Evaluating Banking Supervision in Africa
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Abstract
This paper develops a framework for evaluating the effectiveness of banking supervision in Africa. Assessing and strengthening banking supervision is important given the important role of supervision in promoting financial stability and minimizing the costs of banking crises, including disruptions to economic activity and the financial burden of failure resolution on tax payers. In addition, strong banking supervision enhances the relevance of the banking system to the economy at large as only a stable and robust banking system will be capable of contributing maximally to economic growth and poverty alleviation.

The paper uses a case study of a fictional African country named Sahara Republic to provide a practical illustration of the most important aspects of evaluating the effectiveness of banking supervision in African countries. The proposed evaluation framework does not involve ratings and is designed as a diagnostic tool for Task Managers who need to conduct an evaluation of banking supervision without the luxury of a full Basle Core Principles (BCP) Assessment. Given the fact that the Bank and the Fund normally perform the BCP compliance assessment exclusively under the Financial Sector Assessment Program (FSAP) or the Off-Shore Financial Center Program, this framework could be particularly useful in conducting stand-alone assessments of banking supervision in African countries where no FSAP/OFC is planned (or relevant) in the near future or where time and budget do not permit a full independent BCP assessment.

The framework outlined here also complements a regular Basle Core Principles (BCP) assessment by providing explicit coverage of issues such as: i) the implications of the macroeconomic environment and financial sector infrastructure for banks and supervisors; ii) contingency planning, crisis management and failure resolution; iii) supervisory independence and governance; and iv) the effectiveness of safety nets.

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The findings, interpretations, and conclusions expressed in this paper are entirely those of the author(s), they do not necessarily represent the views of the World Bank Group, its Executive Directors, or the countries they represent and should not be attributed to them.
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by

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Table of Contents

1. Introduction .......................................................................................................................... 1
2. Institutional Framework for Banking Supervision in Sahara ........................................... 2
3. Macroeconomic Environment and Financial Infrastructure .......................................... 5
4. Legal and Regulatory Framework ..................................................................................... 8
5. Supervisory Process and Practices .................................................................................. 13
7. Contingency Planning, Crisis Management and Failure Resolution .............................. 19
8. Recommendations for Strengthening Supervisory Capacity in Sahara ......................... 21

Bibliography............................................................................................................................. 29

List of Annexes

Annex 1: Suggested Outline for Evaluating Banking Supervision ........................................ 27

List of Tables

Table 1: Violations of Prudential Regulations (10 AD) ........................................................... 12
EVALUATING BANKING SUPERVISION IN AFRICA

1. INTRODUCTION

Assessing the strengths and weaknesses of the bank supervisory framework is critical in developing (and developed) countries given the important role of supervision in promoting financial stability and minimizing the costs of banking crises, including disruptions to economic activity and the financial burden of failure resolution on tax payers. In addition, strong banking supervision enhances the relevance of the banking system to the economy at large as only a stable and robust banking system will be capable of contributing maximally to economic growth and poverty alleviation. With the emergence of international benchmarks in the form of the Basle Core Principles of Effective Banking Supervision, many countries are conducting systematic analysis of different facets of banking supervision as an important first step towards identifying deficiencies and implementing appropriate remedial measures. The World Bank and the IMF have taken a front-seat in conducting Basle Core Principles (BCP) Assessments under the Financial Sector Assessment Program (FSAP) or the Off-Shore Financial Center (OFC) Program.

This paper uses a case study of a fictional African country named Sahara Republic (henceforth Sahara) to provide a practical illustration of the most important aspects of evaluating the effectiveness of banking supervision in African countries\(^1\). Where applicable, the analysis also makes use of a fictional time frame, with the time period under consideration specified as 01 AD to 10 AD\(^2\). The local currency is the donge.

The proposed evaluation framework does not involve ratings and is designed as a diagnostic tool for Task Managers who need to conduct an evaluation of banking supervision without the luxury of a full BCP Assessment. Given the fact that the Bank and the Fund normally perform the BCP compliance assessment exclusively under the FSAP or the OFC Program, this framework could also be particularly useful in conducting stand-alone assessments of banking supervision in African countries where no FSAP/OFC is planned (or relevant) in the near future or where time and budget do not permit a full independent BCP assessment.

The framework outlined here also complements a regular Basle Core Principles (BCP) assessment by providing explicit coverage of issues such as: i) the implications of the macroeconomic environment and financial sector infrastructure for banks and supervisors; ii)
contingency planning, crisis management and failure resolution; iii) supervisory independence and governance; and iv) the effectiveness of safety nets.

The rest of the paper is organized as follows: Section 2 presents an overview of the institutional arrangements for banking supervision in Sahara Republic while Section 3 provides an analysis of the implications of macroeconomic conditions and financial sector infrastructure for banks and bank supervisors. Section 4 describes the legal and regulatory framework underlying banking supervision in Sahara. Section 5 evaluates supervisory processes and practices, followed by an assessment of the financial safety net in Section 6. Section 7 describes the arrangements for contingency planning, crisis management and failure resolution while Section 8 offers relevant recommendations for strengthening the effectiveness of banking supervision in Sahara. Annex 1 provides a checklist of issues to be covered in evaluating the effectiveness of banking supervision in Africa.

2. INSTITUTIONAL FRAMEWORK FOR BANKING SUPERVISION IN SAHARA

Under the Sahara Central Bank Act (SCBA) of 03 AD and the Financial Institutions Act (FIA) of 04 AD, the Sahara Central Bank (SCB) is charged with the regulation and supervision of all financial institutions in the Republic, with the exception of pension funds and insurance companies, which are under the oversight of the Retirement Benefits Commission (RBC) and the Sahara Insurance Commission (SIC) respectively. The Deposit Insurance Act of 04 AD also gives the Sahara Deposit Insurance Corporation (SDIC) powers to collaborate with the SCB in the regulation and supervision of insured banks and also play an active role in the resolution of problem banks.

A significant and disturbing gap in the framework for financial supervision is the total absence of prudential oversight for a wide range of non-bank financial institutions (NBFIs), including 5 finance companies, 2 development banks, 2 leasing firms, 7 mortgage companies, and 4 micro-finance institutions. Although these institutions are not formally licensed as “banks”, many of them engage in what could be termed “banking activities”, including the mobilization of deposits from the public. Although these NBFIs jointly account for less than 3% of total financial assets, they are potential sources of vulnerabilities in the system given their increasing linkages with the banking industry and the potential adverse impact of any crisis on public confidence in financial intermediaries in general.

The SCB conducts supervision through the Banking Supervision Department (BSD), headed by a Director of Banking Supervision, who reports directly to the SCB Governor. The BSD is organized into off-site surveillance and on-site examination divisions. There is a small follow-up unit which operates within the off-site surveillance division. The BSD currently has 20 professional supervisors (including 5 members of the Department’s management) plus 10 support staff. 12 supervisors are in the off-site division, with the other 8 involved in on-site examinations. This distribution of supervisory staff is not optimal given

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3 Finance companies, mortgage companies, development banks and micro-finance institutions all mobilize deposits from the public. These NBFIs currently operate with a license from the Ministry of Finance.

4 Finance and leasing companies fund their activities with borrowings from the banking system.
the labor-intensity of the on-site function and the need for more qualified hands to conduct bank examinations. Most SCB supervisors have relatively little experience with about 4-5 years of supervision experience on average.

The available human capacity pales in comparison to the number of financial institutions that require oversight. Following the liberalization of the financial system, Sahara experienced a steady growth in the number of banking institutions from only 4 commercial banks in 04 AD to 21 as at end-10 AD. There are also 2 state-owned development finance institutions (DFIs), 5 finance companies, 2 leasing companies, 4 micro-finance institutions, 7 primary mortgage institutions (PMIs), and 25 bureaux de change which are not being actively supervised at the moment but will require SCB oversight in the nearest future.

This expansion of financial intermediaries is imposing a great burden on the BSD and has impeded its ability to provide effective oversight. In addition, poor and non-competitive conditions of service for bank supervisors (salary and benefits) has made it difficult for the SCB to compete with the private sector in attracting skilled staff. Staff turnover is consequently very high as banking supervision staff (and SCB staff in general) are prime targets for recruiters from the rapidly expanding banking industry.

As a supervisory agency, the SCB does not have a formalized mission statement and this has hampered the development of clear objectives, responsibilities, priorities and strategies in promoting financial stability. Not surprisingly, supervisory activities have often come into conflict with the broader developmental responsibilities vested in the SCB by the Central Bank Act\(^5\). The lack of clearly stated objectives has also made it difficult to assess the performance of bank supervisors in terms of measurable goals and indicators\(^6\).

SCB’s organizational structure does not appear to promote the effective discharge of its supervision responsibilities. In 02 AD, it adopted a matrix organizational structure, which was implemented despite a low level of buy-in from staff. As a result, many staff members appear unsure of lines of reporting and communication and it has been difficult to assign responsibilities and accountability. Coordinated work between off-site and on-site divisions and between banking supervision and other SCB departments (e.g. banking operations) has also been difficult.

As a supervisory agency, the SCB is invested with a range of powers including: i) authority to license and withdraw bank licenses; ii) authority to issue prudential regulations and standards; iii) authority to obtain periodic returns in its preferred format, content and periodicity; iv) authority to conduct on-site inspections; v) authority to take corrective actions and impose sanctions; and vi) authority to close and initiate liquidation of banks.

However, there are other legal provisions which circumscribe the ability of the SCB to exercise these powers, creating a worrying disconnect between its legal mandate and its legal authority. For instance, the decision of the SCB on licensing new banks is subject to the final approval of the Minister of Finance and perhaps more alarmingly, the decision of the

\(^5\) For instance, the SCB has often prevented banks from closing unprofitable branches, especially in rural areas.

\(^6\) Sharing supervisory powers with the MoF also makes it difficult to determine who is accountable for the effectiveness of banking supervision (see below).
SCB to suspend or withdraw a bank’s license can be appealed to the Minister of Finance whose subsequent decision is final and irrevocable. The Minister also has the powers to approve branch and merger applications, issue additional prudential regulations and grant exemptions to regulations.

This situation raises a host of issues relating to SCB’s independence as a supervisory agency. Overall, we see a mixed picture regarding the autonomy of the supervisor. Although the Central Bank Act is silent on the independence of the central bank in carrying out its supervisory as well as monetary policy functions, there is substantial evidence that the SCB has been largely independent in discharging its supervisory functions. It has surprisingly been able to operate without undue political pressures, as demonstrated by its track record of interventions in problem institutions. Over a period of two years (07-09 AD), the SCB closed four insolvent banks, namely Deadwood Commercial Bank, Flotsam International Bank, Jetsam Commercial Bank, and Moonshine Bank. Also, in the last five years, SCB received a total of 25 applications for bank licenses and rejected 13 without any interference from the Minister of Finance who is the final authority on granting licenses. In recent years, successive Ministers have shown a greater tendency to use their powers in interfering with SCB’s formulation and implementation of monetary policy (particularly interest rate and exchange rate policy) than with the conduct of banking supervision. This may be partly explained by the fact that following financial reforms, state-owned banks were privatized and the banking system is now predominantly private. The three remaining state-owned banks are small, currently accounting for a mere 2% of banking sector assets.

Other indicators of independence show a similarly mixed picture. Although supervisory staff have immunity from prosecution or civil lawsuits arising from acts legitimately and faithfully performed in the course of their duties, the SCB as an institution can be sued. This has the potential to discourage it from taking firm enforcement actions against violators of prudential regulations. The SCB however has complete financial independence and the operating budget for banking supervision is regarded as adequate although the emerging strains on capacity suggest a need to increase budgetary allocations, especially to recruit and train staff and also to update information technology.

The SCB is ultimately accountable to the Sahara Government and only the President can appoint or remove the SCB Governor. The Governor has a term appointment of 5 years, which enhances autonomy. Parliament is currently considering proposed amendments to the SCB Act, including a requirement for the President to publicly disclose reasons for removing any SCB Governor. The Presidency has the power to conduct annual reviews of SCB’s performance in all its functional areas including the supervision of financial institutions but this has usually been limited to the discussion of the SCB’s Annual Report within the Presidential Cabinet Committee on Banking and Financial Affairs.

The SCB is a member of the Financial Sector Oversight Council (FSOC), a regulatory coordinating body chaired by the Minister of Finance which also includes the Chief Executive Officers of the SDIC, the Securities Markets Authority (SMA), and the Sahara Insurance Commission (SIC). Membership of the FSOC allows the SCB to share information.
and resolve disputes with other domestic supervisory agencies. Due to the recent approval of Universal Banking by the SCB and the subsequent entry of commercial banks into capital market and insurance activities, there is currently some tension between the SCB and the SMA over the prudential oversight of banks engaging in capital market activities. The SCB has strongly rejected SMA claims that it is legally bound to inspect banks involved in capital market activities and the matter has now been referred to the FSOC for adjudication. In 08 AD, the Insurance Commission signed a Memorandum of Understanding agreeing to sole SCB oversight over banks engaged in insurance activities.

*Training and staff development arrangements* for bank supervisors in Sahara are currently inadequate. The existing training program and training budget are centralized within the overall SCB Human Resources Department and are both insufficient in meeting the special needs of bank supervisors. There is no formal curriculum for bank supervisors and training of staff is sporadic and often *ad hoc*. Many staff have not taken any formal training course in over four years. The level of computer literacy is relatively low and there is a shortage of skills in several key areas, including credit analysis, loan portfolio reviews, consolidated supervision and failure resolution. Supervisors also show a limited understanding of recent developments in the banking industry and supervisory knowledge lags far behind current practices in the fast-changing banking industry. This situation has compromised the ability of the BSD to respond adequately to new challenges. The fact that changes in the legal and regulatory framework considerably lag changes in banking practices further compounds the problem.

At present, banking supervision is not seen as a distinct career within the SCB and good supervision staff are often rotated to other departments after only a few years. This leads to an internal loss of specialized and scarce supervisory skills and it is difficult to count on a fairly stable pool of professional supervisors. The poor skill base among supervisors has considerably eroded SCB’s credibility among banking institutions and the level of compliance with prudential rules and regulations has dropped substantially over the past few years (see Section 4).

### 3. Macroeconomic Environment and Financial Infrastructure

**Macroeconomic Conditions and Banking Activity**

The operations of the Sahara banking system is currently affected by five key factors: i) policy instability; ii) high inflation; iii) large fiscal deficits; iv) substantial government arrears; and v) high domestic interest rates/spreads.

*Macroeconomic policies* in Sahara do not encourage the orderly operation of banking institutions as the government has become notorious for the instability, inconsistency and unpredictability of its financial and economic policies. For instance, interest rate policy has

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7 There is currently no mechanism in place for sharing information with foreign supervisory bodies as there are no foreign banks in the system and Sahara banks are not active internationally.
been changed five times in the past three years, with the government oscillating between liberalizing and controlling deposit and lending rates. The liberalization of interest rates in 05 AD was followed by the re-imposition of a ceiling of 18% on lending rates and a floor of 9% on deposit rates in 07 AD. Rates were again freed in 08 AD only to be capped again in 09 AD. Rates were yet again freed in December 10 AD and even though there are few signs that the authorities will re-introduce controls, many economic agents are operating on the assumption that this is highly likely. This situation has resulted in a high degree of uncertainty, has complicated strategic planning by most banks and shortened the time horizon of most economic agents.

*Fiscal deficits* which peaked at 7.7% of GDP in 09 AD are largely financed by the banking system which is forced to hold substantial amounts of treasury bills to satisfy reserve requirements. As at December 10 AD, domestic government debt stood at 25.8% of GDP, with the central bank and commercial banks holding a combined 95% of the total. Fiscal indiscipline also means that monetary policy tries to compensate for liquidity injections from government expenditures. Liquidity ratios for banks are relatively high at 35% of total liabilities which restricts the ability of banks to determine portfolio composition. Holding large amounts of treasury bills has also diverted banks from normal lending activities and is beginning to weaken their ability of banks to conduct rigorous credit appraisals.

Another source of vulnerability is the significant levels of government arrears and unpaid bills to suppliers and contractors, most of them small and medium-sized firms. Many of these firms have subsequently run up large overdraft balances with various banks. This problem is widespread, affecting businesses who deal with the central government as well as the state and local governments. Not surprisingly, many of these firms have difficulties with servicing debt obligations. Especially affected is the construction industry, where the central government owes over D60 billion to local construction firms for several projects. It is estimated that over 10,000 construction workers have been laid off in the past two years and another 2,000 placed on half-shift as a direct result of the central government’s unpaid bills. There are no reliable estimates on arrears outstanding with other tiers of government although this is suspected to be quite substantial.

As measured by the Consumer Price Index (CPI), inflation in Sahara is high at 30% per annum. This has complicated the task of banks in assessing credit and other risks and has particularly made it difficult to determine collateral values.

Treasury bill rates are currently high with *nominal 3-month treasury bill rates* at 45.5% (15% in real terms) as of December 10 AD. Lending rates are consequently high, standing at 55.4% in 10 AD and *interest rate spreads* are also large, standing at 25.3% as at end-10 AD. This situation is beginning to stretch the ability of many bank borrowers to meet their obligations and the banking system is witnessing a rapid increase in past-due payments.

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8 These include suppliers of office supplies, military supplies (food, uniforms, beds, mattresses, etc) as well as supply of foodstuffs to boarding students in 19 Sahara Federal Government Secondary Schools.

9 01 AD=100
Financial Infrastructure

The infrastructure underlying financial sector activities in Sahara is relatively weak, significantly increasing the costs and risks of consummating financial transactions. The legal framework governing the operations of financial intermediaries and markets shows significant gaps which complicates the task of supervisors (details in subsequent sections). Notable is the lack of legal independence for the SCB in conducting its monetary and supervisory duties as well as the lack of a clear mandate to close insolvent financial institutions. The SCB is not immune from judicial review of its actions and requests for injunctions against the SCB are not uncommon. As mentioned earlier, another important gap in existing financial legislation relates to the lack of provisions for the prudential supervision of NBFIs.

Perhaps the most serious gaps relate to weaknesses in the legal framework governing contracts, property rights, debt recovery, bankruptcy and insolvency which hamper the ability of banks to lend and be able to enforce repayment on their loans. The lack of a coherent bankruptcy and insolvency law means that the rights and obligations of debtors and creditors are often unclear. Due to complications with attaching, perfecting and realizing collateral (and transferring property rights), there is a narrow range of assets acceptable as collateral. Although land is a key asset acceptable in principle to secure lending, the common practice of communal land ownership and the lack of an efficient land registry system makes its use as collateral virtually impractical.

The Companies Ordinance dates back to colonial days and is no longer relevant to current business practices in Sahara. It shows particular weaknesses in provisions relating to the incorporation of firms, disclosure of financial information, corporate governance principles as well as the bankruptcy and liquidation of companies.

Contract enforcement in Sahara is slow and inefficient. The court system is cumbersome and plagued by clogged dockets, poorly trained (and allegedly corrupt) judges, and low credibility. Many judges do not fully understand financial matters. It takes a bank about five years to obtain judgment in recovering loans or realizing collateral, at considerable financial costs. The long period of government dominance of the financial system has also created a poor credit culture, as many people became accustomed to defaulting (without penalties) on loans from state-owned banks and credit schemes. In 08 AD, the authorities established commercial courts in the capital city, Hakuna as a way of expediting consideration of commercial and financial cases but their impact has been minimal.

Accounting and auditing standards are non-existent as the newly-established Sahara Accounting Standards Board (SASB) is still in the process of drafting national accounting, auditing and disclosure standards based on International Accounting Standards (IAS). The proposed document will include Generally Accepted Accounting Principles (GAAP) for use by both financial and non-financial firms in Sahara. The poor accounting, auditing and financial reporting environment makes it difficult for banks to reasonably assess the creditworthiness of potential clients. The lack of accounting standards also makes it difficult for the bank supervisors to assess the financial condition of financial institutions themselves and in a few cases, deteriorating conditions were not detected until it was too late. The poor
accounting environment is compounded by the complete absence of “information vendors” such as rating agencies, credit information bureaux, and market research agencies. The financial press is also underdeveloped.

External audits are not sufficiently sophisticated to detect adverse changes in bank conditions due to the shortage of professional accountants and auditors and the lack of reliable auditing standards. The SCB is providing input into the accounting and financial reporting framework under development in the form of detailed disclosure requirements for banks, covering issues such as the recognition of income, valuation of assets, and the treatment of off-balance sheet transactions.

Finally, a severe shortage of relevant skills impedes the orderly functioning of the banking system and magnifies the risks associated with banking in Sahara. The rapid expansion of banks has strained the available pool of qualified and experienced bankers and banking skills are concentrated in the main cities of Hakuna and Matata. This has hampered banking activities at branches outside the main cities and many banks have been forced into making routine lending decisions at their head offices. Similarly, there is a shortage of professional accountants and auditors and the legal profession is relatively small.

Overall, weaknesses in financial infrastructure substantially increase the risks of conducting financial intermediation in Sahara, with implications for the health of banks, the conduct of prudential oversight as well as the access of the private sector to financial services.

4. LEGAL AND REGULATORY FRAMEWORK

The legal framework for banking supervision in Sahara consists of three key documents:

- The Sahara Central Bank Act of 03 AD.
- The Financial Institutions Act (FIA) of 04 AD.
- The Sahara Deposit Insurance Act of 04 AD.

In addition to these pieces of legislation, the SCB is empowered to issue regulations in carrying out its oversight functions. These regulations are further supplemented by periodic Circulars and Guidelines which the BSD employs in the routine discharge of its supervisory responsibilities. Main regulations and guidelines issued to date include:

- Financial Institutions Regulations (FIR) of 06 AD which sets out conditions of entry and exit for the banking industry.
- Foreign Exchange Regulation of 06 AD
- Prudential guidelines on the management of risk assets, classification of loans and other risk assets, provisioning for losses and accrual of interest.
• Guidelines on measuring capital adequacy
• Guidelines on concentration of credit and other exposure limits

As mentioned earlier, the SCB shares supervisory responsibilities with the Minister of Finance who has the final say on the granting or withdrawal of bank licenses and the powers to approve branch and merger applications, issue additional prudential regulations and grant exemptions to regulations.

Prudential Controls and Limits

Minimum Paid-up Capital. As specified in the FIA of 04 AD, the minimum paid-in capital for banks in Sahara is D1 billion, with new banks subject to a higher threshold of D2 billion. These requirements have been in place for more than five years and efforts are currently underway to review these prescriptions in the face of inflation and the continued depreciation of the donge. There are proposals to either link the capital levels to the exchange rate or specify them as dollar equivalents only. This is a welcome development as it will ensure that the capital levels are not continuously eroded by either domestic inflation or fluctuations in the exchange rate.

Capital Adequacy Ratio. In accordance with the Basle Accord, the FIA prescribes that every bank maintain a minimum total capital of not less than 8% of its total risk-adjusted assets plus off-balance sheet risks. This is however applied on a solo basis only as the SCB does not yet conduct consolidated supervision. In addition, banks are required to maintain core capital at not less than 5% of total risk-adjusted assets plus off-balance sheet risks. A key gap in the capital adequacy regulation is that there is no requirement to deduct insider lending from the reported core capital position of banks before calculating the relevant adequacy ratios. This is a serious flaw considering the inadequacy of the current limits on insider lending (see below). There thus exists a potential for banks to overstate capital by a substantial amount. Also, the risks of operating in an environment like Sahara’s may call for higher capital adequacy ratios than prescribed by the Basle Accord. However, setting such higher ratios requires careful study so as not to unnecessarily impair the operation of banks.

Loan Classification and Provisioning. The requirements for asset classification and provisioning for troubled assets in Sahara are as follows: i) for loans especially mentioned (non-performing for 31-60 days), provisions of 5% of the outstanding loan balance are required; ii) for sub-standard category, (61-90 days overdue), the minimum reserve requirement is 10% of the outstanding loan balance; iii) for doubtful category (unpaid principal and/or interest remains outstanding for 91-180 days), the minimum reserve requirement is 50%; and iv) for loss category (unpaid principal and/or interest remains outstanding 181 or more), a 100% provision is required.

In addition to the specific provisions outlined above, there is a requirement for a general provision of 2% of total loans outstanding. Provisions are however not tax deductable in Sahara, discouraging banks from maintaining adequate levels of provisioning. Although preferential tax treatment for general provisions is not advisable, the authorities should consider tax breaks for specific provisions in order to encourage banks to set aside enough
reserves to protect against anticipated loan losses.

**Interest suspension.** Regulations in Sahara specify that all loans past due and all those classified as substandard, doubtful or loss are to be placed on a non-accrual basis and transferred into a memorandum account. Previously accrued but uncollected interest should be reversed out of income by debiting the income statement and crediting the memorandum account. Subsequent payments or collections received should be applied first to principal and second to interest. Restoration to accrual basis depends on the full settlement of all delinquent principal and interest out of funds not coming from another loan from the same bank. This provision is adequate and ensures that banks’ income statements do not overstate profits. However, SCB on-site examiners do not evaluate compliance with this requirements on a consistent basis and anecdotal evidence indicates that many banks find ways to circumvent these requirements.

**Single obligor limits.** Sahara also follows international standards in the specification of borrower limits. The limit for a single borrower or closely related borrowers is set at 25% of capital but the law does not contain an explicit definition of “closely related borrower”. Another major weakness is that both the Minister of Finance and the SCB Governor are empowered to grant exemptions in case of credit to government or credit guaranteed by government, or against government securities. There is an urgent need to eliminate existing exemptions (and the powers to grant them) particularly in the face of excessive borrowing from the banking system by state governments in the past two years, which has resulted in significant banking exposure to state governments and associated concentration of risk. Although the SCB has defined a “large exposure” as any loan amount greater than 10% of capital, there are no requirements for the regular reporting of such large exposures by banks. Also, prudential regulations do not specify required supervisory actions in case exposures of particular banks are discovered to be too large (e.g. prescribing higher capital standards).

**Insider and connected lending.** Insider lending provisions in Sahara are quite generous as the FIA prescribes that the aggregate amount of unsecured credit on an individual basis to directors, alternates, and shareholders shall not exceed 35% of capital. This definition of insiders or connected parties is too narrow as it excludes bank officials and other staff, affiliated companies, as well as companies controlled by insiders and shareholders. Family members of insiders are also not covered. There is no aggregate limit for exposure to insiders, and insider lending in general is not deducted from core capital for regulatory purposes. There are also no provisions that insider lending be done on the same terms as with outsiders.

**Foreign exchange exposure limits.** There are requirements that the overall net open position for any bank shall not exceed 20% of its capital plus reserves. Various reports on foreign exchange positions are required weekly to monitor this. This requirement is more than adequate as it is even more stringent than the norm in many countries.

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10 This covers the central government as well as state governments.
11 Loans to state and local governments increased from 3% of total loans and advances in 06 AD to 7% by end-10 AD.
Liquidity. Banks are required to maintain minimum liquid assets equivalent to 20% of demand liabilities and the gross loan portfolio must not exceed 80% of total deposits. Balances held abroad do not qualify unless they could be withdrawn on demand.

Information Disclosure. Sahara banks are subject to comprehensive disclosure requirements. They are required to publish quarterly balance sheet and income statements in newspapers of general circulation within 45 days after the end of the quarter. Audited versions of these accounts must be published annually in newspapers within 15 days after approval of the board of directors, but not later than 105 days after the end of the financial year. For all these, the BSD must receive a copy of the statements and information on where publication is to be made. There is a penalty charge of D2 million per day of non-compliance and the SCB reserves the right to impose more serious penalties including inter alia, suspension from lending and restrictions on other forms of banking activities.

Unfortunately, the integrity, accuracy and usefulness of banks’ financial statements is doubtful as there are currently no accounting standards to guide the preparation and presentation of financial statements. Independent auditors are mandated to ensure that statement of accounts prepared by banks present a true and fair view of their financial conditions but it is difficult to assess their performance in this regard given the absence of generally accepted standards. As mentioned earlier, the Sahara Accounting Standards Board is in the process of drafting national standards based on relevant International Accounting Standards (IAS).

Anti-money laundering provisions. Sahara does not currently have a formal anti-money laundering (AML) policy in place but money laundering is not perceived to be a major problem. However, the recent focus of international attention on money laundering and terrorist financing has energized the authorities into drafting a Financial Crimes Bill which will soon go through a first reading in Parliament. The Bill will authorize the establishment of a special AML agency and also include comprehensive provisions covering other forms of financial crime. It will also invest relevant financial regulators (SCB, SMA, SDIC and SIC) with investigating powers and outline a framework for cooperating with law-enforcement agencies.

Bank corporate governance. There are currently no formal guidelines in place for corporate governance although the SCB is currently carrying out a study of appropriate guidelines that might be introduced. It is expected that key elements of such a framework would cover duties and responsibilities of bank directors, as well as a code of ethics for bank officers and employees.

Consolidated supervision. Although Sahara authorities approved Universal Banking a year ago, there are no legal arrangements in place to facilitate consolidated supervision by the SCB.

Enforcement of Prudential Regulations

The FIA grants the SCB sufficient powers to monitor and enforce compliance with regulations and guidelines. SCB has at its disposal a wide range of sanctions it can impose on
any bank violating prudential provisions, including: i) letters of warning; ii) prohibition of declaration and/or payment of dividends; iii) prohibition of the establishment of new branches or other expansion of operations; iv) temporary or indefinite “cease and desist” orders; v) temporary or permanent removal of bank management; vi) suspension of lending and other investments; vii) directives to increase capital; viii) suspension or withdrawal of licenses. The SCB could also require a bank to change its internal organizational structure or levy monetary fines on the bank or individual members of bank management.

The performance of SCB in using these powers has been disappointing as it has often failed to enforce prompt and effective remedial measures in cases of regulatory violations and unsound banking practices. There are no internal policies and procedures for initiating enforcement actions. This is partly responsible for the recent deterioration in the financial condition of many banks. Table 1 below shows the extent to which banks violate various prudential regulations, as indicated in various examination reports for 10 AD.

**Table 1: Violations of Prudential Regulations (10 AD)**

<table>
<thead>
<tr>
<th>Prudential Regulation</th>
<th>No. of Banks in Violation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Minimum paid-up capital</td>
<td>18</td>
</tr>
<tr>
<td>Capital adequacy ratio</td>
<td>15*</td>
</tr>
<tr>
<td>Provisions</td>
<td>21</td>
</tr>
<tr>
<td>Rendition of prudential returns</td>
<td>15</td>
</tr>
<tr>
<td>Liquidity</td>
<td>10</td>
</tr>
<tr>
<td>Foreign exchange exposure limits</td>
<td>10</td>
</tr>
<tr>
<td>Insider lending</td>
<td>08</td>
</tr>
<tr>
<td>Single obligor limit</td>
<td>07</td>
</tr>
</tbody>
</table>

*Source: Sahara Central Bank Supervision Department*

*including 5 banks already classified as distressed*

It shows a possible culture of forbearance as numerous banks are guilty of serious prudential violations, many of them repeat offenders: i) 5 banks (holding 3% of system assets) were officially classified as distressed by the SCB, with capital of under 4% of risk-adjusted assets; ii) 10 other banks with a 6% market share have capital less than the required 8% of risk-adjusted assets; iii) 18 out of 21 banks (75% market share) did not meet the statutory minimum paid-up capital of D1 billion; iv) substantial under-provisioning, with virtually all banks failing to meet provision requirements and aggregate provisions standing at 50% of regulatory requirements; v) 4 banks had insider lending amounting to over 50% of their capital, compared to the required 35%; vi) 10 banks, representing 60% of system assets, held net foreign exchange positions in excess of 50% of capital, compared to the regulatory limit of 20%; vii) 7 banks violated single obligor limits.

Non-compliance with provisioning requirements imply that virtually all banks are overstating capital and earnings to a substantial extent, making it more difficult for the SCB to detect deteriorating conditions. This poor enforcement of prudential regulations is due to a

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12 Suspension or withdrawal of license may be appealed to the Minister of Finance.
combination of factors including: i) severe understaffing and limited SCB capacity to enforce compliance; ii) legacy of prudential leniency dating from the days of a state-dominated banking system; iii) reluctance of SCB to trigger court action and damaging judicial review of its actions; and iv) lack of independence, especially in the powers to suspend or withdraw bank licenses.

This general laxity in the enforcement of prudential requirements has compromised the credibility of the supervisor, creating a cycle of unpunished violations begetting further violations. Examination reports indicate a worrying trend of deteriorating asset quality in several banks and as at end-10 AD, non-performing loans of the banking system amounted to roughly 25% of gross loans and advances.

5. SUPERVISORY PROCESS AND PRACTICES

Licensing

The SCB is the only agency empowered to receive applications for bank licenses but final authority for granting a banking license rests with the Minister of Finance. The SCB reviews the application and makes recommendation to the Minister accordingly. However, renewal of licenses is the sole responsibility of the SCB. Although there are no foreign banks in Sahara, the FIA requires that to license foreign banks, additional information is required from the parent regulatory authority, usually in the form of a “no-objection”. In the last five years, a total of 25 applications were received and 12 were successful. If an application is rejected, the SCB is required to furnish the applicant with an explanation of the grounds for rejection. Although the SCB is mandated to give a decision within 90 days after the receipt of an application, there is a huge backlog of applications due to limited capacity of BSD to process them\(^\text{13}\).

An initial license does not allow the establishment of subsidiaries or branches; specific separate applications for these activities are mandatory. Branch expansion is subject to a good track record in doing banking business in accordance with the business plan submitted during application and the general efficiency and profitability of the institution. Banks may close branches in Sahara or abroad, only with the approval of the SCB.

In considering applications, the SCB does a good job of reviewing various “fit and proper” criteria, including financial soundness, skills, integrity, character and experience of management, soundness of business strategies, plans and policies, and adequacy of capital structure. There is however substantial room for improvement in assessing internal controls and procedures as well as corporate governance issues.

As mentioned earlier, banks are required to commence operations with a minimum core capital of D1 billion. The SCB is however empowered to increase a financial institution’s minimum required capital if a review of its capital adequacy during an on-site

\(^{13}\) License applications are processed by the BSD off-site division.
inspection reveals that available capital is insufficient to match observed balance sheet and off-balance sheet risks.

Once granted, licenses can be suspended or revoked by the SCB with final approval from the Minister of Finance who has the powers to overturn SCB’s decision. Suspension of licenses may be imposed whenever the bank or financial institution violates minimum requirements relating to capital adequacy or when the SCB “is of the opinion that the affairs of the institution are being conducted in a manner detrimental to the interests of the depositors or the national interest”\(^{14}\).

Licenses may be revoked for various reasons, including:

- Insufficient capital, money laundering, or endangering depositors’ money
- Use of false or misleading information to obtain a bank license
- Persistent violations of the FIA, SCB Act, Regulations, Guidelines and Circulars

**Permissible activities**

In accordance with international standards, the FIA restricts the use of the word “bank” to financial institutions duly licensed to take deposits and supervised by the SCB. There is a list of permissible activities for banks, which includes the customary functions of a bank viz. accepting saving and checking deposits, issuing letters of credit, buying and selling foreign exchange, etc. In addition, banks with more than D5 billion of core capital are allowed to perform the duties and functions of a trustee. However, as noted earlier, many NBFIs which are neither formally licensed as banks nor subject to regular supervision do carry on banking activities including the acceptance of deposits from the public.

**Off-site surveillance**

Off-site surveillance relies on the analysis of the weekly, monthly, quarterly and annual returns submitted by banks. *Weekly* reports include: i) report of foreign exchange purchases, sales position, open position and average balances; and ii) report on required and available reserves against total deposits. *Monthly* reports are required on foreign exchange purchases, sales and balances. *Quarterly*, banks are required to send balance sheet and income statements to the SCB and also publish them. Data is also required on past-due loans by classification category and type of loan, associated provisioning, large credit exposures and net open foreign exchange positions as well as statistical reports on deposit activity. *Annually*, audited financial statements are required. Banks are given a grace period of 15

\(^{14}\) FIA Section 10
days after the specified due date to render returns and a penalty of D500,000 per day is imposed in case of non-compliance.

Banks are generally not diligent in rendering returns on time and it is not unusual to receive over 70% of returns 3 months late. Banks complain about the amount of information required and the costly and cumbersome process of rendering returns in hard copy. SCB is aware of the burden on banks and has been somewhat lenient in the application of sanctions for late returns, a practice which has undermined its credibility with banks. It is now making efforts to introduce the electronic transmission of prudential returns. A key problem is that SCB’s IT system is not compatible with banks’ and a recent experiment to have banks submit returns on computer diskettes was abandoned after BSD’s system became infected with a virus from this source.

There are also concerns as to the accuracy and integrity of the prudential returns as many banks have been reportedly sending inaccurate returns. Weaknesses in the overall Sahara accounting and financial reporting environment have contributed to this problem, preventing the full comparability of banks’ financial statements.

Off-site analysis relies on a simple spreadsheet-based system which is currently adequate for processing bank returns. However, the fact that banks furnish returns in hard copy which are subsequently entered manually into spreadsheets gives substantial room for human errors.

There is a division of labor by banks in the off-site division, which allows continuity in surveillance. Each bank is assigned an off-site analyst who monitors the bank on a continuous basis in conjunction with an examiner from the on-site division. To determine the overall condition of the financial institution, off-site staff directly evaluate 4 of the 5 CAMEL components (capital adequacy, asset quality, earnings and liquidity) and compute ratings for individual components. No component ratings are computed. Quality of management is assessed indirectly by evaluating performance on the other 4 components but this assessment is neither validated nor updated during on-site visits.

Off-site analysis produces a quarterly Bank Surveillance Report (BSR) which is not only shared internally but is also used as a means of alerting bank management to weak areas needing attention. The BSR is however not standardized and the performance of individual banks is not systematically analyzed against trends and peers. This prevents the identification of deviant behavior by banks. In addition, while the off-site analysis does a good job of identifying those banks that require remedial action, there are no specific triggers for putting banks on a watch list. The follow-up unit located within the off-site division currently does a poor job of monitoring progress in implementing remedial actions recommended by on-site examiners.

Other shortcomings relating to the off-site surveillance function include: i) overcrowding in offices and inadequate work and filing spaces; ii) low computer literacy of

15 The relatively small number of banks in the system may preclude robust peer group analysis at this point.
staff; and iii) irregular exchange of surveillance information with other supervisory agencies (insurance, pensions and capital markets) 16.

On the positive side, there is adequate communication between off-site staff and the on-site examination division. As mentioned earlier, on-site staff routinely work with off-site counterparts in monitoring individual banks. Further, off-site staff often participate in on-site examinations. This close coordination between the two divisions allows off-site surveillance information to feed into the preparation for on-site visits, thus enabling prioritization in the use of scarce supervisory resources.

**On-Site Examinations**

The supervisory strategy complements off-site surveillance with annual on-site examinations of banks. An attempt is made to visit the head office of every bank at least once a year and branch offices are selected for examination on a sample basis17. This goal is however unachievable given the current understaffing in the on-site division. Only 12 out of 21 banks (representing 70% of total banking assets) were inspected in 10 AD many of which represented backlog from 09 AD. The SCB however makes an effort to examine the three largest banks every year.

In planning examinations, off-site surveillance reports are used in determining priorities in the allocation of resources and relevant off-site surveillance staff usually join the examination team. Unfortunately, there is no Examination Manual in place to guide examiners.

The on-site division is grossly understaffed with only 8 professionals covering 21 banking institutions. In addition, there are 20 NBFIs which are likely to come under the supervisory umbrella of the SCB soon. Given the labor intensity of on-site examinations, this has put enormous pressures on the BSD and impaired its ability to deliver on its annual examination schedule. Using staff from the off-site unit has helped somewhat but this is only a stop-gap measure and the situation needs urgent attention. A more difficult problem to tackle is the lack of credibility of BSD supervisory staff within the industry. Although there are no serious integrity issues, private banks often question the knowledge and skills of bank examiners.

On-site inspections attempt to determine the overall condition of the financial institution by conducting a full-scope examination covering the CAMEL framework as well as other areas such as loan portfolio reviews to clarify non-performing loans, adequacy of provisioning and write-offs, loan concentrations, structure and quality of assets and liabilities and so forth18. This is all done on a solo basis as the SCB is not capable of conducting consolidated supervision, which has become necessary following the approval of universal banking. Supervisors also attempt to verify compliance with laws and regulations. As at now,  

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16 The FSOC meets only twice a year.
17 Surprise visits from the examiners are rare. A two-week notice to the bank is customary.
18 On-site examiners report that virtually all banks give them full access to information on credit and investment portfolios and other relevant files. Direct access to loan officers is however reported to be unsatisfactory.
on-site examinations are not risk-oriented or proactive as there is an unduly heavy emphasis on compliance and controls.

The SCB does not focus enough attention on insider lending during on-site examinations. This is a major oversight given the role of insider lending in the failure of Deadwood Commercial Bank, Flotsam International Bank and Jetsam Commercial bank. There is also poor coverage of banks’ internal management information systems and processes such as strategic planning, internal controls and adherence to formally written and adopted policies and procedures, including credit management and administration. These systems ensure that financial institutions keep risks within manageable bounds and a conscious focus on them by the SCB will ensure that banks and other financial institutions are run safely and soundly and help reduce the probability of an institution running into trouble in the future, even if its current condition (based on the CAMEL components) shows no cause for concern. Another major problem is that on-site examinations are still largely manual and labor intensive, with examiners lacking notebook computers to do their work. There have also been a few problems recently with transport arrangements to get to examination venues.

Examination reports are detailed and are supposed to be issued within a month of completing an on-site examination. However, of the 12 banks examined in 10 AD, examination reports had been completed for only 5 of them as at end-June 11 AD. This is another manifestation of the understaffing of the on-site division. Although the final examination report clearly details problems with bank operations, it is not clear who issues formal instructions to banks to remedy weaknesses and when this should be done. Examination findings are passed on to the off-site unit which is responsible for following up on the remedial measures proposed for any bank exhibiting weaknesses, but there is no particular person charged with actually ensuring that remedial measures are implemented.

To compensate for current inadequacies in on-site examinations, the SCB has begun an initiative to strengthen the interactions between the BSD and the external auditors of banks. In December 10 AD, annual tripartite meetings were introduced among supervision staff, bank management and the external auditor.

6. **FINANCIAL SAFETY NET: DEPOSIT PROTECTION AND LIQUIDITY SUPPORT**

**Deposit Protection**

Following the failure of Deadwood Commercial Bank in 03 AD, the Sahara authorities established the Sahara Deposit Insurance Corporation (SDIC) under the SDIC Act of 04 AD. The SDIC is run by a Board of Directors which is directly accountable to the Minister of Finance.

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19 The SCB could consider holding the on-site team leader responsible for ensuring that remedial measures are implemented.

20 The Board consists of the SDIC Managing Director, the Governor of the SCB, Permanent Secretary to the Ministry of Finance and two other members appointed by the Minister of Finance.
The SDIC provides maximum insurance of D60,000 per depositor, per bank. This ceiling is low enough to ensure that insurance coverage is provided only to the smallest depositors. However, discussions are underway to raise this ceiling due to inflationary trends and the continued depreciation of the donge. As a word of caution, any revision of the ceiling should take explicit consideration of the average size of bank deposits in order to retain focus on only the smallest depositors. Large depositors should not have access to insurance coverage since they have the resources and the sophistication to assess the financial condition of banks and impose some form of market discipline on bank management. This is an avenue of limiting the moral hazard often associated with deposit insurance. The deposit insurance fund is currently not sufficient to cover estimated insured deposits and shows a deficit of over D1 billion donges.

Aside from its main function of insurance assessment and premium collection from financial institutions, the legal backing for the SDIC gives it powers to collaborate with the SCB in the regulation and supervision of insured banks and also play an active role in the resolution of problem banks. This is a welcome feature as a deposit insurer has more at stake if a bank fails (in form of its contingent liabilities) and is often a catalyst for an early intervention in a troubled bank. Unfortunately, the SDIC currently does not possess the capacity to actively play these important roles.

Membership of the deposit insurance scheme is mandatory for all licensed commercial banks and the SDIC is funded primarily through contributions collected from members, currently one tenth of one percent of the average of total deposit liabilities of the bank during the previous twelve months. The deposit fund is supposedly not guaranteed by the Sahara government, which should mitigate the moral hazard problem if strictly observed.

In consideration of the fact that available deposit insurance may induce banks to take more risks with depositor funds, the design of deposit protection in Sahara allows for risk-related premiums if necessary. The Deposit Insurance Board is empowered by law to raise premiums beyond the prescribed maximum or terminate deposit protection for banks found to be taking undue risks.

In case of a bank failing to meet its premium obligations, the SDIC can levy a penalty interest charge not exceeding one-half percent of the unpaid amount for every day outside the notice period on which the amount remains unpaid. It is also allowed to withdraw deposit insurance coverage if it determines that a particular bank is taking undue risks.

The trigger and procedure for paying depositors is specified in the FIA which provides that in event of a bank insolvency, a customer of that bank is required to lodge his/her claim with the Board, along with documentary proof showing entitlement to payment out of the fund. On payment of a protected deposit, the SDIC is entitled to receive from the bank or its liquidator an amount equal to the insolvency payment paid by the SDIC.

A weakness in the design of deposit insurance is the failure to specify what kinds of deposits are excluded from coverage. This is especially important if we consider that moral

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21 In the event of the closure of a financial institution, the SCB may appoint the SDIC to deal with claims, receivership and liquidation.
hazard may be increased by the presence of “connected” deposits under the deposit insurance umbrella. Deposits belonging to the directors, managers, shareholders and auditors of a failed bank (and their relations) should ideally be excluded from deposit insurance. There is therefore a need for SDIC to state explicitly which deposits are excluded from insurance coverage.

However, the fact that the SCB has been ready to allow insolvent banks to fail should go some way in compensating for the moral hazard concerns associated with deposit insurance.

**Liquidity support**

Both the SCB and the SDIC are empowered by their respective Acts to perform lender of last resort functions. The SCB normally provides liquidity support to banks primarily through the discount window but support is also available to banks in the form of overdrafts on their clearing accounts at 300 basis points above the prevailing t-bill rate. The SDIC is also empowered to provide liquidity support to banks but has not used this power since its establishment. Due to worries that insolvent banks will continue to have access to liquidity through the overdraft channel, the Bank Operations Department of the SCB is now required to provide weekly reports to the Banking Supervision department on banks that overdraw their accounts, and any bank that overdraws its accounts for three consecutive weeks triggers an emergency on-site examination. This tool could be strengthened further by requiring that collateral be posted for overdrafts on clearing accounts. However, as in the case of deposit insurance, the fact that the SCB has shown its readiness to allow insolvent banks to fail somewhat reduces the moral hazard of liquidity support.

Although not clearly specified anywhere in financial legislation, there is widespread understanding that the Minister of Finance can also use his discretion in authorizing liquidity support for specific financial institutions on a case-by-case basis. This power has been used only once in 02 AD when Jetsam Commercial Bank (a former state-owned bank) received a D2 billion “loan” from the Treasury once rumors of its distress triggered a run on its branches. The relief to Jetsam turned out to be fleeting and the bank had to be taken over by the SCB and liquidated.

7. **CONTINGENCY PLANNING, CRISIS MANAGEMENT AND FAILURE RESOLUTION**

The regulatory authorities in Sahara are in the process of drafting a Framework for Contingency Planning and Crisis Management to inform both the SCB and the SDIC on policies and procedures to follow in case of systemic crisis. The draft version of the framework made available is of adequate quality and includes coverage of such issues as: i) the operation of financial safety nets; ii) policies and procedures for determining the financial condition of banks; iii) establishment of thresholds for supervisory intervention; iv) guidelines for contingency planning by banks; and v) establishment, composition and
functions of a Crisis Management Unit.

The current framework for failure resolution in Sahara is confusing and deserves close attention in the Framework under preparation. Although it is clearly specified that the SCB and the SDIC should work together to resolve distressed financial institutions, the limited capacity of the SDIC means that this function is shouldered entirely by the SCB. In addition, the SCB is hampered by the requirement that the Minister of Finance approves the withdrawal of bank licenses and by its lack of immunity from lawsuits as an organization. The SCB can only take possession of a problem bank with the approval of the Minister and this has caused undue delays in intervening distressed banks and safeguarding assets. But once the Minister’s approval is obtained, the SCB is vested with full management and control powers, and allowed to make an inventory of the bank’s assets and transmit a copy to a court of competent jurisdiction. In two cases in the past, the management of distressed banks petitioned the courts to overturn SCB intervention and the cases were only resolved with the intervention of the Finance Minister on behalf of the SCB.

Although there is some forbearance in enforcing prudential regulations, SCB strangely enough does not exhibit forbearance in dealing with problem banks. Despite the legal complications, its track record in closing distressed banks is relatively good as evidenced by the closure of four banks between 07 AD and 09 AD.

Early intervention and orderly resolution are also hampered by the absence of mandatory triggers for SCB intervention in a bank experiencing deteriorating conditions. Although there is a need to strike a balance between rigid “prompt corrective actions” and flexibility for supervisors in taking action, having mandatory triggers written into law will protect the SCB somewhat from the frequent judicial review of its prudential decisions.

The limited capacity within the SCB and SDIC in the area of problem bank supervision and failure resolution has made it difficult to create robust methods for classifying distressed banks and distinguishing between those with liquidity problems and those that are insolvent (and using appropriate methods for dealing with either). There is no clear trigger for the SCB to declare a bank “problematic” and a rule-of-thumb used frequently is a deterioration in capital adequacy below 5% of total risk-weighted assets. There is thus a need to establish close relations between the failure resolution unit and the “lender of last resort” function of the SCB so that both sides can share information and lower the costs of intervention.

Although the banking law allows for different forms of failure resolution, including liquidation, merger, restructuring/rehabilitation as well as purchase and assumption, the SCB has used pay out/liquidation in virtually all the cases of distress handled so far, thus incurring higher costs than if other methods had been explored. Rehabilitation, merger and purchase and assumption are within the powers of the SCB but compulsory liquidation of a bank can only be decreed by an appropriate court acting upon a petition by the SCB.
8. **RECOMMENDATIONS FOR STRENGTHENING SUPERVISORY CAPACITY IN SAHARA**

Strengthening bank supervision in Sahara will no doubt be a long term endeavor that would involve taking action on several fronts. The following paragraphs develop a possible sequence of actions to strengthen banking supervision in Sahara, identifying actions to be taken immediately, those to be taken in the medium to long-term and those that should be implemented on an ongoing basis.

**Immediate Priorities**

*Address problem banks.* It is crucial for the authorities to restore confidence in the financial system by taking steps to promptly resolve insolvent financial institutions, including those taken over by the SDIC, either through liquidation or mergers. There should also be a careful audit of remaining financial institutions to determine their soundness and viability and institute corrective actions if necessary. While these steps are underway, it is advisable to exercise caution in the granting of new bank licenses until the financial condition of the banking system improves considerably. These steps should go some way in assuring the public that financial intermediaries are robust enough to be safe repositories for their savings.

*Initiate legal and regulatory reform.* Effective prudential oversight in Sahara is only possible if the SCB possesses the requisite authority and powers as well as the autonomy to fulfill its mandate. In particular, it is crucial to invest the SCB with sole authority to issue and withdraw bank licenses. This is one of the most important powers in the arsenal of a bank supervisor as it ensures that weak banks do not enter the system and weak banks already in the system exit without costly delay. More broadly, SCB should be given sole responsibility for the prudential oversight of banks, with the Ministry of Finance represented on the SCB Board. Another area that requires immediate attention is the creation of a legal basis for consolidated supervision, given the emergence of universal banks in the system.

*Updating prudential limits and controls.* SCB should conduct a comprehensive review of prudential regulations and commence steps to address deviations from international standards and norms. Areas that require immediate attention include eliminating exemptions to single obligor limits, as well as strengthening insider lending provisions and extending its coverage, especially to include bank officers and their relations.

*Supervision of NBFIs.* The existence of NBFIs taking deposits from the public without being subject to supervision is dangerous and requires immediate attention. It is unlikely that the public can easily distinguish between NBFIs and banks, implying that weaknesses in the NBFI sector can easily contaminate the banking sector. It is therefore imperative that the SCB begin the design of a comprehensive framework for the systematic supervision of non-bank financial intermediaries, including off-site surveillance and on-site examinations.

*Introduce annual needs assessment.* The SCB is understaffed and does not have the manpower to deliver on its legal mandate. There is therefore an urgent need to recruit more

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22 This section draws in part from Alawode (2002).
qualified supervisors, especially for the on-site division. However, any recruitment plans should be preceded by a systematic comparison of the available skills of current supervisory staff with SCB’s work program, with a view to identifying areas of greatest need. Taking an inventory of available skills is also an essential first step towards building professional and technical excellence as it helps to identify areas of strength and weakness. Areas of skill deficiency could then be rectified either by recruiting new staff or providing appropriate training for existing staff.

**Introduce annual staffing plan.** Following from the needs assessment, a staffing plan should be produced, identifying present and future needs of supervisory staff (number and level of staff required), desired distribution of skills, experience and background. Potential sources of recruitment should also be identified. This assessment can also double as a training needs analysis for all staff in the supervisory function vis-a-vis best practice supervisory skills. In order to make the staffing plan workable, there is a need to strengthen the selection and recruitment process in parallel and ensure that staff needs are aligned with current and planned business needs.

**Improving examination planning.** There is a need to significantly improve the on-site examination process within BSD by developing formalized steps and procedures to follow from pre-examination to reporting inspection findings. In this respect, developing a comprehensive, customized Examination Manual to guide the process is paramount. Such a Manual should cover key areas such as pre-examination planning and documentation standards. Currently, the SCB on-site department operates without an examination manual. In developing a manual, SCB should be aware of best practices but not copy wholesale from similar manuals in industrial countries but should aim for a customized document, given the differences in financial structures and practices as well as the wide disparity in the quality of supervisory staff.

**Improving follow-up.** Although the lack of powers is a major cause of regulatory forbearance, the SCB exhibits forbearance simply because there is no systematic and coherent process for following up on inspection findings. The follow-up office is divorced from the on-site examination division and the examination team leader has no responsibility for ensuring that recommendations of examination teams are implemented. Follow-up is particularly critical in the case of banks directed to take remedial actions to correct unsound practices. There is therefore an urgent need to introduce procedures for following up on remedial measures recommended in on-site examination reports and ensuring that corrective actions are satisfactorily implemented.

Medium-Term Priorities

**Accounting standards for banks.** The ability of SCB to determine the financial condition of banks depends on the accuracy and integrity of banks’ financial statements. While awaiting the implementation of the new accounting standards, SCB should pay close attention to current accounting practices that have the potential to seriously undermine its ability to gauge the financial condition of banks. Top of the list should be practices relating to the accrual of interest on loans that are not being serviced. SCB on-site examiners do not currently evaluate compliance with this requirements on a consistent basis and anecdotal
evidence indicates that many banks find ways to circumvent these requirements.

**Off-site organization and operations:** The capability of the off-site division needs reinforcement, especially in the collection and processing of prudential returns from banks. Aside from staff shortages, a key reason why supervisors in Sahara are over-burdened is the low level of automation in carrying out supervisory functions. Measures should be initiated to end the paper-based system for collecting prudential returns as the electronic submission of bank returns will go a long way in easing the burden on off-site analysts. In addition to improvements in technology, bank analysts also require training in techniques of bank analysis.

**On-site examinations.** Improving coordination with the off-site surveillance division should allow on-site examinations to become more proactive and risk focused, with inspections concentrating on particular areas of regulatory concern. Currently, on-site examinations in Sahara place too much emphasis on monitoring compliance with rules, regulations and controls with little attention paid to corporate governance and the various risks that banks assume in their operations. Ultimately, examination teams would use off-site surveillance reports to determine priorities in the allocation of onsite examination resources. One approach that is gaining favor in other African countries is including off-site desk officers as full members of on-site examination teams right from the pre-examination phase.

While the SCB is making efforts to equip all off-site analysts with desktop computers, a lot more needs to be done in making notebook computers available to on-site examination teams. At present, it is typical for on-site teams to go into the field and do all their work manually. Sometimes, they have to borrow laptops from bank management, a practice which erodes the credibility and prestige of examiners.

**Developing professional career paths.** One of the most important steps in improving the quality of supervisors is to establish well-defined career paths for them, thus giving incentives for continued professional development. At present, banking supervision is not seen as a career in Sahara and good supervision staff are often transferred to other departments. Creating opportunities for fulfilling professional development in the supervisory function should allow the development of proficiency in different supervisory skill areas and facilitate recognition for developing these specialized skills. This will also help improve the ability of the SCB to attract and retain qualified individuals to join the supervision function.

In defining career paths, there is a need to develop written job descriptions and identify core competencies for job functions. These should spell out the expected responsibilities at each grade in the supervisory ladder. It is also essential to clearly define appropriate career milestones and associated promotion criteria. Consideration could also be given to implementing a certification program for supervisors. The grading system could then become an important part of the compensation system and a tool for motivating staff. In addition, regular staff surveys are advisable to measure their growth on the job and identify areas needing further attention.

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23 This is not unique to Sahara Republic and is a common problem in many developing countries.
**Compensation policy.** It is critical that the SCB be able to attract and retain staff of the highest caliber. This is particularly critical for the supervision function because of the specialized skills required in this area. The current SCB compensation package cannot compete with the private sector for the best skilled people available and the SCB is ignorant of the pay incentives available in competing industries. As such, regular salary and benefit survey exercises are required to ensure that it gains some competitiveness in attracting skilled individuals. However, efforts should go beyond merely designing a competitive pay structure and need to include the alignment of performance with pay as well as ensuring that there is reward for outstanding performance. Another way of making supervisory jobs attractive to Saharans is to enhance the benefits available including pensions, life insurance and medical benefits.

**Comprehensive training program.** An appropriate training program should cover a wide variety of training activities, including attendance at formal courses, workshops and seminars, plus attachments/exchange/internship programs with private banks and with renowned supervisory agencies. The training program should cover both managerial and staff development which should in all cases be aligned to the needs of staff. The overall objective should be to plug identified work and skill gaps and ensure that supervisors keep abreast of developments in both banking and banking supervision. Ideally, a good training program will be able to marry formal training with on-the-job learning.

At the core of the training program should be a relevant *training curriculum* to include core courses for supervisors (e.g. bank analysis and examination, bank management, credit risk analysis, bank accounting and auditing, etc) as well as courses aimed at developing management skills, conducting meetings, computer literacy, team building and communication skills (writing, speaking and editing). There should also be an attempt to increase staff understanding of the supervisory mission. The training program (including the training curriculum) should be updated regularly in order to maintain its relevance.

A well-designed training program should also involve the following: i) an annual training and seminar schedule, which is adequately communicated to supervisory staff; ii) continuous identification of relevant, top-rate partners in the delivery of training, including other central banks and supervisory agencies as well as bilateral and multilateral donors (twinning arrangements could be useful in this regard); and iii) appointing a training coordinator/officer or a training committee to oversee the design, update and delivery of the training program. The process of selecting training participants should be as transparent and objective as possible.

Needless to say, implementing a comprehensive training program will require access to an adequate training budget. The SCB training budget is managed centrally and has not been able to meet the needs of the supervision department. There is therefore a need to consider having dedicated training budgets at functional or departmental levels in order to improve the relevance and impact of training programs within SCB.

**Improving internal coordination.** There is a lot of scope within the supervision department for significant improvement in internal organization and processes. One

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24 Regular announcements of upcoming training courses and seminars are also important.
important area of focus should be improving the coordination between the various divisions, especially between the off-site and on-site teams. There is a need for the off-site surveillance division to be actively seen as an early-warning unit, with surveillance information feeding directly into the preparation for on-site visits. Adequate communication between the off-site and on-site divisions will not only help in detecting banking problems early but will also go a long way in making on-site examinations more focused, more efficient and more effective. One particular problem in Sahara is that on-site examinations are often full-scope, leading to a significant burden on available examiners. With the appropriate support from the off-site division, examiners will be able to prioritize and concentrate scarce human and material resources on problematic institutions. Also, examiners will be able to focus attention on specific areas of an institution’s operations identified as problematic by the off-site office.

An option currently under consideration by the SCB is the so-called portfolio approach to supervision, whereby off-site and on-site staff are pulled together into a single team for the continuous, ongoing supervision of a group of banks. This is a welcome move for improving communication and should also contribute to a more effective regime for following up on prescribed corrective actions.

It is also desirable to have more regular consultations between supervision staff and computer specialists to ensure that available hardware and software are put to the best use in the supervisory process. This is particularly useful in updating existing templates for prudential returns or designing new ones. Many supervision staff in Sahara are not yet proficient in the use of computers, and needless to say, computer appreciation courses should be a priority for the supervision department. This should cover various topics ranging from basics of the operating system to the use of relevant spreadsheet and modeling applications. Introducing annual computer refresher courses could help a great deal in upgrading the computer skills of key staff.

Ongoing Priorities

**Enforcement and application of sanctions.** One factor behind the deteriorating condition of banks is the rampant violation of critical prudential limits and controls. It is therefore important for the SCB to substantially lower its tolerance levels with respect to such violations and be more aggressive in its use of sanctions against erring banking institutions. Non-enforcement of prudential regulations erodes the credibility of the SCB and makes the task of prudential oversight more difficult.

In cases of non-compliance with prudential rules and regulations, Sahara supervisors need to be measured and reasonable in the application of sanctions. Efforts should be made to always tailor the punishment to fit the crime. Frequent use of the big stick for minor offences tend to erode the credibility of the supervisor and undermine the partnership relationship that should exist between the supervisor and the supervised. Banks in Sahara already see supervisors as intruders and perceive interactions as interrogations and it is important to remedy this situation as soon as possible. There should also be uniformity in the application of sanctions and enforcement. Any perceived preferential treatment or leniency for particular institutions on the part of the supervisor will erode its authority and credibility within the
banking industry.

**Improving external coordination.** Sahara has multiple supervisory agencies overseeing different segments of the financial system. In addition to the SCB, which is charged with overseeing banks, there is the Sahara Insurance Commission, the Deposit Insurance Corporation and the Securities Market Authority. Given the introduction of universal banking and the expected increase in linkages between different parts of the financial system, there is a need for increased coordination and information sharing between the bank supervisor and other supervisory agencies. The Financial Sector Oversight Committee helps somewhat in this regard but there is a need to also foster bilateral interactions between regulators.

It is also useful to increase interaction with external auditors of banks to facilitate and improve independent validation of supervisory information. External auditors could also be useful in examining specific aspects of a financial institution’s operations. Sahara has a provision in the banking law calling for regular tripartite meetings between banks, their auditors and the supervisor but such meetings are not as regular as desirable.

The bank supervisor should also collaborate closely with the SDIC in monitoring the health of banks. Given the scarcity of supervisory skills, knowledgeable staff of the deposit insurer can be used in carrying out off-site monitoring and on-site examinations. A deposit insurer is also an important ally to have because it typically has more at stake if a bank fails. Despite its own capacity problems, the SDIC was a good catalyst for early interventions in troubled banks in the past. Strengthening the capacity of the deposit insurer and getting its active involvement in prudential oversight may also be a way to check against regulatory forbearance on the part of the SCB.

Finally, it is also desirable to have regular and professional interactions between supervisors and banks in order for supervisors to keep abreast of relevant industry developments. Regular interactions with supervisors from other central banks/supervisory agencies will also allow familiarity with best practices in financial supervision.
Annex 1: Suggested Outline for Evaluating Banking Supervision

A. Institutional Framework
- Regulatory agencies and institutions covered
- Definition and clarity of responsibilities, mission and goals
- Legal backing for responsibilities
- Legal and operational autonomy
- Strategy and approach to supervision
- Authority and powers
- Organization and resources
- Institutional development arrangements
- Staff career development
- Training program
- Depth and staff profile

B. Legal and Regulatory Framework
- Banking law
- Related laws (other financial and commercial codes)
- Prudential regulations and guidelines
- Enforcement and sanctions

C. Supervisory Process and Practices
- Licensing activities
- Off-site surveillance
- On-site examination
- Enforcement and sanctions
- Use of external auditors
- Consolidated supervision
- Public disclosure
- Coordination with other agencies (domestic and foreign)

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25 This outline draws heavily from Guttierrez (1996)
D. Deposit Protection and Liquidity Support

- Legal and institutional framework for deposit protection (explicit or implicit protection)
- Membership and coverage of insurance (ceilings, excluded deposits, etc)
- Level and mode of premiums; relation to moral hazard problems (e.g. risk-oriented)
- Adequacy of insurance reserves
- Supervisory role of deposit insurer (if any), including role in failure resolution
- Triggers for deposit pay-out
- Sources of liquidity support (central bank and others)
- Cost of liquidity to banks; adherence to best practices in offering liquidity support (penal rate, collateral, administrative controls, etc)
- Track record of liquidity support and implications

E. Contingency Planning, Crisis Management and Failure Resolution

- Components of contingency and crisis management framework (operation of safety nets, determination of financial condition of banks, thresholds for supervisory intervention, etc)
- Legal backing for framework
- Resolution techniques and triggers for intervention
- Capacity to implement resolution framework

F. Recommendations
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