FINAL REPORT

MALAWI: NBFI Capacity Building Strategy*

20 February 2005

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1. This Report is presented in compliance with the terms of reference for project No. CNTR IDA.F.03 C284 as detailed in the contract between Carmichael Consulting Pty Ltd and the FIRST Management Unit dated 19 August 2004.

2. This Report completes the project to assess the state of non-bank regulation in Malawi and to recommend a capacity building strategy and action plan.

3. The Report is in two parts. The first is an Executive Summary of the findings and recommendations of the project. The second is the Main Report.


5. We wish to thank the officials of the Reserve Bank of Malawi, especially Patrick Mhango, who gave freely of their time and views.

Dr Jeffrey Carmichael
Executive Chairman
Carmichael Consulting Pty Ltd

20 February 2005
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EXECUTIVE SUMMARY OF THE KEY FINDINGS AND RECOMMENDATIONS

MALAWI: NBFI Capacity Building Strategy

The Reserve Bank of Malawi (RBM) has done a creditable job under difficult circumstances in supervising NBFIs. It has been challenged by a lack of staff resources and an outdated legal framework. Further, the internal structure of regulation and supervision within the RBM has not been conducive to the development of a strong and cohesive supervisory culture.

The challenges of the next decade or more will demand a significant upgrading of the RBM’s regulatory and supervisory frameworks as well as in its staff resources. The RBM’s management are aware of this need and of the magnitude of the task ahead. They are also supportive of the work that needs to be done.

This Report recommends a series of capacity building priorities designed to equip the RBM to meet its regulatory responsibilities. These recommendations cover the following main areas: regulatory structure; legal and regulatory framework; supervisory framework; and human resources.

Regulatory Structure

While the Reserve Bank of Malawi Act appears to impose on the RBM a very wide ranging responsibility for NBFI supervision, the Act provides very little clarity in terms of the institutions covered and very little by way of powers to supervise. Further, there are several important groups of financial institutions that are currently either unregulated or under-regulated in Malawi (including pension funds, microlenders and credit co-operatives). The lack of clarity and potential confusion about regulatory responsibilities needs to be addressed.

Recommendation 1

That the current range of institutions subject to regulation and supervision in Malawi be extended to cover all financial institutions. In particular, it should be broadened to include:

- Pension funds, pension fund administrators, pension fund asset managers, and pension fund advisors;
- SACCOs;
- Medical aid funds;
- Friendly Societies;
- Microlenders;
- Finance and leasing companies (non-deposit taking);
• Development financiers; and
• Bureaux de change.

The Interim Report reviewed the main international structural models in the context of Malawi and suggested that the most appropriate model at this stage of Malawi’s development was the unified ‘Singaporean’ model, in which the central bank takes on responsibility for all financial regulation and supervision.

The advantages of this unified model, relative to the alternatives, are that it: gives the RBM responsibility for all financial supervision, consistent with its legislated responsibility for systemic stability; provides a sound platform for co-ordination and co-operation between supervision and monetary managers in the event of crisis; maximizes scale economies in supervision; provides the best platform for supervising financial conglomerates; provides the best platform for eliminating regulatory arbitrage; provides the widest career opportunities for supervisory staff; minimizes the cost of supervision; provides the greatest synergies among supervisors; and, by drawing on the underlying strengths of the RBM, it provides the best combination of independence, resources and credibility for non-bank supervision.

**Recommendation 2**

*That, consistent with the intent of s48 of the Reserve Bank of Malawi Act (1989), the RBM takes on responsibility for financial regulation and supervision of the entire financial sector in Malawi, and that the Bank pursue the necessary legislative amendments needed to put this into effect (see below).*

There are many issues that need to be addressed in implementing the recommended regulatory structure in Malawi, including the internal structure of the Bank, the structure of the Bank’s Board, and the way in which regulation and supervision are funded.

**Recommendation 3**

*That the RBM be re-organized internally to establish a separate Division of Financial Supervision, headed by a General Manager with supervisory experience.*

**Recommendation 4**

*That the Reserve Bank of Malawi Act (1989) be amended to include two additional board members with financial industry and/or regulatory experience and to create a sub-committee of the main board consisting of these two members plus the Governor (as Chair) and Deputy Governor to consider matters relating to regulatory and supervisory policy.*

Implementing the proposed regulatory structure will require a number of other legislative initiatives. In approaching the legislative reforms we recommend the following strategic approach.

**Recommendation 5**

*That the following strategy be adopted for reform of financial sector laws:*

• The Reserve Bank of Malawi Act (1989) be amended to incorporate all financial sector regulatory powers and responsibilities (details below);

• A new law be drafted for the pension fund industry;*
The draft Securities Law be amended to remove the reference to the establishment of a separate Securities and Exchange Commission; and

The existing industry laws be amended to bring about consistency with this approach.

The implementation of the proposed regulatory structure and the recommendations that follow with respect to staff numbers and skills will require a significant increase in overall regulatory resources. We recommend that the RBM commence the process of adopting industry funding, in line with experience elsewhere in the world. Such an approach would: ensure an adequate long-term funding base for high quality supervisory services; provide greater transparency about the cost of financial regulation and supervision; shift the cost of these activities to the ultimate beneficiaries; provide industry with time to adjust to the idea of “user pays”; and provide a funding base that could sustain a regulatory agency separate from the RBM if ever that were chosen as the next step in regulatory evolution.

Recommendation 6

That the RBM introduces a mixed industry/central bank funding model for financial regulation and supervision under which:

- Supervised entities would pay either an annual licence fee or a levy based on assets under management or a combination of both;

- Levies would start at a very low level of say 5 basis points on assets, increasing over a period of up to ten years to the level required to fully fund financial regulation and supervision;

- Commercial banks would receive a pari passu reduction in the implicit cost of required reserves (either by paying a rate closer to market or by reducing the reserve requirement) for their levy contribution to regulation and supervision; and

- During the period that the mixed funding arrangement remains in place, the RBM will adopt, as soon as practicable, the following principles of accountability:

  - The accounts of the Bank should identify clearly (on an accrual basis consistent with international accounting principles) all costs and revenues related to regulation and supervision, including the allocation of overheads.

  - The supervisory budget should be circulated to industry three months before the start of the financial year for consultation and comment, and be subject to approval by the RBM board no later than one month before the start of the financial year.

  - Funds raised from industry should be used exclusively for the Bank’s regulatory activities and related fixed costs.

  - The RBM should meet with industry at least once a year to discuss its use of industry funds, its approach to regulation and its plans for the period ahead.

Legal and Regulatory Framework

There are several key legislative reforms needed in Malawi.
First, there is a need to remove the current ambiguity about precisely which financial institutions the RBM is to regulate and supervise.

**Recommendation 7**

*That the Reserve Bank of Malawi Act (1989) be amended to include a statutory list of financial institutions over which it has regulatory jurisdiction and that the Minister be given the power by regulation to add new financial institutions to that list if circumstances so warrant.*

Second, there is a need to introduce new legislation to provide the administrative basis for the existence and operation of certain sectors of the financial system. The most immediate need is for a law governing the operation of pension funds and their related industry professionals.

**Recommendation 8**

*That a Retirement Incomes Bill be drafted to establish a firm legal basis for the operation of pension funds and pension industry professionals.*

Overall, there appears to be considerable scope for strengthening the regulatory requirements imposed on insurance companies and capital market participants to better reflect the risks that they incur and to provide a greater level of confidence in their financial sustainability. There will also be a need to develop regulatory requirements for the currently unregulated sectors.

Development of comprehensive regulatory requirements through regulations and directives in line with the framework outlined this Report is an exercise that will take several years. Consequently, we have recommended establishing a group with responsibility for monitoring and overseeing the coherence of the regulatory requirements as they develop.

**Recommendation 9**

*That the RBM establishes a Policy Group within the new Financial Supervision Division to conduct a comprehensive review of the regulatory requirements for each sector against the principles outlined in this Report as well as against the equivalent regulatory requirements established by other countries in the Southern African region and international associations of regulators. This group should be responsible, on an on-going basis, for developing new regulatory requirements and for drafting directives to implement them.*

The powers granted to the RBM under the Reserve Bank of Malawi Act, and other specific industry acts are deficient in many respects. Many of these deficiencies are being addressed by bills currently either in preparation or in the process of being put before the Parliament. They are not, however, completely remediated, and powers in some of the industry laws appear to conflict with those in others. We recommend a comprehensive solution to this problem by removing all regulatory powers from the underlying industry laws and elevating them to the RBM Act.

**Recommendation 10**

*That the Reserve Bank of Malawi Act (1989) be amended to provide the RBM with the regulatory powers outlined in Section 5.3, modified where appropriate for less intensively regulated financial institutions.*

The RBM Act is also deficient in the level of independence that it gives the RBM and in the level of accountability that it demands. Neither of these aspects is in line with international best practice.
Recommendation 11

That the Reserve Bank of Malawi Act be amended to provide:

- more explicit conditions covering the appointment and dismissal of board members and senior officials of the RBM, including ratification by Parliament;

- a explicit and transparent mechanism for dealing with potential conflicts between the Government of Malawi and the RBM on matters of regulatory policy;

- a legal indemnity for staff who carry out their financial sector supervisory responsibilities in the absence of bad faith; and

- the power to recover the cost of financial supervision from industry under the terms outlined in Recommendation 6.

Recommendation 12

That s4 of the Reserve Bank of Malawi Act be amended to provide greater clarity to its regulatory and supervisory objectives, by amending s4(h) to read:

“To regulate and supervise banks and other financial institutions with the objective of fostering:

- the stability of the financial system;

- the safety and soundness of financial institutions;

- the highest standards of conduct of business by financial institutions;

- the fairness, efficiency and orderliness of the financial sector;

- the protection of the interests of consumers of financial services and products; and

- the reduction and deterrence of financial crime.”

And that, in pursuing these regulatory and supervisory objectives, the Bank must take into account:

- the impact of the costs of regulation and supervision on the ability of the community to gain access to financial services; and

- the need to balance the effectiveness of regulation and the efficiency of the financial system.”

Recommendation 13

That the Reserve Bank of Malawi Act be amended to require the RBM to:

- advise the Minister about any distressed financial institution that is in danger of failing;

- appear before the Parliament or appropriate Parliamentary Committee as and when required to respond to questions about its performance and exercise of its powers;
• consult with industry and the public before issuing directives under the Reserve Bank of Malawi Act or recommending regulations to the Minister;

• help educate the public about the RBM’s role, about the financial system generally, and about their rights and responsibilities as consumers of financial services;

• meet with industry annually to discuss industry trends, policy proposals and the exercise of its powers; and

• include the establishment of an external regulatory Appeals Tribunal covering all licensed financial institutions.

Since introducing these bills and amendments to the Parliament in a piecemeal fashion is likely to create confusion and possibly lead to inconsistencies, we recommend a co-ordinated approach to the reforms.

**Recommendation 14**

*That all Bills and amendments arising from this Report be presented to the Parliament as a unified financial sector reform package.*

**Supervisory Framework**

The RBM’s supervisory framework for NBFIs, including its policies and procedures and overall philosophical approach to each group of NBFIs is, not surprisingly (given the shortage of resources), under-developed at this stage.

In addition to the following recommendations, we strongly encourage the RBM to take a more risk-based approach to supervision over time.

**Recommendation 15**

*That, following the establishment of the Financial Supervisory Division in the RBM, the senior management of the Division convene a strategic planning session to develop and agree a supervisory philosophy for both its prudential and market conduct responsibilities (both banking and non-banking). This philosophy should be documented and should address the following issues:*

• the RBM’s supervisory objectives;

• Where the RBM draws the line between responsibilities for itself and for boards and management of supervised institutions in pursuing these objectives;

• The extent to which the RBM will take a risk-based approach to supervision;

• This framework should identify:

  o The primary risks that the RBM has to deal with;

  o The extent to which it can reasonably rely on the supervisory work done by other regulators of the parent institutions of some of Malawi’s foreign-owned financial institutions;*
o How these will determine its supervisory work and methodology;

o How it will prioritize issues and allocate its scarce supervisory resources among competing supervisory demands;

• How the RBM will balance its prudential and conduct responsibilities;

• An appropriate supervisory approach to supervising each industry group for which the RBM has responsibility; and

• A timetable for implementing the various elements of the framework.

Recommendation 16

That the RBM commences a longer-term exercise to document all policies and procedures manuals for each of the NBFI industries that it supervises. These manuals should initially document current practices and should be updated regularly to reflect changes in practices. The relevant manuals should be issued to staff and should be used as the primary reference guide for supervisory actions. Staff should be encouraged to contribute to improving these practices over time.

Recommendation 17

That the RBM considers systematizing and streamlining the consumer complaints handling process by establishing a dedicated small team to process all complaints against regulated financial institutions. The effectiveness of such a team will depend on the ability of existing senior staff to document procedures for handling the vast bulk of routine complaints and to screen complaints to the extent that only those involving serious issues (i.e. those warranting investigation and possible enforcement action) or new precedents are referred to other divisions.

Recommendation 18

That the RBM commissions work to extend the existing banking database system to include electronic collection and validation of statutory returns from NBFIIs, as well as an early warning system for distressed institutions. As part of the exercise to extend the database system there should be a systematic review of all data collected for relevance and use in supervision.

Recommendation 19

That the RBM builds the capacity to enable it to carry out a program of regular and specialist on-site inspections of NBFIIs. The regular inspections should be carried out on a schedule appropriate to each industry group. The specialist inspections should target particular areas of risk such as governance, internal controls, and risk management systems.

Recommendation 20

That the RBM establishes a specialist enforcement section with a mandate to develop a consistent approach to enforcement across and within industry sectors.
Human Resources

The preceding recommendations to upgrade the RBM’s regulatory and supervisory frameworks will, if implemented, have significant implications for the RBM’s human resources capacity.

At a structural level we see a strong case for retaining a relatively simple, industry-based focus for front line supervision for the immediate future. Such a structure should be supplemented by grouping common activities that lie outside front line supervision, such as policy development, licensing and enforcement.

The RBM is currently significantly understaffed in NBFI supervision. While there is no universally accepted formula for assessing supervisory requirements, a comparison with international benchmarks, suitably adjusted for local conditions suggests that the RBM’s total staff complement for financial sector supervision should roughly double from its current level of 32 (including both banking and non-banking supervisors). The Report provides some guidance on how those additional resources might be deployed to maximum advantage in the new Division.

Recommendation 21

That the RBM adopts an internal structure for the Financial Supervision Division along the broad lines suggested in this Report and with the staff numbers to support it

The skill demands of a regulatory agency such as that outlined in the Report extend to the fields of economics, finance, accounting, law, actuarial studies, and general administration, thereby extending beyond the existing capacity of the regulatory staff in the RBM. In part these skills can be developed in-house, but they must also be acquired from the market, which raises the issue of staff remuneration.

While the overall level of salaries in the RBM appears to be competitive, the internal salary scale is based on seniority, which can be inflexible in meeting the salary needs of certain specialist skills. It would be helpful to introduce salary loadings for specialist skills, should they prove to be necessary to recruit the skill levels required for effective financial sector supervision.

Recommendation 22

That the RBM introduces salary loadings for specialist skills in the event that it is unable to recruit the full range of skills needed for effective non-bank supervision.

In practice, there is a very strong case for locating all supervisory staff together in the one location and, where possible, for the location to be where the main financial centre of the country is. This is the practice in most countries and is recognized as best facilitating internal co-ordination and communication as well as communication with the market. In Malawi, there is clearly merit in locating the entire Financial Supervision Division in Blantyre.

Recommendation 23

That the Financial Supervision Division be established in Blantyre and that existing supervisory staff be moved progressively to Blantyre over a period of up to two years following the establishment of the Division.

In terms of budgetary impact, expanding the supervisory staff capacity of the RBM to the level recommended in this Report would add around K160 million to the annual staff cost budget of the RBM (including both staff remuneration and on-costs, including overheads and training). Around a further K13 million would be needed to meet the fit-out cost and basic computer and information systems.
technology support for the additional staff members. A further cost would be incurred in assisting existing supervisory staff to move from Lilongwe to Blantyre.

Staff training will be a key ingredient to the success of the RBM in coming years and we recommend a combination of three approaches.

Recommendation 24

*That the RBM establishes a target program for seconding one promising staff member each year for the next 5 years for a period of between 3 and 6 months to a suitable agency for experience and that it approaches agencies with similar regulatory responsibilities to its own in the UK, Canada, Australia, Denmark, Norway and Sweden as well as the South African FSB with a view to making the necessary arrangements and the relevant country aid programs for assistance and financial support. The program should include a process for debriefing secondees to ensure that their experiences are shared with others in the agency.*

Recommendation 25

*That the RBM co-operates with other English speaking regulators in SADC in approaching the IAIS/World Bank as a group to have the full core curriculum for insurance regulators delivered within the region over a period of say 3 years as a pilot for sharing training resources within the region. Funding support for the program may be available from donor agencies and should be investigated by the potential participating agencies as a group. Internally, the RBM should allocate a proportion of its study scholarships to the financial regulatory area. Other training programs offered by the World Bank, the Toronto Centre and other regulatory agencies should be used as and when they are available, subject to budgetary constraints.*

Recommendation 26

*That the RBM approaches the FIRST Initiative and other relevant donors for assistance with the identification and funding of suitable ex-regulators to provide technical assistance in the areas of: insurance regulation/supervision; financial crime and enforcement; market conduct; and policy development.*

The Report concludes with a five-year implementation plan that prioritizes implementation in the following order: Legislative reform; establishment of the new Financial Supervision Division; recruitment of new staff; staff training and development; development and documentation of supervisory approaches; extension of the RBM’s electronic database to include NBFIs; and review and refinement of regulatory requirements.
MAIN REPORT

MALAWI: NBFI Capacity Building Strategy

1. Introduction

The Terms of Reference for this project include the following:

Project Goal and Purpose

“The GOAL of this project is to create the foundation from which strong NBFI regulation and supervision can be developed.

The PURPOSE of this project is to identify the institutional capacity needs for NBFI regulation in light of current and future NBFI market development.”

Key Deliverables

- Definition and classification of NBFI, for example differentiating between deposit and non-deposit taking NBFI.
- A review of the current legal and regulatory framework and recommendations on required amendments.
- A definition of RBM’s role, strategy and required competences and overlap/coordination with other organizations involved in regulation either now or in the future, including the Ministry of Finance and the proposed Securities and Exchange Commission.
- An assessment of capacity to achieve RBM’s development strategy and to put in place the required competences.
- Identification of generic training courses to be delivered under CISNA capacity building project.
- A five-year capacity building plan that fits within the RBM’s development strategy.
- Identification of potential sources, including external donors (including FIRST), to assist with implementation of specific capacity building TA for NBFI regulation and supervision.

Consultations

During the course of the project we met with representatives of all divisions of the RBM. We also met with representatives of the following industry sectors:
• Insurance companies;
• Insurance brokers;
• Pension funds;
• Asset managers;
• Credit co-operatives
• Stock brokers; and
• The Malawi Stock Exchange.

In addition to the one-on-one and group meetings, we held two workshops with staff to discuss the structure of financial regulation in Malawi and the proposals for capacity building.

Structure of the Report

Section 2 provides an overview of the Malawi financial system, including the participants, the current regulatory structure and an assessment of likely future developments and directions. It also considers the challenges that arise from the characteristics of the financial system. Section 3 reviews the case for establishing effective NBFI regulation and supervision in Malawi.

The following three sections deal respectively with regulatory structure, regulation and supervision. In this Report we will adopt the conventional distinction between regulation and supervision adopted by the World Bank. Thus, “regulation” will refer to the establishment of rules – most often in law – governing behaviour by financial institutions and market participants, while “supervision” will refer to the monitoring, oversight and enforcement of those rules. “Regulatory structure” will refer to the number and nature of regulatory agencies in any given financial system and the formal relationships among and between them for the purposes of regulating financial institutions and markets.

• Section 4 makes recommendations about the regulatory structure in Malawi and how it might evolve over coming decades. The main recommendation is that all regulatory responsibilities for financial institutions and markets should remain within the RBM for the foreseeable future, and that the RBM should be restructured to give greater attention to this responsibility. The section also makes recommendations as to the resourcing of the RBM’s regulatory responsibilities.

• Section 5 provides an assessment of the regulatory framework for NBFI regulation in Malawi. It presents an idealized set of regulatory requirements and powers as well as the corresponding idealized independence, and accountability arrangements to accompany such powers. It ends with an assessment of the current situation in Malawi against the idealized benchmarks and makes recommendations for amendments to the regulatory framework.

• Section 6 offers a parallel review and assessment of the supervisory framework for NBFI s in Malawi. As with the regulatory framework, this section presents an idealized set of supervisory capacities against which to assess the current situation in Malawi. It ends with an assessment of the current situation in Malawi against the idealized benchmarks and makes recommendations for amendments to the supervisory framework.
Section 7 provides a detailed assessment of the capacity building needs for the RBM. This section addresses internal structure, staff numbers, staff skills management capacity and the human resources framework, recruiting, training and sources of external assistance.

Section 8 offers a recommended capacity building program that prioritizes the many recommendations made throughout the Report.

Section 9 provides some concluding thoughts.

A Caveat

There are many views and opinions expressed in this Report. They are the result of our experience as regulators and of our observations about Malawi. While we were exposed to a wealth of information and views while in Malawi, our time there was extremely short – a total of six weeks combined for two consultants. Off the back of such a steep learning curve we cannot profess to be experts on Malawi. The assessments and recommendations below should be read with that caveat in mind.
2. The Malawi Financial System

2.1 Participants in the Malawi Financial Sector

The financial system in Malawi consists of the following main institutional groups and markets:

- Institutional financiers such as banks, discount houses, credit co-operatives, life insurance companies, pension funds, general insurance companies, leasing companies, development finance institutions, medical aid schemes, and microlenders;
- Capital markets and institutions, including the Malawi Stock Exchange and securities dealers; and
- Supporting market professionals such as insurance agents and brokers.

Table 1 provides a snapshot of assets under management by each of these institutional groups. The total in Table 1 is not a completely accurate picture of the total assets of the financial system, however, since a number of institutional groups provide finance to others, thereby creating a degree of double-counting. The role and character of each of these market participants is summarized below.

2.1.1 Institutional Financiers

**Banks** – the banking system in Malawi comprises 10 commercial banks and two discount houses. As at December 2003, assets of the 10 commercial banks (National Bank of Malawi, Indebank Ltd, Stanbic Bank Malawi, First Merchant Bank, Finance Bank of Malawi, Nedbank Malawi, Opportunity International Bank of Malawi, Loita Investment Bank, NBS Bank Malawi, and Malawi Savings Bank) were around K54.8 billion (see Table 1 below), approximately 32.1% of GDP (approximately K171 billion in 2003). All 10 banks are locally incorporated, and 4 of those are locally owned. The Malawi Government holds shares in 6 banks including the largest 2 commercial banks (National Bank of Malawi and Stanbic Bank Malawi).

**Discount Houses** – Continental Discount House and First Discount House provide money market services to corporations and banks primarily through repurchase agreements. They also make a market in short-term Government Treasury Bills. Total assets as of December 2003 were around K7 billion, approximately 4.3% of GDP.

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1 Data in Malawi are not entirely reliable. In some sectors the data are not collected at all.

2 While the Insurance Act (1957) makes an exemption for Friendly Societies no such societies appear to exist at this stage. Similarly, while the Building Societies Act (1993) provides for the establishment of Building Societies, the only such society in Malawi, the New Building Society, converted to banking status (NBS Bank) in 2004.

3 The most recent date for which consistent data are available is end 2003. Since that time, bank assets have grown by around 13% and other financial institution assets appear to have increased as well.
Credit Co-operatives – savings and credit schemes can be operated by specialized savings and credit co-operatives or by multipurpose co-operatives that also carry out traditional agricultural co-operative functions. The savings and credit co-operatives (SACCO) industry is established and well organized in Malawi. SACCOs are regulated by the Registrar of Cooperatives at the Ministry of Trade and Commerce. The Malawi Union of Savings and Credit Cooperatives (MUSCCO), operates as the parent body for the 70 active and registered SACCOs. MUSCCO helps SACCOs set up by providing technical assistance, promotion, and management training. MUSCCO also provides banking services (central finance facility and loans) to SACCOs. Under MUSCCO rules, members may borrow up to two times their accumulated savings. MUSCCO emphasizes mobilization of savings rather than provision of credit. As at end 2003 there were 70 registered SACCOs providing finance. Total assets as of December 2003 were K601 million, about 0.4% of GDP.

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<td>Discount Houses</td>
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<td>Credit Co-operatives</td>
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<td>Life Insurance Companies</td>
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<td>Pension Funds**</td>
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<td>Finance and Leasing Companies</td>
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<td>986</td>
<td>885</td>
<td>5.6%</td>
</tr>
<tr>
<td>Development Finance Institutions***</td>
<td>3</td>
<td>6,131</td>
<td>5,201</td>
<td>8.6%</td>
</tr>
<tr>
<td>Medical Aid Schemes</td>
<td>2</td>
<td>NA</td>
<td>NA</td>
<td>NA</td>
</tr>
<tr>
<td>Microlenders****</td>
<td>20</td>
<td>NA</td>
<td>NA</td>
<td>NA</td>
</tr>
<tr>
<td>Total Financial Institutional Assets</td>
<td>91,568</td>
<td>60,135</td>
<td></td>
<td>23.4%</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Markets</th>
<th>December 2003 (KM)</th>
<th>December 2001 (KM)</th>
<th>2-year CAGR</th>
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<tr>
<td>Stock Market Capitalization</td>
<td>9</td>
<td>584,060</td>
<td>543,219</td>
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<tr>
<td>Local Market Capitalization</td>
<td>8</td>
<td>9,251</td>
<td>10,505</td>
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<tr>
<td>Bonds on Issue</td>
<td>24</td>
<td>3,752</td>
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<tr>
<td>Total Tradable Instruments</td>
<td></td>
<td>597,064</td>
<td>556,037</td>
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* CAGR is the compound annualized rate of growth over the 2-year period.
** Assets for pension funds only include figures from RBM and the 3 life insurance companies who manage 353 of the 582 funds.
*** Data for SEDOM (see below) are not available.
**** This number does not include unregistered private moneylenders.

Life Insurance Companies – there are 3 insurers operating in the life insurance market (Old Mutual, NICO Life, and Vanguard). In 2003, total assets for the industry were K3.4 billion, approximately 2.0% of GDP. Old Mutual holds the largest share at around 60 percent and Vanguard Life Assurance Company, a relatively new entrant (licensed in 2001), has the smallest market share at around 0.3

4 At the time of writing, the Malawi Kwacha/US dollar exchange rate was approximately 110.
percent. NICO Life is the only locally owned life insurance company. Old Mutual is a subsidiary of its South African parent, and Vanguard is owned by Fidelity Life Assurance. Life insurers underwrite death, disability, funeral, health and sinking fund risks, as well as offering long-term savings through endowment policies. Life insurers are not constrained in their investments, other than by Malawi’s exchange controls which make investment in assets outside Malawi extremely difficult.

**Pension Funds** – At this stage there is no national pension scheme in Malawi, although a number of private schemes operate under the Taxation Act. While the public sector has a substantial pension commitment it is presently completely unfunded. Private pensions cover both defined benefit and defined contribution schemes. Six large umbrella funds offer a conduit for amalgamating pension resources of small corporate funds. Advisory, investment and administrative services for private pension funds are provided by five pension fund administrators: Old Mutual, NICO Life, Vanguard, Indetrust, and Aon. As of December 2003, there were 582 funds of which 353 are managed by the three life insurance companies. Total assets managed by the RBM and the insurance companies were approximately K6.5 billion at the end of 2003. Unfortunately, the Malawi Revenue Authority does not aggregate data from the pension funds; therefore no statistics are available for the total size of the industry.

**General Insurance Companies** – there are 8 registered general insurers and 1 reinsurer in Malawi with total assets of about K2.7 billion as of end 2003 (around 1.6% of GDP). The industry is dominated by NICO General which is in the process of acquiring CGU, a smaller player. The combined company will have a market share of 55%. The second largest general insurer only has 17% market share. Almost all of the businesses are short-tail, covering motor, fire and accidents. The industry has been stagnant for the last several years due to inefficient laws, economic downturn, and the inability to receive premiums on time. Zimre, the only reinsurance company in Malawi, is a subsidiary of Zimre (Zimbabwe).

**Finance and Leasing Companies** – the two finance and leasing companies, National Finance Company, and Leasing and Finance Company, provide medium-term hire purchase facilities for acquisition of vehicles, machinery and other capital goods as well as international trade financing facilities to the private sector. As of December 2003, total assets of the industry were K986 million, about 0.6% of GDP.

**Development Finance Institutions** – development finance is provided by The Investment and Development Fund of Malawi (Indefund), The Malawi Development Corporation (MDC), and The Small Enterprise Development Organisation of Malawi (SEDOM). Indefund is a subsidiary of Indebank, which finances medium and long-term loans to medium-scale enterprises owned by Malawians. The state-owned MDC finances larger-scale industrial companies to help increase participation of Malawians in business and industry. SEDOM was established by the Government under the auspices of the European Economic Community (EEC), and it concentrates on small-scale businesses.

**Medical Aid Schemes** – while medical aid schemes in Malawi are mostly in-house, there are 2 open schemes (schemes that are open to the public), Medical Aid Schemes of Malawi and Oasis. Medical aid schemes are unregulated at the moment. There are no reliable statistics available for total assets under management.

**Microlenders** – microlenders consist of microlenders, moneylenders and non-governmental organizations (NGOs). As of August 2004, there were about 20 NGOs and microlenders registered under the Company’s Act or the NGOs Act. Their funds come mainly from personal resources or donor funds. Two of the microlenders are 100-percent owned by government and receive their funding from the Malawi Government. NGOs provide financial services to targeted sectors of the community, including small businesses and women in business. In the rural areas there are small
moneymakers that do mostly pay-day lending, but these are not registered. These moneymakers compete with SACCOs in providing funds to people with lower income. No reliable statistics are available on total funds loaned by microlenders.

### 2.1.2 Collective Investment Schemes

Currently, there are two collective investment schemes in Malawi, only one of which is properly constructed. There has not been much interest in this area due to the small and illiquid stock market as well as to political and economic challenges.

### 2.1.3 Capital Markets

**Malawi Stock Exchange** – The Malawi Stock Exchange (MSE) was established in 1997 and is regulated by RBM. As of August 2004, there were 9 listed companies on the stock exchange; seven are primary listed, one is a dual listed local company, and one is a dual listed South African company. Total market capitalization as at December 2003 was K584 billion, of which only K9.3 billion was accounted for by local companies. Liquidity is low. Volumes traded have picked up slightly in recent months after years of stagnation. Initial public offerings are rare, as are mergers and acquisitions. Not having enough free float is one of the biggest problems with the MSE. Twenty-four bonds have been issued in Malawi totaling K3.8 billion. These have been mainly government bonds issued by RBM which have not been listed on the MSE.

**Securities Dealers** – Malawi has two brokerage firms, Stockbrokers Malawi Ltd is local and Trust Securities is a subsidiary of Trust Holdings in Zimbabwe. Each broker has about 50% market share. Due to the small and illiquid stock market, there has been no need for more brokers, and the industry has been stagnant in recent years. Brokers need to register under the Companies Act and are required to obtain licences from both the RBM license and the MSE license before they can conduct business. They are regulated by RBM and their capital requirement is set jointly by the RBM and MSE on a case by case basis.

### 2.1.4 Supporting Market Professionals

**Insurance Agents and Brokers** – Under the Insurance Act the RBM has responsibility for registering insurance agents and brokers. There are currently 40 registered agents and 12 registered brokers. Their license allows them to do business in both life and general insurance. Baobab and Aon are the two main life insurance brokers, while Baobab, Aon, Alexander Forbes, and Kingfisher are the main general insurance brokers.

### 2.2 Financial Sector Assessment and Trends

#### 2.2.1 Overall Financial Intermediation in Malawi is Relatively Underdeveloped

One measure of financial sector development is the ratio of total financial sector assets to GDP (see Chart 1 below). In developed countries this ratio is usually well in excess of 100%, with countries like Japan, the USA and the United Kingdom having ratios in excess of 200%. The more financially advanced emerging market countries, such as Thailand, Malaysia, Korea and Namibia have financial sector assets of around one and a half times GDP. A rough benchmark for a less developed financial system is when this ratio falls significantly below 100%. In the case of Malawi, financial sector assets are only around 50% of GDP.
Following a long period of relative stagnation, the Malawi financial sector has shown signs of growth over the past two to three years, particularly in the large institutional sector including banks.

Chart 1: Financial Sector Assets to GDP – % Selected Countries 2001

2.2.2 The Malawi Financial Sector is Relatively Bank Centric

A second general feature of the Malawi financial system is the relatively high level of bank dominance (see Chart 2 below, in which financial sector assets are divided into bank assets and non-bank assets\(^5\)). While not as bank-centric as some of the Asian financial systems, the non-bank financial sector in Malawi remains relatively underdeveloped with NBFIs accounting for less than 30% of financial sector assets.

Chart 2: Bank and Non-bank Assets as a Percentage of Total - Selected Countries 2001

\(^5\) In this Chart banks are defined to include all deposit-taking credit institutions and Government banks.
In terms of international comparison, both insurance and pensions have a low level of penetration by developed country standards, as well as by the standards of other countries in the region. For example, on the most commonly used measure of penetration, insurance premiums as a percentage of GDP in Malawi are around .16% for life insurance and .71% for general insurance for an overall penetration of around less than 1% (see Chart 3 below).

**Chart 3: Insurance Penetration – Premiums/GDP – % Selected Countries 2001**

A similar picture emerges for private pension assets as a percentage of GDP (see Chart 4 below). Given the unfunded nature of the Malawi public sector pension fund, the overall level of pension penetration, at 3.8% of GDP, is at the lower end of the emerging market countries worldwide, although not necessarily widely out of line with experience in the African region.

**Chart 4: Private Pension Penetration – Assets/GDP – % Selected Countries 2001**

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6 The picture for Zimbabwe is likely to have changed significantly since the figures in these charts.
Our one caveat on these figures is that there is no official collection of private pension fund assets in Malawi. The figures in Chart 4 were put together on the basis of adding together as many as possible of the statistics available for the largest private funds. There was nevertheless a significant number of funds for which data were unavailable. The overall picture is nevertheless unlikely to change materially from that shown in Chart 4.

2.2.3 Financial Sector Ownership is Dominated by Foreign Institutions and Government

The majority of Malawi banks are either wholly or partly foreign owned. Most insurance companies are at least partly foreign owned. In addition to the high level of foreign ownership, the Malawi Government owns 100% of one bank and has a significant stake in another 5. The Government also has a stake in the development banks. These levels of both foreign and Government ownership are not surprising given the history of Government ownership and the recent move towards privatization.

2.2.4 The Malawi Public Sector Places a High Demand on Private Sector Credit

A fourth general feature of the Malawi financial system is the relatively high level of Government demand on credit. As shown in Chart 5 below the Malawi Government tends to absorb around 65% of total domestic credit, thereby crowding out private sector borrowers.

2.2.5 The Malawi Stock Market is Relatively Underdeveloped

The total market capitalization of the Malawi Stock Exchange is over US$5 billion or roughly 3.5 times GDP. On the surface this appears to be an exceptionally well-developed market. However, when dual listed companies are removed, the picture is much less impressive. The eight locally listed companies have a market capitalization of just US$84 million (5.5% of GDP), which puts it at the lower end of the range of stock markets in the Southern African region.
While the stock market in Malawi is relatively young (less than 5 years old) its growth has been modest at best and relatively stagnant over the past year or two. Market infrastructure is still minimal, with settlement currently operating at T+7.

Given the significant demands made by Government on domestic credit it is not surprising that the domestic bond market is dominated by Government securities. Not only is Government debt very high relative to GDP by international standards, there is a very high reliance on foreign debt raisings (see Chart 6 below).

Chart 6: Domestic and Foreign Government Debt as a Percentage of GDP – Selected Countries 2001

2.2.6 Industry Concentration is high in the Malawi Financial System

The concentration of market share in each of the sectors of the Malawi financial system is very high:

- The 2 largest banks (of 10) account for 60% of assets;
- The largest life insurer (of 3) accounts for 60% of assets;
- The largest general insurer (of 8) accounts for 50% of assets;
- There are only 2 stockbrokers;
- There are only 2 discount houses;
- There are only 2 medical aid funds; and
- There are only 2 finance and leasing companies.

2.3 Challenges in the Period Ahead

It is our assessment that there are four main financial system related challenges for the Malawi Government in the period ahead:

1. Extending penetration of financial services and products into the community.
2. Increasing the overall mobilization of savings.

3. Increasing the diversity of financial products available for diversification of risks.

4. Increasing the use of markets relative to financial institutions.

There is no single Government policy that can address all of these challenges. There are nonetheless several related areas of policy that could have a material impact on these challenges over the next 5 to 10 years. These are general macroeconomic policy reform, pension reform, and regulatory reform.

### 2.3.1 Macroeconomic Policy Reforms

The Malawi financial system is currently inhibited by Government in a number of ways. The stagnant economy is inhibiting growth and savings. The large Government debt overhang is crowding out private sector borrowers from financial markets. The consequent high short-term interest rates are both discouraging investment in the real economy and siphoning private sector savings (both directly and through institutional investors) into Government securities. The combined effect of these factors is a drag on both the Malawi economy and the Malawi financial system.

While recommendations in this area are well outside the terms of reference for this project, there is a clear need for fiscal reforms in Malawi, including budgetary reform, tax reform, further privatization, reduction of the Government’s debt and lengthening of the tenor of that debt. These reforms are likely to take significant time and commitment by the new Government.

### 2.3.2 Pension Reform

As noted earlier, the Malawi pension system is underdeveloped and underfunded. Reform of this sector could provide a significant growth dividend for the Malawi economy in coming years.

Throughout the world there is growing evidence of the impact that pension reform can make to economic growth and financial development. In addition to the social benefit of providing for security in old age, pension fund growth can increase savings, improve resource allocation, add depth and liquidity to capital markets, and even improve corporate governance. A more comprehensive analysis of the role of pension funds was provided in Attachment B to the Interim Report.

### 2.3.3 Regulatory Reforms

There is a growing body of empirical evidence that development of the financial system and economic growth go hand in hand. There is also evidence that the development of non-bank financial institutions and financial markets and economic development go hand in hand. The issues that arise in striking an appropriate balance between the benefits and risks involved with the growth of NBFI s are addressed in the next section.

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7 See, for example, the evidence cited in Carmichael and Pomerleano (2002).
3. The Case for NBFI Regulation in Malawi

3.1 Introduction

As outlined in Section 2, NBIs in Malawi are relatively underdeveloped but with the prospect for considerable growth if economic reforms take place. A large NBFI sector brings with it both advantages and risks. This section reviews those advantages and risks and the need for a strong regulatory framework to mitigate the risks.

3.2 The Role of NBIs and their Attendant Risks

There has been a growing recognition in the past decade or more of the importance of non-bank financial institutions. That importance arises from their contribution to both financial and economic development.

3.2.1 Benefits Associated with NBIs

The contribution of NBIs to financial development is reasonably well understood:

- They deepen financial markets by providing services that banks cannot provide efficiently because of their involvement in the payments system – services such as risk pooling and provision of long-term savings instruments;
- By specializing in particular areas of finance services such as leasing and mortgage finance they lower the cost of those financial services to consumers; and
- They add resilience to the financial system in times of crisis – what US Federal Reserve Chairman Greenspan has referred to as adding a “spare tyre” to the financial system.

The contribution of NBIs to economic development is not nearly as well understood or appreciated. There is now a growing body of evidence supporting two propositions:

- First, that development of financial institutions generally adds significantly to economic growth; and
- Second, that the contribution is greater where there is a balance between banks and NBIs in the financial system.

The reasons behind this second observation lie partly in the efficiency that NBIs add to the financial system, but the contribution goes further than that. For example:

- insurance underpins commerce – particularly international trade - by enabling those who could not otherwise bear the risks involved to shift them to those who are more willing and able to do so;
- some countries have found that micro-finance institutions and credit co-operatives are the only means of providing financial services into remote rural regions and to the poorer elements of the community; and
• pension funds, particularly compulsory national pension schemes, have been found to increase national savings and long-term capital formation - for example, studies in Chile, Switzerland, Mexico and Australia have found that the introduction of compulsory national pensions increased national savings by between 40% and 70%, and GDP by up to 2%.

3.2.2 **Risks Associated with NBFIs**

These benefits from the NBFIs sector are significant. But they come with significant risks as well. NBFIs have sometimes been used to avoid regulations imposed on banks. For example:

- In Thailand, finance companies issued high-yielding promissory notes and borrowed offshore, then loaned the funds in local currency to high-risk borrowers who could not meet banking standards – when the crisis hit, in mid 1997, the Government was forced to close 69 insolvent finance companies.

- Malaysia experienced similar problems with finance companies that had extended hire-purchase loans.

- In Korea, NBFIs grew very strongly in the pre-1997 period precisely because they competed directly with banks, but with a regulatory advantage. This included merchant banks, which borrowed offshore and helped leverage the Chaebol. The problem re-emerged in a different guise between 1997 and 1999 when poorly regulated investment trust companies replaced merchant banks as the primary source of corporate finance.

A second risk arises where NBFIs subsidiaries of banks are used to take on high-risk business activities that are not permitted within banks. This factor was also a contributor to the Asian crisis in the late 1990s, most particularly in Korea and Indonesia. But the problem is by no means confined to emerging markets. While Australia has lost only two banks through outright failure in the past century, both failed because of high-risk activities carried out through their unregulated and very large subsidiaries.

There is a common theme in most of the problems arising in the NBFIs sectors of different countries – either inadequate or (in some cases) non-existent regulation.

The lesson from these experiences is very clear. Competition between NBFIs and banks in providing financial services is healthy. But competition based on poor regulation is unhealthy - and can have costly consequences that may affect economic growth and financial stability for years.

The clearest way of resolving the unquestionable benefits of having NBFIs with the risks that they bring is to have a sound system of effective regulation. That regulatory system should balance the need for these institutions to grow and prosper against the need to ensure that growth is based on sound fundamentals and not just on regulatory arbitrage.

One of the biggest changes in world thinking in the past decade or so has been the recognition that non-bank regulation is as important as banking regulation - and also that it is every bit as challenging to do it well. While regulation involves many elements, its effectiveness ultimately comes down to the quality of regulatory staff. Effective regulation requires that each regulatory agency charged with overseeing NBFIs has staff with the skills and experience to formulate and enforce regulatory policy.

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8 See, for example, the evidence cited in Carmichael and Pomerleano (2002).
That, in turn, requires that each agency has sufficient funds and sufficient independence of funding to ensure that it can recruit and retain suitable staff.

### 3.2.3 Costs Associated with NBFI Regulation

Recognition of the importance of non-bank regulation has also focused attention on both the direct costs and indirect costs associated with regulation.

The direct costs of regulation are the costs of funding the agency (or agencies) that carry out the legislated regulatory responsibilities of the country. While the actual cost of funding regulatory agencies around the world varies enormously, when measured against industry assets the cost is mostly no more than .001 to .0015 (i.e. 10 to 15 basis points or .1 to .15 percent), although it tends to be higher in smaller, less well developed financial systems.

This direct cost is usually dominated by staff remuneration and technological support. The reason for this is straightforward. The finance industry is extremely complex. A regulator capable of meeting the legislated objectives and expectations of the community must have staff with the expertise and experience capable of dealing with the industry on its own terms. Not only does the safety of the consumers of financial services depend on this expertise, but so too does the reputation of the well-run institutions in the market.

This latter point is not always well understood – good regulation is in the interests of the industry. This works in several ways:

- First, an inexperienced regulator that lacks the expertise to properly evaluate a complex new product is more likely to put off making a decision to approve its use than one who has confidence in his/her own knowledge and judgment;

- Second, there has been a world-wide shift in the style of regulation from compliance-based regulation to risk-based regulation. Risk-based regulation requires judgment from regulators as to the assessment of risks, rather than whether or not the industry simply complies with the law. In this way it is much more focused on the intent of the law than on the letter of the law. Risk-based regulation is much more supportive of industry – but it is also much more demanding on the skills and judgment of regulators.

- Third, good regulation facilitates long-term industry growth by ensuring that the growth is soundly based on good business principles. Poor regulation is often associated with periodic collapses of the industry. A failure or scandal associated with a weak financial institution can cause as much difficulty for other institutions in the same sector as it can for consumers. Ukrainian experience with trusts (where the industry has not yet recovered from the crisis of confidence of a decade ago) is a good example of this effect.

In summary, not only consumers but also industry participants benefit in the long term from having a strong and effective regulator.

The indirect costs of regulation relate to the costs that can be imposed on the whole community when regulation fails to meet its objectives. These costs are much more difficult to measure, which explains why they are rarely taken fully into account in the decision to fund a new regulatory agency.

The evidence of these costs can best be drawn from the impact of failed financial systems and sectors. While these failures often reflect a combination of factors, regulatory failure is often a critical element
either as a trigger in the failure or in the scale of the costs associated with the failure. To put these
cost into perspective:

- The rescue of the Savings and Loan industry in the United States in the 1980s cost US taxpayers over $US130 billion;

- The recapitalization of the financial system in Indonesia in the late 1990s could cost industry and taxpayers up to 25% of a full year’s GDP by the time it is finished;

- The collapse of the Farrow Building Society Group in Australia cost less than $A1 billion, but almost bankrupted the State of Victoria which had regulated and subsequently guaranteed its liabilities.

In many cases, the cost imposed on surviving institutions following a crisis is many times the cost that would have been born by adequately funding the regulator before the crisis.

### 3.3 Summary

Without an effective non-bank financial sector and active financial markets, economic and financial broadening tends to be retarded. Not only do non-banks provide a wider range of products and risks than banks, they add a degree of resilience to the financial system that bank centric systems lack.

Malawi’s financial system is in need of deepening. It is critical that the national savings that are generated in coming years are channeled into productive investments that underpin the longer-term growth of the economy. This will require the progressive development of the non-bank financial institutions and equities markets to take the place of Government as it moves back from its position of dominance in the financial sector. It will also require a strong regulatory and supervisory framework for non-banks.

Development of the non-bank sector must be underpinned by sound regulation and supervision. Poor regulation can leave the sector exposed to collapse. At the same time, inappropriate regulation can inhibit the natural growth and synergies that this sector has to offer. Finding the balance between these forces is essential. The following sections turn to the main elements of implementing a balanced regulatory and supervisory framework.
4. Regulatory Structure in Malawi

4.1 Introduction

Regulatory structure (or ‘architecture’ as it is sometimes called) has become one of the most interesting and actively debated topics of the past five or so years. An obvious motivation for interest in the topic is the sheer number of countries that have moved in the direction of amalgamating some or all of their existing regulatory agencies - or that are in the process of considering doing so.

The Interim Report considered the issue of regulatory structure in Malawi in considerable detail. It is not our intention to repeat that detail in this Final Report. Instead, what follows is an outline of the current regulatory structure, a brief summary of the arguments presented in the Interim Report, a recommendation as to the most appropriate structure for Malawi at this stage of its development (which we understand has already been accepted by the Reserve Bank of Malawi), and some thoughts and recommendations on issues that will need to be addressed in implementing that structure.

4.2 Current Regulatory Responsibilities in Malawi

The Reserve Bank of Malawi is the only front line financial regulator and supervisor in the Malawi financial system. Under Part III of the Banking Act (1989) and Part III of the Reserve Bank of Malawi Act (1989) the RBM has responsibility for banking regulation and supervision. Part IX of the Reserve Bank of Malawi Act also gives the RBM responsibility for promoting a sound financial structure in Malawi, promoting a money and capital market in Malawi, and supervising banks and other financial institutions.

While s48 of the Reserve Bank of Malawi Act appears to impose on the RBM a very wide-ranging responsibility for NBFI supervision, the Act provides very little clarity in terms of the institutions covered and very little by way of powers to supervise 9. The responsibilities defined in s48 are only meaningful to the extent that they are supported by specific industry laws that detail the way in which institutions are to operate and the powers and responsibilities of the RBM as regulator.

The powers to regulate and supervise certain financial institutions are supported by specific industry legislation, including:

- the Banking Act (1989);
- the Insurance Act (1957); and

These Acts collectively provide for licensing by the RBM of banks, insurance companies, insurance agents and brokers, investment companies, mutual funds, investment trusts, unit trusts, and other collective investments. We understand that the RBM currently carries out some supervisory oversight

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9 Section 48(2) provides the RBM with the power to collect information from financial institutions, s48(3) gives the RBM the power to issue guidelines, regulations and directives, and to prescribe prudential ratios (though it does not specify the parameters under which these actions may be taken), and s48(4) provides the RBM with the power to appoint inspectors.
of some financial sector groups outside the banking and insurance sectors, it was clear that the focus
on these two groups accounts for the vast majority of the RBM’s supervisory activities. For example,
the Insurance Act explicitly grants exemption from the Act to Friendly Societies and local authorities
carrying on insurance business. While medical aid funds do not appear to be explicitly exempted from
the Insurance Act, nor are they explicitly captured by it; consequently, they are currently unregulated.
Equally importantly, there is no legislation regulating the activities of pension funds (which are
currently only registered by the Malawi Revenue Authority under the Taxation Act), microlenders,
development financiers, or other general finance and leasing companies\(^{10}\). Some of these NBFIs are
registered under the Companies Act, but are not otherwise regulated as financial institutions\(^{11}\). The
Registrar of Co-operative societies registers SACCOS under the Co-operatives Act, although the
Registrar’s oversight role, as envisaged by the Act, does not extend to prudential regulation or
protection of depositors.

4.3 Recommended Regulatory Coverage of Financial Institutions in Malawi

While the level of urgency for extending the financial regulatory net in Malawi varies from one
institutional group to the next and, indeed, the type of regulation should also vary\(^{12}\), it is our
recommendation that the regulatory net be extended to cover all financial institutions operating in
Malawi.

Recommendation 1

That the current range of institutions subject to regulation and supervision in Malawi be extended
to cover all financial institutions. In particular, it should be broadened to include:

- Pension funds, pension fund administrators, pension fund asset managers, and pension
  fund advisors;
- SACCOS;
- Medical aid funds;
- Friendly Societies;
- Microlenders;
- Finance and leasing companies (non-deposit taking);
- Development financiers; and

\(^{10}\) It should be noted that the two leasing companies are currently licenced by the RBM as banks, on the
grounds that they take deposits from the public. However, there is no framework currently in place for licensing
a leasing company that raises funds only through the capital markets.

\(^{11}\) The exception is leasing companies which, as noted above, are currently licensed as banks by the RBM.

\(^{12}\) The type of regulation most appropriate to different institutional groups is discussed further in Section
5 below.
- **Bureaux de change.**

The inclusion of bureaux de change on this list requires a word of explanation. In Malawi, bureaux are currently supervised for exchange control purposes by the monetary policy function of the RBM. To avoid duplication of supervisory resources and to ensure consistency across the financial sector it makes good practical sense for responsibility of these institutions to be shifted to the financial sector supervisory function of the RBM. In this sense their inclusion in the list above is more an internal reallocation of responsibilities than inclusion of a new responsibility. Their supervision would nevertheless require rules of behaviour to be drawn up in conjunction with the monetary policy function.

### 4.4 A Recommended Regulatory Structure for Malawi

As discussed in detail in the Interim Report, regulatory structure has become an issue of considerable interest in recent years. There are two main conclusions that emerge from the combined experiences of countries that have been through the structural reform process.

First, there is no single regulatory structure that is ideal for all countries – or even necessarily ideal for a single country across all time and circumstances. The ideal regulatory structure at any point in time requires a trade off among some pretty serious advantages and disadvantages - which are often situation specific. What best suits one country will not necessarily suit another.

Second, a good regulatory structure does not guarantee good regulation. The debate about regulatory structure is not about what regulators should do and what functions they should perform, it is about which agencies should be responsible for carrying out these responsibilities. Ultimately, if regulatory powers are inadequate, if regulatory skills are inadequate, if regulatory independence and accountability are inadequate, then regulation will probably fail – regardless of the virtuosity or otherwise of the regulatory structure.

Structure nevertheless has an important role to play in eliminating regulatory overlaps and conflicts and in improving the effective use of scarce regulatory resources. The message, however, is that a good regulatory structure is a means to an end – rather than as an end in itself.

The Interim Report reviewed the main international structural models in the context of Malawi and suggested that the most appropriate model at this stage of Malawi’s development was the unified ‘Singaporean’ model in which the central bank takes on responsibility for all financial regulation and supervision. While the current structure in Malawi could already be described as loosely satisfying the Singaporean model, there are several financial institutional groups that are currently unregulated, such as pension funds, SACCOS and microlenders, that will need to be brought more explicitly under the RBM’s jurisdiction. The mechanics of bringing these institutions under the regulatory net are addressed in sub-section 4.5 below.

The advantages of this unified model, relative to the alternatives, are that it:

- Gives the RBM responsibility for all financial supervision, consistent with its legislated responsibility for systemic stability;

- Provides a sound platform for co-ordination and co-operation between supervision and monetary managers in the event of crisis;

- Maximizes scale economies in supervision;
• Provides the best platform for supervising financial conglomerates;
• Provides the best platform for eliminating regulatory arbitrage;
• Provides the widest career opportunities for supervisory staff;
• Minimizes the cost of supervision;
• By drawing on the underlying strengths of the RBM, it provides the best combination of independence, resources and credibility for non-bank supervision; and
• Provides the greatest synergies among supervisors.

**Recommendation 2**

That, consistent with the intent of s48 of the Reserve Bank of Malawi Act (1989), the RBM takes on responsibility for financial regulation and supervision of the entire financial sector in Malawi, and that the Bank pursue the necessary legislative amendments needed to put this into effect (see below).

In making this recommendation we underline the earlier observation that regulatory structure should not be regarded as immutable over time. The preferred structure should always be appropriate to the current state of evolution of the country. It is quite possible that, as the Malawi economy and financial system evolve, new pressures and considerations will emerge that will make it necessary to revisit the question of structure.

4.5 Implementing the Recommended Regulatory Structure

There are many issues that need to be addressed in implementing the recommended regulatory structure in Malawi.

4.5.1 Internal Structure of the RBM

While the potential advantages of the unified ‘Singaporean’ regulatory structure are clear in principle they are not currently being exploited fully in practice in Malawi. In particular, the internal structure of the RBM:

• pushes financial supervision down to a relatively minor role;
• separates supervisors (thereby minimizing interaction and synergies); and
• is highly bank focused.

As a consequence of the breadth and scale of financial sector regulation and supervision involved, the internal structure within the RBM will need to be adjusted to ensure both adequate focus of the regulators, a reasonable balance between the different areas of supervision, and a clearer resolution of the inherent conflicts that can arise between monetary policy and regulatory policy. At the broadest level we recommend establishing a separate Financial Supervision Division.
Recommendation 3

That the RBM be re-organized internally to establish a separate Division of Financial Supervision, headed by a General Manager with supervisory experience.

Further recommendations about the internal structure of the proposed Financial Supervision Division are made in Section 7 below following the analysis of staffing needs.

Separating financial supervision from monetary policy is consistent with the internal organization of the vast majority of central banks that have responsibility for supervision. The case for separation can be summarized as follows.

First, it has been argued that the objectives of monetary policy and banking supervision may, at times, conflict. For example, the Bank may be tempted to relax monetary policy in times of extreme weakness in the financial sector. While such a conflict may arise from time to time, it should be resolved at the board level, rather than at the divisional level, as may happen when the two are contained within the one division.

Second, financial supervision and monetary policy involve very different skills. It is arguable that housing the two within the same division could result in one or the other being downgraded in terms of focus and time by senior management or, worse still, one being a distraction to the other in times of crisis.

Third, at a purely practical level, in most central banks that have responsibility for financial supervision, the sheer scale of resources needed for effective supervision requires a separate division for effective management. While the scale of resources needed for financial sector supervision in Malawi will not be addressed until a later section, given the relatively small numbers committed to non-bank supervision at present, it is inevitable that staffing requirements will increase to a level that would make it highly ineffective to retain supervision within the Economic Services Division.

Fourth, not only are there differences in the skill requirements for monetary policy and financial supervision, there are arguably significant cultural differences. Mixing these cultures in the same division could result in cultural clashes or domination of one by the other.

Finally, there is a clear need to upgrade non-bank regulation and supervision in Malawi. Establishing a separate division would send a signal to industry and staff alike of the importance being attached to upgrading capacity in this area.

4.5.2 The Board of the RBM

As noted above, financial supervision and monetary policy require different skills. This is not only relevant at the staffing level but also at the board level. One argument often put forward for removing financial supervision from the central bank is that the central bank board is typically too focused on monetary policy, with members who are often appointed for their skills in that area. Some central banks have countered this problem by establishing either a separate board or a sub-committee of the main board with an explicit mandate to deal with regulatory and supervisory matters. Such a board or

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13 These arguments are often used to support the case for a complete separation of financial supervision and monetary policy through the establishment of a separate supervisory agency. The arguments are equally relevant for the establishment of “Chinese walls” between the two activities within the central bank where the decision has already been made on other grounds to retain financial supervision within the bank.
sub-committee is usually chaired by the Governor but includes appointees who have specific expertise in the financial markets and industry and, if possible, experience in financial regulation.

The Irish Central Bank, for example, has established its regulatory function as a subsidiary of the Irish Central Bank, with its own board. While this model has many attractive features for Malawi, it could require legislative change and therefore could take time to put into place. The Singaporean approach of creating a new division with its own General Manager and a sub-committee of the Board dedicated to regulatory and supervisory matters is attractive for its simplicity and ease of implementation.

Under s6 of the Reserve Bank of Malawi Act, the Reserve Bank is to have a Board of Directors consisting of the Governor, Deputy Governor and five other directors, who may include the Permanent Secretaries of the Treasury and the Department for Economic Planning and Development, and the Accountant General. While it would be difficult to justify amending the Reserve Bank simply to expand the Board, the fact that other recommendations below require extensive amendments provides an opportunity to broaden the governance structure of the Bank to accommodate a wider regulatory and supervisory role.

**Recommendation 4**

*That the Reserve Bank of Malawi Act (1989) be amended to include two additional board members with financial industry and/or regulatory experience and to create a sub-committee of the main board consisting of these two members plus the Governor (as Chair) and Deputy Governor to consider matters relating to regulatory and supervisory policy.*

**4.5.3 Other Legislative Changes Required to Implement the Structure**

Implementing the proposed regulatory structure will require a number of other legislative initiatives.

The first required legislative initiative relates to the existing draft Securities Bill. Under s3 of the draft Bill there is to be established a Securities and Exchange Commission, independent from the RBM. This Bill will need to be amended to remove this section and to replace it with a clause identifying the RBM as the responsible regulatory authority.

The second legislative initiative involves drafting new laws providing for the regulation of the pension fund industry (pension funds, pension fund administrators, pension fund advisors, and pension fund asset managers), microlenders, medical aid funds, finance and leasing companies and other financial institutions that are to be supervised by the RBM.

There are two alternative paths that can be taken in drafting such laws.

The first involves drafting new laws for each institutional group not presently covered by law. The laws so drafted would include not only the legal foundations for those institutions but also the regulatory framework and regulatory powers.

The second involves writing all regulatory powers and responsibilities into the Act governing the regulator itself, thereby leaving largely administrative and procedural matters for the underlying industry laws.

The latter approach, which is becoming increasingly popular where unified regulation has been introduced, has some distinct advantages:
It ensures that the regulatory agency has consistent powers across all institutions for which it has regulatory responsibility (thereby removing the regulatory gaps and arbitrages that can otherwise arise when powers are included in the individual industry laws);

- It streamlines the process for amending laws in the event that significant changes in powers are subsequently required (for example, if a new power were required, only the agency law would need to be amended, rather than the entire set of industry laws); and

- It reduces the number of laws required – in many cases the industries can operate under the Companies Law for administrative purposes, provided the regulatory framework is dealt with in the agency’s law (for example, finance and leasing companies and development financiers are adequately provided for by the Companies Act, whereas pension funds require extensive administrative law to cover the rights of members and operations of the funds);

Taking the latter path would provide an opportunity to tidy up some inconsistencies and overlaps in the existing legal framework. At present, regulatory and supervisory powers and responsibilities are duplicated in both the Reserve Bank of Malawi Act and the underlying industry Acts, most notably: the Banking Act; the Insurance Act; and the Capital Markets Development Act. Some of these powers and responsibilities are inconsistent (see Section 5 below). A comprehensive reform of the legal framework that consolidated all regulatory powers and responsibilities into the Reserve Bank of Malawi Act would remove these inconsistencies and provide a single coherent framework for financial regulation and supervision. Greater detail about the legal amendments needed is provided in Section 5 below.

**Recommendation 5**

*That the following strategy be adopted for reform of financial sector laws:*

- The Reserve Bank of Malawi Act (1989) be amended to incorporate all financial sector regulatory powers and responsibilities (details below);

- A new law be drafted for the pension fund industry;

- The draft Securities Law be amended to remove the reference to the establishment of a separate Securities and Exchange Commission; and

- The existing industry laws be amended to bring about consistency with this approach.

### 4.5.4 Other Implementational Considerations

The implementation of the proposed regulatory structure and the recommendations that follow with respect to staff numbers and skills will require a significant increase in overall regulatory resources. This raises the inevitable question of how these resources should be generated.

There are three main models of funding financial regulation:

- Budgetary funding;

- Industry funding; and

- A mixture of industry and budgetary funding.
While, in principle, central bank funding is quite different to budgetary funding (given that the central bank is usually a net contributor to the government’s budget and therefore not subject to the same immediate pressures as expenditure lines within the budget) over the longer term the same disciplines that apply to the government’s budget also tend to find their way into the central bank’s budget. Thus, for the purposes of this section, central bank funding will be considered as equivalent to budgetary funding.

**The International Trend in Regulatory Funding**

Over the past decade or so there has been a marked trend towards industry funding of financial regulation and supervision. This trend has been particularly evident among the developed Western economies. It has reflected both the decision to increase regulatory funding and the trend towards regulatory consolidation (or integration), whereby the functions of two or more regulators are combined under the same roof.

For example, a survey carried out at the first meeting of the International Group of Integrated Regulators in Australia in 1999 found that all but one (namely Japan) of the nine foundation members were either partly or fully industry funded. Of these, all but one (Korea) were fully industry funded; the fully industry funded countries included the UK, Canada, Australia, Denmark, Sweden, Norway, and Singapore.

Other amalgamated regulators that have followed, including Germany, the Netherlands, Hungary, Estonia, Latvia, Namibia, and others, have all adopted either full or partial industry funding. For example, Hungary, Estonia and Latvia have all adopted a mixed State/industry funding approach.

At the latest count there are 45 countries in the world with regulatory agencies that have consolidated responsibilities for either banking and insurance, insurance and securities, or all three. The vast majority of these are industry funded.

The main logic behind the shift to a greater reliance on industry funding is that the beneficiaries of good regulation should pay for it. Since financial institutions are usually able to shift at least part of the cost of regulation on to their customers, the cost is ultimately born by both consumers and the industry, both of whom are beneficiaries of regulation. In a sense the cost of regulation can be considered like an insurance premium for a safer, fairer and more stable financial system.

While there is an underlying logic in the shift to industry funding, the main reason behind the shift is more pragmatic than philosophical and derives from the need to adequately fund regulation. The difference between the adequacy of regulatory funding under the two models could not be more pronounced. Regulatory agencies that are funded on-budget are almost universally under-resourced. The reasons for this are hardly surprising:

- There are always more demands on the government’s resources than it can possibly meet. Since the potential costs of poor regulation are unlikely to show up for some years, there is a natural temptation to shift funds away from regulation to finance more immediate and politically expedient demands such as public housing, welfare, health, and education.

- It is also the case that agencies that are funded through the government’s budget are unable to make reliable long-term plans - given that their funding has to be re-negotiated every year in competition with many worthy causes.

- Finally, the needs of financial regulators are largely counter-cyclical - it is the very times at which regulatory resources are most needed to deal with financial problems that the access to budgetary funds is likely to be at its most restrictive.
The international experience suggests that, in most countries, industry funding is the only reliable way to secure the long-term funding base for regulation and to pay remuneration sufficient to recruit and retain the expertise needed for effective regulation. Not only does this enable the regulator to compete with the industry for the skills it needs, it reduces the potential for corruption that arises where a regulator must look to other sources of income to make ends meet.

**Risks in Industry Funding of Regulation**

While reliance on industry funding is clearly advantageous for both the Government and the regulatory agency, it carries some risks.

First, while industry funding largely removes the regulator’s dependence on Government, it potentially creates a dependence on the industry. Whichever the providers of the funds have the ability to withhold funds they have leverage to influence regulatory policy and its enforcement.

The obvious counter to this conflict is to structure the funding in such a way that the providers have no say in the size or timing of contributions. This is best achieved by adopting a simple and transparent formula that is neutral in its impact on industry participants and open for all to see.

Second, an agency that can set its own budget with absolute freedom has a temptation to over-budget and also to over-regulate. To avoid industry capture, and to provide a check against excessive costs, the overall budgets and levy rates of most regulators are subject to final approval by either an independent body or by the Government. In most cases the industry is consulted in the process of determining the final charges, but we are not aware of any case in which the industry has a right of approval or veto over the agency’s budget.

**Methods of Raising Industry Funds**

While the trend towards reliance on industry funds is clear, the method of calculating the funds from individual institutions is much less so.

Regulatory funds are mostly raised from industry using some combination of:

- A base fee calculated on some measure of institution size;
- Licensing fees;
- Fees for specific services; and
- Fines and penalties for breaches of the law.

The trend among developed financial systems is to put a greater emphasis on fees for services.

For example, the UK FSA charges:

- Annual fees that cover the bulk of the FSA’s statutory functions;
- Application fees which are designed to recover most of the FSA’s costs in processing applications such as licences; and
- Special project fees where the FSA carries out a specific activity for an institution and where the benefit accrues predominantly to the institution.
In many countries the levies charged to different industry groups is tailored to reflect the different demands on regulatory resources of the different groups. For example, in Australia, the regulatory charge levied by APRA on pension funds is considerably lower than the charge on insurance companies, reflecting the greater time spent by regulatory staff in supervising the latter.

The UK FSA similarly allocates regulated institutions to “fee blocks” depending on the regulatory activities required to meet the legislated objectives for that group of institutions or activities.

Most industry-funded regulators set the base levy on some broad measure of institution size. Total assets under management is the most commonly-used measure of size, although some regulators have used flow measures such as premiums written for industries such as insurance. Total levies paid by any one licence holder are sometimes subject to absolute maxima or minima.

While much science appears to be used in allocating costs to industry groups the reality is that the allocations are often driven largely by practical considerations.

For example, in Australia, the levy rate on insurance companies and pension funds was, at least in the initial stages following APRA’s creation, considerably lower than the equivalent rate for banks. The differential rates in practice were driven largely by the reality that banks had a long history of being taxed by the previous regulator (the central bank) whereas insurance companies and pensions funds had no such experience and were initially much more resistant to the idea of paying for their regulation. Over time those differences have been reduced as APRA has pursued its objective of establishing a common levy rate.

**Accountability for Industry Funding**

The importance of accountability cannot be over-emphasized with the introduction of industry funding of regulation. Without proper accountability there is a significant danger of over-budgeting and over-regulation. Proper accountability and transparency are also the best means of protecting the system against corruption.

Accountability mechanisms adopted around the world include measures such as the following.

First, the regulator’s proposed budget is typically formulated by the regulator itself – but is then subject to approval by the President, the Minister responsible for regulation (where this is the case), or an independent body. The budget is circulated to the industry for consultation before its finalization and presentation to the approving body. It is important in this process that the discussions start with the adequacy of the budget. The levy structure is then a consequence of the budget, not the reverse. The levies are viewed simply as the mechanism through which adequate funding is raised.

Second, funds raised from industry are restricted in their use to activities related to the regulatory functions of the agency.

Third, to avoid perverse incentives for over-collection, the regulator is allowed to hold a reserve. If funding collected falls short of budgeted expenditure the regulator draws on the reserve, which is then replenished from industry levies in the subsequent period. Similarly, revenue raised in excess of budgeted needs is returned to the industry either as a lump sum or as a reduced levy rate for the subsequent period. Again, this emphasizes that the budget itself is the starting point and the levy structure a consequence. There should be no incentive for the regulator to forebear from firm enforcement action against individual institutions on the grounds that closure will affect its budget. In periods where the revenue base increases, the levy per institution is likely to reduce. Likewise, if the industry contracts in size, the levy per institution is likely to increase.
Fourth, the accounts of the regulator are prepared in accordance with International Accounting Standards, audited by an appropriate audit authority and published for all stakeholders to see. The annual report is often required to include not only the financial statements (with full disclosure) but also an account of the regulator’s activities and the extent to which it has met its statutory objectives. Audits are often required to include periodic performance audits.

Fifth, the regulator is required to appear annually before the Parliamentary or a relevant Parliamentary Committee to account for its use of funds, its performance, and its plans for the period ahead. The plan typically covers both the upcoming year and the regulator’s longer-term strategic plan.

Sixth, the regulator is required to meet with the industry at least once a year to discuss its use of industry funds, its approach to regulation and its plans for the period ahead.

**Funding Financial Regulation in Malawi**

At present, the cost of financial sector regulation and supervision is included in the budget for the Financial Services Division of the RBM. Without a detailed analysis of the Bank’s financial accounts and attribution of overheads it is not possible to estimate accurately the full cost of these activities.

Nor is it straightforward to calculate the revenue raised for financial regulation and supervision. Insurance companies, for example, make no direct contribution towards the cost of regulation. Banks, on the other hand, pay an implicit levy to the RBM on their required reserves. This contribution, which amounts to approximately K1.7 billion, is notionally a contribution to cover the cost of both banking supervision and monetary policy. A number of countries that have introduced explicit levies for banking supervision have reduced commensurately the penalty contribution through required reserves.

There is a strong case in Malawi to move to an industry funded basis for financial regulation and supervision. There is a strong case also for this funding basis to be introduced gradually as the industry grows and for the funding formula (at least initially) to be a simple levy on industry assets, supplemented by licensing fees for those industry participants for whom a fee on assets is inappropriate (such as advisors). The main advantages of such an approach are that it would:

- Ensure an adequate long-term funding base for high quality supervisory services;
- Provide greater transparency about the cost of financial regulation and supervision;
- Shift the cost of these activities to the ultimate beneficiaries;
- Provide industry with time to adjust to the idea of “user pays”; and
- Provide a funding base that could sustain a regulatory agency separate from the RBM if ever that were chosen as the next step in regulatory evolution.

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14 The required reserve ratio is currently 27.5% of deposits, which are currently around K45 billion. The RBM allows banks to invest 14.5% of the required 27.5% at interest with discount houses. The balance is deposited with the Bank at zero interest. Thus the opportunity cost of required reserves can be calculated as the interest forgone at the current RBM bank rate of around 25%. We understand that the current structure for required reserves is currently under review.
Recommendation 6

That the RBM introduces a mixed industry/central bank funding model for financial regulation and supervision under which:

- Supervised entities would pay either an annual licence fee or a levy based on assets under management or a combination of both;

- Levies would start at a very low level of say 5 basis points on assets, increasing over a period of up to ten years to the level required to fully fund financial regulation and supervision;

- Commercial banks would receive a pari passu reduction in the implicit cost of required reserves (either by paying a rate closer to market or by reducing the reserve requirement) for their levy contribution to regulation and supervision; and

- During the period that the mixed funding arrangement remains in place, the RBM will adopt, as soon as practicable, the following principles of accountability:
  
  - The accounts of the Bank should identify clearly (on an accrual basis consistent with international accounting principles) all costs and revenues related to regulation and supervision, including the allocation of overheads.
  
  - The supervisory budget should be circulated to industry three months before the start of the financial year for consultation and comment, and be subject to approval by the RBM board no later than one month before the start of the financial year.
  
  - Funds raised from industry should be used exclusively for the Bank’s regulatory activities and related fixed costs.
  
  - The RBM should meet with industry at least once a year to discuss its use of industry funds, its approach to regulation and its plans for the period ahead.
5. Assessment of the Regulatory Framework for Non-Bank Financial Institutions in Malawi

5.1 Introduction

The regulatory framework is usually defined to encompass:

- the regulatory requirements for financial institutions as set down in primary laws and subordinate legislation such as, regulations, rules, directives, and/or prudential standards\(^\text{15}\);
- the powers to enforce these requirements; and
- the legal characteristics of the regulatory agency (or agencies) in terms of its independence, and accountability arrangements.

The defining characteristic of the regulatory framework is that it deals primarily (although not exclusively) with provisions contained in law. In contrast, the supervisory framework refers to the structures, policies and practices established within the agency to monitor and enforce the provisions of the law\(^\text{16}\). This section deals with the regulatory framework while Section 6 addresses the supervisory framework.

It is our assessment that the regulatory framework supporting the RBM’s role as a non-bank regulator is deficient in a number of respects.

Over the past two or three years there has been an international trend towards rationalization of financial sector laws to better align them with the industry responsibilities of regulatory agencies and to facilitate a more harmonized and holistic approach to supervision. This section draws on the experience gained in those efforts to make some suggestions as to how the regulatory framework might be redesigned in Malawi to make the RBM a more effective non-bank regulator.

The section addresses in turn the regulatory requirements for NBFIs in Malawi, the RBM’s regulatory powers, and its independence, governance and accountability arrangements. The approach taken involves first setting down benchmarks for each area based on international standards and practices and then assessing current arrangements in Malawi against those benchmarks. The recommendations attempt to balance the cost of pursuing overly-ambitious legal reforms against the natural bias towards recommending best practice in as many areas as possible.

\(^{15}\) Precisely which of these subordinate forms of legislation apply depends on the legal structure within which the regulator operates.

\(^{16}\) While this distinction will be followed in this Report for convenience of presentation, it is worth noting that there is no universal agreement on the distinction between regulation and supervision and the two terms are often used interchangeably.
5.2 Regulatory Requirements

Regulatory requirements around the world vary widely by institutional sector and by country. There are nonetheless certain key requirements that have emerged in recent years to form the core of regulation in most countries. Many of these have been picked up by the international regulatory bodies such as the Basel Committee, IOSCO and IAIS in their core principles and regulatory guidelines.

Identifying the appropriate level and form of regulatory requirements for each institutional group demands an understanding of the market failures that give rise to the need for regulation. There are three main types of market failure that justify regulatory intervention:\footnote{A fourth market failure often addressed by regulation, namely anti-competitive behaviour, is less relevant in the Malawi context due to its early stage of financial development.}

- Market misconduct;
- Information asymmetry; and
- Systemic instability.\footnote{This terminology and the concepts outlined in this section are based on the analysis in Carmichael and Pomerleano (2002), and the Wallis Report (1997).}

There are two common forms of market misconduct that cause damage to the financial system: unfair or fraudulent conduct by market participants; and inadequate disclosure of information on which to base investment decisions. Market conduct regulation, which focuses on disclosure, licensing and good governance, is largely about protecting market participants from fraud or unfair market practices. By protecting markets in this way, market conduct regulation seeks to promote confidence in the efficiency and fairness of markets.

Information asymmetry arises where products or services are sufficiently complex that disclosure, by itself, is insufficient to enable consumers to make informed choices. This form of market failure should be distinguished from market misconduct associated with inadequate disclosure. Information asymmetry arises where disclosure by itself is insufficient to resolve the market failure. Information asymmetry arises in situations where buyers and sellers of particular products or services will never be equally well informed - regardless of how much information is disclosed. Regulation to deal with information asymmetry is usually referred to as prudential regulation.

Prudential regulation involves a higher level of intervention than market conduct regulation. Prudential regulation overcomes the asymmetric information market failure in part by substituting the judgment of a regulator for that of regulated financial institutions and their customers. Consequently, prudential regulation is typically more intrusive than conduct regulation. Whereas conduct regulation is primarily about producing market efficiency and fairness, prudential regulation is primarily about increasing safety for consumers who are unskilled in assessing complex financial promises. A by-product of the intrusive nature of prudential regulation is that it should reduce the rate of failure among key financial institutions, thereby increasing systemic stability.

However, while prudential regulation supports financial sector stability, there are other factors that affect systemic stability that lie outside the purview of (most) prudential regulators. It is a fundamental characteristic of parts of the financial system that they operate efficiently only to the
extent that market participants have confidence in their ability to perform the roles for which they were designed. The more sophisticated the economy, the greater its dependence on financial promises and the greater its vulnerability to failure of the financial system to deliver against its promises. Systemic instability arises where failure of one institution to honour its promises can lead to a general panic as individuals fear that similar promises made by other institutions may also be dishonoured. A crisis occurs when contagion of this type leads to the distress or failure of otherwise sound institutions. While the potential for systemic instability is usually associated with payments services and deposit taking, equally disruptive consequences can also flow from other types of market disturbances such as stock price collapses and even the failure of a single large institution where that institution is involved in a complex network of transactions. Responsibility for overall financial system stability is usually assigned to monetary policy and to regulation of critical components of the financial infrastructure such as the payments system.

In every country there is a need to identify which financial institutions could potentially give rise to each particular market failure. There is no unique classification that fits every country. At the most basic level it is widely accepted that all financial institutions and market participants require some form of conduct regulation. This may be as trivial as requiring a licence to operate (for example, where an institution or individual provides financial advice), or it may extend to relatively rigorous disclosure and governance requirements (for example, where an institution seeks to raise funds from the public). Whether or not any particular institution or institutional group involves sufficient information asymmetry to warrant the additional oversight of prudential regulation is usually a matter of weighing the costs and benefits of providing the additional oversight.

A useful rule of thumb in classifying institutions for different levels of regulation is to consider the nature of the “promises” they make. Not all financial promises are equally demanding of the promissor and the promisee. Financial promises can be distinguished according to the following three main characteristics:

- the inherent difficulty of honouring the promise (a demand on the promissor);
- the difficulty faced by the consumer in assessing the creditworthiness of the promissor (a demand on the promisee); and
- the adversity caused by promissory breach.

Each of these characteristics involves risk. The more difficult a promise is to keep, the greater the risk to the consumer and the greater the impact of information asymmetry. The more complex the institution making the promise, the more difficult it is for the promisee to assess its creditworthiness and therefore the greater the risk. Finally, the greater the consequences of promissory failure, the greater the risk, not only to the individual, but also to the community.

A useful guiding principle is that institutions making financial promises warrant prudential regulation only where their promises are judged to have a sufficiently high intensity in some or all three of the characteristics outlined above. Only in these cases will the potential cost of the market failure dominate the potential efficiency costs of prudential regulation. This is the same principle that is usually applied to regulation in other situations characterized by asymmetric information failure, such as air safety, drugs, and medical services. Applying the same principle, it is reasonable to assume that
the intensity of prudential regulation should also increase as the intensity of the promises involved increases\textsuperscript{19}.

In a theoretical context, based on the scale of promissory intensity, most people would rank institutions in the following broad order (of decreasing promissory intensity): banks, insurance companies, defined-benefit pension funds, other demand-deposit takers, defined-contribution pension funds, securities dealers, other financiers such as leasing financiers, finance companies, market professionals, and so on. While it is useful to note that these rankings may vary from country to country, it is even more important to note that many countries do not necessarily reflect their ranking of promissory intensity in their regulatory framework. Anomalies can arise from historical accident, from industry lobbying, and from the differential pace of reform in different sectors.

That said, most countries include banking within the prudential regulatory net. Many also include both life and general insurance and pensions. Some have added to this set of core institutions various combinations of other non-bank deposit takers, securities dealers and organized markets. No simple formula exists for defining the best boundaries for prudential regulation.

Finally, the boundaries of regulation for systemic stability are somewhat vague. Indeed the concept of systemic stability regulation (as distinct from prudential regulation) is a relatively new idea and many central banks are grappling with the best way in which to approach this. Most would accept that, apart from monetary policy, the payments system is the key area of regulatory focus for systemic stability. Some extend this to include other settlement systems. Similarly, provision of the lender of last resort facility is a matter of judgment for the central bank but is often restricted to large banks, although smaller banks and other deposit-takers may be included.

This classification of regulators suggests a pyramidal structure in which the lower levels are less intrusive and broader in their coverage. It also suggests that the lower levels are supportive of the higher levels. Thus conduct regulation, which is directed primarily at improving efficiency and fairness (by correcting market failures that arise from misconduct), supports safety and stability; while prudential regulation, which is directed primarily at creating safety (by correcting market failures that arise from information asymmetry), supports systemic stability\textsuperscript{20}.

One of the advantages of viewing regulation in terms of market conduct regulation, prudential regulation and systemic stability regulation is that each requires a different set of regulatory tools to correct the underlying market failure. Since systemic stability regulation is primarily the responsibility of the RBM’s monetary policy staff it will be ignored in what follows.

The regulatory requirements for good market conduct are based on market fairness. The tools for market conduct that are usually provided to regulatory agencies through the law include:

\begin{itemize}
  \item Entry requirements (mainly the right of the regulator to license market participants).
\end{itemize}

\textsuperscript{19} There is no unique cut-off point for prudential regulation. The suggestion above that some institutions are singled out for prudential regulation because they rate highly on the “promises scale” is largely a reflection of how regulatory agencies are established in practice. It is equally plausible to argue, however, that the “promises scale” is a continuum with low intervention regulation at one end of the scale and highly-interventionist regulation at the other.

\textsuperscript{20} Somewhat perversely, prudential regulation may work against market efficiency by restricting entry and competition into sensitive areas of the financial system.
• Governance requirements (usually in the form of restrictions on the composition of boards, rules for dealing with conflicts of interest, separation of roles etc).

• Prohibition of false and misleading advertising about financial products.

• Prohibition of insider trading.

• Prohibition of undesirable market practices.

• Reporting requirements to the regulator.

The regulatory requirements for prudential soundness are more intrusive and therefore more complicated. Prudential regulatory requirements are built around recognition that every prudentially-regulated financial institution carries, in addition to its own business risk, some combination of the following four risk groups:

• Asset risk, which can be broken down into:
  o Market risk
  o Credit risk

• Liability risk, which can be broken down into:
  o Liquidity risk
  o Provisioning risk

• Asset/Liability mismatch risk, which can be broken down into:
  o Maturity mismatch risk
  o Sector mismatch risk

• Operational risk, which can be broken down into\(^{21}\):
  o Systems failure risk
  o Governance failure risk
  o Reputational and other operational risks

Different financial institutions carry these risk groups to different extents. For example, banks and other deposit takers are exposed most heavily to credit risk; general insurance companies are exposed

\(^{21}\) While there is little ambiguity about the definitions of the first three risk groups, the concept of operational risk is relatively new and is not universally agreed. For example, the definition of operational risk used by the Basel Committee in the new Basel II framework for banks explicitly excludes governance risk from operational risk. These distinctions are, however, largely semantic. For convenience, operational risk will be defined in this Report to include all risks not otherwise defined explicitly under the first three risk groups.
most heavily to provisioning risk; pension funds are exposed most heavily to governance failure risk; and so on. Traditionally, regulatory requirements for different institutional groups have focused most heavily on the primary one or two risks faced by the group. More recently, there has been recognition that secondary risks can be just as dangerous if left unattended.

The extent of exposure to different risks is dependent on the nature of the financial promises made by the institution. Thus, while a defined contribution pension fund ostensibly carries a high level of market risk, the fact that the members absorb that risk (rather than the fund itself) diminishes the importance of market risk as a regulatory issue. In its place there is usually a greater focus on disclosure and mobility, so that members can exit funds that do not meet their market risk preferences. If mobility is limited, either by law or by the structure of the pension industry, there is a stronger case for regulatory requirements to cover market and associated risks.

The tools for prudential soundness that are usually provided to regulatory agencies through the law include:

- Entry requirements (in addition to the basic entry requirements for market conduct, prudential entry requirements usually add minimum capital and skills requirements).

- Governance requirements (in addition to the governance requirements for market conduct, prudential requirements usually add fit and proper tests for owners and managers of prudentially regulated financial institutions, as well as sometimes tightening the restrictions on governance structures\(\textsuperscript{22}\)).

- Capital adequacy/solvency requirements (in addition to the minimum capital requirements for licensing, prudential requirements usually add on-going requirements for institutions to maintain an acceptable level of capital related to the nature of the risks they take).

- Liquidity requirements (where institutions are particularly exposed to liquidity problems the regulatory requirements impose minimum liquidity levels or system requirements).

- Reporting requirements to the regulator (again these are usually more extensive and more frequent than those required by conduct regulation).

- Asset restrictions (these may take the form of restrictions on the types of assets that may be held by a licensed institution, imposition of diversification requirements, limitations on related party transactions, requirements to match characteristics of assets and liabilities, or exclusions on certain assets for the purposes of calculating statutory capital adequacy).

- Actuarial assessment of liabilities (where an institution incurs long-term, high-risk liabilities there is usually a requirement to have these liabilities assessed by a qualified, independent party from time to time).

Possibly the most significant change in prudential regulatory requirements over recent decades has been the shift towards risk-based regulation. The fundamental principle underlying risk-based

\(\textsuperscript{22}\) There is a tendency for some regulators to set overly prescriptive governance requirements with respect to prudentially-regulated financial institutions. The primary intention of governance requirements at this level should be to ensure that governance systems adopted by the institution are appropriate to the risks involved, that they have been developed at all levels of the institutions, and that they are working in practice.
regulation is that the weight of regulatory requirements should be directly related to the risks that the institution takes. The clearest example of the application of this principle has been the risk-based capital framework implemented by the Basel Committee for banking regulation. Increasingly this principle is being extended to other regulatory requirements and to financial institutions other than banks. For example, it is now common to find insurance companies in many jurisdictions subject to risk-based solvency requirements. An extension of this trend towards risk-based regulation is the growing acceptance among many regulators of the idea that prudential regulation should be based on risks rather than on institutional labels. The ability of regulatory agencies to look through institutional labels to focus more on risks has been increased by the worldwide trend towards amalgamating industry-based regulatory agencies to cover more than one group of financial institutions.

The following sub-sections provide a brief overview of the main features of international practice with respect to regulatory requirements for each group of financial institutions under the RBM’s responsibility.

5.2.1 Insurance Companies

The regulatory requirements for life and general insurance companies are typically based on licensing, solvency, actuarial reviews, governance, asset/liability restrictions and accountability.

Solvency involves an assessment of the surplus of assets over liabilities of the insurance company. While asset risk can be significant, by far the greatest risk in insurance business and the most common source of institutional failure is inadequate claims provisioning. Thus a sound solvency regime typically includes rules governing provisioning, solvency margins and the use of reinsurance. The statutory solvency calculation will usually identify inadmissible assets such goodwill, deferred tax benefits and loans to related-party companies. The calculation of solvency also usually excludes from equity certain “less reliable” forms of capital such as convertible notes or hybrid debt-equity instruments. It is usual for the regulations to provide guidance on how to calculate provisions (e.g. restrictions on discount rates used) and to require a prudential margin where claims are highly uncertain.

As noted above, in recent years there has been a shift internationally towards risk-based calculations of solvency. This approach recognizes, for example, that the risk of under-provisioning in business lines such as professional indemnity insurance is significantly greater than in business lines such as motor vehicle or marine insurance. Risks are also greater where the statistical foundations of any given type of insurance are less reliable. The more advanced risk-based approaches also recognize and require insurance companies to hold capital against asset risk and operational risk.

In addition to capital/solvency requirements, regulatory requirements for insurance companies typically include fit and proper tests for owners and managers, strengthening of the corporate

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23 While the current Basel I framework introduced risk-based capital adequacy to the banking industry some 20 years ago, the proposed Basel II framework will raise the sophistication of risk-based regulation to a much higher level.

24 These are known as long-tailed policies, in which the financial outcomes of claims may be delayed or not known for more than 12 months.

25 These are known as short-tailed policies, in which claims are typically settled within 12 months of the event giving rise to the claim.
governance framework if needed, and extensive reporting requirements. Many of these requirements follow similar templates to that set out in the section below for pension funds.

Institutions that offer insurance type products, such as medical aid funds and friendly societies, are usually treated the same as the equivalent category of insurance company for the purpose of regulatory requirements.

5.2.2 Pension Funds

Regulation of pension funds usually concentrates on three main areas: governance, accountability and investment rules. The need for these three areas of regulation arises regardless of whether the funds are public or private.

In a good governance framework, the rules typically require that, for each fund:

- there is clarity of roles and responsibilities;
- there is clarity about the appointment and dismissal of directors and management;
- the fund manager is free from inappropriate interference;
- the process for formulating and executing fund policy is open and transparent; and
- the structure of delegations is well defined and targeted at minimizing corruption, mismanagement and fraud.

These requirements should apply equally to all industry participants, both private and public.

Accountability involves ensuring, by creating compatible incentives, that the governance structures are effective. The central considerations for a good accountability framework are transparency and reward structures. A strong accountability framework typically requires that, for each fund:

- there is full and open disclosure about the governance structure of the fund;
- formal delegations of powers and responsibilities are disclosed;
- in the case of defined benefit funds there are periodic actuarial reviews of the funding of the schemes relative to their commitments;
- funding shortfalls (if any) are disclosed, along with proposed remedial actions;
- there are regular governance and performance audits;
- management reports comprehensively on its decisions and performance (these reports should be against established benchmarks);
- in the case of defined benefits funds, there is an actuarial assessment of the state of the fund at periodic intervals; and

26 The regulatory requirements outlined in this section are based largely on Carmichael and Palacios (2004).
• rewards are linked to performance and responsibilities.

Investment policy is at the heart of pension fund performance. Investment policy comprises three main components: setting long-term performance targets; defining an acceptable risk tolerance; and setting parameters for short-term asset allocation. Many pension laws/regulations constrain the investment policies of pension funds directly to avoid excessive concentrations of risk. Beyond this, regulation typically seeks to establish an open investment framework by ensuring that, for each fund:

• the investment policy is directed solely to the benefit of the members;
• investments should avoid conflicts of interest (e.g. corporate funds should not be invested back into the business of the employer);
• the investment policy is set by the board of directors or trustees, is fully documented, and is available in summary form to members of the scheme;
• the investment policy identifies all relevant risks and the manager’s approach to measuring, monitoring, and managing each of them (in some cases there is an explicit requirement for the manager to ensure that the investments are well diversified); and
• the investment policy clearly delineates the role of managers and, where relevant, the criteria for selection and retention of external service providers.

5.2.3 Capital Markets, Securities Dealers and Investment Managers

The regulatory requirements usually imposed on capital markets and their participants are driven almost exclusively by the need for good market conduct. The cornerstones of capital market regulation are therefore disclosure and rules establishing good market conduct (such as good governance requirements, and prohibitions on insider trading and false and misleading behaviour). Unlike insurance companies, pension funds and deposit-taking institutions, capital market participants generally require only market conduct regulation, rather than prudential regulation, although minimum capital requirements are common for many participants that handle monies for other people. The one exception in this area is the stock exchange itself (and other similar organized markets), where a level of prudential regulation is usually shared between the capital market regulator and the exchange (in a self-regulatory capacity).

Regulation of capital market participants such as securities dealers, unit trusts, asset managers and other capital market participants therefore focuses primarily on licensing, reporting, disclosure, governance and rules of good conduct. The compliance framework should be comprehensive and should provide confidence for market participants that the capital markets are fair and transparent.

5.2.4 Specialized Financiers

Specialized financiers such as development financiers, and finance and leasing companies are usually regulated even more lightly than securities dealers and investment managers in that they typically draw their funding from the wholesale market. In many countries the regulation provided by the Companies Act and the stock exchange (with respect to fund raising) is considered sufficient regulation for these institutions. However, to the extent that misbehaviour by these firms can bring disrepute onto the financial markets, many countries impose some additional requirements through the financial regulatory system.
As with securities dealers, these requirements typically focus on licensing, reporting, disclosure, governance and rules of good conduct. Where the industry has sufficient scale, this regulation may be carried out through a self-regulatory organization.

5.2.5 **Microlenders**

Microlenders are a special category of financial institution. Since they typically do not accept deposits from the public the case for their prudential regulation is very weak. In most countries they are regulated only for their conduct. The most common forms of misconduct in this sector are misrepresentation, lack of disclosure (especially about the true nature of the interest and charges that a borrower may incur), unreasonable collection methods and, where usury laws apply, overcharging.

The primary regulatory requirements for microlenders are therefore usually a minimal licensing requirement, disclosure rules (e.g. in the form of a standardized contract with clear disclosure of all interest and charges in a form comparable across different lenders) and rules of good conduct. These can either be issued through directives or through a Usury Law. The latter route is preferred only in situations where the usury principles are intended to apply across the entire financial system.

5.2.6 **Supporting Market Professionals**

In a well-developed financial system, insurance brokers and agents are licensed and subjected to governance and skill requirements, as are investment advisors, auditors, actuaries, valuers, and professional administrators. This is sometimes achieved through self-regulatory bodies such as professional associations although, where industry numbers are small, supervision should be through one of the regulatory agencies. They are also expected to meet the conduct requirements of the relevant Acts under which they operate. Beyond this basic level of regulation there is not normally a case for more intensive oversight of these institutions and individuals.

5.3 **Regulatory Powers**

Regulatory requirements establish the prudential and conduct benchmarks expected of regulated financial institutions. Regulatory powers establish how, and how effectively, the regulatory agency is expected to monitor and enforce those requirements. In an ideal world a regulatory agency with responsibilities as broad as the RBM’s would have the following powers:

**Registration and deregistration** - the power to register financial institutions under financial sector laws, and to administer registration requirements under those laws. This includes the power to impose relevant conditions, and the power to vary and revoke registrations in appropriate circumstances.

**Making of legally binding regulations/directives and (less formal) guidance notes** - the power to formulate and promulgate regulations for all registered financial institutions and the power to vary and revoke them. Regulations are usually executed formally by the Minister, but the regulatory agency should have primary responsibility for their development. Prudential

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27 While the focus of this Report is on NBFIs, the powers outlined in this section are equally relevant to banks, and so, throughout the section, the broader term “financial institutions” will be typically be used in preference to the narrower term “NBFIs”.

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directives (or standards) and guidance notes on the other hand are usually issued by the agency. In total these subordinate legislative instruments should cover at least the following:

- standards of corporate governance for registered entities, including codes of conduct, roles of boards and management, and methods for resolving conflicts;
- standards governing the ownership and control of financial institutions, including fit and proper conditions and minimum qualification requirements;
- standards of business conduct, including resolving conflicts between financial institutions and their clients, prohibition of certain abuses and insider trading;
- standards governing the prevention of financial crime;
- standards defining capital adequacy/solvency and the measurement of capital, including excluded assets and liabilities;
- standards defining valuation methods where relevant for both assets and liabilities, including choice of discount rates and levels of sufficiency in provisioning;
- standards concerning the management of risks by financial institutions; and
- standards of disclosure for securities and retail investment products, including insurance policies and pension products.

**Reporting obligations and information gathering** - the power to require all financial institutions to provide whatever information the regulator requires in whatever form it judges to be appropriate. This should include both regular reporting and specific reporting in non-routine situations.

**Monitoring and surveillance** - clear monitoring and surveillance powers are an integral part of supervisory and market conduct functions. These include powers:

- to require the production of documents and the giving of information;
- to inspect and copy documents; and
- to test an institution’s compliance with prudential regulations/standards including appointing, at the institution’s expense, an appropriate expert to report on any aspect of the institution’s business, or the business of a group of which it may be a part, for the purpose of establishing compliance with regulatory requirements.

These powers should be able to be exercised without having to demonstrate that there is any suspicion of wrongdoing; they are purely routine information gathering powers.

**Directions** – the power to direct any registered financial institution to do something specific, or to cease doing something specific, for the purposes of ensuring compliance with a financial sector law or regulation/standard. Directions powers are ideally parameterized in the law, both to provide legal certainty and to reduce the possibility of their being misused. A typical parameterization (subject in certain cases to conditions precedent) would include the power to issue directions:
• to comply with the whole or a specified part of a financial services law or directive;
• to appoint an auditor to audit the records of a licensed entity;
• to appoint an actuary to prepare a report on the affairs of a licensed insurer, agent or broker;
• to prevent a specified director or employee of a licensed entity from taking part in the management or conduct of the business of the entity;
• to appoint a specified person or persons to a specified office of a licensed entity;
• to remove an actuary or auditor of a licensed entity;
• not to incur further debt;
• not to pay a dividend;
• not to pay or transfer any amount to any person, or create an obligation (contingent or otherwise) to do so;
• not to undertake a financial obligation (contingent or otherwise) on behalf of another person or to transfer funds to another person;
• to take any other action that the regulator considers necessary or desirable in the interests of the licensed entity, its creditors, or the financial system.

Investigating breaches - where the regulator has reason to suspect a breach of a financial sector law it should have comprehensive powers to investigate the suspected breach.

Responding to breaches – effective responses to breaches of financial sector laws require a combination of the powers to:
  o revoke registration;
  o suspend the operations of a registered institution;
  o remove directors of a registered institution;
  o require a registered institution to appoint new auditors and/or actuaries;
  o levy administrative fines – the regulator should be able to penalise non-criminal breaches appropriately with administrative penalties. Ideally, the regulator should have the power and discretion to negotiate administrative penalties and remedial action without the need to rely on court proceedings. Where such remedies cannot be negotiated, prosecution should result.
  o freeze assets of or under the control of a registered institution where the regulator suspects that the interests of the customers of the institution may be at risk;
  o require a registered institution to publish corrective material;
  o require a registered institution to terminate or unwind specific transactions; and
accept enforceable undertakings from registered institutions and their officers who are in breach of financial sector laws or regulations/standards. These written undertakings can cover any aspect of an activity that is required to be registered under a financial sector law. An enforceable undertaking should be published and, in the event of a breach of the undertaking, the regulator should be able to apply to the court for an order directing compliance with the undertaking.

**Prosecuting breaches** - In many countries the prosecution of criminal breaches of financial sector laws are shared between the regulatory agency and the Department of Justice (or its equivalent). The case for the regulator to prosecute at least some breaches rests on both the support it adds to the agency’s credibility as an effective regulator and to the particular expertise that it brings to the area. Prosecution can nevertheless be expensive and demanding on staff resources.28

**Imposing a statutory manager** – Where the regulator is concerned that a registered prudentially-supervised institution (e.g. a bank, insurance company, friendly society, medical aid fund or pension fund) may be insolvent, behaving imprudently in a manner that is putting clients’ interests at risk, or is violating a financial sector law, it should have the power to appoint a judicial manager. The judicial manager should take directions from the regulator. A judicial manager should not be able to be appointed to a prudentially-regulated financial institution without the regulator’s consent.

**Transfers of business** – the power to approve mergers and acquisitions of registered institutions.

**Winding up a registered institution** – standing to apply to the Courts for the winding up of registered institutions. No application to the Court to wind up a registered prudentially-regulated institution should be able to be made without the regulator’s prior approval.

**Authorising self-regulatory organisations** - the power to authorise and make appropriate arrangements with industry self-regulatory organisations and other agencies with regulatory roles as the regulator sees fit.

**Conglomerate supervision** – the power to supervise a financial group on a consolidated as well as a stand-alone basis.

**Information sharing powers** - the power to share information with other regulatory agencies (some of which may not yet be established), including the central bank, other relevant domestic agencies, and overseas financial regulators, as well as the Police. In all cases, the nature and extent of the information sharing arrangements should be detailed in a Memorandum of Understanding between the agencies.

5.4 **Independence and Accountability**

Strong powers require a willingness to use them and a willingness to be accountable for that use. Any recommendations to strengthen the powers available to the RBM (as will be offered in Section 5.5 below) should be accompanied by a review of and recommendations on its independence and

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28 In a small country such as Malawi it makes sense for most prosecutions to be referred to the Department of Justice. The RBM should nevertheless have standing to bring legal action against financial institutions and others who breach financial sector laws.
accountability framework. This section outlines the ideal combination of independence and accountability for regulatory agencies.

5.4.1 Independence

The Core Principles of each of the international regulatory groups\textsuperscript{29} emphasizes the need for regulatory independence. A regulator’s capacity to meet its legislated objectives is dependent first and foremost on the skills and experience of its staff which, in turn, is dependent on having a sound funding base that is independent in the sense that the resources available to the regulator are free from influence by individuals or groups within the industry or government. Only a financially independent regulator can form regulatory judgments and decisions without fear that its resources will be reduced in retaliation.

While financial independence is fundamental to regulatory independence, full operational independence encompasses other elements that are equally important, including legal protections and adequate powers to meet the regulator’s statutory objectives.

The sole motivation for granting a degree of independence to a regulatory agency is to enhance its effectiveness by ensuring that it is able to pursue and achieve its legislated objectives. Good regulation is primarily about making decisions that are based on objective criteria directed towards the achievement of the objectives specified in the law and free from extraneous considerations and influences. Independence is about removing those extraneous influences to the greatest extent possible (accountability is about ensuring that they are replaced by legislated objectives).

In the context of a financial regulator, independence means that the regulator should have the capacity, without inappropriate interference, to:

- develop regulatory policy;
- implement regulatory policy; and
- enforce regulatory policy.

Removing “inappropriate” influence should not be taken to imply that the government does not have the right to exert some influence over regulatory policy under certain circumstances. On the contrary, since regulatory agencies act ultimately as delegated extensions of government, there should always be provision for the government to overrule the agency where wider issues of public policy or public interest apply, provided this is only done in appropriate circumstances and affected in a transparent manner. The critical element of the relationship should be that “inappropriate” government influence, such as interventions by a Minister or a Member of Parliament with respect to a particular institution, is ruled out.

Thus, the independence to make, implement and enforce regulatory policy is an essential means for achieving the objectives laid down in the legislation for the regulator. In the absence of the independence to pursue its regulatory responsibilities free from inappropriate interference, there is a fundamental incompatibility between the regulator’s objectives and its capacity to deliver against those objectives – a conflict that can quickly undermine its credibility with the public, regulated institutions, and foreign investors alike.

\textsuperscript{29} Namely, the Basel Committee for banking regulation, IOSCO for securities regulation and the IAIS for insurance regulation.
Legal independence derives from legal provisions that both require the regulator to act independently and provide legal support for regulators who exercise that independence. A legally independent regulator can form regulatory judgements and decisions without fear of retribution from individuals or groups within the industry or government.

In practice, legal independence is determined by a wide range of factors including:

- the processes under which regulatory policies are formulated;
- the terms under which regulators are appointed and dismissed;
- legal protections from interference;
- legal indemnities for regulatory staff who carry out their regulatory duties in good faith; and
- the way in which potential conflicts between the regulator and the government are resolved.

The following is a summary of international best practice in these areas.

**Processes for Formulating and Implementing Regulatory Policy**

The statement that an independent regulator should be able to develop regulatory policy refers to the detail of policy, not to the broad policy framework – which is rightly the province of government. The detail, however, is an art rather than a science and can evolve quickly as markets, institutions and products evolve. A good regulator has constant contact with the industry and should have the expertise to assess developments within the industry and to adapt regulations accordingly and quickly – whether to facilitate a new innovation or to head off a potentially dangerous development. Operational independence requires that the agency is able to issue legally binding directives within the parameters set down in the law, without the first having to seek the approval of other departments in the bureaucracy, the Minister, or the Parliament. It is good practice to ensure that such policies are nevertheless subject to adequate consultation, but the right to issue the policies should rest unambiguously with the agency that will be held accountable for their effectiveness.

Similarly, operational independence requires that the agency is able to exercise its powers under the law (including the power to issue and revoke licenses, to issue directions, and to take enforcement actions) without first having to seek the approval of other departments, the Minister, or the Parliament. Natural justice, of course, demands that these regulatory decisions should be subject to appeal, to an appropriate body (such as an appeals tribunal or the courts), but the regulator must be able to act quickly and without interference to protect the interests of those for whom it has a statutory responsibility.

**Mechanisms for Appointing and Dismissing Board Members**

A major factor in the legal independence of a regulatory agency is the process by which board members (or commission members where the agency is established as a commission) are appointed and dismissed. The greater the protection afforded against capricious dismissal, the greater the likelihood that individual board members will act in accordance with the requirements of the legislation, free from coercive pressure from outsiders. At the same time, board members should not be so confident of their tenure that they regard themselves as unaccountable for their performance and for the performance of their agency. There is a balance to be struck; that balance is most likely to be achieved where the appointment of board members is seen to be open, accountable and fair.
Best practice is to include in the law a statutory list of qualifications to ensure that board members are appropriately qualified for the challenges of financial regulation and to minimize the appointment of “political friends” who lack the competence to lead a regulatory agency. As another protection against inappropriate appointments best practice also requires board appointments by the President (or the Minister in countries where the agency is directly responsible to a Minister) to be ratified by the Parliament.

The dismissal process should also be transparent to avoid unfair dismissal or dismissal for political or personal reasons. Board members are best protected from capricious dismissal by including a statutory list of conditions for dismissal in the law establishing the agency. The most common grounds for dismissal are bankruptcy, criminal conviction and mental incapacity. As with appointments, dismissals should be subject to ratification by the Parliament.

While many countries extend the appointment process to include senior executives, this creates a potential conflict for the head of the agency. Unless the head is able to appoint executives in whom he/she has confidence, it is difficult for the head to be held accountable for their performance. Where the appointment process does extend to executives, best practice is for the appointment to be on the recommendation of the head of the agency.

**Legal Protection from Interference**

International best practice is for the law establishing the regulator to make it an offense for any individual to attempt to influence the agency, other than as is provided for in the law (see the section below on resolving potential conflicts with the government).

**Legal Indemnities for Staff**

One design aspect that has diminished regulatory independence in a number of countries has been the absence of an adequate legal indemnity for staff members who act in good faith (in legal terms the protection is considerably stronger if the requirement is for the accuser to have to establish that the staff member acted in bad faith).

It is unavoidable that regulatory decisions affect the capacity of firms and individuals to earn income. Most regulatory decisions favour the rights of one group at the expense of others. It is implicit in the objectives of any regulatory agency that it will, from time to time, be required to uphold the rights of individual depositors, policyholders, or investors relative to those of financial institutions and licensed individuals. It is an inevitable consequence of this requirement that aggrieved parties may seek legal redress where they believe the decisions of the agency have unjustly deprived them of their rights.

For regulators to act in the national interest in carrying out their regulatory responsibilities it is fundamental that they have legal protection against damages generated by their actions, provided those actions are taken in good faith and in pursuit of the objectives set down in the legislation. Without such protection it is difficult for regulators to make decisions; it can also be difficult to recruit good quality staff, given the knowledge that they are taking on substantial personal risk through their work. Most countries have such legal protections in their legislation.

The potential for capricious legal action in some countries has also led to the extension of the indemnity to the agency itself, provided that its office bearers do not act in bad faith and act within the legal powers provided by the law.
Resolution of Potential Conflicts with the Government

While best practice is for the regulatory agency to have the power to formulate, implement and enforce regulations and regulatory policy, as noted above, it is impossible to rule out that circumstances may arise in which the national interest may dominate the legislated objectives of the agency. In such circumstances, the government should have the right to overrule the agency, subject to this being done in an open and transparent manner.

The ideal way to implement such a provision is for the law to specify that:

- Presidential directions (or Ministerial directions in countries where the agency is directly responsible to a Minister) may be made to the agency only where they are in the national interest or where there is a conflict with established government policy;
- These directions should be on broad policy matters and should not relate to individual institutions; and
- Any such directions should be tabled in the Parliament.

5.4.2 Accountability

Strong independence should be balanced by equally strong accountability requirements. Accountability refers to the ways in which the entity reports its decisions and is held responsible for its actions. Section 4 discussed some accountability requirements related to funding. This section considers broader accountability requirements for the agency’s actions.

A pre-condition for a good accountability framework is that the law should specify clearly the objectives of the agency. Without such a statement it is unclear precisely against which standards the agency is to account. While objectives vary from agency to agency according to the range of its responsibilities, a typical set of objectives for an agency with regulatory responsibility for the entire financial sector would include the promotion of:

- the stability of the financial system;
- the safety and soundness of financial institutions;
- the highest standards of conduct of business by financial institutions;
- the fairness, efficiency and orderliness of the financial sector;
- the protection of consumers of financial services and products; and
- the reduction and deterrence of financial crime.

In establishing objectives it is important to recognize that there are certain trade-offs to be made in good regulation. In particular, it should be recognized that over-regulation can be as destructive as under-regulation. Some countries acknowledge this by requiring the regulator to take account of these trade-offs in pursuing its objectives. For example, the objectives may be qualified by a clause such as the following:

- In pursuing these objects the regulator must take into account:
o the impact of the costs of regulation and supervision on the ability of the community to gain access to financial services; and

o the need to balance the effectiveness of regulation and the efficiency of the financial system.

These latter clauses are appropriately included as qualifications. In contrast, they can create contradictory obligations when they are elevated to the same status as objectives such as safety, soundness and fairness of markets.

Accountability of a regulatory agency should extend to the Government, the public, and the industry that it regulates. The governing principle of accountability should be that the greater the degree of independence of the agency, and the greater its powers, the greater should be its accountability.

The first line of accountability of any regulatory agency should be to the individual responsible for appointing and dismissing the leaders of the agency. In most countries this will be the President (as in the case of Malawi) or Minister of Finance.

The primary mechanism for acquitting that accountability is through statutory reporting requirements. Full accountability requires the highest levels of transparency and disclosure. Ideally, a regulatory agency should be subject to the following accountability requirements:

- The agency should be required to report to the President annually and more frequently if either the President requires or the agency sees fit.

- Annual reports should outline the agency’s policies and cover its operations as well as matters affecting the achievement of its statutory objectives.

- As suggested in Section 4, annual reports should include the agency’s audited accounts, prepared in accordance with international accounting standards. The audit responsibilities should include effectiveness audits of the agency’s performance, operational efficiency and its regulatory effectiveness.

- All routine reports from the agency to the President (annual and otherwise) should be required under law to be tabled in Parliament and published.

- In addition to its accountability to the President, the agency should appear regularly before the Parliament or a Parliamentary Committee to provide information and explanations concerning its policies and operations, subject to appropriate safeguards to avoid infringing the rights of persons under investigation, or prejudicing ongoing operations.

- With respect to the formulation of regulatory policy, the law should require the agency to consult with the industry and the public before major policy changes; all proposed regulations and directives should be exposed to the public for comment for a minimum period before being passed into law.

- The agency should have a legislated responsibility to keep the President, or Minister responsible, regularly apprised of any licensed financial institution which the agency has reason to believe is experiencing financial difficulty and is at risk of failing.

Regulatory agencies should also be accountable to the community at large. Much of this accountability is provided for in the annual reporting process and also through the consultation
provisions mentioned above. Beyond these processes regulatory agencies should have a legislated responsibility to educate the public about the financial system in general (including the risks involved), the roles and responsibilities of the regulatory agency, and their rights and responsibilities as consumers of financial products. Regulatory agencies should be required to establish user-friendly complaints handling mechanisms for the public and should be seen to be responsive to the public’s concerns.

Finally, regulatory agencies should be accountable to the industries that they regulate. Again, some of this accountability is provided for in the annual reporting process and consultation provisions mentioned earlier. Accountability to the industry should, however, go beyond these basic disclosure and consultation processes. There is a case for establishing industry advisory panels to ensure that the agency has the benefit of industry expertise in its formulation of policy. As suggested earlier, regulatory staff should be protected against legal action for decisions taken in good faith in carrying out their duties under the law. Such an indemnity, however, should be balanced by adequate provisions to protect industry participants against capricious decisions by the agency. As noted earlier, natural justice requires both that the agency’s decisions, and the basis of those decisions, be available to affected parties, and that there is an adequate process for appealing decisions.

A best practice accountability structure to industry should include some or all of the following:

- The law should provide for the establishment of specialist industry advisory panels – these panels should include representatives of consumers of financial services.
- The agency should conduct regular meetings (e.g. annually) with financial services sector participants to review progress towards achieving its statutory objectives and to allow participants to raise and discuss with the agency any matters of general concern.
- In addition to the exposure period for proposed new regulations, all policy statements and regulations should be available to the industry and the public at all times (e.g. through the agency’s website).
- The law should require the agency to give reasons when it makes decisions adverse to the interests of particular financial institutions or individuals.
- With respect to the enforcement of regulations, the law should generally give affected parties an opportunity to make representations before the decisions (for example, revocation of a licence) become effective.
- Regulatory decisions should be subject to review by an internal panel of agency staff not involved with the original decision. The law should spell out the circumstances and mechanisms under which such opportunities will be given.
- Affected parties should also have access to external review of agency decisions in an appeals tribunal and/or the courts.
5.5  Assessment of and Recommendations for Strengthening the Regulatory Framework for NBFIs in Malawi

5.5.1  Industry Coverage

As noted earlier, the most obvious deficiency in the regulatory framework in Malawi is the number of institutional groups that are not explicitly included within the regulatory net. These include deposit-taking institutions such as SACCOs, the pension fund industry, medical aid funds, friendly societies, and other specialized financiers such as microlenders, finance and leasing companies, and development financiers.

While s48 of the Reserve Bank of Malawi Act appears to give responsibility to the RBM for all financial institutions, the definition of financial institutions in the Act – namely, “financial institutions and pensions, assurance and insurance institutions” - is somewhat imprecise and circular. For example, it is unclear whether the definition of “financial institutions” is intended to include microlenders, development financiers and leasing companies.

The RBM’s regulatory responsibilities for the insurance industry are sharpened somewhat in the Insurance Act which gives the RBM regulatory jurisdiction over insurance companies and agents although, under the Insurance Exemption Order (1971), trades unions, pension funds and medical aid funds are given an exemption from the provisions of the Insurance Law. There is also no explicit reference to insurance brokers in the Act, other than agents for brokers under Part IV dealing with associations of insurers such as Lloyds.

The RBM’s regulatory responsibilities for Malawi’s capital markets are more explicit in the Capital Markets Development Act which gives the RBM regulatory jurisdiction over financial institutions that participate in the capital markets, including: self-regulatory organizations (such as the Malawi Stock Exchange); brokers; dealers; market makers; underwriters; investment advisors; portfolio managers; investment companies; mutual funds; and unit trusts. The Act, however, does not define many of these institutions, thereby leaving some ambiguity as to the actual institutions to be regulated by the RBM.

The Banking Act makes reference to financial institutions as well as to banks. The Act includes the following definitions:

Bank: a person who conducts banking business in Malawi, including the acceptance of funds withdrawable by check or transferable by other means;

Banking Business: the business of receiving funds from the public by accepting demand, time and savings deposits or by borrowing from the public or other banks, and of employing such funds, in whole or in part, by granting loans, advances and credit facilities and by investing or by any other means at the risk of the person conducting such business; and

Financial Institution: a person whose regular business grants loans, advances and credit facilities, and investing funds by other means, and whose business is financed by own or borrowed funds or with funds not acquired by accepting or soliciting deposits from the public, and includes pension funds, insurance companies, investment funds and investment companies.

Again, however, the definition of financial institutions is vague, although it would appear to include development financiers and microlenders. The inclusion of insurance companies and investment companies raises the potential for conflict with the Insurance Act and the Capital Markets Development Act, to the extent that provisions in the Banking Act are inconsistent with those in the
other two laws. Further, without an explicit exemption, the definition of banks would appear to capture SACCOs.

While it is arguable that these laws, in combination, give the RBM regulatory responsibility for the entire financial system, the fact that there are no specific industry laws for complex sectors such as pensions, combined with the lack of precision in some of the definitions of financial institutions has resulted in a number of institutional groups remaining largely unregulated to date.

There is a need to remove the current ambiguity about precisely which financial institutions the RBM is to regulate and supervise.

**Recommendation 7**

*That the Reserve Bank of Malawi Act (1989) be amended to include a statutory list of financial institutions over which it has regulatory jurisdiction and that the Minister be given the power by regulation to add new financial institutions to that list if circumstances so warrant.*

In addition to removing the current ambiguity about precisely which financial institutions the RBM is to regulate and supervise, there is a need to introduce new legislation to provide the administrative basis for the existence and operation of certain sectors of the financial system. The most immediate need is for a law governing the operation of pension funds and their related industry professionals.

**Recommendation 8**

*That a Retirement Incomes Bill be drafted to establish a firm legal basis for the operation of pension funds and pension industry professionals.*

### 5.5.2 Regulatory Requirements

In the review of regulatory requirements that follows we will restrict our attention to NBFIs. We understand that a separate project under the auspices of the International Monetary Fund is addressing the regulatory and supervisory framework for banks in Malawi.

As noted above, regulatory requirements are usually found in a combination of primary laws and subordinate laws, such as regulations and directives. In Malawi, there are three laws under which subordinate laws may be issued: the Insurance Act, the Capital Markets Development Act, and the Banking Act. These laws are of uneven ages and we understand that all three are under active revision. The following comments refer just to the two NBSI laws.

#### Insurance Companies

The regulatory requirements for both life and general insurers are relatively narrow and somewhat outdated. The following is a summary of the strengths and weaknesses of the requirements in the insurance Acts and regulations:

- The Act appropriately requires licensing of insurers but imposes virtually no explicit restrictions on the types of business that they can do. It is usual to restrict general insurers to carrying on only the business of general insurance, and life insurers to carrying only the business of life insurance plus related funds management business such as the provision of pension services.
• Some key prudential requirements are ‘hardwired’ into the primary legislation. For example, the solvency requirement for insurance companies contained in s13 of the Insurance Act specifies both the nature of the solvency calculation and the minimum amount in nominal currency units. Not only does this expose their effectiveness to erosion by inflation, it severely limits the RBM’s ability to update prudential requirements in line with developments in regulatory thinking around the world. There is a strong case for moving the details of many of the regulatory requirements to subordinate legislation.

• The Act imposes no restrictions on the assets that insurance companies may hold or on their ability to encumber assets.

• The fit and proper requirements for owners and managers of insurance companies contained in s6 are minimal.

• There are no explicit regulatory requirements relating to governance or conduct of business. It is becoming increasingly important in industries such as insurance to include extensive conduct of business requirements, including the prohibition of false and misleading advertising, prohibition of third line forcing, the requirement for insurers to conduct their business in good faith, employ sound practices, and to comply with the Act and with any directives or regulations identifying irregular or undesirable practices that are likely to either bring the industry into disrepute or endanger the interests of policyholders.

• The solvency requirements specified in s13 are very limited:
  
  o The solvency requirements for general insurers link the solvency calculation to net premium income rather than to the greater of a net premium income computation and one linked to outstanding claims provisions.

  o The solvency ratio (at 10% of premium income) is low by world standards.

  o The solvency requirement for life insurers is basically no more demanding than the maintenance of commercial solvency plus the minimum capital requirement for registration.

  o The solvency frameworks are not linked to risk (as required by the IAIS Core Principles). While an appropriate risk-based framework is likely to take some time to develop, it would be useful for the regulatory framework to give the RBM the flexibility to introduce it when it is ready.

  o S13 refers to “taking account” of all contingent and prospective liabilities and also the impact of reinsurance. However, it gives no guidance as to how these items are to be taken into account. It is usual in solvency computations to identify categories of assets that are to be excluded from the statutory solvency calculation, such as contingent assets (goodwill, future income tax benefits and loans to related parties), and to make it explicit that the calculation is to be net of reinsurance recoveries. Ideally, the concept of exclusion should be contemplated in the primary law with the regulator having the flexibility to identify the details in directives.

• While there is a requirement for life insurance companies to obtain actuarial valuations there is no guidance for the actuary on how to calculate provisions, and there is no requirement for a prudential margin in provisioning.
• There is no reference to actuarial valuations for general insurers. It is usual to either require regular actuarial valuations (especially where long-tailed business is involved), or to include provision for the regulator to require an actuarial review or to appoint an actuary directly.

• While there is an approval process by the RBM for ownership concentration there are no fit and proper tests for owners or managers of insurance companies and no detailed governance requirements or guiding principles.

• As noted earlier, there is no mention of insurance brokers in the Act.

The insurance regulations issued in 1970 and 1971 add little of substance to the regulatory requirements for insurers.

Overall, there appears to be considerable scope for strengthening the regulatory requirements imposed on insurance companies to better reflect the risks that they incur and to provide a greater level of confidence in their financial sustainability. Most of the issues identified above (and, indeed, the most critical ones) are being addressed in the new draft Insurance Bill. Detailed comments on this draft were made in the Interim Report and it is our understanding that virtually all of our suggestions have been adopted in the latest draft. When the Bill is passed into law, and directives are issued to put detail onto the requirements identified in the new law, Malawi should have a set of regulatory requirements for insurance that will be both stronger and better aligned with world best practice.

Capital Markets

The market conduct regime currently applying to the Malawi Stock Exchange and capital market participants is relatively weak in a number of areas:

• The relationship between the RBM and the Malawi Stock Exchange is not well spelled out in the Act. S11 requires SROs such as the MSE to be registered with the RBM. S10 requires market participants to be members of an SRO before they can trade in securities. S26 also requires them to be registered with the RBM. However, the law does not clearly delineate the responsibilities of the RBM and the SRO in terms of supervision of the SRO’s members. A strict reading of s12 suggests that the RBM only has jurisdiction over an SRO to the extent of the requirements for registration and for breaches of the Act. It is usual for the Capital Markets Laws to establish the relationship between the regulator and SROs more clearly so that there is no duplication of regulatory requirements and enforcement actions.

• Regulatory requirements imposed on securities brokers and dealers include: registration; minimum qualifications (established by the RBM); minimum capital and liquidity requirements (again established by the RBM); and conduct of business requirements (Part VIII) prohibiting false and misleading actions, price manipulation, and accepting bribes. While these are generally sound, there is room for expansion of the governance and accountability rules, including reporting and disclosure requirements.

• Regulation is not extended to asset managers (which manage investments under mandate, but which do not take title to the investments).

• Regulation is not extended to organized markets other than the MSE, nor does it capture clearing houses and central depositories.
The draft Securities Bill addresses some of these weaknesses:

- Parts II and III spell out the relationship between the Regulator and exchanges more clearly, including the regulator’s powers with respect to the exchanges. Importantly, the regulator has the power to direct an exchange to enforce its rules.

- Further regulatory requirements need to be spelled out through regulations and directives.

While the draft Securities Bill is a considerable improvement on the current Capital Market Development Act, a number of definitions could be added to clarify the coverage of the Act. For example, s4(b) gives the regulator the power to license and supervise “securities exchanges, dealers, investment advisers, and their respective representatives and of persons who, within the meaning of the rules made under this Act, are non-bank”. The Bill fails, however, to define precisely what is meant by “non-bank”. In particular, it is unclear whether the definition includes asset managers.

Recommendations

Development of comprehensive regulatory requirements through regulations and directives in line with the framework outlined above is an exercise that will take several years. Consequently, we have focused our recommendations primarily in the area of legislative gaps and ensuring that the policy framework is sufficiently flexible to enable these developments to take place. The following recommendation is aimed at establishing a group with responsibility for monitoring and overseeing the coherence of the regulatory requirements as they develop.

**Recommendation 9**

That the RBM establishes a Policy Group within the new Financial Supervision Division to conduct a comprehensive review of the regulatory requirements for each sector against the principles outlined in this Report as well as against the equivalent regulatory requirements established by other countries in the Southern African region and international associations of regulators. This group should be responsible, on an on-going basis, for developing new regulatory requirements and for drafting directives to implement them.

5.5.3 Powers

In terms of hierarchy, the Reserve Bank of Malawi Act sits above the three industry Acts covering insurance, banking and securities markets.

The powers granted under the Reserve Bank of Malawi Act, while very general, are in some cases, arguably, too general to be effective. For example, s48(3) states that, with respect to liquidity, solvency and sound management of financial institutions the RBM may:

“issue guidelines, regulations and directives, and prescribe prudential ratios to be maintained by certain categories of banks and other financial institutions”.

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As noted earlier, the draft Securities Bill currently provides for the establishment of a Securities Commission outside the RBM. This Report, however, recommends that this responsibility remains with the RBM. To avoid confusion, throughout the remainder of this and subsequent sections any reference to the regulatory body responsible for capital markets under the draft Securities Bill will be to the “regulator”.

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It does not, however, specify which “certain categories” of financial institutions these powers refer to. Despite the apparently general regulation making power in s48(3), the subsequent provisions in s56 gives the regulation making power under the Act to the Minister (albeit with a requirement to consult with the RBM).

Perhaps the strongest power in the Reserve Bank of Malawi Act comes from s48(2) which gives the RBM a general power to gather information from financial institutions.

Significantly, the Reserve Bank of Malawi Act does not give the RBM power to licence any financial institutions, thereby effectively diluting any regulatory control that the RBM might otherwise have over financial institutions that are not otherwise licensed under an industry law.

Some of the weaknesses in the Reserve Bank of Malawi Act are addressed in the underlying industry laws for banks, insurance companies and capital market participants. They are not, however, completely removed and powers in some of the industry laws appear to conflict with those in others.

**Regulatory Powers Over Insurance Companies**

The Insurance Act provides the RBM with some of the necessary powers. For example:

- Under s63 the RBM may demand any information that it needs for the purposes of carrying out its responsibilities under the Act (this power is already available under s48 of the Reserve Bank of Malawi Act).
- Under s66 and s67 the RBM may carry out an investigation of an insurer.

While the Insurance Act provides some powers, it is seriously deficient in some areas. For example:

- Under s6 and s7 of the Insurance Act, the power to approve and remove licences is granted to the Minister rather than to the RBM.
- S82 grants the regulations-making power to the Minister and makes no reference to the RBM’s ability to issue directives under the Act (arguably the RBM could issue a directive under s48 of the Reserve Bank of Malawi Act provided it did not conflict with provisions in the Insurance Act).
- S13 specifies solvency requirements for insurers (thereby removing the RBM’s flexibility to specify alternative requirements through guidelines, regulations, or directives under s48 of the RBM Act).
- The powers of inspection granted to the RBM under s66 and s67 are heavily circumscribed (e.g. an investigation can only be carried out under specified circumstances and, even then, only with the Minister’s approval).
- There is no power to issue directions.
- There is no power to conduct routine inspections.
- There is no power for the RBM to set standards of disclosure or to set market conduct requirements, governance requirements or fit and proper person requirements.
- There is no regulatory power over the ownership and control of insurers.
Enforcement powers in response to breaches of the Act or the regulations are limited. There is no power to suspend operations, to remove directors or officers, to levy administrative fines, and so on.

There is no power to issue enforceable undertakings.

There is no power for the RBM to appoint a statutory manager to a troubled insurer, to oversee the transfer of business of insurers or to play a role in the winding up of a troubled insurer.

There is no power for the RBM to supervise an insurance group on a consolidated basis.

There is no power for the RBM to share information with other regulators, including overseas regulators.

These deficiencies are being addressed in the new draft Insurance Bill.

**Regulatory Powers Over Capital Market Participants**

Many of the deficiencies in powers with respect to the insurance industry are mirrored in the Capital Markets Development Act with respect to capital market participants. The latter Act, however, gives the RBM some additional powers that are not available in the case of insurers. For example, under the Act:

- The RBM has the power to cancel transactions (s8), to suspend trading (s9), and to set qualification standards for market participants (s27).

- The RBM is responsible for licensing and registration (s11 and s26) and has the power to suspend or cancel registrations in certain circumstances (s34).

- The RBM has the power under Part 8 to set the requirements for the operation of collective investment schemes.

- The RBM has the power (s50) to investigate suspected wrongdoing (in this case without first having to seek the Minister’s approval).

- Unlike the situation in insurance, the Act gives the RBM the power to set rules (s54) although these are subject to Ministerial approval.

There are nonetheless many missing powers. For example:

- There is no power to issue directions.

- There is no power to conduct routine inspections.

- There is no explicit power for the RBM to set standards of disclosure or to set market conduct requirements, governance requirements, or fit and proper person requirements.

- Enforcement powers in response to breaches of the Act or the regulations are limited. There is no power to suspend operations, to remove directors or officers, to levy administrative fines, and so on.
There is no power for the RBM to appoint a statutory manager, to oversee the transfer of business of an SRO or to play a role in the winding up of an SRO.

There is no power to negotiate outcomes, or to issue enforceable undertakings.

As with regulatory requirements for capital markets and participants, many of these deficiencies are addressed in the draft Securities Bill. For example:

- S6 gives the regulator the power to issue rules, guidelines and directives with respect to a range of issues. Unlike in the current Capital Markets Development Act, these powers are not subject to Ministerial approval.

- S47 extends the regulator’s licensing power to include securities depositories and custodians.

- S13 gives the regulator the power to close an exchange.

- S55 gives the regulator the power to conduct routine inspections.

- S57 gives the regulator the power to carry out an investigation of a licensed entity without the need to seek prior Ministerial approval.

- S60 provides the regulator with fairly wide directions powers in any situation where it believes a licence holder is breaching the Act or is about to breach the Act.

- Part VIII generally provides the regulator with stronger powers of enforcement than the current Capital Markets Development Act. There are nonetheless a few areas in which these could be strengthened to be consistent with world best practice (mainly in the areas of enforceable undertakings, the power to negotiate outcomes, and the power to share information with other regulatory agencies).

**Recommendations**

One of the main deficiencies in the RBM’s current regulatory framework lies in its powers. It is possible, in principle, to regulate adequately under most circumstances without some, or even all, of the powers listed in Section 5.3. Provided the industry accepts the RBM’s authority without challenge, the system can operate effectively under most circumstances. To some extent this appears to have been the situation in Malawi. Circumstances can easily arise, however, in which the RBM’s legal capacity to regulate can be challenged in the courts. An adverse outcome in the courts could undermine its credibility as a regulator. More generally the absence of some of the more critical powers, such as the power to make directives across a wide range of issues, limits the RBM’s flexibility to develop a robust regulatory framework covering all NBFIs and all financial risks.

There are alternative ways of dealing with legislative reform to establish the powers needed by the RBM for effective regulation. The underlying industry laws could be amended progressively to harmonize the RBM’s powers. This is essentially the direction that is being pursued with the current Insurance and Securities Bills. While the draft Bills strengthen the RBM’s powers significantly, they still leave some inconsistencies between the bills and gaps with respect to other institutions not covered by the laws. Alternatively, new laws could be written that provide the RBM with powers that cut across industries. However, by far the most effective way of establishing the necessary powers is to elevate all regulatory and supervisory powers to the RBM Act and to remove them from the underlying industry laws. Not only would this remove many of the existing conflicts between the
RBM and industry laws, it is the only reliable way of ensuring that the powers apply uniformly across the financial sector. This is an approach that is being applied increasingly around the world.

In taking this approach it is important to recognize that not all powers elaborated in Section 5.3 should apply to every financial institution. A convenient way of structuring the powers is to note that certain broad powers (such as those relating to market conduct, disclosure and licensing) should apply to all financial institutions, while some of the more intrusive powers (such as approval of transfer of business, appointment of a statutory manager, and control of winding up) should only apply where the intensity of regulation is relatively high.

Following this logic it is convenient to define two groups of regulated institutions: financial institutions; and prudentially-regulated financial institutions, where the second class of institutions is a sub-set of the first. In the case of Malawi, prudentially-regulated financial institutions should include: licenced banks, SACCOs, insurers, reinsurers, friendly societies, medical aid funds, pension funds, pension fund administrators, the Malawi Stock Exchange (and its clearing house and central depository should these be established in the future), and securities dealers.

Powers that should apply to all financial institutions include those dealing with:

- licensing;
- issuing rules or directives relating to market conduct, disclosure, and governance;
- prescribing reporting requirements;
- conducting routine inspections;
- applying to the High Court for an injunction against any person who is contravening or is proposing actions that would contravene a financial services law;
- freezing assets of a financial institution suspected of financial crime;
- requiring the removal of a director or officer who is responsible for a material breach of a financial sector law;
- requiring replacement of an auditor or actuary;
- revoking the registration of a financial institution where it is warranted;
- requiring a financial institution to publish corrective material;
- requiring a financial institution to terminate or unwind specific transactions;
- investigating suspected breaches of the law;
- imposing administrative penalties and fines;
- issuing enforceable undertakings; and
- issuing directions.
Powers that should apply to prudentially-regulated financial institutions include (in addition to the above) those dealing with:

- issuing prudential directives with respect to fit and proper requirements, capital adequacy/solvency requirements, ownership and control, liquidity, management of risks, use of off-balance-sheet instruments, outsourcing, and so on;
- approving transfers of business and amalgamations and establishing the conditions under which such approvals will occur;
- appointing and/or approving the appointment of a statutory manager; and
- controlling winding up.

Despite the narrowing of powers for non-prudentially-regulated financial institutions, the recommended definition of prudentially-regulated financial institutions is still quite broad and includes some institutions that, in developed financial systems, might not be included in this group. The recommended powers of the RBM with respect to this group are very broad. It is not anticipated that all of these powers will be used, or that they will be used in precisely the same way, for every group of prudentially-regulated institutions. It is nonetheless useful to have the full range of powers to cater for developments that might occur in the future. For example, capital adequacy directives are unlikely to apply to pension funds other than public offer umbrella funds. Similarly, ownership and control provisions are unlikely to be appropriate for friendly societies.

It is important that the RBM conducts a careful review of the powers that are relevant to each group of prudentially-regulated institutions to ensure that powers are not used inadvertently to over-regulate some groups.

**Recommendation 10**

*That the Reserve Bank of Malawi Act (1989) be amended to provide the RBM with the regulatory powers outlined in Section 5.3, modified where appropriate for less intensively regulated financial institutions.*

**5.5.4 Independence**

In comparison with best practice, as established by the international associations of financial regulators, the RBM has some deficiencies in its operational independence.

*Formulating and Implementing Regulatory Policy* - while the RBM has some scope to formulate and enforce regulatory policy, there are many areas in which responsibilities are confused by the need for Ministerial intervention. For example, the Minister licenses and delicits most financial institutions. Many enforcement actions can only be taken after Ministerial consultation or approval (for example, s34 and s35 of the Insurance Act require Ministerial approval for insurance companies to merge and, under s66 and s67, the RBM may only carry out an investigation of a troubled insurer with Ministerial approval). The extent of Ministerial involvement is equally extensive in the Banking Act, thereby implying by extension that the RBM has limited independence in supervising all financial institutions.

*Mechanisms for appointing and dismissing Board members* – s6(5) of the Reserve Bank of Malawi Act establishes that the President appoints Board members. The terms of 2 years are relatively short by international standards. The terms of eligibility are set down in s7. Under s9 “Any director shall immediately cease to be a director if he becomes ineligible in terms of section 7 or becomes unable or
unfit to perform his duties under this Act.” There are no other provisions governing the terms of appointment and dismissal.

Legal indemnities – neither the Reserve Bank of Malawi Act nor the underlying industry laws provide any protection for supervisory staff who carry out their duties in good faith.

Resolution of conflicts with the Government – there are no provisions for resolving any conflict that might arise between the RBM and the Government of Malawi. The relatively high level of Ministerial involvement with supervisory operations means that responsibility and accountability for supervisory actions are unclear. This is an area that could usefully be made more explicit along the lines discussed in Section 5.4.

Financial arrangements – Finally, in terms of financial independence, the RBM is well funded and independent, as are most central banks. In addition, s53 of the Banking Act gives the RBM the ability to recover the cost of supervision of banks and financial institutions from the industry. It would be more effective to shift this provision to the Reserve Bank of Malawi Act.

Recommendations

Recommendation 10 should automatically remove Ministerial involvement with routine supervisory operations, such as licensing and enforcement, by vesting these powers directly in the RBM (and by removing the old provisions from the existing laws). Thus, these issues should not need to be addressed again in the context of independence.

There are nonetheless some serious remaining deficiencies in the RBM’s independence as judged against world best practice. The extent to which the Reserve Bank of Malawi Act should be amended to strengthen the Bank’s independence in carrying out its regulatory and supervisory duties is a matter of judgment and political will. This is a judgment that we leave to the senior officials of the Bank, in light of the recommendation below.

Recommendation 11

That the Reserve Bank of Malawi Act be amended to provide:

- more explicit conditions covering the appointment and dismissal of board members and senior officials of the RBM, including ratification by Parliament;
- a explicit and transparent mechanism for dealing with potential conflicts between the Government of Malawi and the RBM on matters of regulatory policy;
- a legal indemnity to staff who carry out their financial sector supervisory responsibilities in the absence of bad faith; and
- the power to recover the cost of financial supervision from industry under the terms outlined in Recommendation 6.

5.5.5 Accountability Requirements

Objectives – s4 of the Reserve Bank of Malawi Act defines its principal objectives to be:

(a) to issue legal tender currency in Malawi;

(b) to act as banker and adviser to the Government;
(c) to maintain external reserves so as to safeguard the international value of the Malawi currency;

(d) to implement measures designed to influence the money supply and the availability of credit, interest rates and exchange rates with the view to promoting economic growth, employment, stability in prices and a sustainable balance of payments position;

(e) to promote a sound financial structure in Malawi, including payment systems, clearing systems and adequate financial services;

(f) to promote a money and capital market in Malawi;

(g) to act as lender of last resort to the banking system;

(h) to supervise banks and other financial institutions;

(i) to collect economic data of the financial and other sectors for research and policy purposes; and

(j) to promote development in Malawi.

The relevant provisions for the purposes of the current discussion are clauses (f) and (h). The main weakness with these objectives is that s4(h), which states that the RBM is to supervise banks and financial institutions does not identify the desired outcome of that supervision. Admittedly, s4(e) and s4(f) identify financial sector soundness and promotion of financial markets as possible outcomes, but there is a case to elaborate on these. In particular, there is a need to identify more clearly the desired outcomes of capital market regulation (fairness, efficiency, and orderliness of markets).

The statutory accountability provisions in the Reserve Bank of Malawi Act appear to be driven largely by its monetary policy responsibilities.

**Reporting to the Minister and Parliament** – s51 of the Act requires the RBM’s accounts to be audited by internationally recognized public auditors approved by the Minister and s52 requires the Bank to submit its annual report, including its audited accounts, to the Minister who, in turn, is to present the report to the Parliament. The Bank is also required to publish a monthly statement of its assets and liabilities.

There is no requirement for the RBM to report on its supervisory activities (although, in fact, it does). Nor is there any requirement for the Bank to keep the Minister apprised of any institutions that are in distress although, arguably, the need for Ministerial approval for enforcement action means that the Minister should automatically be aware of any such situations. In view of the recommendation to put greater responsibility for enforcement actions onto the RBM, it would be helpful to broaden the RBM’s reporting requirements to ensure that the Minister is informed about potential financial disruption.

There are also currently no requirements for the RBM to appear before the Parliament or any parliamentary sub-committees, nor does this appear to occur on any regular basis in practice.

**Consultation on policy development** – there is no explicit requirement in the Act for the RBM to consult with anyone before issuing directives. In view of the changes recommended in Recommendation 10 to give the RBM considerably stronger powers, there is a case for strengthening the RBM’s statutory co-operation and transparency requirements.
Education of the public – there is no statutory requirement for the RBM to play an educative role in the financial sector. There is a case for including this more explicitly in the Act.

Regular meetings with industry – the RBM Act does not contemplate industry advisory panels or regular meetings between the RBM and industry.

Review and appeal of regulatory decisions – the RBM does not currently have a formal internal review process for decisions. Given its small size, an independent internal review process is probably unrealistic in the non-bank area. There is a case, however, for establishing an external Appeals Tribunal and procedures for appealing decisions by the RBM, without diminishing the right to appeal to the courts. Such a tribunal is contemplated in the revised Insurance Bill.

Recommendations

The Reserve Bank of Malawi falls well short of world best practice in terms of its accountability provisions. It is important that these be strengthened to complement the recommended strengthening of the RBM’s regulatory and supervisory powers.

Recommendation 12

That s4 of the Reserve Bank of Malawi Act be amended to provide greater clarity to its regulatory and supervisory objectives, by amending s4(h) to read:

“to regulate and supervise banks and other financial institutions with the objective of fostering:

• the stability of the financial system;
• the safety and soundness of financial institutions;
• the highest standards of conduct of business by financial institutions;
• the fairness, efficiency and orderliness of the financial sector;
• the protection of the interests of consumers of financial services and products; and
• the reduction and deterrence of financial crime.”

And that, in pursuing these regulatory and supervisory objectives, the Bank must take into account:

• the impact of the costs of regulation and supervision on the ability of the community to gain access to financial services; and
• the need to balance the effectiveness of regulation and the efficiency of the financial system.”

Recommendation 13

That the Reserve Bank of Malawi Act be amended to require the RBM to:

• advise the Minister about any distressed financial institution that is in danger of failing;
appear before the Parliament or appropriate Parliamentary Committee as and when required to respond to questions about its performance and exercise of its powers;

consult with industry and the public before issuing directives under the Reserve Bank of Malawi Act or recommending regulations to the Minister;

help educate the public about the RBM’s role, about the financial system generally, and about their rights and responsibilities as consumers of financial services;

meet with industry annually to discuss industry trends, policy proposals and the exercise of its powers; and

include the establishment of an external regulatory Appeals Tribunal covering all licensed financial institutions.

5.6 Strategic Approach to Legislative Reform

The recommended amendments to the Reserve Bank of Malawi Act will create some conflicts with existing industry acts. As recommended in Recommendation 5, these conflicts should be removed by amendment to the relevant industry Acts.

Introducing these bills and amendments to the Parliament in a piecemeal fashion is likely to create confusion and possibly lead to inconsistencies. The better strategy is to introduce the full set of Bills and amendments as a single package of financial sector reforms and to ensure that the Minister (who will need to champion their passage) and Parliament are fully briefed about the changes and the reasons underlying them.

Recommendation 14

That all Bills and amendments arising from this Report be presented to the Parliament as a unified financial sector reform package.
6. Assessment of the Supervisory Framework for NBFIs in Malawi

6.1 Introduction

As noted in Section 5.1, the supervisory framework refers to the structures, policies and practices established within the agency to monitor and enforce the provisions of the law. These structures, policies and practices can usefully be considered under the following headings:

- Supervisory approach (or philosophy);
- Consumer/industry complaints handling processes;
- Data collection;
- Off-site analysis;
- On-site inspection; and
- Enforcement.

This section reviews the elements that make up a sound supervisory framework, assesses the current framework in the RBM against these benchmarks, and makes recommendations for strengthening the framework.

6.2 Elements of a Sound Supervisory Framework for NBFIs

6.2.1 Supervisory Approach

There are two levels at which a regulatory agency should agree and document its supervisory approach. The first is at the overall agency level. The second is at the level of each group of supervised institutions. The establishment of a consistent approach or philosophy is critical for guiding exactly how the agency will approach its supervisory activities and also in helping new recruits to understand the supervisory culture of the agency.

Organization-wide Approach and the International Trend Towards Risk-based Supervision

At the organisation-wide level the agency’s supervisory approach should be reflected in the agency’s Vision, Mission and Value statements. These should provide the guiding principles for the implementation of its supervisory approach.

The document containing the organisation-wide approach should spell out:

- The objectives of the agency;
- How it intends to achieve those objectives;
Any broad principles that the agency will adopt in determining its supervisory approach (e.g. these might spell out the respective roles and responsibilities of the supervisor, boards, and management);

- What risks it perceives in the system and how it intends to approach the monitoring and supervision of each; and

- How it will prioritize issues and allocate resources among competing demands.

In the same way that regulatory requirements have become increasingly more risk-based in recent years, so too have supervisory approaches become increasingly more risk-based. In the context of supervision the risk-based approach accepts that it is physically and financially impossible for any supervisor to have sufficient information and expertise to identify and pre-empt every possible problem in the financial system. Recognising this fact, the risk-based approach adopts the following principle:

**Identify risks and apply scarce risk management resources where the risks are greatest**

In other words, the risk-based approach is about managing risk within the regulatory agency. Importantly, it is about applying scarce risk management resources efficiently.

A risk-based supervisory agency will attempt to:

- Identify the riskiest institutions and practices in the system;
- Identify the greatest risks within those institutions; and
- Use its limited resources so as to minimize the overall regulatory risk.

Regulatory risk in this context is the risk that the supervisor will be perceived to have failed in its duties. In crude terms it is the risk that the agency will be criticized or punished by the political system for failing to meet the expectations of the Government and/or the public (however unrealistic these might be).

The first step in this process of risk-based supervision involves identifying and ranking all sources of regulatory risk. For example, an agency with an information system that has been developed completely in-house might identify the potential failure of that system as having a medium impact, a high level of inherent risk and a low level of adjusted risk because of steps taken to have the system fully backed up, by ensuring that the system is fully documented, and by ensuring that knowledge of the system is not concentrated in just one or two individuals. Based on its assessment of regulatory risks the agency should be in a better position to assess the impact and resource requirements of supervising industry risks.

The second step in the risk-based approach involves identifying the riskiest institutions among those over which the agency has supervisory responsibility. This requires the supervisor to have a risk grading system for institutions under its charge.

In banking it is common for supervisors to risk-rate banks using a one-dimensional CAMEL rating system (where CAMEL stands for the adequacy of Capital, the quality of Assets, the capability of Management, the quality and level of Earnings, and the adequacy of Liquidity). The result of analyzing these five factors (or more in some versions) is a grading for each institution, usually on a scale of 1 to 5 (where “1” typically indicates the lowest risk and “5” indicates the highest risk).
Grading systems such as these are less common among insurance and pension supervisors, although they are becoming more common.

More recently some supervisors have moved from the one-dimensional CAMEL-type grading systems to two-dimensional systems with much greater granularity.

The two dimensions of regulatory risk typically used are:

- Probability of failure (PF); and
- Consequences given failure (CGF).

A small financial institution with a high probability of failure may be no more of a risk to a supervisor than a bigger institution with a low probability of failure - it may even be less of a risk. The idea of these systems is to increase the level of objectivity in assessing industry risks by imposing a more disciplined approach to risk rating.

For example, the probability of failure measure is usually calculated from a scoring system based on institutional characteristics such as:

- Asset quality
- Balance sheet risk
- Liquidity risk
- Operational risk
- Legal risk
- Strategic risk and contagion risk

The underlying measure of failure probability based on these factors is usually modified by measures such as the quality of management and control, and the extent of and access to additional capital. In assessing the quality of management and control supervisors typically look at factors such as the quality of:

- The board and senior management
- Operational management
- Risk management systems
- Information systems
- Compliance and application

The modified measure of failure probability is then multiplied by an index of failure impact based largely on size and complexity. The result is an exponential index of supervisory oversight - based on the product of the two graded indexes. This measure is then used to prioritize the allocation of supervisory resources within the supervisory agency.
The third step under the risk-based approach is targeted inspections and investigations driven by the risk-assessment framework. This approach is finding favour with an increasing number of supervisory agencies around the world. Not only does it parallel the approach to risk being taken by the more sophisticated financial institutions, it provides a disciplined way of prioritizing resource allocation within the agency itself.

The risk-based approach contrasts with the more traditional compliance-based approach in which each institution is given more or less the same priority for supervisory oversight and in which the focus of both off-site analysis and on-site inspections is compliance with the law. Thus, for example, under the compliance-based approach each institution might be visited annually for a full review of its compliance. Under the risk-based approach, visits are more likely to be driven by assessed risks, and targeted specifically at those risks. The risk-based approach is more likely to demand judgment by the supervisors and inspectors as to the risks involved and the actions that are needed.

Whichever approach is adopted there should be a readily-accessible document spelling out the philosophy and documenting how it is to be put into practice.

**Supervisory Approach to Sectors**

In addition to a document spelling out the agency’s overall approach to supervision there should be policies and procedures manuals for implementing the approach to each industry sector. While the overall approach will usually contain high-level principles, the sectoral approaches should spell out how the overall philosophy will be implemented in supervising each group of institutions.

Approaches are likely to vary significantly from sector to sector. For example, the approach to unit trusts and asset managers might start with the proposition that these institutions require supervision primarily for market conduct, even though some prudential elements such as minimum capital requirements may be involved. This will then shape the approach to data collection, off-site analysis and on-site inspections.

The supervisory approach should lead into a detailed policies and procedures manual that sets out the way in which the agency will conduct each element of the supervisory process. It should identify procedures for inspections and investigations. It should identify key risks and how the agency approaches the assessment of each. It should identify any rules of thumb used by the agency and triggers for certain actions. It should identify when issues or concerns should be escalated within the organization and to whom. Ideally the manual should be supplemented by a file of precedents to guide users in making judgements. The manual should be sufficiently detailed that a new member of staff could rely on it as a guide to how to do his/her job.

These policies and procedures manuals are a critical part of the agency’s history and evolution. They are critical to the development and application of a consistent approach to supervision and enforcement. They should be a living part of the agency and should be both used and updated continuously.

**6.2.2 Consumer and Industry Complaints Handling Mechanisms**

Complaints from consumers of financial products and from industry members about the practices of other industry participants are the main starting point for market conduct supervision. Routine inspections of supervised institutions for breaches of conduct without the support of this type of information are likely to be both unfruitful and extremely resource intensive. While routine inspections by conduct regulators are not uncommon (especially among the better resourced regulators of the world) it is more normal for conduct regulators to carry out inspections in response to specific complaints, either by consumers or by other members of the industry.
It is important for regulatory agencies with conduct responsibilities to have adequate mechanisms for consumers to lodge complaints and for these to be dealt with on an efficient and effective basis. Complaints handling can be resource intensive and, if not handled efficiently, can distract supervisory staff from more essential tasks.

Many agencies with broad responsibilities have sought to streamline their consumer complaints handling process and minimize the distraction to supervisory staff by establishing a complaints handling division with a single point of contact (e.g. a consumer “hotline”). This may be supplemented by an online facility through the agency’s website. In both cases the process can be further streamlined by establishing a “quick check” procedure to assess the importance and relevance of the complaint. In cases where the complaint involves a dispute between a customer and a financial institution the procedure might, for example, require that the complainant first try to resolve the dispute with the company before it comes into the regulator’s complaints handling system.

Once within the regulator’s system, the complaint should be prioritized, referred to the appropriate area for a decision (if it cannot be handled within the complaints division) and a timetable established for dealing with the complaint and the complainant. The timeframe should identify who is responsible for handling the complaint, what responses are required and a follow-up procedure to ensure that complaints are not “lost in the system”. Information relevant to supervisory follow-up and enforcement should be passed through to the relevant supervisors. Complaints are ideally handled within an electronic document handling system, although manual equivalents can be just as effective if implemented conscientiously. As with other areas of supervision, complaints handling procedures should be fully documented in policies and procedures manuals.

The two main variations to this general approach involve complaints from industry and “whistleblower” information (whether from auditors, actuaries, employees or others). These can be some of the most useful sources of information about regulatory breaches and problem institutions and should never be dismissed lightly. It is useful to establish a “whistleblower” policy at board level within the regulatory agency identifying how the information is to be handled and how far up the agency the information should be circulated. Serious allegations should be circulated to the agency’s board in unabridged form.

6.2.3 Data Collection

Data collection and analysis are the “engine room” of prudential supervision. Without reliable and timely data there is little that a supervisor can do to identify risks and problem institutions.

A sound data system should have all or most of the following characteristics/elements:

- Electronic lodging facilities for financial institutions. This may be via disk, although on-line lodgement is usually preferred.

- Automatic validation checks. Once data are entered into the agency’s data gathering system, a series of mechanical tests should be performed to ensure that the data meet the minimum requirements for acceptance. These typically include checks to test whether any critical information cells have been omitted (e.g. numerical entries as well as the name of the person responsible for supplying the data), simple summation tests, and “tolerance” tests to determine whether data entries are within a reasonable tolerance of information provided in previous returns. Where a lodgement fails the validation tests it should be returned to the institution for correction or explanation.
• A cross-sectional and time series database. The database should keep all historical records for each institution so that trends can be analysed for each institution as well as for the industry.

• Analytic tools. A good database system should provide a suite of analytic tools for the supervisors, including graphical comparisons of key ratios across each industry, historical analyses of key ratios for each institution against regulatory requirements, and cohort analysis to identify institutions that are out of line with other members of the same industry in any of the more sensitive areas (e.g. asset concentrations, ownership concentrations, capital/solvency sufficiency, use of particular instruments and so on).

While a good database is essential for effective supervision it can impose a significant compliance cost on industry. It is important that regulatory agencies review their data collections regularly to ensure that data being collected are relevant and used in off-site analysis. Redundant data should be eliminated from the returns.

6.2.4 Off-site Analysis

An important element of effective supervision is the analysis of regular returns submitted by financial institutions, and other financial information pertaining to institutions such as audited financial statements, published annual reports and interim financial information. Such information should be analysed against established “early-warning” thresholds and compared with peer data from comparable financial institutions. Similar information for the corporate group should be analysed in an equivalent manner. Conclusions should be tested against observations in published reports of ratings agencies and securities dealers.

Off-site analysis should test compliance with the regulatory requirements (e.g. with asset restrictions, minimum solvency requirements, liability calculation requirements, diversification requirements, etc) and should help the analyst to form an overall assessment of the prudence and viability of the institution. The ratio analyses provided by the database, along with industry comparisons, help the off-site analyst to build a historical picture of the performance, strategic direction, strengths and weaknesses of the institution, as well as a feel for how well the institution fits with industry norms.

Based on the data provided, the analyst should be able to identify issues to be followed up with the institution either through follow-up requests for information, regular scheduled on-site inspections or through targeted inspections. For example, if the analyst identifies that an insurer has an asset composition very different to other insurers and not in line with what might be expected given its liability structure (e.g. the asset portfolio might contain a large proportion of non-marketable assets), this might be the focus of an “asset risk” targeted inspection, where the institution would be expected to explain its strategy, justify its valuations and show that it has adequately assessed and compensated for the risks involved.

6.2.5 On-site Inspections

Many regulatory agencies have historically relied exclusively on off-site analysis for supervisory review. The problem with this approach is that the quality of analysis is limited by the quality of the information provided. It is not uncommon for institutions that are experiencing difficulties to manipulate or even falsify their data returns to hide problems. One of the greatest values of on-site inspections is that they afford supervisors an opportunity to assess whether the picture they are being presented with in data returns is consistent with what they see in practice. It also affords an opportunity to test how well an institution’s systems and procedures are working in practice.
For example, it is not uncommon for financial institutions to claim to have first-rate governance and internal control systems. Many of these can be backed up by voluminous manuals detailing the processes and practices involved. It is also not uncommon for on-site inspectors to find that there is a significant gap between theory and practice. An experienced inspector will look at how well-used the manuals are (pristine copies of manuals on high bookshelves are not a good sign of regular use), talk with staff to gain an understanding of how actively the manuals are used, and discuss the processes with the board of the institution to ascertain the extent to which the board has been involved with the governance process and what reports and accounts they receive from the system. To be fully effective, inspections should involve many different levels of staff in the institution, from the line officers through to the board. To the greatest extent possible interviews with each group should be carried out without the others present.

Experienced on-site inspectors look for anomalies and inconsistencies. Poorly documented files, staff who claim no responsibility for or knowledge of decisions that should normally reside with their positions, computer systems that do not communicate or consolidate important information, and inability to produce requested information quickly or in the format requested are just some of the vast range of telltale signs that an institution is not operating efficiently and that data provided to the regulator may be inaccurate.

Approaches to on-site inspection vary widely around the world. At one end of the spectrum, US regulatory agencies tend to use large inspection teams and to spend months within the institution. These inspections tend to be audit-like in nature. At the other end of the spectrum, the British model of inspection (also adopted by several Commonwealth countries including Canada and Australia) uses smaller inspection teams which spend several days to a few weeks on site. These inspections tend to be less audit-like and more targeted on particular issues (e.g. a governance visit or an asset risk visit) although they are typically supplemented by routine annual on-site visits with senior management to discuss strategic issues and overall prudence.

There is no “best” model of on-site inspection. The style of inspection should be tailored to the nature of the local industry and the resources of the regulatory agency. There is also no universally agreed best approach to staffing off-site and on-site supervisory units. In some countries the same staff members perform both roles. In others, the two are kept entirely separate. In yet others, off-site analysts are often included in the on-site inspection team for experience and for their detailed knowledge of the institution being inspected.

While there may be no agreed best model for inspections there is reasonable agreement about the processes involved. Prior to an inspection the off-site analysts should prepare a brief about the institution, identifying issues of concern and matters that need to be followed up. The institution is usually informed about the inspection, its objectives and any questions or request for information that the regulator needs to have in advance of the visit. The visit usually commences with a meeting between the regulator and senior management during which the shape and objectives of the visit are finalised, along with a listing of the information to which the inspectors will require access. Following the visit there is usually a closing meeting between the inspectors and management to review any issues uncovered during the visit and to discuss the process that will be followed after the conclusion of the visit. The process should include time frames and responses required. After the follow-up has been concluded the regulator usually sends a letter to the CEO of the institution with a summary of the findings and responses. It is good supervisory practice to require this letter to be tabled at the institution’s next board meeting to ensure that any messages that the regulator is trying to convey are understood at the highest levels within the institution.

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31 In some cases, US banking inspectors are “parked” more or less permanently within the institution.
On-site inspection procedures should be fully documented as part of the regulator’s policies and procedures manual.

**6.2.6 Enforcement**

Enforcement is the primary response in matters of market conduct. When dealing with prudentially-regulated institutions, however, enforcement is often the last resort. This reflects the fundamentally different styles of the two types of regulation, a difference that is sometimes likened to that between a policeman and a doctor.

Market conduct regulators focus largely on how to reduce financial crime by apprehending those who break the rules. It is in this sense that they are like policemen. They work within a set of laws and legal sanctions, to which they add rules (in particular, rules about governance, disclosure and proper behaviour in markets) and administrative penalties.

It is widely agreed, however, that the real deterrent to crime (both civil and financial) is not so much the severity of the penalties as the likelihood of being caught. Thus a market conduct regulator’s greatest weapon is its ability to investigate, catch and successfully prosecute those who violate the rules and laws. In short, the conduct regulator’s credibility is largely tied up in enforcement. Indeed, it is unusual for conduct regulators to use the term “supervision” at all; they deal primarily with regulations and enforcement.

In contrast, a prudential regulator, like a doctor, is more concerned about maintaining health and, if possible, preventing failure – in this case, the failure of financial rather than physical health. Like a doctor, the prudential regulator must work closely with the patients involved and, like the doctor, the regulator is largely reliant on having the patient reveal honestly the symptoms that it is experiencing.

An important part of this distinction is that, whereas a conduct regulator is focused primarily on enforcement, a prudential regulator is focused primarily on preventative supervision and rehabilitation. The prudential regulator does have an enforcement role, but it is usually the last resort, rather than the main resort.

Unlike the conduct regulator for whom enforcement is the main resort, the prudential regulator usually takes a more graduated approach to intervention. Unlike conduct regulation, where a breach of the rules is usually a legal offence, thereby warranting a legal response, breaches of prudential requirements are primarily warning signals. The usual response to a prudential breach includes a period of co-operation between the regulator and the financial institution, during which a remedy is sought that is capable of returning the institution to full prudential compliance. This is the doctor’s role. Only when the problem becomes intractable, or the institution recalcitrant, does the regulator need to resort to more extreme measures of enforcement. The need for careful judgment by the regulator in this process is critical. Without it, the co-operative work-out can simply become regulatory forbearance – which can have disastrous consequences.

The situation is more complicated when, as is the case in Malawi, the same regulator takes on both prudential and conduct responsibilities for a given groups of institutions. This requires the agency to determine the approach that it will take to enforcement. The approach should be fully documented and should be an integral part of the agency’s philosophical approach to supervision. This approach may vary across different industry groups, although the agency should be reasonably even-handed in the way it enforces breaches of conduct. It is not uncommon in countries where both prudential and conduct responsibilities lie with the same agency to hear complaints from industry that conduct is not enforced uniformly across the whole of the finance industry.
Even where a graduated approach is adopted to prudentially-regulated institutions there is a point in the process at which it is often useful to pass responsibility for enforcement action from the supervisors to a specialist enforcement team. Not only are the skill requirements different for the supervision and enforcement functions but also there is a natural tendency for supervisors to resist the final stages of enforcement in the (often mistaken) belief that the institution they have been “nursing back to health” is still capable of rehabilitation. In these circumstances it is useful to pass responsibility to a group with a more detached perspective.

For these reasons, many regulatory agencies create a separate enforcement division, staffed predominantly by lawyers and with no front-line supervisory responsibilities. Using specialists in this way also ensures that they are able to devote their time fully to enforcement.

The procedures for enforcement action are likely to vary widely depending on the situation. Nonetheless, there are many aspects of the process that can be documented and included in a policies and procedures manual, including basic investigation procedures, interviewing procedures, and the trigger mechanisms for passing an institution from the supervisors to the enforcement arm.

### 6.3 Assessment of and Recommendations for Strengthening the Supervisory Framework for NBFIs in Malawi

The existing supervisory framework adopted by the RBM is still relatively underdeveloped:

- There is a mission statement for the RBM’s overall supervisory function, though it offers little by way of specific philosophical guidance for NBFI supervision.
- There are no policies and procedures manuals for NBFI supervision.
- Documentation of practices is minimal.
- There is an electronic database system for banking supervision that is still undergoing refinement – and NBFI data are added to this database manually.
- At present, the activities of complaints handling, off-site analysis, on-site inspection and enforcement are carried out in general by the same staff members for each group of non-bank institutions.

The lack of documentation is not surprising given the limited staff resources devoted to NBFI supervision at the RBM. Whenever staff resources are stretched, priority is typically given to getting the job done rather than to documenting how it was done or, more importantly, to how it should be done. This short-term pressure to put aside the building of the backbone of the organization can have significant costs if staff leave, taking with them the accumulated experience of how to supervise, without having distilled that experience for those who follow in their footsteps. As with governance and control processes, however, these will need to be given a higher priority in coming years.

Some more detailed comments follow.

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32 The Mission Statement and some philosophy are contained in the Bank Supervisions Department’s Business Plan.
6.3.1 Supervisory Approach

While there is no comprehensive documentation of the RBM’s approach to NBFI supervision, the practice appears to be largely compliance driven\(^33\). In general, the allocation of resources to supervisory activities appears to be driven primarily by the demands of the time.

All regulatory agencies face the challenge of how best to allocate scarce regulatory resources across competing demands. This challenge is much greater for an integrated regulatory agency in that its range of responsibilities is usually increased proportionally more than its resources. Integrated regulators are usually caught somewhere between the industry’s desire to have resources allocated on a sectoral basis in proportion to the resources they contribute towards the operations of the regulator, and the regulator’s preference to allocate resources where they are most needed from a systemic perspective. To reassure industry that the resources are being allocated sensibly rather than arbitrarily, regulators are increasingly making the basis of their allocations public. For example, where resources are allocated according to a measure of regulatory risk, the basis of the risk model might be made public\(^34\).

Allocating regulatory resources according to regulatory risk does not amount to ignoring low risk institutions or activities. Where risks are lower the approach may need to be different. For example, on the risk scale, microlenders would typically rate towards the bottom end. Abuses in that industry nevertheless occur. The cost of inspecting all microlenders on a regular basis, however, might absorb an inordinate amount of the RBM’s resources. The alternative to an intrusive and expensive inspection program is to set an interest rate cap and disclosure requirements for lending contracts, and to rely primarily on unresolved consumer complaints to initiate enforcement action. The challenge is to set these requirements at levels that are “reasonable” given the cost of doing this type of business and the high risks involved. Setting the regulatory requirements too high runs the risk of either driving the microlenders out of business (with obvious costs to the consumers) or driving them to conduct their business without authorization.

We strongly encourage the RBM to take a more risk-based approach to supervision over time.

**Recommendation 15**

*That, following the establishment of the Financial Supervisory Division in the RBM, the senior management of the Division convene a strategic planning session to develop and agree a supervisory philosophy for both its prudential and market conduct responsibilities (both banking and non-banking). This philosophy should be documented and should address the following issues:*  

- the RBM’s supervisory objectives;
- Where the RBM draws the line between responsibilities for itself and for boards and management of supervised institutions in pursuing these objectives;
- The extent to which the RBM will take a risk-based approach to supervision;

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\(^{33}\) While NBFI policies and procedures are not yet well developed, the RBM has procedures for off-site banking supervision and is currently working on developing an on-site manual with the assistance of the IMF.

\(^{34}\) While we are not aware of any regulator that has taken the next step of publishing the rankings of individual institutions on the risk scale, that day may not be far away.
• This framework should identify:
  o The primary risks that the RBM has to deal with;
  o The extent to which it can reasonably rely on the supervisory work done by other regulators of the parent institutions of some of Malawi’s foreign-owned financial institutions;
  o How these will determine its supervisory work and methodology;
  o How it will prioritize issues and allocate its scarce supervisory resources among competing supervisory demands;

• How the RBM will balance its prudential and conduct responsibilities;

• An appropriate supervisory approach to supervising each industry group for which the RBM has responsibility; and

• A timetable for implementing the various elements of the framework.

Recommendation 16

That the RBM commences a longer-term exercise to document all policies and procedures manuals for each of the NBFI industries that it supervises. These manuals should initially document current practices and should be updated regularly to reflect changes in practices. The relevant manuals should be issued to staff and should be used as the primary reference guide for supervisory actions. Staff should be encouraged to contribute to improving these practices over time.

6.3.2 Complaints Handling

At present, consumer complaints are handled by staff in the relevant area. There does not appear to be a systematic process for handling complaints, particularly routine complaints. While, to date, complaints handling does not appear to have been a major imposition on senior supervisory resources, it is likely that extending the range of financial institutions under the RBM’s jurisdiction could increase that demand significantly.

Recommendation 17

That the RBM considers systematizing and streamlining the consumer complaints handling process by establishing a dedicated small team to process all complaints against regulated financial institutions. The effectiveness of such a team will depend on the ability of existing senior staff to document procedures for handling the vast bulk of routine complaints and to screen complaints to the extent that only those involving serious issues (i.e. those warranting investigation and possible enforcement action) or new precedents are referred to other divisions.

6.3.3 Database, Data Collection and Information Systems

As noted earlier, the RBM’s information gathering powers are among its strongest powers under existing financial sector laws. Data are currently collected from insurance companies on a quarterly basis, and from the Malawi Stock Exchange on a daily basis.
At present, data are processed manually and validation checks are carried out on their inclusion into the RBM’s electronic database. This database provides some minimal comparative analytics for off-site supervision. There is a strong case for introducing electronic submission of data from insurers, capital market participants and other non-bank financial institutions that will come under the RBM’s jurisdiction. This will require an extension and upgrading of the RBM’s existing banking database. The database should also be extended to include an early warning system for non-banks.

Recommendation 18

That the RBM commissions work to extend the existing banking database system to include electronic collection and validation of statutory returns from NBFIs, as well as an early warning system for distressed institutions. As part of the exercise to extend the database system there should be a systematic review of all data collected for relevance and use in supervision.

6.3.4 Off-site Analysis

Off-site analysis of NBFIs by supervisory staff is relatively well developed in the RBM, although the procedures are not yet fully documented. Data received from regulated institutions are scrutinised by supervisory staff as are comparative statistics provided by the database system. Developing more detailed policies and procedures appropriate to each industry group is an exercise that is likely to require some assistance. At a minimum, early warning tests, comparable peer data and standard templates should be developed.

6.3.5 On-site Inspections

On-site inspections of NBFIs are much less well developed in the RBM than off-site analysis. This largely reflects the limitations imposed on off-site analysis by staff shortages. At present, on-site inspections are only carried out in response to identified issues. It will be important in coming years for the RBM to develop the capacity for a program of regular on-site inspections of NBFIs.

Recommendation 19

That the RBM builds the capacity to enable it to carry out a program of regular and specialist on-site inspections of NBFIs. The regular inspections should be carried out on a schedule appropriate to each industry group. The specialist inspections should target particular areas of risk such as governance, internal controls, and risk management systems.

6.3.6 Enforcement

The RBM’s approach to non-bank enforcement is carried out at two levels. Where a consumer complaint has been lodged against an institution or a minor issue of non-compliance is involved enforcement is handled by the front-line supervisors. Where a significant breach of the law is suspected, senior management, including the RBM’s Legal Section, become involved. To date the Bank has not been involved with prosecutions.

Internationally, it is unusual for a regulatory agency not to have legal resources dedicated to enforcement of financial regulation. Without such dedicated resources, the RBM’s supervisory function is required to compete for legal support with other priorities within the Bank. By centralising all the Bank’s legal resources it is also more difficult to develop the specialised legal skills required for regulatory enforcement. Such a situation is less than optimal.
In anticipation of the strengthening of the RBM’s enforcement powers recommended in Section 5, it is important that the RBM gives some priority to upgrading its enforcement resources and to developing a consistent approach to enforcement. Consistent with the analysis in Section 5 we believe there is a case for establishing a separate enforcement capability within the Financial Supervision Division, with enforcement responsibilities across all sectors. This section would be a suitable location for the complaints handling group recommended in Recommendation 17.

**Recommendation 20**

*That the RBM establishes a specialist enforcement section with a mandate to develop a consistent approach to enforcement across and within industry sectors.*
7. Capacity Requirements for Effective NBFI Regulation and Supervision in Malawi

7.1 Introduction

Non-bank regulation and supervision are still relatively young in the RBM. To date, efforts have been focused on establishing the supervisory program and dealing with issues as they have arisen. Staff resources have been stretched during this period and some of the important institution-building activities (such as documentation, establishment of agreed approaches, and development of policies and procedures) have not been carried out. This is normal during the establishment phase and, in difficult circumstances, the RBM has acquitted itself well. Nonetheless, as reflected in the RBM’s approach for assistance, it is time for the RBM to upgrade its regulatory and supervisory frameworks. The challenges that are likely to arise in coming years as the Malawi non-bank sector grows in size and sophistication, and the need to provide the sector with a solid foundation for prudent growth, require a more disciplined and intensive supervisory approach than has been the case to date.

Sections 5 and 6 made a number of recommendations about the supervisory framework in Malawi, including:

- Moving to a more risk-based approach to supervision;
- Establishing a Policy Group to review and update the regulatory requirements for each group of institutions;
- Developing and documenting a full set of policies and procedures for supervision;
- Streamlining the approach to complaints handling;
- Developing an early warning system for troubled NBFIs;
- Strengthening its approach to on-site inspections, including instituting specialist inspections; and
- Establishing a specialist enforcement capacity.

These recommendations, if implemented, will have significant consequences for the RBM’s capacity. This section sets down our thoughts on the impact of these recommendations on internal structure within the proposed Division of Financial Supervision, staff numbers and staff skills. Following that, the section turns to avenues for building capacity, including recruitment, training and technical assistance.

7.2 A Recommended Internal Structure for the Division of Financial Supervision

The recommended new division of the RBM will be effectively a unified regulatory agency contained within the RBM. Internationally, there are almost as many internal structures for unified regulatory
agencies as there are agencies. Notwithstanding the many subtle differences in structure, most fall into one or the other of two main types:

- Those that attempt to extract synergies from the consolidation of regulatory functions; and
- Those that keep the industry regulators largely separate, sharing only common infrastructure such as computer resources and administration.

Those countries that have taken the former route have generally been countries in which conglomerates are common and in which there is a high level of financial sophistication. Thus, for example, the Australian Prudential Regulation Authority which is responsible for regulating banks, insurance companies and pension funds, has an internal structure based primarily on whether or not institutions pose a systemic threat. Regulatory departments are divided into those dealing with complex, systemically-important institutions and those dealing with smaller, stand-alone institutions; in neither case are there dividing lines based on industry affiliation. The philosophy behind this integration of staff is that it better reflects the integrated structure of the industry and offers greater synergies among the supervisors (where the approach to supervision can be targeted on types of risk rather than on types of institution). While the benefits of a fully-integrated approach to financial regulation/supervision may be tempting, they have yet to be proved. Further, attempting this level of integration, involves some risks. Staff in fully-integrated agencies have found it difficult to acquire the level of cross-skilling required and, in some cases, the regulator has moved ahead of the industry in terms of its perception of business integration.

At this stage of development of the Malawi financial system there is a strong case to proceed conservatively and to start with a much more conventional, industry-based structure:

- There are currently few conglomerates in the Malawi financial system (although many of the industry participants have conglomerate connections through foreign parent entities);
- The focus for the next few years will need to be on developing regulatory frameworks for the new groups of NBFIs that will be regulated by the RBM and on developing regulatory skills - this is likely to occur more quickly in groups specializing in particular industries than in a structure focused on cross-industry skilling;
- Regulation will be new to some parts of the non-bank financial system and they must be given time to “acclimatize” to the new regime – attempting to push the industry beyond the basics of industry-based supervision could reduce industry support for the reforms.

Therefore, a relatively simple, industry-based structure is likely to be most appropriate for the Financial Supervisory Division and is likely to involve the lowest risk. This structure could include separate supervisory groups for banks, insurance and pensions, and capital markets. Each of these groups would develop its own framework for supervision including, where appropriate, on-site and off-site monitoring.

While such a structure would limit the higher-level regulatory synergies from integration in the short-term, there would still be considerable scope to extract both lower-level regulatory and financial synergies. Some of these could be extracted by creating shared groups to handle activities such as:

- Licensing;
- Policy and research; and
- Enforcement and complaints handling.
A suggested internal Departmental structure for the Financial Supervision Division is shown in Chart 7 below.

**Chart 7 – Suggested Internal Organizational Structure for the Financial Supervision Division**

Under the proposed structure, the RBM will have three front-line supervision Departments plus a Department providing services common to all financial institutions. Further details of these departments are offered in Section 7.4 below following the discussion of staffing levels.

**7.3 Staffing Levels for the Financial Supervision Division**

The RBM currently employs 8 staff members who are employed full-time in non-bank regulation and supervision: 4 are employed in insurance regulation and 4 in capital market regulation. The existing capacity is too small and too disperse to provide an effective foundation for regulating and supervising NBFIs, even without taking on additional responsibilities for pension funds, and the other NBFIs that are currently unregulated. In the analysis below we consider the minimal staffing and skill

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35 There are four additional positions in insurance supervision that are currently vacant. Recently, a fifth vacancy was filled, thereby increasing the number of full-time staff from 3 to 4.
needs for NBFI regulation and supervision within the broader context of the staff and skill needs for the whole of the new division.

There is no universally accepted formula for evaluating staffing needs for regulatory agencies around the world. For example, regulators in developed financial systems such as Canada, the United States, and the United Kingdom typically allocate between 2 and 5 full-time staff member equivalent units to each institution (higher numbers are allocated where the institution involves a conglomerate group – for example, in the US, between 20 and 25 staff members would normally be allocated to a large banking conglomerate)\textsuperscript{36}. In comparison, the banking supervision unit within the RBM currently has a professional staff complement of 24 allocated to supervision of banks and discount houses. However, only half of these are front-line supervisors, with the rest being allocated to research and policy development. The implied average allocation of around 1 staff member per institution is below the international average, and is even a little low by emerging market country standards.

Adding responsibility for SACCOs to the current banking supervisory responsibilities would not increase the need for front-line supervisors greatly given that the industry is still relatively small and much of the supervision for the present could be conducted through MUSCO. We suggest that 3 staff members would be sufficient to cover SACCOs, including the need to supervise MUSCO and to inspect the larger SACCOs. These resources would be most effectively embedded into existing bank supervisory teams rather than established as a stand-alone team.

The staff numbers in banking and non-banking regulation and supervision are not strictly comparable given that, internationally, the numbers allocated to insurance supervision are usually lower than those allocated to banks, notwithstanding that the supervisory needs are often just as demanding. A typical insurance regulator, for example, allocates around 1 staff member to each large insurer and between .5 and .2 staff members to each small and medium sized insurer.

Pension funds require less supervisory attention than insurers and regulators usually allocate between 5 and 100 funds to each staff member, depending on the size and complexity of the funds. In the case of public offer funds (such as umbrella funds) the allocation is typically around 2 funds per staff member. Pension fund administrators should be allocated on the basis of roughly 4 funds per staff member, as should securities dealers. Insurance brokers and agents can be allocated much more thinly at around 25 to 50 per staff member. Finally, the allocation of front-line supervisors to microlenders and other specialized financiers could be spread as thinly as one staff member for every 50 to 100 or so institutions.

Staff allocations in the capital market area are typically heavier in surveillance, and enforcement. Surveillance staff typically focus on the stock exchange and issues arising from securities trading. For a small stock exchange such as the Malawi Stock Exchange this work could be covered by as few as 2 staff members, with a third allocated to securities dealers. As the number of institutions and activities increases over time (for example, if the collective investments industry grows) these staffing levels would need to be reconsidered. The staff allocated to capital market enforcement issues can be shared with other financial institutions.

The allocation of staff suggested by these rough rules of thumb should not be considered rigid. In particular, while the computations above are a rule of thumb for determining overall staff requirements, their deployment may be on an entirely different basis to maximize effectiveness and flexibility within the Division and to ensure that silos do not develop unintentionally. One of the

\textsuperscript{36} These figures are averages across different types of institutions including banks as well as non-banks and conglomerate groups.
advantages of having a larger organization with a broad range of responsibilities is the flexibility that it offers in terms of redeploying resources where they are most needed at any point in time.

In addition to front-line supervisors, a regulatory agency with responsibilities as broad as those of the RBM requires staff for common activities such as enforcement, complaints handling, policy and research, secretarial, and senior management. There is a strong argument for sharing these resources across all areas of regulation and supervision. One advantage of locating the regulatory and supervisory responsibilities within the RBM is that corporate services (such as human resources, finance and information technology) can be shared with the rest of the Bank.

Table 2 provides an estimate of overall staffing needs based on the allocations suggested above.

<table>
<thead>
<tr>
<th>Financial Institution Group</th>
<th>No. Institutions</th>
<th>Institutions per staff member</th>
<th>Staff needs</th>
</tr>
</thead>
<tbody>
<tr>
<td>Banks and Discount Houses</td>
<td>12</td>
<td>1.8</td>
<td>21</td>
</tr>
<tr>
<td>Life Insurance Companies</td>
<td>3</td>
<td>1.5</td>
<td>2</td>
</tr>
<tr>
<td>General Insurance Companies</td>
<td>8</td>
<td>3</td>
<td>3</td>
</tr>
<tr>
<td>Insurance Agents and Brokers</td>
<td>52</td>
<td>50</td>
<td>1</td>
</tr>
<tr>
<td>Pension Funds</td>
<td>582</td>
<td>120</td>
<td>5</td>
</tr>
<tr>
<td>Umbrella funds</td>
<td>6</td>
<td>3</td>
<td>2</td>
</tr>
<tr>
<td>Public Medical Aid Funds</td>
<td>2</td>
<td>2</td>
<td>1</td>
</tr>
<tr>
<td>Stock Exchange</td>
<td>1</td>
<td>.5</td>
<td>2</td>
</tr>
<tr>
<td>Securities Dealers</td>
<td>2</td>
<td>2</td>
<td>1</td>
</tr>
<tr>
<td>Other Financiers</td>
<td>2</td>
<td>2</td>
<td>1</td>
</tr>
<tr>
<td>Microlenders</td>
<td>20</td>
<td>20</td>
<td>1</td>
</tr>
<tr>
<td>SACCOs</td>
<td>70</td>
<td></td>
<td>3</td>
</tr>
<tr>
<td>Market Conduct</td>
<td></td>
<td></td>
<td>4</td>
</tr>
<tr>
<td>Consumer Education</td>
<td></td>
<td></td>
<td>2</td>
</tr>
<tr>
<td>Licensing</td>
<td></td>
<td></td>
<td>4</td>
</tr>
<tr>
<td>Enforcement and Complaints Handling</td>
<td></td>
<td></td>
<td>4</td>
</tr>
<tr>
<td>Policy and Research</td>
<td></td>
<td></td>
<td>4</td>
</tr>
<tr>
<td>Support staff</td>
<td></td>
<td></td>
<td>2</td>
</tr>
<tr>
<td>Senior Management</td>
<td></td>
<td></td>
<td>1</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td></td>
<td></td>
<td><strong>64</strong></td>
</tr>
</tbody>
</table>

The staff numbers in Table 2 involve roughly doubling the number of staff currently employed in financial supervision. Some of the additional staff numbers arise from the additional financial institutions that will be brought under the RBM’s supervisory jurisdiction; the rest arise from the need to increase the number of staff currently allocated to supervision in the non-bank areas. The staff employed in financial supervision would account for roughly 30% of total Bank staff, compared with 14% at present.

37 In a small agency such as the RBM, all Department and Section heads would be expected to play an operational role. The senior management referred to here is therefore just the Head of the Division.

38 At present, legal services are also shared with the rest of the Bank. There is, however, a strong case to locate some legal resources within the Financial Supervision Division in the enforcement function in order to develop the expertise and experience needed.
We should emphasize that the estimated staff numbers above are at the bottom end of the range of staff requirements for a regulatory agency with responsibilities for the entire financial system. Over time, as the size of the financial sector grows, there will be pressure to increase these staffing resources.

### 7.4 Allocation of Staff Within the Division

The following comments expand on the responsibilities and structure of the departments outlined in Section 7.2. They also suggest how staffing levels might be distributed among the various departments and roles.

**Pensions and Insurance, Capital Markets and Banking Departments**

These are the front-line supervision departments with responsibility for the supervision of financial institutions. Each department should conduct relationship management of each supervised entity as well as off-site surveillance and analysis, and on-site examination programs to ensure sound risk management and operating practices by institutions as well as compliance with regulations and standards.

We have suggested dividing supervision along institutional lines at the departmental level, although internally we suggest a division largely along functional lines. Thus, within the Pensions and Insurance Department we suggest establishing two sections, one for off-site analysis and one for on-site inspections. The former might be further subdivided into two teams, one for life insurers and pension funds, and the other for general insurers and medical funds. Chart 8 illustrates how this department might be structured internally.

**Chart 8 – Suggested Organization of the Pensions and Insurance Department**
The Capital Markets Department will oversee corporate disclosure of important information to the investing public, and conduct of all financial institutions and market participants.

In terms of disclosure, the Department will oversee and regulate the fund raising activities of corporations, securities dealers and investment managers. The Department's staff will routinely review the disclosure documents filed by companies including: registration statements for newly-offered securities; annual and quarterly filings; promotional and other material provided to insurance policy holders; statements to members of pension plans; reports to shareholders; and filings related to mergers and acquisitions.

In its consumer protection role, the Department will serve the interests of individual investors, depositors, policyholders and beneficiaries. The Department will oversee industry Codes of Conduct and approve industry-based dispute resolution schemes. It will deal with self-regulatory organizations.

The Department will also be also responsible for the RBM’s objective of promoting a confident and informed consumer and investing public. The RBM has an important task in educating the industry and the public about the financial system, the role played by the Bank, and the limitations of regulation and supervision. It also needs to ensure that public expectations are consistent with the RBM’s objectives and its capacity to deliver against those objectives. This activity must be well resourced and targeted appropriately at different stakeholder groups.

Chart 9 shows our recommended internal structure for this department.

Chart 9 – Suggested Organization of the Capital Markets Department

Since the internal organization of the Bank Supervision Department is outside the terms of reference of this project we offer the following purely by way of suggestion.

Our main suggestion is that the Department be organized in such a way that it breaks the direct alignment between on-site and off-site groups that currently exists within the Bank. In this way, on-
site inspection teams would rotate around the banks so that a fresh set of eyes would be brought to bear on each institution over time.

It is common within banking supervisors to structure the off-site teams by the systemic importance of the institutions involved. Thus, there might be one section that focuses on large, systemically important banks, and another that focuses on smaller banks and SACCOs. A possible organization for the Banking Department is offered in Chart 10 below.

**Chart 10 – A Possible Organization of the Banking Department**

![Diagram of the Banking Department's organizational structure]

**Policy, Licensing and Enforcement Department**

The primary responsibility of the Policy section within the Department is for the development of regulations and supervisory practices across the full range of licensed entities. This section is responsible for monitoring domestic and international developments in regulatory and academic thinking in the area. This section will have the prime responsibility for co-ordination and co-operation with international and regional agencies and groups including BIS, IAIS, IOSCO, the World Bank, IMF and regulators in the various SADC countries and sub-groups.

To broaden the specialized skills in this Section and to provide staff with a practical orientation, staff should be required to spend at least ten percent of their time in on-site examinations, either in specialist visits (for example, a targeted visit to a bank to examine market risk management systems) or as members of a more general supervision team.

While the Licensing section is responsible for managing the process of licensing and re-licensing all financial institutions and financial market participants, in more complex cases (e.g. those involving banks or insurance companies) the decision-making process should rest with a team drawn from
appropriate departments having responsibility for reviewing applications and conducting further investigations and interviews necessary to make a determination to grant the licence.

The Enforcement and Complaints section will continue and enhance the enforcement role in the capital markets currently carried out by the RBM. This section will be responsible for investigating possible violations of financial sector laws, recommending action when appropriate, and negotiating settlements on behalf of the RBM. The Legal and Enforcement section will work closely with criminal law enforcement agencies in Malawi and internationally to develop and bring criminal cases when the misconduct warrants more severe action.

The Enforcement and Complaints section is also responsible for the management and work out of any distressed financial institutions, such as banks, insurance companies, pension funds, securities exchanges, clearing and settlement companies, custodians and investment managers. Supervision of distressed institutions is specialized and resource intensive. Therefore, where remedial action includes statutory management, administration, removal of boards or management or liquidation, RBM responsibility for the distressed institution will be transferred from the front line Supervision Departments to Policy, Licensing and Enforcement Department, until the institution is either wound up or returned to sound financial operations through work out, merger or recapitalization. Where detailed knowledge of a particular institution is considered to be particularly important, staff from the front line Supervision Departments may be transferred temporarily to Enforcement and Complaints section to assist with remedial action.

The Enforcement and Complaints section will also handle routine consumer complaints. The complaints handling unit should provide the filtering needed on complaints. This unit will handle routine complaints (e.g. where the RBM is able to act as a “referee” between the consumer and the financial institution) or where the problem can be resolved by ensuring that the consumer is made aware of his/her rights under financial sector laws. Where complaints involve issues of conduct or concern about an institution’s prudential health they should be referred to the relevant front-line supervision divisions for action. To ensure that the front-line supervisors are aware of all complaints as part of their information support system, all complaints should be logged into a complaints database and cross referenced to the supervisory database. A monthly summary of all complaints should be circulated to the supervisory departments.

Finally, the Enforcement and Complaints section would be responsible for drafting new laws, regulations and prudential standards in conjunction with the Policy section.

A suggested internal structure for the Policy, Licensing and Enforcement Department is shown in Chart 11 below.
Recommendation 21

That the RBM adopts an internal structure for the Financial Supervision Division along the broad lines suggested in this Report and with the staff numbers to support it

7.5 Skill Needs for the Financial Supervision Division

Chart 12 below shows the highest qualification levels of existing regulatory staff within the RBM. The overall qualification level is high, with all professional staff having at least a bachelor’s degree and more than half having either a Masters degree or MBA. The fields of undergraduate expertise are roughly evenly divided between social science and accounting, with 2 staff having a qualification in public administration. The graduate level fields of expertise are dominated by economics and finance.
Chart 12 – Qualifications of Supervisory Staff in the RBM

Chart 13 below shows that roughly half of the supervisory staff in the RBM have had work experience outside the central bank. Of these, 5 have had experience in commercial banking and 4 in other financial services industries. Four staff members have had experience elsewhere in the public sector.

Chart 13 – Experience of Supervisory Staff in the RBM

The skill demands of a regulatory agency such as that outlined in Table 2 and Chart 7 extend to the fields of economics, finance, accounting, law, actuarial studies, and general administration, thereby extending beyond the existing capacity of the regulatory staff in the RBM.

In part, the necessary skills for regulation and supervision can be built up through training programs. The training experience of RBM staff is summarized in Chart 14. As can be seen from Chart 14, virtually all of the RBM regulatory staff have been provided with some additional training, with many
having had more than one training experience. Nearly all staff have had some job-specific training, most have had training in management and efficiency, and 17 members have had specific training in finance.

Chart 14 – Training Experience of Supervisory Staff in the RBM

The recommended structure illustrated in Table 2 and Chart 7 will require an expansion in the skills currently available in the RBM. The recommended Enforcement and Complaints section will require specialist legal skills to support both enforcement actions and legal drafting for the Policy section. At least two experienced lawyers and possibly a junior qualified lawyer would normally be needed to meet the enforcement demands of an agency such as the RBM. There will be a need for expertise within this group for dealing with financial crime in general and, more specifically, in the areas of anti-money laundering and anti-terrorist financing. While good lawyers are usually flexible in moving across different areas of law, it would be helpful if the individuals recruited had qualifications in commercial law, financial crime, and/or regulation.

The recommended Policy and Research section will require specialist skills in the finance industry. The skills needed to develop regulatory policy include an understanding of regulation and supervision, specialist skills in finance, and an understanding of the workings of each of the industries being supervised. The academic qualifications for this section should cover primarily finance (preferably at the Masters level or higher) and, to a lesser extent, law. Experience with the industry would also be very helpful, not only in terms of understanding how the industry works, but also from the perspective of consulting with the industry over proposed prudential and market conduct requirements.

The supervisory demands of the front-line supervision Departments will require expertise primarily in finance and accounting. There will be a need to upgrade the overall skill base of existing supervisory staff through a combination of training and recruitment of new staff with industry backgrounds.

Particular areas of expertise to be developed within the non-bank areas include:

- corporate governance;
• operational risk; and
• market conduct.

Not only will the additional demands of the broader regulatory role envisaged for the RBM require recruitment of additional skills, it will require a concerted training program to extend the capabilities of both existing staff and new recruits. In particular, there will be a need to increase training in the supervision of insurance companies and pension funds. The RBM will need a dedicated and focused training program to meet these needs.

7.6 Remuneration

As noted earlier, the most critical ingredient in providing effective regulation is the quality, skills, and experience of the regulatory staff. This, in turn, requires that the regulatory agency is able to pay competitive salaries in the market for those skills and able to retain experienced staff by offering a sufficiently attractive overall remuneration package.

It is generally accepted that regulators are unlikely ever to be able to compete with industry for the top paid financial experts, but there are many talented individuals in the next bracket who would willingly work in a regulatory agency provided the remuneration is adequate.

It is not possible, without a more in-depth analysis of human resource markets in Malawi to assess exactly how high regulatory salaries should be. Some international comparisons may nevertheless be helpful as a guide to the experience of other similar agencies:

• In Colombia, results of a recent salary review of the finance industry suggested that the median monthly salary for a middle manager in the private finance sector was between 1.2 and 1.6 times that of salaries for equivalent positions in the non-bank regulator. That put regulatory salaries in the lower 25th percentile of salaries in the financial sector overall. The Colombians have been finding it difficult to retain skilled regulatory staff and are currently reviewing the need to increase regulatory salaries to closer to the 75th percentile of financial sector salaries.

• At OSFI in Canada, the compensation strategy developed in 1998 targeted the average of the financial sector market, roughly equivalent to the 50th percentile, for total compensation excluding stock options. Implementing this strategy, which gave rise to a material increase in OSFI’s payroll at the time, proved helpful in reducing the turnover which OSFI had been experiencing. However, senior managers in OSFI’s Toronto-based supervision divisions still found that they could not recruit working level examiners with sufficient industry experience to make the judgments required by OSFI’s supervisory framework. Also, as OSFI sought to build its specialist groups, it found that the general financial market compensation data were irrelevant. Many of the specialists received non-standard compensation packages and targeted survey data were needed. As a result of these experiences and an updated financial sector compensation survey including specialist data, OSFI’s compensation strategy was revised in 2001 to target the 75th percentile of the financial sector market for total compensation, taking into account the actuarial value of long-term incentive compensation including stock-options. In addition, a second compensation band was established for specialists.

• APRA’s experience in Australia’s was similar. The compensation strategy implemented in 1998 targeted the bottom 25th percentile of market remuneration. This proved totally inadequate in attracting the specialist skills needed for effective supervision. In 2003 the
target was raised to the 50th percentile, with loadings for specialist positions. The structure is again under review with the possibility of raising the target percentile further.

These experiences reflect a general trend for regulatory agencies to benchmark their remuneration scales against the private financial sector and to align their structures somewhere above the median of the market, or higher where possible.

Chart 15 shows a comparison of RBM remuneration with the median and upper quartile of financial sector remuneration at equivalent seniority levels. It is our assessment, albeit on limited available information, that RBM appears to be sufficiently competitive with the industry to attract most of the skills required.

![Chart 15 – RBM Salaries Compared with Finance Industry in Malawi](chart)

While the overall level of remuneration in the RBM appears to be competitive, the internal salary scale is based on seniority, which can be inflexible in meeting the salary needs of certain specialist skills. It would be helpful to introduce flexibility to pay salary loadings for specialist skills should they prove to be necessary to recruit the skill levels required for effective financial sector supervision.

**Recommendation 22**

*That the RBM introduces salary loadings for specialist skills in the event that it is unable to recruit the full range of skills needed for effective non-bank supervision.*

### 7.7 Location of the New Division

At present in Malawi the off-site bank supervision staff are located in Lilongwe, while the on-site examination teams are located in Blantyre. The distinction between off-site and on-site activities are

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39 Salaries figures are for total gross compensation, including salaries and allowances.
not drawn in the insurance and capital markets areas due to the small numbers of staff and the consequent need for them to play all roles when required. Discussions with staff in the RBM highlighted that co-ordination between the two locations was a problem.

In practice, there is a very strong case for locating all supervisory staff together in the one location and, where possible, for the location to be where the main financial centre of the country is. This is the practice in most countries and is recognized as best facilitating internal co-ordination and communication as well as communication with the market.

There is clearly merit in locating the entire Financial Supervision Division in Blantyre. In view of the disruption that such a move could involve in the short term, we suggest that this option be phased in over a year or two to minimize disruption to staff.

**Recommendation 23**

*That the Financial Supervision Division be established in Blantyre and that existing supervisory staff be moved progressively to Blantyre over a period of up to two years following the establishment of the Division.*

### 7.8 Approximate Budgetary Impact of the Establishment of the Financial Supervision Department

The cost estimates presented in this section are indicative only and are presented largely for the purpose of providing some guidance as to the likely overall cost of financial sector regulation and supervision. A firmer budget should be drawn up as the details of the new Division are agreed and finalized. These estimates could also be used as a starting point for introducing the mixed RBM/industry funding model recommended in Recommendation 6.

**Staff Costs**

In broad terms, the remuneration scale used for costing purposes is based on the RBM scale as at mid-2004, as shown in Table 3 below.

<table>
<thead>
<tr>
<th>Table 3: Approximate Staff Gross Compensation by Broad Seniority Band</th>
</tr>
</thead>
<tbody>
<tr>
<td>-----</td>
</tr>
<tr>
<td>Division General Manager</td>
</tr>
<tr>
<td>Department Directors</td>
</tr>
<tr>
<td>Chief Examiners</td>
</tr>
<tr>
<td>Principal Examiners</td>
</tr>
<tr>
<td>Examiners Level I</td>
</tr>
<tr>
<td>Examiners Level II</td>
</tr>
<tr>
<td>Support Staff</td>
</tr>
<tr>
<td><strong>Totals</strong></td>
</tr>
</tbody>
</table>
The total estimated remuneration budget of K178 million compares with the current budget of around K67 million\(^{40}\). Thus there would be an increase in staff numbers of 32 and an increase in staff remuneration costs of around K110 million.

Staff on-costs, including pensions and health insurance are assumed to cost approximately 18\% of direct salary costs\(^{41}\). Other staff costs, including travel, recruiting etc. are assumed to cost 8\% of direct salary costs. Training in an agency such as the RBM would normally run at around 10\% of direct salary costs once the agency has reached maturity. However, given the expansion required over the next few years, and given the need to accelerate the development of regulatory and supervisory skills, these are assumed to run at around 20\% of salary costs for the next few years at least.

**Capital Equipment and Premises**

Unlike a start-up operation, the RBM currently has premises and some capital equipment dedicated to financial supervision. In what follows, we assume that the space needed to house the additional 32 staff members can be found in the RBM’s existing premises Blantyre.

In the interests of identifying the full cost of financial supervision for accounting and budgeting purposes, the implicit rental of RBM space should be allocated to financial supervision, along with a reasonable allocation of RBM overheads. Again, this is something that could be pursued over time, as suggested in Recommendation 6.

The total space needs of the Division are based on the following estimates:

- Senior Executives 10 sq M;
- Professional and management staff an average of 7 sq M; and
- Junior and support staff 5 sq M.

This gives a total space requirement of around 470 square metres, or around 240 square metres for the additional staff. This estimate of space would be on the low side if extensive use is made of closed offices, as appears to be the norm in Malawi. The trend in regulatory agencies around the world, however, is to use open plan offices, which are both more cost effective and considerably better for productivity. Following the international trend could reduce the office space requirement by up to 10 percent.

At the time this budget was put together no information was available about office fit-out costs in Malawi. Based on figures from other countries, roughly $US1,600 per head of staff, or $250 per square metre, is normal for an agency such as an NBFI regulator. These estimates both suggest an estimated total fit-out cost for the additional staff of around K6.8 million if international costs are the appropriate benchmark (which they probably are, given that many of the items in the fit-out would need to be imported).

One of the largest and most variable cost elements in financial supervision is that of creating a suitable information technology architecture. Data systems range greatly in cost and effectiveness.

\(^{40}\) In making this comparison it should be remembered that staff salaries generally will increase by approximately 15\% on average between 2005 and 2006.

\(^{41}\) The RBM contributes approximately 16.4\% of salaries towards staff pensions.
At a minimum, the new staff would need basic computers, printers and copiers. An approximate cost of this minimal level of support is a little over K6.3 million, as shown in Table 4 below.

<table>
<thead>
<tr>
<th>Item</th>
<th>Number</th>
<th>Unit Cost (Kwatcha)</th>
<th>Total (Kwatcha)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Desktop Computers</td>
<td>33</td>
<td>120,000</td>
<td>3,960,000</td>
</tr>
<tr>
<td>Laserprinters</td>
<td>3</td>
<td>250,000</td>
<td>750,000</td>
</tr>
<tr>
<td>Heavy Duty Copier/Printer/Fax</td>
<td>1</td>
<td>1,600,000</td>
<td>1,600,000</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td></td>
<td></td>
<td><strong>6,320,000</strong></td>
</tr>
</tbody>
</table>

The effectiveness of financial supervision is, however, greatly enhanced by support from a solid suite of database and analytic tools. While these can be expensive and time consuming to develop, the return can nevertheless be significant. It was our observation that the level of technical support for financial supervision in the RBM is currently well below the level required by regulatory agencies around the world. We estimate that the cost of implementing an information technology system somewhere between the most basic and the most sophisticated would cost in the region of K120 million. A decision will be needed in coming years as to how far the RBM should go down this track.

In addition to the office fit-out and information technology needs of the new division, the recommendation to shift the entire division to Blantyre is likely to require significant financial support for staff to facilitate the move from Lilongwe and to assist them with establishing themselves and their families in the new location. This support is likely to be integral to maintaining the current group of supervisors and their collective experience. We do not have sufficient information to hazard an estimate of how significant this cost might be.

**Summary of Costs**

In summary, expanding the supervisory staff capacity of the RBM to the level recommended in this Report would add around K160 million to the annual staff cost budget of the RBM (including both staff remuneration and on-costs, including overheads and training). Around a further K13 million would be needed to meet the fit-out cost and basic computers and information technology support for the additional staff members. A further cost would be incurred in assisting existing supervisory staff to move from Lilongwe to Blantyre.

In very approximate terms, the full accrual cost of the entire Financial Supervision Division is likely to be in the order of K250 million to K300 million per annum. On total current financial sector assets of close to K100 billion, a levy of between 25 basis points and 30 basis points would be needed to fully fund the cost of regulation and supervision. To put this into context, the contribution of banks to the total operating cost of the RBM is currently around K1.7 billion. At the same time, the non-bank sector has not previously made any contribution towards the cost of supervision. As suggested in Recommendation 6, we believe that full industry funding of the cost of supervision should be phased in over a period of time. Initially we suggest that NBFIs be introduced to the idea of industry funding through a low levy, of say 5 basis points, with the fully-disclosed intention of increasing this over time as the industry grows.
7.9 Options for Training and Experience

Good regulators and supervisors are not created overnight. In many cases, it is only after being exposed first-hand to fraud, misrepresentation and failure, that a regulator can truly consider himself/herself experienced. A well-organized training program can nevertheless contribute significantly to staff expertise, especially where the training draws on cases studies of actual supervisory situations.

Notwithstanding the recommendation to increase the staff complement at the RBM, staff numbers will remain well below the level needed to justify an ongoing in-house training program other than a general induction program designed to introduce new staff to the culture and supervisory approach of the agency. This leaves three main avenues for training: secondments of RBM staff to other regulatory agencies; external training programs; and technical assistance from experienced regulators.

7.9.1 Secondments to Other Regulatory Agencies

Notwithstanding the value and importance of classroom-type training, the best experience is usually gained in the field and efforts should be made to second some of the more promising staff to other regulators to spend between 3 and 6 months developing their expertise. While shorter visits are also used by some regulators, it is difficult for the host regulatory agency to gain much benefit from the secondee in a short visit. Visits of between 3 and 6 months enable the host agency to place the secondee into a line position with responsibilities and therefore tend to be more mutually beneficial.

Secondments can be relatively expensive in that they usually involve transport, accommodation and living expenses for a relatively long period. They also tend to “capitalize” a significant amount of expertise into a single individual. It is also the case that the global demand for secondments of this nature have been growing rapidly in recent years, thereby putting a strain on host agencies. Consequently, they need to be used strategically. Ideally they should be used for a small number of the agency’s most promising staff. There should also be a requirement for the secondee to document the lessons and experiences of the secondment and to devote time after returning to transferring the benefits of the experience to other staff members (e.g. through a seminar or series of seminars to staff). Given the time involved, the loss of key staff members for the period of the secondment, and the using up of goodwill with host agencies, secondments should be limited to one or two each year.

There are several agencies that would be useful to target in this respect. The most obvious agency in the region is the South African FSB. It is likely that secondments could be set up with the FSB without the need for outside assistance. Other target agencies should include the FSA in the UK, OSFI in Canada (for insurance and pensions), the various Scandinavian agencies and both APRA and ASIC in Australia. Assistance may be needed in establishing the necessary contacts with these agencies when a program for secondments has been set up. In addition to the FIRST Initiative, assistance could be pursued for both contacts and financial support from DFID (in relation to the FSA in the UK), CEDA (in relation to OSFI in Canada), AusAID (in relation to APRA and ASIC in Australia) and the various Scandinavian aid agencies (in relation to the Danish, Swedish and Norwegian agencies).

Recommendation 24

That the RBM establishes a target program for seconding one promising staff member each year for the next 5 years for a period of between 3 and 6 months to a suitable agency for experience and that it approaches agencies with similar regulatory responsibilities to its own in the UK, Canada, Australia, Denmark, Norway and Sweden as well as the South African FSB with a view to making the necessary arrangements and the relevant country aid programs for assistance and
financial support. The program should include a process for debriefing secondees to ensure that their experiences are shared with others in the agency.

### 7.9.2 External Training Programs

The RBM has already made some use of external training programs. There are a number of training opportunities in South Africa, including programs run by the FSB. Beyond the FSB’s programs, the other most obvious sources of training are: in-house programs offered by other regulatory agencies; programs offered by international agencies; and programs offered by training groups such as the Toronto Centre and the Financial Stability Institute at the Bank for International Settlements.

Most regulatory agencies in developed countries have some in-house training programs. The high cost of developing and maintaining these has, however, seriously restricted the ability of single countries to establish substantial in-house offerings. Consequently, most programs tend to be very short (usually no more than a day), targeted at a particular topic, and often not taught in the depth that is required for serious capacity development. With the exception of programs offered by the FSB these are likely to be to be a high-cost approach to training.

The high cost facing individual agencies attempting to develop training programs has been a motivating factor behind the emergence of the World Bank and the international regulatory associations such as the BIS and the IAIS as providers of training in this area.

The most significant and immediately relevant of these initiatives for the RBM is the Insurance Core Curriculum program currently under development by the World Bank and IAIS. Recognising the worldwide absence of any comprehensive program for insurance regulators these agencies embarked on a project to develop such a program based on the core principles of the IAIS. Each core principle is developed at two levels; an introductory level that exposits the principle and elaborates how it should be implemented by insurance regulators around the world; and an advanced level that takes the principles to a more detailed level of analysis, including the use of case studies based on actual regulatory situations. Each module (from introductory to advanced) takes 3-4 days to deliver.

This program is still at the pilot stage but is expected to be “rolled out” over the next few years. While the program does not address regulation and supervision of pension funds directly, a number of the modules, including those on asset risk and governance would be directly applicable to pension fund regulators. The intention of the World Bank and IAIS is for each pilot program to include a number of local trainers who will then be able to deliver the programs in the local region, thereby providing a degree of sustainability to the training.

The value of this program to the RBM is likely to be substantial. Given the general need for training of this type within the SADC region it should be possible to have a series of these programs delivered over a period of time in the region. The ideal size for each course is around 20 participants (30 maximum). The critical mass of training needs in the region should be sufficient to justify bringing front-line trainers to the region to deliver the full program over a period of several years, provided the costs and benefits can be shared among the regulators in the region.

The fact that a number of countries in the SADC region are at similar stages of development of their financial and regulatory systems suggests the possibility of running a number of training programs on a shared basis. A common and shared approach to training in the region has much to recommend it, not least the fact that many of these countries share common institutions and may one day form a transnational regulatory agency.

A similar program is being developed by the BIS for banking regulators that will involve mostly self-teaching modules delivered on-line. These will be most relevant to banking supervision staff.
We are not aware of any such coordinated training program for securities regulation.

In addition to co-ordinated programs such as those being developed by the World Bank/IAIS and the BIS, the World Bank has also been active in developing once-off and recurring short-courses and workshops on regulatory issues\textsuperscript{42}. These workshops can be quite expensive, especially where they involve long-distance travel, but they are a useful way for staff to listen to a wide range of world-class regulators and industry participants, and to establish contact with other regulators throughout the world. Since the programs change each year there is a need to follow the Bank’s website for information about upcoming programs.

At a more senior level the Toronto Centre offers high-quality training programs for senior regulators focused on leadership. While the Centre has historically concentrated on banking regulators it has, in recent years, begun to cater also for insurance and pension regulators. Their programs are expensive but offer access to case studies, top international regulators and good networking. They are only relevant, however, for a small number of very senior staff.

Finally, the RBM, like most central banks, operates a general education scholarship program for staff to study abroad. It would be very helpful for the long-run effectiveness of supervision if these programs were expanded to include specialist degrees in the finance industry, including actuarial studies and insurance. Having staff with qualifications in the industries being supervised can be helpful not only in better understanding the technical aspects of the industries but also in raising the credibility of the RBM as a financial sector supervisor in the eyes of the industry. Such programs typically run for one or more years and can be costly in terms of the opportunity cost of having good staff on study leave. If the study leave program is to be extended into the supervisory area there may be a need to recruit additional staff to cover the ‘floating’ members of staff away at any time.

\textbf{Recommendation 25}

\textit{That the RBM co-operates with other English speaking regulators in the SADC region in approaching the IAIS/World Bank as a group to have the full core curriculum for insurance regulators delivered within the region over a period of say 3 years as a pilot for sharing training resources within the region. Funding support for the program may be available from donor agencies and should be investigated by the potential participating agencies as a group. Internally, the RBM should allocate a proportion of its study scholarships to the financial regulatory area. Other training programs offered by the World Bank, the Toronto Centre and other regulatory agencies should be used as and when they are available, subject to budgetary constraints.}

\textbf{7.9.3 Short-term Technical Assistance from Experienced Regulators}

The final source of training and experience comes from having technical assistance in the form of experienced regulators who would spend time in the RBM.

Technical assistance from overseas regulators can be a useful source of expertise during the early stages of building capacity but cannot replace expertise within the agency on a long-term basis. The main areas in which overseas consultants may be of assistance are in the development of the approaches to regulation and supervision and in the drafting of regulations and prudential directives. Experience shows that regulatory and supervisory processes can be designed by overseas consultants. However, there must be a significant involvement of local staff if these are to be effective over time.

\textsuperscript{42} For example, the World Bank has offered a 3-day program for pension regulators in Washington DC in September for the past two years.
Processes that are designed without sufficient “ownership” by the local regulatory agency are prone to break down once the consultants leave for home.

This can be a particularly useful means of transferring regulatory experience and expertise to RBM staff. The advantage of having an experienced regulator within the agency for a reasonable period of time is maximised if the visitor takes an active role in the supervisory process and assists in the development of supervisory practices. Visits by experienced regulators could vary from a month to six months, depending on the availability of suitable individuals and their willingness to spend time on site.

The case for using short-term technical assistance in this way is strengthened by the identified need to establish and document supervisory policies and practices. It is doubtful whether staff currently within the RBM have the time or experience needed to carry out this review. The optimal approach to achieving the desired objective would be to have an experienced regulator or two from outside Malawi working in conjunction with the RBM staff to develop the practices and to assist with the documentation. As noted above, it is essential that RBM staff are committed to and involved with the process, even if it is driven by a consultant.

The key areas in which technical assistance is likely to be most helpful over the next few years are:

- insurance regulation/supervision;
- financial crime and enforcement;
- market conduct; and
- development of regulatory approaches and policies and documentation of policies and procedures.

**Recommendation 26**

_That the RBM approaches the FIRST Initiative and other relevant donors for assistance with the identification and funding of suitable ex-regulators to provide technical assistance in the areas of: insurance regulation/supervision; financial crime and enforcement; market conduct; and policy development._
8. Five-Year Capacity Building Plan

8.1 Introduction

In view of the capacity building needs of the RBM this section outlines a recommended capacity building plan for the next five years. While the plan is broken down into specific projects, many of the projects will overlap. It indicates areas in which external assistance and funding are likely to be required. As with the projects themselves, it should be possible to overlap the assistance required for some of the projects.

8.2 Overview of the Five-Year Plan

The key features of the plan in rough order of priority are summarized in Table 5 below. It should be emphasized that this plan is designed to achieve the capacity needs recommended in the earlier sections. While significant costs are likely to be involved, the plan is meant to be a realistic assessment of the capacity needs to make the RBM an effective regulator and supervisor of the Malawi non-bank financial system as it is likely to evolve over coming years. The ability to implement it in part or in full will depend critically on the RBM’s ability to raise the funds needed (either from its own resources or from donors) to carry it out.

<table>
<thead>
<tr>
<th>Project</th>
<th>Priority</th>
<th>Time Frame</th>
<th>Need for Outside Assistance</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Legislative reform program including amendment of the RBM Act and related industry laws and introduction of a Pensions Bill</td>
<td>Very High</td>
<td>0-1.5 years</td>
<td>High</td>
</tr>
<tr>
<td>2. Establish new Division and internal structure</td>
<td>Very High</td>
<td>0.5-1.5 years</td>
<td>None</td>
</tr>
<tr>
<td>3. Recruitment of new staff</td>
<td>High</td>
<td>1.5-3 years</td>
<td>None</td>
</tr>
<tr>
<td>4. Staff training and development</td>
<td>High</td>
<td>2-5 years</td>
<td>High</td>
</tr>
<tr>
<td>5. Develop and document supervisory approaches and manuals for each sector</td>
<td>Medium</td>
<td>2-5 years</td>
<td>High</td>
</tr>
<tr>
<td>6. Extend electronic database system</td>
<td>Medium</td>
<td>3-5 years</td>
<td>High</td>
</tr>
<tr>
<td>7. Review and refine regulatory requirements and directives</td>
<td>Medium</td>
<td>3-5 years</td>
<td>Some</td>
</tr>
</tbody>
</table>

8.3 Details and Prioritization of Projects within the Five-Year Plan

8.3.1 Legislative Reform Program

The legislative reforms outlined in this Report are fundamental to the reorganization and upgrading of the regulatory and supervisory capacity in Malawi. We see this as the immediate priority. We estimate that detailed drafting of the necessary laws and amendments could be completed within about three to four months from the commencement of drafting. Provided drafting can commence reasonably
quickly there is no reason why the legislation package could not be before the Parliament in the second half of 2005, with some prospect of passage early in 2006.

This is a major task and will require external assistance if the law is to be drafted expeditiously. There is a strong case for approaching the FIRST Initiative for support in this area. Not only is FIRST support likely to be more timely than support from other donor agencies, FIRST is more likely to be able to provide technical assistants familiar with similar legislative reforms in other countries in the SADC region. In view of the longer-term objective of a common financial regulatory framework in the region there should be an effort to harmonize where possible with other legislative initiatives.

Summary:
Priority – Very High
Time Frame – 0-18 months
Assistance needed – possibly up to 2 months of legal review and drafting for relevant laws and amendments.

8.3.2 Establish New Financial Supervision Division

While establishing a new division within the RBM is theoretically straightforward, the mechanics will require agreement by the Bank’s Board to the principles as well as budgetary approval. Given that the 2005 RBM budget has already been accepted, the earliest that the new division could be created is in 2006. In view of the time that will be required for drafting and passage of the legislation, this time frame is not unreasonable. Provided the detailed planning and approval processes are carried out during this year it is feasible that the new division could be established in the first half of 2006.

Summary:
Priority – Very High
Time Frame – 6-18 months
Assistance needed – nil.

8.3.3 Recruitment of New Staff

The recruitment of an additional 32 staff members is likely to take some time. Given the budgetary situation it is unlikely that any serious inroads will be made into recruiting until the new structure is in place, with staff positions available and funds to employ and train the staff appointed to those positions. In the short-term, the Bank should attempt to fill existing vacancies in the supervisory area. Where possible, supervisory staff recruited during 2005 should be located in Blantyre, even if they are transferred temporarily to Lilongwe for experience.

In the longer term the challenge for the RBM will be in recruiting some of the specialist skills that it will need. There may be advantages in “testing the waters” with other SADC regulators to see whether there is likely to be value in pursuing the idea of sharing high-cost resources such as actuarial or investigative skills.

Summary:
Priority – High
Time Frame – 18 months to 3 years

Assistance needed – nil

8.3.4 Staff Training and Development

Staff training should be a significant element of the capacity building plan. As recommended in Section 7.9 staff training and development should follow along three separate lines: staff secondments; externally provided training programs; and expertise transfers through technical assistance from ex-regulators.

Summary:

1. Secondment of one staff member per year to a suitable overseas agency:
   - Priority – High
   - Time Frame – spread over next 5 years (starting as soon as possible after the new structure has been established)
   - Assistance needed – Minimal in terms of expertise (at most, help in making contact with suitable overseas agencies)

2.A IAIS/World Bank Core Curriculum for Insurance Regulators:
   - Priority – Medium
   - Time Frame – 2-5 years
   - Assistance needed – High - SADC countries will need assistance to fund the cost of bringing insurance experts to the region to present the modules. Further, assuming that presentation of the modules is rotated among the participating SADC countries, there will be travel and accommodation costs for staff participating in the modules taught in other SADC countries. Since establishing these courses could take some time yet, it should be possible to request any technical assistants assigned to the RBM (see below) to provide some structured training programs while they are on site. This would help bridge the gap until the more comprehensive training programs are available.

2.B Other externally-provided training programs (e.g. Toronto Centre):
   - Priority – Medium (as suitable courses become available)
   - Time Frame – 2-5 years
   - Assistance needed – None.

3. Expertise transfers through technical assistants:
   - Priority – High
   - Time Frame – 2 to 5 years (starting as soon a possible after the new structure has been established)
8.3.5 Develop and Document Supervisory Approach and Manuals

We put a high priority on starting this process, although it is likely to take several years to complete.

The project should start after the recommended strategic planning session to agree the agency’s overall philosophy.

The second and more time consuming stage will involve the systematic documentation of all current policies and procedures.

**Summary:**

1. Review the RBM’s approach to supervising each group of financial institutions:
   
   **Priority – High**
   
   **Time Frame – 18 months (immediately after the establishment of the new division, or earlier if possible)**
   
   **Assistance needed – Minimal (possibly a facilitator for the discussion if needed)**

2. Documentation of Policies and Procedures Manuals:
   
   **Priority – Medium**
   
   **Time Frame – 2-5 years**
   
   **Assistance needed – Technical assistance from one or two experienced supervisors to spend a total of approximately 6 months between them over a period of 1 to 2 years to assist the RBM staff to develop and document a consistent and appropriate supervisory approach to each industry group, including both off-site analysis and on-site inspection methodologies.**

8.3.6 Electronic Database

We put a medium priority on the development of a suitable computerised database for data collection and analysis for NBFI, including the new institutional groups that will come under the RBM’s jurisdiction following the legislative reforms. This project has four components/stages:

- The design and implementation of a basic data collection and validation system for NBFI (most likely building on the system currently in use in banking supervision, provided that system becomes fully operational in the coming year);
- A review of current data returns for relevance and use in supervision;
- The development of some basic supervisory analytic tools and routines for NBFI; and
- The development of an early warning system for troubled financial institutions.
The first stage should be commenced soon after the establishment of the new division. Some outside assistance may be required in this project for software and hardware design, although the Bank’s own information technology department should be able to assist in this.

The second and third stages have a lower priority than the first. However, since each of these has the potential to affect the final shape of the database, they should be carried out concurrently with stage 1. The RBM staff will need to commit a significant amount of time to this project to ensure that the final product is understood by its users and that they have been the main designers of its outputs.

The development of the early warning system is a longer-term project that will need to be integrated into the database system at a later date. It is likely to require considerable outside assistance, both in conceptual design and programming.

Summary:

1. Design and implementation of database and supervisory analytics and data review:
   
   Priority – Medium
   Time Frame – 2 – 3 years
   Assistance needed – possibly in design and programming

2. Design and implement early warning system:
   
   Priority – Low
   Time Frame – 4 - 5 years (not until after database is fully operational)
   Assistance needed – conceptual design plus computer programming

8.3.7 Review and Updating of Regulatory Requirements

In general this project has a lower priority than the projects in the supervisory area. In the short-term we suggest simply replicating all regulatory requirements currently contained in the sectoral laws in the initial set of regulations and standards. This will ensure continuity and give the industry some “breathing space” before they have to cope with any major changes. Nonetheless, there will be a need to review and refine the regulations and prudential standards on a systematic basis over the next few years and to introduce new standards for institutions not previously regulated. Our suggested priorities within the industry groups, based on a balancing of the state of the current frameworks and the importance of the industries, are (in order) the following:

- Pension funds and pension funds administrators – to establish requirements for pension fund trustees to meet proper governance, accountability and investment standards, and to develop a set of requirements suitable for the administrators based on the risks that they pose to the industry.

- SACCOs – to establish a largely self-regulatory framework with a clear division of responsibilities between the RBM and MUSCO.

- Microfinance institutions – to establish an appropriate framework for self regulation and enforcement of good conduct in this industry.
• Life and General insurance – to bring the overall requirements into line with the modern approach to insurance regulation.

• Asset management companies – to bring their regulatory requirements into line with the risks that they pose to the pension fund industry.

• Market conduct - develop a broad set of principles governing market conduct applicable to all licensed financial institutions covering disclosure statements, selling and promotional tactics, etc.

• Medical aid funds – bring their regulatory requirements into line with those facing insurance companies.

• Stock exchange, clearing house and stock brokers – to revise the principles under which the RBM regulates markets and the SRO framework applicable to markets.

We suggest that this review should begin after the amendments to the RBM Act have been passed and that it should continue over a period of several years. This is an activity that is likely to require outside assistance from consultants familiar with the process and principles involved with policy development. The process must nevertheless involve the RBM senior staff. Ideally, the Head of the proposed Policy and Research section should be in place before any technical assistants are brought in.

**Summary:**

Priority – Medium

Time Frame – 3 to 5 years

Assistance needed – Technical assistance from one or two experienced regulators/policy makers and possibly some legal assistance where regulations are involved. Total time input required could be around 6-9 months in total over a period of several years to assist RBM staff to develop the regulatory requirements for each industry group.

### 8.4 A Suggested Staging of Technical Assistance

Implementing the capacity building plan outlined above will require substantial technical assistance. The following is a suggestion as to how this technical assistance might best be staged and coordinated.

#### 8.4.1 Stage 1

The suggested first stage of assistance should be focused on the legislative reform package:

• Draft Pensions Bill

• Draft amendments to the RBM Act to centralize all regulatory and supervisory powers and to strengthen the independence and accountability framework of the Bank.

• Draft amendments to the Insurance and Securities Bills to ensure consistency with the RBM Act.
Draft amendments to the Banking Act to ensure consistency with RBM Act.

Co-ordinate legal drafting with other amendments that have been suggested in the RBM and Banking Acts.

Co-ordinate legal drafting with the Department of Justice and Treasury.

Help promote the draft laws and gain support for the proposed changes from the Malawi bureaucracy, the Parliament and the industry.

Estimated time required:

- Up to 2 months of legal expert plus 2-3 weeks of financial sector expert – part on-site and part off-site.

Time frame:

- To start as soon as possible, with a view to having the draft reform package in the Malawi Parliament during the fourth quarter of 2005.

8.4.2 Stage 2

The suggested second stage of assistance is more substantial, and should follow after passage of the legislative reforms and establishment of the new Financial Supervision Division. It addresses the following elements of the plan:

- Assistance with development of a consistent and appropriate supervisory approach to each industry group, including both off-site analysis and on-site inspection methodologies;

- Assistance with documentation of Policies and Procedures Manuals; and

- Assistance with experience and training of RBM staff through location of technical experts on-site in Malawi.

Estimated time required:

- Up to 12 months of time in total from 3 - 4 experts covering insurance, pensions, capital markets, and market conduct.

Time frame:

- To start after passage of the legislative reforms and after new staff have been recruited to the new division. Work to run over a period of 2 to 3 years as needed and as determined by availability of experts.

8.4.3 Stage 3

The suggested third stage of assistance is also more substantial and addresses the following elements of the plan:
• Assistance with the revision and updating of regulatory requirements for each of the industries regulated by the RBM; and

• Development and programming of an early-warning system for distressed financial institutions.

Estimated time required:

• 6-9 months in total from one or two experienced regulators/policy makers and legal assistant; and

• 3-6 months of database expert and programmer.

Time frame:

• Should start after new structure has been bedded down and new staff are in place. Likely to run for up to 2 years.

• Could overlap to some extent with Stage 2.
9. Concluding Comments

This has been a long and detailed report with many recommendations. In this final section we attempt briefly to put these into perspective.

Overall we believe that the RBM has done a creditable job under difficult circumstances. It has been challenged by a lack of staff resources and an outdated legal framework. Further, the internal structure of regulation and supervision within the RBM has not been conducive to the development of a strong and cohesive supervisory culture.

The challenges of the next decade or more will demand a significant upgrading of the RBM’s regulatory and supervisory frameworks as well as its staff resources. The RBM’s management are aware of this need and of the magnitude of the task ahead. They are also supportive of the work that needs to be done.

This Report recommends a series of capacity building priorities that are designed to equip the RBM to meet its regulatory responsibilities. These recommendations cover the following main areas:

- Amendments to the legal framework for financial sector regulation and supervision in Malawi, including the introduction of a Pensions Act and amendments to the Reserve Bank of Malawi Act to provide the RBM with stronger powers of enforcement, stronger independence and accountability provisions, and the capacity to develop appropriate regulatory requirements (and harmonized requirements where harmonization is needed) across the industries that it regulates;

- Weaknesses in the RBM’s existing supervisory framework including the need to make its approach to supervision more risk-based, the need to document its approach, policies and procedures for NBFI supervision as well as its policies and procedures, and the need to strengthen its approach to on-site inspections;

- Changes to the RBM’s internal structure to upgrade financial sector supervision and centralize all supervisory staff in the centre of the financial markets in Malawi;

- An increase in the RBM’s overall professional staff numbers and a change in the composition of skills to provide increased capacity in law and finance; and

- The need for a substantial training program including secondments to other agencies, use of technical assistants, and working with other agencies in the region to co-ordinate large-scale training programs in key areas of regulation.
References

