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TECHNICAL ASSISTANCE REPORT

KINGDOM OF LESOTHO

Implementation of Basel II

JUNE 2019

PREPARED BY

Alicia Novoa

AFRITAC South

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GLOSSARY

AFS	IMF's Regional Technical Assistance Center for Southern Africa (AFRITAC South)
BCBS	Basel Committee on Banking Supervision
BSD	Banking Supervision Division
CAR	Capital Adequacy Ratio
CBL	Central Bank of Lesotho
ECL	Expected Credit Losses
FIA	Financial Institutions Act of 2012
ICAAP	Internal Capital Adequacy Assessment Process
IFRS	International Financial Reporting Standard
IMF	International Monetary Fund
Lesotho	Kingdom of Lesotho
LR	Leverage Ratio
MoU	Memorandum of Understanding
RBS	Risk-based Supervision
SA	Standardised Approach
SARB	South African Reserve Bank
SREP	Supervisory Review and Evaluation Process
SRP	Supervisory Review Process
TA	Technical Assistance

Preface

At the request of the Central Bank of Lesotho (CBL), a mission from IMF AFRITAC South[1] visited Maseru on March 4-14, 2019, to provide technical assistance (TA) on the implementation of Basel II. The mission comprised Ms. Alicia Novoa (Expert). The mission evaluated the progress made in the implementation process and provided guidance on the way forward, including (i) reviewing the CBL Draft Guidelines to banks for Pillar 1 and helping to finalize them; and (ii) providing direction on the Pillar 2 Supervisory Review and Evaluation Process (SREP) and the banks´ Internal Capital Adequacy Assessment Process (ICAAP). It reviewed the current Guideline to banks for the ICAAP and assessed changes needed in the current disclosure regime for Pillar 3, in the context of its recent revision. The mission discussed the implementation of select elements of Basel III relevant to Lesotho.

The mission conducted a series of focused training sessions with the staff of the Banking Supervision Division (BSD) covering relevant areas such as risks, risk management and governance; key aspects of the Pillar 2 SREP and ICAAP; and the revised Pillar 3 framework, with emphasis in developing the skills and knowledge of the supervisors and enhancing their confidence.

The mission met with Dr. A.R. Matlanyane (Governor), Mrs. P. Tau (Acting Director of the Banking Supervision and Financial Stability Department, and Head of the Banking Supervision Division) and with section heads, supervisors and on-site and off-site bank examiners.

The mission wants to express its appreciation to the Governor, Acting Director of the Banking Supervision and Financial Stability Department and to all the BSD staff for their participation in the candid discussions and training sessions held, and is very grateful for the cooperation and hospitality of the CBL during its visit.

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[1] AFS provides TA and training to Angola, Botswana, Comoros, Eswatini, Lesotho, Madagascar, Mauritius, Mozambique, Namibia, Seychelles, South Africa, Zambia, and Zimbabwe. AFS donors are the European Union, Switzerland, Germany, China, Mauritius, the United Kingdom, Netherlands, European Investment Bank, and Australia.

EXECUTIVE SUMMARY

This mission, a follow up to the earlier mission from IMF AFRITAC South (AFS) conducted in March 2017 (STX Mr. Bernie Egan), was designed to further help the authorities in the implementation of Basel II and select elements of Basel III. The main objectives of the mission were to help the CBL finalize the Draft Guidelines to banks on Pillar 1; assist in the implementation of Pillar 2, with attention paid to the Supervisory Review and Evaluation Process (SREP) and the banks´ Internal Capital Adequacy Assessment Process (ICAAP); and evaluate current disclosure requirements in view of the recent revision of Pillar 3 by the Basel Committee on Banking Supervision (BCBS). The adoption of select elements of Basel III especially those related to definition of capital was discussed.

The banking system of Lesotho remains concentrated and largely foreign owned. The three major banks are subsidiaries of South African banks and the fourth, the only domestic bank,[2] is fully owned by the Government of Lesotho. All four banks appear to be comfortably capitalized with an average Capital Adequacy Ratio (CAR) of 18 percent as at December 2018,[3] which would facilitate a smooth implementation of Basel III capital requirements given that this level of capital would be exclusively composed of equity and is well in excess of the minimum 8 percent required by the Financial Institutions Act (FIA) of 2012.

The mission noted very good progress since the 2017 Technical Assistance (TA) mission and commends the CBL for the effort. The mission found that the BSD had drafted guidelines for banks on Pillar 1 capital requirements, credit, operational and market risks; guidelines for Pillar 2 ICAAP, stress testing and the SREP; and a guideline on basic disclosures for Pillar 3. The BSD had also requested banks to submit a first draft ICAAP report by June 2018.[4] The mission is of the view that an immediate issuance of the final guideline(s) for Pillar 1 should follow, with full adherence to the definition and requirements for capital set in Basel III. The mission provided input for finalizing all Pillar 1 guidelines and enhancing the current guidelines for Pillars 2 and 3, proposing a roadmap for implementing all three Pillars.

The CBL should implement Pillar 1 standardized approaches by January 1, 2020. Although the BSD was considering implementation by the third quarter of 2020, the mission found the CBL ready for finalizing all Pillar 1 Guidelines shortly, following its consultative process, to make them effective on January 1, 2020. Though the BCBS has finalized the Basel III post-crisis

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[2] Lesotho PostBank.

[3] Figures calculated by the BSD as per Basel I; figures as per Basel II were not available at the time of this visit, for which the mission encourages the CBL to conduct a QIS-like calculation of capital, to anticipate the likely impact of Basel II implementation and inform any adjustment, if needed, to the implementation schedule.

[4] All four banks had submitted their first draft ICAAP reports by end-2018, and had received some written feedback from the BSD by the time the mission visited the CBL.

reforms[5] and issued new standardised approaches for credit and operational risks, these approaches could be considered for adoption by the CBL in due time.

Progressive implementation of Pillars 2 and 3 will help the CBL address some supervisory concerns on the banks and some deficiencies in the BSD's supervisory practices. Implementation of Pillar 2 during 2020 should be followed by a smooth implementation of Pillar 3 requirements by end-2020, given that both Pillars are integral to the migration to Basel II.

The major challenge in the implementation of Basel II is the Supervisor´s progress in the Pillar 2 learning curve, and the ensuing strengthening of its supervisory approach. Understanding the banks´ assessments of risks and capital needs and being able to form a view to challenge the banks are critical for a successful migration and a resilient banking sector. The CBL´s 2010 Risk-Based Supervision (RBS) Framework should undergo a review to get it leveraged by the Pillar 2 ICAAP and SREP. The CBL will need TA for this purpose.

Skills enhancement of the supervisory staff is a high priority. Through a series of focused sessions covering the essential elements of Basel II, the mission aimed to build supervisory skills and confidence. The BSD has a good understanding of risks; however, supervision is yet to be comprehensive and risk-based. The CBL needs to invest in ongoing capacity building of the BSD´s current staff[6] to keep abreast of Basel II, and in adding new skills[7] to the team.

The banks´ readiness for implementing Basel II poses challenges. The simplicity of the banking business and the banks´ comfortable capital positions are factors facilitating a smooth migration; however, the domestic bank will necessitate supervisory handholding to progress into Pillar 2, and to get a better grasp of risks and risk-based capital. All four banks will likely have to fine-tune their information systems to meet Pillar 3 disclosure requirements. The BSD must remain vigilant as to the extent new capital may be required for banks given that Basel II may add pressure to their behavior and business strategies as implementation progresses.

The mission does not see urgency for Lesotho to implement any Basel III capital buffer or a Leverage Ratio (LR) requirement. While the capital conservation buffer would restrict the ability of parents in South Africa to repatriate capital outside Lesotho, the mission sees no urgency in setting a buffer before the minimum Basel III capital requirement materializes. A LR could be implemented in due course, once other capital requirements have been bedded down.

The CBL should make capital enhancements its current priority. The CBL limited resources would not enable it to develop a Basel III-type liquidity framework at the same time; however, the

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[5] Most of them will become effective for Committee´s members by January 1, 2022.

[6] During the last three years, the BSD staff has comprised eight persons and the Head of Banking Supervision.

[7] E.g., in finance and in International Financial Reporting Standards (IFRS), which are mandatory for banks in Lesotho.

CBL must remain alert to liquidity difficulties in all four banks, to take early action as appropriate.

Table 1. Summary of Main Recommendations

	Recommendations	Priority	Suggested Time frame
1.	Finalize Guideline(s) for banks on Basel II Pillar 1, adopting the definition and prescriptions for capital set by Basel III, as guided by the mission.	High	June 2019
2.	Guideline(s) on Pillar 1 to go out to banks for consultation.	High	July 2019
3.	Banks´ send written comments on the Guideline(s) on Pillar 1; CBL conduct workshops with the banks.	High	August 2019
4.	CBL to conduct a QIS-like calculation applying Basel II/III capital rules to the balance sheets of the four banks -at the consolidated level- as of June 30, 2019, to anticipate likely impact of Basel II implementation.	High	September 2019
5.	CBL to issue Final Guideline(s) for banks on Basel II Pillar 1.	High	October 2019
6.	Banks´ parallel-run to come to an end.	High	December 31, 2019
7.	Final Guideline(s) on Basel II Pillar 1 to become effective.	High	January 1, 2020
8.	First quarter-end Pillar 1 prudential reports to be submitted by the banks to the CBL.	High	March 31, 2020
9.	Issue enhanced Guideline for banks on Basel II Pillar 2 ICAAP, and internal Guideline for supervisors on Pillar 2 SREP, developing an internal process to set up additional capital requirements based on risks not covered in Pillar 1, as guided by the mission.	High	March 2020
10.	Banks to submit first complete Board-approved ICAAPs.	High	June 2020
11.	Issue Guideline for banks on Basel II Pillar 3 as recommended by the mission	High	Q3 2020
12.	Banks first Pillar 3 disclosures submitted to the CBL.	High	Financial year ending on Dec. 31, 2020
13	Banks' complete set of audited annual financial statements –including Pillar 3 disclosures- made available to the public on the banks´ and on the CBL´s websites.	High	Financial year ending on Dec. 31, 2020
14.	CBL to hold one-on-one meetings with banks on their implementation of IFRS 9 ECL provisions and their prudential treatment.	High	Q3 2020 TA may be required

	Recommendations	Priority	Suggested Time frame
15.	CBL to initiate the process necessary to obtain any amendment to the FIA that may be necessary to give the CBL an increased ability to make prudential rules without having to seek outside approvals or future amendments to the Act.	High	2020
16.	CBL to revisit implementation of a Capital Conservation Buffer, a Leverage Ratio, and Basel III Liquidity Standards.	Medium	Q2 2021
17.	CBL to review its 2010 RBS Framework to upgrade it, to feed it with Basel II Pillar 2 results.	Medium	Mid-2020 A TA may be required
18.	CBL to get prepared for challenging IFRS in force in the banks (e.g., IFRS 9), and their prudential treatment for capital purposes.	High	Mid-2020 A TA may be required

I. Introduction: Purpose of the Mission

1. **The current mission was designed to further assist the authorities in the implementation of Basel II and select elements of Basel III, as a follow up to the earlier March 2017 AFS mission.** The main objective of the mission was to help the CBL finalize the Draft Guidelines to banks on Pillar 1; assist in implementing Pillar 2, with attention paid to the SREP and the banks´ ICAAP; and to assess the current disclosure regime in view of the Pillar 3 new framework.

2. **The mission evaluated the progress made by the CBL in drafting and issuing final guidelines for the implementation of Basel II.** In addition, the mission assessed the progress made on other aspects relevant to the implementation, such as the evaluation of the banks´ first submission of a draft ICAAP report and their supervisory assessment, and on capital requirements.

3. **The mission met with the staff and management of the BSD.** The mission had extensive discussions with the BSD staff, which allowed for very candid exchanges of views.

4. **The mission met with the Acting Director of the Banking Supervision and Financial Stability Department and Head of the Banking Supervision Division and discussed its most relevant findings.** The mission highlighted the major findings and provided suggestions on the way forward, proposing a granular timeline and strategy to complete the implementation of all three Pillars of Basel II. The mission also highlighted these and other important recommendations to the CBL´s Governor.

5. **The mission imparted a series of sharp focused seminars on Pillars 1, 2 and 3 of Basel II and their implementation challenges to the BSD staff.** The mission enhanced the BSD capabilities on assessing Pillar 1 risks and prudential capital; on Pillar 2 ICAAP and SREP; and on the new Pillar 3 framework and implementation. The mission raised the BSD awareness regarding BCBS ´s revisions to the standardized approaches for credit and operational risks and other related reforms, for consideration in future due time, and enjoined the CBL to keep abreast of them.

6. **Developing capabilities of the supervisory staff in critically assessing the banks´ ICAAP documents to be able to challenge them constructively was another important objective of the mission.** The supervisory staff was trained to assess capital adequacy under Pillar 2, and to critically evaluate the ICAAP documents of banks; the mission aimed to further help supervisors get a better grasp of the SREP and its role within the Supervisory Review Process (SRP) and the RBS, to capture other relevant risks (i.e.: interest rate risk in the banking book-IRRBB, concentration risk, etc.), and to decide on add-on capital and other supervisory measures.

7. **The mission called the BSD´s attention to the implementation of Pillar 3, in the context of its recent revisions by the BCBS.** Implementation of Pillar 3 in a gradual manner, as deemed appropriate in the context of Lesotho, was another area of work for the mission.

8. **The mission inquired about the CBL's current plan for completion of implementation of Basel II and provided input and guidance on the way forward.** The mission recommended the immediate issuance of the final Guideline(s) on Pillar 1, with suggested changes, and proposed a granular timeline and strategy for implementing Pillars 2 and 3 too.

9. **The remainder of the report is structured as follows: Section II** summarizes the regulatory framework for banks in Lesotho and the implementation of the Basel II framework; **Section III** contains the findings of the mission and; **Section IV** sets out the key observations and recommendations of the mission.

II. Regulatory Framework for Banks and Implementation of the Basel II Framework in Lesotho

The Banking Sector

10. **The banking sector remains small and comprises four commercial banks offering traditional personal and corporate banking services through branches around the country.** Total assets of the four banks were about USD 1.2 billion as of December 2018, representing 48 percent[8] of the country´s GDP as of that date. Total staff complement of the four banks remained at the December 2016 level of around 1700.

11. **The sector is largely foreign-owned.** Three banks[9] are subsidiaries of South African banks and the fourth, Lesotho PostBank, is the only domestic bank, fully owned by the Government of Lesotho. The three foreign banks together accounted for 92 percent of the banking sector assets and 91 percent of total deposits, as of December 2018. This significant foreign presence represents a systemic vulnerability from external shocks that necessitates CBL attention. There are no secondary financial markets in the country.

12. **Banks owned by South African banks operate as full subsidiaries.** Foreign banks do not operate as branches but are incorporated as full subsidiaries. Typically, they use their parents´ expertise where local expertise is not available, and are subject to their reporting requirements. Assessing the effectiveness and soundness of the local boards and senior management remains a challenge for the BSD.

13. **The banking sector has expanded since 2016, remaining profitable too**. During the period December 2016[10]–December 2018, total banking assets increased by about 33 percent and

[8] Based on data provided by the CBL.

[9] They are the Standard Lesotho Bank (80 percent South Africa´s, 10;4 percent Stanlib Lesotho Ltd.´s (a multi-specialist asset manager administering assets for about USD 42 billion), and 9.6 percent the Government of Lesotho´s), and the First National Bank-FNB Lesotho and Nedbank Limited South Africa (both 100 percent South Africa´s).

[10] Date of the data evaluated by the previous 2017 TA mission.

loans and advances by 17 percent; however, exposures of foreign subsidiaries to South African banks, by way of balances held with them, went up by about 70 percent.[11] During the same period, total liabilities of the sector increased by 24 percent, namely as deposits went up by 39 percent. Capital was up 28 percent due to increased retained earnings, and net income increased by 6 percent.

14. **Overall, the banking sector remains highly concentrated and well capitalized.**[12] The largest foreign bank[13] held about 53 percent of the total banking sector assets, 56 percent of total loans to customers and 54 percent of total deposits as of December 2018.[14] As per data provided by the CBL, the banking sector regulatory CAR was around 18 percent[15] as at the end of December 2018, on average.

15. **Customer deposits are the predominant liability of the banks while loans to customers represent a smaller percentage of total assets.** Deposits ranged from 73 percent to 83 percent of liabilities across the four banks, as of December 2018; loans to customers varied from 30 percent to 48 percent of total assets as of the same date, with the domestic bank holding loans for the highest rate of 48 percent of its total assets. Balances due from banks in South Africa and from local banks represented the second largest asset category held by the banks, including by the government-owned bank, ranging from 10 percent to 41 percent and from 1 percent to 50 percent respectively, as of December 2018.

16. **The share of foreign assets at banks in South Africa was larger than cash, deposits with the CBL and treasury bills altogether.** The CBL monitors the banks' liquidity positions regularly; as a result, the mission views that making capital enhancements should be the CBL priority, given that its limited resources would not enable it to develop a Basel III-type liquidity framework concomitant with the implementation of Basel II.

17. **Bank lending is concentrated.** Personal loans and mortgages make up 58 percent and 20 percent of the four banks′ lending portfolios, respectively; banks remain thus significantly exposed to the financial health of private households.

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[11] Posing new challenges that require CBL attention.

[12] While there can be many factors distorting the quality of banks' capitalization, most of these would not be present in the banks in Lesotho due to their undertaking of many traditional banking business. Under provisioning for bad loans could surface as a problem if the new International Financial Reporting Standard-IFRS 9′s Expected Credit Losses (ECL) model proved loans quality low. Despite the CBL monitors non-performing loans (NPL) and provisions, it must remain vigilant as to the impact of the new provisions model on the prudential capital of all four banks.

[13] Standard Lesotho Bank.

[14] Followed by the second largest, with about 25 percent of total banking assets, 20 percent of total loans and 23 percent of total deposits.

[15] Figures provided by the CBL and calculated as per the Basel I; figures calculated as per Basel II capital requirements were not available by the time of this visit.

18. **From a prudential perspective, the government-owned bank will necessitate supervisory handholding.** The bank's operations, originally centered on the under and un-banked rural and urban areas, have expanded into retail and business in recent years, with more focus placed on micro, small and medium enterprises. The bank is relatively small in size, although its total assets have almost doubled to about USD 102 million during the period December 2016- December 2018. The bank´s CAR was 16 percent (as per Basel II) as of December 2017,[16] ranking the second most profitable bank in Lesotho. The bank submitted its first ICAAP report in mid-2018, as all three foreign subsidiaries did; however, it took more time and consultations with the BSD for the public bank to achieve its final draft.[17] The ICAAP revealed that the bank has been gradually issuing new banking products (namely, unsecured personal loans) and increasing its credit risk appetite to achieve a higher market share. The bank´s deposits are predominantly overnight and demand, majority government-owned deposits, for which reason the bank seeks to grow deposits outside Government, to dilute the high concentration risk, overtime. The bank has expressed its intention to grow aggressively in electronic products and enablers, and to secure credit lines with the other three commercial foreign banks, although its perception is that the foreign subsidiaries are reluctant to deal with it. The bank´s liquidity policy mandates that additional capital be held for liquidity purposes, above the Basel II capital requirement, which adds pressure to Lesotho PostBank if it were in a situation of not having capital enough to cover all risks taken. Further, the headroom between the bank's capital and Basel II capital requirements could erode overtime, given the bank´s statutory limitation to increase capital up to the amount of its annual operating profits. The mission noted that the previous 2017 mission got no indications that there had been government interference in the bank´s management, or that its operations were not prudential, given its size and market niche. However, the new twists evidenced by the bank´s draft ICAAP report flag important challenges to the bank´s implementation of Basel II, which necessitate immediate supervisory attention and guidance to the bank particularly on how to understand and manage risks and how to plan and provide for regulatory capital (under Basel requirements) based on these risks.

Regulatory Framework for Banks

19. **The CBL's powers to authorize, regulate and supervise banks are set in the Financial Institutions Act (FIA) of 2012.** The Act enables the CBL to set prudential requirements, including a minimum CAR, or to modify it by way of regulations or instructions for individual banks. However, the Act contains language and methodology that belong to the Basel I framework; as a result, unless the FIA is amended by Parliament, it poses some limitations to the CBL's ability to be "fleet footed" in its supervisory processes.

20. **The CBL 2010 Risk-based Supervision (RBS) Framework and the 2016 Risk Management Regulation are the key regulatory pieces for risk-based supervision of banks.** The mission is of the view that the CBL will have to enhance its RBS-framework to get it fully leveraged by the Pillar 2 ICAAP and SREP, for which it will necessitate TA. Further, the CBL

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[16] This level of capital still provides for a good buffer above the minimum legal capital of 8 percent.

[17] The bank, at the request of the CBL, resubmitted a second draft ICAAP report late in 2018.

necessitates to improve its supervisory practices and risk culture, and the pertinent on and off-site work, to make them less compliance-like functions and truly risk-based supervision, understanding the essence of the relevant issues and their implications for the banks and the banking sector. The CBL will require TA to address these issues in the very short-run.

21. **Current regulations address major banks´ risks exposures and prudential capital.** Namely, Basel I risk-based capital requirements, lending limits, asset classification and provisioning, minimum local assets, merger and transfers of assets and liabilities, foreign currency exposure limits, consolidated supervision, liquidity management and corporate governance.

22. **Banks must maintain minimum liquid assets.** Banks must maintain a minimum reserve for liquidity of 3 percent of aggregated deposits, balances due to local and foreign banks, and other borrowed money (excluding funds from the Government and the CBL). Liquid assets cannot go below 25 percent of these same liabilities. The reserve balance and liquid assets must be computed daily and reported to the CBL weekly. These 2016 requirements apply to all banks in the country, at the individual and the banking group´s consolidated levels.

23. **Banks must prepare their annual financial statements as per full International Financial Reporting Standards (IFRS).** December 31 is the uniform year-end date for all four banks to prepare and submit to the CBL their audited annual consolidated financial statements. Despite mandated to do so; the financial statements are not published in full by the banks, in their -or in the CBL´s- websites.

24. **Banks must have their annual financial statements audited in accordance with International Standards of Auditing (ISA);** however, and despite not in the scope of this mission, while reviewing the financials of some banks, the mission found that there seems to be a local banking practice of having a Big 4 audit firm doing audit work for the bank but a small, domestic audit firm issuing and signing the Auditor´s Report. While it is clear for the mission that such audits have not been conducted in accordance with ISAs, and that the "audited" financial statements are not IFRS-compliant, the situation[18] reveals a malpractice that consist of having a Big 4 audit firm with no offices in Lesotho using a small Lesotho audit firm, which –otherwise- would not likely be able to perform as the auditor of a bank, to take full legal responsibility for signing the auditor´s opinion expressing compliance with IFRS and ISAs on financial statements that do not comply with these international standards. The mission flagged this situation to the Supervisor, who knew about it, highlighting its implications.

25. **Good home host relationships with the home Supervisor are critical for supervising banks in Lesotho, given the dominance of South African subsidiaries.** The mission reiterates that not only must the BSD have a very proactive relationship with the South African Reserve Bank (SARB), but also, review its Memorandum of Understanding (MoU) with the SARB to

[18] As surfaced, for example, while reviewing the audited financial statements of the government-owned bank as of December 31, 2017.

ensure that it is a relevant, effective supervisory instrument, given the systemic risk posed to Lesotho by the foreign banks.

26. **CBL trained staff may be sought after by the private sector, as Basel II is implemented.** The CBL must remain alert to secure retention of v skilled supervisors, as Basel II is implemented. The mission found that staff morale appears to be good and the staff eager to learn.

Implementation of the Basel II Framework

27. **The CBL will implement the Standardized Approaches to Basel II Pillar 1 risks.** Pillar 1 capital requirements Guideline(s) should be finalized shortly and become effective on January 1, 2020[19], with full adherence to Basel III´s definition and requirements of capital; the first Basel II quarterly prudential returns[20] should be submitted by the banks as of March 31, 2020.

28. **Implementation of Pillar 2 has commenced.** In December 2017, the CBL issued a Guideline for banks on their ICAAPs, with the purpose to provide guidance in developing an ICAAP document that comprehensively addressed all material risks that banks face; however, the guideline did not convey the CBL´s expectations on the ICAAPs, as part of the Pillar 2 SREP and, is more leaned toward formats and descriptions, at times,[21] risking that banks may regard an ICAAP as a compliance document[22] rather than as a process that must be fully integrated into their decision-making. Banks were requested to submit their first complete draft ICAAP documents in June 2018; all four banks submitted a draft but the government-owned bank was requested to resubmit another draft in late 2018. In December 2017, the CBL issued a Guideline for banks on stress testing and an internal Guideline on the SREP.

29. **Implementation of Pillar 2, and specifically of the ICAAP, is key for the CBL and the banks move beyond Basel I**. It is critical that the ICAAP be the work of the banks. While the subsidiaries of the South African banks have access to the resources of their parents, the government-owned bank will have to rely on its own. In any case, each bank's Board must remain the primary responsible for ensuring that the bank holds capital commensurate with its risk profile and has an appropriate risk management framework, remaining fully involved in the development and finalization of the ICAAP. Any use of parent banks or external consultants by foreign subsidiaries must be limited to providing guidance only, as otherwise, the ICAAP would not be a Board document.

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[19] Dates proposed by this mission, with which the BSD concurred.

[20] By way of prudential templates that the BSD should develop in due time.

[21] The Guideline mandates that banks use a detailed standard structure on their ICAAP documents.

[22] The CBL´s own SREP might become a compliance process as well, which should be inconsistent with a risk-based approach to supervision.

30. **Implementation of Pillar 3 should follow.** In December 2017, the CBL issued a Guideline for banks with basic disclosures for Pillar 3; however, the Guideline needs enhancement to be aligned to the revised Pillar 3 framework, as appropriate to Lesotho. Initially, the CBL should mandate selective Basel III disclosures, essentially on capital components and other prudential metrics, to be published with the banks audited financial statements for the financial year ending December 31, 2020, and subject, at a minimum, to the same level of internal review and control processes as the information provided in the audited financial statements.

31. **Banks appear to be prepared to implement the Basel II capital adequacy regime in a non-disruptive fashion.** All four banks have been working on Basel II implementation with the CBL during the last two years,[23] following the issuance of Guidelines or draft Guidelines, and have participated in QIS conducted by the CBL in August 2016 and May 2017. Discussions with the BSD staff and the mission´s own high-level review of the ICAAP documents submitted by two banks provided an opportunity to appreciate that banks are keen to move to Basel II and likely preparing for a 2019 full compliance. As a result, banks would support January 1, 2020 as a feasible date for Pillar 1 to become effective. The banks have already undergone their first Pillar 2 ICAAP and should be submitting Pillar 3 basic disclosures as of December 31, 2018, by the end of March 2019 too. Banks still face, though, very important challenges that will have to be tackled as they progress in their ICAAPs and upgrade their own capabilities and information systems.

32. **The CBL supervisory staff is becoming more prepared for implementation too.** However, supervisors need to advance their own supervisory skills. Supervisory work needs to be put on sounder footing as Basel II is implemented, becoming more analytical, forward-looking, risk-based, and less descriptive and compliance-based. The CBL´s RBS framework should undergo a critical review as the ICAAPs and SREPs unfold, as discussed by the mission with the BSD staff.

III. Findings of the Mission

33. **The mission evaluated the progress made by the CBL towards implementing Basel II in Lesotho.** The mission evaluated the steps taken by the CBL since the previous 2017 TA mission, the current state of drafting activities, and the skill levels at the BSD. Since Lesotho is not a member of the BCBS, it is not obligated to implement the Basel III standards; however, it will adhere fully to Basel III´s capital definitions and requirements to aligning its banks´ capital adequacy with best international standards and practices. The mission commends this effort.

34. **The mission noted very good progress towards implementation of Basel II.** The BSD had drafted guidelines for banks on Pillar 1 capital requirements, credit and operational risks (March 2018) and market risk (November 2018); guidelines for Pillar 2 ICAAP and stress testing (December 2017) and for the SREP (November 2018); and a guideline on basic disclosures (December 2017) for Pillar 3. Issuance of the Guidelines for Pillars 2 and 3 had followed a consultative process inclusive of all four banks. The CBL had also requested banks to submit a

[23] "Parallel-run" is for the CBL the transition period towards Basel II.

first draft ICAAP report by June 2018; however, the CBL did not carry out a SREP with input from the ICAAP reports received but, rather, a preliminary reading of the documents to check whether they met the requirements set in the ICAAP Guideline. The mission commends all these efforts. The current mission cannot comment on any potentially necessary legislative amendments to the current banking legislation to move beyond Basel I. The mission believes that Basel II may be implemented by way of guidelines; however, legislative amendments should be pursued with some urgency to empower the CBL to be fully able to make regulations on any supervisory matter by way of operational instruments that are within its total control.

35. T**he CBL had updated its plan for implementing Basel II, extending it out to 2020.** Since the previous 2017 TA mission, the CBL remained focused in drafting and then circulating to banks guidelines on all three Pillars, following up with workshops with the banks; completion of Basel II implementation was extended out to Q1 2020, although with no precise date for it becoming effective in the country.

36. **The mission looked at the CBL Drafted Guidelines for the three Pillars**. The mission discussed in detail all the Draft Guidelines for Pillar 1 and addressed their major aspects during the presentations that it conducted for the BSD supervisors, providing input and clarifying doubts to help finalize all them. The mission discussed the current Guidelines for Pillars 2 and 3 following the same approach, and provided guidance on how to strengthen them, building up supervisory skills in the process. Based on these discussions, the mission proposed a timeline and strategy for completing implementation of all three Pillars. The mission found that the BSD supervisors and management are aware of the need to develop their own capabilities and skills, particularly in respect of risks assessment and management, and in understanding what underlies the banks´ ICAAP reports.

37. **Based on discussions with the BSD, the mission would expect banks to have capital adequacy ahead of the minimum Basel II/III requirements, with capital almost entirely consisting of equity;** however, the CBL has not conducted a Basel I-Basel II gap analysis of prudential capital yet, or come up with its own estimates, which is critical to anticipate the likely impact of the implementation of Basel II in banks, and to identify potential needs for adjustments. The mission recommends that the CBL run a QIS-like calculation applying Basel II/III capital requirements to the balance sheets of the four banks, at the consolidated level, as of June 30, 2019, to meet these purposes and to inform the final Guidelines, and that it exercises caution in not rushing to allow any bank to have current capital positions to fall significantly. It would be reasonable to expect a reduction from the 2018 Basel I sector-wide capital level of 18 percent, although to a level still above the legal minimum 8 percent, as a result of the new risks introduced by Basel II for capital determination, the greater granularity and risk-sensitivity of the exposures to be risk-weighted, and the evolution of the banks´ balance sheets towards higher-risk exposures (e.g., unsecured personal and mortgage lending).

38. **Banks submitted their first draft ICAAP report in June 2018, following the CBL December 2017 ICAAP Guideline**. The Guideline is not prescriptive, but it is more inclined towards formats and descriptions, rather than towards emphasizing that the ICAAP must be fit for purpose. No explicit role for stress testing in the ICAAPs is recognized in the Guideline, which

only mandates banks to perform regular stress testing as per the CBL 2017 Guideline. It is very important that the Supervisor guide the banks on how they should examine their future capital resources and capital requirements under adverse scenarios, considering the results of forward-looking stress testing, when evaluating the adequacy of their capital. The major challenge for the CBL lay in integrating the analysis of the ICAAPs in the broader supervisory work, and in feeding—methodically—the findings into the CBL's RBS processes, including the intensity of the overall supervision of each bank, and the intensity of the supervision of a bank's individual activities. The CBL must further progress in developing its own view of each bank´s risks and capital needs.

39. **Arguably, Pillar 2 will provide the greatest opportunity to improve the strength and resilience of the banks in Lesotho, and the quality of the CBL supervision**. Risk management, governance processes and capital planning within the banks will evolve, as banks progress in their ICAAPs; the supervisors´ capabilities and SRP will become stronger as they journey the implementation of Pillar 2, becoming experienced and more skilled in assessing ICAAPs, and gaining rigor in their risk assessments and views. A progressive implementation of Pillar 2 will help achieve this and encourage banks to building up existing risk management and capital assessment practices, including the understanding of Lesotho´s issues and risks by the local boards and management of the foreign subsidiaries.

40. **The CBL issued a Guideline with basic disclosure requirements for Pillar 3.** The Guideline should better adhere to the key disclosure principles and practices of the revised Basel III Pillar 3, and introduce some minimum disclosure templates,[24] essentially, related to Basel III´s capital definition and requirements, to improve transparency and rigor of disclosures. The mission emphasized that the CBL must truly ensure that the banks' Pillar 3 report/disclosures published with the banks´ audited annual financial statements are made available in the banks´ websites[25] and subject, at a minimum, to the same level of internal review and control processes as the information provided in the audited financial statements.

41. **The mission does not see grounds for implementing any Basel III capital buffer at this time**. The current mission concurs with the 2017 mission in that there are strong arguments for the CBL to include a capital conservation buffer as part of its implementation of the Basel III capital rules, even as a tool to limit the ability of the South African parent banks to move capital out of their subsidiaries in Lesotho,[26] however, the current mission sees no urgency in setting a capital conservation buffer before the minimum Basel III capital requirements materialize. The mission flagged that the CBL must remain very vigilant as to South African parent banks moving capital outside the country, and as to all banks, including the government-owned bank, observing

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[24] Initially, these could be templates CC1 (Composition of Regulatory Capital), CC2 (Reconciliation of Regulatory Capital to Balance Sheets), KM1-Key Metrics and, LI1, LI2 and LIA (linkages between financial statements and prudential exposures) of the BCBS´s "*Standards-Pillar 3 Disclosure Requirements – Consolidated and Enhanced Framework*" (March 2017)

[25] And that they are made public in the CBL´s website as well.

[26] Although challenges remain for the government-owned bank.

the restrictions placed by the FIA on dividends distributions. As noted at the time of the 2017 mission, it would be premature to consider a countercyclical buffer in Lesotho at this time.

42. **The mission does not see urgency for the CBL to introduce a leverage ratio under Basel III, at this very time.** As recommended by the 2017 mission, the current mission concurs in that the rationale for a leverage ratio to complement a risk-weighted capital regime is not strong for banks operating in Lesotho, that undertake traditional banking activities, and whose risk-weighted assets are more reflective of their total on and off-balance sheet assets. The CBL should aim to implement a leverage ratio in due course, but not until the other capital elements have been bedded down.

43. **The CBL is not putting liquidity rules in place as part of its Basel II implementation.** The mission is of the view that the CBL should focus on migrating to Basel II before seeking to adopt the Basel III liquidity standards that do not lend themselves well to an environment like Lesotho´s, where there is no secondary market that banks can use to obtain liquidity. All three foreign subsidiaries rely on their parents´ support if under liquidity stress, and the government-owned bank expects government support if needed. As noted earlier, banks do not have large lending books relative to the deposits they hold; nevertheless, the CBL must remain very alert to liquidity difficulties, even in the foreign subsidiaries, to take early action as appropriate.

44. **The mission reminded the CBL that they have the option to incorporate the BCBS´s revisions to the securitization framework, counterparty credit risk, and market risk requirements, on a later date.** There is no immediate need for the Supervisor to rush working on them at this time, as they refer to activities that are either not present (i.e., securitization) or at a very low level in banks in Lesotho.

45. **The mission sensitized the CBL on the recent revisions to the standardized approaches for credit, market and operational risks completed by the BCBS.** It recommended the CBL to keep abreast of these developments, to consider them in due time.

46. **Training, retaining and hiring of good supervisors remain ongoing challenges for the CBL.** The mission conducted targeted training sessions that were able to build the understanding and skills of the supervisors, particularly on Pillar 1 and 2 challenges and the new Pillar 3 Framework. The BSD has limited resources (Total staff at BSD consists of 9 persons out of which 3 have less than 3 years of working experience in the Division) to deliver effective risk-based supervision and handle the work resulting from implementing Basel II in the country; the integrity of the BSD's core supervisory activities may be still at risk. BSD staff training and skills upgrade must be a top priority for the CBL´s activities and budget. In this regards, IMF TA missions can assist the BSD but they cannot be a substitute for on-the-job training. The mission encourages the CBL to remain alert as opportunities (e.g., short and medium-term secondments and aid funding) surface, for example, with other regional[27] and non-regional supervisors, to allow BSD staff to participate in on- and off-site supervision, particularly on Pillar 2 work. As is the case in many

[27] Other than the SARB, with which the CBL already maintains an ongoing home-host supervisor relationship.

jurisdictions, the CBL must keep in mind that banks find their supervisor to be a source of quality staff, for which staff retention should be reinforced by the CBL.

47. **IFRS 9 has become effective in 2018, which introduce significant challenges to both banks and the CBL.** The CBL did not require banks to estimate the impact of IFRS 9 ECL model on their accounting provisions and prudential capital and had not made its own estimate of the effects or discussed them in advance with the banks, to get everybody prepared for it. The impact will now become evident in the banks´ annual financial statements as of December 31, 2018, when the ECL model became effective. The Supervisor needs to understand all relevant issues related to IFRS 9 ECL model for provisions and their prudential treatment as regulated by the Basel Committee, including the exercise of national discretion for a transitional arrangement to phase-in the full impact on regulatory capital. The CBL necessitates to upgrade the BSD´s skills by incorporating some IFRS and finance experts to the team and remaining fully cognizant of IFRS implications on the banks´ balance sheets and prudential capital. TA may be required for this purpose in the very short-run.

IV. KEY OBSERVATIONS AND RECOMMENDATIONS OF THE MISSION

48. **The mission made a number of observations and recommendations for the implementation of Basel II.** The key observations and recommendations are recapitulated below:

49. **The CBL has made very good progress in its migration to Basel II.** The drafting activities, consultations with the banks, and the submission of the banks´ first draft ICAAP report are good testimony to this. From the regulatory perspective, the CBL has a very small supervisory staff, so that it is not possible to dedicate the staff resources that would be necessary for a fast migration; from the banking perspective, banks are resource constrained too, although they do not offer complex banking products and do not operate outside the country, appearing to be comfortably capitalized.

50. **Pillar 1 of Basel II should be ready to become effective on January 1, 2020.** The mission supports an immediate finalization and issuance of the final Pillar 1 Guideline(s) to become effective on January 1, 2020. This is a reasonable date for Pillar 1 that would be supported by the four banks too, as the culmination of a long ongoing process initiated in 2016, that provided sufficient lead time and communications for banks and the Supervisor to move forward, up to the current state. The CBL is adopting the definition and prescription of capital as stipulated by Basel III and the approaches for credit and operational risks as they stand currently.

51. **Pillar 2 should be implemented progressively, during 2020.** The mission recommends that Pillar 2 progress during 2020, with the first, formal (not draft), Board-approved ICAAP documents to be submitted to the CBL no later than by June 30, 2020; enhancements to the current ICAAP Guideline to banks, and to the supervisors´ Guideline on their SREP, will assist in addressing apparent weaknesses in the banks' risk management processes and corporate governance, and, in the BSD's supervisory skills and SREP.

52. **Pillar 3 implementation should ensue.** The CBL needs to enhance its basic disclosures Guideline to better align it to the revised Pillar 3, as deemed relevant as recommended by the mission, fully endorsing the Basel Committee´s principles and best practices. As part of Basel II implementation, Pillar 3 disclosure requirements could become effective and mandatory for publishing with the banks´ audited annual financial statements for the year ending on December 31, 2020. The CBL must require the banks to place their full audited financial statements on their websites together with their Pillar 3 Prudential report/disclosures. The CBL has not been conscientious in enforcing this type of requirements and in keeping its own website up-to-date. This does not reflect a good practice and does not facilitate the transparency that must be an integral part of bank supervision. The CBL has to take steps to rectify its own deficiencies and the BSD must still ensure that the banks meet their regulated obligations in respect of transparency.

53. **The CBL should be mindful of the small number of BSD staff, notwithstanding that it might be broadly commensurate with the small size of the banking sector.** The small number of staff poses severe limits to the extent of supervisory change that the CBL should transit, particularly while implementing Basel II. While the CBL must prioritize improvements to the regulatory framework, it must remain able to retain qualified staff and to attract new skills as needed.

54. **The BSD needs to get better prepared for challenging IFRS in force within the banks, and their prudential treatment for capital purposes**. As discussed earlier in this report, IFRS 9 is an example of very relevant challenges that require immediate attention and work from both banks and the Supervisor. The mission envisages that the CBL will need TA to train the supervisors and enhance pertinent skills on IFRS 9 and, to review pertinent regulation to banks for any necessary amendment or replacement.

55. **The FIA may require some amendment to enable the CBL gain necessary prudential regulatory powers.** A well-established, industry-wide practice gives the CBL the ability and stature to set bank minimum capital requirements and implement Basel II by way of guidelines. The mission supports this approach; however, it still recommends that the CBL seeks any legal instrument that may be needed on top of the Guidelines and works to achieving greater powers to be more "fleet footed" in changing capital and other prudential requirements as needed. The mission recommends that the CBL pursue amendments to the FIA as a matter of some urgency.