AN ASSESSMENT OF THE IMPACT OF REFORMS IN BANK REGULATIONS AND SUPERVISION ON THE PERFORMANCE OF BANKS IN MALAWI

Master of Business Administration (MBA)

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A dissertation submitted to the Faulty of Commerce, the Malawi Polytechnic, University of Malawi, in partial fulfilment of the requirement for the degree of Master of Business Administration.

Declaration

I declare that this work has not previously been accepted in substance for any degree and is not being concurrently submitted in candidature for any degree. It is being submitted in partial fulfilment of the requirement for the degree of Executive MBA in the University of Malawi.

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Certificate of Approval

We declare that this dissertation is from Fund Binwell Mzama's own work and effort and where other people's work has been used there is proper acknowledgement. This dissertation is submitted with our approval

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Dedication

This dissertation is dedicated to my wife Idah, for her relentless encouragement during my studies. I am also grateful to my father and mother, Mr. Baison Binwell Mzama and Mrs Rose Mzama for being on my side all the time. To my daughters Mervis, Glory and Omega, this is for you so that you should be encouraged to achieve even better things in life.

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To the respondents, I thank you most sincerely for taking your time in answering the questionnaires. Your responses simplified my study.

// Abstract

It has been noted worldwide that there has been substantial change in the banking industry which has necessitated the changes in bank regulations and supervisory approach. These changes are also applicable in Malawi. Malawi has witnessed an increase in the number of banking institutions from two in the 1980s to eleven in 2008. Likewise there have also been changes in regulations and supervisory approach in response to the changes in the banking system. Reforms in bank regulations and supervision are carried out in order to keep pace with changes in banking system and to improve the effectiveness of the banking supervisory process. In the case of Malawi, the changes in regulations included the revision of the Banking Act and the Reserve Bank Act in 1989, introduction of various regulations (directives) such as the Asset Classification, Large Exposure, Minimum Capital Ratios and Liquidity Reserve Requirement in 1993. In the case of supervisory approaches, the Reserve Bank of Malawi introduced CAMEL in early 1990 and Risk Based Supervision approach in 2008.

This research has investigated the relationship between the reforms in regulations and supervisory methodologies on one hand and the performance of banks in Malawi on the other hand. In addition, this study has assessed the impact of bank regulatory and supervisory reforms on the performance of the banking system. The performance of banking system was looked at in terms of profitability, efficiency and stability.

The study was based on qualitative and quantitative data obtained through exploratory field research. It covered the period between 1990 and 2008 during which the country witnessed changes in the number of banks and regulatory changes. The research covered nine banks which had been in operation for more than a year as at 31st December 2008.

Based on the empirical analysis of the impact of the regulatory and supervisory reforms on performance of banks, it is evident that the results did not skew on positive impact only but also negative impact. This means that there was little basis to comfortably conclude that the performance of banking institutions have been positively impacted by the regulatory and supervisory reforms.

The conclusion drawn from this study is that the reforms in the regulations and supervision of the banking system had both positive and negative impact on the performance of the overall banking system in terms of profitability, efficiency and stability. This suggests that the changes were still insufficient to provide the desired level of positive impact.

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List of Abbreviations and Acronyms

ADMARC	Agricultural Development and Marketing Cooperation
ATM	Automated Teller Machine
CAMEL	**C**apital, **A**sset quality, **M**anagement, **E**arnings and **L**iquidity
CDD	Customer Due Diligence
DEA	Data Envelopment Analysis
FCLR	Foreign Currency Lending Ratio
FDH	First Discount House
FMB	First Merchant Bank
FSI	Financial Soundness Indicator
FX	Foreign Currency
ICB	International Commercial Bank
ICT	Information Communication Technology
IMF	International Monetary Fund
LCPI	Loita Capital Partners International
MCR	Minimum Capital Ratio
MDC	Malawi Development Corporation
MSB	Malawi Savings Bank
NBM	National Bank of Malawi

OIBM Opportunity International Bank of Malawi Ltd

RBM Reserve Bank of Malawi

RBS Risk Based Supervision

ROA Return on Assets

ROCE Return on Capital Employed

SADC Southern Africa Development Community

SPSS Statistical Package for Social Scientists

STD Standard Bank of Malawi

TB Treasury Bills

USA United States of America

Chapter 1 Introduction

1.1 Background

Banking institutions play a crucial role in the economy of a country. They are principal depository institutions of public savings and operators of the nation's payments system. They channel financial resources from individuals and companies with surpluses to those whose resources are in deficit. In so doing, the banking system helps those with insufficient financial resources to acquire investment capital that is critical for the growth and development of an economy. It is for these reasons that the banking business is regulated and supervised. The regulation and supervision is aimed at fostering financial stability and soundness and protecting the interest of depositors and other creditors. The regulatory function is the responsibility of governments and is undertaken through central banks or state regulatory agencies.

In the case of Malawi, banks are regulated and supervised by the Reserve Bank of Malawi (RBM). The Reserve Bank of Malawi is empowered by the Banking Act 1989[1] and the Reserve Bank of Malawi Act 1989 to regulate and supervise the conduct and operations of banks and other financial institutions in Malawi. Section 14(1) of the Banking Act 1989 provides that:

> ....the Reserve Bank of Malawi shall supervise the banks and financial institutions specified in the Schedule and such supervision shall aim to protect the interest of present and potential depositors and other creditors, with regard to solvency, liquidity and profitability of such institutions and to their maintaining sound banking practices.

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[1] During the period of writing this dissertation, Parliament had passed the revised Banking Act 2009.

Further, Section 4 of the Reserve Bank of Malawi Act 1989 also provides for principal objectives of the Reserve Bank of Malawi which among others include promoting a sound financial structure in Malawi, including payment systems, clearing systems and adequate financial services and to supervise banks and other financial institutions.[2]

1.2 The Malawi banking system

The composition of Malawi's banking system as at the end of December 2008 is as shown in Table 1.1. The number of banks has increased to eleven from two before the Banking Act was revised and promulgated in 1989. The number of banks has for a long time been predominantly monopolised by the two commercial banks; National Bank of Malawi and Standard Bank of Malawi (previously known as Commercial Bank of Malawi). The status changed in the early 1990s following amendment of the Banking Act 1965. The amended Act that was enacted in 1989 removed the entry barriers to the banking sector. Thus, following this removal, the country witnessed the entry of other banks (both local and foreign owned) in the banking system. Some of the new entrants included Malawi Savings Bank, NBS Bank and Indebank which were financial institutions previously registered under different legal frameworks.

[2] Section 4 of the Reserve Bank of Malawi Act 1989 provides about 10 principal objectives of the Reserve Bank of Malawi. Some of them are, to issue legal tender currency in Malawi, to act as banker and advisor to the Government, to promote a money and capital market in Malawi, to act as lender of last resort to the banking system, to promote development in Malawi, among others.

Table 1.1 The Malawi banking system

1	The Reserve Bank of Malawi
2	National Bank of Malawi
3	Standard Bank of Malawi
4	First Merchant Bank
5	Malawi Savings Bank
6	NBS Bank
7	Indebank
8	Nedbank
9	Ecobank
10	Opportunity International Bank of Malawi
11	FDH Bank
12	International Commercial Bank

At the top of the banking system is the Reserve Bank of Malawi. It was established in 1965 under the Act of Parliament to undertake a number of varied functions as provided for in Section 4 and 14 of the Reserve Bank of Malawi Act 1989 and the

Banking Act 1989 respectively.[3] As shown above, one of such objectives is to supervise banks and other financial institutions.

Standard Bank (formerly known as Commercial Bank of Malawi) and National Bank of Malawi (NBM) are the oldest banks in Malawi. They were incorporated in 1969 and 1971 respectively under the Banking Act 1965. The founder shareholders of Standard Bank were Malawi Development Cooperation (MDC) (20%), Press Holdings Limited (20%) and Banco Pinto Sotto Mayor (60%). National Bank, on the other hand, was incorporated when the Standard Bank and Barclays Bank D.C.O both of South Africa with operations in Malawi agreed with Malawi Government to create the National Bank of Malawi.[4] The government effectively owned these banks either directly or indirectly (through Statutory Corporations) until towards the end of 1990s when the government took a policy decision to privatise its shares in these banks. However, the government still has some indirect influence in these banks through Press Trust/Press Corporation in which the Government has a say. As at 31st December 2008, the shareholders of Standard Bank were Stanbic Africa Holdings Limited of South Africa (60.18%), NICO Holdings Ltd (20.08%), Old Mutual Life Assurance Company Ltd (4.63%), Press Trust (2.30%), Standard Bank Pension Fund (2.05%) and the public (10.76%); and NBM's shareholders were Press Corporation Ltd (51.73%), Old Mutual Group (24.83%), members of the public (22.03%) and employees (1.41%).

First Merchant Bank (FMB) is the first privately owned bank to be granted a banking license under the Banking Act 1989. It was licensed in November 1994 and commenced banking operations in June 1995. The bank was listed on the Malawi Stock Exchange in 2005 which eventually led to changes of its shareholding to Zambezi Investments Ltd (44.94%), Simsbury Holdings (22.47%), Prime Bank Ltd, Kenya (11.24%), Prime Capital and Credit Ltd, Kenya (11.24%) and the general public (10.11%)

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[3] See note 1 above

[4] Source: http//www.natbank.co.mw

Other privately owned banks include Ecobank (previously known as Loita Investment Bank), Opportunity International Bank of Malawi (OIBM), FDH Bank and International Commercial Bank (ICB). Ecobank was first granted a banking license in 1998 and it was wholly owned by Loita Capital Partners International (LCPI) of South Africa, until 2008 when the majority shareholding was taken over by Ecobank Transnational Incorporated (86.61%) with LCPI remaining with 13.39 percent. OIBM is owned by Opportunity Transformation Investments USA (53.7%), Opportunity Microfinance Investment Ltd UK (20.3%), Africap Microfinance Fund Ltd (19.8%) and Trust for Transformation (6.2%). It was granted a banking license in March 2002 and commenced banking business in May 2003. FDH Bank was licensed to conduct banking business in January 2008 and commenced its business in June 2008. It is wholly owned by FDH Financial Holdings Ltd. ICB, owned by ICB Global Financial Holdings of Malaysia (99.99%) and Lee Ooi Kim (0.01%) was licensed in June 2008 and commenced its banking business in December 2008.

The banks which were previously registered under different statutes and are now licensed under the Banking Act 1989 include INDEbank, NEDbank, Malawi Savings Bank and NBS Bank. INDEbank was established in 1972 under the Companies Act and transformed into a commercial bank under the Banking Act 1989 in 2001. In 2005, Trans-Africa Holdings of Mauritius and Press Trust acquired 41.38 percent and 30 percent respectively while ADMARC holds 25.67 percent and employees 2.95 percent. Nedbank (formerly Finance Corporation of Malawi and then Fincom Bank), was established in 1976 under the Companies Act and wholly owned by ADMARC. It was transformed into a bank in 2000 under the Banking Act 1989. The bank is now 97.2 percent owned by Nedbank Group Ltd through its subsidiary, MN Holdings. The remaining 2.8 percent interest is attributable to an Employee Share Ownership Plan. Malawi Savings Bank (formally Post Office Savings Bank) was initially established in 1968 under the Post Office Savings Bank Act No. 40 of 1967, Chapter 44:03 of the laws of Malawi (Sibweza, 1991, pp. 172). In 1995 the institution was registered under the Banking Act 1989. Currently, it is the only bank which is wholly owned by the Malawi Government.

The NBS Bank (formally known as the New Building Society) was incorporated under the Building Societies Act 1964 in February 1964. It was registered as a bank under the Banking Act 1989 in 2004. Currently the shareholders of the NBS Bank include, NICO Holdings Ltd (60%), the public (30%) and National Investments Trust Ltd (10%)

1.3 Bank regulation and supervision in Malawi

1.3.1 Background to Bank regulation and supervision in Malawi

The function of regulating and supervising banks in Malawi was established in 1975, under the Banking Act 1965, to actively monitor various aspects of banking operations, promote a viable and sound financial structure and ensuring efficient foreign exchange use and management for productive purposes in the country, among other responsibilities. Prior to 1975, there was no clearly defined supervisory function at the Reserve Bank of Malawi although it was charged with the responsibility of ensuring that there exists a viable financial system through the promotion of monetary stability and sound financial structure in the country. The interaction between the banks was characterised by an amicable and consultative approach. Thus, direct moral suasion was the dominant official practice. This was possible because there were only two banks whose level, character and operations did not warrant official intrusion.

1.3.2 Reforms in bank regulations and supervision

The direction of regulation and supervision of banking systems worldwide has undergone a substantial change. This follows changes in the banking system. The banking system has changed in terms of the numbers of banks and the products they are offering to their customers. The coming in of Information and Communication Technology (ICT), for example, has opened new avenues for financial products innovation in the banking industry. According to Chami et al. (2003, p. 4)

technology is considered as a phenomenally important engine of change in the banking system. They further pointed out that this has been used to fundamentally change the delivery and conception of banking services such as the Automated Teller Machine (ATM). Sahajwala and Bergh (2000, p. 1) noted that innovation, deregulation and globalization in banking have contributed to making banking business more complex and potentially risky.

The changes taking place in the banking sector worldwide are also applicable in Malawi. The country has witnessed an increase in the number of banks and also changes in the types of products offered. The number of banks has gone up from two in the 1980s to eleven in 2008[5]. During the same period, some existing products have been improved upon while new ones have been introduced. The banks are now offering electronic banking (e-banking) services such as ATM and mobile banking in addition to their traditional products of mainly accepting deposits, granting credit facilities and dealing in foreign exchange.

It is evident that these changes have posed challenges to the bank regulatory and supervisory approaches. Thus, the changes in the financial landscape have in a way undermined traditional approaches to bank regulation and supervision. Sahajwala and Bergh (2000, p. 1) observed that the changes in banking business present new challenges to bank supervisors with respect to the structuring of on-going supervision. In response to the changes in the banking systems, supervisory techniques are also changing around the world and Malawi is not an exception. In the case of Malawi, the reforms in bank regulations started with the revision of the legal framework as it is considered essential for effective regulation and supervision of the banking system. This involved the revision of both the Banking Act and the Reserve Bank of Malawi Act and became effective in 1989. The revised legal framework gave the Reserve Bank of Malawi a wider horizon of operations and its

[5] The Banking Act 1989 provides a list of banks that were in existence before new banks were licensed. These are National Bank of Malawi and Commercial Bank of Malawi (now Standard Bank) and the Register of Banks that can be obtained from the Reserve Bank of Malawi (Bank Supervision Department) provides the updated list of banks operating in Malawi.

supervisory responsibilities extended to cover other financial institutions such as leasing companies. The amended laws also mandated the Reserve Bank of Malawi to start issuing regulations in the form of directives/guidelines in order to guide the banks in their operations. In 1993 the RBM came up with regulations (directives) on lending, Minimum Capital ratios and Liquidity Reserve Requirements, among others. Supervisory reforms have been in terms of CAMEL[6] and Risk-Based Supervision.

The Basel Committee[7] on Bank Supervision also plays a role in the regulatory and supervisory reforms. It provides a forum for regular cooperation between its member countries on supervisory matters. Its wider objective has been to improve supervisory undertakings and quality of banking supervision worldwide by improving the effectiveness of the techniques for supervising banks and setting minimum supervisory standards.

The main aim behind these reforms is to improve the effectiveness and efficiency of the supervisory process in order to ensure a sound and stable banking system; a requirement for the financial system. The stability of the banking system needs to be preserved since failure of one or more banks may lead to contraction of money supply, failure of the payments system and a severe dislocation of the real economy.

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[6] CAMEL is the type of supervisory methodology used to evaluate banks' performance. Banks are evaluated on the basis of five critical dimensions relating to their operations and performance. It is referred to by its component factors. These are **C**apital, **A**sset quality, **M**anagement, **E**arnings and **L**iquidity. It is seen to reflect the financial performance, financial condition, operating soundness and regulatory compliance.

[7] Basel Committee on Banking Supervision was established as a committee on Banking Regulations and Supervisory Practices by the central bank Governors of the Group of Ten (G10) countries at the end of 1974 in the aftermath of serious disturbances in international currency and banking markets (notably the failure of Bankhaus Hertstatt in West Germany). The committee members now (2007) include Belgium, Canada, France, Germany, Italy, Japan, Luxemburg, the Netherlands, Sweden, Switzerland, United Kingdom and United States. Countries are represented by their central bank and also by the authority with formal responsibility for prudential supervision of banking business. (Read more on history of Basel Committee at **www.bis.org**)

Llewellyn (2006, p. 5) pointed out that a stable and efficient financial system has a potentially powerful influence on a country's economic development. Ahmad (1992, p. 2) supported this position when he noted that a strong and sound banking system is a conduit to a vibrant economic base with a high level of savings. Vittas (1991, p. 3) reinforced the need to regulate banks when he stated that financial intermediaries need to be subjected to extensive regulation.

1.4 Research problem

Malawi has witnessed changes in the financial landscape since the early 1990s. There has been entry of new players in the banking system as a result of liberalization of the economy and amendment of the Banking Act in 1989. The banking products have also increased. Consequently the banking supervision and regulation approaches have also changed in order to maintain the stability and soundness of the banking system.

However, it is not known whether Malawi has a sound and stable banking system. It is not clear whether the changes in the bank regulation and supervision are timely implemented for the maintenance of stability and efficiency in the banking system. The understanding of the impact of these changes is very important especially at this time when banks are taking many risks. In addition, the new banking products that have flourished in the banking industry following the substantial development in ICT also pose some risks to stability of the banking system.

It is not known whether regulatory and supervisory reforms are appropriately aligned to the changes in the banking system. It is also not known whether or not the reforms in bank regulation and supervision have a positive impact on the performance of the banks in Malawi. In this regard, it is important that the impact of the reforms in regulation and supervision on the performance of banks in Malawi be evaluated; this is the focus of this report.

1.5 Research objectives

This research study investigates the relationship between the reforms in bank regulation and supervision and the performance of banks in Malawi.

1.5.1 Overall objective

The main objective of the study is to assess the impact of regulatory and supervisory reforms on the performance of the banks in Malawi.

1.5.2 Specific objectives

Specifically, this research study seeks to:-

- Evaluate how the reforms in bank regulation and supervision have affected the banking system performance in Malawi.

- Assess if bank regulatory and supervisory reforms have contributed to the efficiency of banks in Malawi and banking system stability.

1.5.3 Research questions

In relation to the objectives above, the research study aims to answer the following main research question that has emanated from reforms in regulations and supervision:

- What is the impact of banks' regulatory and supervisory reforms on the performance of banks in Malawi?

Below are the subsidiary research questions:

- Have these reforms improved banking system stability in Malawi?

- Have the reforms in bank regulation and supervision brought about banks' efficiency and profitability?
- Is there any relationship between banks' performance and bank regulatory and supervisory reforms?

1.6 Research methodology

In order to study the impact of reforms in bank regulation and supervision on the performance of banks in Malawi, the research study was based on nine banks in Malawi. These are banks which operated for a period of more than 12 months as at the end of December 2008. The research used data from both primary and secondary sources. Primary data was obtained through questionnaires and interviews while secondary data was collected from the banks' audited annual accounts.

In order for the above research questions to be answered, the data gathered was analysed using both quantitative and qualitative approaches.

1.7 Significance of the research

It has been noted that despite regulatory and supervisory reforms taking place worldwide, there are still reports of bank failures. Recently, the United States of America had to bail out major troubled banks following the failure of Lehman Brothers Limited (September 2008)[8]. Thus, banks are still failing despite reforms in bank regulations and supervision. It is therefore questionable as to whether reforms in bank regulations and supervision help in maintaining financial system stability in a country. It is also not known whether the situation would have been worse had there not been any changes in bank regulation and supervision. In addition, it is not known whether bank regulation and supervision is preventing banking systems from

[8] More on this is provided at: http://news.bbc.co.uk/go/pr/fr/-/2/hi/business/7615931.stm

systematic failure. This is echoed by Barth, et al. (2008, p. 1) who wondered whether there is a high degree of regulatory reforms in developing countries which can minimise bank failure.

Bearing in mind the negative impact of an unstable financial system, it is important to know whether countries such as Malawi appreciate the need for reforming their bank regulatory and supervisory approaches as suggested by the IMF[9] and the Basle Committee on Banking Supervision. These international bodies are on a continuous basis developing broad supervisory standards and guidelines. It is yet to be found whether the best practices advocated by these international agencies are the best ones for promoting well functioning banks in Malawi. It is not known whether the banking system in Malawi that appears to be stable (despite closure of one bank in 2005) is due to the bank regulatory reforms or merely by chance. Accordingly, it is not clear what type of financial system Malawi could have if there were no reforms in bank regulation and supervision by the Reserve Bank of Malawi.

In addition, it should be appreciated that the heart of the justification of reforms in bank regulation and supervision is the need to preserve a sound and stable financial system in the wider interest of ensuring the smooth functioning of the economy. It remains to be researched whether this is being achieved.

It is also noted that not many studies have been carried out regarding the impact of regulatory and supervisory reforms on the performance of the banking systems. To the best knowledge of the researcher, the studies conducted are on either bank regulatory reforms only or focused on performance of banks only. In addition, studies conducted by Barth et al. (2008) in 'Banking systems are changing: for better or worse', which covered many developed and developing countries did not cover Malawi despite the fact that the country has equally experienced reforms in bank regulation and supervision and changes in financial landscape over the years.

[9] Most bank supervisory documents by IMF can be found at www.imf.org

This study is therefore significant as it will establish whether the bank regulatory and supervisory reforms have any impact on the performance of banks in Malawi. In the case of positive impact, the regulator would be in a better position to enforce the regulations on the banks. Conversely, the regulator would take appropriate action to discontinue the application of the regulation in the case of negative impact.

1.8 Scope and assumptions

The study covered the period from 1990 to 2008. This accommodated the assessment of the impact of reforms in regulations and supervision on the banks' performance from the time Malawi experienced no bank regulatory reforms and had only two banks to the current position where there have been reforms in bank regulation and the number of banks has increased to eleven. This research has covered nine banks. These are the banks that have been in existence for more than 12 months as at 31st December, 2008.

This research will provide an important input to the regulators in Malawi and other countries as regards the importance of implementing reforms in regulations and supervision and the timeliness of implementing the same.

1.9 Limitation

The study is limited to the assessment of the impact of bank regulatory and supervisory reforms on the performance of banks that have been in operation for more than 12 months period as at the end of December 2008. In view of this, the results and conclusions drawn cannot be taken to mean that all banks would be affected the same way. In addition, this research is limited in that the impact of economic conditions on the banking system would not be isolated. Thus, the results could not be specifically attributed to the regulatory reforms since economic conditions also contribute to the performance of banks. Considering that the regulatory and supervisory reforms are continuously taking place, the results and

conclusions on the impact on banks' performance drawn in this research cannot be generalised into the future.

1.10 Outline of the study

This research is divided into six chapters dealing with specific but related issues as follows.

Chapter 1 provides the background to the study, the research problem, significance of the research, the objectives of doing the study, the scope and assumptions of the research and its limitations.

Chapter 2 covers the conceptual framework of the study.

Chapter 3 presents literature review. It among other things gives the definition of reforms and explores the impact of such reforms on the performance of banks. The performance is looked at in terms of efficiency, profitability and stability.

Chapter 4 provides the methodology used in the study including research instruments used and briefly explains how the data has been analysed.

Chapter 5 presents the analysis and discussion of the results of the research. The results are discussed based on data collected vis-à-vis the research objectives.

Chapter 6 gives the summary and conclusion of the study including recommendations based on the findings. Areas for further research are also given at the end of this chapter.

Chapter 2 Conceptual Framework

2.1 Introduction

This chapter introduces variables used in this research. The study was undertaken on the premise that performance of banks can be affected by the regulatory and supervisory methodology applied by the Reserve Bank of Malawi. The reforms to such approach can have an impact on the performance of banks. The literature review has identified the regulations and supervision as independent variables and performance aspects of banks as dependent variables. These variables have been discussed fully in Chapter 3.

2.2 Independent and dependent variables

The Figure 2.1 below provides an overview of independent and dependent variables. Basically, the figure depicts that performance of banks relates to two major categories of the perceived independent variables namely regulations and supervision. The performance of the banking system depends mainly on the regulatory and supervisory methodology. The direction of banks' performance depends on the strength of regulations and how closely the banks are monitored.

The regulations are rules given to banks to follow in conducting their banking business. The banks are therefore required to comply with the bank regulations issued by the Reserve Bank of Malawi. It is believed that banks which operate according to the regulations end up improving their performance. Likewise, supervision provides means of monitoring banks' compliance to the regulations. The monitoring process helps in taking appropriate measures on banks which do not comply with regulations.

The dependent variables in terms of performance considered in this study included profitability, efficiency and stability. These are fully examined under literature review.

Independent variables

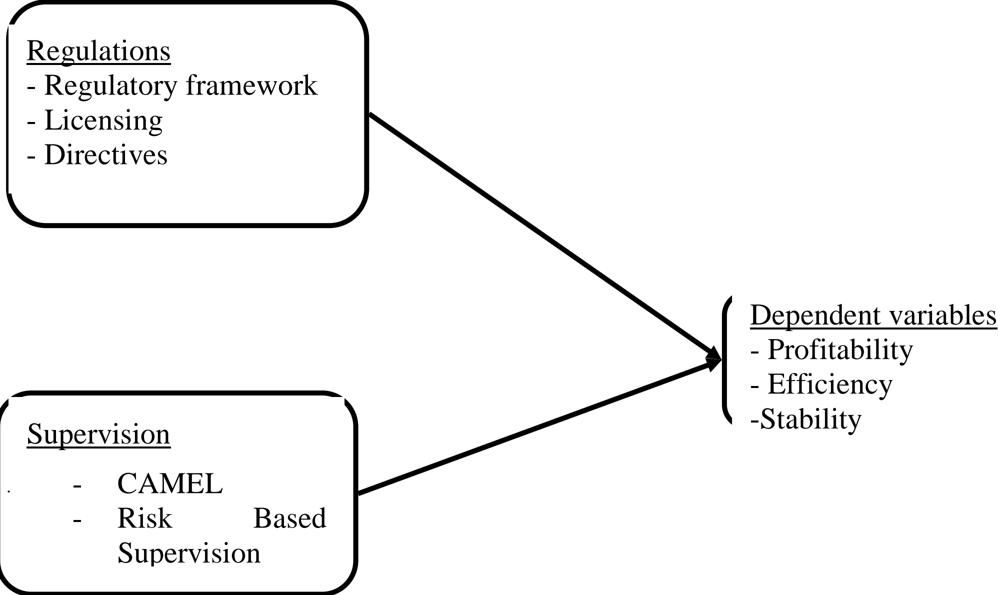

Figure 2.1 Conceptual framework

Chapter 3 Literature Review

3.1 Introduction

This chapter reviews the literature on the bank regulatory and supervisory reforms and bank performance. Firstly, it gives the definition of reform and discussion of the reforms in bank regulation and supervision in Malawi. The performance of the banking system is also discussed in terms of profitability, efficiency and stability.

3.2 Reforms in bank regulation and supervision

Reform is defined in Concise Oxford English Dictionary (2002, p. 1204) as 'make changes (in something, especially an institution or practice) in order to improve it'. From this definition, the bank regulatory and supervisory reform can be construed to mean changes to the bank regulatory and supervisory methodology aimed at improving the way the banks are regulated and supervised.

3.3 Bank regulation

Researchers have looked at regulation differently. For example, Sharma and Vashishtha (2007, p. 287) consider regulation as implying the establishment of specific rules of behaviour. Casu et al. (2006, p. 161) defined regulation as the setting of specific rules of behavior that firms are required to abide by. These may be set through legislation (laws) or be stipulated by the relevant regulatory agency. From these definitions, bank regulation can be considered as the process of setting laws, regulatory directives and policy statements that guide banking business.

The bank regulations are dynamic processes. Thus, they keep on changing. In this regard, the banking sector is required to be adapting to changes in order to remain effective. There are many factors which lead to changes in bank regulations. Chami

et al. (2003, p. 9) highlighted the factors which led to changes in bank regulations in the 1970s and 1980s. Important factors listed included deregulation of interest rates and exchange rates, globalisation of banking business and advances in ICT. In addition, Casu et al. (2006, p. 169) observed that whenever there are financial innovations (new financial products or services) in the market, they often call for new regulation. In addition to the above reasons, bank regulatory reforms are in response to public reaction to financial scandals/crises. For example, in Nigeria, the regulatory framework had to change following financial crisis (Uche, 2000) and in the United States of America the White House introduced Financial Regulatory Reform Plan in June 2009 following the financial crisis of 2008[10]. According to Maimbo (2000, p. 293), the bank regulations in Tanzania, Uganda and Zambia were outdated and inadequate. As such, they were next to irrelevant and needed to be changed so as to suit current banking operations. In the case of Malawi, the bank regulatory reforms were not due to any financial crisis. They were in response to the transformed economic and financial environment and in the context of the Statement of Development Policies for the (1987-1996) decade and also due to the liberalisation of interest rates (Pelekamoyo, 1990).

On the other hand, the change in the bank regulations is also a way of trying to effectively protect the banking system from devastating consequences. Brownbridge and Kirrpatrick (2000, p. 5) observed that the bank regulatory reforms in developing countries were also part of broader programs of financial sector reforms funded by loans from the World Bank.

The changes in bank regulation can take many forms, including introduction of new laws, regulations and directives/guidelines or amendment of the current banking laws and directives/guidelines. Mkulichi (1999, p. 18) observed that the countries in the SADC region had amended their ordinances, regulations and directives. In the case of Malawi, the regulatory reforms started with the amendment of the

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[10] The plan is available at http://www.financialstability.gov/docs/regs/FinalReport_web.pdf

Banking Act and the Reserve Bank of Malawi Act and introduction of various directives and guidelines.

3.4 Bank regulatory framework

Prior to regulatory reforms, there was no clearly defined supervisory function of the Reserve Bank of Malawi. The legal framework then had little provision for effective bank surveillance. However, the Reserve Bank of Malawi was responsible for ensuring that there exists a sound financial system. The Reserve Bank of Malawi's regulatory operations was guided by the Banking Act 1965 and the Reserve Bank of Malawi Act 1965. Ngoliwa (1998, p. 27) reported that in Malawi, the revision of the Banking Act and the Reserve Bank of Malawi Act in 1989 was aimed at creating a conducive regulatory framework to foster competition and prudential supervision of banks. The changes in bank regulation also contributed to strengthening of the supervisory provisions geared towards safeguarding liquidity, solvency and sound banking practices. In addition, the revised Banking Act 1989 empowers the Reserve Bank of Malawi to issue directives necessary for bank operations. As a result, the legal framework reforms would go a long way towards fulfilling the objective of strengthening the bank regulatory and supervisory approach.

3.5 Review on directives

Ngoliwa (1998, p. 38) defined a directive as a written guideline issued by the regulatory authority in order to facilitate the execution of its policies. Thus, the Reserve Bank of Malawi as regulatory authority of banks in Malawi has the authority to issue directives[11] and guidelines to banks. The issuance of directives

[11] The details of the directives can be found at the Reserve Bank of Malawi website: www.rbm.mw

started in 1993 following the enactment of the Banking Act 1989 and the Reserve Bank of Malawi Act 1989. Rashid (2003, p. 2) noted that the Reserve Bank of Malawi issued the directives with the view to ensure that banks conduct their business in line with acceptable international standards. Since the time the Banking Act 1989 came into force, the Reserve Bank of Malawi has issued many directives. Table 3.1 lists some of the directives issued.

Table 3.1 Some of the directives issued by the Reserve Bank of Malawi since 1993

Type of Directive	Year issued	Name of the Directive
DO2-93/MCR	June, 1993	Minimum Capital Ratios for Banks
DO1-97/FX	August, 1997	Foreign Currency Exposure Limits[12]
DO2-97/FXLR	August, 1997	Foreign Currency Lending Ratio
DO1-05/CDD	June, 2005	Customer Due Diligence for Banks and Other Financial Institutions
DO1-06/ASCL	March, 2006	Asset Classification[13]
DO2-06/LAEX	March,2006	Large Exposure[14]
DO4-06/TRP	March, 2006	Transactions with Related Persons
DO1-08/PID	June, 2008	Premises Inspection

[12] It was first issued in August, 1995.

[13] It was first issued in 1993 as “Directive on Prudential Guidelines on Asset Quality for Banks”

[14] It was first issued in 1993 as “Directive on Credit Concentration for Banks”

The following discussion is on some directives which had major impact on operations of banks.

3.5.1 Minimum capital ratios for banks

Capital is traditionally defined as net worth that is equal to the book value of assets minus the book value of liabilities. It is one of the key factors to be considered when assessing the safety and soundness of a bank. The bank regulators view capital as performing several important roles. Ngoliwa (1998, p. 37) outlined some of the roles of capital to banking business. These include bearing of risks and absorbing any unexpected losses caused by events either within a bank's control or due to external factors. Alternatively, Llewellyn (2001, p. 333) looked at capital as an internal insurance fund to cover risks (including credit risk) that cannot be externally insured. Capital also serves as a foundation for a bank's future growth. Thus, bank capital provides a financial 'cushion' that enables banks to continue to operate even when they are temporarily sustaining losses. At the end, the capital is presumed to have maintained public confidence in the soundness of individual banks and the banking system as a whole.

In this regard, the bank is required to maintain a minimum level of capital at all times. The need for the banks to maintain minimum levels of capital against their risk assets started with the Basel Capital Accord in the mid 1980's (Alexander 2004, p. 6). The main aim was to build public confidence in the banking sector. Thus, before the 1988 Basel Capital Accord, the capital adequacy requirement was measured using the leverage ratio, (Caruana and Narain 2008). Countries developed different minimum leverage ratios ranging from 4.0 percent to 6.0 percent. The bank which met the required capital ratio was said to be meeting the minimum capital requirement. Presently the leverage ratio continues to be a supplementary measure of capital strength.

The Reserve Bank of Malawi, as any other supervisory authorities, also places an increasing emphasis on capital adequacy. Like most supervisory authorities the

leverage ratio was the main measure of capital adequacy. However, this measure did not consider credit risk in its calculation. Consequently, banks could meet the acceptable leverage ratio but failing to contain credit risk exposure. In view of this, the assessment of the bank's capital adequacy takes into account credit risk. This is considered as one of the key factors for assessing the safety and soundness of the banking system.

The Reserve Bank of Malawi in 1993 issued the directive called Minimum Capital Ratios for Banks (NO.DO2-93/MCR) which is in line with the 1988 Basel Capital Accord. A bank's minimum capital standard is measured as a percentage of its core or total capital to the sum of all its asset categories weighted by a standardized weighting scheme (risk-weighted assets).[15] The directive prescribes the minimum capital requirements ratios for banks in Malawi. It sets 6 percent and 10 percent for core capital ratio and total capital ratio respectively. Thus, a bank's capital is categorised into core[16] and supplementary capital[17]. The bank whose capital ratios are above the regulatory minimum benchmarks is considered to have adequate capital. Adequate capital base serves as a safety net for banking risks and as foundation for a bank's future growth and stability. The banks are therefore obliged to continually meet two capital adequacy ratios: core and total capital ratios.

The Reserve Bank of Malawi issued this directive mainly to provide the basis for measuring capital adequacy of banks. In addition, it was issued as a compliance with the requirements of section 15(2) of the Banking Act 1989 and the Basel Capital Accord (Basel 1) developed by the Basel Committee on Bank Supervision

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[15] This is provided for in both Minimum Capital Ratio Directive issued by the Reserve Bank of Malawi in 1993 and Basel Capital Accord 1988. Assets are given risk weight ranging from 0% to 100%. The risk-weighted sum of the bank's assets becomes the denominator for both ratios.

[16] Core capital (tier 1) consists of paid up capital, share premium, retained profits, 60% of year to date profits (100% in the case of a loss) less unconsolidated investment in financial companies.

[17] Supplementary capital (tier 2) consists of revaluation reserves and general provisions, when such general provisions have received prior approval of the Reserve Bank of Malawi.

in 1988 . According to Godlewski (2005, p. 128) the main aim of Basel 1 was to promote and achieve international convergence of standard minimum capital requirements. The directive therefore ensures that banks in Malawi maintain capital standards recognised internationally as being prudent.

3.5.2 Large Exposure Directive

Lending can be looked at as granting or allowing someone the use of a sum of money under an agreement to pay back later with interest. The banking institutions remain the most important source of credit supply in the country. However, the lending business exposes banks to credit risks[18]. Thus, a large exposure to a single borrower or group of related borrowers or particular industry or geographical region is considered a common cause of banking failures especially when they default.

In order to promote safety and soundness of the banking system in Malawi, the Banking Act (1989) and the Large Exposure Directive (revised in 2006) prohibits banks from extending and or maintaining credit facilities to a single customer or group of related borrowers when such credit facility is above 25 percent of the bank's core capital. However, the bank can extend large exposure if it is unconditionally guaranteed by the Government of Malawi or it has prior written Reserve Bank of Malawi approval. The direct impact of this restriction is that the maximum of each loan amount will be depended on the level of core capital.

Credit concentration limits have widely become part of effective bank regulation in most countries. Studies conducted by Morris (2001) revealed that most countries set limits on large exposures for banks in line with broadly applied international standards. From a supervisory point of view, this is aimed at instituting sound practice of credit diversification in order to spread the credit risk. Thus, limiting the exposure is one way of ensuring that losses incurred by any single borrower or

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[18] Credit risk is defined as the risk of loss due to borrower or counterparty failing to meet its obligations.

group of related debtors are not large enough as to impair the soundness of the bank. The aim is generally to maintain financial stability and soundness, since default of one or more customers can adversely affect the bank and eventually the banking system.

3.5.3 Asset Classification Directive

Loan portfolio constitutes the major item on the bank's balance sheet. As such it is crucial that banks are guided on its treatment. The directive is concerned with the quality of the assets of the bank.

The Reserve Bank of Malawi issued this directive first in 1993 and it was revised in 2006 in order to provide standards for evaluating the quality of bank assets and the adequacy of loan loss reserves. The directive gives guidelines to banks as to when and how to make provisions for bad and doubtful loans. The main objectives of the directive include, to ensure that banks are in proper compliance with capital adequacy requirements as called for in Section 16 of the Banking Act 1989, and that banks are quantitatively identifying their non-performing credit facilities in line with internationally recommended asset classification and provisioning standards. Thus, the banks are assessed if they are making adequate provisions for bad and doubtful debts all the times. The directive also ensures that banks present balance sheets and income statements that properly reflect the financial impact of non-performing credit facilities. Absence of the directive would lead to banks failing to make adequate provisions. This is echoed by Polizatto (1990, p. 9) who noted that most banks do not identify problem assets, establish realistic provisions for potential losses or suspend interest on non-performing assets.

The philosophy behind the foregoing prudential objective is the need for banks to recognise, in an accounting sense, problem assets by using a quantitative definition of non-performing assets and then properly treat such assets with regard to accrual of interest, classification according to ultimate collectability and to make adequate provisions based on such classification. The recognition of such non-performing

assets stimulates debt collection efforts and thus helps reduce the possibility of loss on such assets.

The coming up of this directive was also in line with other supervisory authorities worldwide who recognise that their effectiveness is dependent on the integrity of balance sheets and income statements of banks which result from proper identification and accounting treatment of non-performing assets. The Reserve Bank of Malawi recognises that failure to set such standards can lead to fictitious profits and misleading balance sheets. Polizatto (1990, p. 9), in support of this fact, stated that the balance sheet does not reflect the bank's actual condition and the income statement overstates profits.

The directive also requires that all credits are supposed to be reviewed for purposes of classification on at least a quarterly basis. The banks are required to review their credits in a systematic way and in accordance with their own written policies and procedures. Each "large exposure" shall be reviewed on an individual item basis. Based on the review, each credit shall be included in one of the classification categories.

There is a need therefore for banks to systematically and realistically identify their problem assets and provide adequate provision. In so doing, banking stability is believed to be enhanced.

3.5.4 Foreign Currency Exposure Limits and Foreign Currency Lending Ratio Directives

The Foreign Currency Exposure Limits (FX) Directive was first issued in 1994 and revised in 1997 while the Foreign Currency Lending Ratio (FCLR) Directive became effective on 1st August 1997. The FX Directive was issued in order to establish prudential limits within which banks may hold foreign exchange positions so as to maximise a bank's ability to conduct business in a sound and viable manner and for the convenience of its customers. It also helps banks to promote favourable

competition in the access to and availability of foreign exchange. On the other hand, the FCLR Directive was issued to provide a consistent and uniform mechanism whereby the Reserve Bank of Malawi may ensure that banks adhere to prudent liquidity management and lending practices.

3.6 Bank supervision

There is no universally agreed definition of supervision. Several scholars have come up with different definitions depending on their school of thought. According to Goodhart et al. (2005, p. 189), supervision is the general observation of the behaviour of banks. Jordan (2001) referred to supervision as the monitoring or oversight function that takes place after regulations have been passed and Mishkin (2001, p. 1) considered supervision to involve government regulation and monitoring of the banking system to ensure its safety and soundness. Bank supervision can also be referred to as ongoing monitoring of banks and enforcement of banking regulations and policies (Polizatto 1990, p. 2). Cooper (1986, p. 32) defined supervision as a process directed primarily at monitoring bank(s) in order to ensure that they comply with regulations and do not behave imprudently.

From these definitions, bank supervision can broadly be understood as a process of monitoring a bank's compliance with various policies, rules and regulations on a continuous basis. This monitoring process starts once the bank is licensed and has commenced its operations. This is done through off-site surveillance and on-site examination. The process is undertaken on the premise that it is a precondition for bank stability, efficiency and profitability. Thus, an effective supervision is important for a stable banking system where bank failure is not frequent and where weak banks are turned around successfully before they fail.

The Reserve Bank of Malawi, like most bank regulators worldwide, supervises the banks in Malawi through off-site and on-site supervision. Briefly, off-site supervision is the minimum tool for ongoing supervision. It involves reviewing and analysing periodic financial statements (commonly known as Call Reports) and

other information received by the Reserve Bank of Malawi relating to the banks' activities. This provides an important complement to on-site examination by providing early warning of actual or potential problems, (Polizatto 1990, p. 25). On-site examination involves assessing banks on their premises. Thus, it requires physical presence of the bank examiners at the bank. During the visit, bank examiners make an overall assessment of the banking institution. This process also allows supervisors to conduct hands-on assessment of qualitative factors such as management capabilities and internal controls among others, (Sahajwala and Bergh 2000, p. 3).

3.7 Supervisory approach

The supervision of banks has undergone changes over time. Initially, the supervisory approach involved mainly protecting the individual depositors since funds from the public provide the resources for the operations of the financial institutions. Then it focused on compliance. Thus, the supervision then was aimed at finding contraventions to banking laws, policies, rules and regulations regardless of materiality. Hotay (2008, p. 1) observed that during this period the bank examiners relied extensively on transaction testing such as reconciling data, counting cash and securities and other detailed checking. The Reserve Bank of Malawi had a similar approach where bank examiners were involved in work which was similar to that of auditors. They were engaged, among other functions, in cash count. With the passage of time, the process was found to be outdated and irrelevant for the modern banking operation. In view of this, it was necessary to keep pace with changes in the banking industry brought about by ICT and financial product innovation. This entailed changing the supervisory approach in order to improve its effectiveness. Several countries had to change their financial supervision arrangement in order to build effective supervisory capacity and achieve economies of scale among others reasons, (Athanassiou 2006, p. 57). The Reserve Bank of Malawi, like other bank supervisors worldwide changed its supervisory approach from traditional checklist approach of determining

compliance with banking laws to the CAMEL rating and more recently Risk-based supervision that is build upon a thorough understanding of the bank's business and risk-management processes. These approaches are discussed below.

3.7.1 CAMEL rating approach

The CAMEL rating system was first used in the USA[19] in 1979 as the Uniform Financial Institutions Rating System. The CAMEL acronym represents the five component rating factors used in the system: **C**apital, **A**sset quality, **M**anagement capabilities, **E**arnings and **L**iquidity. This is a supervisory methodology which helps regulators in assessing a bank's financial performance and operating soundness under certain supervisory criteria. Each of the component factors is rated on a scale of 1(strong) to 5 (unsatisfactory)[20]. A composite rating is assigned as an abridgement of the component ratings and is taken as a prime indicator of a bank's current financial condition, (Sahajwala and Bergh 2000, p. 8). The composite rating also ranges between 1 (strong) to 5 (unsatisfactory) and also involves a certain amount of subjectivity based on the examiners' overall assessment of the institution in view of the individual component assessment (ibid). This system helps the bank examiners to identify banks that need supervisory attention such as increased off-site monitoring.

The CAMEL rating system has been adopted for use in many countries. Malawi adopted this methodology in the late 1990s. Use of the CAMEL is widespread because it is aligned with the Basel Committee's *Core Principles for Effective Banking Supervision*.

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[19] The bank ratings assigned by the USA supervisory authorities are treated as the most significant and reliable tool for assessing the financial condition of a banking institution.

[20] The scale to which CAMEL components are rated are:- 1=Strong; 2=Satisfactory; 3=Fair; 4=Marginal and 5=Unsatisfactory. Thus any component rated '1' is considered to meet supervisory requirements and that it has minimal supervisory concern. On the other hand a rating of '5' means the component is critically deficient and presents an imminent threat to the bank's viability.

3.7.2 Risk - Based Supervision

Risk Based Supervision (RBS) represents a paradigm shift in bank supervisory approach from the traditional rule-based, standardized and point-in-time assessments to a process-oriented, forward looking, continuous and risk profile driven approach to supervision and regulation of banks. Accordingly, it is aimed at assuring a qualitative and quantitative assessment of a bank's risk profile. This follows the quest to improve the effectiveness and efficiency of the supervisory process. In order to achieve best results, the approach is based on a thorough understanding of a bank's business and its risk management process. In this case, the Reserve Bank of Malawi requires each bank to prepare a comprehensive Risk Management Programme (RMP) tailored to its needs and circumstances under which it operates.

Hotay (2008, p. 8) defined the Risk Based Supervision (RBS) as a supervisory approach that is designed to identify activities and practices of greater risk to the soundness of banks and accordingly deploying supervisory resources towards the assessment of how those risks are being managed by banks. In conducting risk-based supervision, assessment of bank's performance takes into account, among other factors, its risk management and ability to manage risks. The banks are therefore expected to be more risk focused in their banking business in order to ensure robustness, effeciency and effectiveness of risk management systems and practices. Thus, the RBS approach promotes sound management of risks in an individual bank which in turn contributes to stability of the financial system

In Malawi, the RBS methodology started in 2007 and was officially launched in January 2009. The approach is therefore fairly new to the banking system.

3.8 Performance of banks

The banking sector is one of the most important sectors in an economy. As such the need to measure their performance is very important. The importance of adequately

measuring the performance of banks has been recognised by many regulators for a long time (Ramanathan 2007, p. 137). However, reforms have a profound effect on the performance of the banking sector and its influence on a country's macroeconomic performance, (Bdour and Al-khoury 2008, p. 162). The banking system performance can be looked at as how well banks are performing in the industry under different regulatory and supervisory approaches. This can be in terms of profitability, efficiency and stability among others.

3.8.1 Profitability

Profitability can simply denote excess of revenues over costs. The bank's profitability level gives an indication as to how well, in terms of profits, the bank is performing. It is believed that the firm which is profitable is inherently efficient and effective (Breton and Côté, 2006). However, the level of net profit suffers from one major drawback as it does not consider the size of the bank. This therefore makes it hard to compare how well one bank is doing relative to another bank. In order to deal with this problem, profitability ratios can be used. The basic profitability ratios are the return on capital employed (ROCE) and return on assets (ROA). The ROCE measures accounting profitability from the shareholders perspective while ROA measures how profitable assets have been employed, (Ngoliwa 1998, p. 92). Another commonly used measure is net interest margin which is the difference between interest income and interest expenses as a percentage of total costs. For the purposes of this study, profitability performance of the banking institutions is measured by using ROCE and ROA.

3.8.2 Efficiency

According to Neely et al. (2005, p. 1228) efficiency is defined as a measure of how economically the firm's resources are utilized when providing a given level of customer satisfaction. On their part, Mukherjee et al. (2002, p. 122) looked at efficiency as achieving competitiveness in the banking sector like never before.

They further noted that the bank is considered to be cost competitive if it spends equal amount of money on resources as others banks but generating high levels of performance. It remains to be researched if banks in Malawi are efficient following the implementation of new regulatory and supervisory approaches.

The efficiency analysis is essential for the evaluation of a bank's performance. The evaluation of bank efficiency has been approached from a variety of dimensions (Chen and Yeh 1998, p. 402). Thus, there are many different methods of estimating bank's efficiency. One such method can be by simple financial ratios (Mkulichi 1999). This measure is also supported by Mukherjee et al. (2002, p. 123) who pointed out that efficiency can be measured by the ratio of outputs and inputs. Chen and Yeh (1998, p. 402) noted that 'financial ratios provide valuable information about a bank's financial performance when compared with previous periods and peer ranking'. The financial ratios which can be used to measure efficiency include return on assets (ROA), return on investment (ROI) and return on capital employed (ROCE). Barth et al. (2008, p. 12) considered bank system efficiency as a measure of the net interest income margin relative to total assets and overhead costs relative to total assets. Alternatively, Mkulichi (1999) provided another measure of efficiency as X-efficiency or scale efficiency. The X-efficiency provides a measure of how effectively banks are using their inputs to produce a given level of output. In addition, some scholars have measured efficiency by using the Data Envelopment Analysis (DEA). The DEA is a non-parametric method of efficiency analysis for comparing units relative to their best peers (efficient frontier) rather than average performers, and to identify benchmarks for inefficient units (Charnes et al. 1978). For the purposes of this research, bank efficiency has been measured by calculating financial ratios especially overhead to income and overhead to total assets.

3.8.3 Stability

Financial stability has different definitions. However, most authors agree that it is about the absence of system-wide episodes in which the financial system fails to

function (crises), and about resilience of financial systems stress. It also encompasses other issues such as the smooth operation of the payment system and system liquidity (Čihåk, 2007). Barth et al. (2001, p. 32) stated that a stable banking system is an important component of a well-functioning financial system. A banking system is considered stable if it can stand shocks in the market. Garcia (2003, p. 112) considered a stable banking system as the one where bank failures are not frequent and where weak banks can be turned around successfully before they fail. When a financial system is stable, it is assumed that failure of one bank does not disrupt the banking system's stability. Sharma and Vanshishthan (2007, p. 276) observed that regulation plays an important role in promoting financial stability and protecting the interest of users of financial services. Kunt et al. (2006, p. 19) supported the fact that regulation and supervision ensure a safe and sound banking system.

Banking stability is measured by using financial stability indicators. There are numerous indicators used to measure the different facets of financial stability. They are divided into the Core Set and the Encouraged Set[21]. The Core Set indicators (12 indicators) relate to the banking sector and the Encouraged Set (27 recommended indicators) include indicators for the banking sector, non-bank financial institutions, households, financial markets and property markets. These indicators represent one of the quantitative methods measuring stability of the financial system. A relatively simple aggregate indicator of banking sector stability can be constructed as a weighted average of individual indicators capturing financial soundness of a bank.

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[21] Source is 'Financial Soundness Indicators: Compilation Guide', International Monetary Fund (IMF), March 2006

Table 3.2 Core Financial Soundness Indicators (FSI) according to the IMF(2006)[22]

CORE SET	**INDICATOR**
Capital adequacy	- Regulatory capital to risk-weighted assets - Regulatory Tier 1 capital to risk-weighted assets
Asset quality	- Nonperforming loans to total gross loans - Non-performing loans net of provisions to capital - Sectoral distribution of loans to total loans
Earning and profitability	- Return on assets - Return on equity - Interest margin to gross income
Liquidity	- Liquid assets to total assets - Liquid assets to short-term liabilities
Exposure to FX risk	- Net open position in foreign exchange to capital

[22] For a detailed definition of indicators see Compilation Guide for Financial Soundness Indicators (IMF 2006)

3.9 Chapter Summary

This chapter has reviewed literature on regulatory and supervisory reforms. From the foregoing review it is evident that bank regulatory and supervisory methodologies are changing in most parts of the world. The most prominent changes noted include amendments of legal frameworks and introduction of directives/guidelines. It is also noted that there are various reasons which lead to reforms in banking regulations and supervision. The reasons include financial crises, weakness of existing laws, liberalisation of interest rates and foreign exchange rates and globalisation. The Reserve Bank of Malawi has also changed its regulations and supervisory approaches. The country has changed its legal framework and introduced various directives and supervisory approach. It is noted that these reforms have profound effect on the development of the banking sector and its influence on the country's macroeconomic performance.

Chapter 4 Research Methodology

4.1 Introduction

This chapter gives an outline of the data and methodology used in examining the impact of regulatory and supervisory reforms on the performance of banks. The chapter outlines the research design, data sources and collection method and how data has been analysed. It also describes the reliability of the study and ethical considerations recognised in carrying out this research.

4.2 Design of the research

The study of reforms in bank regulation and supervision and its impact on the performance of the banking system in Malawi was based on qualitative and quantitative data obtained through exploratory field research. Qualitative approach was used in order to obtain different views and opinions of the respondents on the impact of regulatory and supervisory reforms on the performance of banks. Quantitative approach was used in order to statistically analyse the numerical data obtained through annual accounts. The quantitative approach was important in giving deeper understanding of the impact of regulatory and supervisory reforms on the performance of banks. A combination of interviews and a structured questionnaire were used together with primary and secondary data obtained from the banks' annual accounts.

4.3 Research scope

The study covered the period from 1990 to 2008. This period covers the period from the time Malawi had only two banks to the current position where the number of banks has increased to eleven. This research covered nine banks which had been in operation for more than a year as at 31 December 2008.

4.4 Research instruments

The research instrument which was used in this study is the questionnaire. The research questions were formulated on the basis of the main objective of the study. The research questionnaire was administered through email to nine banks and was addressed to either the Chief Executive Officer or the Deputy Chief Executive Officer. In certain cases it was sent to Senior Managers (heads of departments). These were considered appropriate because of their experience and their involvement in policy making and therefore presumed to provide reliable information. All respondents confirmed receipt of the questionnaire through the telephone or emails. There was a 100 percent response rate.

The researcher also conducted interviews. This approach allowed the researcher to examine various issues in detail with the respondents. These included their attitudes towards reforms taking place in bank regulation and supervision. Thus, this method was considered appropriate for this research because it helped in obtaining a clear picture of respondents' views, opinions, experience and perceptions of the regulatory reforms. In addition, the approach enabled the researcher to seek more clarification to the responses and/or ask supplementary questions whenever there was need to explore the objective of the study fully. Masons (quoted by Bitzenis et al. 2008, p. 54) stated that the interviews allow for greater flexibility and encourage people to speak their minds.

4.5 Data sources

The sources of data used in this research study were categorised into primary and secondary sources. Saunders et al. (2007, p. 607) define primary data as data collected specifically for the research project being conducted and secondary data relate to data used for a research project that were originally collected for some other purpose. For the purpose of this research, both sources of data were used for various purposes as outlined below.

4.5.1 Primary data

Under this, data was collected from banks though the use of questionnaire and interviews. Questionnaire is defined as a data collection technique in which each respondent is asked to respond to the same set of questions in a predetermined order (Saunders et al. 2007). This method was used because it was considered to be inexpensive as it was administered through e-mail and it allowed for complete anonymity by respondents. On the other hand, interviews involved asking the respondents questions in person or over the phone. This method was used because it allowed the researcher to get feedback immediately and also gave room for further probe.

4.5.2 Secondary data

The secondary data used in this research study were banks' annual reports. The researcher used this data source because it was considered to be reliable and valid, could be used in trend analysis and give historical background of the banks.

4.6 Sample design

4.6.1 Unit of analysis

The unit of analysis of this study is banks operating in Malawi. Currently there are 11 banks conducting banking business in Malawi. These are National Bank, Standard Bank, First Merchant Bank, NBS Bank, INDEbank, NEDbank, Ecobank, Malawi Savings Bank, Opportunity International Bank of Malawi, FDH Bank and International Commercial Bank. However, the study used only nine banks which had operated for a period of more than 12 months as at the end of December 2008. Thus, it excluded FDH Bank and International Commercial Bank since by this time they had only operated for six months and one month respectively.

4.6.2 Sample size

The sample size included one senior officer either Chief Executive Officer or Deputy Chief Executive Officer or a senior manager of each of the nine banks. The study had a sample size of nine (one respondent from each bank).

4.7 Data analysis

Analysis of data was done after assessing its completeness and accuracy. The data was then first coded by using Microsoft excel software and analysed using the Statistical Package for Social Scientists (SPSS) for easy assessment of the impact of reforms in bank regulation and supervision on performance of the banking system. The coding process involved assigning numbers to answers. This was done in order to reduce the responses to a few categories needed for analysis.

In this research study, the data on performance of banks was analysed by calculating financial ratios and comparing such ratios with the period before or after the regulatory reforms.

4.8 Research ethics considerations

The researcher observed ethical issues during the conduct of the research. Accordingly, the confidentiality, privacy and anonymity of the respondents were strictly observed. The respondents who opted for anonymity were assured of the same. Thus, care was taken not to disclose names of those who responded to the questionnaire. This was in line with Saunders et al. (2007) who defined research ethic as the appropriateness of behaviour in relation to the rights of those who become subject of the work or are affected by it.

In order to abide by the research ethical requirements, the respondents were not forced to provide any personal information.

4.9 Chapter summary

In conclusion, this chapter has provided vital information regarding methodology used in this study. The chapter has discussed the source of data and how such data was collected and analysed.

Chapter 5 Discussion of Results

5.1 Introduction

This chapter discusses results of the research conducted on the impact of the regulatory and supervisory reforms on the performance of banks in Malawi. The summary of the findings are essentially divided into two complementary sections: the first covers the analysis of each dependent variable by using the financial ratios while the second presents the views and opinions of respondents. For the purposes of the study and to ensure proper comparison, banks were classified into two peers. These were big banks (NBM, STD, FMB and NBS bank) and small banks (OIBM, Ecobank, Indebank, Nedbank, and MSB). Each peer was determined by the asset size as at December 2008. Once the bank was placed in a particular group, it was assumed to have belonged to it from the date it commenced banking business.

On the other hand, assessment of the regulatory and supervisory reforms on the performance of the banking system was based on the opinion and views of the respondents on a number of questions asked.

5.2 Designation of the respondents

As indicated in Chapter 4, the respondents were carefully chosen to include only those in high positions of the bank's hierarchy. The purpose was to have more reliable information. Table 5.1 indicates that out of nine respondents, two were Chief Executive Officers and two Deputy Chief Executive Officers and the rest were senior managers.

Table 5.1 Designation of the respondents

Position of respondent in the bank	Frequency	Percentage	Cumulative percentage
Chief Executive Officer	2	22.2 %	22.2%
Deputy Chief Executive Officer	2	22.2%	44.4%
Senior Manager	5	55.6%	**100%**
Total	**9**	**100%**	

5.3 Work experience of the respondents

As regards work experience, all respondents had worked in the banking system for more than five years. Table 5.2 shows that 55.6 percent of the respondents had work experience of between 5 and 15 years while three respondents (33.3 percent) had 15 to 25 years of work experience. One respondent out of nine had worked in the banking system for more than 25 years. The results indicated that all respondents had adequate knowledge and experience of banking operations to be aware of the impact of regulatory and supervisory reforms on the performance of the banking system.

Table 5.2 Working experience in the banking system

Years of employment in the bank	Frequency	Percentage	Cumulative percentage
0 to 5 years	0	0%	0%
5 to 15 years	5	55.6%	55.6%
15 to 25 years	3	33.3%	88.9%
More than 25 years	1	11.1%	**100%**
Total	**9**	**100%**	

5.4 Reforms in bank regulations and supervision

As a starting point, the researcher found out from the respondents whether they agree to the assertion that bank regulatory and supervisory reforms are necessary to the performance of the banking system. Figure 5.1 shows that 78 percent of the respondents believe that bank regulatory and supervisory reforms are necessary and 22 percent of respondents were undecided on the necessity of reforms.

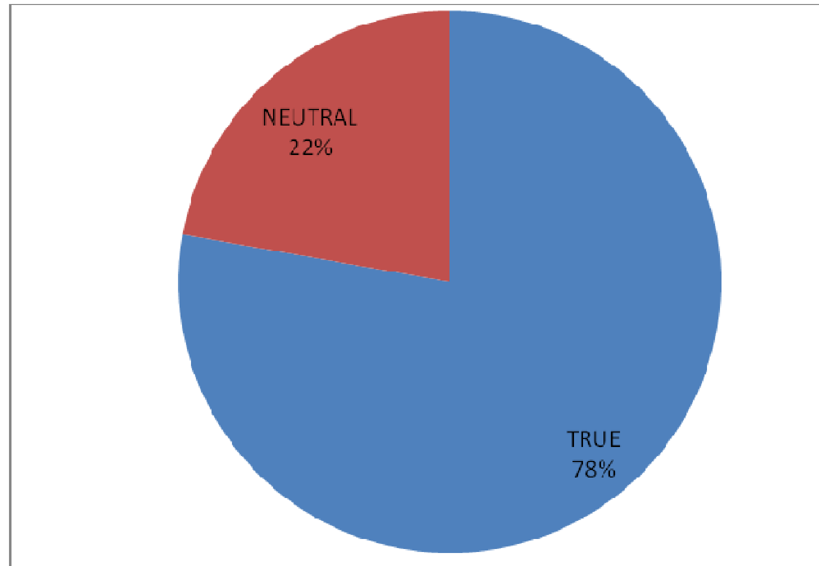

Figure 5.1: Importance of reforms in bank regulations and supervision

Although the majority of the respondents were in favour of the regulatory and supervisory reforms, they expressed dissatisfaction with the pace at which the reforms take place. They indicated that the Reserve Bank of Malawi delays in coming up with the appropriate regulations or amending the existing regulations. For example, some respondents wondered why the RBM delayed in coming up with regulation for e-banking while others wondered why the regulator took a long period before revising the Banking Act (last revised in 1989) despite many changes in the banking sector. Consequently, the delay leads to ineffective regulatory environment. In addition, this means that there are some banking services and products which are not effectively regulated due to the absence of appropriate regulations. In this regard, the RBM is required to respond to changes taking place in the banking system promptly by coming up with the appropriate regulations.

5.5 Ownership structure of the banking system

Following the reforms in regulations, Malawi witnessed a change in ownership structures of the banks. The banks whose ownership was dominated by Government[23] changed hands to the general public through privitisation. In addition, there were entries of both local and foreign investors in the banking system. Some investors opened their own banks while others acquired shares in existing banks. As discused in Chapter 1, the number of banks started to increase as a result of changes in regulations. In the end it led to having different ownership structures as shown in the Figure 5.2. The Figure shows the ownership structure of the banking system as at 31st December 2008.

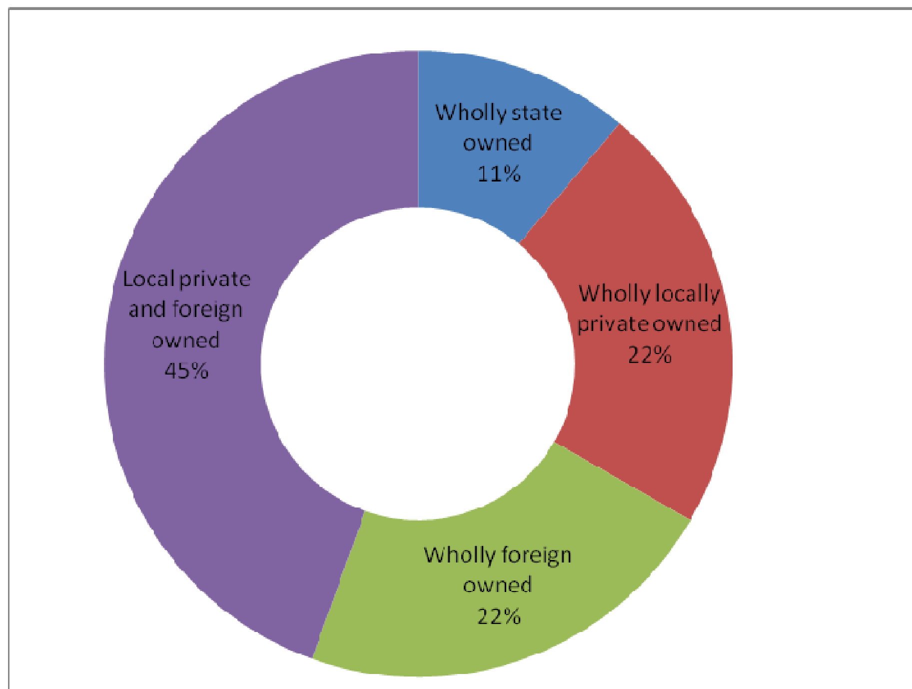

Figure 5.2: Ownership structure of the banking system as at 31st December 2008

[23] Malawi Government owned some banks directly and indirectly (through statutory corporations)

5.6 Impact of regulatory and supervisory reforms on the profitability of the banking system

The study assessed the impact of regulatory and supervisory reforms on the profitability of the banking system. The assessment was based on the profitability ratios and on respondents' opinions and views.

5.6.1 Profitability ratios

The profitability ratios used in the assessment were return on capital employed (ROCE) and return on assets (ROA).

a. Return on Capital Employed (ROCE) and return on assets (ROA)

The profitability of the banking system as measured by the return on capital employed (ROCE) and return on assets (ROA) revealed an erratic trend over the period under study as shown in the Figures 5.3 and 5.4. These figures depict the trends of ROCE and ROA for the whole banking system, large banks and small banks for the 18 years period from 1990 to 2008. As can be seen from the graphs, the trends for the banking system and large banks are the same from 1990 to 1995 because during this period National Bank of Malawi and Standard Bank were the only banks in Malawi. Thus, the banking system and the large banks were therefore represented by the same banks. As regards small banks, their impact started in 1995 although the entry of banks started in 1994. The figures for small banks in 1994 were considered very insignificant.

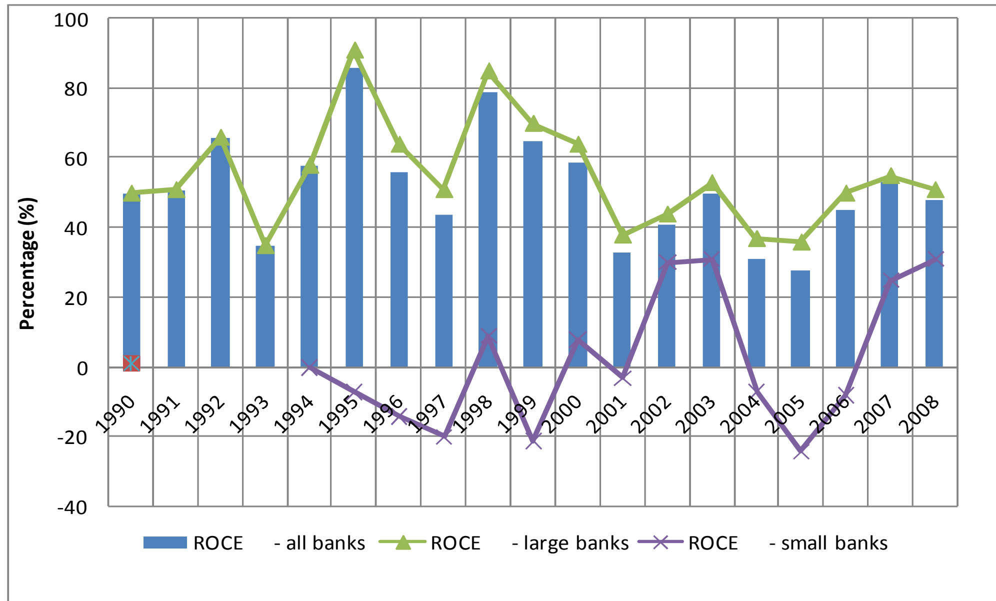

Figure 5.3: Profitability ratio – Return on Capital Employed (ROCE)

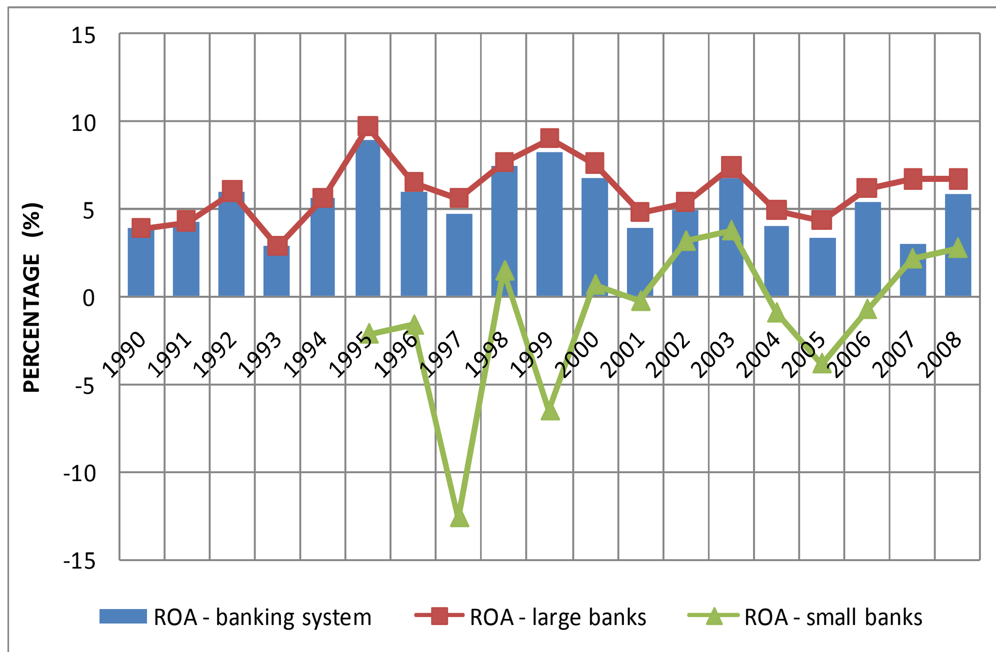

Figure 5.4: Profitability ratio – Return on Assets (ROA)

The graphs in both Figure 5.3 and 5.4 depict a similar trend from 1990 to 2008. The ratios declined significantly in 1993. During this period, the Reserve Bank of Malawi introduced various directives for the first time. One of the directives which impacted negatively on the profitability level of the banking system was the Asset Quality Directive for banks (revised in 2006 as Asset Classification). The directive requires banks to make adequate provisions and suspend interest accrued and not received on non-performing loans and advances. The introduction of the regulation therefore had a negative impact on the profitability of the banking system as the banks experienced reduction in profits since they were required to make adequate provisions and suspend interest not received but accrued to income statement.

The profitability started to improve in 1994. However, it was inconsistent over the period as shown by the trend of profitability ratios. The irregular trend is mainly noted whenever a new bank enters the banking system and there is an introduction or revision of the regulations. Thus, every time there was a new entrant in the banking system, there was a corresponding decline in the profitability ratios of the whole banking sytem. This can be explained by the disproportionately large increase in capital and assets than the increase in profits. Thus, whenever the new bank enters the banking sector, there is a corresponding increase in capital and assets without an immediate boost to profit. This is because most new banks make losses in the initial years of operations.

5.6.2 The Respondents' views and opinions on regulatory and supervisory reforms

Having studied the impact of regulatory and supervisory reforms on profitability of the banking system through profitability ratios, the responses received from the interviewees were also used in the assessment.

One of the questions the respondents were asked was to state whether they agree that changes in regulations had improved banks' profitability. The respondents' opinions and views are summarised in Table 5.3.

Table 5.3 The extent to which the respondents agreed that changes in regulations and supervision improved profitability of banks

	Frequency	Percent	Cumulative Percent
Strongly agree	1	11.1	11.1
Agree	3	33.3	44.4
Not sure	4	44.4	88.9
Disagree	1	11.1	100.0
Total	**9**	**100.0**	

As presented in Table 5.3, four respondents (representing 44.4 percent), agreed that that regulatory and supervisory reforms improved profitability of their banks. They indicated that reforms in regulations led them to proper credit administration and prudent approach in extending credit to customers. However, four of the respondents, (representing 44.4 percent), were not sure whether the profitability levels of their banks were affected by the regulatory and supervisory reforms, while one disagreed. Those who were not sure and disagreed argued that there are some regulations which restrict operations of banking institutions, such as the Foreign Currency Lending Ratio and the Large Exposure Directives. These directives restrict the volume of loans and advances the banks can extend. Thus, some banks fail to extend foreign currency loans to some customers or extend huge loans and advances to a single customer. In so doing, they fail to make adequate profits. In addition, they note that most banks get their earnings from investment in Government securities such as Treasury Bills and Local Registered Stock and other non interest income which have nothing to do with the regulations and supervision.

5.6.3 The Respondents' views on the introduction of Risk-Based Supervision Methodology

The Risk Based Supervision (RBS) methodology was one of the supervisory reforms introduced by the Reserve Bank of Malawi. Though it is a fairly new methodology, the respondents were asked for their views on the new supervisory approach. The respondents had different views and opinions when asked to comment on the impact of RBS on the profitability level of the banking system. Table 5.4 reveals that 66.7 percent of respondents agreed that RBS had a positive impact on the profitability level of their banks. They indicated that adequate understanding of the activities of the banking institutions and their attendant risks and how to manage those risks afford management to have adequate oversight on banks' operations. In so doing, banks engage in activities whose risks can be monitored and controlled. However, two respondents out of nine had a contrary view while one took no sides. They indicated that there is no relationship between the RBS supervisory methodology and the profitability level of banks. To them, economic factors play a very vital role in profitability levels of the banks.

Table 5.4 The extent to which respondents agreed that the introduction of Risk Based Supervision improved profitability of banks

	Frequency	Percent	Cumulative Percent
Yes	6	66.7	66.7
No	2	22.2	88.9
Not sure	1	11.1	100.0
Total	**9**	**100.0**	

5.6.4 Respondents' views on the impact of entry of new banks on profitability of the banking industry

As noted above, there are entries of both local and foreign banks into the banking system following the amendment of the Banking Act in 1989 which removed the entry barriers to the banking sector. In view of this, it was necessary to know whether such entry had positive or negative impact on the profitability of the banking system.

From the responses received, as per Table 5.5, it was noted that five out of nine respondents were of the view that the entry of new banks led to improvement in the profitability of their banks. They indicated that the entry of new banks led to an introduction of new products and improvement in the service delivery so as to maintain their market share. These contributed to an increase in profits. However, three respondents were not sure and one respondent disagreed with the assertion that the new entry had brought about improvement in the profitability of the banking system. Thier different view was based on the fact that the economic emviornment plays a greater role in the profitbilty of the banking system.

Table 5.5 How far respondents agree that the entry of new banks improved profitability of the exiting banks?

	Frequency	Percent	Cumulative Percent
Strongly agree	2	22.2	22.2
Agree	3	33.3	55.6
Not sure	3	33.3	88.9
Disagree	1	11.1	100.0
Total	**9**	**100.0**	

From the foregoing, it is noted from respondents that regulatory and supervisory reforms had more positive than negative impact on the performance of the banking system in terms of profitability. It was also noted that profitability level could not only be affected by the regulatory and supervisory methodology but also economic factors prevailing in the environment in which the banks are operating.

5.7 Impact of regulatory and supervisory reforms on the banking system efficiency

The impact of regulatory and supervisory reforms on efficiency of the banking system was assessed by using efficiency ratios and views and opinion of the respodents. The ratios used in this study included overhead cost to income and overhead cost to total assets.

5.7.1 Efficiency ratios

The international benchmark for overhead cost to income ratio is pegged at 50 – 60 percent. This means that any bank that has recorded a ratio of above 60 percent is considered an inefficient bank. The other ratio, overhead cost to total assets, has no minimum benchmark. However, the lower the ratio the better. Thus, the bank whose ratio is low is considered efficient. On the other hand, whenever the ratio shows an increasing trend, it is a sign of becoming inefficient while a declining trend is deemed an improvement in efficiency.

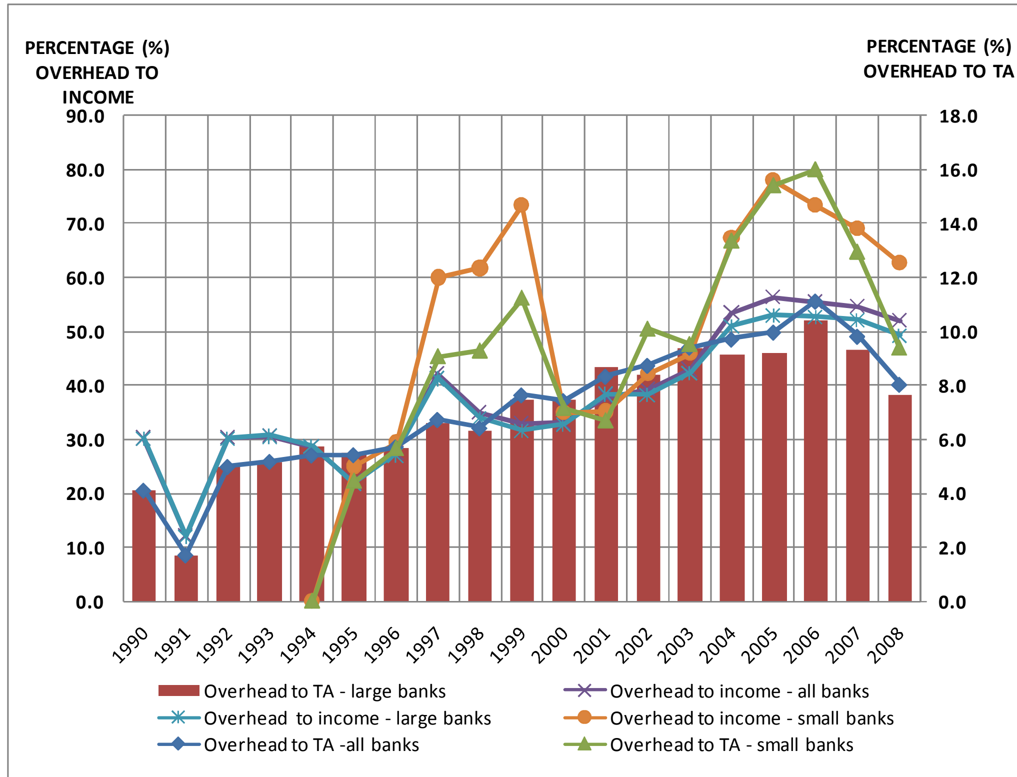

Figure 5.5: The efficiency ratios in the banking system

The overhead cost to income ratio as shown in Figure 5.5, shows that the banking system and large banks remained efficient over the entire period under review. However, the ratio for both large banks and the banking system was above 50 percent between 2004 to 2008. This shows that the efficiency of both large banks and the entire banking sector declined during this period. This is mainly because of relatively low growth in income in comparison to the growth in overhead expenses. The entry of new banks necessecitated the existing banks to incur additional administrative and staff costs in order to improve their services for fear of losing their market share to new entrants. On the other hand, the ratio for small banks revealed an inconsistent efficiency level over the period under study. Figure 5.5 shows that efficiency levels for small banks declined in 1998 and 1999 and from 2004 to 2008. During these periods, the small banks had to incur huge administrative costs to enable them penetrate the market. At the same time their

income could not match with the growth in administrative expensives. However, small banks were efficient from 2000 to 2003 because during this period they invested much of their resources into Government securities such as (TB) which were high yielding. The situation changed from 2004 when it was no longer attractive to invest in TB due to low yielding rates.

The overhead cost to total asset ratio was also used to assess efficiency of the banking system. From Figure 5.5, it is noted that this ratio shows a similar trend as the overhead cost to income ratio discussed above.

5.7.2 The respondents' opinion on efficiency following regulatory and supervisory reforms

The respondents gave different responses when asked about their views and opinions on the impact of the changes in regulation on efficiency of the banking system. Their responses are as outlined in Table 5.6.

Table 5.6 The extent to which respondents agreed that regulatory changes had improved banks' efficiency

	Frequency	Percent	Cumulative Percent
Strongly agree	3	33.3	33.3
Agree	5	55.6	88.9
Not sure	1	11.1	100.0
Total	**9**	**100.0**	

Table 5.6, shows that almost all respondents (eight out of nine respondents) were of the view that the reforms in regulations and supervision had positive impact on

efficiency of their banking institutions. They indicated that changes in regulations and supervision brought stiff competition in the banking sector. As a result, most banks improved their ways of conducting business in order to maintain their market share or increase it. In so doing, the income increased more than the increase in overhead costs. However, one of the respondents was not sure whether the bank regulatory and supervisory reforms had contributed to the improvement in the efficiency of the banking system. The respondent argued that the efficiency of the banking system depends on how loyal the customers are to the bank than reforms in regulations and supervision. Thus, there are some customers who are so loyal to a particular bank that they can not leave it just because there are new products or banks in the banking sector.

5.7.3 Respondents' views on effect of the entry of new banks on efficiency of the Banking System

The respondents were also asked if the entry of new banks had any impact on efficiency of their banking institutions. Figure 5.6 gives the details of views and opinions of the respondents. It shows that all respondents were of the view that the entry of new banks had a positive impact on the efficiency of the banking system. They argued that the existing banks incur some costs in order to improve their services to their customers so as not to lose them and to maintain the market share. However, in some cases, the impact is negative especially when the costs incurred could not result into immediate increase in income. For example, the benefits of training staff takes too long to be realised.

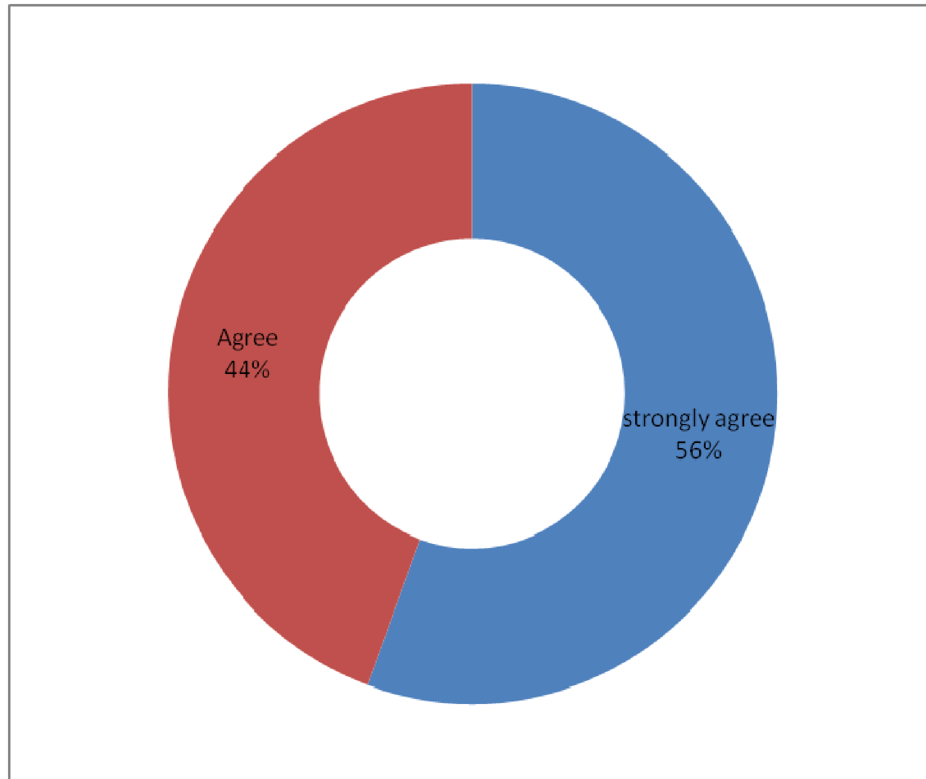

Figure 5.6 The opinion of respondents on whether entry of new banks improved banks' efficiency

From the foregoing, it can generally be concluded that the regulatory and supervisory reforms have more positive than negative impacts on the banking system's efficiency. Thus, in most banks the reforms had improved efficiency.

5.8 Impact of regulatory and supervisory reforms on stability of the banking system

The impact assessment of the bank regulatory and supervisory reforms on stability of the banking system is considered crucial as it helps to understand whether or not the banking system is capable of withstanding shocks in the economy. The findings are essentially divided into two complementary sections: the first provides an

analysis based on the Financial Stability Indicators (FSIs) and the second presents the views and opinions of the respondents.

5.8.1 Financial stability indicators of the banking system

The Financial System Indicators (FSIs) provide detailed information on the general health of the financial system. In the case of this study, the FSIs used included capital adequacy ratios, asset quality and liquidity ratios.

Banks are required to maintain, at a minimum, the regulatory capital ratios of 6 percent and 10 percent of core and total capital respectively. As presented in Figure 5.7 and 5.8, it is noted that capital ratios for the whole banking system and large banks during the entire period under review were above the regulatory minima. The Tier I and total capital ratios for the whole banking system started at 11.4 and 14.3 percent respectively in 1993 when the Directive on Minimum Capital ratio was introduced. At this level, the ratios remained above the regulatory minimum benchmarks throughout the period. The total capital ratios of large banks also remained above the regulatory minimum during the period under study. As regards small banks, they met the regulatory minimum except for their total capital ratio which was below regulatory minimum at 6.5 percent in 1997.

From the charts (Figure 5.7 and 5.8) it can be concluded that the banking system has remained well capitalised hence stable despite the erratic movement and missed regulatory minima of small banks in 1997. Thus, the banks maintained sufficient cushion to cover any loss that might have risen. The regulatory and supervisory methodology might have contributed to the banks' ability to continuously maintain adequate capital level during the period under study.

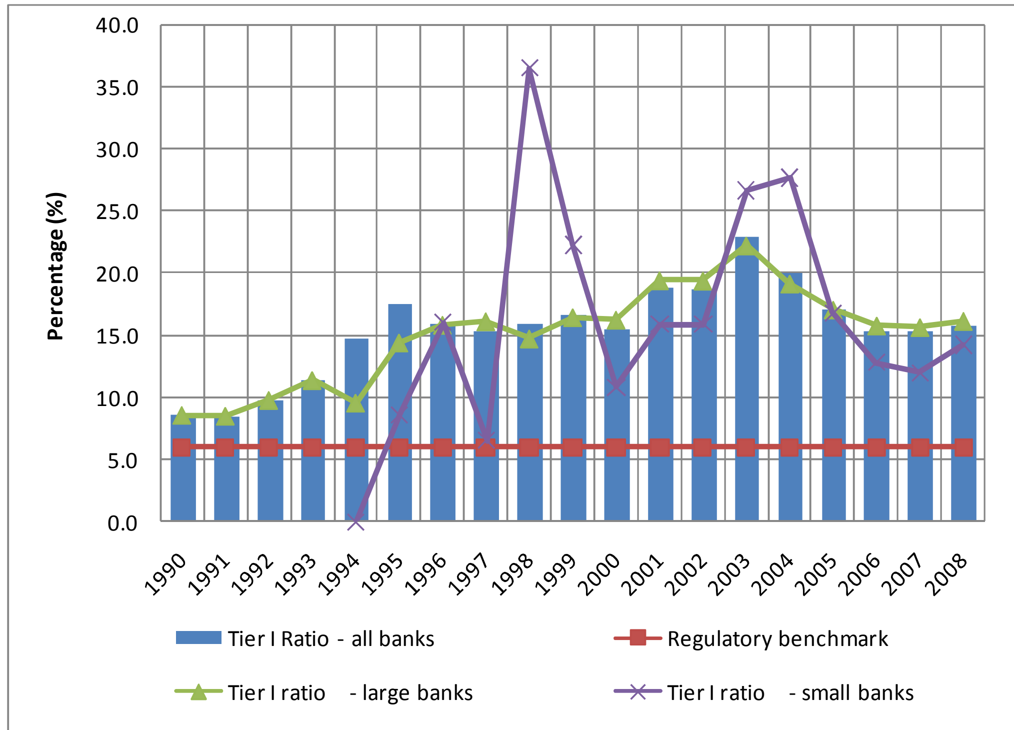

Figure 5.7 Tier 1 (Core) capital ratios as FSI of the banking system stability

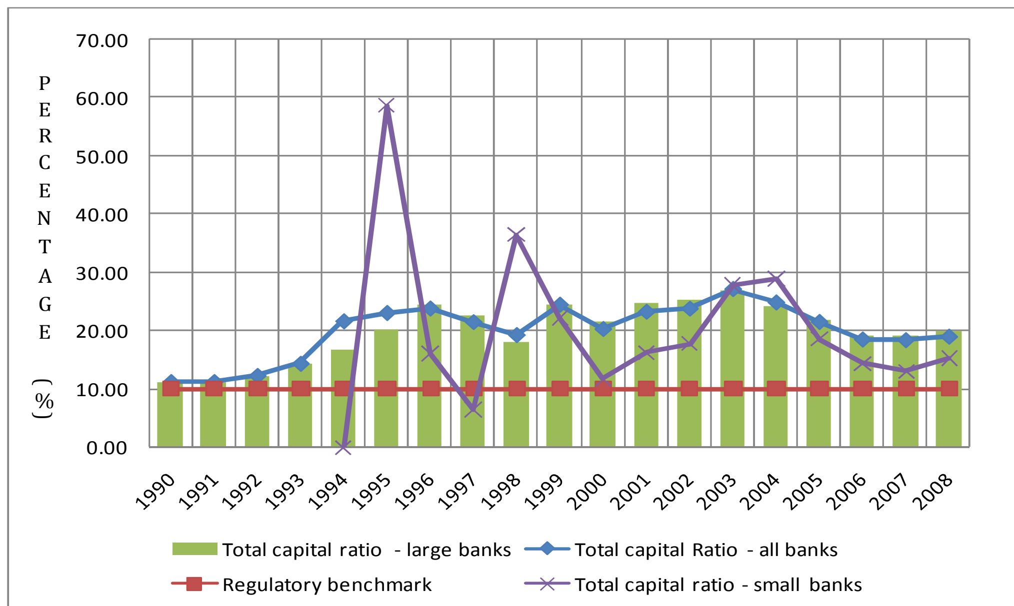

Figure 5.8 Total capital ratios as FSI of the banking system stability

Asset quality is measured by the quality of loan portfolio and the level of non-performing loans. In assessing asset quality, the Reserve Bank of Malawi uses the ratio of non-performing loans and advances (which are made up of impaired assets and past due items) to total loans and advances. Figure 5.9 shows that between 1990 to 1993 the quality of assets was not known as the banking sector had no regulation governing its asset quality. The regulation was issued in the late 1993 and the banks started experiencing its effect in the consecutive year. Figure 5.9 shows an erratic movement in stability of the banking system, with the worst situation in 2002. During this period, the level of non-performing loans grew by 89.9 percent while gross loans went up by 28.9 percent implying worsening of quality of assets. On the other hand, the graph for small banks started at the worst position at 42.3 percent in 1998 but started improving in subsequent years. The ratio drastically dropped to 19.2 percent in 1999 implying an improvement in asset quality. Since then the quality of assets continued to show a sign of improvement, though inconsistent, up until at the end of the period under review in 2008.

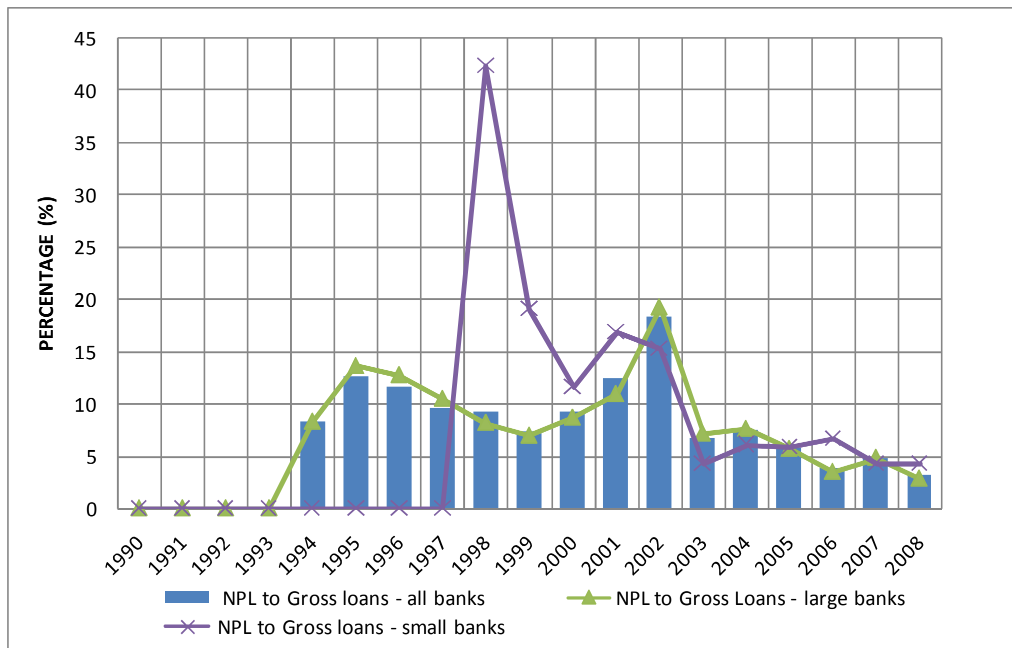

Figure 5.9 Asset Quality as FSI of the banking system stability

The Liquidity position is another FSI of stability of the banking system. The liquidity ratio as shown on Figure 5.10 reveales that the liquidity position of the banking system was healthy during the period under study. As depicted in the graph, the liquidity ratios for large banks, the whole banking system and small banks were all above the 30 percent regulatory minimum indicating that the banking system was liquid enough to meet its obligations without any disruption. This is because during the period under study banks had invested most of their funds in Government securities such as treasury bills as they had attractive interest rates and they are risk free investments.

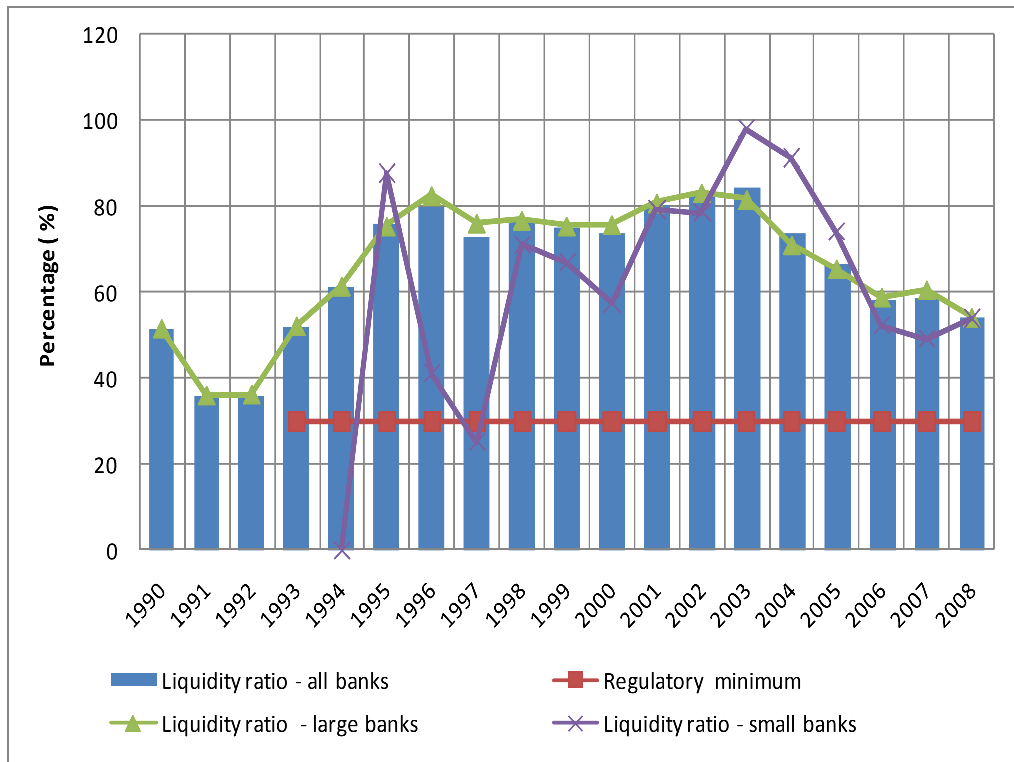

Figure 5.10 Liquidity ratio as FSI of the Banking System Stability

5.8.2 The respondents' opinions on financial stability following regulatory and supervisory reforms

In addtion to the FSIs, the assessment of the stability of the banking system was also conducted by asking different questions to the respondents to which they gave their views and opinions. One of the questions was whether the respondents agree that regulatory and supervisory reforms have brought about stability in the banking system. Table 5.7 shows that eight out of nine respondents agreed that reforms in regulations and supervision have improved the banking system stability. One respondent, representing 11.1 percent, was not sure whether banking stability existing in Malawi was as a result of reforms in bank regulations and supervision. From the table, it means that changes in regulations and supervision are believed to have positive impact on the banking system stability.

Table 5.7 The extent to which respondents agreed that regulatory reforms have improved banks' stability

	Frequency	Percent	Cumulative Percent
Strongly agree	7	77.8	77.8
Agree	1	11.1	88.9
Not sure	1	11.1	100.0
Total	**9**	**100.0**	

5.8.3 Respondents' views on effect of thee entry of new banks on stability of the banking system

The respondents were also asked if the entry of new banks had any impact on stability of their banking institutions. Table 5.8 illustrates details of the views and opinions of the respondents. From the table, it is noted that five respondents, two of whom strongly agreed, indicated that stability in the banking system has been contributed by the entry of new banking institutions. They argued that entry of new banks led to increase in capital by many banks in order to easily introduce new products and be able to open new outlets among others. The existing banks undertake all these in order to mantain their market share On the other hand, two respondents representing 22.2 percent, disagreed with the assertion that the entry of new banks contributed to the stability of the banking system. The rest of the respondents (two respondents) were not sure of the contribution which the new entry brings to the stability of the banking system. They doubt if the entry of new banks contributed to the stability of banking system.

Table 5.8 The extent to which the entry of new banks has improved banks' stability

	Frequency	Percent
Strongly agree	2	22.2
Agree	3	33.4
Not sure	2	22.2
Disagree	2	22.2
Total	**9**	**100.0**

From the foregoing, it can generally be concluded that the entry of new banks plays a crucial role in maintaining financial system stability.

5.9 Chapter summary

The chapter has provided the results of the study on the impact of bank regulatory and supervisory reforms on the performance of the banking system. As observed from the discussion of the results, the assessment was based on financial ratios and on views and opinions of the bankers themselves. The financial ratios analysis, though showing erratic movement, revealed that the impact of the regulatory and supervisory reforms on the performance of banking system in Malawi was both positive and negative. This means that some banks improved their performance as a reasult of the regulatory reforms while others had different experience. On the other hand, the results from the questionnaires which were administered to bankers themselves show a mixed position as regards the impact of regulatory and supervisory reforms on the performance of banks in Malawi. The respondents had different views and opinions about the same. There were other respondents who indicated that the improvement in banking performance was a result of changes in regulations and supervision while others had different views. It was noted that some respondents disagreed with the assertion that regulatory and supervisory reforms had brought some improvements to the performance of banks in Malawi.

Overall, it can be concluded that the reforms in the regulations and supervision of the banking system had both negative and positive impact on the improvement of the overall banking system's performance in terms of profitability, efficiency and stability.

Chapter 6 Summary, Conclusions and Recommendations

6.1 Introduction

This chapter summarises the outcome of the impact of regulatory and supervisory reforms on the performance of the banks in Malawi. It gives the summary of the results and conclusions and major recommendations to be considered in regulatory and supervisory reforms. It also highlights limitations of the research study and possible areas of further study.

6.2 Summary

The main objective of this research study was to assess the impact of the bank regulatory and supervisory reforms on performance of the banking system in Malawi. There are different types of regulations or rules in form of the Banking Act and various directives which the Reserve Bank of Malawi has issued to the banking system in Malawi. On the other hand, the banking system performance was looked at in terms of profitability, efficiency and stability. In assessing the performance of the banking system, the study analysed financial ratios calculated on the basis of financial data obtained from annual accounts of the banks. In addition, analysis was also made of different responses from the interviewees to the questionnaire administered to them.

The questionnaire was administered to each bank that had been in operation for more than a year as at 31st December 2008. In addition, in-depth interviews were conducted with the respondents.

6.3 Conclusion

The results indicate that the reforms in bank regulations and supervision have both positive and negative impact on the performance of the banking system. It was observed that regulations and supervision contributed to the improvement of performance of some banks. The guidance and monitoring process the banks receive from the Reserve Bank contributed to their performance. On the other hand, the performance of other banks, especially the new and small banks, was affected by the reforms in regulations and supervision. Thus, the regulatory and supervisory reforms have negative impact on performance of some banks especially when they were unable to venture into some activities such as lending to a single customer above 25 percent of their capital base.

6.4 Recommendations

In view of the above discussion, it is recommended as follows:

a. Review the regulations on a regular basis by taking into account environmental change

It was observed that the Reserve Bank of Malawi is generally slow in changing the regulations despite changes in environment. It was noted that some regulations were issued long time ago and became irrelevant considering the fact that many factors which were relevant then have changed. The delayed revision of some regulations has negatively impacted on performance of banks. In this regard, it is recommended that regulations should regularly be reviewed so that banks are regulated effectively.

b. Introduce regulations relevant to new products and services in the banking system

The RBM also delays in introducing appropriate regulations for the new banking products or services. It was noted that the banking sector has some new services and products such as e-banking which are not regulated due to

lack of relevant regulations. The RBM is therefore urged to timely introduce relevant regulations whenever the banking system is introducing new products and services.

c. Enhance the capacity of the regulator

As learnt during the study, most respondents complained of insufficient regulator's oversight. Thus, monitoring process is virtually absent for some banks due to the fact that some banks are not visited by the Reserve Bank regulator for more than one and half years. In view of this, it is recommended that the Reserve Bank of Malawi should enhance its capacity in terms of human resources so that it is able to visit all banks at least once each year.

6.5 Research limitation and areas of further research

The research is limited in that the impact of economic conditions on the performance of the banking system could not be isolated. Thus, Malawi has witnessed many economic changes during the period under study. The most common economic changes included the volatility of interest rates and exchange rate. These had some significant impact on the performance of the banking system. Thus the results of this research study could not be specifically attributed to the regulatory reforms only.

Except for the peer analysis, the research did not study the impact of the regulatory reforms on the performance of the banking system by age group. The assessment could have been meaningful had it been banks were grouped according to size and period the bank has been in existence. As such, the results could not be generalised to where different attributes are considered.

Considering that the regulatory and supervisory reforms are continuously taking place, the results and conclusions on the impact on performance of the banking system drawn in this research study cannot be generalised into the future.

As regards areas of future research, there is need to conduct an assessment of the impact of technology on the performance of banks in Malawi. This is an important area, among others, that can be researched upon considering that many reforms taking place in the banking system are a result of new developments in information technology.

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Appendix: Student’s Questionnaire

Dear Sir/Madam,

RE: RESEARCH STUDY OF AN ASSESSMENT OF THE IMPACT OF REFOPRMS IN BANK REGULATIONS AND SUPERVISION ON THE PERFORMANCE OF BANKS IN MALAWI

I am carrying out a study on the above captioned topic. This research is being conducted in partial fulfilment of the requirement for the Master of Business Administration (MBA) degree offered by the University of Malawi – the Polytechnic.

The main objective of the study is to evaluate if reforms in bank regulations and supervision are contributing to the banking system’s profitability, stability and growth.

In this regard, find enclosed a questionnaire which you are kindly requested to complete and return to me on my email address, fmzama@rbm.mw. Alternatively you can contact me on 08 955 690 so that I can pick it up in person. I may also contact you for additional information if necessary.

Please be assured that the information provided by you will be treated in the strictest confidence and will be used only for the purpose of helping me in my research study.

I thank you in advance for taking your time to fill the questionnaire

Yours faithfully

Fund B Mzama

MBA STUDENT, THE POLYTECHNIC

ASSESSMENT OF THE IMPACT OF REFORMS IN BANK REGULATIONS AND SUPERVISION ON THE PERFORMANCE OF BANKS IN MALAWI

A. THE RESPONDENT

1. Name (optional) : ____
2. Name of your bank : ____
3. Your position in the Bank:____

Please circle statement below which applies to you

4. For how long have you worked in the Bank
   a. less than 5 years
   b. 5 years but less than 10 years
   c. 10 years but less than 15 years
   d. 15 Years but less than 20 years
   e. 20 years but less than 25 years
   f. 25 years and more

5. For how long has your bank been in existence
   a. less than 5 years
   b. 5 years but less than 10 years
   c. 10 years but less than 15 years
   d. 15 years but less than 20 years
   e. 20 years and above

B. OWNERSHIP STRUCTURE

Please circle one

6. Which of the following ownership structures describes your bank?

    a. Wholly state owned
    b. Wholly locally private owned
    c. Wholly foreign owned
    d. State and privately owned
    e. Local private and foreign owned

7. Has the entry of other banks affected your bank's performance?

    a. Yes
    b. No
    c. Not sure

8. Reforms in bank regulations and supervision are necessary

    a. True
    b. False
    c. Neutral

For questions 9 to 10 please tick in appropriate column

9. How far do you agree that the entry of other banks has improved the performance of your bank in terms of:	Strongly agree	Agree	Not sure	Disagree	Strongly disagree
a. Profitability					
b. Efficiency					
c. Stability					

C. CHANGE IN BANK REGULATIONS

10. **To what extent do you agree that changes in regulatory and supervisory approaches have brought about improvement in:-**	Strongly agree	Agree	Not sure	Disagree	Strongly disagree
a. Bank's profitability					
b. Bank's efficiency					
c. Bank's stability					

Please circle statements applicable to your bank

11. Do changes in bank regulation and supervision prevent your bank:-

    a. From being profitable

    b. In achieving stability

    c. In achieving efficiency

12. **Do you think there is any relationship between bank regulation and supervision with respect to**	yes	No	Not sure
a. Profitability			
b. efficiency			
c. stability			

13. Do you think Risk based supervision methodology contributes to banks'	Yes	No	Not sure
a. Profitability			
b. Stability			
c. Efficiency			

THE END

I THANK YOU FOR HELPING ME IN MY RESEARCH