

**LAPSE OF
TIME**

SM/22/82
Correction 1

April 27, 2022

To: Members of the Executive Board

From: The Secretary

Subject: **West African Economic and Monetary Union—Financial System Stability
Assessment**

Board Action: The attached corrections to SM/22/82 (4/13/22) have been provided by the staff:

Evident Ambiguity **Pages 6 (para. 1, line 6) and 12 (subsequent footnotes renumbered)**

Factual Errors Not Affecting the Presentation of Staff's Analysis or Views **Pages 2, 3, 5 (lines 7, 9, 13, 16 "-UMOA"), 6 (para. 1, line 7; para. 3, para. 4), 8, 16**

Typographical Errors **Page 5 (lines 3, 16 "Garantie", 17)**

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- The FSAP team was led by Romain Veyrune (International Monetary Fund, IMF) and Pierre-Laurent Chatain (World Bank, WB), and included deputy mission chiefs Silvia Iorgova (IMF) and Jean Michel Lobet (WB); Thierry Bayle, Stéphane Couderc, André Kahn, Romain Lafarguette, Moustapha Mbohou Mama, and Alice Mugnier (all IMF); Tulu Balkir, Antoine Bavandi, Alex Berg, Caroline Cerruti, Dorothée Delort, Chiara Teresa Maria Lunetti, Fredesvinda Fatima Montes, Graciela Miralles Murciego, Antonia Menezes Preciosa, Ou (Owen) Nie, Tanjit Sandhu Kaur (all WB); external experts Gonçalo Coelho, Sophie Imani Poinot, Jay Purcell, Philippe Roussel-Galle, Maria Chiara Malaguti, Patrice Berge Vincent, and Jean-Marie Weck.
- The mission met with the BCEAO, the Secretariat General of the [CBU West Africa Economic and Monetary Union's \(WAEMU's\) Banking Commission \(SGCBU\)](#),¹ CBU Supervisory Board members, the Securities Agency of the WAEMU (UT), the Regional Public Investment and Financial Markets Board (CREPMF), the Deposit Guarantee and Resolution Fund (FGDR-UMOA), the Credit Reporting Bureau (BIC), and representatives of other public sector institutions, financial institutions, industry organizations, and the private sector.
- FSAPs assess the stability of the financial system as a whole and not that of individual institutions. They are intended to help countries identify key sources of systemic risk in the financial sector and implement policies to enhance its resilience to shocks and contagion. Certain categories of risk affecting financial institutions, such as operational or legal risk, or risk related to fraud, are not covered in FSAPs.
- This report was prepared by Romain Veyrune and Silvia Iorgova, with contributions from the FSAP team members.

¹ The CBU is the common banking supervisor for the WAEMU.

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This report is based on the work of the Financial Sector Assessment Program (FSAP) mission conducted remotely from ~~July~~ January 2021 to February 2022. The FSAP findings were discussed with the authorities in January 2022.

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Glossary

AML/CFT	Anti-Money Laundering/Combating the Financing of Terrorism
BCEAO	Central Bank of West African States (In French: <i>Banque Centrale des États de l'Afrique de l'Ouest</i>)
BIC	Credit Reporting Bureau (In French: <i>Bureaux d'information sur le crédit</i>)
BOAD	West African Development Bank (In French: <i>Banque Ouest-Africaine de Développement</i>)
CBU	Banking Commission of the West Africa EMonetary Union (In French: <i>Commission Bancaire de l'UMOA</i>)
CM	Council of Ministers of the WAEMU
CREPMF	Regional Public Investment and Financial Markets Board (In French: <i>Conseil Régional de l'épargne publique et des marchés financiers</i>)
CSF-UMOA	Financial Stability Committee of the WAEMU (In French: <i>Comité de Stabilité Financière danse l'UMOA</i>)
ECOWAS	Economic Community of West African States
ELA	Emergency Liquidity Assistance
FGDR- UMOA	Deposit Guarantee and Resolution Fund (In French: <i>Fonds de Ggarantie des Dépôts et de Rrésolution</i>)
FSAP	Financial Sector Assessment Program
HQLA	High Quality Liquid Assets
IMF	International Monetary Fund
LCR	Liquidity Coverage Ratio
ML/TF	Money Laundering and Terrorism Financing
NPL	Nonperforming Loan
PEP	Politically Exposed Person
RAM	Risk Assessment Matrix
SGCB	General Secretariat of the CBU (In French: <i>Secrétariat General de la CBU</i>)
SME	Small and Medium-sized Enterprise
SVT	Primary Dealers in Treasury Securities (In French: <i>Spécialistes en Valeurs du Trésor</i>)
UT	Securities Agency of the WAEMU (In French: <i>UMOA-Titres</i>)
WAEMU	West African Economic and Monetary Union

EXECUTIVE SUMMARY

1. The WAEMU's financial sector has undergone important structural changes since the 2008 FSAP. The size of the financial sector has increased significantly; regional banking groups have come to play a dominant role; and banks have accumulated considerable portfolios of government securities. Banks' asset quality and capitalizations have improved but should be further enhanced. The banking sector remains heterogenous in terms of solvency, risk exposures, risk management, and performance. Prudential regulation has been enhanced and aligned with [international-Basel II/III](#) standards, but its implementation is [somewhat delayed in progress](#). The banking sector has withstood the impact of COVID-19, with support from the authorities, but the fiscal space is now reduced.

2. Credit risk is amplified by asset concentration and interconnectedness. Banks are exposed to risks from a deterioration of health, security, and/or macroeconomic conditions. Stress tests, conducted based on growth-at-risk and inflation-at-risk models, indicate that a severe but plausible deterioration of economic growth or a rise in inflation, on their own, would entail moderate recapitalization needs due to the relatively small size of banks' assets as percent of regional GDP and the soundness of large banks. Many smaller banks would be affected. Yet, a concurrent economic growth slowdown and an inflation spike could further elevate these needs. Importantly, the concentration of bank exposures to private borrowers and sovereigns and banks' interconnectedness—via the interbank market and common exposures—could amplify the impact of credit shocks and raise recapitalization needs, particularly for certain member countries.

3. Liquidity and interest rate risks are amplified by the inadequate development of the regional [secondary bond market and interest rate risks have been on the rise](#). Liquidity risk is exacerbated by deposit concentration and the limited liquidity of the secondary market for government securities. Several banks are persistently dependent on BCEAO refinancing. Banks' exposure to interest rate risk has likely increased due to the rise of the share of government securities on their balance sheets, whose maturities tend to be longer than banks' funding.

4. These vulnerabilities call for a well-calibrated response. Concentration and interest rate risks, including those linked to sovereign exposures, should be covered by capital surcharges under Basel Pillar 2 to account for heterogeneity in banks' risk profiles. The timely introduction of the Basel III liquidity ratios will help banks internalize liquidity risk. The supervisor's autonomy and resources should be strengthened to support implementation of risk-based supervision. The supervisor should impose monetary sanctions more consistently, publish censure letters, and refrain from repeated use of stays of proceedings. Resolution/liquidation tools should be applied promptly to address undercapitalized, nonviable institutions. The resources of the Deposit Guarantee and Resolution Fund (FGDR-[UMOA](#)) and the autonomy of the CBU's Resolution College and the FGDR-[UMOA](#) should be reinforced. Banks dependent on BCEAO financing should be required to prepare funding plans. The BCEAO should adopt procedures for emergency liquidity assistance (ELA) and measures to mitigate balance sheet risks. The supervisory program for Anti-Money Laundering/Combating the Financing of Terrorism (AML/CFT) should be further reformed to fully adopt a risk-based approach and further enhance the capacity and methodology for onsite inspections.

Table 1. WAEMU: FSAP Key Recommendations

	Counterparty	Priority
Banking Sector Supervision and Regulation		
Modify the CBU's governing documents to institute independence of its Supervisory Board from member states and require state representatives to serve in a non-voting capacity or establish selection of commissioners based on professional qualifications.	BCEAO/ Council of Ministers (CM)	ST
Make the WAEMU Court of Justice the appellate jurisdiction for the CBU Supervisory and Resolution Boards' decisions.	BCEAO/CM	MT
Continue strengthening the number and capacity of staff at the Secretariat General of the Banking Commission the WAEMU (SGCB) assigned to supervisory functions.	BCEAO	ST
Impose capital surcharges for concentration risk and interest rate risk (Pillar 2).	CBU	ST
Make more consistent use of monetary sanctions, publish sanctions and censures, and avoid repeated stays of proceedings.	CBU	ST
Publish a guidance note for banks on the preparation of stress tests.	BCEAO/CBU	ST
Strengthen AML/CFT supervision by fully adopting a risk-based approach and enhancing the capacity and methodology for onsite supervision.	BCEAO CBU	ST
Macroprudential Framework and Tools		
Designate the BCEAO as the "macroprudential authority" and introduce a mechanism for national authorities to raise legitimate concerns.	BCEAO/ CSF-UMOA	ST
Fill residual data gaps, including on the financial conditions of nonfinancial corporations, households, and the real estate sector.	BCEAO	MT
Strengthen the monitoring of WAEMU's Financial Stability Committee (CSF-UMOA) recommendations by introducing a "comply or explain" mechanism.	CSF-UMOA	MT
Systemic Liquidity		
Introduce the Basel III liquidity ratios and: (i) institute a government securities haircut; (ii) count required reserves toward liquid assets; and (iii) require banks to regularly report residual maturities on assets and liabilities, and interest rates.	BCEAO	ST
Impose a higher liquidity coverage ratio (LCR) for banks with riskier profiles (Pillar 2).	CBU	MT
Support the development of the regional bond market by: (i) introducing a development objective in medium-term borrowing strategies; (ii) unifying the central depositories; and (iii) reforming the status of the primary dealers.	BCEAO/UT/ CREPMF	MT
Introduce: (i) funding plans to manage certain banks' excessive dependence on BCEAO funding; (ii) haircuts and concentration limits for BCEAO eligible assets adapted to the underlying risks; and (iii) a framework for emergency liquidity assistance (ELA).	BCEAO	ST
Resolution and Crisis Management		
Liquidate or resolve undercapitalized, nonviable credit institutions on a timely basis.	BCEAO CBU	ST
Finalize banks' resolution plans in accordance with best practices.	CBU	ST
Strengthen the independence of the: (i) Resolution Board from the Supervisory Board and member states; and (ii) FGDR, particularly from active banking industry members.	CM/CBU/FGDR	MT
Adopt a program for enhancing systemically important banks' loss-absorption capacity; speed the attainment of FGDR-UMOA's target insurance reserves coverage of eligible deposits; enable FGDR-UMOA recourse to member states in case of resource inadequacy.	BCEAO/CBU CM/FGDR	MT
Climate Risk		
Adopt a strategy for managing climate risks, including raising supervisors' and financial institutions' awareness of climate-related issues.	BCEAO/CBU	ST
Define the prudential expectations for financial institutions' integration of climate and environmental risks in risk management systems and disclosures.	BCEAO/CBU	MT

Note: ST = Short Term (1 to 2 years); MT = Medium Term (3 to 5 years).

diversification effects are limited, given the bias toward holding own-country and Côte d'Ivoire debt securities, and the possible correlation of member states' vulnerabilities.

16. Contagion risks in the WAEMU are high, buoyed by the presence of multiple interconnectedness channels (Figure 4). These include: (i) mostly unsecured direct interbank exposures; and (ii) considerable common exposures to private and sovereign borrowers, including cross-border investments in other member states' debt securities (e.g., Côte d'Ivoire).

17. The rise in banks' sovereign exposures and greater reliance on BCEAO short-term funding have contributed to a rise in interest rate risk. Historically, the prevalence of short-term private credit claims in banks' portfolios curbed this risk as maturity mismatches were minimal. The sharp rise in government debt holdings and expanded use of BCEAO short-term funding have raised banks' asset-liability mismatches and the risk of a contraction in their interest rate margins should interest rates rise.

18. Banks' capital buffers are limited and uneven across banks (Figure 5; Table 5).⁴ The system-wide capital adequacy ratio has risen, reaching 12.4 percent at end-June 2021, up from 10.5 percent at end-2018. This reflects an increase in the regulatory capital requirement in the context of the transition toward Basel II/III. Yet, banks' capital positions are weaker than they seem. Full provisioning of NPLs would mostly absorb existing Tier 1 capital buffers, curbing banks' capacity to cope with risk amplifiers (e.g., concentration and contagion) and emerging risks (e.g., interest rate risk).⁵ Disparities among institutions also persist, with 18 banks (10.2 percent of banks' assets) not complying with the solvency norms at end-June 2021.

19. Liquidity risks are exacerbated by the underdevelopment of the regional bond markets (Figure 6). Banks' funding, largely based on customer deposits, has been stable. Yet the heavy skew of banks' funding base toward large deposits—with the five largest depositors on average accounting for 25 percent of deposits—amplifies the impact of liquidity shocks. The illiquidity of the secondary markets for government securities hampers banks' ability to mitigate such shocks. It also stands in the way of developing the repo market, which offer a more robust form of interbank funding than the prevalent unsecured transactions. Finally, banks do not actively use debt issuances to curtail maturity mismatches and interest rate risks.

20. The quality of banks' internal risk management systems is heterogeneous.⁶ Only 35 percent of banks systematically require approval by their risk management department before making a loan. Banks also do not uniformly develop formal audit plans or risk maps. Credit risks are monitored via analysis of borrowers' financial statements and internal ratings, but credit risk analysis tools are rudimentary and suffer from the lack of borrower data. Few banks use external ratings and

⁴ The capital buffers include capital in excess of the minimum 8.25 percent capital adequacy requirement.

⁵ Provisions at end-2020 stood at 65 percent of NPLs, a level that may be insufficient to compensate for the high uncertainty of banks' debt recoveries, given inefficiencies in the legal system.

⁶ [The findings in this paragraph are based on a survey conducted by the FSAP.](#)

FINANCIAL SECTOR SUPERVISORY FRAMEWORK

A. System-level Oversight

Institutional Architecture

32. WAEMU’s institutional framework for financial stability and the legal mechanisms underpinning its functioning have seen substantial progress since the 2008 FSAP. Institutional reforms have clarified the mandates of the BCEAO and the CBU and strengthened the CBU’s legal autonomy and enforcement powers. In addition to the objective of preserving price stability, the BCEAO has explicitly been charged with the core task of ensuring financial stability. The law on the banking regulatory framework has established an overarching framework for the supervision of banks’ activities, which has been made more proactive and risk based with the gradual implementation of the Basel II/III framework since 2016. A macroprudential policy framework, a bank resolution regime, and a deposit guarantee fund—whose mandate was extended to bank resolution funding—have been introduced.

33. The CBU’s independence from member states should be strengthened. The principle of independence, which prohibits CBU members from receiving instructions from external entities, including member states, should be explicitly enunciated in the CBU’s governing documents (specifically the Annex to the CBU’s governing Convention). The CBU’s governing documents should also stipulate that commissioners serving on the Supervisory Board because of their status or position in a WAEMU member state’s administration (eight of the 16 members) should do so in a non-voting capacity. As an alternative, the CBU’s composition could be amended to increase representation of CM-nominated commissioners based on professional qualifications. Finally, maintaining the CM’s appellate jurisdiction over CBU decisions raises institutional independence concerns. As per good practices, such decisions should only be appealed before the WAEMU’s Court of Justice, which also has jurisdiction on these matters.

Macroprudential Policy

34. Since the 2008 FSAP, the BCEAO has implemented key elements of WAEMU’s macroprudential policy framework. The Financial Stability Committee of the WAEMU (CSF-UMOA), which was created in 2010, includes all regional financial sector regulators and is charged with conducting regular assessments of systemic risks, recommending macroprudential measures, and ensuring coordination across the various authorities responsible for financial sector oversight.

35. The macroprudential policy framework applicable to banks, introduced in 2010, includes appropriate instruments. These include capital surcharges (e.g., a countercyclical buffer, a conservation buffer, and a systemic buffer) and measures to contain credit growth applied to loans secured by real estate collateral (e.g., ceilings on loan-to-value and debt-service coverage ratios).¹¹

¹¹ The systemic buffer is applied solely to ~~domestic~~ regional systemically important institutions.