Aligning Supervisory Structures with Country Needs in Small Open Economies – The Case of Sub Saharan Africa

Marc Quintyn and Michael W. Taylor

International Monetary Fund and Hong Kong Monetary Authority, respectively. The views expressed in this paper are the authors’ and do not necessarily represent those of their institutions.
I. INTRODUCTION

1. Until just over a decade ago the institutional structure of financial regulation and supervision was not considered a worthy topic of extensive policy debate, or even one that should attract much academic attention (Goodhart, 2002). In the past decade this perception has changed radically as more and more countries have reviewed their regulatory structures and, in some cases, have embarked on extensive institutional change. While the restructuring wave took off in advanced economies, it has since reached most corners of the world. Several middle- and low-income countries have in recent years revisited their supervisory structures as well. The aim of this paper is to review, and contribute to, the restructuring debate in a part of the world that has only received partial attention—sub-Saharan Africa (SSA).

2. The reform debate is most often cast as a choice between either separate supervisors for each of the main industry sectors or the creation of a unified financial regulatory agency, i.e. one that combines the responsibility for the regulation of the banking, securities and insurance sectors in a single organization. This model of regulation, which was pioneered in Scandinavia during the late 1980s and attracted international interest following its adoption in the United Kingdom in the late 1990s, has since been taken up by a number of countries with widely different financial and regulatory systems.

3. Three main justifications have been advanced for creating a unified regulatory agency. First, that it is necessary to ensure the effectiveness of regulation and supervision, given the convergence of the previously distinct banking, securities and insurance sectors of the financial industry, particularly due to the development of financial conglomerates (the “industry change” argument). Second, that it is possible to achieve economies of scale in regulation, particularly in small countries or countries with small financial systems, and thus to achieve regulatory goals more cost effectively (the “economies of scale” or “small economy” argument). Thirdly, unified regulation is also sometimes adopted as a measure to build supervisory capacity. In this regard, what we will call the “institutional strengthening argument” is heard most often as part of the response to financial crisis, the intention being that institutional change can be used as a way to break down entrenched interests, cultures, and work practices that are believed to have contributed to the crisis in the first place. However, the institutional strengthening argument can apply equally where the regulatory system is seriously underdeveloped and a major development effort is required to place it on a sound footing.

4. In addition to these three main arguments, other factors have also been at work in the trend toward restructuring the supervisory institutions. For example, within the euro-zone the transfer of monetary policy functions to the European Central Bank left national central

---

2 For up-to-date overviews, see among others, Fleming and Vanicz (2006) and Cihak and Podpiera (2006).

banks with an opportunity to redefine their role with respect to financial regulation and financial stability more generally. Some have done this by adding other regulatory responsibilities to their traditional banking supervision function. For example, in Ireland, the central bank has assumed responsibility for non-bank regulation in addition to its banking supervisory functions, thus creating a unified regulator as a unit of the central bank.

5. Finally, although not explicitly cited as a justification for the reform of regulatory structures, another important factor behind some revisions of institutional structures has been the very fact that other countries have also done so. In particular, unified regulation has often been seen as the “latest fashion”, especially as it has been adopted in several of the most advanced financial markets, and thus it is tempting to engage in reform merely to be seen as being part of the current trend. Thus, the decision to adopt unified regulation can be taken without considering the appropriateness of this model for the circumstances of a particular country. In some cases, the idea that regulatory reform is necessary because it is the trend in other countries can be used to provide cover for less high-minded motives for embarking on institutional reform, such as the desire by some finance ministries to obtain greater control over financial regulation by wresting it from the hands of the central bank. Once the issue of regulatory reform is raised, there is a risk that it will lead inexorably to the adoption of a new regulatory structure, and the creation of new institutions, irrespective of whether it is likely to improve the quality of supervision.

6. The main goal of this paper is to develop some principles to guide the restructuring debate in the countries of the SSA. In so doing, we take the view that there is a need to consider a richer variety of institutional forms than is generally introduced into discussions of the institutional structures of supervision. As noted above, it is often assumed that there is a straight choice between unified supervision in a stand-alone agency (the “FSA model”) or separate agencies (including, where applicable, banking supervision within the central bank). In practice, however, countries have adopted a wide variety of institutional forms, with varying degrees of central bank involvement in regulation. In addition to the FSA model of regulation, we also introduce the concept of a “multi-sector agency” in which one agency supervises two of the three sectors with the other sector (usually banking) the responsibility of a separate agency. According to Cihak and Podpiera (2006), in 2004 there were 29 unified supervisors (half of them in Europe) and 22 countries that have restructured around at least one multi-sector supervisor. There are also a range of possible roles that the central bank might play in regulation. The “FSA model” is one pole of this debate, but in between there are a variety of different structures – including the Irish unified regulator as a subsidiary of the central bank, the Finnish model involving the sharing of infrastructure and support services between the central bank and the regulatory agency, and the Singaporean model of locating all financial regulatory functions in the central bank.

7. In small developing economies, a particularly important reason why the FSA model may not be optimal is that it keeps the central bank at arms-length from the regulatory process. In comparison to a country with an advanced financial system like the UK, this has two important disadvantages. The first is that in many developing economies only the central bank has the financial resources and budgetary independence to ensure that regulation is adequately funded. The second reason is that developing economies are more prone to periods of financial instability than advanced countries.
8. The search for an appropriate supervisory structure starts from the recognition that the capacity constraints that most developing countries experience will be the overriding determinant in the design of any supervisory structure. Having established this point of departure, the paper subsequently discusses regulatory scope and intensity as two key tools to develop a supervisory strategy tailored to the needs of an individual country. It will also highlight recent trends in the financial systems in SSA that are relevant to the regulatory reform debate. Finally, it argues that central banks need to be kept involved in the regulatory process given the particular circumstances of low-income developing countries.

9. The paper will also assess the relevance to the SSA region of the arguments for restructuring used to justify realignment in advanced countries with sophisticated financial systems. For example, where financial conglomerates do not form a major part of the financial system, it is doubtful that this particular justification for unification should carry much weight in the decision whether or not to unify. Unless the other arguments for unification are particularly powerful, therefore, it is probably not worth considering a move to unified regulation. As we will show in the course of this paper, the arguments that are the most clearly applicable to small developing economies are those relating to the economies of scale and institutional strengthening. However, this being the case, it is important to examine alternatives to the “FSA model” that could achieve these objectives in a way that is more appropriate for the circumstances of SSA countries. These alternatives include both the formation of multi-sectoral regulators and a more active involvement of the central bank in regulation. Following this analysis, the paper moves on to discuss pros and cons of a number of stylized models in the context of SSA.

10. The structure of this paper is as follows. The next section reviews the three main strands of argument identified above and considers their applicability to the specific circumstances of small developing economies. Section III reviews key characteristics of SSA’s financial systems and supervisory structures, derives the arguments for aligning from those characteristics, presents some guiding principles for restructuring, and reviews potential models. Section IV will draw some conclusions for small developing economies that may be considering the institutional reform of their regulatory systems.

II. ALIGNING SUPERVISORY STRUCTURES—WHERE DO WE STAND?

11. This section briefly reviews the main arguments using for unifying—or restructuring—supervisory structures and analyzes their applicability to the case of countries with small and/or underdeveloped financial systems.

   A. The “Changing Structure of the Financial System”-argument

12. The primary factor behind the consolidation of Scandinavian regulatory agencies—where it all began during the 1980s—was the growing importance of financial groups that combined banking and insurance activities. The combination of previously separate banking and insurance commissions seemed to be a natural step in response to these industry trends, especially as there had been a long process of agency consolidation over several decades, and
banking supervision was not part of the responsibilities of the central bank in any of these countries. In the Scandinavian countries, therefore, the creation of unified regulatory agencies was driven by market developments and was mainly an attempt to ensure that regulation remained effective in the light of them. Moreover, while the final steps towards full integration in the early 1990s were discussed in the Scandinavian press and debated in the respective ministries, it did not, for the most part, lead to a significant public or academic debate (Taylor and Fleming, 1999).

13. The argument that the nature of the financial industry was changing and that the institutional structure of regulation needed to be adapted accordingly was also influential in those countries where an active public and academic debate did take place around the need for regulatory reform. It was especially important in Australia where it formed a major justification for the recommendations on the organizational structure of regulation made by the Wallis Committee (1996). In this context Australia has subsequently moved to a type of “Twin Peaks” structure (Taylor, 1995), where responsibility for regulation is divided between agencies specializing in prudential supervision on the one hand (the Australian Prudential Regulatory Agency) and consumer protection and market regulation on the other (the Australian Securities and Investments Commission).

14. The industry change argument also played a role in the intense debate – both in the financial press and in academic circles – that took place in the UK immediately in advance of, and subsequent to, the establishment of the FSA. This intensity was related in part to the fact that the Bank of England had established a substantial banking supervisory capacity and had stressed, over many years, the need to keep monetary policy making and banking supervision in the same body. This, it was argued, enabled the sharing of market intelligence and led to some important synergies. Much stress was put on the argument that monetary and financial stability are interrelated, and hence the central bank should retain the banking supervision function. On the opposite side of the argument, however, was the claim that unified regulation was necessary to reflect the new reality of the financial sector. The main academic contributors to the UK debate were Goodhart (1995), Taylor (1995, 1996) and Goodhart et al (1998). From within the FSA itself a robust defense of the unified regulator model was offered by Briault (1999) and by its former chairman, Sir Howard Davies, in numerous speeches. Among the supporters of reform there was, however, an important difference between those who argued that all financial regulatory activities should be combined in a single agency, and those who argued in favor of an Australian-style “Twin Peaks” model that separated prudential from consumer protection regulation.

15. In both Australia and Britain the main argument advanced in favor of regulatory reform was that the formation of financial conglomerates necessitated a financial regulatory agency that could adopt a “group-wide perspective” on the risks that they incurred. It was argued that the formation of financial conglomerates required more intensive oversight and

---

4 For example, in Norway, the banking commission had absorbed the regulatory agency for savings banks in the 1920s and had acquired responsibility for the oversight of securities brokers and dealers (in reality mainly banks) in the 1960s.
information-sharing than could be achieved by separate regulatory agencies, no matter how well they were able to cooperate. Regulation, it was argued, should mirror as far as possible the risk-management approach of the financial conglomerate groups, which tended to look through legal form to the underlying economic reality. This would only be possible if separate institutionally-based regulators were replaced by a single unified regulator.

16. A related argument in favor of unification in both countries was based on what became known as the “blurring of boundaries” between different types of financial product. The development of deposit products with returns linked to the performance of a stock index, or products that had insurance-like characteristics but that were not insurance products (credit derivatives being an example) required consumer protection rules to be applied flexibly and without the constraints imposed by institutionally-based regulation. Thus in addition to the financial conglomerates argument that had been influential in Scandinavia, in Australia and Britain it was argued that a further market development that required unified regulation was the emergence of these types of financial products that crossed traditional product boundaries.

17. In both Australia and Britain the position of the central bank was a key factor in the outcome of the debate on regulatory reform. Both were initially opposed to losing the responsibility for banking supervision and lobbied hard, behind the scenes, against such an outcome. However, once the respective governments had made the decision to embark on regulatory reform, both central banks fell in line with it, and made considerable efforts (such as the transfer of key staff members) to ensure that the new agencies could be fully effective. Their acceptance of the decision was in part due to the fact that in both countries it was made by a government with a strong and relatively recent electoral mandate. This was reinforced by the fact that in both countries the decision was taken after an extensive public debate in which the central bank itself had been a participant. Nonetheless, the acceptance and support of the central bank was a key factor in establishing both the FSA and APRA.

B. The “Economies of Scale”-argument

18. A second strand of justification for the creation of unified regulatory agencies was what has been called the “economies of scale” or “small country/financial system” argument. This justification had a number of different dimensions. In the first place, it was argued that centralizing regulatory functions and activities could permit significant gains from economies of scale through the development of joint administrative, IT and other support functions. In addition, it was also argued that it would assist in the recruitment and retention of suitably qualified regulatory personnel, who might perceive that the career opportunities available to them in a unified regulatory agency would be significantly greater than in a series of specialist agencies. Finally, it was also argued that it would permit the regulatory authority to achieve efficiencies in the deployment of staff with rare intellectual capital.

19. This justification was most obviously influential among the Scandinavian countries, since they needed to maximize their use of scarce human resources if they were going to be able to ensure that regulatory functions were performed adequately. A single regulatory agency permitted scale economies to be attained with regard to the gathering and use of know-how in specialist areas and in the development and improvement of supervisory methods, while also permitting the Scandinavian countries to participate fully in international
regulatory forums. In their survey of Scandinavian regulatory practice, Taylor and Fleming (1999) noted that this economy of scale argument – which they also termed the “small country argument” – was cited by all the Scandinavian countries as a significant factor in their adoption of unified supervision and was generally regarded as one of its clearest benefits.

20. By contrast, the economies of scale argument played a relatively minor role in the British debate. To the extent that it was raised as an issue it was mainly because some of the smaller regulatory agencies that were absorbed into the FSA had recruitment and retention problems of long standing, and in part because particular specialist skills – such as those required to review the market risk models used by banks and securities firms – had been in short supply in every regulatory agency. Nonetheless, it was clearly much less significant for the UK given the FSA’s staff compliment of over 2,000 is almost ten times larger than the comparable agencies created in Scandinavia.

21. As Taylor and Fleming (1999) also noted, however, the creation of a single, unified regulatory authority on the FSA model was not the only possible response to the economies of scale argument. They discussed the Finnish model in which the banking and securities regulator was a separate legal entity with its own board, but whose staff, IT and administration services were provided by the central bank. Significantly, financial conglomerate groups were not a major part of the Finnish financial system in the late 1990s, and therefore the regulation of insurance companies and mandatory pension schemes was in the hands of another agency which lacked the banking regulator’s close association with the central bank. Since the Taylor and Fleming survey was conducted, several other countries have adopted innovative approaches to secure economies of scale in regulation, one notable example being the Central Bank and Financial Services Authority of Ireland (“CBFSAI”) which was created by the Central Bank and Financial Services Authority of Ireland Act 2003. A component part of the CBFSAI is known as “The Financial Regulator” which was established on 1 May 2003 as the single regulator for all financial services in Ireland. The Financial Regulator has its own separate board and acts independently of the central bank in the performance of its day-to-day functions, but there are a number of important connections between the agency and the Central Bank, in particular in relation to financial stability issues and the provision of support services. In the latter regard, the Financial Regulator is able to enjoy economies of scale both from being the single financial regulatory agency in Ireland and from sharing support services with the central bank.

C. The “Institutional Strengthening”-argument

22. We shall devote some attention to the argument that the creation of a single regulatory agency might be used as a mechanism for strengthening regulatory capacity and for improving the effectiveness of regulation because it might appear to be particularly applicable to small emerging economies. This argument did not receive much attention in the early literature on unified financial regulators. Regulatory capacity was already comparatively strong in Scandinavia and in Britain before they created unified agencies, and thus, to a large extent, institutional reform reorganized existing capacity but did not
significantly add to it.\(^5\) Alone among the Scandinavian countries, Sweden undertook its unification of financial sector supervision in the aftermath of a banking crisis. One factor behind the decision to create the Finans Inspektionen (the Swedish FSA) was the perceived need to strengthen supervisory capacity which, it was suggested, had been exposed as inadequate by the financial crisis. (Interestingly, however, Finland reached an opposite conclusion after experiencing a banking crisis at around the same time, since it decided not to create a fully unified regulatory agency but to strengthen the links between the bank regulator and the central bank).

23. Since the turn of the present century the argument that a unified regulatory agency can be used to build regulatory capacity has been heard more frequently, especially where institutional reform has been undertaken in response to a financial crisis. Following the Swedish experience, a number of other countries have either established or developed plans to establish a unified regulator as part of their response to financial crisis. The most prominent example was the Republic of Korea which established a new regulatory body, the Financial Supervisory Commission (FSC) as part of its IMF program. In Indonesia, also part of an IMF program, the government published plans to establish the Otoritas Jasa Keuangan (OJK), a single regulatory agency for the financial services sector. In the event, however, the implementation date for the proposed new agency had to be considerably delayed owing to the extensive legislative and administrative preparation that needed to be undertaken. The wide disparity in terms of the level of regulatory capacity among the potential constituent agencies of the OJK was seen as particularly problematic.

24. Among the factors that have been claimed to have contributed to weak supervision prior to the emergence of significant banking sector problems, are entrenched bureaucratic interests that prevent the emergence of independent and effective regulation (especially if this would mean interfering with other government policy objectives, such as directed lending), and regulatory capture by the industry, thus leading to inadequate enforcement of prudential regulations. Both can be seen as a consequence of inadequate agency independence (Quintyn and Taylor, 2003). Thus the common thread in this line of argument is that for regulation to be effective it needs to be performed by an agency with a clear mandate and strong enforcement powers that is insulated from both industry and political pressure. In consequence, it is argued, underfunded, understaffed and politically compromised agencies need to be replaced by a strong and credible regulator with sufficient bureaucrat clout of its own to withstand vested interests.

25. It should be noted that this line of justification points to strengthening the independence of regulatory agencies, but not necessarily to establishing a unified regulator. Indeed, one of the clearest examples of this line of argument leading to institutional reform is provided by the decision of the Chinese government to establish the China Bank Regulatory Commission (CBRC) as an agency separate from the People’s Bank of China (the central

\(^5\) It should be noted, however, that a subsidiary issue in Britain arose from the perception by some politicians that the pre-FSA regulatory system had provided insufficient protection to consumers. For a discussion see Blair et al (2001).
(bank), with pay scales for staff significantly above those in the central bank. The CBRC was not, however, established as a unified regulator and remains a specialist bank supervisory agency. By establishing a specialist bank regulator in combination with a major recapitalization of the state-owned banks, the Chinese authorities aimed to create a powerful voice within the government institutions in favor of maintaining the banks’ prudential soundness. Without such a voice the dominant influence would be exercised by those ministries which wished to see continued bank funding for state owned enterprises and other policy lending.

26. In other countries, however, the desire to establish a more powerful and independent regulator has resulted in the creation of a unified agency. The Japanese Financial Services Agency (JFSA) is an example of this type. In the Japanese case, following the serious banking problems that emerged in the late 1980s and early 1990s, the authorities concluded that the independence and effectiveness of regulation was being compromised by the role of the Ministry of Finance, which often pursued policy goals that conflicted with the prudential soundness of the banks it regulated. In consequence, the MoF’s responsibilities for regulating banks, as well as its securities and insurance bureaus, were transferred to the JFSA, which was also granted greater political influence by being placed directly under the Prime Minister’s office. The chairmanship of the JFSA also became a high-profile political appointment. Many commentators on Japan have attributed the substantial improvement in the financial condition of the banking system during the present decade in part to the more robust and independent regulation that resulted from these institutional changes. It should be noted, however, that while the JFSA has taken over the responsibilities of the MoF for regulating banking, securities and insurance, the Bank of Japan has significant regulatory and examination powers in respect of banks that were unaffected by these reforms.

27. The Republic of Korea provides a further example of this motivation for establishing a unified regulatory agency. As part of its program of reforms agreed with the IMF, it created the Financial Supervisory Commission (FSC) in April 1998 and established the Financial Supervisory Service (FSS) in January 1999. The former was created to act as an integrated supervisory agency for all types of financial institutions and markets while the latter was established to function as its executive arm. The FSC is a state agency whereas FSS has been established as a private corporation. Although they are formally separate, the two agencies are supposed and expected to operate as a single supervisory authority. Under this new system of unified financial supervision FSC/FSS is the sole supervisory agency for banks and non-banks, formerly the charges of the Bank of Korea (BOK) and the Ministry of Finance and Economy (MOFE), respectively. The move to establish the FSS/FSC was in theory part of a package of measures designed to allocate clearer roles and responsibilities to the various agencies responsible for monetary and financial stability, including the MOFE, the Bank of Korea, and the Korea Deposit Insurance Corporation (KDIC).

28. An analysis of the performance of the new Korean regulatory structure (Kim and Lee, 2005) suggests, however, that the actual results from these reforms have been disappointing. Due to the lack of complementary reforms to the institutional context in which regulation is situated, Kim and Lee conclude that the attempt to establish functionally independent regulatory agencies with clearly defined mandates has failed. In spite of the apparent division of responsibilities among specialized and separate agencies it was not long before the new
regulatory regime in effect turned into a hierarchical system headed by MOFE (Kim et al. 2002). With the power to initiate legislation, MOFE has become the most powerful agency dominating other agencies, although the system is supposed to work on the basis of the division of responsibilities and powers. In fact, FSC/FSS and BOK have come under the direct influence of MOFE, and there has been very little of either functional cooperation or horizontal checks and balances among the public agencies.Appearances to the contrary, the modus operandi of the new regulatory regime has remained the same as that of the old one in which all the powers and policy functions were concentrated in the hands of MOFE. In short, the post-crisis reforms in financial supervision have had very little effect on the way that financial supervision is carried out in Korea (Kim and Lee 2004 and 2005).

29. Thus the evidence of countries that have created a unified regulatory authority to establish a stronger, more independent regulator is quite mixed. This is not a surprising conclusion as the creation of a unified regulatory agency does not guarantee per se that it will be more independent and effective than the agencies it replaced. Among the factors that are essential to independence are the governance and funding arrangements for the new agency (Quintyn and Taylor, 2003) and its accountability arrangements (Hupkes, Quintyn, and Taylor, 2005). The most that can be said is that the decision to create a unified agency provides an opportunity to rethink these issues. As Abrams and Taylor (2000) argue, maintaining and enhancing supervisory capacity and the effectiveness of supervision should be the primary goal of any proposed regulatory reform. Among the prerequisites for effective supervision they include: clear objectives; agency independence and accountability; adequate resources; effective enforcement powers; comprehensiveness (i.e. the avoidance of gaps in the jurisdiction of regulatory agencies); and cost effectiveness. These factors can be considered independently of the case for or against unification.

30. In summary, it would seem that none of the three main lines of justification for creating a unified regulatory agency are decisive for small, developing economies. Given that institutional reform is unlikely to be necessary to reflect the changing structure of the financial industry in most small developing market economies (especially as securities and insurance business tends to be relatively undeveloped – see below), the case for unification rests largely on either the second or third justifications that we have identified. Economies of scale are an important factor to consider, but alternative ways of achieving these benefits exist that may be better adapted for the specific conditions of a developing economy than the “FSA model” would be. The institutional strengthening argument is also likely to be very significant, although in this case it will be important to keep in mind the importance of complimentary reforms to institutions and the overriding importance of measures to ensure agency independence.

31. A further point that needs to be emphasized is that the structure of supervision is a means to an end, not an end in itself—or as Mwenza (2004) puts it, “a second order discussion.” Focusing on issues of regulatory structure can often distract from the more essential, but less dramatic, business of improving the quality of supervision. The key question for emerging markets is whether reform to regulatory structures can be used as an opportunity to build supervisory capacity. This consideration needs to be paramount in deciding to embark on regulatory reform. Thus, for an emerging market country, structural
reform plans need to be combined with capacity building measures. Without the latter, they will be merely cosmetic changes.

III. ALIGNING SUPERVISORY STRUCTURE IN SUB SAHARAN AFRICA

32. Recent years have seen growing interest in reforming supervisory architecture among the countries of SSA, and some of them have already embarked on reforms. As might be expected, the trend towards revisiting supervisory structure has emerged first in middle income SSA countries with their more developed financial systems. South Africa unified NBFI supervision in the 1990s and has now a bi-polar supervisory system, which is still under discussion (Bezuidenhout, 2004). Mauritius established a unified supervisor in 199., Nigeria has a bi-polar system with bank and pension fund supervision in the Central Bank and insurance and securities supervision in a separate agency. Zambia regrouped supervision in three institutions, with the central bank in charge of banks, building societies, and bureaux de change, a Securities and Exchange Commission and a newly established Pension and Insurance Authority (1997). Namibia is in advanced stages of implementing a NBFI regulator, and other countries are contemplating modifications to the supervisory structure (Botswana, Malawi, Swaziland and Uganda). Thus far, no significant developments have taken place in central or western Africa. However, if current financial sector trends continue in low income SSA, the search for an alignment of the structure with the country needs will intensify, and the MIC experiences could provide useful lessons.

33. Common factors behind the reforms that have already occurred or which are currently under consideration seems to be (i) the association of several of these countries with SADC (Southern African Development Cooperation). SADC’s goal of harmonization of cross-country financial sector legislation provides the added incentive to members to collectively rethink their supervisory structures; and (ii) the fact that that several of the countries that have embarked on reforms, such as Botswana, Mauritius, and Namibia are among those with the more developed and diversified financial systems in the region. This forces the authorities in these countries to focus relatively more on effective supervision of the financial sector than their LIC neighbors.

34. Whatever the driving force, these emerging developments deserve attention. Starting from an overview of the current situation in SSA in terms of financial sector development and financial sector supervision, this section first analyzes how the supervisory alignment in Africa fits into the broader picture presented in the previous section. Subsequently it analyzes factors to be taken into account when aligning supervisory structures in SSA, and finally, based on this, looks at the pros and cons of some stylized models that take these factors into account.
A. Financial sectors and their supervision in SSA

Key facts and trends in financial sector development

35. SSA, and in particular its LICs, is home to some of the least developed financial systems in the world.\textsuperscript{6} The range of institutions is narrow, access to (even basic) financial services is low, and informal sectors remain a major source of credit for large parts of the productive sector. The current decennium signals some positive developments, although at a slow pace. Some of the MICs show higher levels of development, but are still relatively less developed than their counterparts in other parts of the world.

36. Key features of financial sector development in SSA, relevant for this analysis, include:

- The level of financial development remains low, with M2/GDP at about 27 percent in low income countries, and just over 55 percent in middle income countries (including South Africa).\textsuperscript{7} On the positive side, these and other indicators have shown a marked increase since the 1990s.
- All systems are bank-dominated (table 1). In most countries banks cover close to 90 percent of financial system assets.\textsuperscript{8} Insurance sectors are very small throughout and securities markets nonexistent, or in their early infancy. NBFIs and microfinance are growth sectors, in particular in middle income SSAs, albeit from a low base.
- As a result of the opening up of national system for foreign banks in the 1990s (for most countries), several banking systems now have a relatively strong foreign bank-presence. In the low income group, their presence amounts to 40 percent of total bank assets, and 60 percent in middle income countries.
- Partly reflecting the above, the presence of state-owned banks has declined steadily during the past decade-and-a half. In low income Africa they do not represent more than 20 percent total bank assets, and no more than 10 percent in middle income countries.
- The sector of nonbank financial institutions (NBFI) contains a wide variety of institutions in English-speaking SSA (nonbank-deposit taking institutions, insurance companies, pension funds, finance and leasing companies, merchant banks, mortgage

\textsuperscript{6} IMF (2006).

\textsuperscript{7} Middle income countries include Angola, Botswana, Cape Verde, Equatorial Guinea, Gabon, Mauritius, Namibia, Seychelles, South Africa and Swaziland. According to the World Bank rankings, low income countries have a GNI per capita of $ 825 or less and lower income countries have a GNI per head between $826 and $3,255.

\textsuperscript{8} In some countries, such as Angola, Chad, Congo DR, Equatorial Guinea, Eritrea, Guinea Bissau, Liberia, Sao Tome and Principe, they cover 100 percent of the officially registered sector. These countries are not listed in table 1.
finance, consumer credit companies). In general, these sectors are still extremely small, with a few exceptions. However, in several countries they have started to grow and show a potential to raise the level of financial services

- Among the NBFIs, the importance of nonbank-deposit-taking institutions is on the rise. Microfinance is becoming a key vehicle to provide the poor and rural groups access to organized finance in several countries. Governments and NGOs alike are pushing this development. Some of the microfinance groups accept deposits and provide a range of financial services. Credit cooperatives are increasing their significance as providers of (basic) financial services in a number of countries. Both sectors are increasingly attracting deposits from the informal sectors.

**Financial sector supervision**

37. Many sources—among them the joint World Bank-IMF FSAPs—concur that supervisory capacity remains limited in most of SSA. Many supervisory agencies or departments are understaffed and lack essential skills. Compliance with BCPs is low and supervisory enforcement is also often very low. Supervision of nonbank sectors is even weaker—or nonexistent. However, in recent years, several countries have embarked on major reform programs (often following FSAPs) to upgrade their banking supervisory skills and their regulatory framework.

38. A detailed overview of supervisory structures is provided in table 2 and a summary overview in table 3. The following are some key observations:

- Central banks are the dominant supervisors for banks in SSA. The legacy of the colonial powers is undeniable: countries with a British tradition typically house bank supervision in the central bank while most former French colonies established bank supervision in a separate agency. 9

- Central banks are also often called upon to organize supervision for nonbank deposit taking institutions, as a natural extension of their bank supervisory responsibility. In more than half of the countries in the sample, the central bank has some responsibility in supervising these nonbank deposit taking institutions. The same seems to be happening with respect to microfinance. Some countries are well-advanced, while in others central banks have been recently assigned the regulatory and supervisory responsibility over microfinance institutions, and central banks are trying to organize themselves (taking stock of the sector, defining the institutions that should be supervised and establishing the regulatory and supervisory framework).

9 In the Central African (CEMAC) and the West African Monetary Union (WAMU) banking supervision is established at the regional level.
Table 1 – Sub Saharan Africa: Relative importance of subsectors in the financial systems of selected countries 
(in percent of total assets of the system, latest available data) \(^{10}\)

<table>
<thead>
<tr>
<th>Country</th>
<th>Commercial banks</th>
<th>Other (mainly) deposit-taking institutions</th>
<th>Microfinance institutions</th>
<th>Rural banks</th>
<th>Insurance companies</th>
<th>Pension funds (^{11})</th>
<th>Other</th>
</tr>
</thead>
<tbody>
<tr>
<td>Botswana</td>
<td>40</td>
<td>34.3</td>
<td></td>
<td>1.6</td>
<td>17.4</td>
<td>6.8 (^{12})</td>
<td></td>
</tr>
<tr>
<td>Burundi</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Central African Republic</td>
<td>68.5</td>
<td>2.7</td>
<td>7.6</td>
<td>21.1</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Comoros</td>
<td>94</td>
<td></td>
<td></td>
<td>6</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Congo Rep</td>
<td>89.8</td>
<td>7</td>
<td>3.2</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Ethiopia</td>
<td>88.4</td>
<td>3</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Gabon</td>
<td>83.6</td>
<td>4.8</td>
<td></td>
<td>7.8</td>
<td></td>
<td>5 (^{13})</td>
<td></td>
</tr>
<tr>
<td>Gambia</td>
<td>97</td>
<td></td>
<td></td>
<td>2</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Ghana</td>
<td>50.9</td>
<td>6</td>
<td></td>
<td>2</td>
<td></td>
<td>15.1</td>
<td></td>
</tr>
<tr>
<td>Guinea</td>
<td>98.2</td>
<td>1.8</td>
<td></td>
<td>1.8</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Kenya</td>
<td>60.4</td>
<td>15</td>
<td>0.5</td>
<td>8.2</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Lesotho</td>
<td>91.8</td>
<td></td>
<td></td>
<td>7.8</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Madagascar</td>
<td>97.8</td>
<td>0.6</td>
<td>1.6</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Malawi</td>
<td>70.9</td>
<td>17.5</td>
<td></td>
<td>29.1</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Mali</td>
<td>98.7</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Mauritius</td>
<td>94.8</td>
<td>4.4</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Mozambique</td>
<td>94.9</td>
<td>4.3</td>
<td>0.1</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Namibia</td>
<td>38.1</td>
<td></td>
<td></td>
<td>24.8</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Niger</td>
<td>61.9</td>
<td>1.1</td>
<td>1.7</td>
<td>7.6</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Nigeria</td>
<td>90.5</td>
<td>8.1</td>
<td>0.7</td>
<td>2.1</td>
<td>0.6</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Rwanda</td>
<td>53.0</td>
<td>2.6</td>
<td>4.5</td>
<td>4.3</td>
<td>20.6</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Senegal</td>
<td></td>
<td></td>
<td>2.6</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

\(^{10}\) Numbers do not always add up to 100 percent

\(^{11}\) In most countries, state pension fund

\(^{12}\) Capital investment funds

\(^{13}\) Development bank

\(^{14}\) Development bank
<table>
<thead>
<tr>
<th>Country</th>
<th>Total</th>
<th>Capital</th>
<th>ROE</th>
<th>ADR</th>
<th>ROA</th>
</tr>
</thead>
<tbody>
<tr>
<td>Seychelles</td>
<td>87.1</td>
<td>6.0</td>
<td>2.1</td>
<td>5</td>
<td></td>
</tr>
<tr>
<td>South Africa</td>
<td>25.3</td>
<td></td>
<td></td>
<td></td>
<td>14.6</td>
</tr>
<tr>
<td>Swaziland</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Tanzania</td>
<td>78</td>
<td></td>
<td>4</td>
<td>13</td>
<td></td>
</tr>
<tr>
<td>Uganda</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Zambia</td>
<td>59.6</td>
<td>23.0</td>
<td>0.2</td>
<td>3.8</td>
<td>16.7</td>
</tr>
<tr>
<td>Zimbabwe</td>
<td>76.6</td>
<td>10.2</td>
<td>0.1</td>
<td>3.0</td>
<td>2</td>
</tr>
</tbody>
</table>

Source: International Monetary Fund, 2005b.

- In several cases, the supervisory responsibility of the central banks goes further than banks and other deposit taking institutions, making the central bank the dominant supervisor. For instance, in Nigeria the central bank is also the pension fund supervisor, and in Mozambique, the securities supervisor. In some cases the central banks seem to be the supervisor-by-default, given the lack of capacity outside the central bank. In ten countries, the central bank supervises each sector that is in existence, or that is considered important enough to be regulated.

- Table 2 also shows that there are an impressive number of unregulated sectors. In most cases, this situation reflects the fact that these sectors are either nonexistent, or still have only a marginal presence. Pension funds remain typically unregulated. Securities markets have a (separate) regulator in seven countries and fall under a multi-sector regulator in three cases. The insurance sector falls under some form of supervision in a broad number of countries (the central bank, a separate insurance supervisor, or the ministry of finance). Very often, when the central bank is not involved in these sectors, regulation and supervision remains limited to licensing by a registrar (located in a ministry), without any further supervisory oversight and a light regulatory framework.

- As indicated above, a revision of supervisory structures—or a deepening and widening of such structures—is of quite recent date. South Africa started the process in the 1990s and has been followed by Mauritius, Zambia, Namibia, Botswana, Malawi, and Uganda.
Table 2 – Sub Saharan Countries: Supervisory Structure for Financial System in Selected Countries

<table>
<thead>
<tr>
<th>Country</th>
<th>Banks</th>
<th>Microfinance institutions</th>
<th>Other deposit taking institutions</th>
<th>Insurance</th>
<th>Securities</th>
<th>Pension Funds</th>
</tr>
</thead>
<tbody>
<tr>
<td>Angola</td>
<td>CB</td>
<td></td>
<td>MOF</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>BCEAO-WAMU</td>
<td>B (regional)</td>
<td></td>
<td>I (national)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>BEAC</td>
<td>B (regional)</td>
<td></td>
<td>I (national)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Botswana</td>
<td>CB</td>
<td>CB</td>
<td>M</td>
<td>M</td>
<td>M</td>
<td>M</td>
</tr>
<tr>
<td>Burundi</td>
<td>CB</td>
<td>CB</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Comoros</td>
<td>CB</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Congo DR</td>
<td>CB</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Eritrea</td>
<td>CB</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Ethiopia</td>
<td>CB</td>
<td>CB</td>
<td>CB</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Gambia</td>
<td>CB</td>
<td>CB</td>
<td>CB</td>
<td>CB</td>
<td>S</td>
<td></td>
</tr>
<tr>
<td>Ghana</td>
<td>CB</td>
<td>CB</td>
<td>CB</td>
<td>I</td>
<td>S</td>
<td></td>
</tr>
<tr>
<td>Kenya</td>
<td>CB</td>
<td>CB</td>
<td>CB</td>
<td>S</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Lesotho</td>
<td>CB</td>
<td></td>
<td></td>
<td>CB</td>
<td>CB</td>
<td></td>
</tr>
<tr>
<td>Madagascar</td>
<td>B</td>
<td>B</td>
<td></td>
<td>B</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Malawi</td>
<td>CB</td>
<td>CB</td>
<td>CB</td>
<td>CB</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Mauritius</td>
<td>CB</td>
<td>CB</td>
<td>M</td>
<td>M</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Mozambique</td>
<td>CB</td>
<td>CB</td>
<td>CB</td>
<td>I</td>
<td>CB</td>
<td></td>
</tr>
<tr>
<td>Namibia</td>
<td>CB</td>
<td>M</td>
<td>M</td>
<td>M</td>
<td>M</td>
<td></td>
</tr>
<tr>
<td>Nigeria</td>
<td>CB</td>
<td>S</td>
<td></td>
<td>S</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Rwanda</td>
<td>CB</td>
<td>CB</td>
<td></td>
<td>CB</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Sao Tome</td>
<td>CB</td>
<td>CB</td>
<td></td>
<td>CB</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Seychelles</td>
<td>CB</td>
<td>CB</td>
<td></td>
<td>CB</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Sierra Leone</td>
<td>CB</td>
<td>CB</td>
<td>CB</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>South Africa</td>
<td>CB</td>
<td>M</td>
<td>M</td>
<td>M</td>
<td>M</td>
<td>M</td>
</tr>
<tr>
<td>Swaziland</td>
<td>CB</td>
<td>O</td>
<td>I</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Tanzania</td>
<td>CB</td>
<td>CB</td>
<td>I</td>
<td>S</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Uganda</td>
<td>CB</td>
<td>CB</td>
<td>I</td>
<td>S</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Zambia</td>
<td>CB</td>
<td>CB</td>
<td>CB</td>
<td>S</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Zimbabwe</td>
<td>CB</td>
<td>CB</td>
<td>CB</td>
<td>I</td>
<td>S</td>
<td></td>
</tr>
</tbody>
</table>

Source: Courtis (2005) and national sources.

Legend:
CB – central bank
B - separate banking supervisor
O - separate supervisor for other financial institutions
I - separate insurance supervisor
M - multi-sector regulator (but not for all sectors, which would be U)
S - separate securities supervisor
P - separate pension fund supervisor
U - unified supervisor (ie, supervisor of all subsectors)

Notes:
In many cases, the listed supervisor for other deposit taking institutions, insurance companies and pension funds is often just a registrar, without supervisory functions.
Blanks mean no supervisor (sometimes a ministerial department serves as the registrar—this department is not listed here unless it has a specific name).
### Table 3 – Supervisory Models in SAA – Overview

<table>
<thead>
<tr>
<th>Supervisory model</th>
<th>Number of countries</th>
<th>Countries</th>
</tr>
</thead>
<tbody>
<tr>
<td>Central bank for banks, multi-sector agency for others</td>
<td>4</td>
<td>Botswana *, Mauritius, Namibia, South Africa</td>
</tr>
<tr>
<td>Central bank for banks, separate agencies for others</td>
<td>8</td>
<td>Ghana, Kenya, Mozambique, Nigeria, Rwanda, Tanzania, Uganda*, Zambia*</td>
</tr>
<tr>
<td>Separate agency for banks, others separate or not regulated</td>
<td>3</td>
<td>BEAC, BCEAO, Madagascar</td>
</tr>
<tr>
<td>Central bank for everything that exists</td>
<td>6</td>
<td>Ethiopia, Gambia, Lesotho, Malawi*, Seychelles, Sierra Leone</td>
</tr>
<tr>
<td>Central bank for banks, rest unregulated</td>
<td>4</td>
<td>Angola, Burundi, Swaziland*, Zimbabwe</td>
</tr>
</tbody>
</table>

* currently under reform

---

**How does the emerging SSA debate fit into the broader debate?**

39. Given the various weaknesses in regulation revealed by this survey of existing regulatory systems, there is a strong case for reforming regulatory structures in the countries of SSA. The need to rectify these shortcomings is particularly pressing in light of the point made by Goodhart et al (1998) that, among all groups of countries, developing countries are most in need of effective (banking) supervision given several specific issues that make them prone to financial instability. Weak legal systems, lack of accounting standards and practices and a lack of financial instruments and markets to hedge financial risks are factors making systems prone to instability.

40. However, despite the urgency of reform, the SSA countries begin from a starting point that is very different from that of the advanced economies or some MICs that provide the clearest examples of institutional reform to date. Not only do countries of SSA have comparatively weak regulation of the dominant banking sector, but the regulation and supervision of several non-bank sectors that are starting to become significant is either weak or non-existent. Some of these sectors may soon assume a systemic importance in their respective countries, and hence will need attention. Hence, the discussion about aligning supervisory structures in SSA is, more than in other countries, a discussion about starting a supervisory structure from scratch for some sectors, than aligning existing structures with the new needs. So, the effort to be undertaken in SSA countries will often be more a matter of shaping the supervisory structures than of reshaping them.

41. It follows from the above observations that any institutional reform needs to be part of a broader package of measures designed to build effective regulatory capacity. Institutional change should support the foundations upon which regulatory and supervisory capacity can be built and can flourish. In addition, given the current state of development of SSA financial sectors, any new supervisory structure needs to be built in a forward looking
manner, i.e. be flexible to adapt to new needs and developments and to provide the basis for the regulation of new financial sectors and sub-sectors as and when they become significant.

42. These considerations imply that the institutional strengthening argument for regulatory reform is particularly relevant to the countries of SSA. This argument goes hand in hand with that derived from economies of scale/small country argument. Most, if not all, SSA countries have small financial sectors and cope with a lack of skilled professionals in the sector, including in oversight functions. Hence, faced with the emergence of several subsectors in need of supervision, the argument to pool scarce supervisory resources in one or in a limited number of agencies, comes to the fore as a very strong one in the debate.

43. By contrast, however, the industry structure argument does not apply under the current circumstances in any of the SSA countries. In addition, as Llewellyn (2006) points out, in most sub-sectors the core business is expected to dominate the institutions’ activities for a long time, and these lines of business are expected to continue to differ sufficiently, so that the blurring boundaries argument in favor of a unified supervisor remains weak.

44. Taken together, the case for revisiting supervisory structures in SSA rests on the recognition that, faced with growth and diversification in the financial systems, there is currently a unique opportunity to support a strengthening of supervisory capacity by providing an appropriate and flexible institutional framework. Having recognized this opportunity, the economies of scale argument in the case of SSA seems to argue against the establishment of separate agencies, but in favor of a structure that allows for synergies and flexibility to take into account the scarce resources/limited capacity problems. However, it does not necessarily follow that the “FSA model” of a fully unified regulator separate from the central bank represents the most appropriate way of achieving these objectives in the specific circumstances of SSA. The absence of financial conglomerate groups suggests that a single regulator is not necessarily the best or only response. Some creativity in institutional design will be needed and the next section tries to provide inputs into this process.

B. An analytical framework for shaping SSA’s future supervisory structures

45. The overarching constraint in institutional reform in SSA countries is the very limited supervisory capacity that currently exists. By contrasting this constraint with the obvious need for more effective supervision in SSA we reach the crux of the continent’s regulatory problem, a problem that any discussion of supervisory structures cannot ignore. This paper’s contribution to the search for suitable supervisory models for SSA countries, in light of the above constraint, rests on the analysis of two elements. On the one hand, we discuss how a supervisory strategy can be developed that allows the authorities to deal with this constraint. On the other, we look at the role of the central bank as a crucial factor in the selection of models.

---

15 Even in South Africa, the argument was not considered strong enough to move to a unified supervisor. Bezuidenhout (2004) argues that there is (still) a lack of true integration in financial groups.
Capacity constraints.

46. Capacity constraints must be recognized as major hurdles for any reform in SSA, in particular LICs. Supervisory agencies in most SSA countries lack skilled and trained staff, as well as the equipment and infrastructure to conduct on-site inspections and off-site supervision. Salary scales are typically low, making staff retention a major challenge because, once trained and proficient, staff are easily lured away by higher paying banks or other financial institutions.

47. In addition, supervisory skills cannot remain static, but must continue to evolve in response to industry trends and developments. In recent years, the widespread adoption of risk-based supervision, combined with ever more complex banking regulations and supervision (including the emerging Basel II framework) has placed a premium on the constant upgrading of supervisory skills. Thus countries which are unable to provide the right incentives to attract and retain suitably qualified supervisory staff run the risk of falling ever further behind supervisory practices in the rest of the world.

48. Capacity constraints will remain a factor for the foreseeable future. Hence, they will have to be taken into account when designing supervisory structures. Three points emerge from this discussion. First, capacity constraints clearly argue against setting up (new) separate agencies for each segment of the system, as this would risk spreading resources too thinly across several different regulatory bodies. It also calls into question plans that would merely “upgrade” or strengthen existing separate agencies. Economies of scale must be achieved. Secondly, the issue of institutional design has implications for the ability of the regulatory agency or agencies to attract and retain suitably qualified staff (for example by providing them with a career ladder) and the incentive structures faced by regulatory personnel. Thirdly, as will be discussed further, the central bank as one of the better-resourced institutions in most countries should be given (or should keep) a role in the supervisory process.

Regulatory strategy: scope and intensity

49. A response to the capacity constraint problem is to prioritize the need for regulation of the various financial sectors and sub-sectors. For example, if a sector is small, undeveloped, and showing little sign of growth, it may be a more efficient use of scarce resources to prioritize other sectors that are more significant for financial system stability. The process of prioritization requires an analytical framework, which we refer to as a “supervisory strategy.” In following such a supervisory strategy the authorities need to consider two issues: (i) which sectors should be supervised and at what point in time (i.e. in their development) should they be brought into the supervisory net. This is the issue of scope; and (ii) once a sector has been identified as needing supervision, what type of regulatory and supervisory regime should be imposed. This is the issue of intensity.

50. A supervisory strategy will need to be regularly updated to stay abreast of market developments and contain, monitor or control emerging risks. Financial systems in SSA are fledgling and therefore vulnerable. Hence, proper supervision is needed to ensure that their growth is not compromised by (systemic) crises which would undermine consumers’ fledgling confidence in the system and turn the clock back a number of years. However, the purpose of developing a supervisory strategy in the first instance is to allow strategy and structure to be considered together. The agreed upon structure should be such that it serves
the strategy by allowing scale economies and building capacity. Moreover, the structure should be such that both issues can be dealt with in an evolutionary manner, so that the structure need not be modified each time a new (sub)sector emerges.

51. To define the appropriate regulatory scope for a given financial system from a prudential viewpoint, Carmichael and Pomerleano (2002) propose as a first step, to rank the nature of the particular financial promises being made by given groups of financial institutions. Financial promises can be distinguished according to three characteristics: (i) the inherent difficulty of honoring the promise; (ii) the difficulty faced by the consumer in assessing the creditworthiness of the promissor; and (iii) the adversity caused by promissory breach.

52. To define the regulatory scope, the guiding principle could be that those subsectors whose financial promises have a high intensity with respect to all three features should be captured in the supervisory net. If one is to rank the types of financial institutions in order of decreasing promissory intensity, banks would typically come first, followed by either insurance companies or other deposit taking institutions (credit cooperatives, credit unions, microfinance organizations that take deposits), defined benefit pension funds, organized exchanges. Such an order may somewhat differ from country to country for country-specific reasons, but would be fairly generally applicable.

53. Once such a ranking has been arrived at, as a second step, the size of the sector, and possibly other considerations, enter the picture as a proxy for the systemic risk that this particular sector would pose. So, once a “risky” sector would have passed a certain threshold in terms of size and share, the regulatory and supervisory net should be expanded to include this sector.

54. The combination of these two criteria could provide governments with some yardsticks to determine whether, and at what point in time, a specific sector should fall under the supervisory umbrella. Adopting such an approach should also be of great help in avoiding regulatory gaps in the system. Based on these criteria, credit cooperatives, credit unions, and deposit taking microfinance institutions should probably (already) be regulated in a number of SSA countries. In the same vein, the insurance sector and securities business should be supervised in some other countries. This approach addresses the limited capacity issue since it allows government to “grow into the regulatory supervisory business” instead of having to do everything at once.

55. At this point regulatory intensity comes into play. Once it has been decided that a sector needs to be regulated because of the risks it poses, the authorities need to decide on the desired and desirable regulatory and supervisory intensity.

---

16 See also FIRST Initiative (2004a and b).

17 For instance, if in a country insurance companies typically belong to the same group as a bank, there are reasons to extend to “prudential regulatory net” to insurance companies, perhaps before any other subsector.
56. Regulatory intensity refers to the type and number of prudential rules and regulations and reporting requirements that should be imposed on a certain category of institutions. Public oversight of a particular sector or sub-sector might begin with a basic licensing regime, be extended to requiring occasional reports to be filed with the regulator, and at its most intensive stage apply a specific set of prudential requirements with on-site and off-site monitoring. For example, applying an extensive set of prudential requirements to microfinance institutions might not be appropriate, but it would be appropriate to require them to be licensed and to file an annual or semi-annual return with their regulator. This reporting would provide indications regarding the growth of the subsector and individual companies within it. Once the activity passes a certain threshold and becomes systemically more important, the regulatory and/or supervisory regime could be intensified, either for some individual institutions or for subgroups within the sector.

57. Decisions on regulatory intensity have two sorts of impact on the capacity constraints. The first one is direct and unrelated to the supervisory structure. A lighter regulatory regime should be accompanied by a lighter supervisory regime. Both off-site monitoring and on-site inspections could be less intense for smaller, less risk-prone sectors. Up to a certain point of development of the sector, the latter could even be ignored completely. Such “supervision-light” approach should result in less pressure on staff, and therefore alleviate the capacity constraints somewhat.

58. The second one is indirect and runs through the supervisory structure. Economies of scope can be reached if a country’s supervisory structure is such that similar approaches to regulation and supervision are grouped in the same agency. There could be more cross-fertilization of skills among supervisory staff. With some additional training, bank supervisors (on- or off-site) could also be part of teams that supervise other deposit taking institutions. The latter could learn basic supervisory techniques from their colleagues in bank supervision. These factors, in conjunction with a lower intensity of supervision of some sectors could reduce the need for additional staff. Thus, economies of scope are another motivation for aligning supervisory structures with country needs in developing countries, in addition to economies of scale.

59. In adopting a regulatory strategy it is important to bear in mind that regulatory scope and intensity have a direct bearing on the costs of regulation. Goodhart (1988) identifies both direct and indirect costs. The direct costs are mainly the resources costs (staff, equipment, equipment, equipment, equipment, equipment). For instance, there is a broad consensus by now that deposit taking institutions, other than banks, should have a lighter regulatory regime than banks (e.g., lower minimum capital, perhaps lower capital requirements,). On credit cooperatives, see Cuevas and Fischer (2006, forthcoming).

18 For instance, there is a broad consensus by now that deposit taking institutions, other than banks, should have a lighter regulatory regime than banks (e.g., lower minimum capital, perhaps lower capital requirements,). On credit cooperatives, see Cuevas and Fischer (2006, forthcoming).

19 This strategy should, of course, ensure that the playing field for several groups of institutions remains level.

20 Scope economies can mainly be realized in the deposit taking sectors. The argument is less applicable in, for instance, insurance, securities and pensions supervision.

21 On the costs of regulation, see also Goodhart (1999) and, in the context of institutional restructuring, Llewellyn (2006).
buildings). The entire purpose of supervisory restructuring is to contain them (scale economies). However, in the context of SSA developments, the indirect costs are extremely relevant: regulation could reduce competition and stifle innovation. In Africa’s fledgling financial systems, regulatory intensity should be such that it does not kill new avenues to finance. The fact of being unregulated has certainly brought some sectors in some countries a certain degree of success in that it has provided access to finance for social groups that have no access to the regulated system. In bringing them under the regulatory umbrella, a balance needs to be struck between containing the risks that a sector poses and allowing it to grow and bring competition and innovation. These considerations suggest that the primary focus of regulation should be on the risks to financial stability presented by a particular sector, and that the regulatory burden on other sectors should be kept as light as possible to allow the process of financial deepening to progress.

The role of the central bank

60. A final issue to be considered, before discussing some specific supervisory models, is the role of the central bank in the supervisory structure. In the specific case of SSA, there are some strong arguments for central banks to remain involved in financial sector supervision. At SSA’s current stage of development, these arguments are more convincing than some of the standard arguments against keeping monetary policy and supervision under one roof. In line with Goodhart (2002), we see three major arguments for having the central bank involved in the regulatory process.

61. The first one is that, despite the trends in the SSA financial sectors discussed earlier (the growth of several non-bank segments), it can reasonably be expected that the banking sectors will remain the dominant segment in the financial systems. Moreover, as Table 2 shows, in a large number of countries, the central banks are currently responsible for banking supervision. This role is partly the result of historical factors, but also reflects the synergies between banking supervision and monetary policy which are particularly important in bank-dominated financial systems. There are also important informational advantages in having banking supervision and monetary policy in the same institution, as the information collected for the two purposes overlaps to a great extent. Hence, the combination of the synergies between monetary policy and banking supervision, and the expectation that banks will remain dominant justifies a continued supervisory role for the central banks.

62. The second reason why the central bank needs to be more closely involved in regulation in a small developing economy than in an advanced country is that developing economies are more prone to periods of financial instability, or even financial crises. This places a particularly high premium on the strength and effectiveness of crisis management arrangements. The central bank is an indispensable part of these arrangements, both because

---

22 Llewellyn (2006) notes that these indirect costs—which are difficult to measure—could rise even if the direct costs are reduced. Admittedly, this can happen in any supervisory structure, i.e. with or without separate regulators.

23 See also Llewellyn (2006, p 128 – 132) for a review of these arguments.

24 Masciandaro (2005) refers to this as the “endowment effect.”
of its traditional lender of last resort function and also because it often possesses the greatest 
expertise in the financial sector. Most ministries of finance, especially in developing 
economies, lack the skilled and experienced staff to be able to take on a lead role in crisis 
management. By contrast, there is a greater likelihood that, if these resources are to be found 
anywhere, they are to be found in the central bank. Thus, keeping a meaningful role for the 
central bank facilitates coordination at times of crises—including an easier collection and 
exchange of information—and increases the likelihood that high quality staff can be hired 
and trained.

63. The third reason—arguable the strongest one—is that in many developing countries 
central banks are often one of the few reputable institutions with a reasonable degree of 
independence from the political process and also from commercial interests. Several 
advantages come with this reputation and independence.

- First, typically only the central bank has the financial resources and budgetary 
independence to ensure that regulation is adequately funded. The alternative is to 
have the regulatory agency funded by an appropriation from general government 
revenue, an approach which is almost universally a recipe for ensuring that the 
regulator lacks the resources necessary to perform its tasks with appropriate 
independence and professionalism. The approach used in some advanced markets, in 
which the unified regulator is funded by a levy on the regulated industry, is 
impractical for many small developing economies. Their financial sectors often lack 
the profitability to be able to support a direct levy of this type, and in many cases it 
would leave the regulator dependent on a handful of large, and politically-influential, 
institutions for its main revenue source.

- Second, their status allows them to attract and retain the best staff, and pay salaries at 
close to market levels, which creates a virtuous cycle with higher quality staff leading 
to higher credibility for the institution, which in turn strengthens its independence.\(^\text{25}\) 
Despite lingering problems with independence and quality in some countries, central 
banks are very often the only agency in a country that brings these qualities together. 
So establishing a new agency that is properly funded, has the same quality of staff, 
enjoys credibility and independence will in most cases be a very challenging 
undertaking. Mwenda’s (2004) analysis of the new supervisory agency in Zambia 
clearly testifies to these problems. Among the main problems, he cites the fact that 
the Pension and Insurance Authority has no political or budgetary autonomy and that 
its staff has no legal immunity. These features put the agency in a weak starting 
position and will make it very hard to bring its regulation and supervision to the level 
exercised by the central bank.

- If banking supervision remains a central bank responsibility for the above reasons, the 
central bank can also reap some scale and scope economies if some other sectors with 
bank-like features are also brought under its supervisory umbrella.

\(^{25}\) Even then, many of these central banks are often confronted with a loss of staff—mainly 
supervisors—often moving on to better paid positions in the financial sector.
From a practical point of view, few developing countries can afford the creation of another agency with the same quality level and independence as the central bank, or more broadly, cannot afford a complex and costly regulatory system. Hence, there are few realistic alternatives to providing the central bank with a role in banking supervision in many developing countries, and its role may need to be extended to cover other sectors and sub-sectors if other credible regulators are difficult to create.

In the case of SSA—and developing countries more generally—these arguments for keeping the central bank in the supervisory process seem to outweigh the often cited drawbacks of keeping monetary policy and supervision under one roof. In any case, that debate (see, among others, Goodhart and Schoenmaker (1995) for a summary of the main arguments for and against) has always been relatively inconclusive because many of the arguments in favor of separation (too powerful an institution otherwise, conflict of interest, and regulatory failure compromising the authority of the central bank in other fields) either have their counterarguments, or can be addressed at the institutional level. For example, concerns about excessive concentrations of power can be addressed through proper accountability mechanisms, and the conflict between banking supervision and monetary policy can be handled through separate governance structures.

C. A typology of possible models

The previous analysis enables us in this final section to review some possible supervisory models that could meet the needs of a large number of countries in SSA, if and when they decide to revisit their supervisory structures. One of the conclusions of the previous section is that, if countries are restructuring, preferably, there should be and remain a role for the central bank in the supervisory process—certainly in those countries where central banks already have a supervisory role. In the case of developing countries, the arguments for taking (banking) supervision out of the central bank are rather weak at this stage of their financial system development.

Without aiming to be exhaustive, this section identifies five possible models—four with central bank involvement, and one without (table 4). Pros and cons of these models are reviewed in the light of the analysis in the previous section. One model would be unification of all supervision within the central bank (also called the Singapore model). The second one represents a structure whereby there the supervisory agency has logistical and budgetary links to the central bank, but from a governance point of view the agency operates at arm’s length from the central bank. Several variations of this model exist but we have called it the Irish model. Models three and four are bi-polar models with the central bank retaining or acquiring supervision over some sectors and another multi-sectoral agency taking the other ones. The fifth model is the “FSA model” with a unified supervisor outside the central bank.

Model 1. The unification of all supervisory functions inside the central bank has several advantages. New supervisory activities could benefit from the existing ones (scope and scale economies); there would be no regulatory gaps and regulatory scope and intensity could be build up smoothly—there would be no contentious inter-agency issues. In addition the supervisor could benefit from the central bank’s infrastructure, budget, expertise and also

---

26 This argument has been used for small economies more generally—see McDowell (2001).
from the institution’s prestige and independence (if it is independent). Crisis management would be facilitated as well.

Table 4: Overview of advantages and disadvantages of selected supervisory structures

<table>
<thead>
<tr>
<th>Structure</th>
<th>Advantages</th>
<th>Disadvantages</th>
</tr>
</thead>
<tbody>
<tr>
<td>Unified inside CB (Singapore model)</td>
<td>No regulatory gaps</td>
<td>Moral hazard (LLR etc)</td>
</tr>
<tr>
<td></td>
<td>Not contentious</td>
<td>All burden on CB</td>
</tr>
<tr>
<td></td>
<td>CB logistical support</td>
<td>CB very powerful</td>
</tr>
<tr>
<td></td>
<td>Benefit from CB independence, prestige, budget, expertise</td>
<td>CBs are typically small – capacity limitations</td>
</tr>
<tr>
<td></td>
<td>Financial stability is for CB</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Economies of scale</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Crisis management unified</td>
<td></td>
</tr>
<tr>
<td>Separate agency sharing</td>
<td>CB logistical and budgetary support</td>
<td>Will require expansion of CB staff/budget</td>
</tr>
<tr>
<td>infrastructure of CB (“Irish model”)</td>
<td>Benefits from CB expertise</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Indirectly benefits from CB prestige</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Economies of scale</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Financial stability</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Close to, but not in CB, therefore no moral hazard, no institution that is</td>
<td></td>
</tr>
<tr>
<td></td>
<td>too powerful (unless perceived as such)</td>
<td></td>
</tr>
<tr>
<td></td>
<td>No regulatory gaps</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Crisis management unified</td>
<td></td>
</tr>
<tr>
<td>Partially unified A (only banks in CB)</td>
<td>CB responsible for banks (financial stability, monetary policy argument)</td>
<td>Possibility for regulatory gaps remains</td>
</tr>
<tr>
<td></td>
<td>CB not involved too much in all sectors (remains small and not too powerful)</td>
<td>Startup problems for other agency (see above)</td>
</tr>
<tr>
<td></td>
<td>Burden on CB limited</td>
<td>Crisis management coordination needed</td>
</tr>
<tr>
<td></td>
<td>Limits contentious issues (with MOF for instance)</td>
<td>Transfer of responsibilities is needed when nonbank deposit taking institutions become banks</td>
</tr>
<tr>
<td>Partially unified B (all deposit taking</td>
<td>No regulatory gaps in most important subsectors from financial stability</td>
<td>Startup problems for new agency (capacity, prestige,....)</td>
</tr>
<tr>
<td>institutions inside CB)</td>
<td>point of view</td>
<td>Possibility of regulatory gaps remains but is more limited</td>
</tr>
<tr>
<td></td>
<td>No moral hazard issues</td>
<td>Crisis management coordination needed</td>
</tr>
<tr>
<td></td>
<td>Banks and other deposit taking institutions in continuum, no regulatory</td>
<td></td>
</tr>
<tr>
<td></td>
<td>gaps, level playing field can be better guaranteed</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Limits contentious games</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Financial stability argument (Key sectors in CB)</td>
<td></td>
</tr>
<tr>
<td></td>
<td>CB not too powerful</td>
<td></td>
</tr>
<tr>
<td>Unified outside CB “FSA model”</td>
<td>CB is not too powerful</td>
<td>No tradition – has to start from scratch</td>
</tr>
<tr>
<td></td>
<td>No moral hazard issues</td>
<td>Capacity building</td>
</tr>
<tr>
<td></td>
<td>Economies of scale</td>
<td>Coordination of crisis management with CB still needed</td>
</tr>
<tr>
<td></td>
<td>No regulatory gaps</td>
<td></td>
</tr>
</tbody>
</table>
68. On the downside, the country would be faced with an extremely powerful institution. Some scholars see this as a potential drawback, although solid accountability arrangements should be able to keep this institution “under control” (Hupkes, Quintyn and Taylor, 2005). In addition, all the drawbacks listed in the literature on bank supervision in or out of the central bank (conflicts of interest, moral hazard) would apply here but could be overcome by setting up an appropriate governance structure within the central bank.

69. **Model 2.** The Irish model has most of the advantages of Model 1, but none of the drawbacks and therefore seems to be a model worth studying in developing countries. Under this model, the supervisory function is closely linked to the central bank, and yet remains at arm’s length. The supervisory agency is legally separate from the central bank, is established under its own statute and has its own governing board, separate from that of the central bank (although there may be some overlap in membership of the two boards). However, the regulatory agency shares the infrastructure of the central bank (premises, IT systems, data collection) and its staff are employees of the central bank, on the same terms and conditions as other central bank staff. This construction has the advantage that supervision can benefit from the central bank’s logistical and budgetary support (scale economies with the central bank, and scale economies as a unified supervisor). Since it is assimilated with the central bank, it can even benefit from the central bank’s prestige and independence. Because, on the other hand, there is a distance with the central bank, the construction escapes the often listed conflict of interest and moral hazard issues of supervision being too close to monetary policy.

70. In the original Finnish version of this model the regulatory agency with close links to the central bank is responsible for banking and securities regulation, with a separate, stand-alone, multi-sectoral agency responsible for the other sectors. However, in Ireland the supervisory agency was established as a unified supervisor with responsibility for supervising all financial sectors. As a unified supervisor, it can plan a strategy for regulatory scope and intensity, while avoiding any regulatory gaps. Crisis management should be easy to arrange, given the proximity of the central bank. As such, this is a model that deserve close attention. Variations exist. A similar model exists for banking supervision alone in France, Poland and South Africa, where the governance structure for banking supervision is different from the one for monetary policy.

71. **Model 3.** The third model is a bi-polar or partially unified model. It leaves banking supervision with the central bank and regroups supervision of all other sectors in a separate agency—often to be newly established. The main advantages of this model are that the central bank remains involved in the key sector—banking—which is also expected to remain the key sector for some time to come in most SSA countries. Crisis management (at least for banking problems) and coordination with financial stability remain guaranteed and bank supervision can benefit from the central bank’s infrastructure, independence and prestige.

27 For example the Governor or Deputy Governor of the central bank might serve on the board of the regulator in an ex officio capacity.

28 Implementation of this model may require legal changes, which are not always easy to make. In Swaziland, for instance, this model was considered seriously, but the legal framework prevents the central bank from establishing subsidiaries, and changing the legal framework was considered too difficult (FIRST Initiative (2004)).
Moreover being in the central bank brings guarantees of reasonable salaries and high quality staff. On the other hand, the conflict of interest and moral hazard issues stemming from having banking supervision and monetary policy under one roof remain.

72. Success of this model largely depends on the way the other supervisory agency is set up and operates. The institution has usually to be built up from the ground and needs to be endowed with an appropriate governance structure and budgetary autonomy in order to be an independent and effective supervisor. In many developing countries it has proven extremely difficult to establish new agencies without political interference, and to staff them with competent people. As an example (see above), Mwenda (2004) observes that the Pension and Insurance Authority in Zambia lacks many features that could make it an independent and therefore effective supervisor, such as the fact that the registrar is nominated by the minister of finance, has reporting lines to the permanent secretary who also has budgetary control and that staff has no judicial immunity.

73. This model has other drawbacks as well: (i) crisis management coordination with the central bank is not automatic; (ii) some deposit-taking institutions or bank-like entities will be outside the scope of the central bank’s supervision, and yet they might be significant from a financial stability perspective; (iii) the agency may lack adequate funding and resources, especially if it has to rely on appropriations from the general government budget. On the positive side, the agency can gradually widen its regulatory scope and vary its intensity since it is responsible for all sectors excepting the banking sector.

74. **Model 4.** This model differs from the previous one in that all deposit taking activities (including, for example, credit cooperatives and microfinance institutions) are supervised by the central bank and all other financial sectors by a newly established agency. In addition to the advantages listed for model 3, this model has the added advantage that, the central bank supervises the institutions that are most likely to be significant from a system stability perspective. It can therefore decide on the regulatory scope and on the regulatory intensity (and aim for a level playing field) for these sectors, and hence, benefit from scale and scope economies in its operations. Transitions among deposit taking institutions are also facilitated, e.g. if a credit cooperative or a microfinance institution “graduates” to become a bank. Also, regulatory gaps in the deposit taking business are eliminated in this model.

75. The issues discussed above for model 3 with respect to the establishment of a separate agency from scratch are the same in this case. However, the advantage of this model is that it brings the supervision of all banks and bank-like entities together under one roof in the central bank. The new agency has a wide(r) variety of types of institutions in its supervisory net, but scale economies can be reaped nonetheless.

76. **Model 5.** The unified regulator (outside the central bank)—the FSA model—seems the least desirable for developing countries. As discussed earlier, the conglomerates argument and the blurring of boundaries-argument are not applicable in largely bank-dominated financial systems. Moreover, not involving the central bank in the supervisory process and instead starting a new institution from scratch with all the problems that go with it will be very demanding in terms of institution and capacity building. The only advantages with this model are that (i) economies of scale can be realized—although it may take some time for them to become apparent given the extent of institution building that is required; (ii) there will be no regulatory gaps; (iii) the central bank will not be too powerful and there will be no moral hazard problems in the central bank.
77. On balance, the two models that seem to have most to recommend them in the circumstances of SSA are the Irish (or Finnish) model and the bipolar model with the central bank supervising all deposit taking institutions:

- Both models take advantage of the central bank’s prestige and capacity, which makes capacity building (and retention) easier and faster. As discussed earlier, it is easier for a central bank with an established reputation to attract new staff;

- Both keep the most systemically significant financial activities (as defined above) within the central bank. With this, it allows the central bank to work out a supervisory strategy around regulatory scope and intensity and at the same time enjoy scale and scope economies;

- Both allow for crisis management coordination and for coordination with financial stability policies within the central bank;

- The bi-polar model allows the other (new) institution to build up capacity smoothly (the to-be-supervised sectors are typically still small) and establish its own supervisory culture. Transfer of personnel from the central bank to the new agency can be minimal, so the cultural adjustment will be minimal too.

- Regulatory gaps can be completely avoided in the Irish model and are very unlikely in the other model because there is a relatively clear boundary between the types of activities supervised by both institutions.

78. As indicated, country specific circumstance may always justify the selection of another model, either one of those discussed above, or another country-specific one. This paper only intended to guide the debate somewhat by shedding light on the most critical issues in the selection process and highlight pros and cons of potential models.

IV. CONCLUSIONS

[to be written]
V. REFERENCES


FIRST Initiative, 2004a, Swaziland: Supervision of Nonbank Financial Institutions – An Initial Assessment and Proposed Strategy (Carmichael Consulting Pty Limited),


Kim, Daesik, Kyung Soo Kim, Hong-Bum Kim and Seok Won Lee, 2002, “Suggestions to Improve Deposit Insurance System in Korea” (unpublished report commissioned by the Korea Money and Finance Association), December.


