g. regarding licensing requirements, reporting standards, and observance of prudential regulations – can be detrimental to the entire banking system and is a major concern, particularly in low-income countries where supervisory capacity is limited and which is characteristic of most African banking systems.

Legal Challenges

Weak Legal and Judicial Systems

Recent studies⁶ show that the operation of foreign banks in low income countries (which characterizes most African countries) is lesser due to, *inter alia*, the costliness of contract enforcement and limited credit information sharing.⁷ Other studies go as far as showing that developing countries that attract the much needed external finance to build industry through the operation of foreign banks, are those countries possessing legal systems able to effectively enforce contracts and where there are more effective credit information sharing systems.⁸

The enforcement of contracts law is determined by the strength of the domestic legal and judicial system. Where legal and judicial systems are characterized by delays in the legal process, this makes the enforcement of contract and property rights problematic and this is the case in many African countries. The poor enforcement of contract law can also inhibit the development of financial infrastructures such as payment and clearing and settlement systems - all of which depend on the sound enforcement of contract

⁶ S Claessens and N Horen, 'Foreign banks: Trends and Impact' (2014) 46 (1) *Journal of Money, Credit and Banking* 295-326

⁷ Ibid

⁸ V Bruno and R Hauswald, 'The Real Effect of Foreign Banks' (2013) *Review of Finance* 1-34

laws and which have also been the reason for slow financial markets development in Africa.

Weak enforcement of contract law greatly inhibits the ability of financial institutions to enforce contracts (on loans and collateral) and thereby inhibits financial systems development and to more efficient allocation of capital in the economy. It also inhibits the financial system's contribution to corporate restructuring.

The poor enforcement of contract and insolvency laws, amongst other things, can obstruct the development of sophisticated financial products in African banking markets such as financial derivatives. These products can help develop the local financial market. The benefit associated with these products is that they hedge risk exposures facing the financial sector (such as interest rate risk, credit risk, risk-return, etc). Some of the precise benefits to the local financial market in this regard include: promoting the allocation of resources to productive means, enhancing the allocation of cross-border capital flow, creating opportunities for diversification of portfolios, and encouraging liquidity in the markets. Nonetheless, as a great majority of these products are dependent on the effective enforcement of contract and insolvency laws and on the existence of robust financial infrastructure such clearing and settlement systems, their introduction into African banking markets is likely to be delayed.⁹

Weak Banking Resolution Frameworks

A strong banking resolution framework curtails excessive risk-taking during normal times, as banks become aware of the readiness of supervisors to implement prompt corrective actions. This, as such, strengthens the hand of supervisors in sanctioning banks should they fail to live up to prudential requirements, and reduces the necessity for forbearance and bailouts. African banking supervisors are known to take recourse in regulatory forbearance because local resolution frameworks either do not exist or are not used.

If there is evidence of a potential bank crisis, a sound bank resolution regime would allow supervisors to overrule shareholders during the pre-insolvency stage. This makes room for timely solutions, which could involve the transfer of a set of liabilities and a corresponding set of performing assets to an acquiring bank, while the remainder can be liquidated. It also provides for continuity, which preserves the much needed information within the bank. The absence of a bank resolution framework is likely to lead to a delay in authorities' intervention, which has a financial instability risk, which in turn can be costly to tax payers.

Weak bank resolution frameworks in Africa is a main legal challenge for African cross-border banks. There is no distinct framework for bank resolution and in most countries; either supervisors or courts can intervene in banks.¹⁰ Even in South Africa, with a quite advanced financial system, there is no clear-cut framework and supervisors have to

⁹ For more on this see: Salami, 'Derivatives Markets in Africa – Legal and Regulatory Issues' (2012) 27 (10) *Journal of International Banking Law and Regulation* 416 - 428

¹⁰ T Beck and others, *Financing Africa: Through the Crisis and Beyond* (The World Bank, 2011)

obtain approval from the minister of finance to intervene in a bank. The absence of legal clarity with respect to the power of intervention and a clear framework for resolving weak banks, undermine not only market discipline, but also supervisory independence with respect to banks. It, as such, becomes problematic for cross-border cooperation when cross-border banks with branches in host states fail. As such it is believed that the improvements in bank resolution in Africa, would greatly enhances cross-border cooperation in times of crisis and therefore is critical to the operation of cross-border services.

Despite the significance of an effective bank resolution mechanism as revealed in the recent global financial crisis, the Africans have not placed this same amount of urgency or significance to bank resolution frameworks. The primary reason for this includes: high capitalization and liquidity levels across most of Africa's banking systems and the increasing but currently still limited interconnectedness among the banking systems (and therefore the somewhat more limited immediate impact that bank failures would have on financial systems and real economies). All of this appears to suggest to African regulators/states that resolution frameworks should be of less immediate concerns for legislators and regulators across Africa. However, as stated above, it is crucial to remember that resolution frameworks also set incentives for banks and their supervisors during normal times.

Closely linked to this is the need for African states to review their crisis management regimes. A number of countries including South Africa, Namibia and Uganda, have undertaken major reviews of the crisis management and bank resolution frameworks, which in some cases has involved crisis simulation exercises, in helping them plan in the event of a crisis.

Tackling all these legal and regulatory challenges without obstructing the sector's growth and development – should, therefore, be the paramount concern of bank regulators in Africa.

4.4 STRENGTHENING THE OPERATION OF CROSS-BORDER BANKING IN AFRICA

It is widely accepted that the risks posed by cross-border banking services by large banks can be mitigated by: the existence of a sound consolidated supervisory framework for the cross-border bank; the signing of Memoranda of Understanding (MoUs) among all supervisory authorities concerned (both the home supervisors of the cross-border banks and the host supervisors where the bank operates) and the operation of Colleges of Supervisors (CoS).¹¹ At the heart of these three tools is information - the collection of

¹¹ This is based on the principles most relevant for cross-border regulatory cooperation in the Basel Committee's Core Principles for Effective Banking Supervision. These principles highlight the traditional tools for regulating and supervising cross-border banks as consolidated supervision, the signing of Memoranda of Understanding (MoUs), and establishment of Colleges of Supervisors (CoS)

information about the financial health of the cross-border bank and the exchange of information among home and host country supervisors.

This section assesses the extent to which these three tools can mitigate the risks of the operation of cross-border African banks within Africa.

Consolidated Supervision

Consolidated supervision is the supervision of a financial conglomerate, which could include a group that is composed of a bank and a non-bank financial institution. Typically a financial conglomerate would be a group that has a banking, capital markets and insurance business. However, such a conglomerate/group may also operate other commercial businesses that are non-financial. The supervision of such a group is referred to as consolidated supervision where the entire group structure is supervised. This would entail, *inter alia*, that the corporate governance regime and system is robust enough to manage the risks of the group's entities on a solo and a group basis and also that the entire group is capitalized such that capital is available to cover risks and losses arising from any part of the group.

Consolidated supervision of financial conglomerates is a rather challenging task for supervisors even in advanced markets as the varied activity of the group (banking, capital markets, insurance and at other instances the engagement in other non-financial commercial activities of the group) calls for the input of regulatory expertise from the various sectors represented within the group. The group's engagement in cross-border business activities further complicates consolidated supervision and calls for effective cooperation between home and host country supervisors. One of the reasons why cooperation among home and host state regulator is critical here is the likelihood of intra-group exposures - especially where resources can be easily and quite speedily transferred across different banks and parts of the group. Such cases make financial reporting of individual bank branches and subsidiaries insufficient to determine the health of a particular bank in the group or of the entire group.

It has also been argued that the basis for the consolidated supervision of conglomerates should be a risk based approach to supervision, as opposed to a rule based approach. The reason for this is that the risk based approach embraces a flexible regulatory regime thus giving supervisors the power to exercise discretion needed for the supervision of complex group / conglomerate structures particularly as in most cases the rationale for the creation of such structures is to conceal ownership and responsibility and circumvent regulatory / reporting requirements for some activities of the group.

Banking regulation in Africa is a challenge, however, the rise in cross-border African banking services presents an even greater regulatory challenge. This is primarily due to the fact that these African states now play a critical role as home countries for large cross-border banks, many of which have complex corporate structures which further complicate their supervision and for which effective consolidated supervision is now critical. For example, Standard Bank of South Africa and FirstRand both have complex holding structures as well as many subsidiaries, which makes risk assessment very difficult. Furthermore, quite a few big financial groups, including Standard Bank Group and Ecobank, reportedly have high intra-group exposures. The difficulty of acquiring

data on intra-group exposures makes them much more difficult to monitor. The urgency to effectively regulate such groups is borne out of their large regional presence, which can easily result in a regional systemic crisis if one of these big banks fail.

This challenge therefore requires that a strong framework for effective consolidated supervision of these bank groups is put in place. This framework would necessarily go beyond the institution of a sound domestic regulatory framework in one state but, also that African states (home and host) are able to cooperate effectively through information exchange on the performance of branches and as well as the true state of the group – information all of which is relevant for the financial stability of home and host states.

In reality, however, only a few African countries have a proper framework for consolidated supervision. Even in francophone West Africa, where there is a monetary union and a ‘supposedly’ single banking regulatory framework for banks, the consolidated supervision of bank groups operating across the region is still a challenge.¹² The West African Economic and Monetary Union (WAEMU) Banking Commission is the single banking regulator of banks in WAEMU, however, consolidated supervision falls short of the fact that the Banking commission cannot supervise certain entities of a banking group if such an entity is not a bank thus creating a fragmented approach to supervision and defeating the idea of consolidated supervision of the banking group. It is argued that as complex banking structures lend themselves more to regulatory breaches - as indicated above – the WAEMU Banking commission should take on a more risk based approach to consolidated supervision and provide the much needed flexibility needed by the banking Commission to supervise such groups as a whole.

In this vein, both host states and home states have a role to play. While it is the responsibility of the home state to ensure that that the group is adequately supervised, it is reliant on information from the host state on the operations of its branches as well as the macro-prudential conditions within the host states financial system that may affect the branch and require home state/parents company intervention. It is the responsibility of the host state also to ensure that the home country adequately supervise the activities of the bank group. The host state has an interest in ensuring that the home country supervisory authorities adequately supervise the group to avoid cases where branches operating within its territory are affected through intra-group exposures and then possibly have a systemic implication on their own banking system - depending on how big the bank branch is within the host state.

The framework for consolidated supervision which can be adopted across Africa is the Kenyan framework which has only been recently improved. For the regulation of complex financial group structures, the Kenyan Central bank, in collaboration with other regulators in Kenya and in the host states, have put together a framework to identify ultimate owners in these group structures. It is using the supervisory college for the most dynamic Kenyan-based cross-border bank, Kenya Commercial Bank, as a pilot for implementing this framework.

¹² See I Salami ‘Banking Harmonization in an African Context’ (2008) 9 (3) *Journal of Banking Regulation* 187–195

Memoranda of Understanding (MoUs)

These are bilateral or multilateral non-binding agreements used where parties have no intentions of being legally committed or bound. With respect to the context of banking supervisory authorities, it is a mechanism used by home and host state regulators to adhere to principles aimed at preserving financial stability from the operation of cross-border banks.

Aspects of MoUs on Regulatory Cooperation among Supervisory Authorities

The agreement usually covers areas of 'material supervisory concerns' relating to the operation of bank branches and subsidiaries in the host states - which concern both home and host country supervisors.

A significant area of cooperation for both home and host country regulators covered in the MoU include the assessment of application to open branches and subsidiaries in the host country where the potential host country regulator would see information from the home country regulators on the suitability of banks to open a branch or subsidiary in the host country. This would involve sharing information with respect to the applicant's capacity to effectively operate a cross-border operation. Matters such as the solvency and fitness of proposed directors would be addressed here.

Another area where information would be shared would be with respect to matters existing or arising which is likely to threaten the stability of banking institution in the host or home state and any penalties or actions taken against a bank group that would need to be known to the host supervisor. Other aspects covered in the MoU include cooperation with respect to financial crime. Perhaps most pertinent of all matters to be covered in the MoU is the mechanism for home and host country supervisory cooperation in the event of a crisis.

Aspects of MoUs Governing Home and Host State Relationships

This part outlines expectations from the relationship between supervisory authorities such as providing authorization for supervisors to exchange confidential information among themselves but maintain confidentiality with respect to information exchanged between parties to the MoU.

Also, due to the nature of banking services and the interconnectedness between home and host countries through the operation of cross-border services, the MoU provides for the continuous flow of information as opposed to periodic exchange of information. It also provides for mechanisms through which information will be exchanged such as through regular meetings between supervisors.

MoUs also provides for mechanisms for collaborative work between inspectors such as joint inspections, which could cover, for example, domestic and group-wide supervisory risk assessments.

Despite the content of MoUs, the main disadvantage is that they are non-binding and are of no legal relevance. The drawback with this is particularly obvious perhaps at the

most critical time when cooperation is required between supervisors – during a crisis. As this is the period where supervisors mostly cage information as to the true extent of the impact of a crisis on their banking system, the non-binding nature of MoUs render them useless.

The only way this drawback can be corrected is if MoU's are given a binding status. This would involve international agreements, mechanisms for mediation set up for breach/violation, domestic legal infrastructure allowing / permitting influences from other states – all of this raise serious international and constitutional law issues and are assessed in section 6 of this article.

Challenges of MOU's in Africa

The use of MoU's by banking supervisors in Africa is on the increase. There are at least 30 bilateral MoUs between bank regulators within Africa. This, for instance, includes, the MoU signed by the Central Bank of Kenya with other regulatory authorities (regulators of the insurance, capital markets and pensions industries) in Kenya in 2009.

There are also records of multilateral MoUs agreed between Member States of the East African Community (EAC) and Member States of the West African Monetary Zone (WAMZ).¹³

In the case of the WAEMU, despite the fact that cross-border WAEMU banks operate in thirty (30) countries, the banking Commission has only signed five MoUs with other supervisors. WAEMU has signed bilateral cooperation agreements with supervisory authorities of France, Morocco, Nigeria, Guinea and the CEMAC. There are still nineteen (19) countries with which no formal or informal collaboration exists.

Within SADC, bilateral MoUs are the primary mechanism for facilitating information sharing. There are nine MOUs within SADC and South Africa has in addition signed MOUs with three other African countries but a huge number of SADC MoUs fail to provide for the resolution of cross-border banks in the event of a crisis or insolvency. Even South Africa, with the most advanced financial system in sub-Saharan Africa, has not yet developed a cross-border resolution strategy, and is indeed currently looking to strengthen its legal framework governing insolvency and bank resolution – an effort directed in the first instance at establishing a coordinated framework for resolving group structures with the financial sector in South Africa.

The main criticism with the operation of MoUs within regional groups is that despite their existence, no formal protocols governing the frequency and methods of communication are in place – thus making their existence redundant. In addition, they are criticized for covering only a small part of cross-border banking linkages. Also, despite their existence; their non-binding status has been problematic particularly in the African contexts, for its failure to get member states to coordinate supervisory functions in an effective way.

¹³ Nigeria, Ghana, Sierra Leone, Gambia and Liberia

Colleges of Supervisors (CoS)

Colleges of Supervisors bring together supervisors from countries where a cross-border bank group has its operations and they are usually organised by the home country supervisor. They are not decision-making bodies and the rationale for their creation is to promote effective consolidated supervision of cross-border bank groups. Like the operation of MoUs, they are primarily designed to enhance the cooperation and the flow of information among banking/financial supervisory authorities. Again, like MoUs, they can be established for specific banks or for general cooperation. CoS meet once or twice a year to exchange information and coordinate supervisory activities. As such, they should serve as a useful forum for information sharing and collaborative supervision among supervisory authorities involved.

According to the Basel Committee, supervisory colleges should be designed to enable the home supervisor exercise effective oversight of groups on a consolidated basis, while allowing host country authorities to be adequately represented to allow the home supervisor gain from their in-depth assessment of local subsidiaries.¹⁴ The composition of representation should be determined by two main factors: the economic significance of subsidiaries of the bank group and of the systemic importance of the bank for the host country.

The operation of CoS organized by African supervisory authorities for the operation of African cross-border banks is not wide spread nor is the involvement of African supervisory authorities in CoS of non-African cross-border banks. As indicated above, CoS of large, particularly western banks, have existed for some time now, however, few African supervisors participate primarily as they are not invited. Again, this is largely due to the fact that the home states of the banking group do not consider that the branches and subsidiaries in these African countries carry a risk to the parent bank. There are only a few examples of African participation in supervisory colleges for non-African banks. These include: the participation of Bank of Mauritius in the colleges of State Bank of India, Bank of Baroda, Deutsche Bank, HSBC, Standard Chartered Bank, Barclays Bank Plc, and Standard Bank of South Africa. The Reserve Bank of South Africa (SARB) participates in the Barclays CoS, which is not surprising given the importance of Barclays Africa Group as a growth driver for Barclays. The SARB also participates in the supervisory college for China Construction Bank. The Bank of Mozambique also participates in the college for the Portuguese Grupo Banco Comercial Portugues.

Although the establishment of Colleges of Supervisors by African cross-border banks is a recent phenomenon and is not yet wide-spread, progress is being made at increasing the number of such colleges for cross-border African banks. So for instance, Kenya has started setting up CoS for its largest cross-border banks. It is doing so with the assistance of the IMF East AFRITAC and the first one, the Kenya Commercial Bank Supervisory College, was launched in Nairobi in October 2012. The establishment of more CoS is also planned.

¹⁴ Principle 2, Basle Committee on Banking Supervision, 'Good Practice Principles on Supervisory Colleges' <<http://www.bis.org/publ/bcbs287.htm>> accessed 13 September, 2014

Currently, the only existing supervisory college in SADC are the two for Mauritius Commercial Bank and the State Bank of Mauritius, which convened for the first time at the end of 2013, and the colleges for Standard Bank of South Africa.

Within ECOWAS there are no formal CoS established for specific banks but there is a general CoS in the WAMZ, which meets on a regular basis. Nonetheless, as this is a generic college, participation is by country representation rather than on the basis of the operation of a cross-border bank of systemic importance. The aim of this college is to foster coordination, cooperation and information exchange among supervisors in the WAMZ area in general, rather than at strengthening the supervision of a specific bank. The operation of this college would as such benefit all banks operating cross-border services within WAMZ alone and immediately leave out any WAMZ headquartered banks operating outside the WAMZ region. This immediately calls the effectiveness of this college into question as it does not involve the supervisors of banks established outside WAMZ but those with significant operations within WAMZ, nor does it involve host supervisors of the subsidiaries and branches of large WAMZ banks operating outside the WAMZ area.

The huge supervisory gap of the absence of a forum for information exchanging and supervisory coordination and cooperation carries with it a potential regional systemic risk. Also problematic is the absence of CoS designed specifically for large African cross-border banks. Currently, there is no specific supervisory college for the largest African cross-border bank, Ecobank, which is headquartered in Togo but has subsidiaries across Africa. There are also no supervisory colleges for the operation of some large Nigerian cross-border banks with subsidiaries in other parts of Africa. Although subsidiaries may not be believed to be systemic from the home state regulators point of view, they may nonetheless be systemic in the host countries where they are located - and here lies the financial stability implications for African cross-border banks. It is the recognition of a common interest in managing home/host risks, that the Central Bank of Nigeria and other host county central banks have commenced joint examinations of Nigerian banks operation in West African countries.

Suffice to mention that there are also regular meetings of central bankers and other financial regulators within ECOWAS where they discuss financial regulatory harmonisation. But again such meetings would only benefit WAMZ Member States and with the growth in African cross-border banks across Africa, such meetings can only go so far in alleviating the risk of a potential regional systemic crisis.

Challenges of Operating Colleges of Supervisors and the African Context

One main challenge, as indicated above, is that as colleges of supervisors are usually convened by home state regulators they may leave out some host state regulators where their banks have subsidiaries but who they believe carry no systemic risk to a specific bank group. Nonetheless, these branches may pose a systemic risk within the host state and as such should, ideally, necessitate the involvement of such host state supervisor in the supervisory college for the bank. African supervisory authorities should bear this in mind as they put together Colleges of Supervisors.

Another challenge for CoS is the effectiveness of the composition of the college in the event of a crisis. It is agreed that while supervisors are the most relevant persons for the day-to-day supervision during normal times, resolution and fiscal authorities are critical in the case of crisis management whether relating to an individual bank failure or a general systemic bank crisis. It is argued, as such, that there is a need to expand the CoS to Crisis Management Groups whose composition would include resolution and fiscal authorities who all play a critical role in the event of a crisis. Again African supervisors should bear this in mind as they put together their supervisory colleges.

Another challenge is the enforcement of the decision of colleges of supervisors. As supervisory colleges are not statutory bodies or established by virtue of a binding legal agreement among states they are informal and their decisions are non-binding. As such each supervisor is free to take his/her own decision, even if it goes against the decision of the committee or the interest of other supervisors. Ultimately, the final decision to intervene in the parent bank, with consequences for the subsidiaries elsewhere, lies with the home country supervisor.

Regionally binding provisions such as a directive/regulation, which derive from a regional integration arrangement among member countries, can resolve this problem. This is so as the provisions of these arrangements can guarantee a binding effect of the decisions of supervisory colleges as seen in the operation of the supervisory colleges set up under the framework for micro-prudential supervision in the EU through the work of the European Banking Authority (EBA).¹⁵

In summary, African states should consult the Basel Committee's 'Good Practice Principles on Supervisory Colleges'¹⁶ with respect to establishing supervisory colleges. These principles were put together in 2010, with the aim of promoting and strengthening the use of supervisory colleges. In addition to explaining the background of the principles, the document also provides detailed implementation guidance, which can be useful to Africa states as they put together supervisory colleges.

The rationale for the operation of both MoUs and CoS are the same - to foster information exchange, coordination and cooperation among banking supervisory authorities of cross-border bank in order to achieve effective consolidated supervision of bank groups engaging in cross-border activities. However, the *de jure* implementation of MoUs and CoS is far behind formal agreements, which in turn are insufficient as a basis for effective supervision of cross-border banks in Africa.

¹⁵ Under EU law, Colleges of Supervisors have to be established for EEA banks with subsidiaries or significant branches in other EEA countries. To assist in developing a consistent and effective college framework, the EBA's predecessor, CEBS, published guidelines (i) on the operational functioning of colleges and (ii) on the joint assessment of banks' risks, and joint decisions on the adequacy of cross-border banks' capital within a college setting. With the implementation of the Capital Requirements Regulation and the revised Capital Requirements Directive, these guidelines will be replaced by the directly applicable technical standards covering the functioning of colleges and joint decisions on institution-specific prudential requirements. For more on this see <<https://www.eba.europa.eu/regulation-and-policy/colleges-of-supervisors>> accessed 14 September 2014

¹⁶ See (n 14)

Nothing proved this point more than the recent financial crisis in the advanced markets which cast doubt on the efficiency of standard tools of cooperation such as CoS and MoU. During the crisis, several large banks with cross-border exposure failed. Despite the existence of CoS and MoUs, it appeared that these tools were effective only during normal times, they failed in times of fragility, where swift, decisive and collaborative intervention was needed.

One of the most poignant illustrations of this point is the case of Fortis bank Group. Fortis was a financial conglomerate with significant interests in Belgium (where it was headquartered), the Netherlands and Luxembourg. Given the longstanding cooperation between the Benelux countries, one would have expected smooth cooperation in the fall of 2008, when Fortis got into serious problems. While in the first round of liquidity support, Belgian and Dutch supervisors still seemed to cooperate well, this cooperation failed when it became clear that solvency support was needed and national ministers of finance had to become involved. This not only gave the resolution a political dimension but led to recriminations on the split-up of Fortis along national lines and cost-sharing between Belgium and the Netherlands.

4.5 PROPOSALS TO BOOST THE REGULATORY FRAMEWORKS FOR AFRICAN CROSS-BORDER BANKS

Strengthen the Regulatory Framework among African States

As noted in the analysis of the core principles provisions on cross-border banking services, the challenge for Africa in regulating large cross-border banks would be the varying stages of banking sector development in African states. Effective consolidated supervision and supervisory cooperation among African states of cross-border banking entities is only effective when home and host states regimes of such countries have a robust supervisory framework. If supervision is weak in home or host states of large African banking groups, this is likely to pose a financial stability threat to the region.

Strengthen the Bank Resolution Cooperation Framework among States

This would necessarily entail strengthening the resolution frameworks within individual states in Africa and arming the supervisory authorities with the power to intervene in banks where there are clear signs that a bank is approaching a crisis situation or very nearing insolvency.

Once this has been effectively achieved amongst states, the need for home and host state regulators to cooperate and coordinate a resolution strategy if a cross-border bank with significant interest in host states appears to be in trouble. Conducting a simulation exercise to assess regulatory reactions and capacity in the event of a major domestic systemic crisis, would be a good mechanisms to enhance a coordinated effort in an actual crisis. The exercise would reveal gaps in the coordinated supervisory framework such as exposing weakness in communication among regulators and with all other relevant authorities such as fiscal authorities. It could also expose weaknesses in bank

insolvency frameworks and as such, inform the reform process of the bank resolution framework.

In 2010, the Basel Committee's Cross-Border Bank Resolution Group found that actions taken to resolve large banks during the crisis were inadequate and thus required significant public support. This was largely due to weak or non-existent frameworks for bank resolution in many countries. The Cross-Border Bank Resolution Group as such outlined a number of recommendations to: strengthening national resolution powers and their cross-border implementation; encourage mutual recognition of national arrangements among relevant supervisors; reduce the complexity and interconnectedness of group structures and operations; and ensure firm-specific contingency planning for all systemically important cross-border financial institutions. The recommendations also promoted the use of a set of risk mitigation mechanisms, which could help in reducing contagion.

Also the Financial Stability Board (FSB) published the 'Key Attributes of Effective Resolution Regimes for Financial Institutions' (the 'Key Attributes') at the end of 2011.¹⁷ The aim of the Key Attributes was to enable resolution authorities take an organised approach to the resolution of financial institution without reliance on public support but at the same time ensuring that the institutions can continue to function effectively. Essential features, which should form part of the resolution frameworks of all countries is outlined in the 'Key Attributes' document and these include: resolution authority and powers, safeguards, legal framework conditions for cross-border cooperation, Crisis Management Groups and recovery and resolution planning.

African financial institutions should take into account the Basel Committee's Cross-Border Bank Resolution Group recommendations and the FSB's Key Attributes as they strengthen and/or build their bank resolution frameworks.

Bank resolution to be covered in MoUs and CoS

MoUs and CoS do not usually have a strong bank resolution component. Hence, Ministers of Finance who play a critical decision making role regarding bank rescue are not signatories to MoUs, nor are they known to participate in CoS. As such, as part of their response to the financial crisis, the G20 and the FSB highlighted the need for enhanced cooperation particularly with respect to supervisory colleges. They emphasised the need to promote flexibility in the composition of supervisory colleges and for supervisory college to have inputs into Crisis Management Groups comprising central banks and finance ministries of home and host states.

In 2011, the FSB boldly argued in its Key Attributes paper, that Crisis Management Groups should be set up for large banking groups with systemic implications. It stated that these groups should necessarily include: the supervisory authorities, central banks, and finance ministries of jurisdictions that are home or host to entities that are material

¹⁷ Financial Stability Board, 'Key Attributes of Effective Resolution Regimes for Financial Institutions' (2011) <http://www.financialstabilityboard.org/publications/r_111104cc.pdf> accessed 13 September 2014

to resolving the crisis, and these crisis groups should cooperate closely with authorities in other jurisdictions where banks have a systemic presence.¹⁸ These groups would be responsible for the recovery and resolution planning process for systemically important institutions under institution-specific cooperation agreements, and ensuring that systemically important institutions are effectively resolved.

An example of such crisis management group is the Nordic-Baltic cooperation¹⁹ which involved a recent Memorandum of Understanding on cross-border cooperation signed by Denmark, Estonia, Finland, Iceland, Latvia, Lithuania, Norway and Sweden reflecting the interconnectedness of their banking systems.

The prominent difference between this agreement and other agreements is that it includes: ministries of finance (as tax payer representatives), an explicit focus on crisis management and resolution, as well as specific burden sharing agreements. The recent global financial crisis revealed that such an agreement was hugely significant as the crisis severely affected some of the Nordic countries, due to close cross-border banking links. The enhanced Nordic cooperation recognises that cross-border banks have brought great benefits (but also risks) to both home and host countries. This should, as such, be an approach adopted by African states given the appreciation of the huge benefits that cross-border services can bring but also cognisant of the financial instability implications of their operations considering the predominantly weak banking regulatory framework in African countries. However, it has to be mentioned that historic links across the Nordic states involved in the agreement, as well as a history of good cooperation amongst the states assisted in putting together a common approach to crisis management and resolution planning. Suffice to say that African states have not had such a record through regional integration and this might not be as easily achieved in the African context.²⁰

It should also be mentioned that despite the involvement of central banks and finance ministries in MoUs and CoS, they would not change the fact that these agreements/arrangements are non-binding. Nonetheless, the inclusion of resolution authorities provides the forum to put together a crisis management plan should a crisis occur. This would facilitate speed in the resolution and restructuring of weak cross-border banks in the event of their failure.

Instituting Legally Binding Cooperation

Due to the drawbacks of MoU particularly their ineffectiveness when needed the most - during a crisis - the need for legally binding MoUs should be contemplated. However, one significant drawback of a legally binding MoU is that it would violate state sovereignty where the relevant regulatory authority is not accountable to the organs of

¹⁸ Ibid

¹⁹ Cooperation agreement on cross-border financial stability, crisis management and resolution between relevant Ministries, Central Banks and Financial Supervisory Authorities of Denmark, Estonia, Finland, Iceland, Latvia, Lithuania, Norway and Sweden <<http://www.sedlabanki.is/lisalib/getfile.aspx?itemid=1207b563-c75f-11e1-b050-001ec9ed78b2>> accessed 14 September 2014

²⁰ For a more detailed coverage of both economic and financial integration in Africa see Salami (n 23)

government within a state but to a group comprising other states' regulatory authorities. As such, for a binding cooperation to work, it would need to be passed into law. A good example of this is the legally binding cooperation among regulators in Australia and New Zealand. The cooperation is entrenched in law by a 2006 amendment to the Reserve Bank of New Zealand (RBNZ) Act, which legally obliges the RBNZ to cooperate and consult with Australia's financial supervisory authorities to try to avoid actions that may negatively affect financial system stability in Australia. The Australian Banking Act was amended in similar manner. These legal provisions have led to extensive cooperation and information sharing between the Australian Prudential Regulatory Authority (APRA) and the Reserve Bank of New Zealand (RBNZ).

However, suffice to mention that this arrangement can work for the following reasons: the countries are closely integrated financially, with branches and subsidiaries of Australian banks dominating New Zealand's financial sector; they share similar levels of regulatory development and they have a common history and legal tradition. This approach can work in Africa only to the extent that countries share similar characteristics, and some of the countries typically displaying such characteristics include countries within the East African Community (EAC) including Kenya, Tanzania and Uganda. These countries, recording progressive success in economic and financial integration, are likely to succeed at this approach. However, others such as the proposed West African Monetary Zone (WAMZ) countries comprising Nigeria, Ghana, Sierra Leone, Guinea and Liberia may not be as successful in adopting such legally binding cooperation as, although they largely share a common history and their financial sector developments are not far apart, their financial systems are not financially integrated. They also do not have a history of successful regional cooperation as such. Also, as records of African cross-border banks have not showed that their banking operation spread on a sub-regional basis but cut across the entire continent (as is the case with ETI), it would be a challenge to find home and host countries of a cross-border bank sharing similar legal, and historic backgrounds and whose financial systems are integrated - all of which would be expected for a legally binding cooperation to work as in the case of Australia and New Zealand.

Supranational Framework for Banking Supervision

The absence of a supranational/pan-African banking regulatory framework is not only problematic for the effective supervision of a large cross-border bank and the coordination of its restructuring and resolution should it fail, as seen above, it is also very costly as cross-border banks (for example Ecobank) which operate in several countries, have to comply with the different rules and regulations of the host states.

A supranational framework for banking supervision would involve the existence of one supervisory authority for the supervision of banks operating in a region. This is also the strongest form of regulatory cooperation across borders as the authority is responsible for the regulation and supervision of banks in states within the specified region. Examples of such a framework are the European Central Bank (ECB)²¹ and the WAEMU

²¹ The ECB engages in macro-prudential supervision supporting the European Systemic Risk Board in this light but will assume direct supervision of systemically important European banks from November

Banking Commission, which both engage in the supervision of banks across their respective regions/sub-regions.

The main challenge for supervising African cross-border banks is that only a pan-African supranational framework would be best suited to perform this task. The primary reason for this is that the large African banks operate across the continent and are not restricted to a specific sub-region. As the frameworks for financial integration in Africa are set along sub-regional lines, any sub-regional supranational regulatory framework will be limited in its coverage of banks and have a limited impact. A typical example is that a West African banking regulatory authority would not be equipped to supervise the operations of the West African bank, Ecobank,²² which operates in 36 countries across the continent, spanning West, Central, East and Southern Africa. Supervision of such an entity, would be best achieved by a pan-African supervisory authority and given the slow pace of financial integration among sub-regions, it is unlikely that this would be achievable in the near future.²³

The second challenge of any such arrangement as in the case of the EU would be how to deal with the fact that the single supervisory authority is located differently from the fiscal authority in the event of a crisis. So despite the existence of a single supervisory authority, in the event of a crisis, such an authority may be unable to bail banks and this task would inevitably fall on the resolution authorities which remained at the national level although coordinated across country. The recent financial crisis revealed that such an approach is unsustainable as a safety net as most states (even those within the a monetary union) would usually be preoccupied with bailing their own banks out rather than instituting a coordinated bank resolution framework for the failure of a large cross-border systemic bank.²⁴

The position is the same with the CFA zone, which covers West and Central Africa (WAEMU and CEMAC). In both sub-regions, a formal regional banking supervisory authority exists but the responsibility for bank resolution continues to lie with the respective country fiscal authorities. The position in the CFA franc zone has hardly been criticized due to the low depth of financial systems across the regions and which limit the fiscal implications of potential bank crises. Another reason for this is the non-independence of the supranational supervisory authority who are usually put under pressure from ministries of finance to allow forbearance for extended periods, thereby postponing the realization of the escalating fiscal costs of bank restructuring and eventual resolution.

2014 as part of the move to institute the Single Supervisory Mechanism and a Single Resolution Mechanism for banks, which are integral parts of the European Banking Union

²² Suffice to mention that as Ecobank is headquartered in Togo, West Africa, it is for this purposes treated as a West African bank although its biggest shareholders are South Africans

²³ For a detailed assessment of financial integration in Africa, see Salami (n 23)

²⁴ This was what led to calls for a banking union within the European Union, which has as its main components: the Single Supervisory Mechanism and the Single Resolution Mechanism all based on the single rulebook. The single rule book is EU law which collectively govern the financial sector across the entire EU

Nonetheless, it is generally believed that in reality, the biggest impediment to a supranational supervisory framework is the fear of smaller member states of the framework of relinquishing supervisory authority to a supranational authority comprising countries with stronger economies, such as Nigeria and South Africa, whose interests are likely to dominate the policies of the supranational authority and through that violate their sovereignty.

4.6 CONCLUSION

The rise in African cross-border banks has potential benefits both for the development of financial systems across Africa and for the development of the continent in general. Nonetheless, the continued rise of such entities pose a huge financial stability threat to the entire region if it is not supported by robust regulatory frameworks. The failure of one big bank - such as Ecobank - would have grave consequences for the stability of the region if the right regulatory framework is not instituted within home and host states of these cross-border banks. Also necessary is the consolidated supervision of such entities, which would require effective supervisory cooperation among African states where these banks operate.

As seen in this chapter, it is not enough for regulators to rely on the existence of MoUs and CoS as they have their drawbacks. What regulators should be aware of is that consolidated supervision is only as effective as the weakest regulatory regime. So that even the existence of pockets of weak regulatory frameworks in Africa presents a challenge for effective consolidated supervision of entities that operate across Africa. This, in other words, means that with the rise of African cross-border banks, it is in the interest of all regulators charged with safeguarding their financial systems, to ensure that sound regulatory frameworks exists in all parts of the continent. This is critical if a regional systemic crisis is to be avoided.