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Staff Country Reports

**Republic of Madagascar: Financial System Stability Assessment,
including Reports on the Observance of Standards and Codes on
the following topics: Banking Supervision, and Anti-Money Laundering and
Combating the Financing of Terrorism**

This Financial System Stability Assessment on the Republic of Madagascar was prepared by a staff team of the International Monetary Fund and the World Bank as background documentation for the periodic consultation with the member country. It is based on the information available at the time it was completed on April 17, 2006. The views expressed in this document are those of the staff team and do not necessarily reflect the views of the government of the Republic of Madagascar or the Executive Board of the IMF.

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INTERNATIONAL MONETARY FUND

REPUBLIC OF MADAGASCAR

Financial System Stability Assessment

Prepared by the Monetary and Financial Systems and African Departments

Approved by Ulrich Baumgartner and Abdoulaye Bio-Tchané

April 17, 2006

The main macro-relevant findings of the FSAP are:

- **The financial system appears to be relatively sound, although nonperforming loans, at over 11 percent, are a concern.** Banks are generally profitable, liquid, adequately capitalized and stable. Financial soundness indicators and stress tests confirm the relative soundness of the system. However, many bank borrowers are susceptible to external shocks, and the sector remains shallow and undiversified. Nonbank financial institutions are small, underdeveloped, and do not pose a systemic threat. Nevertheless, public pension schemes appear financially unsustainable, with potential fiscal consequences.
- **Implementation and enforcement of banking rules and regulations needs to be reinforced, although the framework is broadly adequate.** The Commission de la Supervision Bancaire et Financière (CSBF) faces serious challenges, including an implementation backlog, as well as additional responsibilities in microfinance supervision and AML/CFT. The insurance regulator lacks resources, skills and operational independence, while a regulatory framework for pension funds needs to be established.
- **Continuing uncertainty over the financial position of the Banque Centrale de Madagascar (BCM) threatens the effective exercise of monetary policy and adequate resourcing of the CSBF.** The BCM was insolvent at end-2004 and has reported operating losses over the last three years.
- **The financial system is not in a position to fully support economic development, in light of the low level of access to financial services.** Only 35 percent of low income households have access to depository services and 2 percent to credit.
- **The key requirements for financial sector development are sustained macroeconomic and political stability and the predictable rule of law.** Creating these conditions requires long-term commitment and planning. Without these foundations, it will be very difficult to significantly broaden and deepen financial intermediation, increase competition, or develop markets for longer-term finance.
- The FSAP therefore recommended measures to (i) upgrade regulation and supervision; (ii) deal with BCM's financial weakness; (iii) address other deficiencies in the financial infrastructure; and (iv) broaden access to financial services.

FSAPs are designed to assess the stability of the financial system as a whole and not that of individual institutions. They have been developed to help countries identify and remedy weaknesses in their financial sector structure, thereby enhancing their resilience to macroeconomic shocks and cross-border contagion. FSAPs do not cover risks that are specific to individual institutions such as asset quality, operational or legal risks, or fraud.

This Financial System Stability Assessment (FSSA) is based on joint IMF/World Bank Financial Sector Assessment Program (FSAP) missions to Antananarivo from April 19-May 3, and July 21-29, 2005.

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GLOSSARY

AML/CFT	Anti-Money Laundering and Combating the Financing of Terrorism
BIANCO	Independent Anti-Corruption Office
BCM	Central Bank of Madagascar
BCP	Basel Core Principles for Effective Banking Supervision
CAR	Capital Adequacy Ratio
CEM	Caisse d'Épargne de Madagascar
CFT	Combating the Financing of Terrorism
CIS	Central Intelligence Service
CPAC	Anti-Corruption Criminal Data System
CSBF	Banking and Financial Supervision Commission
CSLC	High Council on the Fight against Corruption
FIU	Financial Intelligence Unit
FMG	Malagasy Franc
FSAP	Financial Sector Assessment Program
FSI	Financial Soundness Indicator
FX	Foreign Exchange
GDP	Gross Domestic Product
LOLR	Lender of Last Resort
MdF	Ministry of Finance
MFI	Microfinance Institution
NPL	Nonperforming Loan
PEP	Politically Exposed Person
ROSC	Report on the Observance of Standards and Codes
SC	Security Council
SME	Small- and Medium-Size Enterprise
STR	Suspicious Transaction Report
UN	United Nations
RWA	Risk-Weighted Assets

EXECUTIVE SUMMARY

1. **Commercial banks dominate the financial sector, hold 84 percent of total system assets but offer only very basic savings and credit products to a select clientele.** All commercial banks are now foreign-owned, and the subsidiaries of three large internationally active French banks have a combined market share of around 65 percent of assets. In addition to being supervised by the *Commission de Supervision Bancaire et Financière* (CSBF), banks are subject to parental controls and supervision on a consolidated basis by the home regulators.

2. **Banks in Madagascar are generally profitable, liquid, adequately capitalized and stable, although nonperforming loans (NPLs), at over 11 percent, are a concern.** Financial soundness indicators and stress tests confirm the relative soundness of the system. However, many bank borrowers are susceptible to external shocks and the sector remains shallow and undiversified. Credit to the private sector stands at around 10 percent of GDP, and total banking assets are equivalent to around 25 percent of GDP. Nonbank financial institutions are small and do not pose a systemic threat. Payment services are slow, and intermediation margins are high.

3. **The insurance sector is underdeveloped and has been inadequately supervised to date, as the regulator lacks the requisite independence, skills and resources.** The sector is dominated by two state-owned companies. The third company is an insolvent mutual insurer which is currently under provisional administration. Insurance penetration is low.

4. **The three public pension systems, which cover less than 10 percent of the active population, appear to be fiscally unsustainable.** They need to be placed on a sound actuarial and financial footing to maintain confidence and to avoid future quasi-fiscal liabilities. Private pensions operate in a legal and regulatory vacuum.

5. **Access to financial services is still very limited.** Only 35 percent of low-income households (roughly 80 percent of the population) have access to depository services, and 2 percent to credit. Nevertheless, the microfinance sector has grown rapidly, especially during the last five years. During this period, the number of customers of financial cooperatives grew 28 percent per year, while deposits grew 62 percent and loans 36 percent. Banking supervision of microfinance institutions still has to become fully effective. Further development of the microfinance sector requires long-term donor assistance.

6. **The banking regulatory and supervisory framework is broadly adequate, although implementation and enforcement need further strengthening.** The CSBF has not functioned for several years, and faces challenges in the form of a backlog of actions as well as additional responsibilities in microfinance supervision and Anti-Money Laundering and Combating the Financing of Terrorism. Insurance regulators lack resources, skills and operational independence. The pension sector lacks a regulatory and supervisory framework.

7. **The weak financial position of the Central Bank of Madagascar (BCM) could undermine macro and financial policies and contribute to economic and financial instability.** According to the audited accounts over book year 2004, the BCM was insolvent. The weak financial position of the BCM complicates the effective conduct of monetary and exchange rate policies and can also impact the quality of financial sector supervision, as the BCM funds and staffs the CSBF. The authorities recognize the problem and have sought Fund TA to help lay the basis for sustained financial viability of the BCM.

8. **The primary obstacles to development of the financial sector lie in the poor operating environment for financial services, and significant deepening and broadening can only be expected when key conditions for financial intermediation improve.** Although macroeconomic and political stability have improved over the past years, earlier episodes of political and macroeconomic instability have dampened both the supply and demand for credit, and are reflected in the risk premium banks charge for credit. Access to credit is further constrained by deficiencies in contract enforcement, the lack of credit information sharing, and the limited use of financial statements in the nonfinancial private sector. Moreover, registration and enforcement of property rights and collateral are severely impeded by deficiencies in the legal framework, in land and pledge registries, and the judicial system.

9. **AML/CFT policies and practices are in an early developmental stage in Madagascar, and currently do not meet international standards.** While an AML/CFT law has been adopted, the necessary regulations and implementing procedures are not yet in place, and oversight by the authorities is not yet effective, although preliminary drafts have been approved by the CSBF and the industry has been consulted.

10. **The FSAP therefore recommended measures to (i) upgrade regulation and supervision; (ii) deal with BCM's financial weakness; (iii) address other deficiencies in the financial infrastructure; and (iv) broaden access to financial services (Box 1).**

Box 1. Key FSSA Recommendations

Regulation and supervision

- Many additional refinements are needed to banking rules and regulations, and the CSBF's action plan should be implemented as soon as possible.
- The CSBF should continue to monitor carefully the level of nonperforming loans as well as loans with guarantees from parent banks.
- A legal and regulatory framework for private pensions must be put in place.
- The actuarial soundness of the three public pension plans must be analyzed with a view to placing the plans on a sustainable financial footing.

Central bank issues

- Diagnose and remedy the underlying causes of negative equity of the BCM, and develop a plan to ensure its sustained financial viability (including remuneration at market rates of all government debt on the BCM's balance sheet, or re-assumption of this debt by the government).
- Statutory advances to the treasury should be strictly limited to a low percentage of average recurring revenue, and be promptly repaid.

Financial infrastructure

- A comprehensive program for legal, judicial and land and pledge registry reform should be started.
- Action must be taken to improve corporate financial data preparation and disclosure.
- A comprehensive credit information bureau is needed, accessible for all credit institutions.
- A task force should draft a feasibility study for payment system reform, including the legal framework and check clearing systems.
- The legal framework must be adapted to allow foreign banks to own foreclosed property.

Access to financial services

- A plan for long-term technical and financial assistance for the development of sound, sustainable and professional microfinance should be drawn up.

AML/CFT

- Regulations and procedures for the effective implementation of the AML/CFT Law should be issued, consistent with the best international practices.
- The Financial Intelligence Unit needs to be made operational, through issuance of guidelines and allocation of resources.
- Staff of all involved authorities, including all financial supervisory authorities, must be trained in the area of AML/CFT.

I. BACKGROUND

A. Structure of the Financial System

11. **The financial system in Madagascar is dominated by commercial banks (Figure 1 and Table 1).** All seven registered commercial banks are foreign-owned,¹ with three subsidiaries of large French banks (Crédit Lyonnais, Société Générale, and BNP-Paribas) accounting for around 65 percent of banking sector assets. Nonbank financial institutions (NBFIs) account for around 16 percent of financial system assets, and include insurance companies, pension funds, and several other institutions that are involved in microfinance. NBFIs are small and do not pose systemic risks. Access to financial services is still very limited, with only 35 percent of low-income households having access to depository services and 2 percent to credit.

B. Potential Sources of Vulnerability

12. **Although growth has accelerated in recent years, Madagascar is susceptible to frequent exogenous shocks.** The economy grew by over 5 percent per year in real terms in 2003-05, and real growth is expected to average 6 percent per year over the medium term. However, the country remains vulnerable to: (i) weather-related shocks, such as the cyclones which severely damaged the country's infrastructure and rice crop in 2004; (ii) price shocks to both key commodity exports, such as vanilla, and imports, such as petroleum products; and (iii) trade policy shocks, such as those resulting from the termination of the Agreement on Textiles and Clothing in early 2005 and the expected termination of the third party provision under the African Growth and Opportunity Act in 2007.

13. **Against the above background, economic developments in Madagascar have felt the effects of significant political turmoil.** The political crisis of 2001-02 brought a sharp downturn in economic activity, with real GDP falling by around 13 percent in 2002. While the banking sector continued operations throughout the crisis and ensured the continuity of the payments system, the quality of the banks' loan portfolio deteriorated significantly.

14. **Recent macroeconomic performance of Madagascar has been broadly satisfactory, buoyed by strong performance in the agricultural, construction, tourism, transport, and export processing zone sectors; however, the external sector remains weak.** The current account deficit widened considerably in 2004, despite the sharp depreciation of the exchange rate. Furthermore, the limited data available for 2005 point to a considerable weakening in the value of vanilla exports, due to a plummeting in world vanilla prices, though, on the positive side, performance in the export processing zones, including garments and tourism-related sectors, seems to be good.

¹ At the time of the FSAP missions, the smallest bank in the country was domestically owned. That bank had a weak capital position and required immediate action by the authorities. Following the mission's recommendations, the authorities set a deadline for recapitalization of this bank, which effectively took place in August 2005, through acquisition by a new foreign shareholder.

Figure 1. Features of the Financial Sector

Banks form the core of the financial sector...

... and have been growing albeit remain relatively small

3 subsidiaries of French banks account for around two thirds of the system

Share in total bank loans

Share in total bank deposits

Around half of banking assets are liquid instruments ...

Composition of bank assets

... while the credit portfolio is quite diversified

Composition of bank loans

Sources: BCM and CSBF.

Table 1. Structure of the Financial System, 2003-2004

	December 2003				December 2004			
	Number	Total Assets (In billions of FMG)	In percent of total	In percent of GDP	Number	Total Assets (In billions of FMG)	In percent of total	In percent of GDP
Banks	7	7,648	81	23	7	9,996	84	25
Private banks	7	7,648	81		7	9,996	84	
Domestic	1	42	0		1	80	1	
Foreign	6	7,607	81		6	9,916	83	
Insurance and Pension Funds	5	1,105	12	3	4	1,317	11	3
Insurance Companies 1/	3	721	8		2	793	7	
Pension Funds 2/	2	384	4		2	524	4	
Other Nonbank Financial Institutions	12	686	7	2	12	556	5	1
Finance Companies	2	34	0		3	62	1	
Microfinance Companies (licensed)	5	130	1		5	165	1	
Other 3/	5	522	6		4	329	3	
Total Financial System	24	9,439	100	28	23	11,869	100	29

Sources: BCM, CSBF, and Ministry of Finance.

1/ Figures for insurance available only for two companies ARO and Ny HAVANA 2004.

2/ Caisse de retraite de la Caisse Nationale de Prevoyance Sociale (CNaPS) and FUNRECO (private pension Fund).

3/ Caisse d'épargne, CCP and three unlicensed financial (microfinance) cooperatives. Information for Caisse d'épargne not available for 2004.

15. The operating environment for financial services shows considerable structural weaknesses and is not conducive to a robust development of the financial sector.

Macroeconomic improvements and political stability have been relatively recent.

Weaknesses persist in the legal, judicial and accounting frameworks, financial information on enterprises is available only to creditor banks, and integrity and governance concerns persist. Banks' risk perceptions, and relatively high levels of nonperforming loans, lead to high-risk premiums and correspondingly high lending rates. Payment systems are slow.

II. STRENGTHS AND VULNERABILITIES OF THE FINANCIAL SYSTEM

A. Commercial Banks

Financial soundness indicators

16. The financial soundness indicators show a generally adequately capitalized, liquid and profitable banking system, although NPLs remain a concern (Table 2). The overall capital adequacy ratio (CAR) is well above the required minimum of 8 percent. In late 2004, the CAR of one large foreign institution fell slightly below 8 percent, as a result of a rapid increase in loans to the private sector issued in 2004, but this bank subsequently increased its capital, and its CAR rose to above 10 percent in March 2005. Solid bank profits are mainly due to high net interest income, supported by the predominance of unremunerated or low yield short-term deposits. Over recent years, banks have had large amounts of excess liquidity, on average 24 percent of required reserves during 2004, mainly for lack of viable lending opportunities.

17. Loan quality of commercial banks remains a concern. The ratio of NPLs to total loans remains high, although declining (11.4 percent as of December 2004, compared to around 20 percent as of December 2002). The ratio of provisions to NPLs is low at 49 percent.² The NPL problem is compounded by the lengthy legal procedures for claim recovery, the lack of training of the judiciary in financial matters and weak financial information on borrowers.

18. Although diversification over sectors is adequate, corporate credit overall is concentrated in a relatively small number of borrowers. Bank loans to the ten largest corporate clients account for 24 percent of the total corporate loan portfolio. In comparison to countries at similar levels of development, the sectoral distribution of credit is reasonably diversified, with the largest concentrations in the industrial and trade sectors.³ Credit to households is low but growing rapidly.

² Based on staff calculations. The authorities calculate NPLs net of accrued interest on NPLs, which results in a higher provisioning ratio of 66 percent (Table 2).

³ About 10 percent of bank lending to domestic borrowers is covered by guarantees from the parent banks, thus minimizing the risk and allowing the banks to bypass the large exposure rule for single borrowers.

Table 2. Financial Soundness Indicators for the Banking Sector, 2000-04

(In percent unless otherwise indicated)

	2000	2001	2002	2003	2004	Adj. ¹
Regulatory Capital						
Regulatory capital to risk-weighted assets	14.1	15.7	15.3	14.0	11.6	11.9
Tier 1 capital to risk-weighted assets	13.9	14.8	14.2	12.8	10.5	9.9
Capital to assets ratio	7.1	7.0	6.7	6.8	6.2	6.3
Sectoral distribution of loans to total loans						
Industries	30.3	28.4	25.3	27.0	32.3	32.3
Agriculture	16.7	19.8	22.0	22.7	14.5	14.5
Trade	29.4	29.1	29.7	23.7	21.7	21.7
Construction	5.7	5.6	5.0	5.3	6.5	6.5
Transport	3.2	3.4	3.0	2.9	3.1	3.1
Households	3.7	5.5	6.5	9.6	12.3	12.3
Others	11.0	8.2	8.6	8.8	9.6	9.6
Asset Quality						
FX-denominated loans to total loans	10.2	9.1	6.4	5.9	4.4	4.4
NPLs to total gross loans	8.6	10.4	19.6	16.7	11.4	11.4
Provisions to gross NPLs 3/	75.0	74.1	56.3	62.2	66.3	49.4
NPLs net of provisions to regulatory capital	7.7	9.8	36.0	25.9	19.5	40.6
Large exposures to Tier 1 capital	163.0	125.1	131.9	100.0	123.0	153.3
Spread between lending and deposit rates	14.5	12.1	11.1	10.8	12.1	12.1
Earnings						
Return on assets	3.2	2.1	0.9	2.4	3.0	3.0
Return on equity	35.7	27.1	11.8	31.9	38.8	54.2 ²
Interest margin to gross income	68.6	66.3	68.4	67.0	60.6	58.9
Noninterest expenses to gross income	52.9	58.3	63.1	54.9	50.2	48.8
Personnel expenses to noninterest expenses	32.9	32.2	31.8	33.4	31.8	31.8
Liquidity						
Liquid assets to total assets	37.9	46.2	52.8	51.8	48.5	48.5
Liquid assets to short-term liabilities	58.4	66.2	73.5	69.4	62.9	62.9
Deposits to total (noninterbank) loans	172.1	201.3	226.9	202.5	192.0	192.0
FX-denominated liabilities to total liabilities	23.3	18.1	19.6	19.7	25.0	24.9
Sensitivity						
Net open position in FX to capital	11.5	9.7	13.3	9.2	8.2	8.2
Net open position in equities to capital	0.0	0.0	0.0	1.0	3.5	3.6

Sources: BCM and CSBF.

1/ FSIs recalculated by the staff for end-2004 in accordance with the Compilation Guide on FSI (www.imf.org).

2/ Net income divided by bank equity.

3/ Recalculated from the balance sheet as specific provisions divided by gross NPLs. The denominator of this ratio as calculated by CSBF staff was net of accrued interest on NPLs, which led to a higher ratio.

Stress tests

19. **Results of the stress tests conducted by the mission suggest that credit risk is the main risk facing the banking system (Table 3).** In the event of a severe shock to the asset quality (e.g., a doubling of NPLs for each individual bank, or a migration of 10 percent of outstanding loans to more severe classifications), the banking system as a whole would lose more than 30 percent of its capital base. The impact on the overall capital adequacy ratio would be slightly smaller but still significant as Tier I capital accounts for around 90 percent of the total regulatory capital. For the majority of banks, even substantial exchange rate or interest rate shocks would not have serious impacts on capital.

20. **Given the small size and particular structure of the formal commercial banking system—i.e., significant foreign ownership—the cost of recapitalization could most likely be borne by the banks or their parent institutions.** A doubling of NPLs would correspond to the level recorded in the aftermath of the political crisis in 2002, and would require recapitalization of around 0.1 percent of GDP. The worst case macroeconomic stress test scenario would require broadly 0.6 percent of GDP. Moreover high profitability will help cushion any recapitalization effort.

Systemic liquidity and lender of last resort

21. **The interbank money and foreign exchange markets function reasonably well, although chronic excess liquidity reduces its necessity and is a disincentive for its development.** The market would benefit from introduction of standardized instruments, such as repos and reverse repos, with a standard contract (“*contract cadre uniforme*”) agreed upon by all market participants. As a result of restrictions on loans in foreign currency, banks hold a large share of their foreign assets in the form of correspondent accounts with parent banks or other banks overseas, and are unlikely to face shortages of foreign exchange liquidity.⁴ Earlier missions had identified a need for counterparty risk management in the money market, in order to mitigate the segmentation of the market, and the authorities have requested technical assistance in this area. The lack of suitable borrowers also contributes to banks’ high liquidity.

22. **The Treasury has been an important contributor to the liquidity in the system, through the use of statutory advances from the BCM, in the amount equal to 15 percent of previous year’s budget receipts.** In 2005, the use of this facility has been limited voluntarily to 10 percent of budgeted receipts. Such advances should be strictly limited to a low percentage of average recurring revenue and be promptly repaid. The BCM has sufficient instruments to manage liquidity in the system: reserve requirements, central bank benchmark rates, open market operations with T-bills, two automatic refinancing windows for 24-hour and 2-10 day credit, at penalty rates of 5 and 7.5 percent above the BCM base rate. However, the instruments have not always been used in a timely and efficient manner.

⁴ Banks are only allowed to make loans in foreign currency for trade purposes, and only for a period of up to 12 months. At the same time, there are no restrictions on accepting foreign currency deposits.

Table 3. Summary Results of the Stress Tests

(Data per December 31, 2004)

Test	Change in Tier I capital resulting from hypothetical shocks (in percent of original Tier I capital)				
	Group 1 1/	Group 2	Groups 1+2	Worst Bank	Best Bank
Baseline Tier I Capital (in percent of RWA)	9.4	14.0	10.5	6.4	31.4
A. Sensitivity analysis					
Credit Risk					
Shift in assets 2/	-21.2	-12.5	-18.2	-37.1	-0.1
Increase in NPLs by 100 percent	-49.0	-31.1	-43.0	-97.0	-0.1
Increase in the ratio of NPLs to total loans to 20 percent 3/	-24.7	-47.5	-32.3	-76.7	-13.9
10 percent of outstanding loans become NPLs	-36.8	-39.3	-37.7	-55.4	-17.9
Exchange Rate Risk					
Depreciation by 30 percent 4/	0.8	2.4	1.3	-21.5	4.5
Depreciation by 50 percent	1.3	4.0	2.2	-35.9	7.5
Appreciation by 10 percent 4/	-0.3	-0.8	-0.4	-1.5	7.2
Interest Rate Risk					
Increase in FMG rates by 500 points 5/	-4.1	-5.0	-4.4	-6.6	3.5
Increase in FX rates by 200 points	-0.2	-0.5	-0.3	-0.8	-0.1
B. Scenario Analysis 6/					
Scenario 1	-28.7	-30.0	-29.1	-42.4	-14.2
Scenario 2	-55.4	-58.5	-56.4	-82.6	-27.2
Scenario 3	-77.0	-81.2	-78.4	-114.8	-38.0

Sources: CSBF; and Fund staff estimates.

1/ Group 1 includes three French-controlled banks, and Group 2 includes the other four banks.

2/ 50 percent of current bank holdings of government securities and placements with other banks are assumed to be shifted toward loans.

3/ The magnitude of such a shock would correspond to the level recorded in the aftermath of the political impasse in 2002.

4/ The magnitude of these shocks was similar to the largest monthly depreciation and the largest monthly appreciation of the FMG against the Euro and the U.S. dollar observed over the last 10 years.

5/ The magnitude of such a shock would be similar to the increase in the central bank main rates in May-July 2004.

6/ Scenario 1 is based on an assumption of a moderate shock to the agriculture sector (25 percent of all agriculture loans become nonperforming, the FMG depreciates by 20 percent, and the FMG interest rates increase by 300 bp). Scenario 2 is based on an assumption of a significant shock to the agriculture sector (50 percent of all agriculture loans become nonperforming, the FMG depreciates by 20 percent, and the FMG interest rates increase by 300 bp). Scenario 3 is based on an assumption of an economy-wide shock (10 percent of all outstanding loans become nonperforming, the FMG depreciates by 30 percent, and the FMG interest rates increase by 500 bp).

23. **There is an active market for T-bills, but better coordination between the BCM and the Treasury is needed on the timing and amounts to be issued.** T-bill issuance is primarily dictated by budgetary needs, and does not always take sufficient account of liquidity conditions in the market. Forecasting of the systemic liquidity situation needs improvement as well. The Treasury also has access to the abovementioned statutory advances, further decreasing the effectiveness of T-bills as a monetary policy instrument. There is also a need to develop a comprehensive public debt management program.

24. **The BCM has the necessary instruments to provide liquidity to the banking system, but its weak financial condition could limit its ability to do so.** In practice, banks rely mainly on interbank liquidity. In addition to the repo facility, the BCM can provide lender-of-last-resort (LOLR) support. The LOLR support is intended to function automatically, but every transaction needs to be approved by BCM management, which can lead to undesirable delays in emergency situations.

Banking supervision

25. **While a broadly adequate set of rules and regulations has been put in place, enforcement by the CSBF needs to become more effective, and the supervision of microfinance and AML/CFT responsibilities will create additional burdens.** Furthermore, even as the CSBF is being reinforced, its operations could be adversely affected by the weak financial position of the BCM. Based on the Banking Law of 1996, the CSBF supervises commercial banks as well as finance companies and microfinance institutions.⁵ Until March of 2005, the Commission had not functioned for several years, as a result of unfilled vacancies on its Board. This led to a backlog of regulation, administrative decisions and reports as well as an inability to take effective enforcement action. The Board vacancies have recently been filled, however, and a long agenda of overdue activities awaits the newly constituted CSBF.

26. **The FSAP mission was presented with an action program of the CSBF, covering a broad range of measures to strengthen supervision.** These include revision of the banking law, introduction of International Accounting Standards (AIS), regulations on interest rate risk and liquidity, introduction of a program for on-site inspections, stress testing, issuance of new prudential regulations, corrections in the capital definition in conformity with Basel I and increase in the minimum risk-weighted capital adequacy ratio from 8 to 10 percent. The self-imposed deadlines in the plan show heavy bunching in the final months of the annual work program. This does not seem realistic, also because the newly hired staff will not be fully effective for some time.

27. **Although a formal assessment of compliance with the Monetary and Financial Policies Transparency Code was not performed, banking supervision policies and practices overall seem sufficiently transparent for interested parties.** This is partly a result of the small size of the system and easy contacts between the authorities and banks. On

⁵ See the Report on Observance of Standards and Codes in the Annex for more discussion of the status of the banking supervision in Madagascar.

the other hand, the introduction of new foreign exchange regulations in the Spring of 2005 was not subject to a meaningful consultation process and should be reviewed. In principle, an annual report is issued by the CSBF on its activities and on the condition of the banking sector, but since its creation in 1995 the CSBF has issued only three reports, most recently in 2001.

Remedial measures and safety net

28. **The CSBF has an adequate range of sanctions to enforce legal and regulatory standards as well as improvements in the banks' conduct of business.** These include requests for explanations by the bank, warnings and binding instructions, removal of management, the appointment of a provisional administrator for a maximum of six months (once renewable), and withdrawal of the banking license, leading to immediate liquidation. Withdrawal of a banking license can be suspended by the Minister of Finance for eight days during which the CSBF must review its decision. Pending this period, the CSBF may take conservatory measures. The Chairman of the CSBF also has the authority to "invite" shareholders or members for financial assistance to the bank. He may also request other banks, on a nonmandatory basis, to participate in a life-boat operation.

29. **Currently, no deposit insurance system exists in Madagascar, although the authorities are debating its introduction.** Issues being debated include legal personality for the insurance fund, mandatory membership for all banks, risk-based contributions, no coverage of wholesale clients or foreign exchange deposits, ceilings per client, per institution and authorization for the fund to intervene in a bank. It is important that a system be properly structured to limit moral hazard and potential quasi-fiscal liabilities. A well designed system could help protect small depositors and thus provide an incentive to increased participation in financial intermediation.

30. **Of the approximately 140 "caisses" of the mutualist credit institutions (around 4 percent of banking system assets), around 80 (three networks) benefit from mutual solidarity arrangements, assuring assistance from other entities in the organization.** Two of the five mutualist networks ("reseaux"), totaling around 60 "caisses," do not participate in such solidarity arrangements, but are considering establishing a guarantee fund. In practice, there are serious concerns with regard to the safety of the mutualist groups, in particular as three out of five networks have not been licensed and are therefore not under supervision. The process to license these networks has been ongoing for many years, and has not been finalized for unclear reasons. The licensing and placement under supervision by the CSBF of these networks should be finalized immediately or the networks closed.

B. Insurance Companies

31. **With only three companies in operation, the insurance industry remains underdeveloped, even when compared to most other markets in the region (Table 4).** A sound and stable financial situation and the establishment of an efficient regulatory and

Box 2. Financial Situation of the BCM

According to the audited financial statements for 2004, the BCM had negative equity equivalent to US\$26 million, and reported operating losses over each of the last three years. In 2004, the losses of the BCM amounted to the equivalent of US\$14 million (or 1.5 percent of its total assets). The losses have been largely due to the absence of remuneration on a significant amount of loans to the government, write-off losses due to financial transactions assumed on behalf of the treasury and high operating expenditures. Loans to the government stood at around 21 percent of total assets of the BCM at end-2004. The bulk of these loans (77 percent of the total) consisted of unpaid, BCM-guaranteed London Club debt, which the BCM had to assume when the guarantee was called. BCM loans to a former state enterprise, for which the obligations were transferred to the state when the company was privatized, have also remained unremunerated and account for an additional 15 percent of the total exposure of BCM to the state.

A financially strong BCM is needed to ensure its ability to carry out its prime functions. Failure to promptly address the losses and their causes could interfere with monetary and exchange rate management, performance of the LOLR function, and/or jeopardize the supervisory functions of the CSBF, which is funded and staffed by the BCM—and is currently in need of reinforcement in human and financial resources.

The underlying causes of the insolvency of the BCM, e.g., the ongoing operating losses, need to be urgently addressed. The authorities intend to seek Fund TA to develop a basis for sustained financial viability of the BCM. Key measures to return the BCM to profitability are: (i) either remuneration at market rates of all government debt on the central bank's balance sheet, or repayment or other forms of removal by the treasury from the BCM's balance sheet; (ii) review of noninterest operating expenditures with a view to their reduction to a level commensurate with revenues; and (iii) nonrecurrence of transfers of government debt or quasi-fiscal expenses to the BCM, other than through statutory advances on tax revenues at the beginning of the budget year, provided these advances are at an acceptable level and are promptly repaid.

supervisory regime are the necessary conditions for the development of the sector. A new insurance code, largely in conformity with international standards, was adopted in 1999 but has not been effectively implemented.

32. **The insurance market is dominated by two state-owned insurance companies, which hold a market share of 89 percent of premium income.** There has been no foreign presence since the 1975 nationalization of a French insurer. However, foreign companies have expressed an interest in entering the market, although reportedly not as potential parties to the planned but long-delayed privatization of the two state-owned companies. Nonlife insurance—including compulsory motor third party liability, traditional property and casualty, health, and travel insurance—dominates the sector with 77 percent of total premiums. Life insurance offering has not evolved for the past thirty years.

Table 4. Insurance Market and International Comparison, 2003 1/

Country	Per capita GDP (In U.S. dollars)	Premiums per capita (In U.S. dollars)	Insurance penetration (Gross premiums/GDP)
Madagascar	229	1.18	0.60
Rwanda	300	1.22	0.43
Kenya	320	10.11	2.98
Benin	455	2.30	0.75
Ghana	320	2.22	0.64

Sources: Swiss Re Sigma 6/2003, WB WDI.

1/ Additions in this table reflect rounding of figures.

33. **The performance of the insurance sector is generally weak.** Although claims ratios are low and stable, expense ratios are fairly high—which seem to suggest that tariffs are set too high with respect to the risk taken, and nominal rates of return are relatively low.⁶ While the two state-owned insurance companies are rather inefficient, the private insurer is insolvent and unable to meet claims payments. A detailed supervisory report on this private company recommended its liquidation, but this was not acted upon. It has been under provisional administration since early 2005.

34. **Insurance supervision is currently the responsibility of the Ministry of Finance, which lacks trained staff, resources and operational independence.** Considerable upgrading of its effectiveness will be required in a more dynamic liberalized market. This will include training in off-site and on-site examinations, remedial actions, and in licensing of new companies, application of sanctions, liquidations and wind-ups.

C. Pension Funds

35. **The pension sector in Madagascar is dominated by three publicly-managed institutions which operate pension schemes for formal sector employees.** In addition, insurance companies offer some limited private pension products, and there is at least one private company which provides endowment and annuity products. Existing private sector plans (other than those offered by insurance companies) operate in a legal vacuum, which represents a potential vulnerability to the savings and old age security of fund members. It is estimated that the present schemes, private and public combined, cover less than 10 percent of the active population.

⁶ Investments of both insurance companies and pension reserves are in a mixture of short-term government paper (highest concentration) and real estate, with a characteristic mismatch between assets and liabilities. There is little foreign investment (due to legal restrictions) and little domestic equity or corporate bond investment due to the lack of a securities market.

36. **Two of the three public pension funds currently show cash flow deficits, and short term projections indicate that their financial situation is likely to deteriorate.** While income currently exceeds payout at the third (and largest) provider, the level of benefits does not appear to be sustainable, and rationalization is necessary to streamline benefits and contributions. None of these pension providers has performed an actuarial study of their schemes.

37. **A comprehensive regulatory and supervisory framework for pension providers needs to be established.** There is currently no direct oversight or supervision for either public or private pensions, and the scope of private funds is not known as there is no reporting requirement. An appropriate regulatory framework would provide, inter-alia, (i) for powers of the supervisory body; (ii) funding, reporting, valuation and actuarial standards; (iii) permissible assets; (iv) tax treatment; (v) information to members; and (vi) prohibitions on self-dealing and transactions with related parties. Capacity of the designated supervisor will need to be built from the ground up.

III. FINANCIAL INFRASTRUCTURE

A. Legal and Judicial Framework

Legal environment

38. **Several legislative reform initiatives have taken place recently in the financial sector:**

- Business, banking and other financial laws have been modernized and improved. New legislation governs such topics as securities trading, commercial and credit registries, companies, secured transactions and insolvency; and
- Furthermore, in order to address the existing obsolete formal property rights regime, Madagascar is currently formulating a new land reform strategy.

39. **However, recent initiatives have not resolved all existing deficiencies:**

- There is still no regulatory framework for insolvency liquidators;
- Individuals remain unable to pledge an asset without transferring possession of the collateral, which hinders access to credit;
- No foreign-owned bank/mortgagee may be awarded title to real estate following foreclosure on a mortgage, which further constrains lending;
- In order to develop lending to small- and medium-size enterprises (SMEs) and consumer loans to individuals, alternatives to mortgage-based lending need to be encouraged and legal mechanisms created or improved; and
- Finally, in the absence of a bank insolvency law, depositors have limited protection against insolvency of a deposit-taking institution.

40. **Efforts to improve the legal framework in Madagascar are hindered by a lack of legislative skills.** Drafting skills are weak, and technical complexities and nuances in the legislation are not necessarily appreciated. As a consequence, legislation is sometimes difficult to implement in a practical way. Moreover, legal information, including jurisprudence, remains inaccessible to many in the judiciary, to lawyers, and to the population at large.

Judicial system

41. **In 2004, the Ministry of Justice started a program of judicial reform, including simplification of procedures to reduce massive backlogs in commercial cases.** In two pilot courts, a process of random allocation of cases has been initiated, so as to limit personal considerations. The establishment of the Training College for Judges and Clerks (*École Nationale de la Magistrature et des Greffes*) is another positive development.

42. **Further efforts are needed to modernize the judicial system, but the Ministry of Justice lacks the necessary resources to carry out basic administrative mandates, let alone tackle important reform.** Corruption in the judiciary remains a major concern despite the recent establishment of an apparatus to tackle corruption in the public sector. However, only a few concrete measures have been taken so far to address corrupt behavior in the public sector. Furthermore, the 2005 budget for the justice sector generally, and for judicial reform in particular, has been curtailed at a time when significant expansion is needed to implement the government's good governance strategy. Without the necessary financial and full-time human resources of the caliber needed, the Ministry of Justice is set up for certain failure in the execution of any generalized and thorough judicial system reform agenda.

B. Payment System

43. **The payment system in Madagascar is underdeveloped, which constrains the emergence of a modern and efficient financial system.** Cash transactions still dominate, due to low bank penetration (only approximately 3 percent of the population has a bank account, and there are only 7 bank branches per million inhabitants). The clearing system is entirely manual, with physical exchanges of checks and bills taking place in 14 clearing houses.

44. **The system for clearing and settlement via the books of the BCM may pose risks.** It is not automated and depends on how long it takes for the checks to reach BCM headquarters by fax or mail. This can result in time lags between the closing of positions at bank branch accounts and settlement on the books of the BCM, making end-of-day closing positions unpredictable for banks.⁷ Banks are highly liquid and have not encountered acute settlement risk. However, this could change under tighter liquidity conditions.

⁷ While processing times are within acceptable limits for transactions which do not require physical transportation of checks, they range from 21 to 60 days for "out station" checks.

45. **The legal framework for the payment system is outdated, with core provisions dating back to 1935.** Moreover, a law recently adopted by Parliament on uncovered checks, intended to promote check usage, is overly harsh and rigid, and may be counter effective. This law need to be revised, and the legal framework modernized to allow for the secure development of noncash (especially electronic) payment instruments and processing systems.

46. **A number of reform initiatives, supported by strong stakeholder motivation, are underway or planned.** Recent positive developments include the standardization of checks, the modernization of bank information systems, and the launch of card systems. Furthermore, under the U.S Millennium Challenge Account agreement, up to US\$21 million has been earmarked for payment system reform. This affords Madagascar an excellent opportunity to modernize its payments, clearance and settlement systems. However, administrative capacity to provide leadership to these reform efforts needs strengthening.

C. Anti-Money Laundering and Combating the Financing of Terrorism Framework

47. **AML/CFT policies and practices are in an early developmental stage in Madagascar, and currently do not meet international standards.** Although an AML/CFT law has been adopted, the necessary regulations and implementing procedures are not yet in place, and oversight by the authorities is not yet effective, although preliminary drafts have been approved by the CSBF and the industry has been consulted.

48. **Draft implementation instructions for the AML/CFT Law are in an advanced stage of preparation but still require improvements.** Through lack of training, experience and the necessary manuals and instructions, the prudential authorities are unable at this time to exercise oversight over banks' compliance with sound AML/CFT practices, off-site as well as on-site. While the large foreign-owned banks have well developed internal AML/CFT rules, based on those used by the parent bank, this is not the case for the microfinance institutions, money changers and other smaller commercial banks.⁸

IV. FINANCIAL SECTOR DEVELOPMENTAL ISSUES

A. Access to Financial Services—Issues and Challenges

Microfinance

49. **Given the magnitude of the still unserved market in Madagascar and tentative or nonexistent efforts of banks to expand and deepen outreach, further development of the microfinance sector remains a key factor in increasing access to finance.** The MFI sector in Madagascar is relatively young but it is growing rapidly. At end-2004, the sector included nine financial cooperatives, one finance company (*établissement financier*), three

⁸ Considerable uncertainty still exists as to the legal status of money changers. The Ministry of Finance has delegated to the CSBF the responsibility to regulate, license and monitor money changers, which have so far not been subject to CSBF oversight. An appropriate legal basis needs to be created to provide sanctioning authority for the CSBF with regard to the money changers, without which its oversight role cannot be effective.

international nongovernmental organizations, and the *Caisse d'Epargne de Madagascar* (CEM). The CEM, which is not a licensed financial institution and is not authorized to grant credits, caters mostly to low-income savers and accounts for roughly 80 percent of total depositors of MFIs. Given the large number of depositors, it is a matter of concern that CEM is not subject to supervision by any regulatory authority and relies solely on external audits as a control mechanism.⁹

50. Adequate supervision of MFIs by the CSBF is a major prerequisite for further sound development of the sector, although care should be taken not to stifle the sector with over-burdensome regulation and supervision. Only six groups of MFIs are formally registered and licensed and are under CSBF supervision (five cooperative networks and a finance company). Although steps have been taken to reinforce CSBF, the adequacy of resources needs to be kept under review, to see whether further reinforcement may be necessary to maintain regular and systematic oversight, in particular on-site inspections. Off-site supervision and reporting are routinely delayed, due primarily to the manual preparation of reports in most MFIs and slow means of communication.

51. While the soundness indicators for the MFIs under CSBF supervision appear to be satisfactory on average, some prudential rules for MFIs need to be strengthened. In particular, the minimum capital adequacy ratio and loan loss provisioning rules for MFIs are currently the same as those for commercial banks. Given the higher risks involved in microfinance business, it would be more appropriate to have tighter capital and provisioning requirements for MFIs than for commercial banks. However, a careful balance will need to be struck between a possible need for stricter capital requirements and the need to avoid over-regulation.

52. The quality and diversity of financial services offered by MFIs need substantial improvement. The provision of deposit services is already creating value among the clientele by providing safety and, to the extent that institutions remain stable, reliability. Yet the limited range of deposit types, the scarcity of credit provision, and the paucity of payment and insurance services represent a major challenge that Malagasy MFIs are only beginning to address, with limited efforts that are largely confined to urban areas. Scaling-up of outreach, with regard to deposit services outside of the CEM and credit services, is clearly a priority, if microfinance is to make an impact in Madagascar as a poverty alleviation tool.

53. The legal framework governing MFIs has several flaws. In particular, deposit-taking MFIs which are not financial cooperatives are not subject to any regulation. Also, as a result of tax exemptions and the possibility to collect deposits, all licensed MFIs except one are registered as financial cooperatives regardless of whether that organizational form reflects their actual ownership structure and operational model (financial companies cannot mobilize deposits and do not benefit from any tax exemptions). Either a new microfinance

⁹ A related concern stems from the launch of deposit taking from the public by the former CEM partner *La Poste* in 2004, also seemingly without any regulatory oversight.

law will be passed (a draft law which has been prepared recently suffers from a number of important shortcomings), or the banking law will be revised to include an MFI category.

Small- and medium-size enterprise financing

54. **There is a group of small- and medium-size enterprises (SMEs) that is too large to obtain financing from the microfinance sector, but not sufficiently formal to be served by the banking system.** While the microfinance sector has had some success in providing credit to micro and small enterprises, particularly in urban areas, there are small enterprises with credit demand that cannot be satisfied by MFIs since it is beyond the regulatory single borrower limit. These firms, however, do not have formal financial statements, a pre-condition to obtain loans from the banking system. Their access to bank finance is also impeded by lack of clear property rights over their land, which is often used as collateral for bank loans. Further, the lack of effective credit information sharing with MFIs prevents these borrowers from building up a credit history that they could present to banks as they graduate from the MFI sector.

55. **While there are several governmental and sectoral initiatives to foster the access of SMEs to bank finance, they seem to be too limited or ineffective in reaching their target.** In particular, the guarantee fund, created in 2003 and financed by Malagasy banks, does not guarantee the smallest loans. Few new borrowers seem to have been brought under the guarantee.

56. **Enforcement of the legal obligation to disclose annual financial statements of enterprises, and the establishment of a credit reference bureau could help overcome some of the obstacles to SME financing.** A credit information sharing system that collects relevant information on all clients—at a minimum past and outstanding credit and payment history—and makes this information available on request to financial institutions, can allow lenders to provide credit more safely, and borrowers to build up a credit history. It can thus help foster access to credit, especially by smaller borrowers who have a greater need to establish a positive track record. Given the existence of the *Centrale des Risques* in the BCM, the central bank seems a natural location for such a credit reference bureau.¹⁰

57. **The development of leasing and factoring could also help SMEs obtain financing.** In fact, leasing and factoring do not rely heavily on the judicial system and obviate the need for other forms of collateral. The recently enacted leasing law provides the legislative basis for a rapid expansion of leasing in Madagascar. However, there is no law on factoring. There is currently only one provider of leasing in Madagascar. Under the old law, leasing had no legal advantage in terms of enforcing claims in case of default, although the property right of the financed equipment stays with the lessor. This has been remedied under

¹⁰ The *Centrale des Risques*, which is housed by the BCM, collects information on all bank loans above FMG 50 million and distributes aggregate information on outstanding bank credit for each client to all banks. Additionally, information on maturity (short-, medium- and long-term) of the credit is provided. No information on nonperforming loans is collected or provided at the client level, though information on bounced checks is collected and provided through a separate system.

the new law, which also follows international accounting standards concerning which party books the asset on its balance sheet. However, no provision in the Malagasy legislation seems to allow the sale of claim to a third party, which is a pre-condition for factoring.

B. Promoting Long-Term Financing

58. **The financial system provides little long-term financing to the economy.** The macroeconomic environment, the widespread lack of reliable accounting information, and deficiencies in the legal and judiciary systems discourage long-term financial intermediation. In addition to general political and economic uncertainty in the last few years, inflation and interest rates have been high and volatile, further pushing up risk premiums in lending rates. Pre-conditions for the development of long-term financing include sustained macroeconomic and political stability, use of accurate accounting records, financial disclosure, predictable rule of law, and a functioning system for registering and enforcing property rights.

59. **While creating the above conditions will require long-term commitment and planning, several other measures could be taken almost immediately.** In particular, a standardization of the mechanism to adjust floating interest rates, used on most long-term loans, periodicity of revision, and transparency in adjustment of rates, would be desirable. Also, the taxation of financial products should be modified to eliminate the bias against long-term financial instruments. Specifically, bank savings accounts currently represent a greater share than their product appeal would normally justify, because they benefit from the distorted tax regime on interest earned, relative to time deposits.

60. **As there are no established securities markets, no public raising of private capital occurs.** Shares of private sector companies are generally held with an indefinite time horizon, and the few transfers of shares which take place are mostly related to corporate events (e.g., privatizations, mergers, etc.). Moreover, besides the bills and bonds issued by the government, there has been no issuance of debt securities to the public in recent years. A substantial volume of government financing is raised through issuance of short-term treasury bills. With sustained macroeconomic stability, consideration might be given to gradually lengthening the maturity of government securities.

61. **The liberalization of the insurance market and the development of a nascent private pension sector should contribute to greater demand for longer-term securities.** Currently, market financing is impeded by the lack of multiple and diversified institutional investors. The reforms in the insurance and pension sectors could have a significant impact both on developing the market for long-term finance and on improving the performance of the insurance companies and pension funds.

OBSERVANCE OF FINANCIAL SECTOR STANDARDS AND CODES—SUMMARY ASSESSMENTS

The Annex contains summaries of the assessments of compliance with the 40 +9 Recommendations of the Financial Action Task Force on Anti-Money Laundering and the Combating of the Financing of Terrorism (FATF 40+9), and with the Basel Core Principles for Effective Banking Supervision (BCP). The FATF 40 +9 assessment was prepared by Mr. Pierre-Laurent Chatain, and Mmes. Isabelle Schoonwater and Maryline Goncalves, all of the Financial Sector Vice-Presidency of the World Bank, from July 4 to 16, 2005. The assessment of the BCP was performed by Messrs. Marcel Maes, formerly of the Belgian Banking Commission, and Mr. Jean Sarazin, of the Office of the Superintendent of Financial Institutions of Canada, from April 21 to May 3, 2005. Also detailed assessments were prepared for both of these codes.

Both of these assessments were prepared on the basis of the laws regulations and practices in place at the time of assessment.

The assessments were based on several sources, including:

- Self-assessments by the authorities;
- Reviews of relevant legislations and regulations, policy statement sand other written sources; and
- Interviews with officials and staff of the relevant agencies, market participants, service providers, donor agencies and others.

FINANCIAL ACTION TASK FORCE (FATF) 40+9 RECOMMENDATIONS ON ANTI-MONEY LAUNDERING AND COMBATING OF THE FINANCING OF TERRORISM

Current situation with regard to money laundering and the financing of terrorism

62. The main offenses connected to money laundering or the financing of terrorism are drug trafficking, precious metal and precious stone trading, and offenses related to international trade transactions, although the 2004 law on AML expands the concept of money laundering to cover the proceeds of all serious crime. Financing of terrorism has not yet been made a criminal offense. Drug trafficking, also on a regional basis, is significant in Madagascar. The authorities are aware of the problem and have undertaken numerous large-scale seizure operations, but are severely resource-constrained and find little cooperation regionally.

63. Mining and international trade are vulnerable sectors. Precious stones are mined and subsequently exported, often without the knowledge of the authorities. Marketing of these stones also generates considerable external financial flows, susceptible to money laundering and the financing of terrorism. This is all the more worrying as the profession is not covered by the new law on money laundering (see below). The government project on mining intends to streamline the allocation of concessions, professionalize the industry and improve oversight.

64. **Customs inspections have uncovered numerous fraudulent practices.** Finally, the rapid growth in the number of casinos appears more than the market can support.¹¹ Licensing and controls over casinos are inadequate, and certain business practices seem illegal. Corroboration has been obtained concerning the presence of foreign Islamic fundamentalists among the recently established nongovernmental organizations (NGOs).

Main findings

Overall conclusion

65. **Despite the progress achieved recently, the assessment shows a low level of compliance with the FATF 40 + 9 recommendations.** The mission urges the authorities to increase the pace of reform of the current legal system and to provide the FIU with the technical and human resources it needs to meet the international standards. The AML roles of the central bank and the CSBF must be clarified and strengthened considerably. The FIU, the supervisory authorities as well as the police and judiciary need adequate financing, structures and training. Procedures must be developed for AML investigation and prosecution.

66. **Combating money laundering and the financing of terrorism are new concepts for Madagascar and much remains to be done to build an adequate legal basis and to instill a different mind frame.** A stronger control culture must be built, particularly in the banking and other financial sectors, which will need to put in considerable effort to implement the new law.

Summary assessment

67. **A number of weaknesses have been identified in the current AML/CFT measures:** (i) financing of terrorism is not a specific criminal offense; (ii) the Financial Intelligence Unit (FIU) is not yet in operation; (iii) the absence of preventive rules in the majority of the sectors subject to supervision; (iv) noncoverage of nonfinancial professions; (v) embryonic AML/CFT supervisory measures in the financial sector; and (vi) a judiciary inexperienced in cases involving financial crime.

68. **Compliance would require efforts on all fronts:** (i) acts of terrorism and the financing of terrorism must be made criminal offenses; (ii) nonfinancial professions (lawyers, notaries, accountants, etc.) as well as politically exposed persons (PEPs), NGOs, dealers in precious metals and precious stones and money transmitters must be explicitly covered by the law; (iii) the FIU must be provided with all necessary resources; (iv) administrative controls in key sectors must be strengthened; (iv) more in-depth supervision of banks, exchange bureaus and other financial institutions; (v) training of police and judiciary in AML/CFT; and (vi) allocation of the necessary resources.

¹¹ Eleven casinos have been set up in four years.

Legal framework and international cooperation

International cooperation

69. **Madagascar has ratified the UN Convention Against Illicit Traffic in Narcotic Drugs and Psychotropic Substances of 1988 (Vienna Convention) on March 12, 1991.** It has signed the 2000 UN Convention against Transnational Organized Crime (Palermo Convention) and the 1999 International Convention for the Suppression of the Financing of Terrorism. Ratification is under way.

Criminal law

70. **The new AML law of 2004 covers all the main crimes and offenses, except the financing of terrorism.** Enforcement powers and international cooperation have also been established or strengthened, for instance on undercover operations, controlled delivery, and systematic extradition.

Provisional measures

71. **Malagasy law provides the full arsenal of provisional and punitive measures, such as confiscation, freezing and seizure of goods, moneys, or proceeds of crime.** The law also empowers the seizure of assets connected to the offense as well as evidence that may help identify such assets.

The Financial Intelligence Unit

72. **The new law also creates a Financial Intelligence Unit (FIU), lays down measures for prevention and detection of money laundering, sets prudential rules and establishes a reporting system.** To perform its duties, the FIU may obtain from any public authority, or from a wide range of persons information relating to the “know your customer,” rule, also on beneficial owners, originators, or the transactions themselves. The FIU refers to the public prosecutor when there is a suspicion of money laundering. It may, subject to reciprocity and confidentiality, exchange information with foreign FIUs. However, only judicial and law enforcement authorities are authorized to apply the freezing, seizure or confiscation powers.

Combating corruption

73. **Madagascar ratified the UN Convention against Corruption, and, under the Office of the President, has set up an institutional framework, consisting of the High Council on the Fight Against Corruption (CSLC), the Independent Anti-Corruption Office (BIANCO) and, within the judiciary, the Anti-Corruption Criminal Data System (CPAC).**

Effectiveness of the current measures

74. **However, the FIU has not yet been made operational, and there is not yet a nationwide structure to oversee the effectiveness of the AML efforts or to promote further reform.**

Preventive measures applicable to the financial and nonfinancial institutions

75. **The new law lays down an adequate “know your customer” system, including retention of identity documents.** However, a significant shortcoming is the lack of provisions on “politically exposed persons” (PEPs). However, the law remains vague on due diligence and retention of documents on the nonfinancial legal and accountancy professions and enterprises, in particular lawyers, notaries, and public accountants, covering only persons or legal entities who carry out, control, or advise professionally on financial transactions.

76. **Banks and financial institutions as well as insurance companies and casinos are required to report suspicious transactions to the FIU.** The law places, however, no explicit obligation on dealers in precious stones or metals, NGOs, money transmitters, lawyers, and accountants, and is therefore not compliant with international standards.

77. **Banks are required to set up internal AML programs to centralize information on customer identity, originators, to train staff on an ongoing basis and to monitor the effective implementation and effectiveness of the programs.**

78. **However, practical weaknesses persist, for instance, because banks, other than the subsidiaries of major foreign groups, do not yet have the IT to monitor and detect unusual, doubtful or complex transactions, nor have compliance officers been appointed.** As the FIU is not yet operational, individuals and legal entities are not able to report suspicious transactions. The FIU has also not been able to issue practical procedures against money laundering.

79. **In the insurance and securities sectors, there are no internal procedures or rules to prevent the use of companies to launder money or finance terrorism.**

80. **The CSBF is the relevant authority to monitor banks’ compliance with the rules.** However, the CSBF has not yet performed any AML focused on-site inspections. Neither in the insurance and securities sectors, nor with regard to money transmitters, bureaux de change or micro-credit institutions have similar inspections been conducted. The insurance and securities regulators have not issued AML instructions. The CSBF, however, is on the point of issuing an AML instruction.

81. **The self-regulatory bodies of nonfinancial professions, in particular lawyers and accountants, do not monitor compliance with the new rules.** Furthermore, initial and ongoing controls of NGOs, casinos and mining concessions are inadequate, poorly coordinated and intransparent.

Table 5. Priority Action Plan to Improve Compliance with the FATF Recommendations

40 + 9 FATF Recommendations	Main Measures Recommended
Legal System and Institutional Measures	
Scope of the criminal offense of money laundering (Recommendation (R)1, R2 and 32), and Criminality of the financing of terrorism (Special Recommendation (SR) II et R32)	<ul style="list-style-type: none"> • Include the financing of terrorism in the scope of the main criminal offenses of money laundering; • Create computer databases acting as data inventories for the police, the customs service, and the courts enabling information to be centralized and reliable statistics to be compiled. • Criminalize both the financing of terrorism in accordance with the international standards and its corollary, acts of terrorism; • Create computerized and centralized police records; and • Create an interministerial body comprised of the representatives of the various institutions and professions involved to coordinate AML policy and to provide regular progress reports.
Confiscation, freezing, and seizure of assets derived from criminal activity (R3 et R32)	<ul style="list-style-type: none"> • Build a database on the number and nature of the assets seized.
Confiscation of the proceeds of criminal activities or of assets used to finance terrorism (SR III)	<ul style="list-style-type: none"> • Criminalize terrorism, to bring it within the scope of preventive measures regarding associated assets and proceeds.
Financial Intelligence Unit (R26, R30, and R32)	<p>Operationalize the FIU, in particular:</p> <ul style="list-style-type: none"> • Provide the FIU with sufficient resources; • Compile statistics on the number of suspicious transaction reports (STRs); and • Criminalize financing of terrorism, to bring it within the scope of suspicious transaction reporting.
Implementation of the law, enforcement, and other designated authorities (R27, R28, R30, and R32)	<ul style="list-style-type: none"> • Train judges in combating organized financial crime; • Provide the judiciary with sufficient resources; and • Compile statistics on prosecutions convictions, and sentencing.
Preventive Measures Applicable to Banks	
Due diligence: Know-your-customer and document retention requirements (R.5, 6, 7, 8, and 10)	<ul style="list-style-type: none"> • Issue to banks, insurance companies, currency dealers, and market intermediaries instructions on implementing the new AML law; • Analyze the financial sector to determine high AML –risk category/ies of customer and types of transactions; • Require banks and institutions to update files on former customers. Encourage banks’ preparation of instructions on customer due diligence; and • Amend the law to apply stronger due diligence to Politically Exposed Persons.
Wire transfers (SR VII)	<ul style="list-style-type: none"> • Add specific rules to the legislation with regard to wire transfers, strengthening the due diligence requirements in respect of the originator.
Monitoring of transactions (R11)	<ul style="list-style-type: none"> • Instruct banks and other financial institutions on when and how to monitor of unusually or unjustifiably complex transactions; and • Encourage the banks to prepare internal instructions on continuous monitoring of accounts and transactions. Define the role of the internal AML/CFT control structures (inspection and audit).

Shell banks (R18)	<ul style="list-style-type: none"> Prohibit shell banks and require that banks refuse correspondent banking relationships with shell banks.
Regulation and supervision, competent authorities and their powers (R17, R23, R29, R30)	<p>The CSBF is urged to:</p> <ul style="list-style-type: none"> Monitor proper implementation of laws and regulations by banks, financial institutions, money and currency dealers, and microfinance institutions; Ensure that banks have the means to prevent, detect, and report on this; Verify that banks have AML-trained and qualified staff; and Apply similar recommendation to insurance and securities sectors.
Guidelines (R25)	<ul style="list-style-type: none"> Prepare detailed instructions for banks, other financial institutions, and currency dealers on implementation of national AML/CFT measures.
Reporting of suspicious transactions (R.13, R14, R19, R.25, and RS IV)	<ul style="list-style-type: none"> Draw up list of institutions and persons required to file STRs, including legal advisers, notaries, accountants, auditors, public accountants; Issue standard STR format, distribute it, and issue instructions on its use; Draw up instructions for financial institutions to help detect types of suspicious financial activities (typology exercise); and Explain to supervised entities current AML/CFT laws and requirements, and provide them with advice on how to comply.
Regulation and supervision (R.23, 29, and 32)	<p>The CSBF is urged to:</p> <ul style="list-style-type: none"> Monitor proper implementation of laws and regulations by banks, financial institutions, money and currency dealers, microfinance institutions; Ensure that banks have the means to prevent, detect, and report on this; Verify that banks have AML-trained and qualified staff; and Apply similar recommendation to insurance and securities sectors.
Preventive Measures for Nonfinancial Professions and Enterprises	
Know-your-customer and document retention requirements (R12)	<ul style="list-style-type: none"> Extend legal due diligence and document retention requirements to lawyers, notaries, public accountants, etc).
Reporting of suspicious transactions (R16)	<ul style="list-style-type: none"> State in the 2004 law that the due diligence, document retention, and suspicious transaction reporting requirements apply to the nonfinancial professions (lawyers, notaries, real estate agents, public accountants, etc); and Specify the list of institutions and persons required to report suspicious transactions including all the relevant professions (legal advisers, notaries, accountants, auditors, public accountants).
Internal control, compliance, and audit (R16)	<ul style="list-style-type: none"> Extend the scope of the law to nonfinancial professions and enterprises.
Regulation, supervision, and control (R17, 24-25)	<ul style="list-style-type: none"> Identify agencies to be responsible for monitoring AML standards for nonfinancial professions and enterprises; Ensure that self-regulatory bodies enforce compliance by their members; and Ensure that self-regulatory bodies issue implementation and compliance guidelines to assist members implement and comply with requirements.
Legal Entities and Nongovernmental Organizations	
Legal entities (R.33)	
Nongovernmental organizations (NGOs) (SR VIII)	<ul style="list-style-type: none"> Subject this sector to greater regulation; Strengthen controls.

National and International Cooperation	
National cooperation and coordination (R31)	<ul style="list-style-type: none"> • Create a National Coordination Committee tasked with defining and directing national AML/CFT policy, monitoring its implementation, and facilitating cooperation among the various competent authorities; and • Organize cooperation procedures among agencies involved in AML/CFT (MoU on information exchange, confidentiality, etc.).
United Nations resolutions and international conventions (R35 and SR I)	<ul style="list-style-type: none"> • Ratify the Vienna and Palermo Conventions; • Investigate banks, other financial institutions, and nonfinancial professions to ensure their customers do not include persons suspected of terrorism according to the Resolution 1373 lists.
Mutual legal assistance (R32, 36-38, SR V)	<ul style="list-style-type: none"> • Implementation the rules on mutual legal assistance with regard to CFT offenses.
Extradition (R32, 37, and 39, SR V)	<ul style="list-style-type: none"> • Provide for application of extradition rules to financing of terrorism; and • Prepare and establish analytical and statistical tools.
Other forms of cooperation (R32 and 40, SR V)	<ul style="list-style-type: none"> • Prepare partnership agreements to organize information exchange between the FIU and its foreign counterparts.

Authorities' response

82. **The authorities recognized that the current AML regime needs several improvements on both the legal and operational levels.** The enactment of a specific law for combating terrorist financing has been perceived as an important issue that has to be carefully considered in the short run in order to fully comply with the international standards. The authorities broadly agreed on the recommendations made by the team to address the main weaknesses identified in the supervisory, law enforcement and judiciary sectors. They expressed interest in receiving assistance, in particular for the operationalization of the FIU.

BASEL CORE PRINCIPLES FOR EFFECTIVE BANKING SUPERVISION

Institutional and market structure—Overview

83. **Madagascar's banking sector, with total assets equivalent to around 25 percent of GDP, is stable, liquid, adequately capitalized and profitable, but remains shallow and undiversified.** Credit to the private sector stands at around 10 percent of GDP. Commercial banks hold 84 percent of total system assets and offer only basic savings and credit products to a select clientele.

84. **The Malagasy banking system consists of seven banks.** The three subsidiaries of large French banks account for around 65 percent of system assets. Of the four remaining banks one is a subsidiary of a Benin-domiciled parent bank, two are subsidiaries of Mauritian banks. One formerly domestic bank was recently acquired by investors from Hong Kong.

85. **Mutualist financial institutions with five networks (180,000 members), microcredit institutions (5,500 clients) and the *Caisse d'Epargne de Madagascar* (CEM) are the main microfinance providers in Madagascar.** Of these, only the mutualist financial institutions are formally (on paper) under CSBF oversight. A new legal framework for nonbank intermediaries is in preparation, in connection with a National Microfinance Strategy. The banking system is one of the smallest in comparable African countries, although the branch network is relatively dense.

86. **Banking and microfinance supervision is exercised by the CSBF, based on the 1996 Banking Law.**

General preconditions for effective banking supervision

Macroeconomic stability

87. **Recent macroeconomic performance of Madagascar has been broadly satisfactory.** Growth has been supported by strong performance in the agricultural, construction, tourism, transport, and export processing zone sectors, the external sector remains weak. However, Madagascar is susceptible to frequent exogenous shocks, such as adverse climatic conditions, price shocks to commodity exports, import prices, and trade shocks, such as the recent termination of the Agreement on Textiles and Clothing.

88. **In 2001-2002 Madagascar experienced significant political turmoil.** The crisis led to a fall in real GDP of around 13 percent in 2002. The banking sector continued business throughout the crisis and kept the payment system operational, although asset quality suffered.

Public infrastructure

89. **The operating environment for financial services still shows weaknesses.** Macroeconomic and political stability are still relatively recent. Weaknesses persist in the legal, judicial and accounting frameworks. Financial information on borrowers is limited to creditor banks, and integrity and governance remain a concern. Lending risk and relatively high levels of nonperforming loans, lead to high risk premiums and lending rates. Payment systems are slow.

90. **There is no systematic policy to promote transparency of monetary and financial policies, although the small size of the financial community implies that market parties generally have the information they need.** Nevertheless, timely consultation of the industry is needed in the preparation of administrative measures and regulations. The CSBF envisages publishing an annual report over 2004. Since 1995 only one report was issued, in 2001.

Market discipline

91. **Financial market discipline is limited, mainly due to the small number of institutions and the nonenforcement of rules on the disclosure of corporate financial**

data. Corporate financial statements are not available to the public. Furthermore, with 70 chartered accountants in the country, accounting and auditing capacity is limited. Banks' annual statements are generally disclosed by the institutions themselves.

Resolution of problem banks

92. **For several years, remedial action by CSBF against banks and microfinance institutions has been delayed as a result of unfilled vacancies on the CSBF Board.**

93. **The CSBF has an adequate range of sanctions to enforce legal and regulatory standards, including an invitation to bank management to explain its position, the issuance of warnings and binding instructions, removal of management, the appointment of a provisional administrator, and withdrawal of the banking license.**

94. **The CSBF's order to surrender the banking license—after an eight-day period within which the Minister can ask the CSBF to reconsider—leads to immediate liquidation of the bank.** The Chairman of the CSBF also has the authority—unused since the enactment of the LB in 1996—to “invite” the shareholders or members to provide assistance to the institution. The authorities are debating the introduction of a deposit insurance system. Banks do not frequently access the lender-of-last resort facilities of the BCM, as they are highly liquid, with high liquid reserve requirements of 15 percent, and loan to deposit ratios averaging around 50 percent (end 2004).

95. **There are concerns about the safety of the mutualist groups, in particular as three out of five networks have not been licensed and are therefore not under supervision.** Slightly over half of the mutualist “caisses” benefit from mutual solidarity arrangements, although two of the five mutualist networks, with around 60 “caisses,” do not participate in such solidarity arrangements, but are considering establishing a guarantee fund.

Main findings

Overall conclusion

96. **Considerable work is still needed to improve compliance with the Basel Core Principles (BCP), although the authorities are to be commended for losing little time to undertake the most urgent measures as soon as the CSBF had become operational again.**

Summary assessment

Objectives, autonomy, powers, and resources (CP 1)

97. **The legal framework allocates clear supervisory authority to the CSBF.**

However, for microfinance institutions, a strong legal and regulatory framework is still not in place. Nor is supervisory operational independence complete, as the Minister has the authority to suspend CSBF de-licensing decisions for an eight-day period. Strengthening of CSBF resources is ongoing, but concerns about the financial situation of the BCM could impact adequate funding and staffing of the CSBF in the face of its expanded responsibilities. However, CSBF IT capacity, staffing and training opportunities have been reinforced. Training has been supported by the Banque de France, the World Bank and the Financial Stability Institute. The mission suggested that banks could contribute to the cost of supervision. Supervisory officials have no explicit protection against lawsuits for acts performed in the exercise of their duty, or against legal defense costs. The authorities agree that more protection needs to be included in the law. The Group of Francophone Supervisors is preparing formal arrangements for the exchange of information with the home supervisors in Francophone countries, in particular France and the Monetary Union of West Africa (home supervisor of the Bank of Africa). Arrangements with the authorities of Mauritius are being formalized.

Licensing and structure (CPs 2–5)

98. **The Banking law sufficiently describes activities permitted to licensed institutions and prohibits the use of the word “bank” by nonlicensed entities.**

Bank licensing rules are in line with international good practice, and applied appropriately. When the CSBF decides to withdraw a banking license, the Minister has eight days to have the decision reconsidered. This limits the operational independence of the supervisor, and creates an opportunity for dissipation of assets which needs to be closed off. Transfer of ownership in a bank, mergers, investments in other companies, and voluntary closing and restructuring of capital are subject to supervisory approval.

Prudential regulations and requirements (CPs 6–15)

99. **Certain corrections are required in the regulatory definition of capital in Madagascar to fully conform to the Basel standard.**

No explicit regulations are in place on credit policies and asset quality review. The internal control regulations are intended to cover this, but are considered to be insufficiently strong, and not specifically aimed at banks' credit policies. Also off-balance sheet items should also be covered by the impaired asset rules. Although difficult to apply in a small economy, large exposure limits need to be more strictly enforced. The authorities are developing regulations on liquidity and interest rate risk. Standards for exchange rate risk have already been put in place. Internal controls are adequately regulated. A law against money laundering and financing of terrorism still needs to be operationalized.

Methods of ongoing supervision (CPs16–20)

100. **The CSBF is updating its manuals for on-site inspections and, with additional staff, will be better able to implement its on-site program.** However, off-site analysis and on-site inspections could be better integrated, and more frequent on-site visits are recommended. The CSBF has powers to set reporting standards and collect any information. An electronic data storage system needs to be developed. Malagasy banks have only one small holding abroad, and supervision on a consolidated basis is largely unnecessary. However, the CSBF should be familiar with the structure of the groups operating in its jurisdiction.

Information requirements (CP 21)

101. **Starting in 2005, IAS are being applied, and the banking law will need to provide for supervision on a consolidated basis.** The CSBF has powers to sanction inaccuracies in the financial statements, review the contract between bank and external auditor, and veto an external auditor. It may also require the auditor to prepare reports on specific issues.

Formal powers of supervisors (CP 22)

102. **The CSBF has sufficient remedial and intervention powers, including financial penalties, although the Minister has the power to delay withdrawal of a banking license for eight days.** Temporary administration can be imposed. After its reconstitution in March 2005, the CSBF will be better able to exercise its powers in this area, although there has been a serious instance in the past when—notwithstanding full composition of the CSBF, no corrective action was taken.

Cross-border banking (CPs 23–25)

103. **Agreements need to be concluded with foreign supervisory authorities on exchange of supervisory information.** Negotiations with Mauritian supervisory authorities are ongoing, and the Group of Francophone supervisors decided to formalize cross-border cooperation arrangements among the countries involved.

Table 6. Recommended Action Plan to Improve Compliance with the Basel Core Principles

Reference Principle	Recommended Action	Authorities' Stated Actions Since the Mission
CP 1(2) Operational independence and adequate resources	Increase professional resources of the CSBF, in particular for supervision of microfinance institutions, and enhance operational independence of the CSBF by eliminating Ministerial power to delay license withdrawal by 8 days.	10 new professional staff have been recruited, of which 4 for microfinance, and 4 for on-site inspections. Authorization has been requested to hire 3 additional staff for supervision of microfinance institutions.

Reference Principle	Recommended Action	Authorities' Stated Actions Since the Mission
CP 1 (5) Legal protection for supervisory officials and staff	Introduce appropriate legal protection for supervisory officials and staff into the Banking Law, currently being amended.	Language included in the draft revised Banking Law.
CP 1 (6) and CP 25 Confidential exchange of information among supervisory agencies	Formalize contacts with home supervisory agencies, i.e., WEAMU, France, and Mauritius.	Agreement with Mauritius awaiting finalization. Decision taken within Group of Francophone supervisors to formalize exchange of information.
CP 6 Capital adequacy	Increase minimum capital adequacy ratio from 8 to 10 percent; align capital adequacy regulations, including the definition of "capital" to the standard of the Basel 1988 Accord; exclude reserve for general banking risks from Tier I capital.	The authorities agree with the need to raise the minimum capital adequacy ratio to 10 percent; introduction of international accounting standards starting January 2005, implies exclusion of the reserve for general banking risks from Tier I, and the relevant reporting form has been adjusted to reflect this.
CP 7 Credit policies	Introduce specific regulation on banks' credit policies, procedures and practices, rather than rely on regulation on internal controls.	
CP 8 Asset quality and provisioning	Include off-balance sheet items in regulation on internal controls (which also covers provisioning).	
CP 9 Large exposure limits	Now that CSBF has been reconstituted, enforce limits on large exposures.	CSBF has started a program to discuss with the banks outstanding breaches of regulations and the need to increase capital.
CP 11 Country risk	Issuance of a specific regulation on country risk and transfer risk.	Regulation on internal controls will shortly be amended to incorporate this.
CP 13 Other risks	Issuance of precise limits on liquidity risk, exchange risk and interest rate risk.	A limit on open foreign exchange positions has already been issued. Two regulations, on liquidity risk and interest rate risk, respectively, are being drafted.
CP 14 Internal control and audit	Include conclusions of internal audit report in on-site inspection program; provide training on internal controls to officials and staff of microfinance institutions.	Authorities have agreed to use information in the internal audit reports as part of the information base for on-site inspections. Training of staff and officials of microfinance institutions will be incorporated in the Millennium Challenge Agreement.
CP 15 Know your customer- rules, ethical standards and prevention of criminal abuse	Introduction of implementing regulations and instructions.	Authorities are in the process of introducing regulations to implement new legislation against money laundering and terrorist financing.

Reference Principle	Recommended Action	Authorities' Stated Actions Since the Mission
CP 16 Off-site and on-site supervision	Fill two vacancies in supervisory staff; revise on-site inspection manual; introduce system of electronic filing of prudential returns; renewed attention to follow-up of inspections, now that CSBF has been reconstituted.	Vacancies have been filled per 9/1/05; revision of manual has been taken to hand; the authorities have issued a circular to the banks in August, requiring electronic filing and shortening the deadline for submission from 25 to 15 days.
CP 17 Contacts with bank management	More frequent on-site inspections.	This can be implemented now that additional staff has been recruited; two additional inspections have been planned for the remainder of 2005.
CP 21 Accounting and audit	Publication of financial statements by microfinance institutions, as required by law.	
CP 22 Corrective measures	Draw up an inventory of outstanding breaches of the regulations and establish a remedial program, in consultation with the banks; introduce measures to penalize managers of banks; introduce the power to prohibit dividend payments.	CSBF has started a program to discuss with the banks outstanding breaches of regulations.

Authorities' response

104. **The authorities submitted two rounds of comments to the detailed assessment, in many cases of a technical and factual update, which were incorporated into the detailed assessment.** However, the authorities indicated that the assessment criteria did not require the presence of a training institute for supervisors, so long as an adequate training program existed. The authorities were also of the view that the assessment of the principles on credit policy and provisioning could be upgraded, as these issues, also for instance concentration risk, were addressed in the regulation on internal controls. For the remainder, the assessment met with the broad agreement of the authorities.