

Your Money and the New Capital Accord for banks

Financial institutions have always featured highly in the PricewaterhouseCoopers' Survey of East Africa's Most Respected Companies. In spite of this Tanzanians have not been rushing to deposit their money in bank accounts, as can be seen from the country's very low savings ratio of 10.5% of GDP. Partly this reflects the relatively limited real returns for savings. However, it may also reflect an inherent fear of entrusting money to banks especially after the experience of banks such as Greenland Bank, Meridian Biao and Trust Bank. So, how safe is your money in the bank, and what role does the bank's capital have in this regard? What are the capital adequacy requirements all about?

Well, capital provides a foundation for a bank's future growth and protects bank against unexpected future losses. Adequately capitalised and well-managed banks are better placed to withstand losses and to provide credit to consumers throughout all business cycles. The major challenge has always been to determine how much capital is needed to create a sufficient buffer against future unexpected losses. If capital levels are too low, banks may be unable to absorb high levels of losses and thereby increase the risk of bank failures, which may put depositors' funds at risk. On the other hand, if capital levels are too high, banks may not be able to make the most efficient use of their resources, which may affect their ability to make credit available.

Switzerland is famous for its banking sector. This fame has been both positive (in terms of the reliability of the banking system) and in part negative (in terms of the reliability at least until relatively recently of its secrecy, which enabled people like Abacha, Marcos and others to hide away their ill-gotten fortunes). Given the strength of its banking sector, it is perhaps appropriate that the Swiss city of Basel is the location for the Bank for International Settlements, the world's oldest international financial institution and the principal centre for international central bank cooperation. The international debt crisis in the 1970s brought to the fore the issue of the regulatory supervision of internationally active banks and was a catalyst for the setting of international standards for capital adequacy by way of the original Basel Capital Accord (Basel I), which was announced by the Basel Committee on Banking Supervision in 1988 and implemented in 1992. It established a method of relating capital to assets using a simple system of risks weights and a minimum capital ratio of 8. This framework became the basis for bank capital regulation and was adopted in more than 100 countries, including Tanzania. Its aim was to increase the levels of capital in the banking industry, which had dropped significantly since 1970. Basel I requires banks to group their exposures into pre defined "classes", which reflects similar types of exposure. Exposures to the same kind of borrowers (such as all balances with other banks or exposures to all corporate borrowers etc) are subject to the same capital requirement.

A major criticism of Basel I is its non-recognition of the potential differences in the creditworthiness and risks that each individual exposure within a "class" of exposure might pose. For example, in a corporate loan portfolio not all loans will have the same risks, and it has been argued that lending to different governments pose different risks.

On 26 June 2004, central bank governors and the heads of bank supervisory authorities in the Group of Ten (G10) countries met and endorsed the publication of the International Convergence of Capital Measurement and Capital Standards: a revised Framework, which is commonly known as Basel II. Basel II is a response to the need for reform of the regulatory system governing the global banking industry. Indeed, financial stability in the wake of economic integration and globalisation, as highlighted by the 1997 Asian crisis, has received a lot of attention recently.

The new framework is targeted to be available for implementation in member countries from the year 2006. However, the implementation at that date will very much depend on the readiness of the supervisory structures for the Basel II Framework in the individual member countries. Countries other than the G10 countries may therefore need to proceed at their own pace.

Basel II adopts more risk-sensitive minimum capital requirements for banks. It provides incentive and creates opportunity for banks to improve their risk measurement, management and reporting processes, which is expected to improve banks' overall efficiency and resilience. It is also expected to strengthen market discipline by enhancing transparency in banks' financial reporting processes.

The approach will bring the following improvements in the capital framework:

- It aligns the minimum regulatory capital held against credit risk with formal risk-assessment of individual counter-parties;
- For the first time, banks will be required to hold capital against operational risks;
- Regulators will set total capital requirements by assessing banks' overall risk profiles and their risk measurement and management processes; and
- New disclosure rules, which are aimed at giving more information to the market on the adequacy of banks' capitalisation.

Whilst it will in due course be beneficial for banks to move to adopt certain aspects of Basel II, the level of sophistication and products range available in our market may make it difficult for banks to employ and fully utilise all its aspects. Indeed responses received by the Bank for International Settlements from 22 African countries to a questionnaire on Basel II indicated that three quarters of the respondents intended to implement Basel II between 2006 and 2009 but that such implementation would be in progressive stages with the less sophisticated approaches being gradually adopted before moving on to the more advanced approaches.

Of course, capital adequacy rules alone will not persuade individuals to deposit more of their money in the bank. Other considerations come into play such as the extent to which any interest return on such deposits is eroded by inflation or taxation. The Government is certainly playing its role with tight macro-economic control, which has kept inflation low, and the new Income Tax Act 2004, which has reduced withholding tax on interest from 15% to 10%. Ultimately, the building of a savings culture is critical to set the

foundation for our economic growth and it is to be hoped that our savings ratio will improve.