Bankable Assets: Africa faces many obstacles in developing financial systems

by Jakob Christensen, Anne-Marie Gulde, and Catherine Pattillo

Sound, deep, and efficient financial sectors are vital for high sustained, private sector–led growth. But financial sectors in their current form pose major problems for the economies of sub-Saharan Africa (SSA). Insufficient access to credit by small and medium-sized enterprises constrains their ability to expand and limits countries’ growth potential. Most households cannot build formal savings, so their ability to escape poverty by investing in education or housing is limited.

Over the past decade, many SSA countries have begun reforms to expand access to financial services for the poor and relieve financing constraints on the private sector by fostering new financial institutions and, to a limited extent, improving the operating environment. More recently, policymakers are facing new challenges that reflect the nascent globalization of African financial markets. While these developments could contribute to deeper, more diversified financial sectors, they also pose difficulties in what are often weak institutional and legal frameworks.

Financial sector reforms in SSA must be more comprehensive to address the large unmet need for financial services. Reforms must be directed not only at the banks—the dominant institutions in SSA financial sectors—but at the development of new markets and institutions, and the operating environment. The newer developments signal a changing financial sector landscape and, with these changes, the potential benefits of financial sector reforms could be greater, but the risks and complexities are also heightened.

A weak starting point

Access to financial services—savings and loans—is lower in SSA than in other developing regions. On the savings side, household deposits in commercial banks have increased slowly relative to GDP since the 1990s. Whereas 90 percent of households in industrial countries have savings accounts, and one-fourth of households in other low- and middle-income countries have them, only a tenth of households in a large set of SSA countries do. Banks serve mainly governments, the formal sector, and affluent households.

Widespread poverty limits both the demand for and the supply of savings facilities. The share of the population having a formal savings account is strongly correlated...
with poverty rates and per capita income (Gulde and others, 2006). Poor people have only small sums to save, which limits banks’ economic opportunities, given the high costs of maintaining small accounts. Banks often respond by charging for opening and maintaining a deposit account, making access to bank services more difficult for small-scale savers.

Structural constraints further limit access. A small branch network makes it hard for people to get to banks, most of which are located in urban areas. And some countries apply fairly high administered minimum deposit rates, which are designed to ensure decent returns for small-scale customers, but in practice make banks reluctant to accept deposits.

As for loans, enterprises and agriculture are also ill served. Bank lending to the private sector has been sluggish in most countries, limiting working capital and investments, notably in agriculture. Moreover, in many SSA countries—essentially the poorest, predominantly agriculture-based ones—banks lend mainly to export and import firms and the government. Agriculture, which in most African countries employs a majority of the workforce, receives a small and declining share of commercial bank lending (see Chart 1).

The unavailability of credit can seem puzzling, given that most SSA banking systems appear to have ample liquidity—mainly from government deposits and savings from the formal enterprise and private sector. Previous research identified several reasons private sector credit remains low:

- **Weak institutional and legal environments.** Private sector lending is a risky business. For example, enforcing a commercial contract through the courts is more difficult in SSA than anywhere else: on average, creditors must go through 35 steps, wait 15 months, and pay 43 percent of country per capita income before receiving payments.

- **High real lending interest rates.** Costly loans limit the range of potential customers. In 2004, the average real lending rate in SSA was 13 percent, compared with an average of 8 percent in other low and middle-income countries and 3.5 percent in industrial countries. Bank financing is often the only option for enterprises, and high interest rates limit firms’ access to credit more than in other developing regions.

- **Weak property rights and land titling systems.** Most bank lending takes place against collateral. Deficiencies in property rights systems in many SSA countries for both land and movable property (like cars) limit the use of such assets for collateral and thus impede financial intermediation.

- **Attractiveness of providing funds to government.** Where demand from the sovereign is high, many SSA banks are increasingly lending to the government or buying government or central bank debt instruments. By comparison, even at higher interest rates, credit to the private sector may look less attractive.

Over the last decade, SSA governments and their international partners have increasingly realized that if their economies are to progress further, their financial sectors must be deeper and more efficient. Many countries have started financial sector reform efforts. These reforms have built on the key role of the banking system, but are aimed at increasing the range of financial institutions available to the poor and to small and medium enterprises. There have also been early, but still incomplete, efforts to strengthen the overall operating environment.

**Microfinance.** More microfinance institutions (MFIs) are springing up every day, responding to the demand for financial services not met by commercial banks. According to a new database compiled by the Consultative Group to Assist the Poor, more than half the MFIs in SSA were created after 1998, and the numbers almost doubled during 2001–03. These institutions have emerged to a greater extent in countries where the outreach of the formal financial system is particularly limited. Many SSA governments and non-governmental organizations have financially supported the microfinance movement, but purely private sector initiatives have also contributed to the trend. MFIs clearly reach broader groups of the population; for example, average member savings in MFIs amount to less than half the average per capita income and are significantly smaller than the average savings account in banks.

Despite the sector’s rapid growth, its outreach is modest. On average, fewer than 2 out of every 100 persons have an account with an MFI; in most countries, this is fewer than those reached by commercial banks (see Chart 2). Given MFIs’
reliance on small-scale savings and loans, their assets, for the average SSA country, amount to 1.3 percent of GDP compared with commercial bank assets, which average 6 percent of GDP, although MFI shares are substantially larger in some countries.

Although loan repayment by MFI clients is generally good, MFIs struggle with high costs. As a result, real lending rates (averaging 43 percent) often exceed those in banks. Overdue loans amounted to 7 percent of the total loan portfolio of MFIs at the end of 2003, significantly lower than for commercial banks. But given high operating costs and significant fixed costs, profitability is low or even negative in many MFIs. Based on their current business model, many MFIs may remain dependent on further subsidies.

**Diversification of financial sectors.** Developed and deep financial sectors tend to include more than banks. Nonbank financial institutions (NBFIs) provide products and services that banks either cannot or may not offer and have the potential to deliver other savings, investment, and risk management tools. Over the past years, many SSA countries lowered regulatory restrictions and provided incentives to develop NBFIs.

As a result, NBFIs in SSA have grown in importance. They include insurance companies, pension funds, mortgage finance companies, consumer credit companies, finance and leasing companies, and postal savings banks. At present, the sector is much smaller than the banking sector in almost all countries. Assets of NBFIs are about 10 percent of those in the total financial system. But there are notable exceptions: insurance sectors are quite large in Kenya and Gabon, as are pension funds in Rwanda and Botswana.

**Government financial institutions.** Some countries are reinventing state and development banks to promote more financing. Gabon, for example, is using development banks to channel credit to priority sectors. Other countries, such as members of the West African Economic and Monetary Union (WAEMU), are forming state-owned specialized banks to give certain sectors access to desired types of finance. In many countries, export credit agencies are subsidizing access. But these efforts failed dismally in the past, and current incarnations seem likely to be fraught with the same types of risk.

**Stock markets.** Many African countries have set up stock markets to help companies raise long-term finance. Whereas there were just 5 stock markets in SSA in 1989, there are now 15, including the most recently established in Malawi, Swaziland, and Uganda. Corporate financing patterns in certain SSA countries, such as Ghana, South Africa, and Zimbabwe, suggest that stock markets can be a source of finance, but only for a limited number of listed firms. In addition, in all SSA countries except South Africa, stock markets suffer from little turnover and market capitalization partly because of inadequate informational and disclosure rules and supervisory frameworks. Finally, stock markets tend to be more efficient and deliver greater economic benefits when basic financial sector infrastructure and a well-functioning banking system are in place.

**Better use of technology.** New technologies for deposit and payment products are being tried in some countries, and the potential for new credit products alsoexists. The spectacular rise in cell phone usage in the region suggests that this and other telecommunications technology have vast potential to connect the “unbanked”—particularly people in remote and difficult to access locations—to financial services. Technological innovations are already facilitating broader access to financial services, such as prepaid cards (Ghana, Malawi, and Nigeria), electronic kiosks at post offices and e-banks (South Africa), and mobile phone technology (Uganda).

**Improving the operating environment.** Many countries are trying, with varying success, to improve the financial sector operating environment. Legal changes, such as the modernization of cen-
Central bank and banking laws, allow greater roles for markets. In 1993, in an effort to modernize business law, 16 African countries implemented the Organization for the Harmonization of Business Law in Africa, which has already standardized a wide range of commercial laws. In Rwanda, the authorities expanded the scope of public registries’ credit reports and even made them available online in 2004. Rwanda and Burundi streamlined and imposed time limits for filing appeals on commercial disputes, cutting nearly three months off the time to recover debt in Burundi, according to the World Bank’s Doing Business 2006. Still, surveys indicate that the operating environment—including business laws, judicial systems, accounting practices, and the enforceability of contracts—continues to impede financial sector reforms.

**Signs of a changing landscape**

While ongoing financial reforms have been slow to bear fruit, the environment is changing in important ways as globalization affects African financial markets. Most of these changes are positive, but in the context of weak institutional settings, shallow markets, and deficient legal and regulatory frameworks, they may nevertheless raise significant policy challenges. In many cases, unless financial sector reform can be accelerated, countries may not be able to benefit fully from the changes.

**Emergence of domestic debt markets.** More than 30 SSA countries have introduced treasury bill markets, replacing, in many cases, such as the WAEMU countries, direct borrowing by governments from central banks (see box). Treasury bills are an important step for better fiscal management and can contribute to financial market development. Their main financial market benefits are the establishment of interest rate benchmarks for other commercial paper and their use as collateral. Low-risk government debt can also help offset the high risks of private sector lending, allowing it to increase within prudential limits on risk-weighted capital asset ratios. Most treasury bill markets in SSA are immature. The average size of a set of key markets was only about 14 percent of GDP in 2005. The instruments offered on these markets are generally short term, and the investor base is narrow, consisting mainly of commercial banks. Secondary markets are nonexistent or small, except in Nigeria, South Africa, and Uganda.

**A regional African treasury bill market**

In 2001, the eight members of the West African Economic and Monetary Union (Benin, Burkina Faso, Cote d’Ivoire, Guinea-Bissau, Mali, Niger, Senegal, and Togo) set up a regional treasury bill market. The hope was to help develop regional financial markets and provide an alternative source of financing—replacing the long-standing direct lending of the regional central bank to national treasuries, which ended in 2002. With all countries issuing securities, the treasury bill market has been growing rapidly, from about CFAF 55 billion in 2002 to about CFAF 290 billion in 2005, and interest rates have fallen (Sy, 2006). While demand for treasury bills reflects better fiscal positions, additional incentives have come from excess banking liquidity, tax exemption and zero risk weighting of interest earnings, and allowable refinancing at the regional central bank.

Recently, there have been signs of better regional financial integration, with an acceleration of cross-border treasury bill sales—in 2004–05, over half the treasury bills issued were purchased by banks in another WAEMU country, with Mali showing cross-border sales of as high as 76 percent of total sales. These bills can help financial deepening if they are used for market-based pricing for government debt, collateral for interbank deals, and a pricing benchmark for other commercial debt issues.

Still, domestic debt markets in a number of SSA countries have recently started to attract interest from foreign investors. Push factors—historically low interest spreads between government securities of emerging markets and industrial countries—sparked investor interest. Pull factors—higher risk adjusted returns on SSA government debt securities following improvements in macroeconomic performance and debt relief—also help explain the recent capital inflows.

African countries see a number of potential benefits from foreign portfolio investment, but in the context of weak financial systems, the potential risks need careful consideration. Inflows, for example, can help put downward pressure on interest rates, support market efficiency, and help put countries “on the map,” stimulating much-needed foreign direct investment. But capital inflows can leave finan-
cial sectors vulnerable to sudden reversals and add to the macroeconomic challenges of managing those inflows.

**Higher remittances.** Remittances to SSA countries, another type of capital inflow, have increased rapidly in recent years. Recorded flows—which are thought to underestimate total flows by at least half—were about $7 billion in 2005. As strong demand for money transfer services continues, spurring needed improvements in the financial sector infrastructure for remittances, more people—including the rural poor—could gain access to financial services. But countries need to reform payment systems to increase the efficiency of remittance services. Predictable legal and regulatory frameworks that do not discriminate against smaller money transfer operators must be put in place, and there is also a need for competitive market conditions and skills upgrading in the industry.

**Emergence of regional banking groups.** Another development is the expansion of regional banks, which have affiliates in several countries. For example, there are now banking groups based in South Africa and Nigeria, each with operations in more than 10 countries. The resulting increases in market size could improve banking sector efficiency, allow banks to achieve economies of scale and risk diversification, and contribute to financial integration. Regional banks may combine the potential advantages of foreign banks—advanced technology, good management, and promotion of competition—with the local knowledge of domestic banks. However, regional banks also increase the linkages among financial systems and, therefore, require adequate cross-border supervision, in case financial sector problems emerge in one of the countries in which those banks operate.

**More reforms are needed**

With large unmet needs for financial services, financial sector reform is an ongoing challenge, and some of the newer developments may increase the complexity of the task. New reform efforts should provide financial sectors with market-based incentives to increase their engagement with the private sector and address the pressures from the starting globalization of African financial markets.

Several priority actions are required. **Financial sectors need to be freed from excessive restrictions and state direction.** For example, remaining interest rate limits on deposit and lending rates and various forms of directed lending should be eliminated. Restrictions on fees and charges as well as difficult “know your customer rules” should be reviewed to ensure they are not creating obstacles. Monetary policy may need to be reformed to reduce reliance on high reserve requirements (an implicit tax on banks that contributes to higher spreads between lending and deposit rates).

**The information base on which financial decisions depend should be bolstered.** Credit information bureaus could help banks effectively screen customers, which could induce more lending. Strengthened accountancy principles and services would also allow banks to better assess risks.

**New markets and institutions need to be able to flourish.** Countries could promote increasing market size—as pioneered by emerging regional banks—by harmonizing regulations and maintaining low restrictions to market entry. Similarly, a largely untapped potential for financial integration exists in countries belonging to monetary unions.

**Regulatory obstacles to the registering and seizing of collateral, including those created by unclear land and property rights, need to be tackled.** But given the lengthy time frame for such reforms, new thinking is needed on how to overcome, in the short term, bottlenecks in the legal and regulatory systems. Alternative instruments (such as leasing) or alternatives to collateralization (group guarantees) could be promoted. While most countries in SSA are not yet meeting the challenges of financial sector reform, in a few countries (Uganda, for example), these reforms—when taken together—have shown promising signs.

Finally, **countries need to keep in mind the ultimate goal of integrating into the global financial system.** While avoiding added restrictions, countries should review macroeconomic policies, eliminate administrative restrictions that contribute to excessively high yields, and develop longer-range financial instruments and secondary markets in tandem with full capital account liberalization.

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