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Basel III in Sierra Leone: Delivering on it

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ABSTRACT

Basel III framework is employed to safeguard the banking sector stability in the international arena. Sierra Leone intends to employ Basel III framework for capital regulation in the banking ecosystem. This article attempts to stimulate discussions on policies to enable Basel III deliver on its goals in Sierra Leone. It elucidates on the significance and plausible strategies for implementing Basel III to facilitate delivery. Within this space the banking sector is anticipated to prop-up capital quality and quantity, propelling minimum liquidity requirement for banks, dampening systemic risks and enabling a smooth transition to Basel III Capital Framework. This study emphasizes a cooling-off period to adopting Basel III framework in Sierra Leone, a fine mix of micro and macro prudential regulations required to be deployed and ; the drive to fortify banks' balance sheet in lieu of Basel III capital and liquidity framework adoption. This article recommends that the Sierra Leone's Central Bank should boost market discipline and bolster effective and efficient supervision within the Basel perimeter. The need for cross-border supervision amongst domestics and foreign banks is more so portended. Furthermore, the Central Bank should also stand ready to always protect depositors' funds and deploy crises management strategies including emergency liquidity support amongst others.

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Introduction

Basel III is the second phase of agreements reached by the Basel Committee on Banking Supervision in response to the Global Financial Crisis of 2007 - 2009. With Basel III come increased minimum requirements for capital adequacy, liquidity, and risk coverage. According to the Bank for International Settlement, the overall aim of Basel III is to strengthen the regulation, supervision, and risk management measures of banks. Basel III is already operational in some countries, although the transition window is open till 2028.

Basel III capital and liquidity framework brings with it the merits of standardizing the capital and liquidity thresholds across all banks in the international realm. It also embeds the role of macroeconomic policies including monetary and fiscal policy in preserving their respective banking sector. Indeed many countries including developed and developing countries have completely transitioned to Basel III framework, whilst others including some African countries have partially transitioned to Basel III including South Africa, Swaziland, Uganda and Nigeria amongst others. That said, Sierra Leone is on course to transition to Basel III capital and liquidity framework.

It is true that some jurisdictions think that they are obliged to fully transition to Basel III structure, despite the fact that their banking sectors are unripe to adopt Basel III. Others in the West African setting paint the picture of their intent to transition but on a later date in order to have enough time to understand the frameworks and enhance their monetary and financial stability policies ensuing in conduciveness of the banking sector. Some other advocates have put forward that Basel III framework is only needed for jurisdictions with advanced banking systems like the European banking system. In the political realm, some regulators in African countries like those in Ethiopia are against this Basel III framework since they need to safeguard their country's national identity. This means that they view Basel III adoption as an albatross against their nation's identity.

More specifically, Sierra Leone sees the need to continue strengthening the banking sector and build on resilience in withstanding shocks in the banking sector in particular and the financial system in general. This feeds into the wider spectrum of strengthening the shock absorbency for economic and financial crises management.

This study supplements the existing literature on Basel III implementation with special focus in Sierra Leone. It fills the gap on Basel III potential implementation in the banking sector in Sierra Leone by portending prescriptive policies options and strategies to deliver o this target. In all economies including Sierra Leone, a strong financial sector is key for financial stability and economic development. Safe and sound banking is important for financial stability and these catalyze economic developments and help to support central banks mandate.

The rest of the study is structured as follows section 2 gives brief background on Basel Capital and Liquidity Framework incorporating the evolution from Basel I, II and III in the international banking platform.. Section 3 elucidates on delivering of Basel III framework in Sierra Leone. Section 4 then delves into impending or potential challenges that should be transformed into opportunities for the banking sector in Sierra Leone. Finally, section 5 concludes the discussion and shares some thoughts looking ahead.

Succinct Background of Basel Capital Framework

Basel Capital and liquidity framework is a platform to safeguard stability of the international banking arena. By extension Sierra Leone has accepted the drive to incorporate this framework for ease of banking sector regulation.

The Basel Committee of Banking Supervision (BCBS) issued the first set of capital accords in Basel 1 in 1988.This first set was structured to building understanding on core banking supervision elements and enhance the quality of banking supervision amongst countries. Subsequently, the BCBS, in 1997 issued the 'Core Principles of Effective Banking Supervision', and this unleashed an inclusive and effective banking supervision. That said, it should be noted that over time regulators observed that Basel I was too simple for a complex world engulfed with a facet of risks.

In the realms of Basel II accord, the focus is on financial system soundness. It was entrenched on revamping regulations of capital by employing risk weights, customizing bank regulations to specific jurisdictions' landscape, and incentivizes banks to gauge risks and management capabilities. The evolution of Basel II was such that it was initially issued in 1999 in the form of four consultative papers by the BCBS over the period 1999, 2001, 200III and 2004 respectively. Consequently, an amendment was made in 2005and 2006 with a finalized version approved in 2008. That being said, it was unraveled much later on that Basel II was much more risk- capturing, and banks used models for calibrating capital that were most times not understood by the central bank regulators. This resulted in banks gaming the system, in the sense that minimum capital thresholds were tampered with.

The financial crisis of 2008 and 2009 prompted the regulators to do a deep rethink risk management practices which were until then based on Basel II Accord. This gave rise to the BCBS instituting Basel III to remedy the deficiencies of Basel II Accord. Basel III lays immense importance on liquidity and the impact of economic cycles on financial system- the macro-prudential and micro-prudential approach. Basel III is a continuum of dynamics to revamp regulations in the banking sector and it embeds three principles. These include:

- The first principle being the "minimum capital requirements'. The Basel III increased the minimum capital requirements from for banks from 2 percent in Basel II to 4.5 percent of common equity, as a percentage of banks' risk weighted assets. Furthermore, an addition al 2.5 percent buffer capital requirement is placed hence resulting in total common equity of 7 percent.
- The second principle being the 'leverage ratio' which deployed a non-risk based leverage ratio that requires banks to hold a minimum of 3 percent leverage ratio. The leverage ratio was calculated by dividing Tier 1(core) capital by the bank's average total consolidated assets.
- The third principle being the 'liquidity requirements' which incorporates two liquidity ratios, namely, the 'liquidity coverage ratio' and the 'net stable funding ratio'. Liquidity Coverage Ratio (LCR) confirms that banks' maintain sufficient volumes of high-quality liquid assets that is resilient to a 30-day liquidity stressed funding scenario as depicted by the banking regulator or supervisor. Conversely, the Net Stable Funding Ratio (NSFR) builds on shock absorbency in the long term by requiring that banks maintain stable funding over a vintage of one year extended stress. The NSFR is deployed to address structural liquidity situations in banks.

Furthermore, Basel III also introduced capital requirements to cover Credit Value Adjustment (the difference between the risk-free portfolio and the true portfolio value that takes into account the possibility if a counterparty's default. In other words, CVA represents the market value of the counterparty credit risk.) (CVA) risk and higher capital requirements for securitization products.

From a financial stability perspective, the Basel III merits include strengthening regulation, supervision and risk management practices within the banking industry. Moreover, it is expected to dissuade banks from taking excessive risks that is inimical to the economy. This also translates in making banks more resilient, improving transparency and disclosures.

Basel Iii in Sierra Leone: Delivering on it

The Basel III can be made to work in Sierra Leone by all segments of the banking system and the government doing their part in a full, timely, consistent and efficient strategy. The driver of this implementation includes the banks, the central bank and the fiscal.

The Role of Banks in Sierra Leone in Adopting Basel III

Banks are the driving membranes and amongst the most leveraged given the prime moving roles they play and the ecosystem within which they operate, specifically how they interact with the rest of the economy. Banks can now bring several measures to bear in adopting Basel III standards. Banks in Sierra Leone should display full support for instituting Basel III standards and complying with standards via:

- ➢ Rendering intensive training on Basel III to their risk management and compliance staff.
- ➢ Portraying a potent culture trickling down to all cadres of the banks.
- ➢ Horn skills of Board risk committee members to enhance competency in risk management and regulations.

In addition, banks in Sierra Leone should adopt process ownership for Basel III adoption by appointing a Chief Risk Officer (CRO) or Chief Compliance Officer with wealth of experience who will spearhead the adoption of Basel III standards across banks.

Furthermore, Banks should ensure that they all meet the minimum capital levels buttressed with high quality capital to boost their resilience and by extension safeguard financial system stability.

The Role of the Central Bank of Sierra Leone

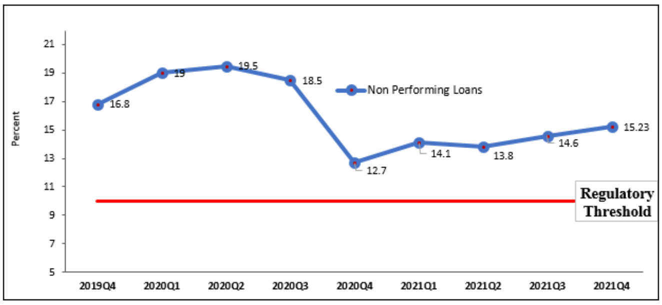
The Central Bank as the chief regulator of the banking system should oversee the transition period from Basel II to Basel III preferably in a phased manner to ensure enough time in order to translate Basel III standards into the national macro-prudential policy framework.

Additionally, the Central Bank should customize the Basel III standards to fit the specificities of the Sierra Leone Banking Sector. The current minimum paid-up capital is Le85.00 billion for banks in Sierra Leone. It is a truism that delivering on Basel III will improve the efficiency and effectiveness of the banking sector in Sierra Leone as key elements in the Basel III framework will be employed by regulators to further boost banking sector stability. Having said that, the country is not Basel 2 compliant as the delivery of Basel 3 will be will be accompanied by key elements of Basel 2 to complement Basel 3 Capital Framework ultimately.

Furthermore, it is essential to indicate that Central Bank of Sierra Leone has put in place building blocks for the impending implementation of Basel 3 Capital Framework. By way of information, the following are noted:

- On the Deposit Protection Scheme, the Bank is well advanced with the development of the Sierra Leone Deposit Protection Scheme (SLDPS) following the Bank of Sierra Leone's Board approval in May 2018. The Bank through the support of a Consultant provided by the US Treasury Department, developed a draft Deposit Protection Bill which will provide the legal framework and the said document has been forwarded to the Ministry of Finance to facilitate Cabinet approval and the final preparation by the Law Officers Departments (LOD), of the Attorney General's Office prior to enactment by the Parliament of the Republic of Sierra Leone. Other administrative and logistical arrangements to support the scheme are well advanced.
- On the Sierra Leone Collateral Registry, the Bank of Sierra Leone continues to work with Government of Sierra Leone and the World Bank under the Sierra Leone Economic Diversification Project for the implementation of the phase II of the Collateral Registry Project, which includes the drafting and enactment of a new Borrowers and Lenders Regulation, public education and awareness raising on the collateral registry and the reconfiguration of the Collateral Registry System in line with the new Borrowers and Lenders Act, 2019. The latter would enable individuals and non-incorporated entities (entities other than financial institutions licensed by the BSL) to open an account and register security interests on the Collateral Registry Platform. The Bank has also revised downwards the various fees charged for the use of the Sierra Leone Collateral Registry System in order to enable Micro, Small and Medium Enterprises have access to credit facilities.
- Based on Development in the IFRS Implementation, the BSL fully implemented IFRS 9 in 2018 for all banks in the industry and had successfully issued an IFRS 9 Implementation Guideline with the support of the Office of Technical Assistance, U.S Treasury. The Post implementation team continues to assess the credit risk model used by banks to monitor the variables incorporated and the respective impact of such variables on the Expected Credit Losses (ECL) of financial institutions.
- In addition addressing asset quality issues in in the banking sector is vital. Non-performing loans is on the uptrend. As at End December, 2022, non-performing loans stood at 15.23 percent above the regulatory threshold of 10 percent as shown in figure 1.

Figure 1: Non-Performing Loans Trend



Source: Bank of Sierra Leone

The Role of the Government

Fiscal can give the central bank full support in adopting the Basel III for the banking sector of Sierra Leone. More specifically, fiscal should understand the merits and ramifications of transitioning to Basel III standards especially in the front of procyclicality and counter cyclicality of capital buffers. This is needed to keep government well-informed about the Basel III standards and implementation plans, so that any future fall-out or negative externalities of the banking sector will be well anticipated and provided for.

Additionally Government should support in enacting new laws or regulations to establish new institutions as deemed expedient by the chief regulator (Central Bank) to support the banking system in Basel III era. Moreover, a crisis management plan and emergency liquidity crisis measures should be put in place to rescue the financial system [1-9].

Conclusion and Recommendations

The article has unraveled what is needed to deliver on Basel III standards in the banking sector of Sierra Leone. This transition will no doubt be an intensive one as the central bank should leverage on all its resources and muster the drive directed to making Basel III standards work in Sierra Leone's banking sector. Basel I was too simple for a complex world and did not encompass all the risks, Basel II was encompassing but banks were gaming the system, hence Basel III is needed to standardize capital levels such that comparable will be made across the different jurisdictions of the banking sector and the resiliency, soundness and profitability is increased in. the banking sectors. The BSL surely will not adopt a wholesale approach in the implementation of Basel III Accord. Instead, it has provided a set of implementation guidelines which have been varied to reflect the peculiarity of the Sierra Leonean banking sector. To this extent, the BSL, amongst others, may vary the risk weight assigned to specific credit risks on financing transactions.

Accordingly, when the adoption of the Basel commences it will run concurrently with the preexisting (Basel II) regulatory framework for some time.

In conclusion, it is important that banks in Sierra Leone have sufficient capital above regulatory minima at all times, depending on their risk profile, business models and bank-specific conditions. Furthermore, Basel III regulation standards will bring more regulations, transparency and more clarity to the banking system in Sierra Leone. Secondly, Basel III regulation will encompass macro and micro-prudential approach to safeguard banking sector stability. Thirdly, Basel III will reduce procyclicality and build on counter-cyclicality in addressing systemic risks. Moreover, the chief regulator should phase the implementation process as this should be a learning process for banks.

Additional research work should be done in in investigating the effect of Basel III implementation using a Quantitative Impact Study (QIS) entrenched by granularity of data. The findings from this study can unravel the performance and behavior of banks in Sierra Leone going forward. It is also true that Basel III framework can reduce excessive risk taking in banks and non-performing loans. Consequently, future research can unravel whether banks in Sierra Leone have more or fewer loans in the Basel III era relative to Basel I.

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