FACTORS THAT HAVE CONTRIBUTED TO THE SMOOTH FUNCTIONING OF THE FINANCIAL SYSTEMS

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ABSTRACT

Literature in banking and finance emphasizes that the purpose of the financial System is to ensure that the funds flow from those with excess finding to those who value finding the highest. Therefore this article focuses on factors that have contributed to the smooth functioning of the financial systems to ensure that funds are channeled effectively. The focus is on financial systems in general although emphasis is on the financial systems in the sub region.

The details in this article is entirely collected through secondary research, specifically from scholarly articles in banking and finance, various text books in banking and finance and journals from professional bodies such as the Zambia Institute of banking and financial services, , the Zambia Institute of Chartered Accountants and the Certified Public Accountant (CPA).


INTRODUCTION

This article details the factors that have contributed to the smooth functioning of the financial system. Initially a description of how the financial system operates is offered and what financial stability means as well as its importance. Furthermore the factors that have contributed to the smooth functioning of the financial system are discussed namely the legal and regulatory environment, accounting and auditing, anti-money laundering and countering the financing of terrorism, bank supervision and examinations, international banking regulations and corporate governance.

FINANCIAL SYSTEM

The essential components of financial systems are financial intermediaries, financial markets, financial instruments (or securities) and rules and regulations. Essentially like mentioned in the abstract the purpose of the financial system is to enable the flow of funds from units with excess funding to units with a shortfall of funding. The units with excess funding are known surplus units while units with the shortfall of funding are known as deficit units. It should be noted that funds are also transferred back to the real owners when they need them and the real owners of funds are of course the surplus units.

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The transmission of funds is done through financial markets and financial intermediaries. Financial intermediaries act as mediators in the transmission of funds and this is referred to as indirect finance. While financial markets transmit funds through the buying and selling of securities and this is referred to as direct finance. This is a brief description of how the financial system operates.

The financial system facilitates the transformation of savings into investment and consumption “Page 1, 1994, Venkateswara and Madras”

**FINANCIAL STABILITY**

A financial system is stable if it facilitates the smooth flow of funds from surplus units and deficit units through the effective and efficient use of financial intermediaries, markets and market infrastructure. This helps promote growth in economic activities. While a financial system is unstable when it faces material disruption to the intermediation process having potential damaging implications for the real economy. Identifying vulnerabilities within the financial system and, where possible, taking mitigating action is essential safeguarding the stability of a financial system. A number of the vulnerabilities have a macroeconomic dimension having potential negative effect to the level and distribution of financial risk within the economy.

In addition, a financial system is resilient when there are well developed crisis management arrangements for handling distressed financial institutions in the manner where public confidence in the financial system is not undermined. Furthermore a resilient financial system possesses the payments system that is safe and robust.

In Zambia institutions that are key in ensuring the financial system is stable are the Bank of Zambia (BOZ), Insurance and Pensions Authority Patents and Companies Registration Agency (PACRA) and Lusaka Stock Exchange (LUSE). The Bank of Zambia and), Insurance and Pensions Authority regulates banks and non-bank financial intermediaries while the Lusaka Stock Exchange regulates capital markets. While the Patents and Companies Registration Agency is an institution that does the registration of companies and ensures that companies do comply with established regulatory requirements.

The Zambian government initiated Financial Sector Development Plan (FSDP) in recognition of the strategic importance of the development of the financial sector. It was aimed at addressing the weaknesses in the Zambian financial system. The Financial Sector Development Plan (FSDP) was further extended into FSDP into phase II. It was aimed at guiding efforts to realize the vision of a financial system that is ‘stable, sound and market-based and that would support efficient resource mobilization necessary for economic diversification and sustainable growth (Source: BOZ Publication on the Financial Sector Development Plan.)

**THE LEGAL AND REGULATORY ENVIRONMENT**

The legal and regulatory environment is an essential ingredient in the smooth functioning of the financial sector and in the efficient integration and management of domestic savings and capital flows. Legal and regulatory frameworks govern the conduct of market players in the financial system and are a cornerstone of orderly operation and the development of the financial system. Legal and regulatory frameworks empower the regulator to regulate the financial system ensuring that it is sound. The legal and regulatory environments should offer a framework that makes the development of sustainable markets, facilitates monitoring and enforcement of rules, and ensures investors are protected. The aim is to encourage the development of the financial
systems. A well-functioning financial system combines up-to-date laws and regulations backed by strong intermediaries with enforcement mechanisms and effective monitoring.

The legal framework governing and empowering the regulator and the regulatory framework make the cornerstone of the orderly existence and development of financial markets. Accordingly, the essential laws are those governing the formation and operation of the central bank and the laws regulating the operation of banks, the financial institutions and markets.

The essential components of an effective legal framework for the supervision and regulation of financial systems are laid out in various international standards for the supervision of the financial system. For instance Basel Core Principles (BCP) relate to bank supervision.

Currently, the legal and regulatory environment of several financial systems in Africa has been undergoing a necessary process of modernisation and establishment of effective enforcement mechanisms. Currently several countries are carrying out legal reforms as well as harmonize legal and regulatory frameworks. For the financial system to develop there is need for clear and effective legal framework as they value of the claims of financial intermediaries.

In Africa Legal systems widely differ and are the reflection of the continent’s diverse historical background. Legal systems are mostly a reflection of the patterns of colonial rule across the continent; some countries follow the common law tradition, while others are based on the civil law system.

In Zambia one of the major role of the Financial Sector Development Plan (FSDP) phase I was the review of the financial sector legislation which took the form of review of several acts and regulations that govern the supervision and regulation of banks and non-bank financial intermediaries in Zambia. Some acts were reviewed, others harmonized and other repealed and transitioning them.

**ACCOUNTING AND AUDITING**

Auditing and accounting standards are at the core of the financial information infrastructure needed for financial development. They enable the provision of transparent and reliable disclosure of information to the various stakeholders. Information provided facilitates informed financial decision making as well as the effective functioning of markets and efficient resource allocation.

Common accounting standards and codes enhance the transparency and comparability of financial statements there by fostering sound financial systems. This increases the ability of investors to examine potential investments. The Generally Accepted Accounting Principles (GAAP) in the US, Financial Reporting Standards (FRS) in the UK, the International Financial Reporting Standards (IFRS) and the International Accounting Standards (IAS) are commonly used accounting frameworks for financial accounting and reporting.

The statutory auditors conduct the audit of selected branches and various departments of the head office of the bank to ensure that the balance sheet and profit and loss account reflect a true view of the affairs and profit and loss of the bank for the year “Page 1159, 2002, M.L.Tanan”

African countries differ in the application of financial reporting and accounting standards. Some African countries, particularly in the COMESA and SADC regions, mainly use IFRS in the preparation of financial statements. South Africa uses GAAP system and IFRS, which are almost identical. In other countries, such as Morocco the local GAAP co-exists with IFRS, while listed companies use IFRS, all statutory accounts must be prepared under the local GAAP in such countries.
In Zambia the disclosure of the bank’s finances is among the most important regulations that are placed on banking institutions.

**ANTI-MONEY LAUNDERING AND COUNTERING THE FINANCING OF TERRORISM**

Money laundering is the process hiding the illegal origin of the proceeds of crime. Good examples proceeds of crime are illegal arms trafficking, drug trafficking, corruption and other activities relating to organised crime. Funds from such illegal activities usually end up flowing into the financial system, frequently through the individuals pretending to have obtained the funds from legitimate businesses, and then relocated or circulated in the financial system to disguise their illicit origin, hence preparing them for reinvestment into legitimate businesses.

The funding of terrorism or the channelling of funds both whether legally and illegally obtained towards the illegal activities related to terrorism is closely connected with money laundering. Money laundering and terrorism can both be prevented by similar measures.

Research indicates that generally, in Africa the framework to combat money laundering and terrorism is still under development and has not yet reached the level of other regions.

Currently the Financial Action Task Force (FATF) coordinates efforts to fight money laundering and financing of terrorism. According to research in Africa regional bodies have been formulated to coordinate the efforts on Anti-Money Laundering and Countering the Financing of Terrorism. They conduct research, develop strategies and conduct mutual evaluation assessments of the frameworks in member countries.

**BANK SUPERVISION AND EXAMINATIONS**

Bank supervision consists of monitoring and on-site examinations of commercial banks. Banks usually file reports with bank regulators, which include details of a bank’s income, liabilities and assets. Statistical models that highlight industry trends are used to analyse the reports and allow quick comparison of financial tests among several banks to observe which banks are becoming financially troubled.

Bank examinations are done onsite, on an annual basis, and more frequently sometimes. For any signs of financial distress a commercial bank shows the bank examiner comes to the bank and examines every aspect of the bank.

Ensuring that the bank has enough capital for its assets, how risky the assets are whether bad loans have been written off are some of the things that bank examiners notes when conducting examinations.

A scoring system called CAMELS is used to rate banks and it stands for Capital adequacy, Asset quality, Management, Earnings, Liquidity, and Sensitivity to risk. A scoring of 1 to 5 is assigned to each category, which is then used to select banks for greater scrutiny.

In Zambia the central bank does conduct the function that is referred to as supervisory review. Supervisory review involves issuing banking licenses to banks, supervising the licensed banks for compliance with the requirements responding to the bank’s breaches of the requirements, giving directions, imposing penalties or revoking the bank’s license.

**INTERNATIONAL BANKING REGULATIONS BASEL ACCORD**

Although an international agency that regulates international banking is non-existent, there have been two Basel Accord agreements that set out minimum international standards for banking, to also level the playing field so that banks can compete under the same regulatory requirements as well as to reduce global risk. The aim of having Basel accord evolving is to establish
minimum capital requirements that are adjusted for the risks of the bank’s assets. The Basel Accord serves as a guide for governments, especially in developing countries, even though it has no legal force.

CORPORATE GOVERNANCE

Corporate governance requirements are intended to encourage the bank to be well governed, and is an indirect way of achieving other objectives. Banks, especially the listed one are required to comply with corporate codes of conduct that govern sound governance of institutions. As many banks are relatively large, with many divisions, it is important for management to maintain a close watch on all operations.

CONCLUSION

Sound and robust financial systems are a hallmark of thriving economies. It is therefore necessary for governments and institutions involved in fostering the stability of financial systems to ensure that the financial systems are stable and sound, where necessary engage in the reforms of financial systems, a good example is the financial sector development plan in Zambia. It vital to state that the factors stated above are among the factors that have contributed to stable financial systems in most economies and trading blocks.

Assessing the vulnerabilities affecting the financial system, identifying and overseeing action to address them, and promote cooperation and information sharing among authorities responsible for financial stability are essential in ensuring that financial systems are stable. Stable financial systems may act as catalysts in economic development and they have an impact on individuals, businesses, corporations and governments alike. The soundness of financial systems therefore has an effect on the livelihood people.

REFERENCES