



*cutting through complexity*

**AFRICAN BANK OF THE FUTURE SERIES**

# **EVOLVING BANKING REGULATION: SUB-SAHARAN AFRICA**

**Regulations Driving Banking Changes  
and Financial Risk Management**

**2016**



## About this report

This report is part of a regional series developed by KPMG's network of regulatory experts. The insights are based on discussions with our member firms' clients, our professionals' assessment of key regulatory developments and through our links with policy bodies in each region.






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## CONTENTS

	<b>PG</b>
1. Foreword	2
2. Executive Summary	4
<b>3.</b>  Financial Stability Landscape <i>3.1 Update on Sub-Saharan Africa's Regulatory Reforms</i>	8
<b>4.</b>  Regulations Driving Business Change <i>4.1 Key Areas of Regulatory Reform</i> <i>4.2 Regulatory Pressure Index (RPI)</i> <i>4.3 The Cost Implications of Regulatory Reforms</i>	10
<b>5.</b>  Potential Banking Industry Response <i>5.1 Structural Changes and Measures</i> <i>5.2 Conduct, Markets and Culture</i> <i>5.3 Data and Reporting</i> <i>5.4 Risk and Governance</i> <i>5.5 OTC Derivatives Regulation / Reform</i>	28



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# Foreword



**W**elcome to this year's Evolving Banking Regulation focused on the Sub-Saharan African (SSA) markets and banks operating within the region. This piece is the first part of our more encompassing write-up termed the 'African Bank of the future' which seeks to define what the African banking landscape of the future will look like as well as the responses and preparations that leading banks will need to make to retain their leadership positions. This first edition is focused on the regulations that are driving changes in banks operating and business models as well as Financial Risk Management.

Globally, regulatory reforms intended to improve the resilience of banks and markets, make banks resolvable without recourse to public funds, and increase the intensity of supervision on Systemically Important Banks (SIBs) have begun to take shape. There has been a relentless march by regulators across the globe to prevent future systemic failures by strengthening financial institutions themselves, and the markets they operate in as a whole. In this pursuit, we have seen a host of new regulations and modifications to existing ones.

In Sub-Saharan Africa, the challenges and opportunities are a little more diverse. Different appellations have been coined in order to classify developing countries of the world in order of their economic status, political landscape and general potential for growth and development. To gain insight into the possible regulatory landscape that African banks of the future will face, we considered regulations that already exist across different jurisdictions of the world, as well as those regulations that are likely to be issued over the short to medium term. Our view is that these regulations will typically be around the following critical areas required for banks' continued survival and performance - Liquidity and Capital Adequacy, Customer and Markets, and Governance and Supervision.

While different jurisdictions in Sub-Saharan Africa (SSA) are at different stages of regulatory sophistication, the liquidity and capital adequacy considerations will be covered by the implementation of Basle 2 and 3 standards within the short to medium term, as well as a focus on the requirements and preparation for the roll-out of Basle 4 in the longer term.



In the customer and markets arena, privacy rules (which are virtually non-existent in most of Africa) and consumer protection mandates will dominate. In addition to these, we also foresee major focus on the definition of regulations on the use and sale of complex and semi-complex products like derivatives and other related products. Given their important role in the increase in leverage and the peculiarities in measuring their risks, the time for regulators to make conscious attempts at designing rules that will work for SSA is now.

Governance and supervision is a key area of improvement as capacity building among regulators is further adversely compounded by the fact that regulators usually have tool and infrastructural limitations. However, some African regulators are beginning to place more emphasis on recruiting industry veterans who have the requisite skill for effective supervision. This will ultimately raise the standards of regulatory supervision and oversight within the industry and put banks to task as they must up-skill to comply.

In subsequent editions of our African Bank of the Future publication, we shall also share our views on other critical business-impacting areas including the changing needs of customers and markets, technology and the role of big data, talent and people matters, as well as distribution and alternate channels.

We hope you enjoy reading this report and that it provides useful insights on the evolving regulatory landscape in Sub-Saharan Africa that you can apply to your business.

**Adebisi Lamikanra**

# Executive Summary

**A**cross various parts of Sub-Saharan Africa, many changes are taking place in banks, their markets and regulatory environments. These changes, driven by both regulation and extraneous structural events like technology and demographics, have ignited a series of changes to financial stability landscapes, structures, culture and governance.

Although change is common, the pace and intensity vary widely across national jurisdictions within Sub-Saharan Africa. This diversity largely reflects variations in size and economic fortunes as well as market and overall macro-economic complexity.

In this edition of our Africa Bank of the future series, we identify regulations that have been introduced, or are likely to be introduced in regions where changes have been fast and intense. Across Sub-Saharan Africa, the emerging regulatory requirements range from the preparation for and implementation of Basel 2 to the anticipation of a possible Basel 3 and 4.

## The financial stability landscape

Regulators in Sub-Saharan Africa have very strong imperatives for monitoring to ensure that the banks within their jurisdictions are liquid, adequately capitalized, and run in a manner that protects customers while improving the overall health and development of their markets.

For Banks in South Africa, Basel 3 is an immediate concern while the possibility of a Basel 4 is impending. In a handful of other jurisdictions, the immediate requirement for capital and liquidity is or will be governed by Basel 2. In this later case, a Bank may derive value within its jurisdiction by preparing ahead for Basel 3 depending on the rate of increase in the use of derivatives and other complex products.

Given their role in increasing leverage and overall liquidity requirements – two principal differences between the risks addressed in Basel 2 and Basel 3 – regulators may well find that some jurisdictions with traditionally low use of leverage have changed materially thus requiring an upgrade to the more sophisticated Basel 3.





In addition, other regulators who considered that Basel 2 may not be an immediate requirement, or who have developed long-dated implementation roadmaps may realize a stronger need for implementation. For example, in Nigeria's case, the recent fall in crude oil prices and the resultant effect on the vulnerability of the economy, its currency and its commercial banks is a relevant case study.

The Central Bank of Nigeria appears adequately prepared to address capital adequacy concerns of banks as a result of strong oil industry exposures only because the regulator had transitioned its banks towards Basel 2 standards. Prior to this, many of the options available within the regulator's arsenal would have been applicable after the fact and therefore not useful. For non-oil exporting countries, the risk is not nil; the increase in foreign direct investments into frontier markets makes them vulnerable to economic downturns in foreign jurisdictions as well.

Regulators will therefore need to periodically reconsider changes in their sectors and at the macro-economic level in order to redefine changes needed in key regulatory frameworks. Bank regulators also need to pay further attention to the resolution of systemically important banks and the need to ensure overall financial stability in the event of a resolution.

**Structural Changes and Measures**

The strong influence of foreign banks in many of the smaller African economies (i.e excluding Nigeria, South Africa, Kenya etc) typically ensures that those banks become strategically important in the local jurisdictions in which they operate. Regulators of economies with such vulnerability will increasingly seek to protect their local banks and the integrity of the financial system at large, from shocks emanating from the groups and home countries of those foreign banks. This may necessitate legal and functional changes in the structures of international banking groups, especially in their host African countries.

**Conduct, Markets and Culture**

As regulators push for more financial inclusion and customer protection, banks will need to be more forward-looking and customer-centric. These changes will affect charges and inducements, distribution channels, and customer satisfaction. Banks will also need to significantly improve on the security of financial transactions and on the education of their customers if they hope to gain their trust and reduce the fear for risks associated with online transactions. New or improved regulations may also be introduced to guide and properly channel the use of derivatives and other complex financial products. We expect that these will be

followed by the gradual development of definite market structures to support the transfer of ownership.

**Data and reporting**

Increasing sophistication in regulatory requirements will push investments in automation and IT infrastructure in general. Besides the implementation of Basel 2 and its later versions, effective monitoring of money laundering requires advances in data management, capable of supporting monitoring and reporting.

**Governance and risk**

Increased regulatory oversight will come with greater demands for better corporate governance and improved risk management practices. In the coming years, banks in Sub-Saharan Africa are going to see regulators demand more responsibility and authority for Chief Risk Officers (CRO) and senior management including board of directors. This may be followed by specific regulations on ownership and structure that may be aimed at improving the overall corporate governance profile of banks. At Board level, we envisage more attention focused on the ability of board members to provide effective risk oversight. This will increase the need for better risk appetite articulation as well as investments in risk monitoring tools, systems and people.

**BANKS NEED TO RESPOND TO MULTIPLE PRESSURES**

**CUSTOMERS**

- \* Fewer, more expensive products
- \* More transparency but less flexibility
- \* Offered what the regulator allows, not necessarily what they want or need

**Investors**

- \* Will not put up more capital without adequate returns
- \* Prepared to accept lower returns if risk is correspondingly lower
- \* Debt coupons will need to reflect the threat of bail in

**Regulators**

- \* Regulatory demands increase the cost of capital
- \* Mistrust of banks, capital markets and shadow banking
- \* Emphasis on personal responsibility and improved risk governance





# Financial Stability Landscape

## 3.1 Update on Sub-Saharan Africa's Regulatory Reforms

Globally, regulatory reforms intended to improve the resilience of banks and markets, make banks resolvable without recourse to public funds, and increase the intensity of supervision on Systemically Important Banks (SIBs) have begun to take shape. Although the direction of travel is all too clear, the list of unfinished business remains long, casting a pall of uncertainty over the details of regulatory reform agenda across regions. This is particularly true of the concerns around the leverage ratio, counter-cyclical buffers and the impact of regulations on the growth of the very economies they were designed to protect.

In Sub-Saharan Africa, the challenges and opportunities are a little more diverse. Different appellations have been coined in order to classify developing countries of the world in

order of their economic status, political landscape and general potential for growth and development. South Africa is the only African country that is a member of the BRICS (Brazil, Russia, India, China and South Africa). These countries have economic and financial systems that have been able to meet basic characters exhibited by developed economies. South Africa's economy is regarded as an Emerging Market – a name used to describe the biggest and most advanced set of the developing world. South Africa is also a member of the Basel Committee on Banking Supervision.

Next are the MINTs (Mexico, Indonesia, Nigeria, and Turkey). Although these countries are not as developed as the BRICS, their vast potentials and high growth rates are believed to warrant the confidence that they can quickly develop should they adopt the right economic policies. Nigeria is the only African country believed to have such potential. Its economy, now the biggest in Africa in front of South Africa, is regarded as a Frontier Market.

Some other sources have also classified Kenya, Côte d'Ivoire, Botswana, Ghana,

Namibia, Zambia, Gabon, Tanzania and Mauritius as Frontier Markets along with Nigeria. These markets are far from developed but still have the depth and diversity to attract significant investments. The remaining countries of Sub-Saharan Africa have not attracted as much attention as the Emerging or Frontier Markets as their economies are considered to be too small.

While these appellations do not in any way attempt to classify countries according to their standards of living or quality of life – those are better measured by, for example, per capita income, diversity of income, life expectancy - they do however identify the dynamics of issues that drive regulation. The extent and structure of economic activity, the existing political and demographic structure, the state of the "war" between current socio-economic reality and developmental aspirations, and the limitations and vulnerabilities of the economy as a whole are some of the vital issues that shape regulatory actions and pronouncements.

With this in mind, it becomes easy to picture a classification of the developing economies of Sub-Saharan Africa into the following categories:

- South Africa, a member of the BRICS, and an Emerging Market exhibiting characteristics similar to those of developed countries and requiring regulations of similar complexity.
- Nigeria, a Frontier Economy and a member of the MINT, believed to have the reasonable potential to become a more developed economy and therefore requiring forward-looking regulations to prepare it for that future.
- Other Sub-Saharan Frontier Economies with enough market depth and complexity to attract some significant level of investment, requiring better regulatory structure to support growth
- The last category of countries in Sub-Saharan Africa may be preoccupied only with regulations designed to spur growth to a certain level. The vast majority of Sub-Saharan African countries belong to this category

The diversity in economic depth and structure explains the varied nature of regulatory actions and directives across Sub-Saharan Africa. Regarding the journey to Basel for instance, while South Africa has commenced the implementation of Basel 3 rules, only a handful of other African countries

have commenced the Basel 2 journey. Indeed, the vast majority of regulators still set fixed amounts as minimum capital for banks within their jurisdiction, regardless of individual country peculiarities.

In spite of these differences, some common ground exists. The global drive to reduce the number of the unbanked population has given rise to various forms of Pan-African banking. Numerous mobile banking services now exist e.g. mobile insurance, targeted predominantly at the retail/ unbanked segment, in order to enhance banking access to the financially excluded. The drive to reduce the number of financially excluded individuals has led to a proliferation of mobile technologies at a rate that was hitherto unprecedented. Though the proliferation itself was a result of repeated concerted efforts aimed at improving financial services access – including education and banking - the extent to which various regulators have monitored these new services is varied. While these developments are positive, it still remains unclear how these services will enhance banking access, deepen African financial markets, or encourage financial integration.

Africa has attracted significant attention from investors seeking to earn high risk-adjusted returns. Investors who have been able to understand the market and address the inherent risks have created

portfolios and investment vehicles for various sectors of the Sub-Saharan market. Some of these vehicles include venture capital and private equity firms and angel funds. The services offered by these investments vehicles however vary. Some of the services fall within the realms of shadow banking, for which regulation is lacking or virtually non-existent.

Another common trend is the struggle with implementing regulations that thrive on vast social and demographic data. While African countries have generally drawn or subscribed to regulations around Know-Your-Customer (KYC), terrorism and money laundering, the effective implementation of the underlying requirements of these regulations pose a major problem for most countries. This is because there are typically several challenges including the structural limitations preventing the capture and gathering of reliable data. This same problem plagues the implementation of Foreign Account Tax Compliance Act (FATCA) and Basel 2 and is similar to challenges faced by European countries in their adoption of Basel 2 and 3.



# Regulation Driving Business Change

## 4.1 Key Areas of Regulatory Reform

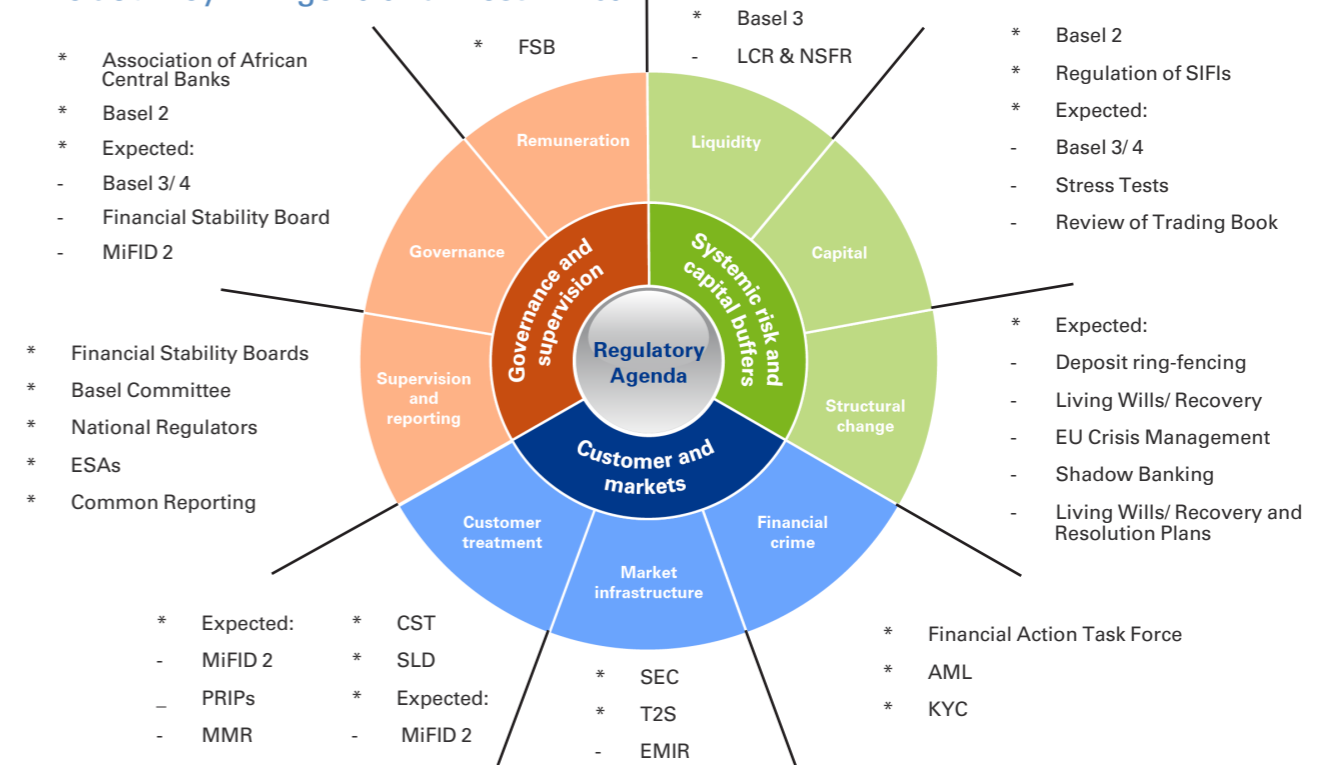
There has been a relentless march by regulators across the globe to prevent future systemic failures by strengthening financial institutions, and the markets in which they operate. In this pursuit, there have been a host of new regulations and modifications to existing ones. The implications of these regulations have been so far-reaching that there are concerns that they may begin to stifle the host economies. Over the next couple of years, we foresee a further rash of regulations from industry regulators, especially for 'fairly large' markets in Africa - for instance, in a 2013 report, the IMF advised the Nigerian regulator to, among other things:

- strengthen macro-prudential oversight and crisis
- strengthen the capacity of supervisors and establish clarity regarding their regulatory authority
- improve availability and quality of data for macro-prudential analysis
- revise the 2009 regulatory framework for Mobile Payment Services

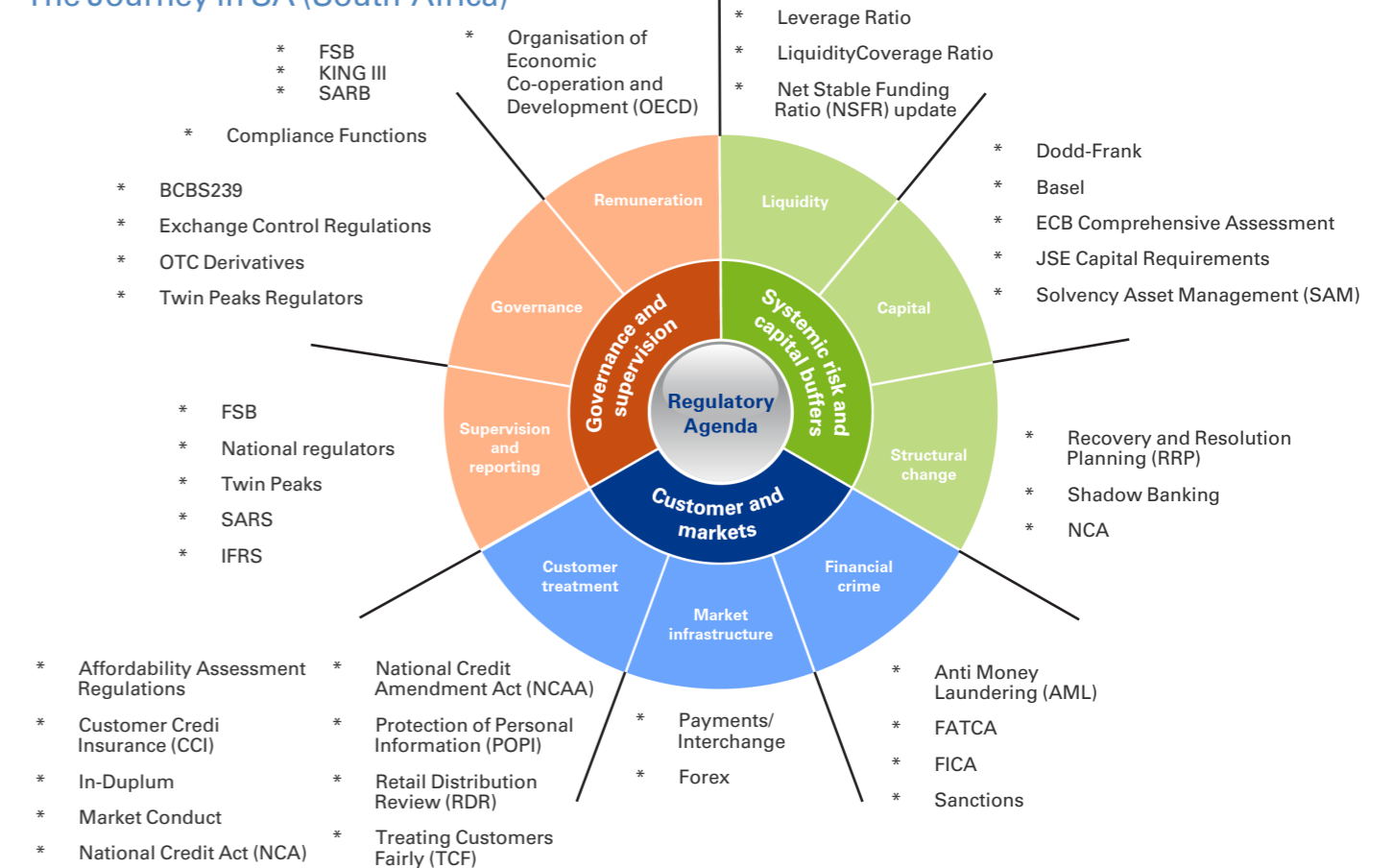
To gain insight into the possible regulatory landscape that African banks of the future will face, we considered regulations that already exist in different jurisdictions of the world, including in countries within Sub-Saharan Africa, as well as those regulations that are likely to be issued. These regulations will typically cover the following major areas, which we believe are critical to the survival and performance of banks:

- enhance oversight on banks with international presence
- Liquidity and Capital Adequacy
- Customer and Markets
- Governance and Supervision

## The Journey in Nigeria and West-Africa



## The Journey in SA (South-Africa)



Further details on our Regulatory Centre of Excellence can be found on [link](#): our Africa Regulatory Center of Excellence site

The Journey in East Africa



Liquidity and Capital Adequacy

Basel 2

The Basel Committee on Banking Supervision drew-up the Basel 2 rules in order to better align the capital base of banks with the economic realities represented by the risks they carry. Even though most of the developed world has moved on to implement Basel 3, only a few Sub-Saharan African countries can boast of a financial system that measures economic risks and capital requirements in the way

prescribed by the Basel 2 accord. In fact, for example, the journey of implementation has only just begun in Nigeria.

The reason is not far-fetched; while the benefits of compliance with the regulations cannot be denied, the cost implications in small economies with 'small' commercial banks can be overwhelming. Additionally, regulators may not even have the capacity to conduct assessments needed to establish that the regulated entities are operating in line with the accord.

Implementation in West Africa can be expected to take a minimum of 3 years. Implementation in other regions of Africa may have started earlier, but even in those regions, stress testing capabilities still have to be improved. The vast majority of the countries in Sub-Saharan Africa are still not ready; their economies and banks are considered too small to warrant the investments and their regulators are just fine with setting increased minimum capital levels for all banks operating within their jurisdiction.



Basel 3

Improvements were made to the Basel 2 accord largely to take care of systemic risk, leverage and liquidity. Of all the countries in Sub-Saharan Africa, South Africa is the most advanced in its implementation of the Basel 3 accord. No West or East African country has issued specific guidance or timeline on the implementation of Basel 3.

Aside cost, the motivation for the implementation of Basel 3 may be weak in most of Sub-Saharan Africa at the moment. This is because leverage ratios are traditionally higher than the 3% (i.e. 33.33 times) specified by the Basel 3 accord. However, that is not to imply that this position is not likely to change; derivatives instruments which play a crucial role in the use of leverage are more and more in wider use across different sectors and in different jurisdictions. In West Africa for instance, even some of the smallest banks have one form of derivative instruments or the other in their books. As these banks implement better means of pricing and selling these products, they are bound to get creative on how they can use them to increase revenue and possibly, leverage. Nevertheless, there are already a number of moves that are seemingly designed to rein in the

effects that systemically important / internationally active banks have on the economy.

Risk-weighted assets

In a recent publication, KPMG noted that Basel 3 focused mostly on the quality and quantity of capital, and the new minimum leverage and liquidity ratios, while maintaining the internal model-based approaches to credit, market and operational risk. More recently, however, the Basel Committee and other regulatory authorities have been focusing on the risk weightings generated by banks using their own internal models.

The main regulatory concerns here are that:

- Some banks have been too aggressive in the use of internal model-based approaches to drive down risk weightings;
- Some banks are reducing their capital requirements through 'risk weighting optimization', even if some of this reflects no more than cleaning up data and the planned rolling out of risk modelling to a broader set of exposures;
- Risk weightings generated by internal models are too complex and opaque;

- A prolonged period of low interest rates is enabling borrowers to avoid default, and thereby generating misleadingly low probability of default estimates; and

- There is limited transparency – and therefore limited scope for relying on market discipline – in this area.

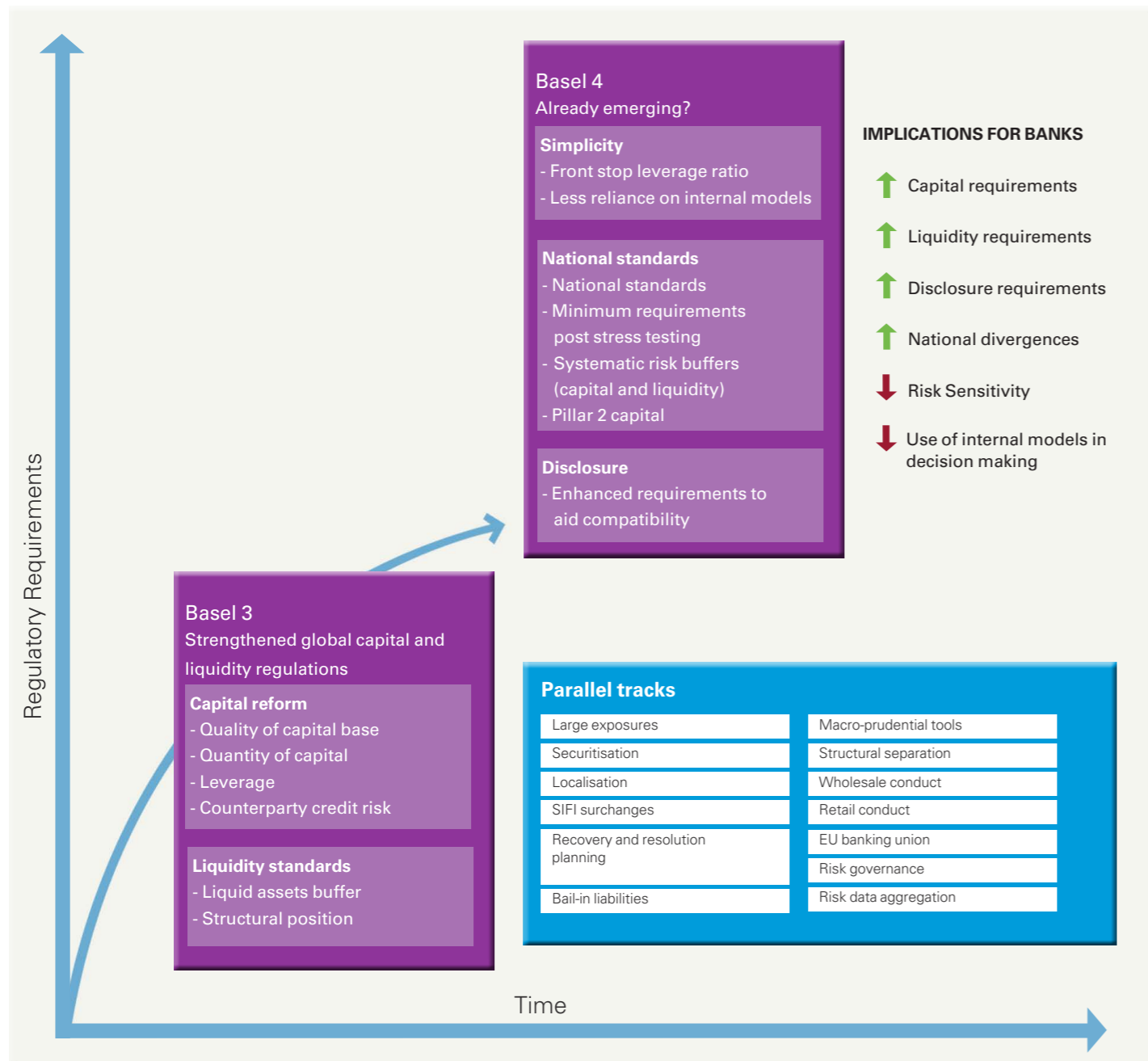
- A series of Basel Committee and European Banking Authority (EBA) reports during 2013 on the risk weightings of banks' banking book and trading book assets have revealed wide divergences in risk weightings. Underlying differences in the risk composition of banks' assets are found to explain between half and three-quarters of the variations in risk weightings across banks for banking book assets, but only half of the variation for trading book assets. The remaining variation is driven by two main factors – diversity in the models used by banks, and diversity in supervisory guidelines and practices.

Basel 4

While most countries in Sub-Saharan Africa march on with starting the implementation of Basel 2, albeit at their own pace, fragments of what might become Basel 4 are already emerging.



EMERGENCE OF BASEL 4



KPMG has argued that a 'Basel 4' may already be emerging, even before Basel 2 is fully implemented in most Sub-Saharan countries. Key elements of this may include:

- A higher leverage ratio and higher risk weighted assets;
- The gold-plated implementation of Basel 3 in some countries, including the US and the UK; and
- Requiring banks to meet minimum capital ratios after the potential impact of severe stress events, and therefore to hold significant additional capital buffers, contrary to the intention in Basel 3 that the capital conservation buffer and any counter-cyclical capital buffer would be the cushion to absorb a shock.

while the FSB's Guidance papers on recovery and resolution planning (July 2013) form the basis for more detailed planning for the recovery or resolution of a major international bank.

Meanwhile, the bail-in tool – which passes the cost of meeting losses and of recapitalizing a failing bank on to creditors by writing down the value of their claims or converting them into equity – has been gaining momentum albeit not yet in Sub-Saharan Africa. It has been used as one element in the resolution and restructuring of banks in Cyprus, Denmark and the Netherlands.

In Nigeria, the CBN issued last September the Framework for Regulation and Supervision of Domestic Systemically Important Banks (SIBs) which is supposed to take effect 1st March 2015. Recovery and Resolution frameworks are expected to cover:

- The preparation by banks of recovery plans and the review of these plans by national supervisors;
- The provision of information by banks to national resolution authorities, to enable these authorities construct resolution plans;

- Granting powers to national authorities to require banks to change their legal and operational structures – and even their business models – to enhance recovery and resolution;
- Legislative changes to give national authorities the full range of resolution tools;
- The basis on which the bail-in tool will be operated; and
- Establishing national resolution funds

Given the growing number of regional or pan-African banks in Sub-Saharan Africa, it is expected that different country based attempts to RRP should be supplemented by a Single Resolution Mechanism (SRM). The two main elements of the SRM could be to establish a single resolution board and a single resolution fund for the banking region (or at least sub-region for e.g. West Africa or the Southern African Region). This would also allow:

- an appropriate legal framework for different regimes to address the failure of banks or bank holdings; and
- an increase in cross-border cooperation for adequate SIBs RRP.

Recovery and Resolution Plan

The legislation and regulatory guidance necessary to underpin Recovery and Resolution Planning (RRP) is being strengthened considerably. The Financial Stability Board (FSB) 'Key Attributes for Effective Resolution', published in November 2011, have been carried forward in EU and national legislation,



## BANK RECOVERY AND RESOLUTION DIRECTIVE: THE BAIL-IN TOOL

The BRRD sets out in detail how the bail-in tool would operate as part of a resolution. There are four key elements:

- ➔ Some liabilities are excluded from being eligible for bail-in;
  - \* Covered (insured) deposits;
  - \* Secured liabilities, including covered bonds
  - \* Liabilities arising from the holding of client money or client assets;
  - \* Liabilities with a remaining maturity of less than seven days of payment systems;
  - \* Interbank liabilities with an original maturity of less than seven days (to avoid disorderly runs ahead of a possible resolution);
  - \* Liabilities to employees such as fixed salary and pension benefits; and
  - \* Commercial claims relating to goods and services critical for the daily functioning of the institution.

➔ The BRRD introduces an expectation that eligible liabilities will be bailed-in in the following order:

- \* Equity;
- \* Other regulatory capital;
- \* Ordinary unsecured creditors (including bondholders) and large corporate depositors;
- \* Deposit Guarantee Schemes (but leaving insured depositors themselves fully protected, so the cost here would fall on other banks that fund the Scheme).

➔ National resolution authorities would have the discretion to exclude, or partially exclude, liabilities from bail-in on a discretionary basis if they cannot be bailed in within a reasonable time, to ensure the continuity of critical functions; to avoid contagion; or to avoid value destruction that would increase the losses borne by other creditors.

National resolution authorities would be able to compensate for the discretionary exclusion of some liabilities by passing these losses on to other creditors, provided no creditor is made worse off than under normal insolvency proceedings, or through a contribution by the national (or single) resolution fund - assuming that there are sufficient funds available to follow either of these alternative routes.

However, the use of a resolution fund could only be as a backstop, after losses equal to at least 8 percent of total liabilities had been imposed on a bank's shareholders and creditors, and where the contribution of the resolution fund would be capped at 5 percent of the total liabilities of the failing bank.

In extraordinary circumstances, where other resolution tools (including bail-in) are deemed to be insufficient to preserve financial stability, government support may be provided through injections of new capital or taking a bank into temporary public ownership.

➔ National resolution authorities will have the discretion to set minimum requirements for the total of regulatory capital, other subordinated debt, and senior debt with a remaining maturity of at least one year, expressed as a percentage of a bank's total liabilities. This requirements can be set on a case-by-case basis for each bank, taking into account the size, risk, resolvability, systemic impact and business model of each bank. A review clause in the Directive would enable the Commission to propose from end-2016 a harmonised set of minimum requirement applicable to different types of bank.

### Customer and Markets

Africa has benefited immensely from the push to improve financial accessibility. Improvements in mobile telephone and data access has also enabled the delivery of new financial products and the inclusion of many people who were previously unbanked. Technology and Financial regulations regarding such mobile services have evolved enough to make delivery available in an effective and sustainable manner. However, there are related subject areas that need to be pursued by regulation. Privacy rules are virtually non-existent in most of Africa, although South Africa is slightly ahead of the curve. In West and East Africa, rules on customer protection are weak and often leave customers at the mercy of financial service providers. In Nigeria, the CBN as the primary financial services regulator has recently commenced the process of reforming the current consumer protection regime. This reform agenda is expected to define the overall framework for addressing consumer concerns, issues and challenges, in their relation with financial service providers.

In relation to complex or semi-complex financial products and services, few African countries have actively

implemented regulations on the use and sale of derivatives and related products – whether traded on active markets or transacted over the counter. Yet, their use in corporate business transactions is increasing and not all of them are for hedging purposes. Given their important role in the increase in leverage and the peculiarities in measuring their risks, the time for regulators to make conscious attempts at designing rules that will work for their jurisdictions is now, not when the products become conventional.

Regulators therefore need to develop or improve regulations for both newer and changing forms of banking such as rural, mobile and social banking, while proactively enhancing policies and supervisory requirements that protect an ever increasingly knowledgeable banking population. This latter part will need to cover specific topics like data protection, identity theft, privacy, and minimum standards for network providers - as distinct from agents or mobile money providers.

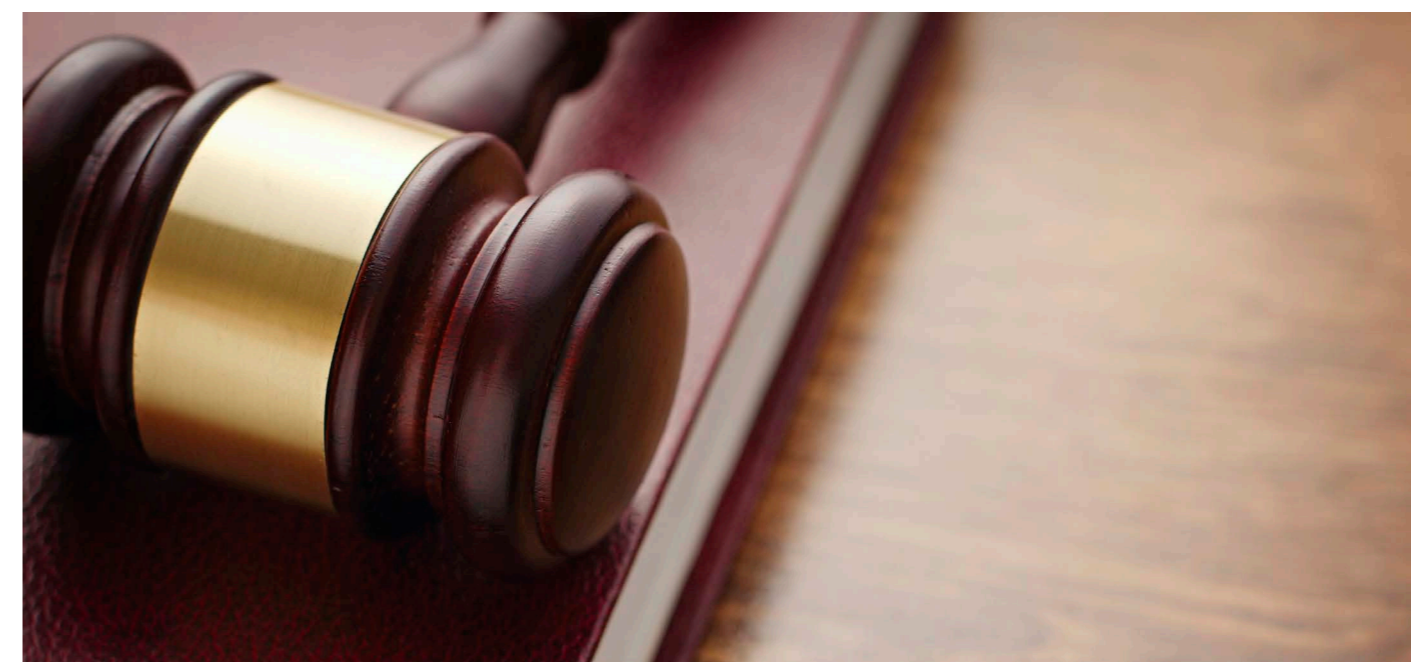
### Governance and Supervision

Another area of improvement is in capacity building – this time, among regulators. There are instances where the knowledge level of regulators and the regulated may be miles

apart. Compounded with the fact that regulators usually have tools and infrastructural limitations, episodes of brash and inappropriate regulatory implementation or foot-dragging become common place. Regulators across the world (including those in Africa) have long identified the need for capacity building on their own part. To improve the quality of regulatory supervision, some African regulators are beginning to place more emphasis on recruiting industry veterans who have the requisite skill for effective supervision.

While this may sound like good news, it also means that the days of latitude in regulatory compliance may soon be over. As regulatory pronouncements become less fallible and more unambiguous, definitive and direct, failures on the parts of banks to meet regulatory requirements will more likely be met with tough and decisive sanctions as the room for discretion and arguments thin out. Therefore, banks should be prepared to have stronger imperatives for improved bank-wide regulatory compliance.

Whilst the quality of regulators is very important, it is also to be noted that just as important is the political will to enforce regulatory rules and circulars.



## 4.2 Regulatory Pressure Index

In a world struggling for growth, Africa stands out as the rate of growth is significant in many African countries. The extent of regulatory coverage is also diverse. In an assessment of the regions within the continent that are, or are likely to be the hub of heavy regulatory activity, four regions easily come to mind: West Africa, East Africa, South of Africa (excluding South Africa), and South Africa.

Regulatory changes in West Africa are largely centered on the implementation of Basel 2, financial inclusion, Anti-Money Laundering (AML) and Combating the Financing of Terrorism (CFT), and Foreign Account Tax Compliance Act (FATCA). New capital requirements for Systemically Important Banks (SIBs) have also been introduced while further regulations and guidance on stress tests and resolution planning are expected.

In East Africa, new regulations have been introduced to reduce information asymmetry and ensure that banks fully disclose relevant information on loans to their customers. In addition, a draft amendment to the Act was issued in 2014 by the Central Bank of Kenya. Among other things, the amendment seeks to further enhance retail participation by requiring the Central Bank of Kenya to act as lender of last resort to microfinance banks and create avenue for retail investments in government securities. The Bank of Tanzania has also recently issued a framework for financial inclusion. Meanwhile, there are expectations

that regulators within the region will introduce guidelines on Islamic banking

The South African Reserve Bank effected its Basel 3 rules in January 2013 and has since provided periodic updates on liquidity and leverage requirements. The country has also implemented regulations relating to Over The Counter (OTC) derivatives and market infrastructure. There are however possibilities of further tightening of capital requirements for SIBs and more stringent regulations for the mortgage industry. The impending shift to a twin peaks regulatory regime and the establishment of the Financial Services Conduct Authority ("FSCA") has brought significant focus to market conduct. Financial crime remains a key area of focus for the regulator.

In March 2014, the National Bank of Angola (or Banco Nacional de Angola) made a public presentation to all banks requiring a shift in financial reporting to the International Financial Reporting Standards (IFRS) standards effective January 2016. In Zimbabwe, the Reserve Bank is finalizing preparations for the complete implementation of Basel 2 standards in 2016.

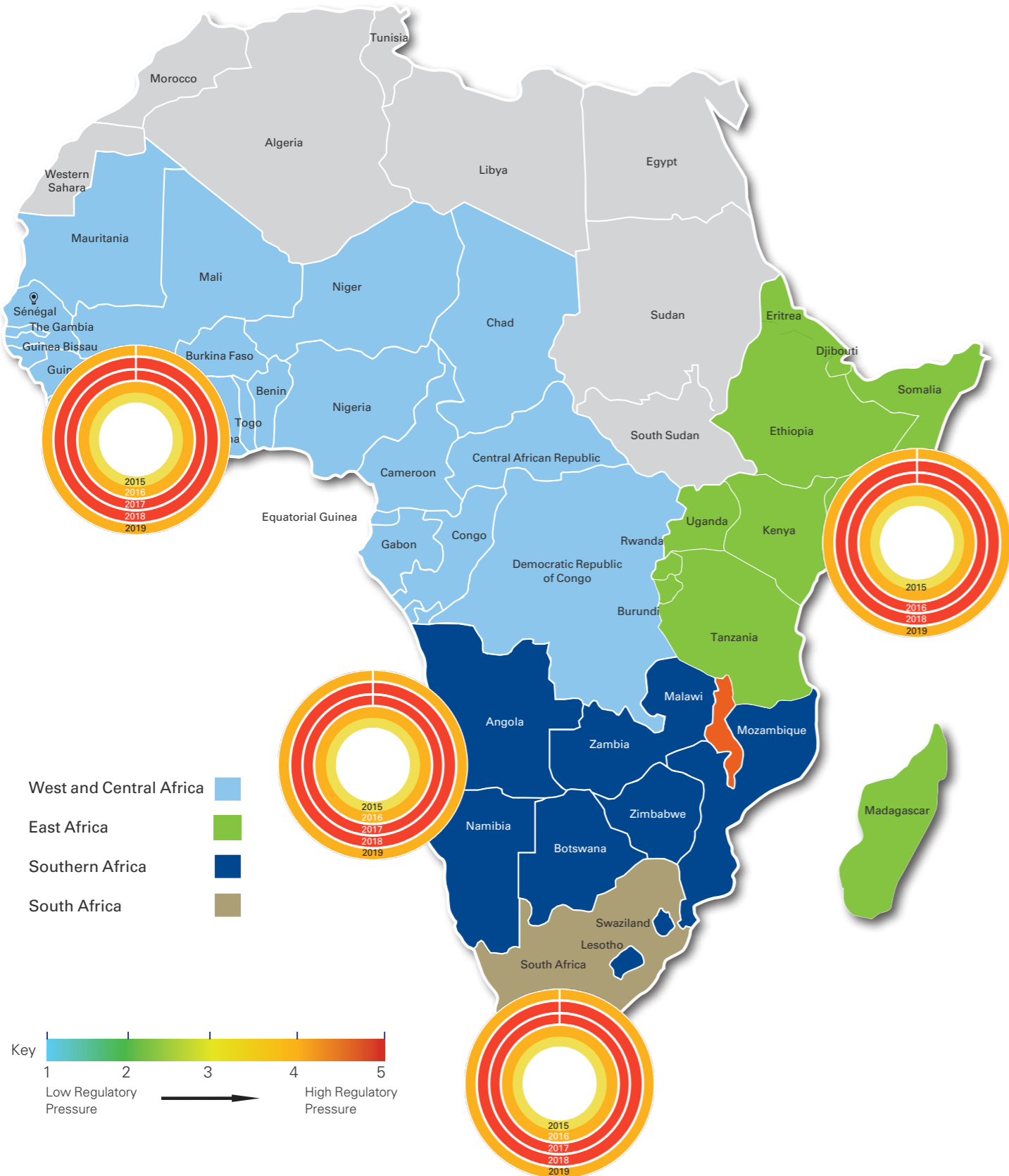
Overall, the Regulatory Pressure Index (RPI) which measures the level of government or regulator interference stands slightly higher than a year ago. Six and a half years into the financial crisis, the overall regulatory pressure on banks shows little sign of abating. KPMG also noted that in Sub-Saharan Africa, the regulatory pressure is also linked to the country political stability and over-all governance. However, on an overall basis, the regulatory pressures still remains lower in Sub-

Saharan Africa than in Asia Pacific, the Americas and the EMA regions. In most if not all regions, pressure should radically increase and leap-frog to catch up with the global regulatory landscape around:

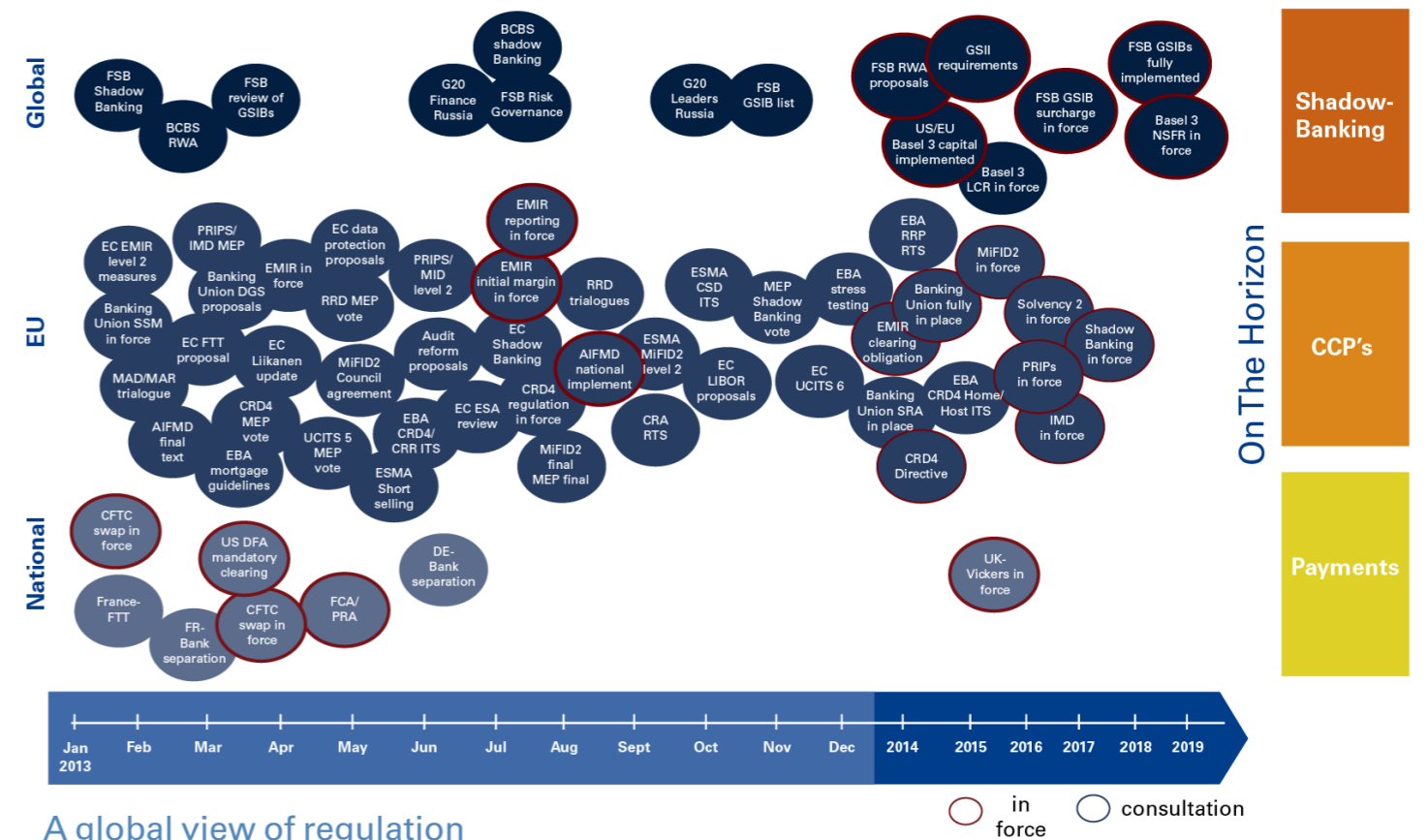
- **Supervision** – the increasingly intensive approach of supervisors across the continent, more so given the different roles of socio-economic growth enabler they play;
- **Liquidity** – reflecting the relaxation to the Liquidity Coverage Ratio and the balance sheet adjustments made by the banks themselves;
- **Capital** – the prospect of 'Basel 4' emerging through a combination of a higher leverage ratio and a much tougher approach to the weighting of banks' credit and market risk exposures;
- **Remuneration** – where earlier dire predictions on banks' responses to regulatory restrictions have proved largely unfounded;
- **Market infrastructure** – where adjustment to the requirements on the clearing, trading and reporting of derivatives is under way;
- **Systemic risk** - reflecting initiatives made on recovery and resolution planning, but only in some countries;
- **Governance** – the series of central banks and Basel Committee related initiatives on risk governance, and the wide-ranging new requirements on data reporting; and
- **Culture and conduct** – where banks will face heightened pressure to improve their culture and conduct.



The regulatory heat map below represents Sub-Saharan Africa and the respective regions that are currently, or expected to experience intense regulatory pressure.



Following up on the distribution of the pressure index from a sub-regional view point, the tables that follow show major current and expected regulatory pronouncements in the key regions of Sub-Saharan Africa. The period covered is from 2012 to 2020.

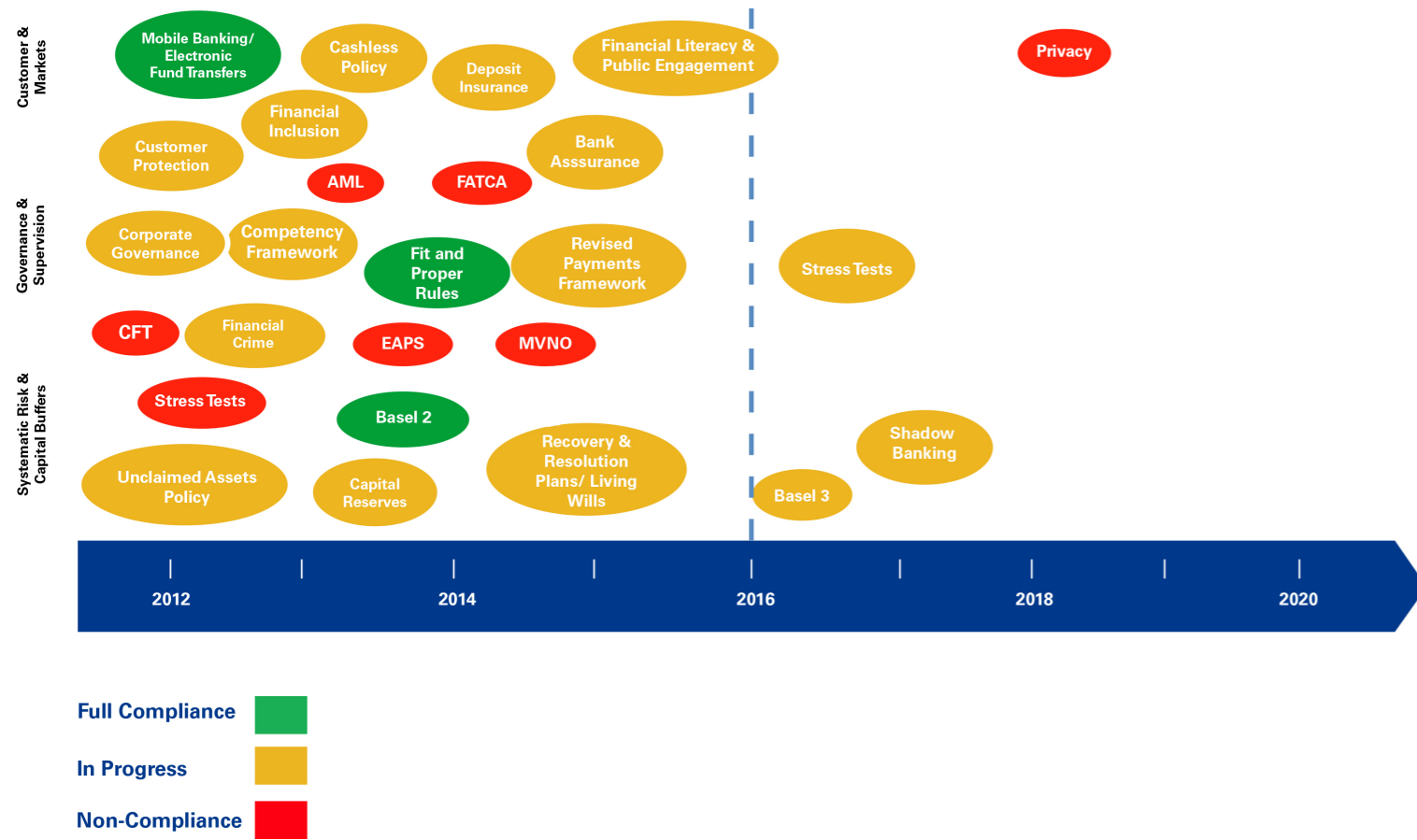


A global view of regulation

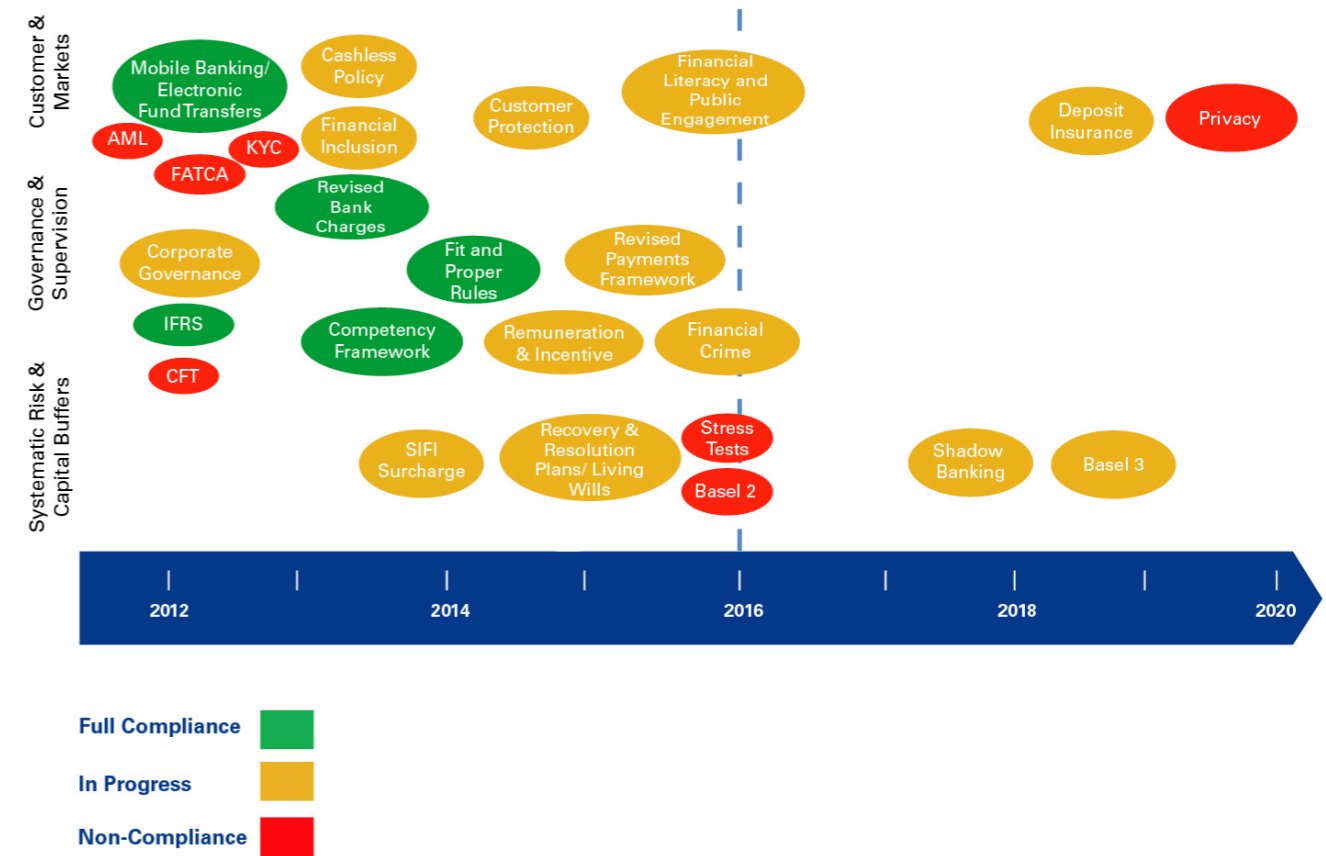
This diagram depicts the various new regulations which are coming into effect globally. From a South -Africa point of view, we follow the global trend of regulation. The experience is that these usually takes effect in SA within an 18month/2 year period after the regulations have been released globally.

Following up on the distribution of the pressure index from a sub-regional view point, the tables that follow show major current and expected regulatory pronouncements in the key regions of Sub-Saharan Africa. The period covered is from 2012 to 2020.

### The Journey in West Africa



### The Journey in East Africa





### 4.3 The Cost Implications of Regulatory Reforms

The cost of implementing major regulations has been prohibitive. Banks repeatedly kick against any regulation requiring major infrastructural investments. In addition, most regulators do not have the capacity to conduct needed assessments even if banks were ready to undertake the investments. In this regard though, while change may be slow, it is certain.

As African economies have grown and deepened, regulators have pushed for the implementation of regulations

that were hitherto avoided. A host of African countries have proceeded with the implementation of Basel 2 rules and some are even preparing to implement Basel 3 in quick succession. As the banks in these regions and their larger economies acquire the financial muscle to install infrastructure capable of securing some form of basic compliance, regulators will push on with implementation plans that seek to address their priorities.

We feel that the rate of the regulatory drive in Africa is likely to be determined largely by the economic realities of its constituent states. Whereas the kinds of economic fears triggered by the implementation of European regulations are not likely in Africa, there is a risk

that regulators might not wake up early enough to shoulder full and effective implementation of needed regulations until events and realities stipulate an immediate need.

One thing that many African countries will need to, and are likely to pay more attention to, is Anti-Money Laundering (AML) and Combating the Financing of Terrorism (CFT) in the future. With recent political uprising, upheavals and acts of terrorisms, countries that once thought themselves peaceful have suddenly realized that they may be havens, feasting nets, or even targets of organizations or bodies they would rather not finance or inadvertently support.

## THE CUMULATIVE IMPACT OF REGULATION

Detailed analysis by KPMG member firms in the Netherlands and Belgium has provided a bank and customer perspective on the cumulative impact of regulation

This work involved four key stages:

- Qualitative discussions with local banks about which banks were likely to have the greatest impact on banks' financial positions, business models, operating model, and change capacity;
- Identifying from this quantitative regulatory the four most significant regulations- CRR/ Basel 3, Financial transaction tax, Ball-in debt and the pre-funding of deposit guarantee schemes;
- Quantitative analysis of the impact of these four regulations on bank's leverage and liquidity regulatory ratios, and the impact on the net income, profitability and the cost: income ratios in the absence of any actions by the bank; and
- Assessing the extent to which banks could mitigate the regulations by taking management actions, such as reducing costs, reprising loans and issuing new capital, retaining profits by not paying dividends, changing the structure of assets (Holding more high quality liquid assets) and liabilities ( raising long-term wholesale funding) and reducing the size of the balance sheet.

### Three core findings emerged from this analysis:

→ In the absence of any management actions, many banks would fail to meet minimum regulatory requirements and would see on equity fail below 8 percent

→ A radical set of management actions would be required to enable the banks both to meet the minimum regulatory requirements and to achieve an 8 percent return on equity. This could not be achieved by cost reduction alone, but would require a combination of actions.

### In the central scenario, this would require:

- A 9 percent reduction in the size of the balance sheet;
- An increase in the price of loans by 80-90 basis points;
- No payment of dividends;
- A 5 percent reduction in costs; and
- Replacing the equivalent of 2.5 percent of total liabilities with long-term wholesale funding.

→ Such a set of management actions would have significant implications for customers of the banks and for the financing of the wider economy, in particular though less and more expensive credit and the provision of fewer risk management products and services.

## IMPACT OF WIDER REGULATION ON A WIDER ECONOMY

As KPMG has argued elsewhere, the relentless introduction of more and more regulation may already have taken many economies, especially in Europe, beyond the “tipping point” to a position where the costs of regulation exceed the benefits- in terms of the permanent downward drag on economic growth exceeding the benefits of avoiding future periods of financial instability.

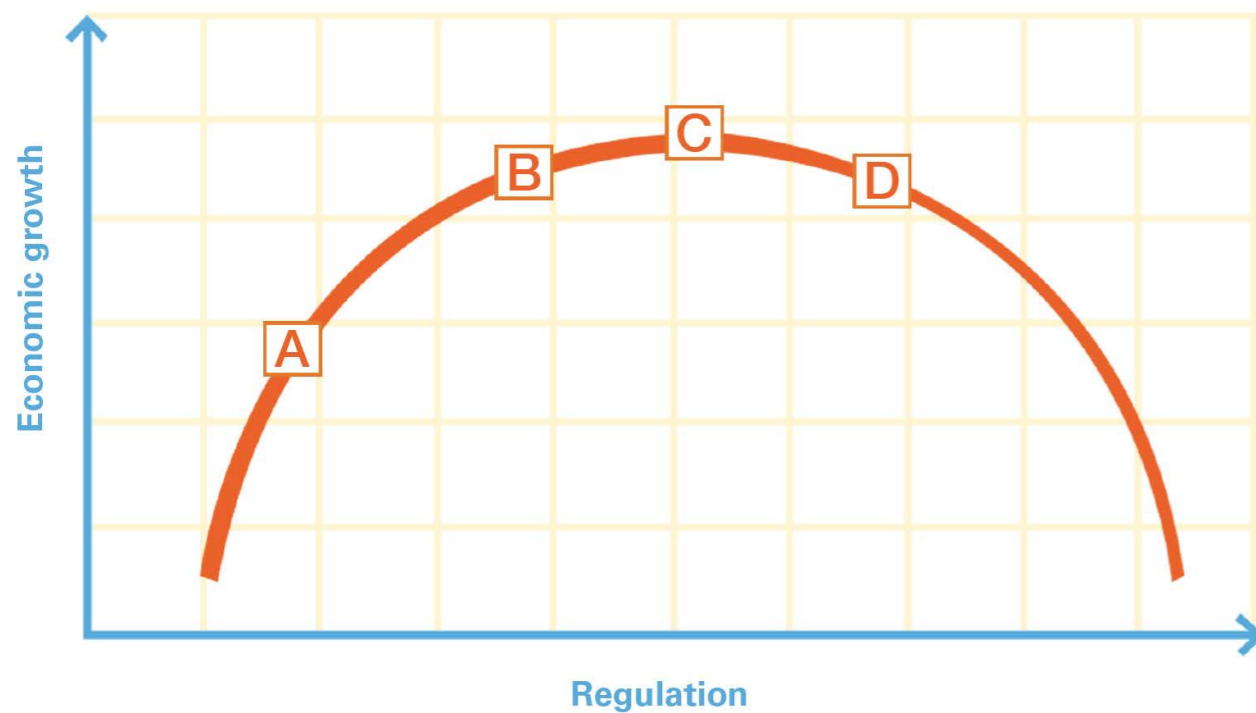
The relationship between regulation and economic growth may be illustrated

by a simple chart, plotting these two variables. Up to a point, regulation promotes economic growth, because the negative impact of regulation on economic growth in normal times is more than offset by avoiding the severe costs of financial crises. But there is an inflexion point beyond which the negative impact of regulation on economic growth in normal times begins to exceed the benefits of regulation.

The really difficult question is establishing where the “tipping point” lies. There is general agreement that before the financial crisis we were

at point A, where too little regulation contributed to the costs of financial crisis on economic growth. Official estimates of the Basel 3 capital and liquidity reforms moved regulation up to point B, leaving scope for additional regulatory reforms before reaching the “optimal” point C. However, the evidence in Europe in particular suggests that we have moved beyond point C to point D, where excessive regulation is so damaging to the wider economy that the net impact of regulation on economic growth has become negative.

Regulation versus economic growth



*The cumulative impact of regulation in Sub-Saharan Africa may not have gone past the “A point” or a situation where regulations are not enough to enable sustainable growth within the Banking Industry with socio-economic flow-on effects.*





# Potential Banking Industry Response

Emerging global and local regulatory requirements – including structural reform, conduct, governance and possible emergence of “Basel 4” – are game changing. For banks in Sub-Saharan Africa, the reshaping has begun and is likely to increase as more regulations evolve and local but internationally active banks delve further into the international space.

Regulatory drivers do not operate in a vacuum. Macro-economic developments, market competition and technological advances are also key factors driving business change. Banks in Sub-Saharan Africa will benefit from evolving into business structures and processes that give them control of their own destiny and the power to determine their own commercial strategy, or at least leave them with choices as regulatory requirements evolve. Regardless of what the drivers are, some key themes can be identified on how Sub-Saharan banks have, or are likely to respond to regulatory pressures.

## 5.1 Structural Changes and Measures

Regulatory requirements may force banks to rethink current and planned structural changes, including possibly favouring a patchwork of smaller locally or separately regulated subsidiaries. As more banks in Africa become globally active, they may have to evolve into different legal structures and may need to restructure their balance sheets. Addressing the myriad of regulatory, legal, compliance, capital, liquidity, funding, tax and governance considerations they will be exposed to is a complex, multi-dimensional issue and may also bring about more operational complexities than they are traditionally accustomed to. If these complexities are not intentionally planned with due consideration for regulatory requirements and operational efficiency, banks may increasingly find themselves inadvertently precluding their options, or increasing the cost and time of implementing some.

### Legal Entity Re-structuring

Although Africa does not have the types of tax havens found in Europe, the strong influence of foreign banks in many small African countries typically ensures that those banks become strategically important in the foreign jurisdictions in which they operate. In fact, it is not uncommon for many of these banks to channel huge foreign deposits for trade purposes on behalf of their customers. Still, a number of investors channel funds for the purpose of earning the higher returns on the borrowing instruments of local governments. Should there be a banking crisis in any country that is particularly so exposed, will the protection from deposit insurers still hold?

In the future, banks that may be required to ring-fence specific activities may need to implement some changes. More generally, emphasis on resolution planning especially by regulatory authorities of countries that may be particularly vulnerable may lead banks to reconsider their operating and legal structures. Although many jurisdictions across the world are yet to reach any conclusion on how (if at all) banks

should restructure in order to make resolution easier, internationally active banks in Sub-Saharan Africa will also be subject to those regulations should they choose to operate in local and international jurisdictions that impose such restrictions.

### Banks would need to create a viable business models with

- a legal entity structure that would enable the resolution authorities to apply their resolution tools and powers effectively;
- a financial model that can support the costs of the new liability requirements (capital and additional loss absorbing capacity), if any; and
- an operating model that efficiently and continuously ensures the supply of internal and external supplies in support of critical functions.

Banks would also need to consider how to reflect the cost of recovery optionality and resolution flexibility in their pricing. Some banks are pressing ahead with restructuring, in particular where the necessary changes to their business models in response to the financial crisis and regulatory expectations are clear.

There is no single model here, but the general shape of restructuring has focused on moves towards:

- A top level holding company (in part to meet regulatory pressures for a ‘single point of entry’ approach to bail-in debt);
- Operating subsidiaries that reflect a closer alignment between business activities and legal entities, based on a simplification and rationalisation of legal entities;
- Meeting local regulatory requirements for capital, liquidity, recovery and resolution, governance and risk management capabilities;
- Implementing clearer and better understood governance, control and accountability structures within the key operating entities;

• A more regional ‘hub’ structure and approach to running businesses and managing risk, including booking trades and transactions – although it remains unclear whether this will be a stable end-point in either commercial or regulatory terms;

• Either a decentralization of services to individual entities within the group, or the creation of a ‘resolution-proof’ shared service provider structured as a separate entity within the group; and

• Simplifying and netting down trades with major counterparties.

### Focus on Core Activities

Banks in Sub-Saharan Africa will have to carefully choose the markets, geographies and customer segments in which they want to remain active. This is particularly true because the extent of regulatory requirements within Africa varies widely and even more so when compared with those found in developed countries. Banks in the Sub-Sahara will therefore need to actively consider which business activities can succeed in each financial and regulatory environment and therefore determine which activities and operations are ‘non-core’, ‘marginal’, or beneficial.

In some cases, the choice may be a purely commercial decision, driven by factors such as profitability, risk and reward trade-off, customer types and market structures, capital, leverage liquidity, systems, people, competitive advantages, taxation and regulatory risk. In more unfortunate instances however, the choice may be driven by regulatory pressure forcing the sale or transfer of assets or withdrawal from certain types of businesses.

Globally, retail and corporate banks have generally pulled back most sharply from international business activities, including sales of overseas business units and a sharp reduction in overseas lending. Investment banks have in many cases withdrawn from specific business lines (for example some segments of fixed income and commodities trading) while seeking to maintain a scale presence in whichever business lines they consider to be ‘core’ activities.

In West Africa, banks have also been forced to exit certain markets and sell off subsidiaries. Others have been forced to exit international markets due to increased regulatory pressure particularly regarding increased capitalization requirements. Nevertheless, banks in Sub-Saharan Africa may still have a chance to better reshape their future if they better plan their expansion into territories within and outside Africa

### Cost Reduction

Banks are seeking to reduce their costs, not least in an attempt to offset the cumulative impact of regulatory reforms on the costs of funding, compliance, reporting, risk management and governance. This is becoming more critical in an environment of lower returns.

The following avenues for cost reduction may be explored:

- Greater efficiency of processes and data management through investment in IT systems;
- Closing branches and relying more on centralized and increasingly automated and industrialized front to back office processes;
- Focusing more on the overall profitability of products and services and on areas of competitive advantage rather than justifying new or incremental products and services on the basis of their marginal contributions to profit and loss;
- Simplifying products and services and taking a more risk-adjusted approach to costs and revenues;
- Greater automation of some controls, including compliance and internal audit, based on a re-assessment of risk tolerance in these areas;
- Simplifying legal entity and operating structures;
- Reducing variable remuneration, on the basis of weak economic conditions and regulatory constraints on remuneration; and
- Off-shoring and near-shoring.



## Developing Better Stress Test Capabilities

Stress testing plays an important role in critiquing an organization's strategy, and preparing it for dangerous terrains that may lie ahead; but only if it is done right. Stress testing loses its value if its scenarios or stress variables do not deal with core vulnerabilities. The structures of African economies vary widely. Quite a number of countries are almost entirely dependent on foreign income that come from exploiting natural resources. This vulnerability

becomes even more interesting if object of trade is also at the center of local business activity. Stress testing tools and assumptions that ignore these peculiarities will amount to nothing more than theoretical paper work.

Beyond meeting regulatory requirements, Sub-Saharan African banks that develop good stress testing methodologies stand a good chance of not just surviving, but taking advantage of difficult and volatile market and regulatory environments.

## Appropriate Risk Pricing Regimes

Banks and other financial institutions need to better measure the level of risks they carry. This is the objective of the recent Basel regulations. One feedback from these regulations is a realization that risk exposures are, quite often, inappropriately priced. Operators will benefit from implementing proper risk adjusted-pricing mechanisms, after all, there is no point setting aside capital for risk and failing to earn income for it.

## 5.2 Conduct, Markets and Culture

### The Retail Conduct Agenda

Banks will need to adopt a more strategic, forward-looking, and customer-centric approach. This will involve a different approach to the product life-cycle including product design and governance; charges and inducements; distribution channels, and conflicts of interest. A more outcomes-driven view of customer satisfaction will also need to be adopted.

This should result in a less product-driven and more customer-centric approach. Laying the foundations of trust will depend on providing more transparency, simplifying products and providing better quality advice, regardless of the sales channel.

The pricing of products will also need to be adjusted for increased cost of new operating models and increases in risk and compliance staff. In addition, the pressures from regulations on anti-money laundering, tax, and client

assets will push up the cost of retaining certain clients, maintaining and updating their data, and continuously monitoring their accounts and transactions. Some banks may be forced to pull back from some customers and customer types as a result of the risks and costs involved. This may be particularly painful for smaller banks who may suffer disproportionately from the cost increase and yet be unable to pass on the costs to their customers due to competition.

Banks may however benefit by automating trading and processing with a view to reduce cost and the risk of inappropriate market conduct. For example, the automation of foreign exchange trading and the reporting of prices and transactions could reduce conduct risk and increase productivity.

### Culture

It is widely argued that fundamental culture change is needed in many banks if the lessons of the crisis are really to be learned and if a more stable, publicly-acceptable banking industry is to emerge. Banks are therefore under

considerable pressure to reform their cultures and behaviours and to regain trust with regulators, customers and the public.

This is driven by a combination of:

- Regulatory and supervisory considerations, reflecting the perceived failings in culture that led (or failed to prevent) some banks to take excessive credit and market, mistreat their retail and wholesale customers, fail to manage conflicts of interest appropriately; and engage in inappropriate market conduct;
- Shareholders, customers and other market participants, all of whom see negative consequences from investing in, or transacting with, banks with poor standards of culture and behaviour;
- Other influential players such as politicians and the media, for whom banks have made themselves too easy a target; and
- Banks' self-interest in improving their culture and behaviours and learning some of the lessons from the financial crisis

## ASSESSING RISK CULTURE

The FSBs proposed guidelines are intended to support supervisors in taking a judgemental, outcomes-based, forward looking approach. Supervisors should understand institution's risk culture, in particular, whether it supports appropriate behaviours and judgements within a strong risk governance framework. To achieve this, supervisory interaction with Boards should be stepped up, based on high level sceptical conversations with the Board and senior management on the bank's risk appetite framework, and on whether the bank's risk culture supports adherence to the agreed risk appetite. Supervisors will be expected to focus on four "risk culture indicators" looking in particular for behaviours and attitudes that are not supportive of sound risk management, and intervening early to address these culture observations and thereby the potential build-up of excessive risk.

The four indicators:

➔ **Tone from the top** - how the bank's leadership ensures that its core values are communicated, understood, embraced and monitored throughout the organisation. This includes leading by example, assessing the impact of the high level values on behaviour throughout the organisation, ensuring common understandings from risk, and learning from risk culture failures;

➔ **Accountability** - a clear allocation of risk ownership, escalation process, and internal enforcement procedures;

➔ **Effective challenge** - encouraging challenge and dissent, and organising the risk functions to provide access of risk and compliance to senior management and the Board; and

➔ **Incentives** - basing remuneration on adherence of risk appetite and to desired cultures and behaviours, and appropriate talent development and succession planning.



Calls for culture change are commonplace. Successful implementation is, however, rare. It is clear that historical practices were wrong, and need to be changed. A fundamental change in culture and behaviour is an essential step on the road to rehabilitation and the creation of a sustainable and safer banking sector for the future. Some banks are beginning to undertake significant reorientation of their business models and their treatment of customers. Hand in hand with cultural change comes the need for banks to understand, monitor and manage talent risk more effectively. For a sector that is familiar with risk management as a discipline, the extension of the existing risk framework and practices to incorporate people and talent is a powerful way to underpin lasting cultural change.

Banks need to show that the root causes of the behaviour that caused the crisis are being addressed by demonstrating that they are re-balancing stakeholder interests when making core business decisions. Previously, banks demonstrated a disproportionate focus on profit and employee remuneration at the expense of benefits to the customer or market practice. In the future, successful and sustainable business models will need to be built on based on a requirement for a fair balance of stakeholder interests.

Many banks in Sub-Saharan Africa have started top to bottom cultural change programs.

This approach often includes:

- A new 'tone from the top' – clear and public commitments from the chairman and CEO that the old ways of working are no longer acceptable, and that the journey towards a 'new

bank' will include major culture change;

- New, high profile value statements and codes of conduct usually including a principle of ethical, responsible banking and the importance of fair and high quality service for customers;
- A redefinition of the skills and behaviour needed to deliver the business strategy in an environment focused on risk management, transparency and ethical behaviour;
- Changes to risk culture, through a strengthening of the role of the CRO and of the risk management and compliance functions.

However, this may not be sufficient to drive fundamental change in culture and behaviour throughout banking organisations. In addition to a realignment of promotion processes, the needed culture change will, at least, require:

- A true commitment from senior executives to transformational change, including a review of the core beliefs and routines that exist within the bank. To be effective, it is vital to have visible and authentic role-modelling of values, with leadership demonstrating decisive action to prevent the re-emergence of unacceptable behaviour;
- Some high impact, symbolic actions that demonstrate that the bank is taking culture change seriously and that there is no going back. These actions could include pulling out of certain business activities, and stopping the sale of, or redesigning, products that are perceived to be contentious or unfair;

- A radical overhaul of traditional norms and routines. This should include variable remuneration incentives – removing them in some cases, and at least adopting a meaningful balanced scorecard approach, with a genuine input from the risk and compliance functions;
- A structured approach to managing people risk and the incorporation of talent risk into wider risk management governance and reporting; and
- The articulation of clear measures and performance indicators for judging success in changing culture and behaviours, and the communication of these measures and indicators both internally and externally.



### 5.3 Data and Reporting

One clear consequence of the financial crisis has been an exponential increase in the amount and granularity of data that banks are being required to report to their regulators and/or to disclose directly to investors and other market participants. Every new regulation brings with it additional reporting requirements, as does the increase in supervisory intensity and coverage, and the growing emphasis on stress and scenario testing. This places considerable costs on banks in terms of the people, systems and quality assurance processes necessary to support this reporting.

The key questions for supervisors therefore relate to the ability of banks to aggregate risk data quickly, accurately, and across all risk types, activities and geographies.

This myriad of reporting and disclosure requirements also has an immediate impact on banks' procedures for data capture, data reconciliation (across systems, and between regulatory reporting and financial statements), control processes, and governance procedures. This is being reinforced by the growing emphasis of supervisors on the quality and accuracy of reported data and other information, which in turn has led to an increased focus on individual responsibility for reported data, banks' internal assurance processes (including the role of internal audit), and governance (e.g., how a bank's non-executive directors gain assurance about the quality of reported data).

There are also wider issues for banks here, relating not just to data capture but also to how the full range of reporting requirements are identified and how data is used to meet regulatory requirements.

Banks will need extensible and scalable data to meet all these requirements, perhaps ultimately in the form of a single 'data tape' that can be captured and interrogated by supervisors and other authorities.

Supervisors have also become increasingly frustrated by the inability of major banks to aggregate their risk exposures quickly and accurately at group level, both for internal reporting purposes and for meeting information requests from supervisors. These supervisory concerns are not limited to the state of banks' IT architecture and

data gathering – they also extend more generally to the internal reporting of risk data and the use of these reports as an input to properly-informed risk and business decisions.

The key questions for supervisors therefore relate to the ability of banks to aggregate risk data quickly and accurately across all risk types, activities and geographies; and to the ability to produce and use high quality management information both routinely and in response to emerging risks as an input to high quality decision making.

Banks should be reviewing:

- The quality and harmonisation of the risk data they collect;
- Their ability to aggregate risk data effectively, including across legal entities within a banking group;
- The use of IT to streamline data management and to make it more efficient – it will be too expensive to rely on manual processes and work-arounds;
- The combination of risk and finance data;
- The internal reporting of aggregated risk data to senior management and the Board, and the use of this information for decision-making; and
- Governance procedures (at Board and senior management level) for risk data aggregation, and reporting and the consideration of IT capabilities in these areas.

## RISK DATA AGGREGATION AND REPORTING

In January 2013 the Basel committee published 14 principles on the aggregation and reporting of risk data.

The principles cover:

- The importance of Boards and senior management exercising strong governance over a bank's risk data aggregation capabilities, risk reporting practices and IT capabilities. This includes:
  - The documentation, validation and robustness of these capabilities and processes;
  - The design, build and maintenance of data architecture and IT infrastructure to support risk data aggregation capabilities and risk reporting practices both in normal times and in times of stress;
- The accuracy, integrity, completeness, timeliness and adaptability of aggregated risk data. This includes:
  - The adequacy of the systems and controls that generate risk data and its aggregation; and
  - The capability to adapt rapidly to changes in key risks and regulatory requirements.
- The accuracy, comprehensiveness, clarity, usefulness, frequency and distribution of risk management reports, including to the Board and senior management. This includes:
  - Procedures for managing the accuracy of data and model reliability;
  - Making good use of forward-looking assessment of risk; and
  - Reviewing the usefulness of risk management reports to senior management and the Board.
- The need for supervisors to review and evaluate the bank's compliance with these principles, to take remedial action as necessary, and to cooperate across hamo and host supervisors.

### Banks' self-assessment against the principles

The Basel committee published in December 2013 a self-assessment by 30 G-SIBs of their progress in meeting the risk data aggregation and risk reporting principles.

The results show that the three principles with the lowest reported compliance related to data aggregation; data architecture and IT infrastructure, the accuracy and integrity of data, and adaptability. Nearly half of the banks reported the material non-compliance on these principles and many reported that they are facing difficulties in establishing strong data aggregation processes and are therefore having to resort to extensive manual walk-around

Banks self-assessed the highest compliance on the principles relating to reporting of risk data, report distribution and the comprehensive, clarity and usefulness of reports.

In both the retail and wholesale sectors, banks need to better exploit the technological advances that are enabling more effective customer profiling, especially as customers get increasingly used to non-banks who use technological advances to understand and communicate better with them.

Banks will therefore need to extract more value from their data, not only to meet complex customer-based regulatory requirements, but also to become more customer-centric, less product-driven, and become more competitive in the future.

The real competitive advantage here will come from the successful integration and analysis of all sources of customer and market data to develop a better understanding of customer needs and thereby to enable banks to serve customers more effectively, efficiently and profitably.

But even if banks begin to place more value on data and invest more in data analytics, they will remain

constrained by their IT infrastructures. These infrastructures are typically characterized by multiple disparate, aging and increasingly unreliable systems that have been stitched together during a period of mergers and acquisitions, entry into new areas of business, and a poorly managed series of IT enhancements.

Beyond bank-specific IT issues, most countries in Sub-Saharan Africa also suffer from more general / structural data issues. Reliable data that uniquely identify citizens and residents is hard to come by. The integration of stand-alone demographic databases is yet another issue. These realities place a limitation on the effectiveness of technology designed to track and report financial activity.

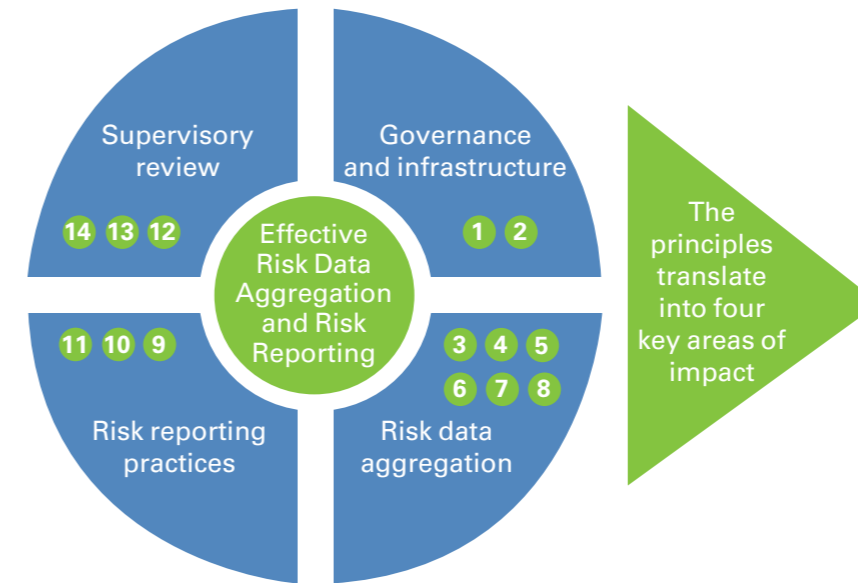
Banks are therefore likely to remind regulators of the external limitations and push for improvements that will require a wider pool of stakeholders. Without this, improvements in compliance with AML, CFT, KYC, and FATCA rules will only suffer limitations.

## INCREASE IN REGULATORY REPORTING REQUIREMENTS

Banks face an exponential increase in regulatory reporting requirements



## RISK DATA AGGREGATION AND REPORTING FROM PRINCIPLES TO ACTIONS



- |   |   |
|---|---|
| 1 Governance                              | 8 Comprehensiveness                         |
| 2 Data architecture and IT Infrastructure | 9 Clarity and usefulness                    |
| 3 Accuracy and integrity                  | 10 Frequency                                |
| 4 Completeness                            | 11 Distribution                             |
| 5 Timeliness                              | 12 Supervisory review                       |
| 6 Adaptability                            | 12 Supervisory review                       |
| 7 Accuracy                                | 13 Remedial action and supervisory measures |
|   | 14 Home/host cooperation                    |

### IT ARCHITECTURE

- Risk data models unified or automatically reconcilable across banking group with unified naming conventions
- Unified level of detail of data across the group to enable fully flexible reporting
- Risk and accounting data to be reconciled
- High degree of automation for risk data aggregation
- Strive for single source of risk data for each risk type

### DATA QUALITY FRAMEWORK

- Effective data quality management including automated measurement methods and escalation procedures
- Comprehensive data governance for risk data including data owners from business and IT
- Documentation of reporting and reconciliation processes

### RISK REPORTING

- Adaptable and ad hoc reporting capability with drill-down into various risk dimensions stress testing
- Comprehensive, timely, dependable and adaptable risk reporting capability across all units and all material risks

### ORGANISATION AND IT MANAGEMENT

- Risk reporting and aggregation to be mapped into IT strategy/ implementation roadmap
- Independent validation of standard compliance
- Full business continuity capability for risk reporting
- Automatic and manual quality checks in the reporting process

## 5.4 Risk and Governance

Banks need to do more in the area of risk governance. New risk management and risk reporting procedures are being introduced, but roles and responsibilities have not always been fully determined, leading to both an underlap and overlap. Many banks need radically different management information which only significant investments in core and critical systems will provide. Some banks have made progress in improving governance and risk governance, but most banks need to make further progress in these areas.

### Focus on Risk

At Board level, more attention is now being focused on understanding risk, on setting risk appetite, and controlling, measuring, monitoring and reporting risk. This includes a reinforcement of the Board with non-executive directors who bring a deeper experience and expertise of banking and risk management; a more active role for the Board risk committee; a closer consideration of risk maps and risk related management information; and a more active role for the CRO in discussing risk with the Board risk committee and/or the Board itself. However, at many banks, the shift from the pre-crisis problem of inadequate and fragmented oversight to improved group-wide, timely Board level reporting remains incomplete.

As the volume and nature of internal and regulatory risk reporting grows, many banks will need to invest further in risk data, systems, and architecture. Meanwhile, the need to place additional emphasis on specific risks such as liquidity, conduct and reputational risk will make it even more challenging for a CRO, senior management and the

Board to form a group-wide view of the risk profile and manage the global business across regional, national, product and legal entity lines. As the cost of capital and funding increases, there will also be an increasing need to consider the risk adjusted return on particular products and services.

Banks will also need to consider how risk governance adds value within the organization and to define clearly the role and mandate of functions and individuals with regard to risk management responsibilities.

### Oversight and Accountability

On oversight and accountability, banks will need to provide better clarity of accountability across core business activities and processes. Senior management sometimes struggle to agree on those lines. Banks need to develop and implement the necessary ownership of, and accountability for, their core business activities and processes and reach a position where they can attest with confidence to the clarity and effectiveness of these roles and responsibilities.

### Role of the CRO

Many banks have reviewed and revised the role, responsibilities and reporting lines of the CRO, and in doing so have generally enhanced the CRO function. CROs increasingly report directly to the CEO rather than through the Chief Financial Officer (CFO) and have much greater access to the Board and the Board risk committee.

However, in some banks there are still issues around:

- establishing a genuine group-wide view of risk, in particular with respect to (i) the capital, funding and liquidity

issues that have traditionally been the responsibility of the CFO; and (ii) the operations of a bank – be they specific business activities or geographies that have traditionally been managed independently;

- operating a group-wide view of risk alongside local views that are sometimes different at national levels;
- managing dual reporting between business lines and risk management at all levels of the bank including at Board level; and
- increasing the abilities and capacities of CROs – and risk management staff in general – in order to equip them with the ability to take a forward-looking and strategic view of risk. This is borne out of the need for a strong proactive view of risk, rather than reactive and backward-looking monitoring of limits and procedures.

The perceived relative importance of risk management and business units needs to be revisited. Risk management also needs to be more embedded in the business units (the ‘first line of defense’) which is still largely revenue-driven with very little risk constraints.

In general, the ‘second line of defense’ (including risk management) needs to be more dominant, more powerful, and more centralised. An independent second line should focus more on advice, framework design, effective monitoring and challenging and risk aggregation to identify concentrations and correlations.

Regulatory reforms designed to improve the independent assessment of the effectiveness of risk governance may also call for significant investment and up-skilling in the ‘third line of defense’ in order to provide positive assurance on the effectiveness of risk policies, processes and controls.

## SOUND RISK GOVERNANCE PRACTICES

A thematic review undertaken by the FSB of 36 banking groups across the G area showed that these firms had made improvements since the financial crisis in risk governance, not least in:

- Assessing the collective skills and experience of the Board;
- Undertaking the more frequent and more demanding Board effectiveness reviews;
- Instituting a stand-alone risk committee; and
- Establishing a group-wide CRO.

However these groups had made less progress in:

- Establishing and implementing a clear risk appetite statement;
- Defining the responsibilities of the risk committee and its interaction with the audit committee; and
- Strengthening risk management functions, in particular IT infrastructure and the ability to aggregate risk data efficiently and effectively. The review drew a clear link to Basel Committee principles on risk data aggregation and reporting.

The FSB used examples of good practice to develop a set of sound risk governance practices for banks to aspire to, and for national authorities to use as basis for assessing risk governance in major financial institutions. The FSB also recommended that international standard setters and national authorities should adopt more consistent approaches and should toughen their standards to reflect these sound risk governance practices.

The sound risk governance practice identified by the FSB include:

- The independence and the expertise of the Board;
- The role of the Board in establishing and embedding an appropriate risk culture throughout the firm on a business line basis, legal entity and a group basis;
- The membership and terms of reference of the risk and audit committees;

- The reporting line of the CRO (direct to the CEO, not through the CFO) and a distinct role from other executive functions and the business line responsibility;
- The importance of the CRO involvement in all significant group-wide risks (including treasury and funding) and in key decision-making processes from a risk perspective (including strategic planning, acquisitions and mergers);

- The independence, authority and scope of the risk management function; and
- The independent assessment of the risk governance framework, including both an enhanced role of internal audit and the use of external third parties.

The review found significant gaps in all the banking groups in its sample, so banks should not assume that they performing well against these criteria.

## RISK APPETITE FRAMEWORK

The FSB's principle for an effective risk appetite framework recognises that the concept of risk appetite was not always well understood, quantified or embedded in business management. The principle state that the framework should:

- Be driven by both Board leadership and the involvement of management at all levels;
- Be communicated, embedded and understood across the bank, including being embedded into the bank's risk culture;
- Act as a brake against excessive risk-taking;
- Allow for the risk appetite statement to be used as a tool to promote robust discussions of risk and as a basis upon which the Board, risk management and internal audit functions can effectively and credibly debate challenge management recommendations and decisions;
- Cover subsidiary third party outsourcing suppliers that may be outside the direct control of the bank; and
- Be adaptable to changing business and market conditions.



The FSB then define the three key elements of an effective risk appetite framework as:

→ A risk appetite statement that:

- Is linked to the bank's short-and long-term strategic, capital and financial plans;
- Establishes the amount of risk the bank is prepared to accept in pursuits of its strategic objectives and business plan, taking into account the interest of its depositors and shareholders as well as capital and other regulatory requirements;
- Determines for each material risk the maximum level of risk that the bank is willing to operate within, based on its risk appetite, risk capacity and its risk profile;
- Include quantitative measures that can be translated into risk limits applicable to business line, legal entities and groups;
- Includes qualitative statements for risks that are not easy to measure, including reputational and financial consequences of poor management of conduct risks across retail and wholesale markets;
- Ensures that the strategy and risk limits of each business line and legal entity align with the bank-wide risk appetite statement; and
- Is forward looking and subject to scenario and stress testing to ensure that the bank understands what events might push the bank outside risk appetite and/ or risk capacity.

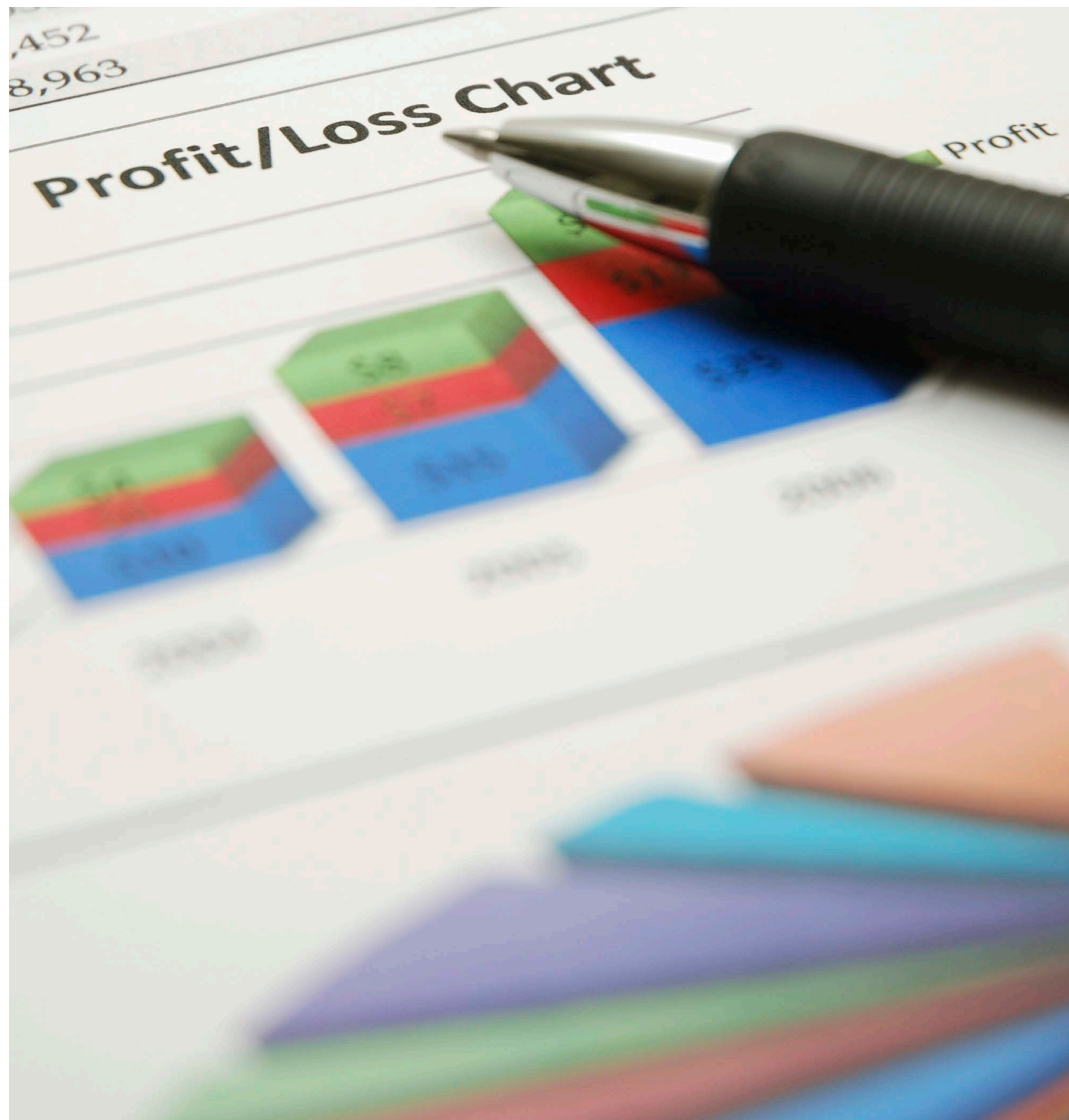
→ Risk limits that interact with the risk appetite because they:

- Constrain risk-taking within risk appetite;
- Are established for business lines and legal entities, and include material risk concentrations at the firm-wide, business line and legal entity levels (e.g. counterparty, industry, country/ region, collateral type, product);
- Do not default to regulatory limits, and are not overly complicated, ambiguous or subjective; and
- Are monitored regularly.

→ A set of supporting roles and responsibilities- the principles include detailed job descriptions that outline the roles and the responsibilities of the Board and senior management with respect to the risk appetite framework.

## 5.5 OTC Derivatives Regulation / Reform

The use of derivatives in financial transactions is increasing across Sub-Saharan Africa both in terms of number and volume of transactions covered. At some point, national regulators may need to introduce regulations requiring OTC derivative related transactions to pass through specified central clearing agents. This may prove to be particularly important in regulating significant OTC transactions entered into by major national or regional financial players in the continent.



## ACKNOWLEDGEMENT

The editorial team would like to acknowledge the contribution of our colleagues from across Sub-Saharan Africa KPMG, who helped develop this report:

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