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EXECUTIVE BOARD MEETING

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From: The Secretary

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INTERNATIONAL MONETARY FUND

LIBYA

SELECTED ISSUES

May 5, 2023

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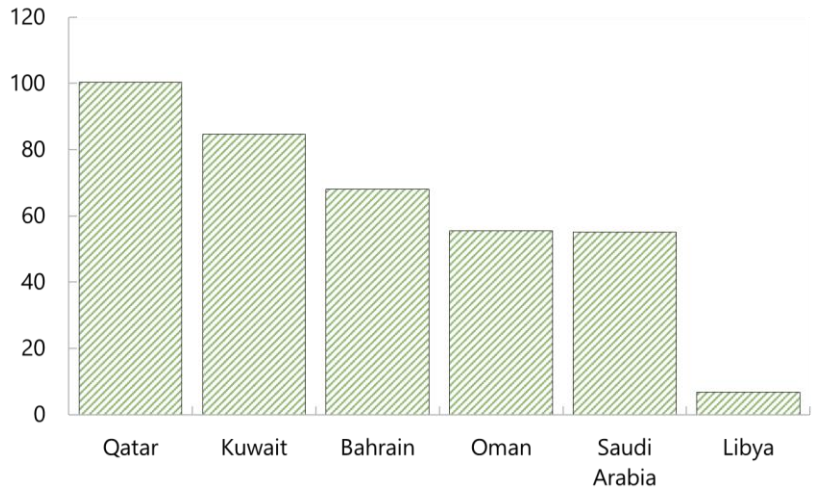
BANKING SECTOR REFORM: A ROADMAP

This paper provides an overview of the challenges facing the banking sector in Libya and puts forward reforms to strengthen financial stability and accelerate credit growth. Priority reforms are identified using the 2012 sound principles for effective supervision, issued by the Basel Committee for Banking Supervision (BCBS), while also considering limitations imposed by the country's fragility and conflict situation. The chapter recommends that the authorities (i) follow a gradual and consultative approach to regulatory reforms and (ii) support the development of human capital and systems at the commercial banks and at the Central Bank of Libya.

A. Banking Sector Challenges

1. The banking sector is rudimentary. Decades of socialist policies during the Gadhafi era, followed by civil war and political infighting stifled financial sector development, impaired credit intermediation, and contributed to low private sector participation in the economy. A short period of modernization took place between 2005 and 2010, when foreign banks were allowed to acquire ownership stakes in local banks as strategic partners. Today, Libya has 20 banks with total assets of around LYD 143 billion. Loans and credit facilities are less than 15 percent of total banking sector assets, the majority—around 60 percent—are balances at the Central Bank of Libya (CBL). Credit to GDP continues to be low at 12 percent in 2022.

Private Sector Credit, 2022
(Percent of GDP)

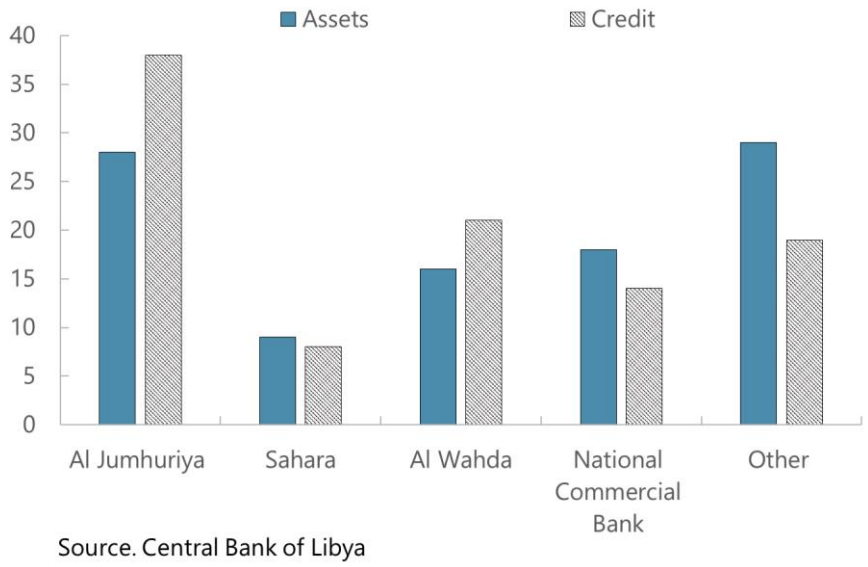


Sources: National Authorities.

2. The CBL's ownership of banks limits competition and undermines governance. The CBL owns six banks, including the four largest banks: Al Jumhuriya, National Commercial Bank, Al Wahda, and Sahara. Together these banks make up approximately 70 percent of banking sector assets and 80 percent of total credit. Banking supervision is part of the CBL's mandate, and its ownership of commercial banks creates a conflict of interest between its shareholder's profit maximization drive and its regulatory role. In addition, the public sector mindset at banks stifles innovation and contributes to inefficiencies.

Concentration in the Banking Sector

Percent of total



Source. Central Bank of Libya

3. Banks are struggling to develop Islamic finance products. Interest has been outlawed since 2013 and conventional banks are still struggling to fully convert to an Islamic system and develop Islamic finance products, which is hampering credit growth. To compensate for the loss of interest income, banks have turned to fee income, including on foreign currency transactions; this is one reason why the parallel foreign exchange market continues to exist after the 2021 currency devaluation.

4. The CBL has an ambitious agenda to introduce international standards and best practices to the banking sector. The BCBS sets global capital adequacy standards that determine

the quantity and quality of capital.[1] The CBL recently issued regulation number 11/2022 which requires the banks to calculate capital adequacy using the Basel II capital accord and maintain a ratio above 12.5 percent. It also issued regulation 2/2023 and 14/2022 to introduce Basel III net stable funding ratio and the liquidity coverage ratio. A dedicated unit within the CBL was also created to oversee implementation.

5. Foreign currency letters of credit (LCs) are approved by the CBL, and the CBL also conducts AML/CFT checks. The 2015 oil price crash and volatility in oil production prompted the CBL to introduce capital flow measures (CFMs) and macroprudential measures (MPMs) to protect foreign exchange reserves.[2] As a result, a parallel exchange rate market developed, and criminal groups took advantage by fraudulently obtaining US$ at the official rate to sell for a large profit. To reduce AML/CFT risks and limit CFM leakage, the CBL became the clearer of US$ for Libyan banks, conducting AML/CFT checks on banks' customers and funding the LCs it approves.

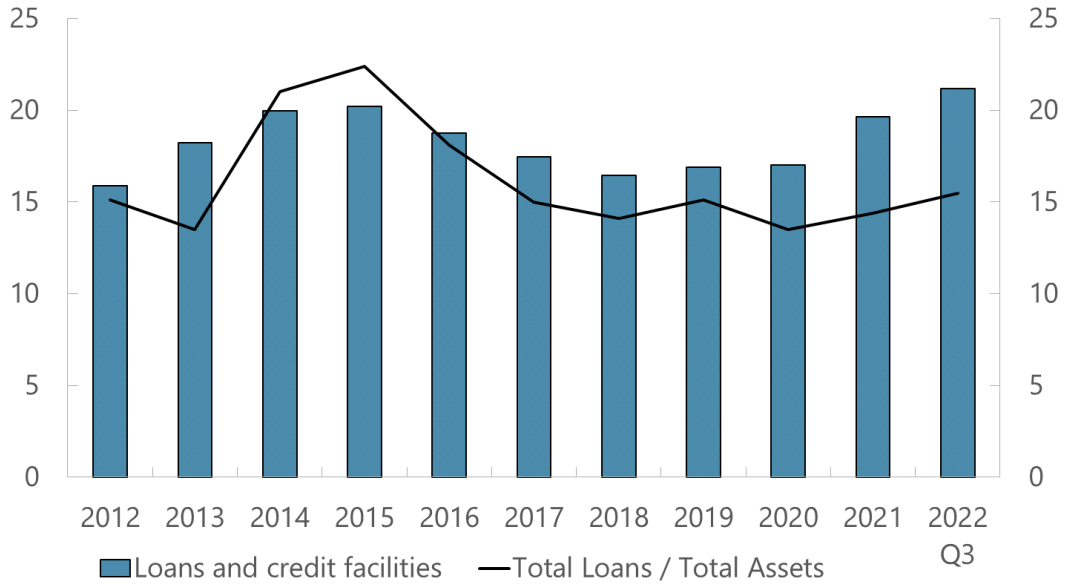
6. The relaxation of CFMs/MPMs brought the official exchange rate in line with the parallel market and supported credit growth. The introduction of a transaction tax on foreign exchange in 2018, followed by the devaluation of the LYD in 2021, allowed for the relaxation of CFMs. As a result, the gap between the official rate (US$/LYD 1.44) and the parallel market (US$/LYD 9) narrowed significantly to only 6 percent. However, the parallel market continues to exist primarily due to banking sector inefficiencies, scarce foreign currency physical notes, and the CFMs/MPMs that remain in place. The CBL decision to allow lending the banks to lend up to 70 percent of the value of LCs, supported credit growth in 2021 and 2022.

[1] The standards have been revised several times over the years and the latest revisions, referred to as Basel III, strengthened banks' capital position and introduced liquidity quantitative requirements in the wake of the 2008 financial crisis.

[2] Capital controls includes annual limits on foreign currency for personal use, CBL approval for import letters of credit and limits on foreign currency prepaid cards.

Loans and Credit Facilities

(Billions of LYD and percent of total loans)

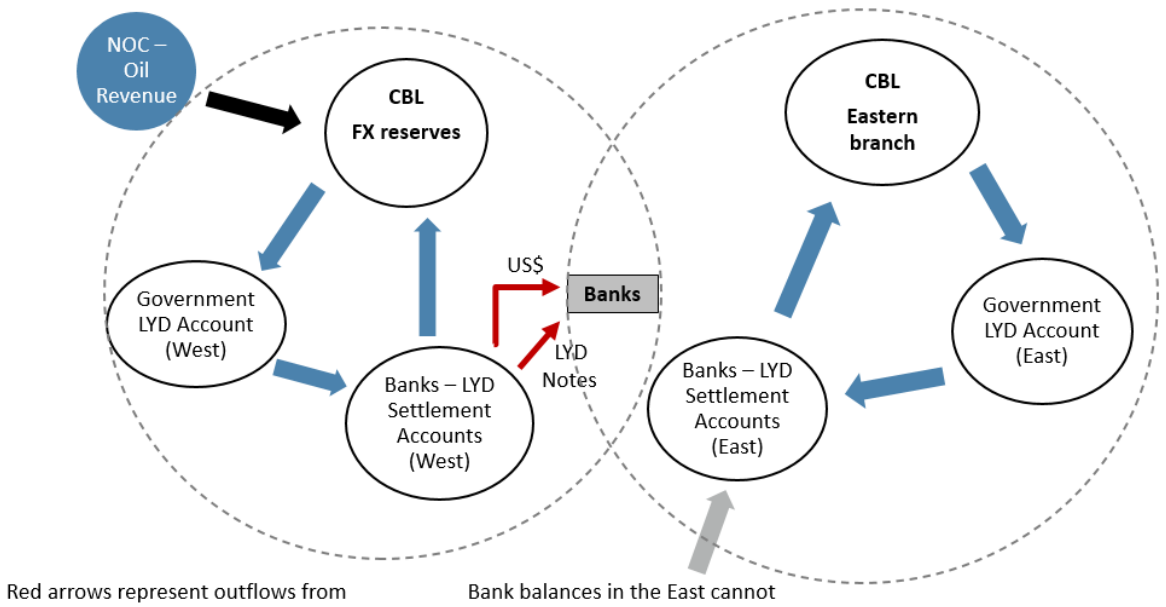


Source: Central Bank of Libya.

7. The continued split of the central bank increases risks to financial stability. Since the conflict started in 2014, the Eastern branch of the CBL operated independently of the head office in Tripoli and provided monetary financing to the administration in the East. Banks hold settlement accounts with the CBL and its Eastern branch, but only the CBL in Tripoli can provide US$ and is legally allowed to print currency notes. Banks' use of their balances with the CBL in Tripoli for FX and notes puts pressure on the liquidity in the west, while settlement balances in the Eastern branch remain high (see Figure 1).[3]

[3] Banks' settlement account balances are reduced when LYD is sold to purchase FX or when a bank requests physical notes to be printed and delivered. Settlement balances at the Eastern branch of the CBL have been reduced when it printed LYD 4 billion in notes and through balance transfers to the CBL in Tripoli as part of the unification process.

Figure 1. Banking System Flows

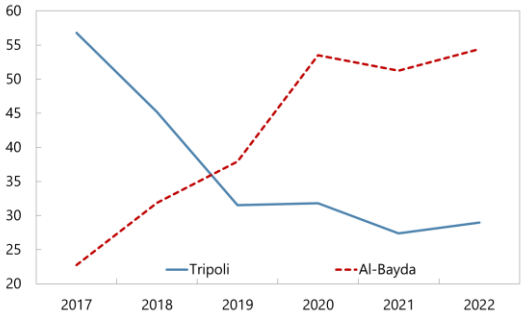


8. As part of the unification process, the CBL has begun transferring banks' settlement balances to Tripoli. The CBL has so far transferred around LYD 29 billion of the balances in Eastern branch to banks' settlement accounts in Tripoli, alleviating some of the liquidity pressure. Nevertheless, the Eastern branch has recently engaged in LYD 8 billion of new monetary financing for the GNS and for development projects in the East. Further monetary financing endangers financial stability and should be avoided.

B. The Preconditions for Effective Banking Supervision

The banking sector in Libya is assessed against select reform-critical principles. The BCBS sets out six prerequisites and twenty-nine principles for effective banking supervision. Prerequisites are sound macroeconomic policy, financial stability, crisis management, recovery, and resolution framework, developed public infrastructure, and effective market discipline. The principles cover supervisory powers, responsibilities and functions of the regulatory

Settlement accounts with Central Bank of Libya
(Billions of dinars)



Sources: Central Bank of Libya.

authority, criteria for good corporate governance, and banks' risk management practices for credit, market, operational, liquidity, and conduct risks. In the following two sections, the paper focuses on the prerequisites and some of the principles that are most relevant for banking sector reform in Libya.

9. Financial stability mandate and governance architecture should be strengthened. Financial stability mandate and governance are not clearly articulated in the banking law. The CBL functions outlined under Article 5 of the 2012 banking law do not clearly include financial stability and no governance structure is provided for it. The law should include a clear, formal, financial stability mandate and a governance structure that brings together key authorities such as the Ministry of Finance, the Ministry of Economy and the CBL to discuss threats and coordinate measures to preserve financial stability.

10. The prohibition of interest rates should be revisited, or a full conversion to Islamic finance completed. In 2013, the authorities abruptly introduced a law that prohibited charging interest and, with no adequate preparation to ensure a smooth transition to Islamic banking, already-weak credit intermediation was further disrupted.[4] A decade later, banks are still struggling to develop Islamic finance products, and credit to the private sector is only slightly above the level seen in 2014. The authorities should either allow for both conventional and Islamic banks to coexist or establish a road map for banks' to fully embrace Islamic finance and develop Sharia-compliant lending products. An exit plan should be agreed with the banks that are not able to make the conversion to allow allocation of resources to those banks that can provide financing.

11. Islamic finance expertise must be developed to support credit growth. A Sharia board consisting of qualified Sharia scholars must approve products before being offered by an Islamic bank. However, a Sharia board is not usually responsible for structuring products, and the banks' staff need to acquire the necessary skills to develop Islamic finance products that meet the customers' needs and get the Sharia board endorsement. The Sharia Board relies on sharia compliance, internal audit, and an external sharia audit to ensure management and staff comply with its decisions. The CBL should ensure banks establish effective sharia governance structures and develop human capital in Islamic finance to support credit growth and economic activity.

12. A macroprudential framework is required to promote financial stability and support monetary policy. This framework would identify tools that can serve macro-prudential objectives, depicts transmission mechanism to the real economy, and assesses potential leakages to enable recalibration. In the absence of monetary policy instruments, a macroprudential framework may support monetary policy objectives in addition to preserving financial stability. Most macroprudential tools are micro measures developed to limit risk-taking at individual banks and enhance their resilience, but they can also be used to influence aggregate credit supply. The CBL has taken steps to strengthen micro-prudential regulations, including introducing key ratios in the areas

[4] See *IMF Country Report 13/150*.

of credit, capital, and liquidity.[5] However, further work is needed to ensure proper implementation by banks, strengthening CBL supervision, and developing a macroprudential framework.

13. The CBL should continue to ease CFMs/MPMs as conditions permit. The IMF adopted an institutional view on the use of CFMs in 2012 and recommended their use in a limited manner to address macroeconomic challenges and financial risks. As foreign exchange reserves increase and the political and the security situation improves, the CBL should continue to gradually relax CFM/MPM measures to eventually eliminate the parallel market and support credit growth.

14. In the medium term, crisis management, recovery, and resolution regimes should be developed. These frameworks can serve as a contingency plan to allow the CBL more time to act to limit spillovers from bank failures to the financial system. They will also reduce moral hazard and ensure public funds are not used in bailouts. CBL ownership of the major banks reduces the urgency for the development of these frameworks in the short term. However, they remain essential for private-sector-led development and a well-functioning financial system over the medium term.

15. Legal and administrative procedures need to be developed. To intermediate credit and efficiently allocate resources in the economy, banks rely on an ecosystem that includes accountants, auditors, credit and title deed registries, and tax records. This ecosystem is not well developed in Libya. The accounting and audit profession in Libya faces challenges in accessing information and verifying data, which limits the quality of financial statements and reduces their usability by banks and investors. Significant delays and, in some cases, the complete absence of public financial statements prevents investors from exercising market discipline.

- Tax administration is weak, and the degree of non-compliance is high. Widespread tax exemptions weaken compliance, and the use of manual processes to store information makes tax data less usable by banks.
- The credit registry is infrequently updated and not always used by banks to assess credit. The CBL latest circular 4/2023 reaffirms the process to update and use the information in the credit registry, but it has not yet been implemented. Further automation of the credit registry would improve data quality and usability.
- No collateral registries. Property records were largely destroyed during the Gadhafi regime and proving ownership was further complicated by internal conflict after the fall of the regime. This rendered immovable assets largely useless as a source of collateral.

16. The rule of law should be strengthened. A legal system that protects ownership rights, enforces contractual obligations, and allows for the efficient realization of collateral is necessary to protect creditors' rights and give comfort to banks to expand credit to the private sector. Where the system is deficient, banks are exposed to higher credit losses. The legal system in Libya is inefficient,

[5] Key prudential ratios may include loan to value, debt service ratio, counter cyclical capital buffer, liquidity coverage and net stable funding.

court proceedings are lengthy, and enforcement is slow. Reforming the legal system and strengthening law enforcement is a cornerstone for banking sector reform, and economic reform more generally.

C. The Principles for Effective Banking Supervision

Applying the principles of effective banking supervision does not prevent bank failure but it significantly reduces the likelihood of bank distress by strengthening the stability of the financial system. It is understood that not all BCBS principles can be implemented in the short term given the political divide, the fragile security situation, and capacity constraints. Nevertheless, the principles serve as a roadmap to guide future reform efforts. In this chapter, the most relevant principles are grouped as they pertain to the banking law, corporate governance and transparency, prudential soundness and conduct requirements.

a) The CBL Governance and Legal Powers

17. The CBL's governance framework should be enhanced. The banking law outlines the CBL's governance structure. Due to the political conflict and the central bank split, it has been difficult to convene the CBL's board of directors, and some governance safeguards specified in the law have not been followed.[6] Reestablishing an effective board for the CBL would strengthen governance and increase public confidence in the financial system. When it is not possible to convene the board, decisions made outside the governance structure should be based on necessity, clearly identified, and disclosed in a transparent manner. Alternative arrangements for governance and oversight should also be introduced; for example, through the development of internal committees that make decisions in a consultative manner and provide scrutiny.

18. The scope of the regulatory parameter to cover innovative financial services (Fintech) should be expanded to support financial inclusion and protect consumers. The existing banking law covers traditional financial institutions like banks, finance companies, investment funds and exchange houses. More recent Fintech business models, such as payment services, crowdfunding, digital assets, and E-money are not explicitly covered. The law should be revised to address these gaps by regulating the financial service activity regardless of the provider. For example, activities such as deposit-taking, providing and arranging credit, issuing stored value, and money remittance should be regulated activities. This approach allows wider coverage of financial service providers, especially when services are offered by telecoms, social media firms, and Fintech startups leveraging technological advancements.

19. Applying a consultative approach before issuing new regulations would minimize unintended consequences and facilitate implementation. New laws should require the CBL to publicly consult with stakeholders (e.g., banks, finance companies, consumer groups, academia), before issuing regulations. This process would enable the CBL to better understand the potential impacts of new regulations, any transition periods needed, and implementation challenges. It would

[6] Since 2014, the CBL board of directors met only once in 2021, when it took the decision to devalue the LYD.

also indicate to the banks the regulatory direction, allowing them to prepare, and improving compliance. Currently, no consultation takes place.

20. Some requirements stated in the banking law are better covered in regulations. The banking law is unnecessarily prescriptive in some areas and many details captured in the law are better suited for regulations, where they can be easily modified and amended as practices evolve. For example, the fit and proper regime, criteria for auditors and collateral valuers, and who can petition the CBL to conduct an inspection are not common in banking laws. Similarly, many corporate governance articles that cover general assembly, shareholders' protection, and financial statements, may be better covered in listing rules or in the corporate law that apply to all companies.

b) Banks' Corporate Governance and Transparency

21. A fit and proper regime is needed to improve governance and compliance culture at the banks. The starting point for good governance is to build a culture of compliance and internal challenge by having qualified and capable individuals in positions of authority. A fit and proper regime that identifies key control functions at banks, sets out the minimum criteria for candidates, and outlines the CBL's approval and review process. This would improve governance and compliance and reduce corruption within the banking sector. The CBL regulation number 6/22 is a major step forward, but some refinements are needed. For example, candidates should be required to pass regulatory interviews, hold exit interviews with departing officers, and afforded protection from unfair dismissal when acting in good faith. The CBL should also have the power to sanction authorized individuals for misconduct, including imposing a ban on holding office at regulated financial institutions.

22. A fit and proper regime should also apply to banks' controllers. CBL approval should be required for legal or natural persons seeking to hold a controlling interest in a regulated financial institution. A prerequisite for public banks' divestment, a fit and proper controllers' regime is likely to ensure new owners promote good governance, hold management accountable and effectively monitor performance. It also ensures criminal groups do not control financial institutions and engage in money laundering activities.

23. The CBL should implement temporary measures to address its ownership of banks. Until such time when it is possible for the CBL to relinquish its ownership of banks, it should establish internal safeguards to limit conflicts of interest between ownership and supervision. One option is assessing a public bank's board from two separate perspectives—that of an investor, and that of a supervisor. In the former, the focus should be on maximizing return and shareholder wealth, and in the latter the focus should be on risk appetite and governance. Within the CBL, a strict internal separation between functions overseeing investments and banking supervision will be required. Safeguards may also include establishing and observing guidelines on appointing and dismissing banks' board members.

24. The governance structure of banks should be strengthened, including board oversight, decision-making, and accountability. At a minimum, every bank should have an executive committee comprising of the senior executives of the banks as well as committees for

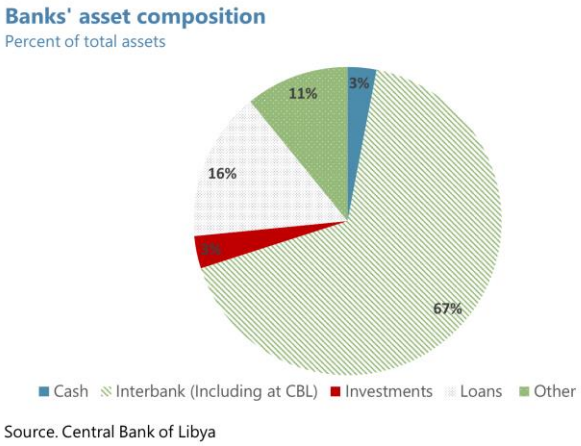
credit risk (CRCO), assets and liabilities management (ALCO), operational risk (OPCO), compliance and legal risk. A comprehensive management committee structure facilitates the implementation of the board strategy, creates accountability, and reduces corruption. The CBL regulation 10/2022 requires banks to establish an ALCO, however the specified functions and mandate are too broad, and its membership includes the chairman of the board, which might blur the line between daily risk management and board oversight. The management committees will need to have clear and manageable terms of reference, a set of periodic reporting requirements and a mechanism to track the implementation of their decisions.

25. Comprehensive internal and external reporting systems should be developed to strengthen management facilitate supervision. A comprehensive set of internal management information is critical to enable board and management to track strategy implementation, performance, and risk exposure of the bank. As part of assessing governance at the banks, the CBL should periodically review the information received by management for its coverage, quality and usefulness for decision making. Data reporting to the CBL, in a format that is easy to aggregate and analyze, would help assess risk at individual banks and at the level of the banking system. The requirement for the general assembly to approve financial statements delay their publication and should be replaced with board approval. The banks should also be required to publish unaudited interim statements.

26. A modern bank reporting system is needed to enhance the CBL's offsite analysis and risk identification. The CBL set up a task force to automate and modernize bank reporting, which made good progress on module design and system development. To limit the administrative burden on banks and ensure only necessary data are collected, the task force should widely consult with data users within the CBL, as well as with representatives from the banks. A gradual roll-out that prioritizes critical modules (e.g., capital, liquidity, and credit) should be followed to allow time for banks to build their systems. The CBL would also benefit from a phased approach to develop its analytic capabilities and fine-tune the existing modules before introducing new ones.

c) Soundness and Prudential Requirements

27. Banks are likely in need of recapitalization. The banking sector has adequate capital at face value with a Basel I capital adequacy ratio of around 16 percent, but this is because of deficiencies in asset impairment recognition and provisioning (see also paragraph 28). In addition, over 60 percent of banks' assets are exposures to the CBL with no capital requirements.[7] If banks increase credit supply by shifting exposures from the CBL (zero risk weighted) to private

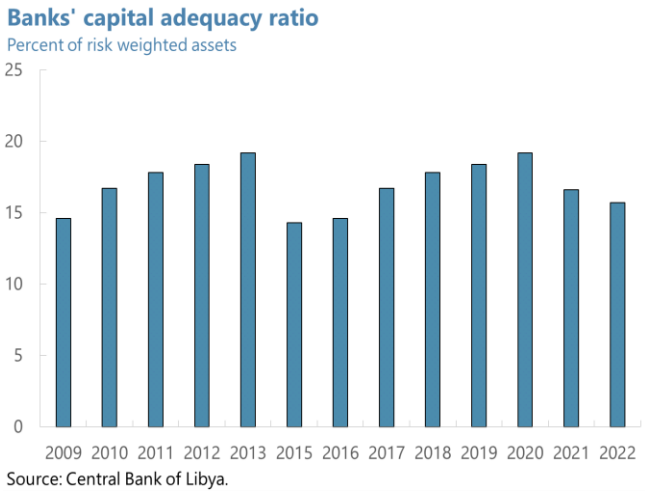


Source. Central Bank of Libya

[7] Banks' holdings with the CBL include mandatory and elective reserves, demand deposits in LYD and foreign currency, and CBL Certificates of Deposits.

sector borrowers (positive risk weights), the new assets will consume capital quickly. In addition, the recent devaluation of the LYD in 2021 has increased the LYD value of foreign currency-denominated exposures and caused some banks to breach large exposure limits.

28. Identification, monitoring, and reporting of NPLs needs to be improved. Since 2011, non-performing loans (NPLs) have been estimated at around 20 percent of total loans and cannot be accurately measured due to conflict and political instability. It is likely that the true NPLs are much higher. This implies that banks are under-provisioned, and capital adequacy is likely overstated. The CBL should request banks to undertake an asset quality review against set NPL criteria, establish the actual capital position, and develop recapitalization plans that could include bank mergers, profit retention, and capital infusion. It is imperative that banks balance sheets reflect an accurate picture of financial positions and risks to support credit growth and better facilitate the eventual divestment of CBL interests to the private sector.

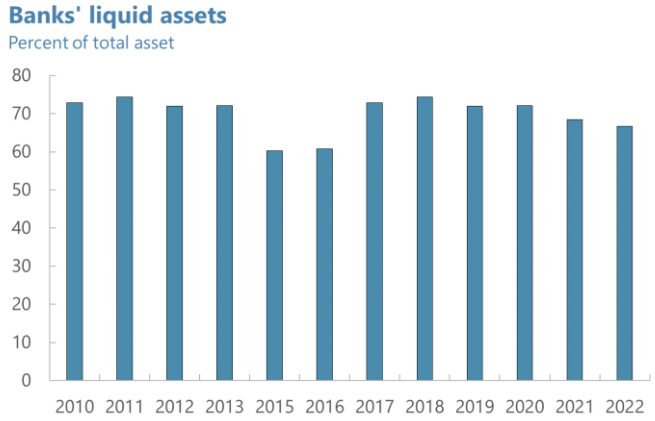


29. CBL should not hesitate to use pillar II capital add-on to influence banks' behavior and risk profile. Capital absorbs unexpected losses and reduces the likelihood of bank default; it is also a cost to the bank and reduces profitability. In October 2022, the CBL issued circular 9/2022 which gives banks three months to implement the guidance on Basel II pillar II. It requires banks to conduct an Internal Capital Adequacy Assessment Process (ICAAP) and submit the results for regulatory review. As part of the ICAAP supervisory review and evaluation process (SREP), the CBL should apply a capital add-on to banks that have risks not fully reflected in Basel pillar I capital, such as concentration and liquidity risks. Pillar II capital add-on can also be used to influence bank behavior and risk taking, to address, for example, underinvestment in technology, weak governance, and deficiency in AML and CFT controls.

30. The credit underwriting framework is the first line of defense against credit losses and should be enhanced. The role of banks in credit intermediation is made necessary due to information asymmetry between providers of funds (depositors) and the users (borrowers). The banks are in a better position to obtain the borrowers' information, analyze it and make credit decisions based on clear underwriting standards that reflects the bank's risk appetite. Lax underwriting standards increase the likelihood of exposure defaults, leading to higher credit losses, provisioning, and capital erosion, which destabilize the bank and negatively affects credit supply to the economy. CBL can strengthen underwriting frameworks by requiring the banks to adopt a credit risk appetite, clear underwriting criteria, exposure limits, and the controls necessary for effective implementation. Where underwriting standards are deficient, a capital add-on under Basel II pillar II should be used to mitigate against higher losses.

31. The CBL should ensure that banks periodically assess the credit quality of their assets, identify signs of delinquency, and assign a credit rating commensurate to the asset's likelihood of default. A granular and timely rating allows banks to allocate adequate resources to deal with deteriorating credit quality, take prompt action to minimize the loss, and prepare to deal with the impact. Supervisors should evaluate the rating methodology and its implementation and take corrective measures. To enable monitoring of the banks' asset quality, sharing of credit information across banks, and performing stress testing to identify vulnerabilities, banks should report loan portfolios rated under standardized criteria, to the CBL and credit information center. Granular reporting of large credit exposures helps identify concentration risk and assign appropriate Basel II pillar II capital add-on.

32. Liquidity management should be strengthened to support future credit growth. Banks usually manage short term liquidity through interbank markets and short-term debt instruments, but after abolishing interest rates in 2013, CBL did not introduce Islamic instruments and the interbank market never developed. This leaves the banks with no avenue to place excess liquidity, and funds are left in the CBL settlement accounts. The CBL should introduce liquidity management instruments tailored to Islamic banks, issue liquidity regulation in line with BCBS Basel III to limit banks' liquidity and funding risk and, set minimum criteria for sound liquidity risk management at banks. This is especially important when credit growth picks up and the banks start viewing excess liquidity at CBL as a cost, it also increases CBL's ability to conduct monetary policy.



Source: Central Bank of Libya.

d) Operational Risk, AML, and CFT

33. There is an urgent need to reduce operational risk Libya. BCBS defines operational risk as "*the risk of loss resulting from inadequate or failed internal processes, people, and systems or from external events*". Banks in Libya operate in a difficult environment characterized by a fragile security situation, an inefficient legal system, and weak rule of law. This gives rise to all types of operational risks, including AML/CFT, fraud, and physical damage to branches and ATMs. The use of internet and mobile banking can reduce the need to protect physical assets and increase the security of information and traceability of transactions. Developments in AML/CFT screening and investigating software can also assist banks in reducing AML/CFT risks, while automating back-office functions can reduce human errors and increase efficiency. CBL should introduce a comprehensive set of operational risk requirements to encourage the banks to invest in technology and human capital. This may include specific requirements for systems and user functionality.

34. AML/CFT supervision should be enhanced, and financial intelligence unit (FIU) resources should be increased. The AML regulatory regime should be aligned to the Financial Action Task Force (FATF) recommendations, including recent updates on virtual assets and virtual assets service providers. The very low number—113 in 2022—of suspicious activities reports (SARs) to the Financial Intelligence Unit (FIU) indicates weak AML/CFT controls at banks. The backlog of SARs implies inadequate resources at the FIU, including systems, to investigate and resolve suspicious transactions. The CBL should take steps to ensure full implementation of the AML/CFT regulations, and address AML/CFT control failure at banks. FIU should update its systems and processes and increase resources to deal with existing SAR filings and a rise in filings that will occur when AML/CFT controls at the banks improve.

35. Improved domestic and international cooperation needed in the fight against AML/CFT. The FIU has 12 memorandums of understanding with domestic authorities and 7 with international counterparts. Domestic exchange of information and coordination across law enforcement agencies, customs, and the FIU is vital for successful investigations and prosecution of AML/CFT cases. International cooperation with other FIUs increases confidence in Libya's financial system and discourages money laundering syndicates from using Libya to launder money or for terrorist financing. Formal communication channels should be established to deal with higher SAR volumes and more complex investigations.

e) Conclusion and Summary Table

36. The success of financial sector reforms depends on Libya's ability to achieve political and social stability and address the gaps in the BCBS perquisites and principles. The task faced by the authorities is enormous and requires a coordinated effort as well as security and political stability, including central bank unification. Several recommendations are summarized below, prioritized as high (short term), medium (medium term) or low (long term), considering their importance for credit growth, addressing corruption, and implementation ability.

Table 1. Summary of Recommendations		
Area	**Actions**	**Priority and reason**
Structural	Unification of the CBL	High. Unifying monetary policy, payment systems and banking supervision is essential for policy making and financial stability.
	Banks' disclosure	High. Periodic and detailed public disclosure of financial position, performance and key risks introduces market discipline and improves governance.
	Property registry	High. The availability of collateral provides an avenue to loan recovery and increases credit growth.
	Macroprudential Framework	Medium. A macroprudential framework will support monetary policy and promote financial stability.
	Gradual easing of CFMs/MPMs	Medium. Further relaxation of CFMs/MPMs will eliminate the parallel exchange market and support credit growth. However, it is a medium-term objective given the fragility of the country's political and security situation.
	Frameworks for crisis management, recovery, and resolution	Low. The CBL ownership of banks reduced the need for these frameworks in the short term. However, they are a pillar of a private led financial sector in the future.
Banking Law	Establish a financial stability committee (FSC)	High. A FSC can coordinate policy and promote macro-economic and financial stability.
	Islamic finance only or conventional and Islamic dual system	High. Provide certainty to the sector and a way forward. Depending on the decision, a road map should be agreed with banks to develop Islamic products.
	Requirement to consult on new regulations	High. The CBL should be required to widely consult before issuing regulations to refine rules, assess impact and implementation challenges. Given the large number of circulars issued by CBL, consultation is important to ensure proper implementation.
	Expand financial services coverage	Medium. Bringing in new financial services under the regulatory parameter. Introduce regulation by activity.
	Streamline and reduce complexity	Low. Remove sections in the law that can be better covered in regulations.
Governance	CBL - Establish alternative temporary governance arrangement	High. Temporary governance arrangement to address CBL board absence can increase transparency and support decision making.
	CBL - Public ownership of banks	High. CBL should apply strict separation between ownership and supervision functions of banks until it is possible to divest its interest in banks.

Table 1. Summary of Recommendations (Continued)		
		Medium. Divestment of the CBL ownership can increase the efficiency and improve governance.
	Fit and proper	High. The CBL should get involved at an early stage by approving the candidates for key function prior to appointments and the process should include interviews. The CBL should also have powers to sanction individuals for misconduct. Fit and proper should also apply to controller.
	Bank reporting system	High. A gradual roll out of the new reporting modules aligned with new regulations, can improve compliance and ease transition.
	Governance review and supervision	Medium. The CBL should build capabilities to review and assess governance at banks, including governance structure, quality of management information, adequacy of challenge and decision making. The CBL should take appropriate measures to address weakness.
Credit	Islamic products	High. The ability of the banks to develop Islamic finance products will increase credit flow to the economy.
	Credit underwriting	High. Building credit governance framework and functions at the banks mitigates credit risk and reduces corruption.
	Credit information center	Medium. Improve system automation and usability, to increase access to credit and improve asset quality.
		Medium. Increasing the accuracy and usability of the credit registry supports credit assessment and efficient credit allocation to the economy.
Liquidity	Islamic liquidity management tools	High. The ability to manage system liquidity hinges on the availability of Sharia compliant instruments.
	Liquidity management at banks	Medium. Banks should be required to develop systems and controls to manage liquidity risk.
	Liquidity quantitative requirements	Medium. Adopting Basel III LCR and NSFR frameworks reduces liquidity and funding risk. However, given the very high cash balances at the CBL and low credit intermediation, this is a medium-term priority.
Capital and Asset quality	Recapitalization of banks	High. Banks are likely undercapitalized and not in a position to support credit growth.
	Past due and NPLs identification, reporting and provisioning.	High. The ability to establish the banks' capital position is directly linked to accurately identifying and provisioning NPLs.

Table 1. Summary of Recommendations (Concluded)		
	Pillar II capital add-on	Medium. Supervisory capital overlay is effective in addressing systems and controls deficiencies at banks. Nevertheless, focus should be on proper Pillar I implementation in the short term.
Operational risk	Improve technology adoption in the banking sector	Medium. Encourage banks to automate and introduce digital channels to increase resilience and mitigate operational risk.
AML/CFT	Enhance AML/CFT supervision.	High. Improving AML/CFT systems and controls at the banks is needed to address financial crime and corruption.
	FIU automation and resources.	High. Automating the FIU processes and increasing resources allows the FIU to deal with high volumes of SARs and increase efficiency.
	Strengthen domestic and international cooperation	High. Successfully prosecuting AML/CFT cases is crucial for deterrence and framework effectiveness. Cooperation is a must to complete investigations and gather the needed information for a successful prosecution.

Annex I. Select BCBS Sound Principals

Principle 1 – *Responsibilities, objectives and powers: An effective system of banking supervision has clear responsibilities and objectives for each authority involved in the supervision of banks and banking groups. A suitable legal framework for banking supervision is in place to provide each responsible authority with the necessary legal powers to authorize banks, conduct ongoing supervision, address compliance with laws and undertake timely corrective actions to address safety and soundness concerns.*
Principle 2 – *Independence, accountability, resourcing and legal protection for supervisors: The supervisor possesses operational independence, transparent processes, sound governance, budgetary processes that do not undermine autonomy and adequate resources and is accountable for the discharge of its duties and use of its resources. The legal framework for banking supervision includes legal protection for the supervisor.*
Principle 4 – *Permissible activities: The permissible activities of institutions that are licensed and subject to supervision as banks are clearly defined and the use of the word "bank" in names is controlled.*
Principle 5 – *Licensing criteria: The licensing authority has the power to set criteria and reject applications for establishments that do not meet the criteria. At a minimum, the licensing process consists of an assessment of the ownership structure and governance (including the fitness and propriety of Board members and senior management) of the bank and its wider group, and its strategic and operating plan, internal controls, risk management and projected financial condition (including capital base). Where the proposed owner or parent organisation is a foreign bank, the prior consent of its home supervisor is obtained.*
Principle 10 – *Supervisory reporting: The supervisor collects, reviews and analyses prudential reports and statistical returns from banks on both a solo and a consolidated basis, and independently verifies these reports through either on-site examinations or use of external experts.*
Principle 11 – *Corrective and sanctioning powers of supervisors: The supervisor acts at an early stage to address unsafe and unsound practices or activities that could pose risks to banks or to the banking system. The supervisor has at its disposal an adequate range of supervisory tools to bring about timely corrective actions. This includes the ability to revoke the banking license or to recommend its revocation.*
Principle 16 – *Capital adequacy: The supervisor sets prudent and appropriate capital adequacy requirements for banks that reflect the risks undertaken by, and presented by, a bank in the context of the markets and macroeconomic conditions in which it operates. The supervisor defines the components of capital, bearing in mind their ability to absorb losses. At least for internationally active banks, capital requirements are not less than the applicable Basel standards.*
Principle 17 – *Credit risk: The supervisor determines that banks have an adequate credit risk management process that takes into account their risk appetite, risk profile and market and macroeconomic conditions. This includes prudent policies and processes to identify, measure, evaluate, monitor, report and control or mitigate credit risk (including counterparty credit risk) on a timely basis. The full credit 12 Core Principles for Effective Banking Supervision lifecycle is covered including credit underwriting, credit evaluation, and the ongoing management of the bank's loan and investment portfolios.*

Principle 18 – Problem assets, provisions, and reserves: The supervisor determines that banks have adequate policies and processes for the early identification and management of problem assets, and the maintenance of adequate provisions and reserves.
Principle 26 – *Internal control and audit: The supervisor determines that banks have adequate internal control frameworks to establish and maintain a properly controlled operating environment for the conduct of their business taking into account their risk profile. These include clear arrangements for delegating authority and responsibility; separation of the functions that involve committing the bank, paying away its funds, and accounting for its assets and liabilities; reconciliation of these processes; safeguarding the bank's assets; and appropriate independent internal audit and compliance functions to test adherence to these controls as well as applicable laws and regulations.*
Principle 24 – *Liquidity risk: The supervisor sets prudent and appropriate liquidity requirements for banks that reflect the liquidity needs of the bank. The supervisor determines that banks have a strategy that enables prudent management of liquidity risk and compliance with liquidity requirements. The strategy takes into account the bank's risk profile as well as market and macroeconomic conditions and includes prudent policies and processes, consistent with the bank's risk appetite, to identify, measure, evaluate, monitor, report and control or mitigate liquidity risk over an appropriate set of time horizons. At least for internationally active banks, liquidity requirements are not lower than the applicable Basel standards.*
Principle 25 – *Operational risk: The supervisor determines that banks have an adequate operational risk management framework that takes into account their risk appetite, risk profile and market and macroeconomic conditions. This includes prudent policies and processes to identify, assess, evaluate, monitor, report and control or mitigate operational risk on a timely basis.*
Principle 29 – *Abuse of financial services: The supervisor determines that banks have adequate policies and processes, including strict customer due diligence rules to promote high ethical and professional standards in the financial sector and prevent the bank from being used, intentionally or unintentionally, for criminal activities.*

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