Basel II as a tool for Financial Institutions Supervision in Lesotho

The tide in banking supervision is very strong towards adoption and implementation of the Basel II accord. This is given momentum by the various developments in the financial sector in both the developing and developed worlds which at times culminated into financial crises. The process of adoption of the accord for countries such as Lesotho presents a number of challenges…

Background

Banking supervision is increasingly challenging in recent years in both developing and developed countries. Globalisation has given impetus to these challenges because it has led to more complex financial services industries with a lot of different products and services being introduced. These developments have since shaped the financial sector landscape. The rapid changes in financial architecture warranted equally rapid responses in regulation. In addition, it has become increasingly necessary to improve risk management and alignment of capital measurement framework with sound contemporary practices. In effect, this is the purpose of Basel II which was based on Basel I accord and aims at improving the safety and soundness of the banking system. This accord emphasises bank's internal control, supervisory review process and the market discipline. The Basel II minimum standards are grouped under three pillars which are explained as follows:

Pillar 1: A bank is required to maintain minimum capital against credit risk, market risk and operational risk exposures. Risk management should be at the pinnacle of the banking practice and bank supervisory authority should apply a risk management approach to supervision.

Pillar 2: A bank is required to demonstrate sound management of capital which includes ensuring that the bank holds adequate capital for risks to which the bank is exposed. The supervisor should assess the quality and management of capital by the Bank. This pillar provides for more authority on the supervisor to

require more capital i.e. even above the regulatory minimum.

Pillar 3: A bank is required to make meaningful disclosure of information pertaining to available capital, capital management and risk exposures. The market should require banks to be transparent, to disclose reliable and relevant information relating to the financial position and performance, corporate governance and risk management issues.

The tide towards adoption and implementation of Basel II on an international arena exerts pressure on developing countries such as Lesotho to follow along. This is much more so in countries whose financial industries are dominated by trans-national banks. Nevertheless, it is pertinent to establish the reasons for adoption, challenges facing developing countries and the implications for the Lesotho economy.

Basel II and Financial Stability

The importance of financial institutions supervision to financial stability cannot be overemphasized. Prudential regulations serve as a safeguard against a financial crisis. Moreover, the capital requirements spelled out in Basel I help mitigate financial risks. However, Basel II is presented as a better framework than Basel I as relates to financial institutions supervision. Basel II goes beyond Basel I in the sense that it reflects more on the underlying banking risk. It also provides stronger incentives for banks to improve their risk management. It builds on Basel I's basic structure for setting capital

requirements and improves the risk sensitivity of the old framework. More importantly, it combines the capital requirements with supervisory review and market discipline. Consequently, this would enhance financial stability in the economy.

Benefits of Basel II

In recent years, financial sector regulation appears to swing towards the implementation of Basel II. It may be useful to examine some of the advantages of adopting Basel II which could be summed up as follows:

- Basel II would ensure greater stability in the financial system due to improvements in corporate governance, transparency and risk management.

- It would improve a country's credibility and standing on the international arena.

- In addition, it would ameliorate cross border cooperation and grant bank subsidiaries international standards thus simplifying bank operations.

Beyond the benefits enumerated above, there are several challenges for the developing world.

Challenges for the developing world

The challenges that face the developing world cannot be taken for granted. These encompass the following challenges:

- Costs and resources: The implementation of Basel II would require resources to invest in human capital and the improvement of IT systems to cope with the new demands.

- Data architecture: Banks would need data for calculation of default rates. In addition they would need to properly segment bank portfolios and validate internal risk based (IRB) models through inputs, back testing and reference benchmarks.

- Public infrastructure issues: these cover demands on the legal environment. It underscores the need for property, data and insolvency laws.

- Internal and external supervisory issues: Domestic supervisors need to share information with external supervisors timely on issues of national discretion and process of model validation.

- The application of IRB cannot be contemplated for economies whose financial systems are not sophisticated and data are fragmented. Instead, other simplified options such as the standardised approach which closely relates to credit approach under Basel I could be considered.

The Supervisory Horizon in Lesotho

The Central bank of Lesotho recognises the importance of the Accord on the supervisory landscape which warrants careful study and understanding of its complex structure. It is clear that the areas covered by Basel II relate to several changes to the measurement of risk with specific changes on operational risk computation. It also incorporates two new pillars on supervisory review and market discipline. In order to avoid adopting instead of adapting the new framework, the Bank set up a Task Team to evaluate the suitability of Basel II for Banks in Lesotho and plan for the transition thereby.

It is notable that due to the complexity of Basel II it is appropriate for each jurisdiction to take a meticulous analysis of this Accord in the context of its own financial system. The Task Team therefore had the responsibility of:

- Identification of similarities and differences between Basel I and II including strengths and weaknesses of the former;

- Identification of personnel and other needs such as the upgrading of the regulatory reporting and IT systems;

- Assessment, in accordance with the requirements under Basel II, of the regulatory infrastructure, the current disclosure regime, corporate governance, accounting and provisioning practices; and

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- Consideration of trans-border implications of the implementation of the option adopted by the home supervisory authority where the subsidiary operates which may be different from that adopted in the mother company jurisdiction.

Conclusion

The Team found that banks need to plan for resources to fund training of staff for skills upgrade and capacity building and also to upgrade their information systems. The strategies are necessary to undertake as relates to appropriate approaches under credit, market or operational risks. Due to unavailability of data and lack of complex and robust statistical models, adoption of relevant options under the Accord, rather than implementation of the whole Basel II, is imperative.

2. Monetary Policy Operations for December

The major objective of Central Bank of Lesotho (CBL) to achieve and maintain price stability is attained through the maintenance of an adequate level of Central Bank net foreign reserves. This is because a large portion of Lesotho's inflation is imported from South Africa due to close trade and financial links between the two countries. Hence a need for adequate foreign reserves so that residents would be able to import goods and services without devaluing the loti currency, a process that might escalate domestic prices. A significant decline in external reserves would not be desirable for Lesotho as the fixed exchange rate system would be threatened by possible failure to honour the exchange of loti for rand at the fixed one-to-one rate. A weak external reserve position could also reduce investor confidence on Lesotho as it would serve as an indication that the country may not be able to honour its foreign currency obligations (e.g. foreign debt). A target for CBL net foreign assets is determined quarterly by the Monetary Policy Committee.

The Bank uses reserve money as an operating target of monetary policy, while interest rates, particularly on government treasury bills, are an intermediate target. Reserve money is made up of currency issued and commercial banks' deposit held with the Central Bank. It represents the banking sector's potential to create money through a direct increase in currency issued or creation of deposits by lending out excess reserves of commercial banks. An excessive growth in reserve money would result in a jump in money supply, which could in turn lead to a build up of inflationary pressures. Excessive growth in money supply could also result in a deterioration in the country's external reserve position as those who hold the excess increase their expenditure on imports. Therefore, the CBL controls reserve money to ensure that it does not grow in a manner that would encourage depletion of

the Bank's net foreign assets or excessive growth in money supply.

Open market operations (in the form of purchase and sale of 91-day treasury bills in the primary market) are used as instruments of monetary policy and, as mentioned earlier, the discount rate on treasury bills is monitored as an intermediate target of monetary policy. A competitive discount rate relative to rates of comparable instruments offered in the region would encourage investors to invest in Government of Lesotho securities instead of investments abroad. This would help preserve the net foreign assets of the Central Bank. The securities are sold in a competitive auction system to allow for market determination of treasury bill rates. A Dutch Auction system is used

where all successful bids are awarded at a uniform interest rate that clears the market to eliminate winner's curse.

The CBL studies liquidity conditions in the economy to determine amounts of treasury bills that should be auctioned. Normally, liquidity levels in the economy are driven by the manner in which the Government finances the excess of its expenditure over revenue, transactions between residents and the rest of the world as well as amounts of maturing securities. Auction amounts can be higher than estimated levels of liquidity in the system in cases where the Bank aims to attract funds invested by residents abroad in order to raise the level of official reserves.

Table 1: Treasury Bill Auctions

Type of Security	Auction Date	Auction Amount (million)	Amount Issued (million)	Discount Rate
91-day TBs	05 Oct	M150.0	M150.0	6.86%
91-day TBs	01 Nov	M170.0	M170.0	6.76%
182-day TBs	08 Nov	M50.0	M16.5	7.00%
91-day TBs	29 Nov	M170.0	M170.0	6.76%

Table 1 above shows amounts auctioned and discount rates that prevailed for each of the auctions. The December auction was fully subscribed and consequently, the whole auction amount to the tune of M170.0 million was issued. The level of competitiveness in the market, as estimated by the number of participants in an auction, remained unchanged during the December auction. There were 9 bidders who submitted 18 bids for the auction

and all bidders became partially successful. This number was equal to the November figure of 9 successful bidders.
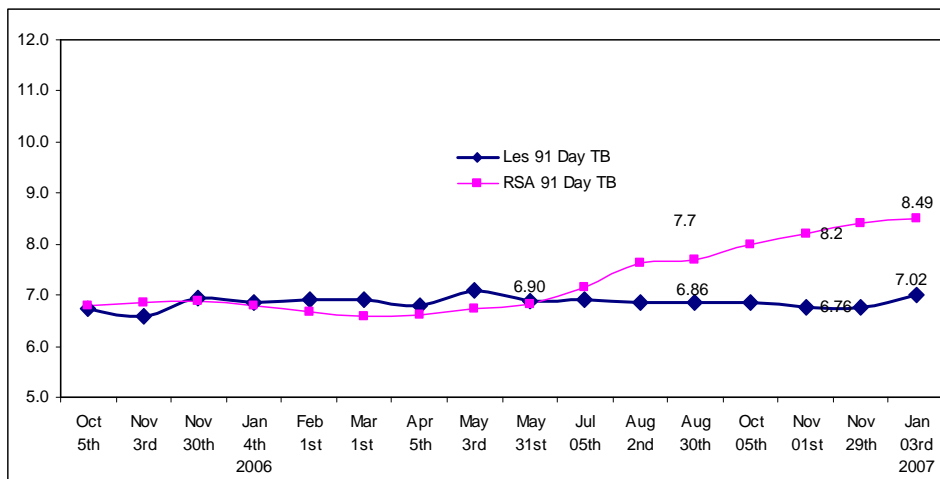Although the margin between the Lesotho and SA 91-day treasury bill rate is still within the guideline range, it continued to widen in December. In December, the rate remained unchanged at its November level of 6.76 per cent. The rate was still below the counterpart South African rate which continued to rise from its

previous level of 8.20 per cent in November to 8.41 per cent in December. Consequently, the margin between the two rates widened from 144 basis points to 165 basis points at the end of the review period.

Figure 1. Measuring the Success of Monetary Policy Objectives:

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3. Monetary Developments for December

The broad measure of money supply (M2) slowed down by 0.3 per cent at the end of December, contrasted with an increase of 0.7 per cent realised at the end of November. The decline in money supply was mainly attributable to a fall in the overall banking sector's net foreign assets which offset the rise in domestic credit including net claims on Government. The net foreign assets (NFA) of the whole banking system fell by 2.9 per cent in December contrasted with a 0.7 per cent increase registered at the end of November. However, private sector credit increased by 1.2 per cent in December following a rise of 3.6 per cent recorded in November. This was mainly attributable to a rise of 2.9 per cent in credit granted to households which offset a 0.3 per cent fall in credit to business entities.
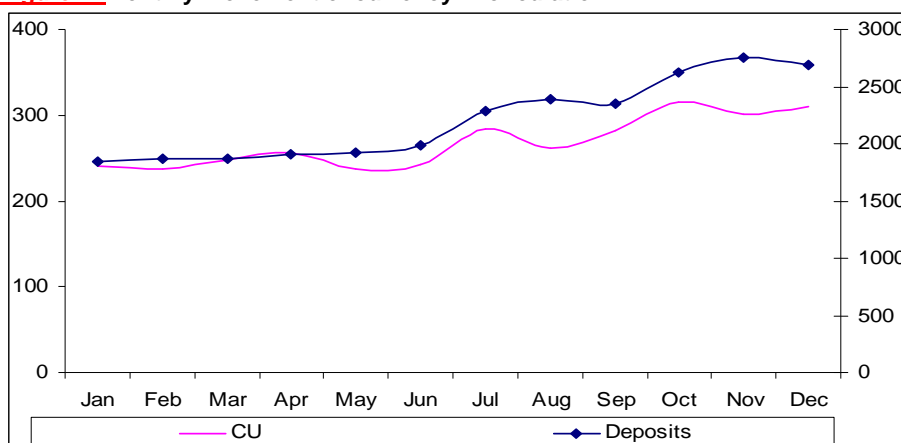
On an annual basis, M2 grew further by 35.7 per cent in December compared with 35.9 per cent rise recorded in November. This was at the back of 47.5 per cent and 21.6 per cent increase in NFA and domestic credit, respectively.

4. The behaviour of currency in circulation

Currency in circulation refers to notes and coins held outside banks. This is the most liquid monetary aggregate. It is a very important variable for policy because, together with deposits of commercial banks held with the central bank, it makes up high powered money. It serves both as a store of value and medium of exchange. Theory posits that the demand for money depends on the level of income, the level of transactions and the interest rate earned for holding financial assets as alternatives to cash. The graph below depicts that in December, cash held outside banks increased substantially. Obviously, this reflected increased demand for cash to finance transactions associated with Christmas festivities. This reflected an increase in consumption in December whereby the public held cash to derive utility from its function as a medium of exchange.

Figure 2: **Monthly movement of currency in circulation**

Interestingly, the public held deposits with local banks throughout the year, and as the volume of transactions rises, such as in winter and during the festive season, more cash is held. An increase in currency with the public accompanied by a fall in deposits indicated that indeed the public preferred holding cash to bank deposits. It showed that the demand for cash was seasonal and transient and warrants no policy reaction.

5. Selected Monetary and Financial Indicators+

	Oct	Nov	Dec
1. Interest rates (Percent Per Annum)			
1.1 Prime Lending rate	12.69	12.67	13.50
1.2 Prime Lending rate in RSA	11.50	12.00	12.00
1.3 Savings Deposit Rate	1.84	1.84	2.68
1.4 Interest rate Margin(1.1 – 1.3)	10.85	10.16	9.32
1.5 Treasury Bill Yield (91-day)	6.76	7.16	7.05
2. Monetary Indicators (Million Maloti)			
2.1 Broad Money (M2)	3387.38	2532.40	3505.80
2.2 Net Claims on Government by the Banking System	-1986.82	-1751.00	-1498.76
2.3 Net Foreign Assets – Banking System	6358.55	6376.99	6149.69
2.4 CBL Net Foreign Assets	5328.61	4460.29	4377.24
2.5 Domestic Credit	-1113.62	-839.21	-576.82
2.6 Reserve Money	436.14	465.51	490.92
3. Spot Loti/US$ Exchange Rate (Monthly Average)	7.4085	7.2400	6.9930
4. Inflation Rate (Annual Percentage Changes)	6.8	6.8*	6.8*
5. External Sector (Million Maloti)			**2006**
	QI	QII	QIII
5.1 Current Account Balance (Excl. LHWP)	26.67	105.84	406.57
5.2 Capital and Financial Account Balance (Excl. LHWP)	99.88	52.28	-132.32
5.3 Reserves Assets	-86.90	-177.17	-641.50

+These indicators refer to the end of period. Prime and deposit (savings) rates are averages of all commercial banks' rates operating in Lesotho. The Statutory Liquidity Ratio in Lesotho is 25 percent of commercial banks' short-term liabilities.

6. Selected Economic Indicators

	2003	2004	2005	2006*
1. Output Growth(Percent)				
1.1 Gross Domestic Product – GDP	2.7	4.0	2.7	4.8
1.2 Gross Domestic Product Excluding LHWP	4.3	4.5	3.2	5.1
1.3 Gross National Product – GNI	6.0	6.1	3.4	5.7
1.4 Per capita –GNI	3.7	3.9	2.2	4.4
2. Sectoral Growth Rates				
2.1 Agriculture	0.3	13.5	20.0	10.7
2.2 Manufacturing	5.7	2.1	-8.0	1.2
2.3 Construction	-4.9	-4.4	2.5	2.8
2.4 Services	6.1	2.6	3.5	2.8
3. External Sector – Percent of GNI Excluding LHWP				
3.1 Imports of Goods	84.0	84.5	69.5	77.7
3.2 Current Account	-6.3	-1.2	-1.0	8.6
3.3 Capital and Financial Account	3.9	1.5	2.0	2.3
3.4 Official Reserves (Months of Imports)	5.6	5.2	6.4	7.1
4. Government Budget Balance (Percent of GDP)	-0.4	5.6	4.4	9.3

* Preliminary estimates