Limiting the Risk of Failure in Financial Institutions

Remarks

By

Dr. C. L. Dhliwayo

Deputy Governor, Reserve Bank of Zimbabwe

on the occasion of the Public Accountants & Auditors Board conference held at Rainbow Towers in Harare, from 9 - 10 April 2015.

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SALUTATION

- Dr. D. Sibanda, Head of Fiscal Policy and Investment in the Ministry of Finance and Economic Development;
- Dr. W. Sibanda, Chairman of the Public Accountants & Auditors Board;
- All Board Members of the Public Accountants & Auditors Board here present;
- Mr. J. Chikura, Chief Executive Officer of the Deposit Protection Corporation;
- World Bank officials here present;
- Members of the Accounting and Auditing fraternity here present;
- Distinguished presenters;
- Ladies and gentlemen,

1. I wish to start by thanking the organisers of this event, the Public Accountants & Auditors Board (PAAB) for inviting me to address you on a very important topic: **'Limiting the Risk of Failure in Financial Institutions'**.
2. I wish to commend this initiative by PAAB in organizing this seminar. The accounting and auditing profession is **an anchor stakeholder** in the promotion of economic growth and development in all sectors. The Reserve Bank believes that the effective collaboration between the accounting fraternity and the

supervisory authorities is fundamental in our pursuit for financial sector stability.

3. Ladies and gentlemen, over the last few years, Zimbabweans from all walks of life have taken great interest in the state of our financial sector. The apparent interest and concern in the sector is not by any means unwarranted given the number of banks that have failed recently considering the key role that the financial sector plays in the development of our economy.

4. Financial institutions, through their intermediation role, have the ability to influence developments in other sectors of the economy.

FINANCIAL SYSTEM IN ZIMBABWE

5. In Zimbabwe the financial system is well developed relative to the size of the economy. The principal financial intermediaries, comprising banking and non-banking financial institutions, offer a wide range of services.

6. The **banking sector** is constituted by **15 commercial banks**, **one merchant bank**, **three building societies** and **one savings bank**.

7. Meanwhile, the **non-bank financial institutions** in the financial sector include insurance companies, pension and provident funds, asset management companies, unit trusts, development financial institutions microfinance institutions, stock brokers as well as the Zimbabwe Stock Exchange.

8. Ladies and gentlemen, as you would know, the banking sector and the non-bank financial subsectors play hugely complementary roles in the provision of financial services.

9. My discussion today is going to focus on the banking sector, which is regulated and supervised by the Reserve Bank of Zimbabwe.

ROLE OF THE BANKING SECTOR IN THE ECONOMY

10. Banking institutions play a unique role in the economic process. Numerous researches have confirmed that strong linkages exist between financial sector stability and economic growth.

11. The primary functions of banks entail the acceptance of deposits from surplus units and advancing of loans to the country's productive sector.

12. As already indicated by the Reserve Bank, through its various publications, the banking sector had mobilised deposits amounting to $5.1 billion as at 31 December 2014 while total banking sector loans amounted to $4.01 billion. Lending to manufacturing, agriculture, mining and construction sectors accounted for 49.54% while loans to individuals and transport and distribution sector constituted 37.31% of banking sector loans.

13. Banking institutions also have secondary functions which include international trade finance, purchase and sale of financial

instruments, money transfer, provision of letters of credit and guarantees and provision of custodial services, among others.

14. However, banking systems the world over, are generally considered to be inherently fragile, unstable and therefore prone to turbulence, by the reason of their financial intermediation and maturity transformation roles.

15. Meanwhile, problems in the banking sector have profound effects on the real and service sectors of the economy.

16. In this respect, financial sector regulators attach great significance to the stability and soundness of the financial system. Effective bank regulation and supervision is therefore essential for financial and economic stabilization.

ROLE OF RESERVE BANK IN PROMOTING FINANCIAL STABILITY

17. At the apex of the banking sector is the Reserve Bank of Zimbabwe which performs much of the traditional central bank functions as defined in section 6 of the Reserve Bank of Zimbabwe Act [*Chapter 22:15*]

18. One of the principal roles of the Reserve Bank outlined in the Act is the maintenance of a sound and stable financial system through prudential supervision of banking institutions.

19. In this respect, the Reserve Bank has a robust supervisory tool kit for the effective oversight of the banking sector in line with international best practice.

20. Our supervisory methodologies and techniques, which have also been independently assessed by the IMF and the World Bank, range from a strong bank licencing framework, risk based on-site examination system, off-site surveillance, consolidated supervision, stress testing to early warning systems, among others.

21. It is common knowledge that the banking industry is one of the highly regulated sectors, ostensibly after the aviation industry.

22. Bank regulation arises due to a number of reasons which include:

    a) Limiting cost of bank failures which are typically very costly and often require the use of taxpayer's funds.
    b) Correction of market imperfections and failure emanating from information asymmetry, agency problems and opaqueness of financial products.
    c) Protecting the interests of depositors and creditors.
    d) Regulatory authorities have a fiduciary responsibility to curb moral hazard behaviour on the part of both depositors and financial institutions.
    e) Regulation provides a yard stick for acceptable behaviour in the market in order to create a level playing field.

23. Financial crises experienced all over the world demonstrate beyond doubt that a sound financial system is essential for economic

prosperity as well as social welfare and national security. The Reserve Bank, therefore, attaches great significance to the stability and soundness of the financial system.

24. Achieving long-run financial stability is a difficult and continuous challenge, as it requires constant efforts first to detect, and then to correct the building up of institution specific as well as financial sector-wide problems.

25. However, literature as well as our experiences locally reflect that in spite of the best efforts and supervisory intentions by the regulators, financial crises and bank failures can and still happen.

HISTORY OF BANK FAILURES IN ZIMBABWE

26. Bank failures are a phenomenon that has characterised the economic histories of many developed and developing nations, and Zimbabwe is not an exception.

27. On the international arena, the Global Financial Crisis of 2007-2009, is a recent example during which a number bank failures occurred.

28. In Zimbabwe, we have experienced over 20 cases of bank failures since 1980.

29. In 1980, there were only 5 banking institutions in the financial sector. The financial reforms adopted in the 1990s saw the entry of more players into the banking sector which was previously dominated by a few large foreign banking institutions. At their peak in 2002, there were 40 players in the banking sector. The

expansion of the banking sector was largely welcomed as a positive development. However, some of these banks have since failed and there are only 20 institutions remaining.

30. Most of the bank failures occurred during the period 2003/4, when 10 banking institutions were placed under curatorship, 2 were placed under liquidation, and one discount house was closed.

CAUSES OF BANK FAILURES

31. Ladies and gentlemen, the major causes of bank failures in Zimbabwe by and large mirror the experience of other nations, emanating macroeconomic factors and institution-specific deficiencies. The banking institutions that have failed in our market have faced serious challenges that ranged from **chronic liquidity problems**, deep-rooted **risk management deficiencies** and **poor corporate governance practices**.

32. The failed banks commonly **took excessive risks and engaged in over-trading**. Further, the pressure from increased competition also led to the narrowing of margins and hence reduced profitability against a background of increasing credit defaults.

33. One of the key causes of bank failures is the **failure to manage risks** faced by the financial institution. Our experience of bank failures points largely to the failure by boards and senior management to put in place strong risk management practices

which are commensurate with the size and complexity of their operations.

34. Failure to implement strong risk management practices is compounded by **rapid expansion in operations** in the absence of appropriate policies and controls.

35. **Weak governance structures** characterised by lack of policies, failure to enforce compliance with policies and failure to interrogate management reports is a common characteristic of failed banks. This is often the case in owner-managed institutions, where owner managers often exert **overbearing influence** in the day to day operations of the banks, without due consideration for best practice standards of risk management.

36. **Non-performing loans**, have also been a significant contributory fact in the failure of banking institutions. In particular, we have noted the abuse of loans and advances by related parties (particularly, directors and shareholders) which has resulted in huge levels of non-performing insider loans leading to bank failures.

37. **Inadequate capitalisation** of banking institutions limits the ability of banks to absorb unforeseen losses. Such banks are unable to weather the shocks of unexpected losses when they occur.

38. **Regulatory arbitrage**, often through the abuse of group structures, is another cause of bank failures in our economy. In pursuit of

higher profits, some banks engaged in non-banking activities, often very speculative in nature resulting in excessive risk exposure.

39. These transactions were often conducted through group structures so as to avoid regulatory scrutiny. In most instances, management had **inadequate skills and expertise** to exercise the appropriate oversight of these products.

40. Banks have also recently been affected by the challenge of information asymmetry arising from the lack of a dedicated credit reference bureau to serve the needs of banking institutions. This has resulted in banks experiencing defaults from over-borrowed customers.

41. All of these elements have the combined effect of exposing banks to excessive risk of failure reflected in inability to meet payment obligations.

42. Ladies and gentlemen, it should also be accepted that the earlier experiences of bank failures in Zimbabwe were partly attributed to inadequate supervision and regulation at the time.

43. The first two banks which failed before 2004 were due to the separation of the licencing and supervision functions, where licencing was conducted by the Ministry of Finance while prudential supervision was the responsibility of the Reserve Bank. This arrangement was not in line with international best practice, such as the Core Principles for Effective Banking Supervision.

44. However, in spite of the introduction of a number of reforms and measures to improve our legislation and supervisory approaches, bank failures continued to occur.

45. This therefore raises the point that **regulation in itself is not the panacea to bank failures.** In fact, in spite of strong regulatory systems and supervisory tools the world over, bank failures still do occur. The role of supervision is therefore to ensure that key risks and vulnerabilities are identified timeously and that failed banks exit the market with minimal disruption to the overall functioning of the economy.

IMPACT OF FINANCIAL INSTITUTION FAILURES

46. Ladies and gentlemen, bank failures are not merely a change in the architecture of the sector, they represent lost savings, lost pension funds and the inability to pay for school fees and other basic necessities for the common man on the street.

47. As a result of the bank failures we have faced, the banking public endured tremendous psychological, emotional, social and financial trauma.

48. The impact of financial institution failures is not limited to the depositors of a banking institution. The failure of a single financial institution has the potential to cause widespread disruption to the

country's payments infrastructure and hence poses systemic risk to otherwise financially sound banking institutions.

49. Due to the very nature of financial institutions, the failure of just one bank, sends waves of differing magnitudes across the entire economy. Bank failures impact negatively on the real sector by causing company closures and job losses, in certain instances.

50. Further, resolution of failed financial institutions represents an additional cost to taxpayers as public funds are channelled to resolution strategies. These funds could have been channelled to other productive needs of the economy.

51. Ladies and gentlemen, the huge cost of financial institution failure is the loss of confidence in the entire banking system. Banking is based entirely on a relationship of trust to safeguard liabilities placed by the banking public. Once this trust is lost or eroded, it is the most difficult to reinstate.

52. I would like to outline some of the lessons we have learnt from bank failures over the years.

LESSONS LEARNT FROM BANK FAILURES

53. A well-known adage says "**failures are great learning tools … but they must be kept to a minimum.**"

54. Ladies and gentlemen, some key lessons have been learnt from these experiences which will assist us in limiting the risk of these occurrences going forward.

55. We have noted the need for regulators to execute their mandate in a timely and proactive manner in order to curb incidents of bank failures.

56. There is need for a strong legal and regulatory framework, which recognises the unique nature of banking institutions as opposed to other commercial enterprises.

57. In addition, there is need for information sharing and co-operation between regulators and key stakeholders in order to keep abreast with developments in different sectors and jurisdictions which pose a threat to banking institutions.

58. On the part of the banking institutions themselves, strongly capitalised banks with the support of strong anchor shareholders are better placed to weather the storms which may arise in the banking sector. Capital provides the much needed cushion to absorb such losses.

59. The role of robust management information systems in the day to day operations of banks cannot be over-emphasised. Manual systems with inadequate internal controls are fertile ground for nefarious banking activities.

60. Banking institutions should take seriously the trust placed in them by depositors and carry out banking business in a prudent manner.

In this regard, ethics, integrity and transparency play a key role in maintaining depositor trust.

61. **External and internal auditors**, as assurance functions, need to provide the assurance that information supplied by management regarding the condition of banking institutions is reliable and reflective of the reality obtaining in the financial institution.

62. As regulators we are duty bound to supervise and regulate the sector within the provisions of the regulatory and supervisory framework to ensure that banks are operating in a safe and sound manner. Further to this, we owe it to the banking public to ensure that accurate information regarding the state of health of the sector is readily available.

63. All stakeholders need to work together closely to maintain the banking sector in a safe and sound position.

SUPERVISORY RESPONSES TO PROMOTE BANKING SECTOR STABILITY

64. Ladies and gentlemen, the adage, "**an ounce of prevention is worth a pound of cure**" is also appropriate in the banking sector.

65. At this juncture I wish to briefly outline the efforts that we have made to date in limiting the risk of financial institution failure.

Strengthening the Legal And Regulatory Framework…

66. Much work has gone into strengthening the legal and regulatory framework for banking institutions. Proposals to amend the

Banking Act aimed at **enhancing governance structures** within banks, strengthening the powers of the regulator and punishing non-compliance or any errant activities have been made.

Resumption of the Lender of Last Resort function…

67. Going forward, the Central Bank is set to fully resume its Lender of Last Resort function following its recapitalisation. This will assist in managing temporary liquidity challenges faced by solvent banks, thereby limiting their risk of failure.

Enhancement of Supervisory Approaches…

68. The Reserve Bank's supervisory framework, which is founded on the principles of **risk-based supervision** has been enhanced continuously. The approach has become more interactive to involve other regulatory agencies as well as non-executive board members and assurance functions of banks.

69. The **consolidated supervision framework** provides for oversight of holding companies and affiliates of banking institutions as a means of identifying sources of risk from non-bank operations.

70. Further to this, **memoranda of understanding** were signed with various local and regional supervisory authorities to promote supervisory cooperation and coordination.

71. We now hold **supervisory colleges** which provide us with a forum for bank supervisors to share information on the condition and

performance of subsidiaries of banking groups operating in their respective sectors and/or jurisdictions.

Role of the Deposit Protection Scheme as a Safety Net…

72. Deposit insurance schemes have been globally accepted as a means for promoting financial stability and protecting depositors and creditors of banks.

73. In Zimbabwe the Deposit Protection Corporation is a significant player in the financial sector as it provides a safety-net for the savings, banking and payments systems.

74. The introduction of the deposit insurance system has promoted public confidence in banks, thereby making the financial system more stable. As a safety net, the DPC limits the effect that problems at one bank might have on other, healthier banks in the market, thereby reducing the possibility of contagion or a chain reaction within the banking system as a whole.

75. The Reserve Bank and DPC have collaborative arrangements which promote effective, orderly and logical exit procedures of failed banking institutions.

Issuance of Guiding Policies to the Market…

76. The Reserve Bank has also issued numerous guidelines to financial institutions on topical issues such as corporate governance, financial disclosures, special purpose vehicles and risk management, among others. The guidelines serve as a reference to bank management on minimum regulatory expectations.

Enhanced Risk Management Systems in Banks…

77. Banking institutions have embraced enterprise-wide risk management as a risk management approach, which enables them to have a holistic view of the risks they face and the inter-linkages between risks.

Revised Capital Requirements…

78. The Reserve Bank has revised upwards capital levels that should be held by banks.

79. Adequately capitalised banks are better positioned to weather the storms of banking sector challenges and are therefore less prone to failure.

80. Banks have worked resolutely to raise their capital positions to levels compliant with minimum regulatory requirement.

Establishment of an Asset Management Company…

81. The resolution of the current scourge of non-performing loans under the ZAMCO initiative is expected to rejuvenate the banking sector by injecting back liquidity previously tied up in non-performing assets and freeing up banks' balance sheets. This will enable banks to resume in earnest their role in funding productive sectors of the economy.

Establishment of a Credit reference System…

82. Ladies and gentlemen, in an article entitled building a *Better and Safer Banking system in Latin America and the Caribbean,* **Gerald**

Corrigan, argues that the "**most important and also most difficult thing in banking is to promote a deeper credit culture**".

83. The Reserve Bank is in the process of establishing a Credit Reference System which will assist in limiting the risk of information asymmetry which has been partly blamed for the rising non-performing loans in Zimbabwe. The system will foster responsible behaviour on the part of both borrowers and lenders, thereby reducing the incidence of delinquent borrowings.

Disclosure requirements…

84. All banking institutions are required to disclose their financial statements in circulating newspapers periodically.

85. These minimum disclosure requirements have also enabled depositors and investors alike to make informed decisions regarding banking institutions.

Cooperation with the Accounting and Auditing Profession…

86. Ladies and gentlemen, it is important to note that financial reporting forms the basis of various elements of prudential supervision. In this regard, collaboration and dialoguing between regulatory authorities and accounting profession promotes adoption of sound accounting and reporting practices

87. The Reserve Bank recognizes and applaud the International Accounting Standards Board (IASB) for including the expected loss notion in their new financial instruments standard, IFRS 9.

88. We expect the local accounting and auditing profession to take a leading role in the implementation and compliance to the new accounting standards, and in aligning supervisory & accounting requirements.

89. Consistent implementation and compliance to accounting and regulatory requirements contribute to the financial stability of the banking sector.

Contingency Planning…

90. In order to deal with systemic risk vulnerabilities within the sector, the Reserve Bank has developed a Contingency Planning Framework. The framework seeks to guide banking institutions in planning for distressed conditions, thereby limiting the risk of failure.

Training and Industry Workshops…

91. Regular training and workshops conducted for the banking sector enhances management skills for board members and management.

Enhancing Supervisory Capacity…

92. The Reserve Bank has received technical assistance from the International Monetary Fund for the purposes of enhancing

supervisory tools. The programmes have also enhanced the Reserve Bank's capacity building efforts by exposing regulators to the latest trends in regulatory techniques.

93. Our capacity building initiatives are geared at ensuring that the supervisory and regulatory framework and methodologies are sufficiently robust to ensure prompt identification of banking weakness and implementation of appropriate remedial action in line with global best practice.

Consumer Education…

94. Consumer education on the functioning of banks and their right to accurate information on the safety and soundness of institutions in which they entrust their hard-earned monies is also key to limiting risk of failure. To this end, the Reserve Bank and other stakeholders have embarked on numerous consumer education initiatives including road shows and periodic bulletins, highlighting the rights and responsibilities of the banking public.

CONCLUSION

95. Ladies and gentlemen, tremendous measures have been instituted to reduce the scope for financial institution failures, we have witnessed over the last few decades.

96. The Reserve Bank recognises that a lot still remains to be done. The process is continuously evolving and calls for all stakeholders, including the accounting and auditing fraternity, to be committed.

97. Nonetheless, regulation and supervision does not guarantee that there will be no failures of banks. Instead, regulation merely assists to proactively identify and manage institutions in distress thereby limiting the negative consequences of bank failures.

THANK YOU