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Banking in Africa: financing transformation amid uncertainty

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BANKING IN AFRICA

financing transformation
amid uncertainty



European
Investment
Bank

The EU bank

Banking in Africa:

financing transformation
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Banking in Africa: financing transformation amid uncertainty

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About the report

The Banking in Africa report is a product of the EIB Economics Department providing an analysis of recent development in the African banking sectors and specific structural topics of relevance. It combines in house research with contribution from leading market experts from commercial banks operating in the region, IFIs and other institutions.

About the EIB Economics Department

The mission of the EIB Economics Department is to provide economic analyses and studies to support the Bank in its operations and in the definition of its positioning, strategy and policy. The Department, a team of 40 economists, is headed by Debora Revoltella, Director of Economics.

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Executive summary

This fifth full edition of the European Investment Bank's study of banking sectors in Africa casts light on recent developments in the continent's banking sectors and the policy options for all stakeholders. The chapters devoted to banking sector development in each sub-region have been enhanced compared to earlier editions, with greater focus being placed on micro, small and medium-sized enterprises (MSME) and on financial inclusion. Another objective of the 2020 edition of this study is to contribute to the EIB's Africa Day on 27 February 2020 in Dakar, Senegal, in partnership with UN Habitat.

In Africa, real GDP growth is set to remain relatively resilient despite persistent uncertainty in the global economy. Economic growth is projected to accelerate moderately in 2020, due to strengthening demand, but it is expected to be held back on a longer-term basis by the slowing pace of reforms. The population growth rate means that GDP per capita will increase less than needed to ensure fast convergence with middle- and high-income economies, to make a significant dent into poverty and create enough jobs for the growing labour force. Inflationary pressures have eased and the average current account and government deficits are projected to decline, reflecting the recovery of commodity prices since their 2016 low and, in some countries, fiscal consolidation. The average debt situation of African countries shows signs of stabilisation, but there is a high risk of debt distress in several countries due to the high level of government debt, particularly non-concessional debt, and rising debt-servicing costs. There is a significant degree of heterogeneity across countries regarding the pace of recovery, medium-term prospects and debt sustainability.

The economic performance of North Africa is improving. The economies of the region are expanding and GDP growth is expected to accelerate to 4.4% in 2020 and 2021. For some time, restoring macroeconomic stability was a primary concern for the national authorities. More recently, however, reforms to promote private sector development have been implemented.

In the WAEMU zone, the economic outlook remains resilient. Real GDP growth is set to increase to 6.5% in 2020 from 6.4% in 2019 and to average 6.8% over 2021-2024. Growth in private investment and an increase in agricultural productivity are expected to sustain economic activity over this period. There is a risk of fiscal slippages ahead of the forthcoming elections in several countries in the WAEMU zone.

The outlook for West African countries outside the WAEMU zone is mixed. The region's largest economy, Nigeria, which accounts for two thirds of West Africa's GDP, is expected to grow at around 2.5% in 2020. Growth rates are expected to average 2.6% over 2021-2024. Ghana, on the other hand, is expected to grow at 5.6% in 2020, but faces a risk of fiscal slippage ahead of the 2020 elections. The main downside risks for the sub-region stem from significant uncertainty in the global economy and escalating trade protectionism, including in the region. The Nigerian economy remains highly vulnerable to any drop in oil prices.

There has been a notable acceleration in economic activity in the Central African Economic and Monetary Community (CEMAC) zone. Economic growth is projected to reach 3.0% in 2020 in the CEMAC. The IMF programmes agreed with all countries in the region are bearing fruit but the improvement in the fiscal situation comes against a background of many external risks that might undermine a scenario of gradual acceleration in growth.

Economic growth is expected to remain solid across East Africa. GDP growth is expected to accelerate to 6% in 2020 and 2021, above the average of sub-Saharan Africa (SSA), as infrastructure investments across the region give an extra boost to domestic demand. Still, risks to the outlook are tilted to the downside, mostly stemming from potential external shocks.

Economic developments in Southern Africa in recent years have generally been characterised by low growth. Growth in the sub-region remained subdued during 2019 but is expected to pick up to 1.6% in 2020, although domestic and external risks to this outlook remain substantial. The high level of public debt leaves a number of states vulnerable to external shocks and reduces or even blocks access to external financing.

In line with the generally improving economic conditions in most African countries, the banking groups surveyed for this report are generally in expansionary mode, mostly thanks to organic growth but also due to greenfield and brownfield investments. Nevertheless, some groups are still in consolidation mode, especially in the short term. The banking groups report improvements in terms of loan origination and funding conditions. Non-performing loans (NPLs) appear to be coming under control in most banking groups but they are still on the rise in others. Efforts to comply with Basel II and Basel III standards are also reported. In terms of products and service focus, African banking groups are still emphasising investment in e-banking and mobile banking services. Some groups are also deploying or planning the development of fintech, with the main focus on facilitating mobile money, electronic transfers and back-office operations. A considerable proportion of groups are also investing in lending-related fintech, including data analytics and blockchain technology. The situation of African countries is also heterogeneous in terms of financial market development and the degree of advancement of financial inclusion.

Financial inclusion in North Africa is more advanced than in many other regions on the continent. The financial sectors in the region are dominated by banking activities. Banks, in turn, are well developed, and some have a pan-African vision. The sub-region's banks have started to offer non-financial services to SMEs, micro-firms and start-ups, which can improve the management practices of firms, and thereby promote entrepreneurship and innovation. Access to finance can be further improved by reforming the institutional framework governing secured lending and by developing non-bank finance. Reform of secured transaction frameworks would benefit both banks and firms. Such a reform would make it easier for firms to pledge movable assets as collateral. This would help SMEs in particular, as they are more likely to lack high-quality collateral.

Despite improvements in the soundness and stability of West African banking systems, access to finance remains a challenge across West Africa. The banking sector in the West Africa Economic and Monetary Union (WAEMU) remains sound and profitable, while Basel III capital requirements are being implemented. The profitability of Nigerian and Ghanaian banks remains adequate, thanks to high interest rate spreads and high yields on government securities. Soundness and stability are also improving in these markets, with non-performing loans declining and capital adequacy improving. Progress has been particularly marked in Ghana, where the central bank led a process of reform and consolidation, reducing the fragmentation of the banking sector. Access to finance is still the most commonly cited constraint in more than half of the countries in West Africa, followed by political instability and practices in the informal sector. Banks consider lending to SMEs highly risky and ask for significant levels of collateral, while a significant portion of their investment is allocated to government assets.

The balance sheet activity of the banking sector in the CEMAC zone has improved significantly, owing to the economic recovery. However, the quality of the zone's credit portfolio still calls for vigilance. The sector's prudential situation has improved slightly, thanks to banks' capitalisation efforts. The regulatory and prudential arsenal continues to be changed and adapted but the banking sector continues to be predominant in the financial activity of all CEMAC countries. Businesses are using banking services less in CEMAC countries than in the rest of Africa. Some efforts are expected to strengthen banking infrastructure in the zone that will, in turn, ease SMEs' access to corporate financing. On the other hand, financial inclusion is experiencing very strong growth in CEMAC countries, thanks in particular to the advent of mobile banking, even though there is still significant room for improvement. In the Democratic Republic of the Congo (DRC), although banking activity is developing well, the quality of assets calls for caution. Bank account penetration still has a long way to go to contribute to the country's economic diversification and to make growth more inclusive. A series of regulatory reforms could lead to profound changes in the sector.

The financial sector in East Africa remains stable. In the past two years, a favourable economic outlook and regulatory developments have underpinned the performance of the banking sector in East Africa. The improvement in economic activity in 2018 and 2019 dispelled some of the fears that followed the deceleration in previous years. Going forward, the performance of the regional banking sector will continue to depend on the extent to which the banks address not only the downside risks to the economic outlook, but also the challenges related to regulation and digitalisation. Financial inclusion has improved more significantly in East Africa than in other regions, but access to finance still remains the main bottleneck for companies throughout the region, although less so in the bigger economies. This is particularly the case for

SMEs and micro-enterprises. In some countries, the fact that the local banking sector is keen to mainly lend to the public sector is resulting in less finance available for the private sector. Mobile accounts and financial inclusion are improving unevenly across the region. Despite generalised access in countries such as Kenya, in some countries still less than 5% of the population uses digital banking or payment systems.

Southern Africa's banks generally have good capital and liquidity positions, which are closely linked to their conservative risk appetite and management. Although banking sectors vary widely across the region, some themes of recent years cut across borders. Firstly, the weakening of government finances in several countries puts pressure on the sector as banks have had to fund budget deficits, sometimes at the expense of lending to the private sector. Secondly, the weak economic performance has fed an increase in non-performing loans in most markets. Thirdly, banking supervision and regulation are improving. Fourthly, concerns regarding anti-money laundering and combating of terrorist financing have triggered a decline in international correspondent relationships, which has reduced the region's access to the international financial system. The outlook for the banking sector is generally positive, reflecting the cautious recovery, but SMEs will continue to face bottlenecks when looking for financing due to high interest rates and strict collateral requirements. Larger firms typically find it easier to arrange credit, and the difference with respect to smaller firms is particularly pronounced in Lesotho, Malawi, Namibia and Zambia. Credit constraints are loosely linked to the development of the financial sector, as countries such as Botswana, Mauritius and South Africa have a lower share of credit-constrained firms. This link is confirmed when considering the population's access to finance.

This year's report touches on three important thematic issues of cross-cutting importance in African countries. Firstly, the report explores policy options to finance urban development in the context of fast expanding African cities. Secondly, the financing of Africa's agricultural value chains is discussed. Finally, the report examines how remittances can be harnessed to boost financial sector development.

Adopting a territorial and inclusive approach is key to unleashing the potential of urbanisation in Africa. The lack of effective urban planning has long been the root of the uncontrolled development of African cities and of higher investment costs for infrastructure and services. In particular, secondary cities are expected to play a special role in eradicating poverty, facilitating structural transformation and unlocking the potential of Africa's agricultural value chains. Inclusive approaches that secure the involvement and buy-in of all stakeholders, including the population, can generate smart solutions, resilience, and cost and energy efficiency. Building climate change resilience in urban areas requires a holistic, comprehensive and multi-sectorial/dimensional approach. Social and affordable housing is a key sector for sustainable urbanisation and African authorities and local financial intermediaries have a critical role to play. Inefficient land allocation systems are fuelling conflict due to the general inability to properly allocate and manage land rights and interests. Successful African examples of land reforms and land title systems exist and can serve as a benchmark. They can have significant cross-cutting effects on the business environment.

Well-structured agricultural value chain financing can boost agricultural productivity, thereby supporting sustainable economic development in Africa. Agriculture is a key sector of economic activity in the region, as shown by its large contribution to GDP and its high employment share. Raising productivity along the value chain would help end hunger and malnutrition and meet growing food demands. It would also increase the incomes of the often poor smallholder farmers and enable the export of products that are less price-sensitive and more profitable. However, a considerable financing gap holds back agricultural development as lending to the agricultural sector is often deemed particularly risky. The perceived high risks can be mitigated by well-structured agricultural value chain financing (AVCF). The success of AVCF depends in particular on getting the right expertise and partners, creating the right structures and procedures, tailoring financial products to the specific needs of farming activities, the upstream and downstream sectors of agriculture, training farmers and building trust, and fostering the smart use of digital solutions. These factors all help reduce risks and lower transaction costs, thereby making AVCF work for providers of finance and their users.

Remittances are already a crucial source of external finance for many African countries. Furthermore, the large numbers of African citizens living and working abroad, both on the continent and elsewhere, suggest that there is potential for remittances to become an even more effective driver of economic and social development on the continent. However, the impact of remittances depends on how they are used, and

particularly on the extent to which they are channelled towards productive investment. This depends in turn on financial sector development. In some African financial sectors, the positive impact of remittances is hindered, the costs of remittance services are high and migrants are incentivised to channel funds through informal channels. Some measures to enhance financial sector development can boost the development impact of remittances. For example, developing payment systems and promoting competition in remittance markets could bring down the costs of sending remittances and encourage remitters to use formal channels to send funds. New technologies and the use of mobile money systems can also help bring down costs, but countries need to put the appropriate frameworks in place to facilitate the use of these technologies while at the same time mitigating risks.

The first part of this report represents a study of the banking sectors across Africa. The second part consists of thematic chapters that address transversal challenges and opportunities with regard to financing investment in Africa. Chapter 1 reports on the responses to a survey of banking groups in Africa. Chapters 2-6 examine recent trends in the banking sectors in, respectively, Northern Africa, West Africa, Central Africa, East Africa and Southern Africa. Chapter 7 concerns the opportunities and challenges associated with investing sustainably in Africa's cities, to set the scene for discussions during and after the conference. Chapter 8 analyses how well-structured agricultural value chain financing can boost agricultural productivity, thereby supporting sustainable economic development in Africa. Chapter 9 discusses how remittances can become an even more effective driver of economic and social development on the continent. The study ends with a chapter summarising how the EIB has been investing in sustainable development across Africa since 1963, explaining the type of financial support and technical assistance offered by the EIB to financial sectors on the continent and briefly exploring the way forward.



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Results from a survey of African banking groups

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Summary

This chapter takes stock of trends and strategic issues affecting banking groups in Africa, based on the results of the fourth edition of the European Investment Bank's survey of banking groups in Africa (see Appendix 1). Our survey's coverage has been extended to include the whole African continent, and the sample size has been increased in this edition from 25 to 46 banking groups operating in Africa. The 2020 sample of banking groups is composed of a mix of pan-African banks, sub-regional banks, foreign banks operating in Africa and national banks. A continental approach has the advantage over a regional approach of better encompassing banking group relationships that span multiple sub-regions. The overall message coming out of responses to this year's survey is one of cautious optimism about a gradual return to growth and stability in African banking markets.

In line with the generally improving economic conditions in most African countries, most groups are in expansionary mode, mostly thanks to organic growth but also due to greenfield and brownfield investments. Nevertheless, some groups are still in consolidation mode, especially in the short term. The banking groups report improvements in terms of loan origination and funding conditions. Non-performing loans (NPLs) seem to be coming under control in most banking groups but they are still on the rise in some groups. Efforts to comply with Basel II and Basel III standards are also reported.

The groups are planning to expand their loan books, identifying manufacturing and agriculture as their top sectoral focuses at the moment. In addition, most banking groups report putting a very high priority on SME financing as a growth area. However, the banking groups identify some specific constraints to lending to SMEs: a shortage of bankable projects, a lack of effective collateral, a lack of managerial capacity, informality and a high default rate amongst SMEs. Most banking groups consider portfolio guarantee products as important but, unfortunately, guarantee needs are still predominantly unmet. Similarly, banking groups report a strong demand for local currency financing. Some groups also report that their most important technological needs concern credit risk management and lending technology.

In terms of products and service focus, African banking groups are still emphasising investment on e-banking and mobile banking services. Some groups are also deploying or planning the development of fintech, with the main focus on facilitating mobile money, electronic transfers and back-office operations. Banking groups view telecom companies primarily as partners rather than as competitors for the provision of mobile money services. It is commercial banks that banking groups consider as their most direct competition. A fair proportion of groups are also investing in lending-related fintech, including data analytics and blockchain technology.

Introduction

This chapter takes stock of strategic issues affecting banking groups in Africa and attempts to provide a snapshot of banking sectors. The analysis relies on the results of the fourth edition of the EIB's survey of banking groups in Africa. For this purpose, an attempt is made to reflect in our sample the wide variety of banking groups operating in Africa's banking markets. Three groups of foreign banks competing in the region can be distinguished: foreign affiliates of global banks from developed countries; foreign affiliates of banks from emerging countries, in which we can include the foreign affiliates of banks from South Africa; and foreign affiliates of regional African banks (multinational banks from Africa). The term pan-African banks is used when grouping banks operating across several African markets, based in an African country, including South Africa. Regional African banking groups are headquartered in a variety of countries and some enjoy a significant presence in a large number of countries.

The EIB survey questionnaire and its sample of banking groups are in their fourth edition in Africa thanks to the ongoing collaboration of many banking groups, national, regional and global. A first pilot edition of the survey was launched in 2015 (European Investment Bank, 2015) covering pan-African banks operating in sub-Saharan Africa (SSA). The second edition of the survey (European Investment Bank, 2016) was expanded in two ways. First, the sample of banking groups that agreed to participate in the survey grew from 10 to 17 banks and it included some global banks with a wide footprint in SSA. Second, the number of questions put to banking groups was expanded from 10 to 20 questions, covering an enhanced set of strategic issues, including demand and supply of local currency loans and technological deployment. We estimated using BankFocus data that these 17 banking groups (and their African subsidiaries) represented on average around a third of total assets in SSA (including South Africa) over the 2006-2015 period. In the third edition of the survey (European Investment Bank, 2018), the sample of banks and the questionnaire were further expanded, with a net gain of eight banks. An effort was also made to broaden the sample to include a larger number of African regional banks. The result was a sample comprising 25 banking groups. The number of questions increased from 20 to 25, with new questions focusing on SME lending, fintech, collaboration between banks and telecom companies, banks' competitors, regulatory capital, subordinated debt and strategic sectors for lending.

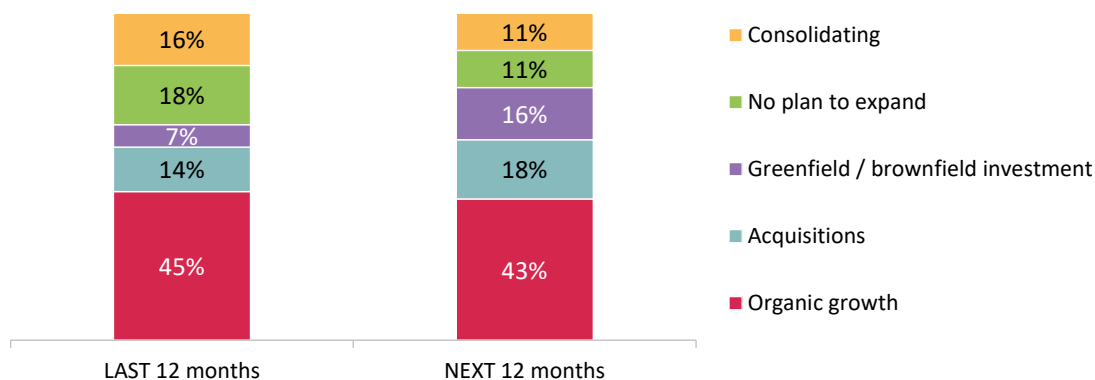
For this fourth, 2019 enhanced edition, the geographical coverage of the survey was expanded to the whole African continent and some of the questions were enriched and fine-tuned. This helped to bring the number of banking groups participating in the survey from 25 to 46. The intent is to match the geographical coverage of the overall report this chapter is published in, and of the EIB's Africa Day, the annual event where the report is launched and discussed. Obviously, a continental approach also has the major advantage of better encompassing the banking groups that are more and more joining the banking sectors of Africa's sub-regions. Finally, many of the market dynamics, challenges and opportunities characterising North African banks are relatively similar to those of their southern neighbours. This is confirmed by the fact that extending the survey's coverage to the whole continent has not altered the main structural observations made in the earlier editions of this survey. The sample of banking groups is a mix of global and pan-African banking groups and a few national groups. The sample includes many EIB clients but not all and not exclusively.

The rest of this chapter discusses the strategic positioning of banking groups in Africa and their perceptions of market conditions, both on the lending and funding side. The next section discusses how banking groups are positioning themselves in terms of growth and acquisitions, sectors and implementation of Basel principles. This is followed by a discussion on how banking groups in Africa perceive the challenges of financing SMEs and what development partners can do to help. The chapter then examines how banking groups in Africa are positioning themselves in terms of investing in new technology, including mobile money and fintech. Finally, we report on how banking groups assess recent and current funding conditions. Appendix 1 documents in detail the questionnaire used in the EIB survey.

Overall strategic positioning

In the short run, most banking groups are in an expansion mode but consolidation is not over in parts of the sector (Figure 1). Within the next 12 months, the vast majority of the banking groups (77%) plan to expand, mostly organically, although acquisitions and greenfield and brownfield investment will also play a role. In contrast, some banking groups (16%) have been in consolidation mode over the past year and some others (11%) plan to consolidate over the coming 12 months.

Figure 1: Short-term strategic approach (share of survey respondents)

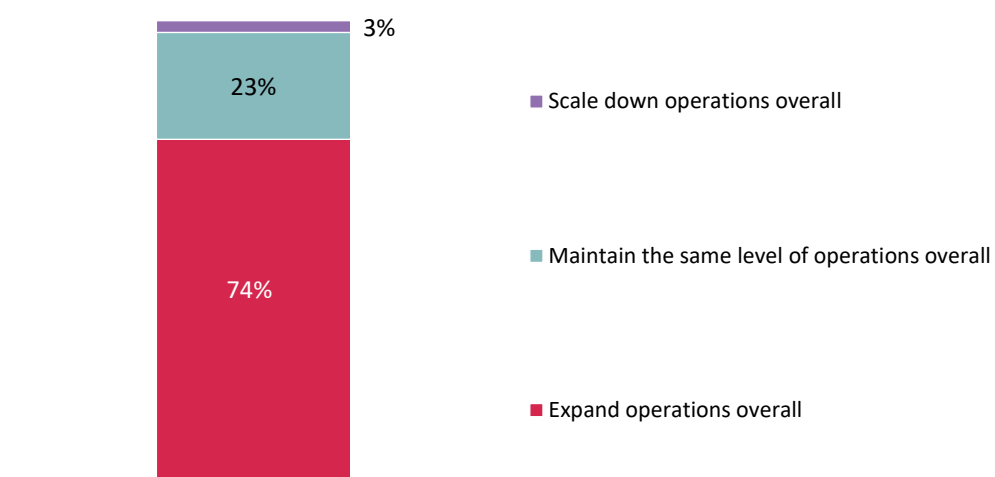


Source: 2019 EIB survey of banking groups in Africa.

Note: Question 16 (see Appendix 1).

In the longer run, the trend towards expansion is even stronger and the banking groups expect that consolidations have largely run their course (Figure 2). Only a small minority (3%) of banking groups are planning to scale down beyond the next 12 months. Around three-quarters of banking groups report an intention to expand operations on a long-term basis, as in the 2018 edition of our survey.

Figure 2: Long-term strategic approach (beyond 12 months - share of survey respondents)

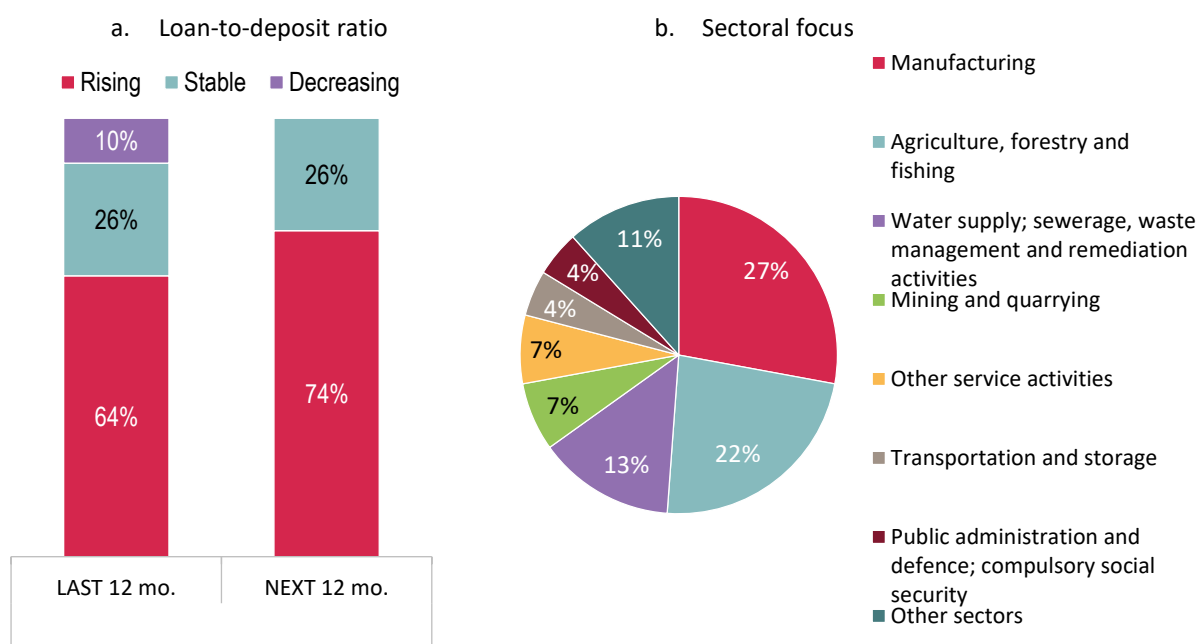


Source: 2019 EIB survey of banking groups in Africa.

Note: Question 4a (see Appendix 1).

The surveyed banking groups plan to accelerate the expansion of their loan portfolio and they are reporting interest in the primary and secondary sectors (Figure 3). Nearly three-quarters (74%) of the banking groups indicate that they expect the ratio of their loan book to their deposits to rise. They also report that manufacturing (27%) and agriculture, forestry and fishing (22%) are the most attractive sectors for lending. Service sectors are also mentioned but with less frequency than would be expected - in 2018, they were cited by 15% of banking groups as the most attractive sectors - perhaps indicating some sectorial saturation. These responses do not match the types of loans that are usually found on the balance sheets of banks in the region. This therefore calls for research on whether this reflects rising potential offered by the primary and secondary sectors in Africa, compared to the tertiary sectors. Chapter 8 in this report explores ways the financial sector can indeed support the development of the primary sector.

Figure 3: Lending policy focus (share of survey respondents)

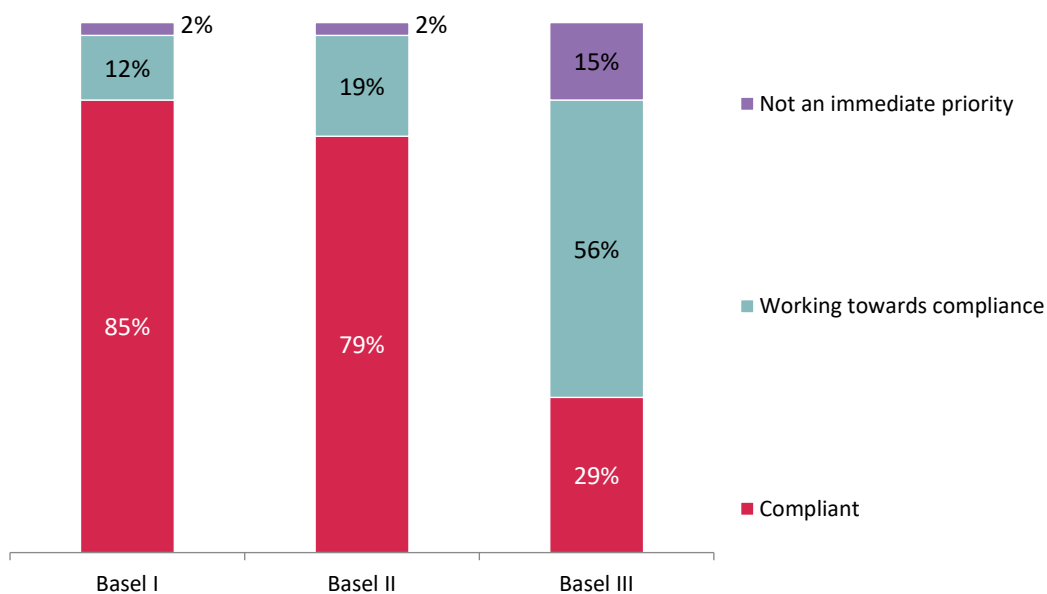


Source: 2019 EIB survey of banking groups in Africa.

Note: Panel a refers to Question 2 and panel b to Question 17 (see Appendix 1); the category 'others' comprises the sectors favoured by 2% or less of the banking groups.

The vast majority of banking groups report being compliant with Basel I and II and most banking groups report to be either compliant or working towards compliance with Basel III (Figure 4). Despite broad compliance with Basel I, there is a lingering perception that single exposure limits/concentration ratios are not always respected. With respect to Basel II standards, close to four-fifths of banking groups consider themselves compliant, with most of the rest reporting that they are working towards compliance. When it comes to Basel III standards, less than one banking group out of three reports being compliant, while the majority of groups report working towards compliance and less than one-sixth of groups state that they do not consider Basel III a priority, compared to close to one group out of four (27%) in 2018. The responses to our survey illustrate the efforts undertaken by (i) regulatory and supervisory authorities to apply more rigorous international best practices; and (ii) banking groups in Africa to increasingly align themselves with the standards. However, it would be worth investigating why one sixth of the surveyed banking groups does not have an immediate concern to work towards compliance with Basel III standards, especially with respect to disclosure requirements, market discipline and access to capital markets.

Figure 4: State of Basel standard compliance (share of survey respondents)

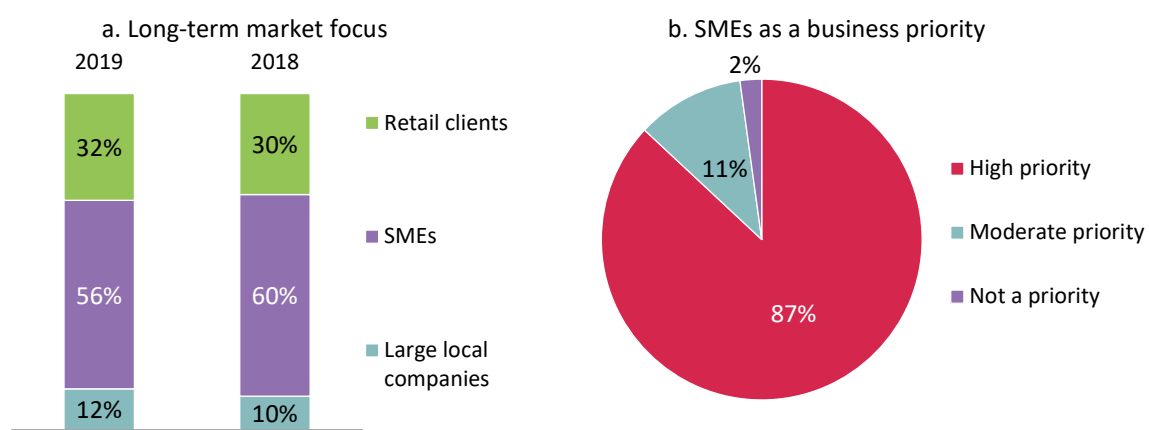


Source: 2019 EIB survey of banking groups in Africa.
 Note: Question 20 (see Appendix 1).

SME financing, challenges and opportunities

Although SMEs do not yet constitute a large proportion of bank portfolios in Africa, a majority of banking groups report a strategic focus on SMEs and most report that SMEs represent a high business priority for business development at the margin (Figure 5). Only a small minority of banking groups in Africa (12%) report a long-term market focus on large local companies, and none a focus on large multinationals anymore, compared to 8% back in 2016. Correspondingly, the vast majority (87%) of banking groups declare SMEs as a high business priority and only very few (2%) report SMEs not being a business priority at all. One-third report a market focus of groups on retail clients, in line with the importance of deposit financing for African banking groups (see section focusing on technological positioning, mobile banking and fintech). This strong focus on SME lending, as a growth area, is partly a reflection of growing competition among banking groups that is pushing them outside of their traditional comfort zone, large corporate clients, in an attempt to sustain portfolio growth and profitability.

Figure 5: Strategic focus and technical assistance (TA) needs (share of survey respondents)



Source: 2019 EIB survey of banking groups in Africa.

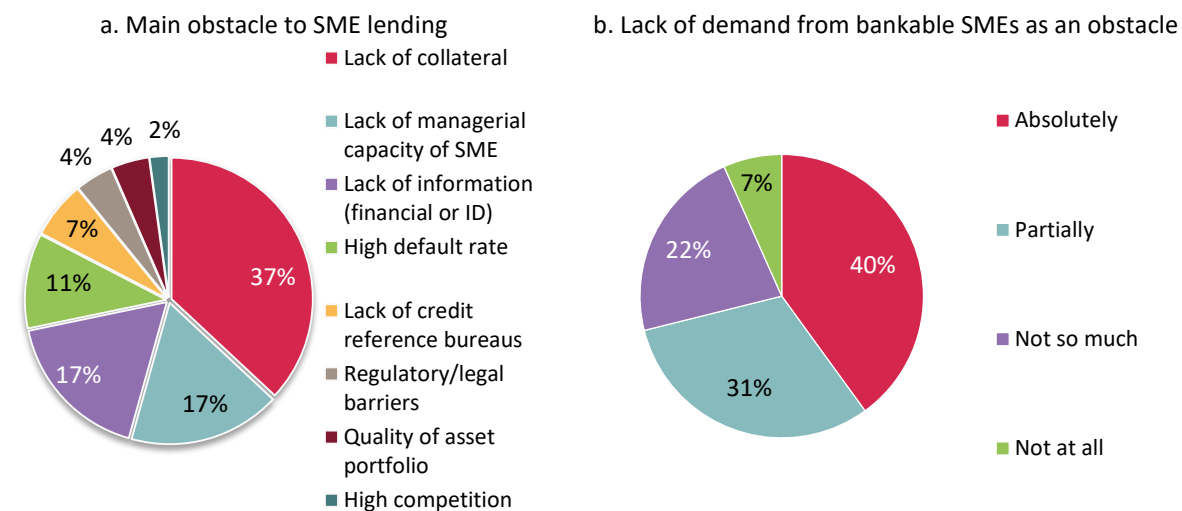
Note: Panel a refers to the second line of Question 4; panel b refers to Question 21 (see Appendix 1).

Banking groups in Africa report that the lack of adequate collateral (37%) and of bankable projects (40%) are key reasons that hold them back from lending more to SMEs (Figure 6). Two other important obstacles reported by banking groups are high default rates (17%) and lack of information (17%). The lack of managerial capacity in SMEs is yet another hurdle (11%) that is reported. The lack of collateral (33%), high default rate (33%) and lack of managerial capacity of SMEs (17%) were already mentioned as top constraints to lending to SMEs in 2018. The sharp competition amongst banking groups to finance SMEs is reported as an issue by very few groups (2%), confirming the notion that there is potentially a very wide scope for banking groups in Africa to expand in the area of SME lending.

These results suggest a number of ways in which development partners can support lending to SMEs. The lack of collateral suggests that incentive-compatible portfolio guarantees could have an important role to play (see below). The high default rates and lack of managerial capacity of SMEs suggest that managerial capacity building for SMEs is an important tool for development partners. Indeed, capacity building provided through dedicated TA programmes - both at the level of the intermediaries and of clients - have been highlighted as a highly desirable contribution to financial intermediation by development partners. With firms often operating informally and lacking proper accounting and financial reporting documents, it is difficult for banks to assess credit risk and to monitor borrowing entities. However, some banks are developing proxy data to overcome these challenges (see section about fintech below).

The lack of information on SMEs suggests that building the capacity of credit bureaus could play an important role. There is a need for better cooperation between commercial banks and domestic policymakers to enhance financial infrastructure, notably credit reporting systems and collateral registries to allow more SMEs' financial inclusion. Credit reference bureaus help mitigate the asymmetry of information and increase transparency in the system. In addition, for good borrowers, positive information from credit reference bureaus can help them negotiate their borrowing rate, which is often in the two-digit bracket. However, few countries in Africa have fully functioning credit bureaus.

Figure 6: Demand and supply for SME financing (share of survey respondents)

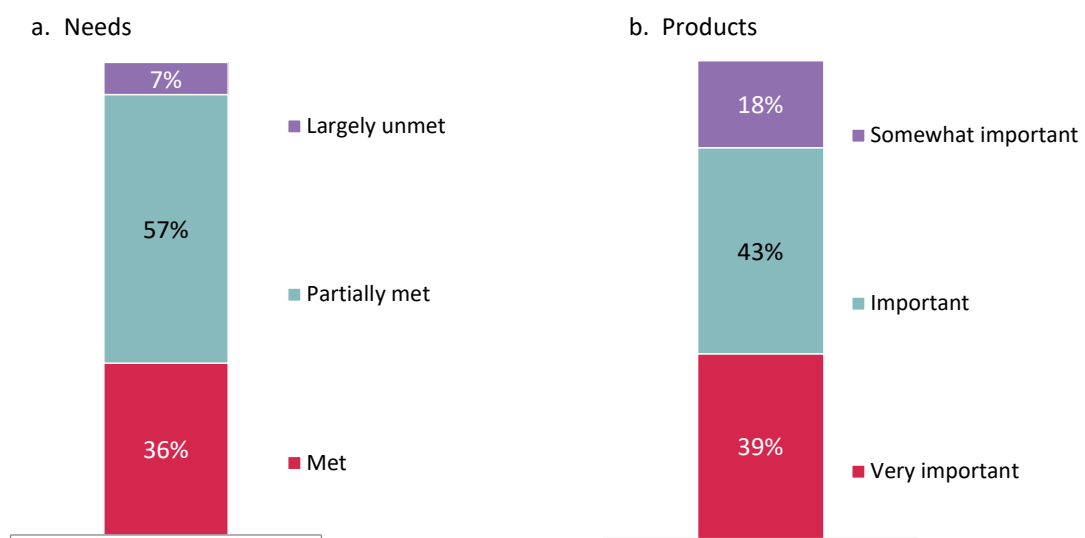


Source: 2019 EIB survey of banking groups in Africa.

Note: Panel a refers to Question 23; panel b refers to Question 22 (see Appendix 1).

Although international financial institutions (IFIs) have developed programmes to offer portfolio guarantees to commercial banks when lending to SMEs, a significant portion of the need for portfolio guarantees is still unmet, even though most banking groups consider such products as either important or very important (Figure 7). The good news is that only a minority (7%) of banking groups consider their needs to be largely unmet, as compared to 18% in 2018. However, only a third of banking groups report that their portfolio needs are met, and two thirds report them as being either unmet or partially met. In addition, four-fifths of groups consider that portfolio guarantees and other de-risking tools are important or very important. These answers suggest that more could be done by development partners, IFIs and development finance institutions (DFIs) to de-risk SME lending. The success of a guarantee programme depends on its design, incentive compatibility, etc. (see Section 6.4.1, EIB, 2016). Also, credit risk is not, unfortunately, the only risk affecting SME lending. Local currency volatility, should banks fund themselves in hard currency, can create currency mismatches on the balance sheet of banks and can also deter banks from lending to SMEs (see below).

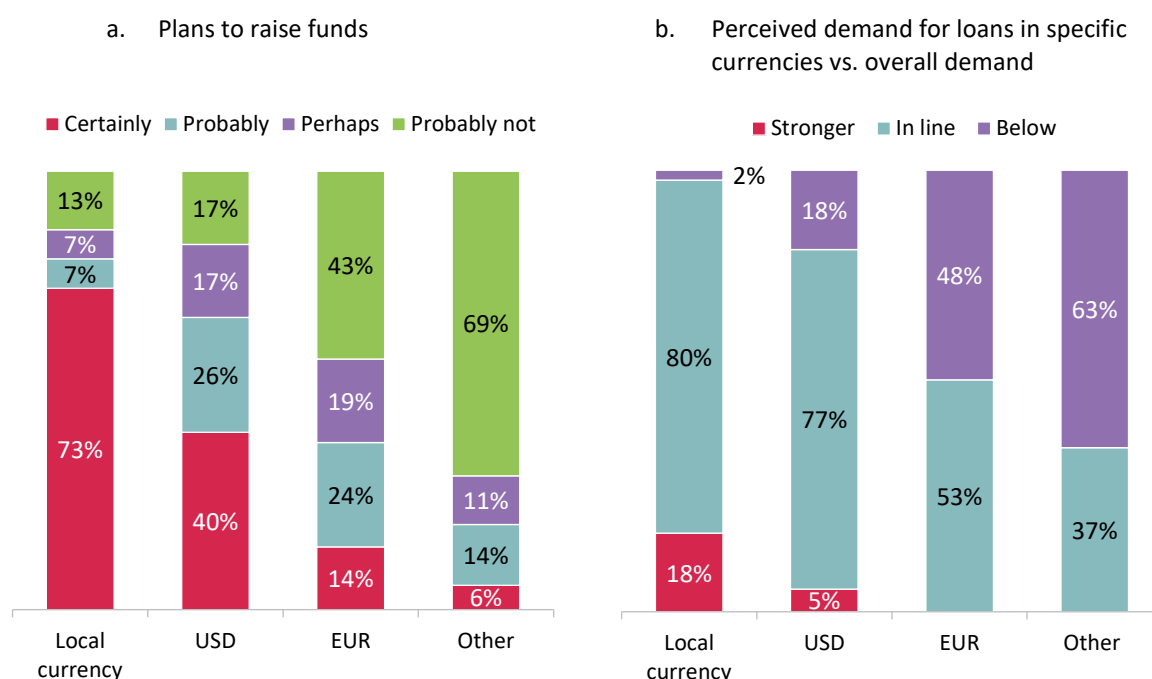
Figure 7: Portfolio guarantees (share of survey respondents)



Source: 2019 EIB survey of banking groups in Africa.
 Note: Panels a and b refer to Question 12 (see Appendix 1).

Banking groups are mainly (73%) planning to raise funds in the local currency, a continuation of the trend observed in 2018. Correspondingly, the banking groups perceive demand for loans in local currency to be either growing faster than (18%) or in line with (80%) overall market demand (Figure 8). Banking groups also report plans to raise funds in USD, albeit with less certainty than in the local currency. They also perceive loans in USD to be in demand, although less so than those in the local currency. More than half of the banking groups indicate that they are likely, to some degree, to raise funds in EUR and the majority (55%) of them report that demand for loans in EUR is in line with market demand. About a third of the banking groups are planning to raise funds in other currencies, although a large majority of respondents indicate that the demand for loans in other currencies is below market demand. Of course, there is a wide diversity of situations at subsidiary level, with some operating under a fixed exchange rate set-up (e.g. in the two Franc CFA zones, expected to be replaced by ECO in 2020 in WAEMU), some under a floating exchange rate regime, and some in a dollarised or quasi-dollarised environment (e.g. in the Democratic Republic of the Congo).

Figure 8: Local currency and foreign exchange funding and lending (share of survey respondents)

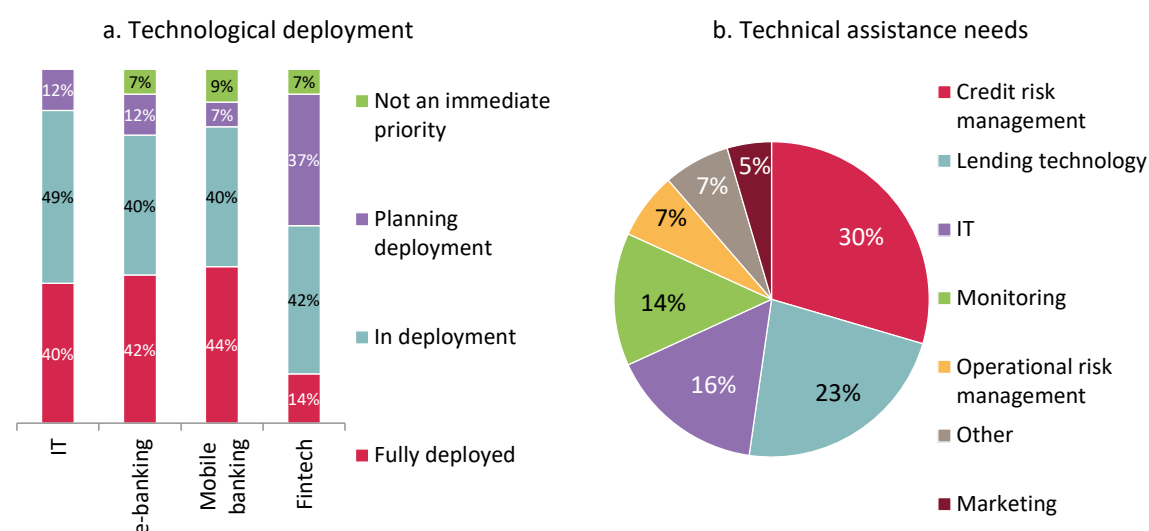


Source: 2018 EIB survey of banking groups in Africa.
 Note: Question 11 (see Appendix 1).

Technological positioning, mobile banking and fintech

Banking groups are increasing their focus on IT and mobile banking technologies while declaring that the highest needs for technical assistance (TA) are related to credit risk management and lending technology (Figure 9). In 2018, only 5% of banking groups considered IT as a priority for TA, compared to 16% in this edition. Lending technology has also risen as a priority in this edition (16%) as compared to the 2018 edition of the survey (5%). This is consistent with the declared longer-term market focus, as growth areas, on SME financing and retail clients, as discussed above. A notable proportion of groups (44%) report being fully deployed in terms of mobile banking technology, illustrating how fast the deployment of this technology has been in Africa. In contrast, very few banking groups in Africa (14%) consider themselves fully deployed yet in terms of fintech, i.e. technologies used to automate and improve financial services. A large share of groups, however, are either in fintech deployment (42%) or planning such deployment (37%).

Figure 9: Technological positioning (share of survey respondents)

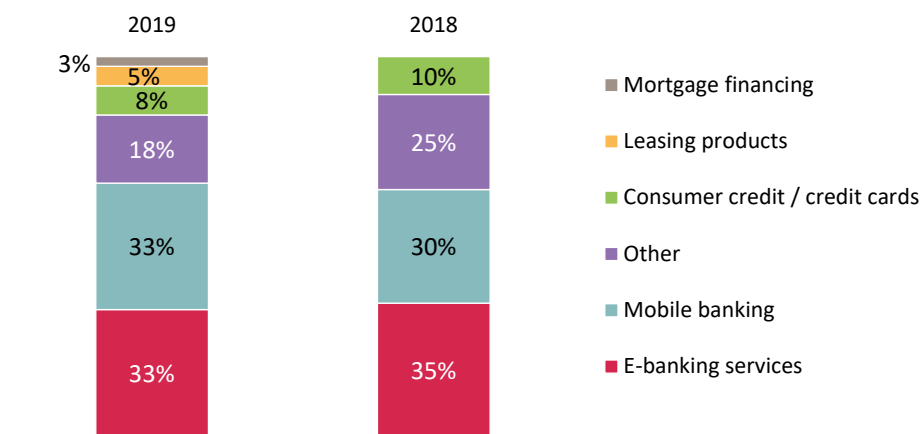


Source: 2019 EIB survey of banking groups in Africa.

Note: Panel a refers to Question 19; panel b refers to Question 18 (see Appendix 1).

Banking groups report having over the long term a product and service focus on e-banking services and mobile banking services (Figure 10). Again, this is consistent with a growing concentration on retail clients and also on SMEs, as in 2018. E-banking and mobile banking services reduce the cost of intermediating with smaller clients and provide deposit collection at a lower cost, as well as relieving some pressure on branch networks to serve professionals and self-employed individuals. Two new types of products are being reported as a strategic product focus by some groups: leasing (5%) and mortgage financing (3%). This is prima facie evidence that the range of products offered by African banking groups is expanding and is being tailored to address an expanding set of needs as the middle class grows in size in some markets (see also Chapter 7 concerning mortgage financing in Africa’s cities).

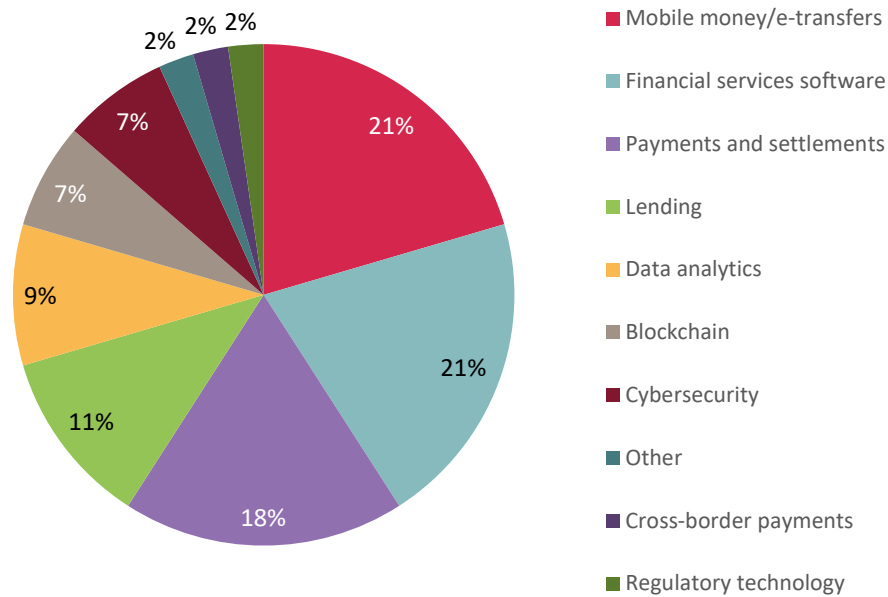
Figure 10: Product and service long-term strategic focus (share of survey respondents)



Source: 2019 EIB survey of banking groups in Africa.
 Note: Question 4 (see Appendix 1).

Within fintech, mobile money and e-transfers (21%), financial services software (21%) and payment and settlements (18%) are key areas for investment (Figure 11). Lending, data analytics and blockchain are also areas of focus for some groups, but less so. Fintech in Africa (as elsewhere) is still at an early stage of development and banking groups are not investing significantly yet on fintech for lending purposes. The main focus is still on facilitating transfers and back-office operations. Nonetheless, it is noteworthy that more than one banking group in four reports focusing its fintech investments on lending, data analytics and blockchain technology. In other words, while fintech is not yet being deployed extensively for lending, a quarter of banking groups are investing money in that direction.

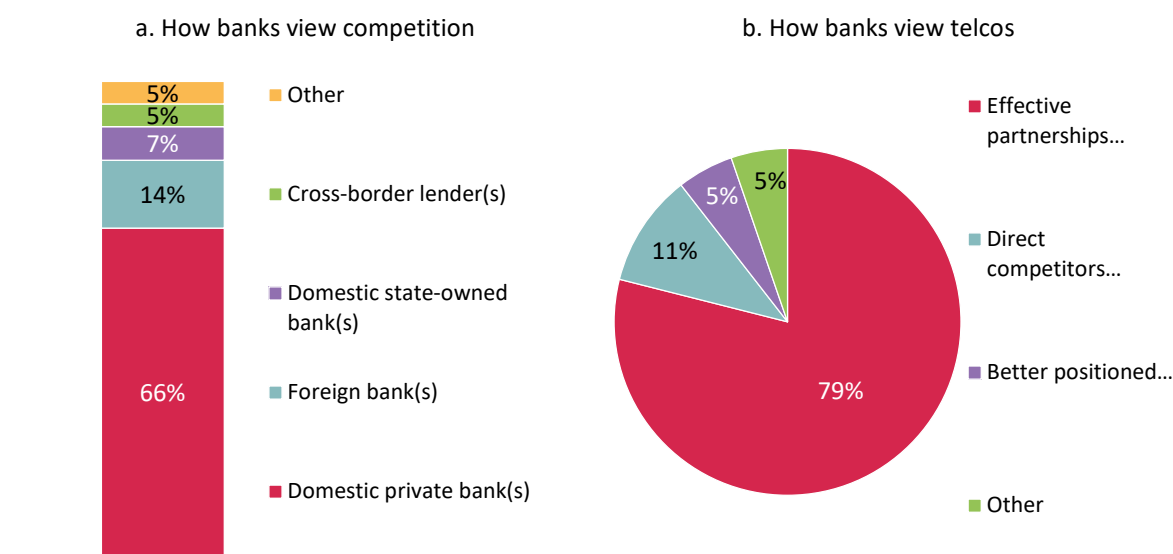
Figure 11: Technological focus with fintech (share of survey respondents)



Source: 2019 EIB survey of banking groups in Africa.
 Note: Question 24 (see Appendix 1).

Banking groups still view private domestic banks as their main competitors and most of them see the dominant model for providing mobile money as one of effective partnerships with telecom companies (telcos) (Figure 12). Foreign banks are considered a competitive threat by some banking groups (14%). Few groups (7%) consider domestic state-owned banks as their main competitors. Regarding telcos, these are seen more as partners (79%) than as direct competitors (11%). This is in line with responses from 2018 (78% and 17% respectively). Only a few banking groups (5%) consider telcos to be better positioned than them to offer mobile money. In a nutshell, banking groups in Africa do not seem to fear disruption from telcos and rather see their peers as their main competition. Of course, this can be partly explained by the fact that regulatory authorities often prevent telcos from gaining banking licences, and therefore from competing with banks. Banks are also generally blocked from gaining telco licences.

Figure 12: Competitive landscape for financial intermediation (share of survey respondents)



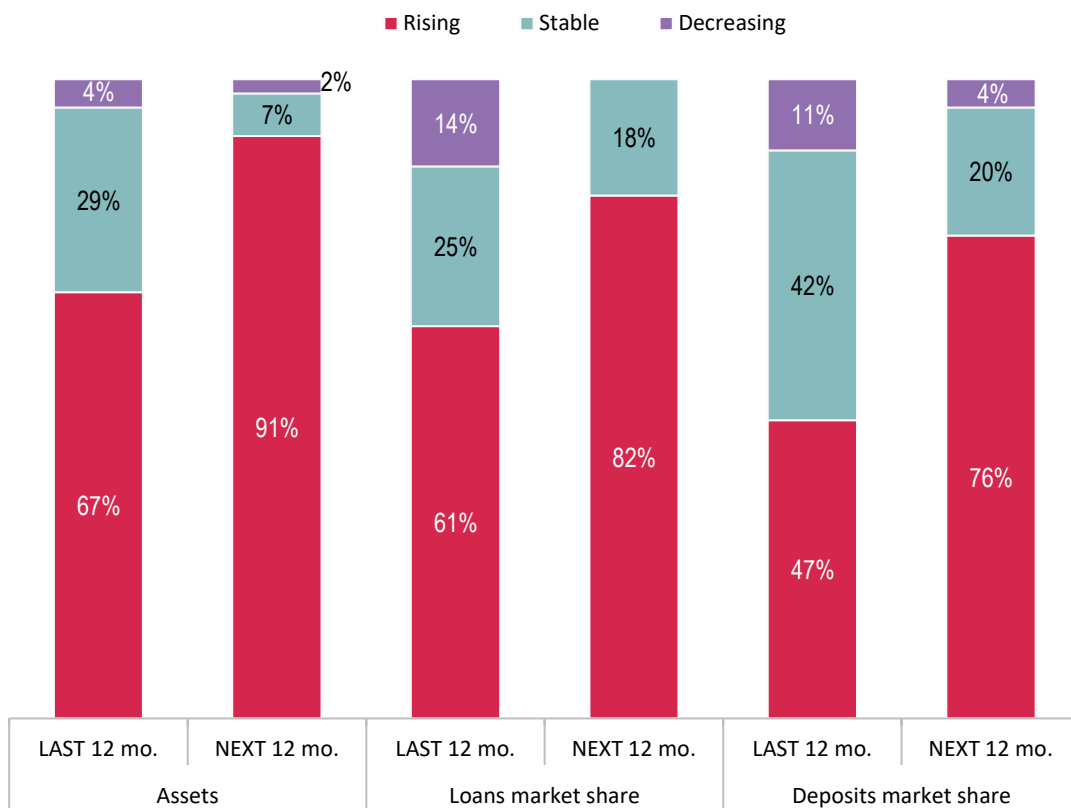
Source: 2019 EIB survey of banking groups in Africa.

Note: Panel a refers to Question 13; panel b refers to Question 25 (see Appendix 1).

Banking and funding strategy

Banking groups report that they are eager to expand their balance sheets and to boost the collection of deposits (Figure 13). The vast majority (91%) of respondents expect assets growth to accelerate in the short run, up from 88% in 2018. They also expect a pickup in their loans and deposits market shares, which is indicative of increasing competition, at least in some African markets. Expanding market shares for large banking groups, if they materialise, will come at the expense of smaller banks that are less covered by this survey, potentially signalling a maturing of the banking markets in Africa. Expectations of rising deposits market shares and loans-to-deposits ratios are indicative of sharpening competition also in terms of deposit collection.

Figure 13: Assets, loans and deposits strategy (share of survey respondents, as %)

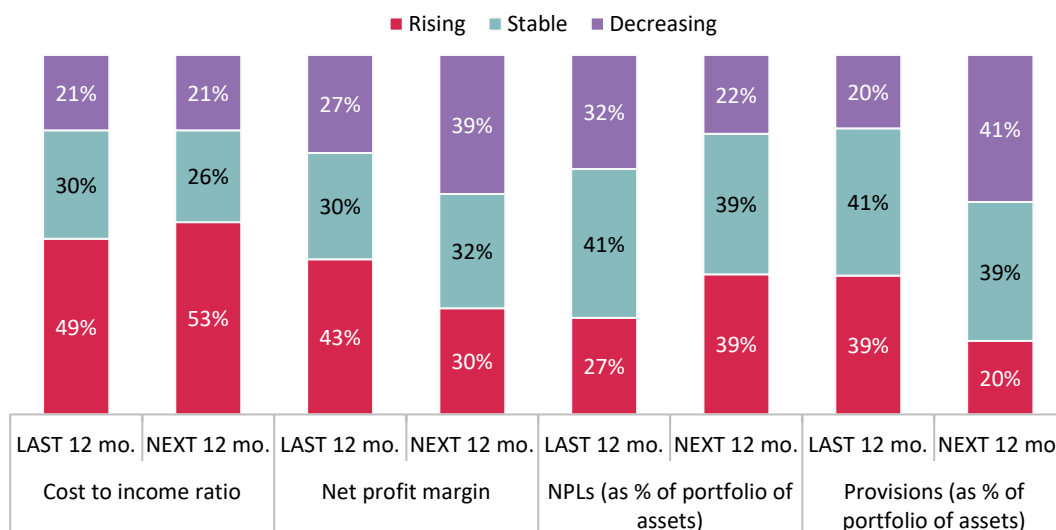


Source: 2019 EIB survey of banking groups in Africa.

Note: Question 2 (see Appendix 1).

Although banking groups expect their cost-to-income ratio to rise, they have balanced expectations with respect to profitability and expect non-performing loans (NPLs) to slowly come under control (Figure 14). In 2019, less than half of banking groups (39%) still expect NPLs to rise going forward, as compared to 58% in 2018. Accordingly, more banking groups are planning to taper off the constitution of provisions (41%) than to increase them (20%). In contrast, in 2018 the same proportions of banking groups were planning to increase and to decrease provisions (26%). Less encouragingly, more respondents expect profit margins to come down (39%) than to increase (30%), a situation similar to that in 2018.

Figure 14: Assessment of profitability and portfolio risk (share of survey respondents - as %)

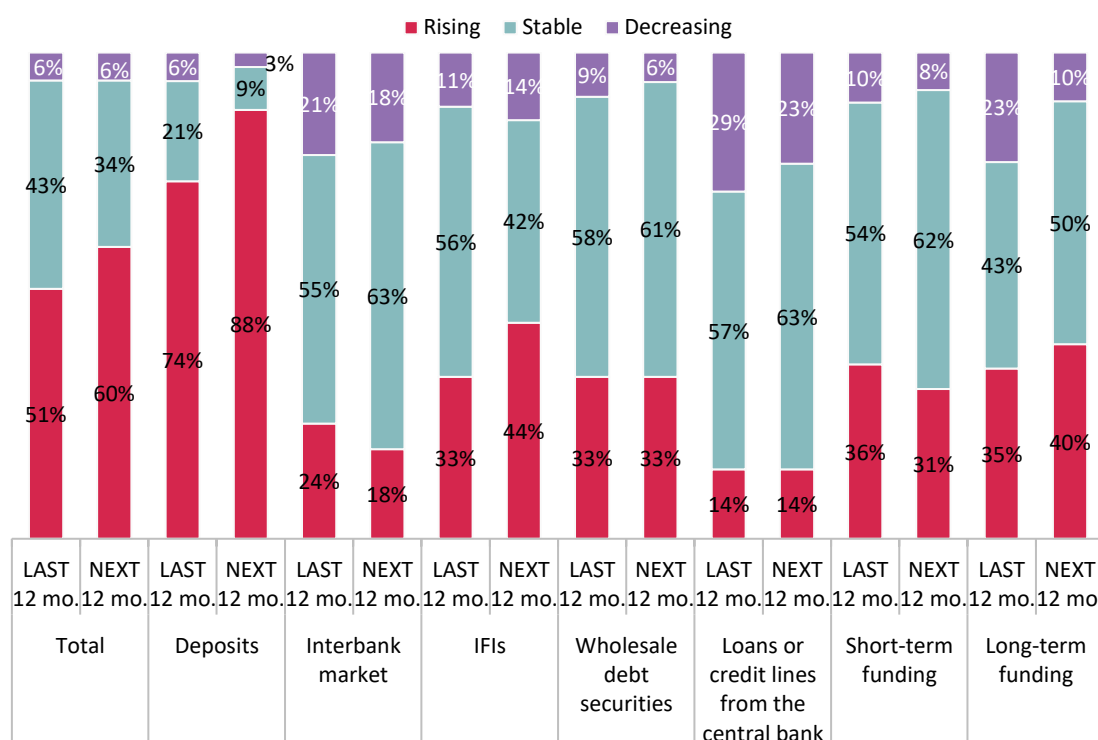


Source: 2019 EIB survey of banking groups in Africa.

Note: Question 2 (see Appendix 1).

On balance, the majority of banking groups expect rising access to funding at group level with a strong emphasis on deposits and, to a lesser extent, IFI funding (Figure 15). The vast majority (88%) of banking groups expect their reliance on deposit financing to keep on increasing in the near future. Forty-four per cent of banking groups intend to increase access to international financial institutions (IFIs) funding, up from 33% in 2018. Forty per cent of groups plan to increase access to other forms of long-term funding, roughly the same share (43%) as in 2018. Less than a fifth of respondents intend to increase access to the interbank market (18%) and about a seventh (14%) to increase credit from the central bank. More than one group in five (23%) is planning to curb the use of central bank funding. However, close to a third of the groups are planning to tap short-term funding and wholesale debt securities. Banking sector deepening is positively correlated to interbank transactions, whose growth is a sign of banking sector soundness.

Figure 15: Sources of funding of banking groups in Africa (share of survey respondents)

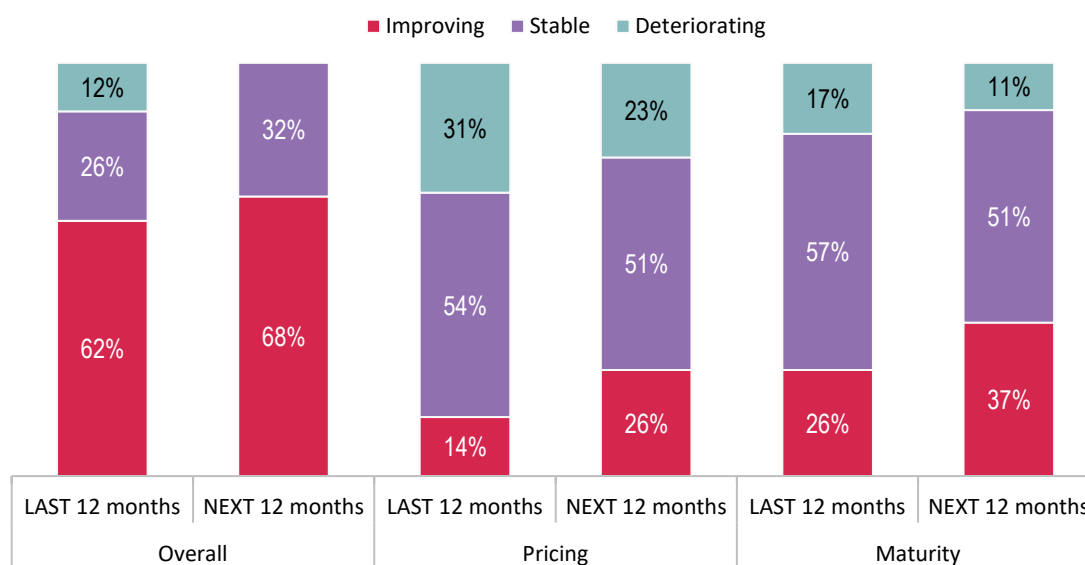


Source: 2019 EIB survey of banking groups in Africa.

Note: Question 3 (see Appendix 1).

Banking groups report growing optimism with respect to overall access to funding conditions but they are less hopeful in terms of pricing and maturity (Figure 16). In the short run, the majority of banking groups (68%) expect an improvement in overall funding conditions at subsidiary level. This compares with 40% in 2018. A growing share of banking groups expect an improvement in pricing and maturity conditions for funding at subsidiary level but the majority of banking groups expect pricing and maturity conditions either to remain stable or to deteriorate. Nevertheless, going forward, more banking groups expect an improvement than a deterioration both in terms of pricing and maturity, indicating that the worst seems to be over given the improving economic outlook in most African countries (see IMF, 2019).

Figure 16: Trends in funding conditions (share of survey respondents)

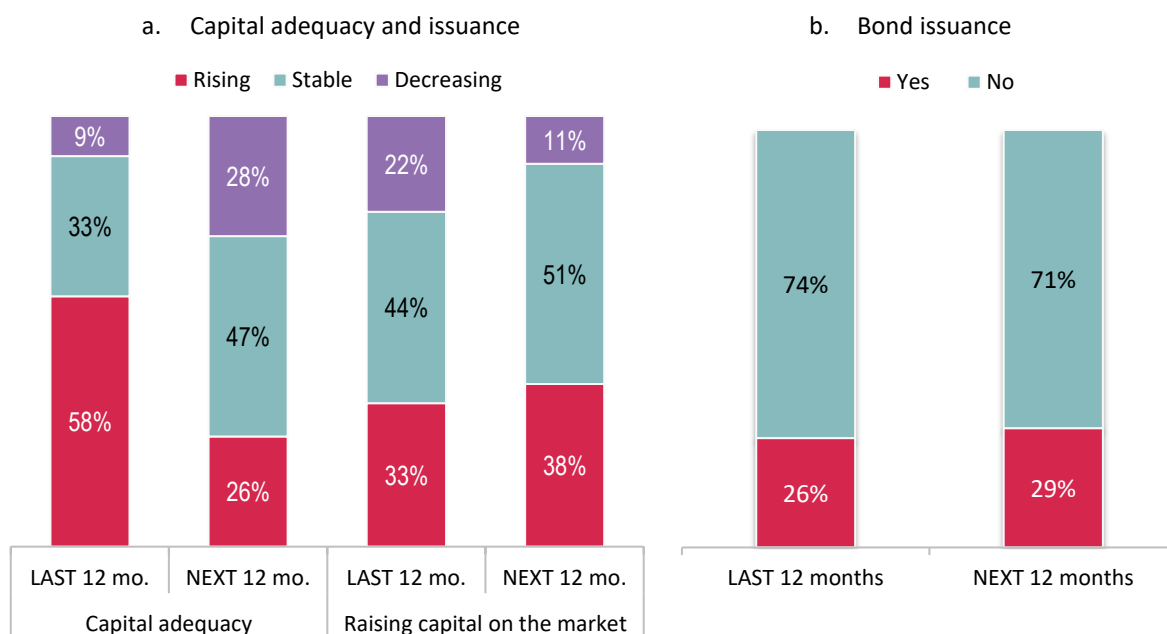


Source: 2019 EIB survey of banking groups in Africa.

Note: Question 9 (see Appendix 1).

Most banking groups (71%) report no intentions to issue bonds or to raise regulatory capital and subordinated debt going forward (Figure 17). Most banking groups consider their capital adequacy to be improving or stable. Consequently, the majority of them report that their efforts to raise capital on the market will remain stable or decrease. A large minority of banking groups plan to raise capital (38%) but less so than in 2018 (43%). Similarly, 29% plan to issue bonds, compared to 41% in 2018.

Figure 17: Capital, subordinated debt and bond issuance (share of survey respondents)



Source: 2019 EIB survey of banking groups in Africa.

Note: Panel a refers to Question 2; panel b refers to Question 15 (see Appendix 1).

Conclusions

The recovering optimism amongst banking groups should not be mistaken for extreme confidence nor taken as implying that it is a time of complacency. Indeed, some groups are still in consolidation mode, in both the short- and long-term perspective. And while there is some evidence that NPLs are stabilising, their continued rise in some groups begs for caution and attention. Progress on compliance with Basel II and Basel III standards should not hide the fact that less than a third of banking groups are in line with Basel III standards and that a fifth still have some work to do to align even with Basel II standards. It is reassuring to hear from banks that they are investing in credit and operational risk management, IT and credit monitoring. However, these investments will invariably take time to bear all their fruit.

The responses of banking groups concerning SME financing continue to tell a story of rising ambitions that run up against the informal nature and capacity constraints of most SMEs in Africa, but one to which development partners can contribute. On the back of the perception of high default rates of SMEs, the majority of banking groups consider their needs for portfolio guarantees to be unsatisfied. Development partners should help to turn the high business priority that banking groups attach to SMEs into a reality by addressing the constraints faced by the groups. Chapter 8 makes this case in detail in the specific context of agricultural value chains. Providing incentive-compatible portfolio guarantees suggests itself readily but design issues loom large and other instruments that can promote access to finance and financial development deserve consideration. Longer-term financing of commercial banks by IFIs, including the EIB, remains in demand and an important part of the toolbox to facilitate investment in the private sector. Banking groups also report a high demand for loans denominated in local currency. Development partners can help local economic development by providing banks with more loans in local currency, thereby hedging financial intermediaries from currency risk and incentivising them to on-lend in local rather than foreign currency to SMEs with revenue streams in the domestic currency. Funding capacity development amongst SMEs themselves is one straightforward way to scale up the pipeline of bankable SMEs in Africa.

The investments in fintech made and planned by some groups can also offer development partners leverage when it comes to boosting the capacity of banking groups to finance private sector development in Africa. Banking groups can be supported in their efforts to deploy and adapt fintech to African markets. Mobile money technology has had a palpable impact on access to finance for retail clients in Africa. The next step would be to deploy technology adapted to the context of African countries to lower the cost of, and risks associated with, providing loans to micro-, small and medium-sized enterprises (MSMEs). Optimising the level of competition within Africa's banking sectors is another challenge, as policymakers must strike a balance between decreasing lending margins and ensuring financial stability.

Appendix 1: the survey questionnaire, 2019 enhanced edition

The survey is administered by the European Investment Bank under a confidentiality agreement with the individual participating banks. It is addressed to senior officials of the banks involved. African banking groups are surveyed at the group level, leaving it to the group to collect information from its subsidiaries. The inclusion of a specific bank in the survey does not in any way represent a statement about business preference or compliance with EIB policies.

Q1 | What is your bank's positioning in each country²...

	... current positioning	... perceived market potential	... strategic positioning
1	Algeria		
2	Angola		
...			
54	Zimbabwe		

In Q1, for current positioning, the following answers are possible: a. active with subsidiary or branch – with significant market share (among top 3 market players); b. active with subsidiary or branch - with medium market share; c. active with subsidiary or branch - with niche market presence; d. active with representative office; e. inactive. For perceived market potential, the following answers are possible: a. low; b. medium; c. high. For strategic positioning, the following answers are possible: a. increase presence with new acquisition; b. increase presence with new capital provided by parent company/reinvested earnings; c. increase presence with new funding from parent company; d. increase presence via cross-border lending activity; e. remain stable; f. decrease presence via reduced cross-border lending activities; g. decrease presence with lower funding from parent company; h. decrease presence by selling assets/subsidiaries.

Q2 | In Africa, key indicators have been/are expected to be ...

	LAST 12 months	NEXT 12 months
Assets		
Loan applications		
Loans market share		
Deposits market share		
Loans/deposits ratio		
Return on assets		
Cost-to-income ratio		
Net profit margin		
Non-performing loans (as % of portfolio of assets)		
Provisions (as % of portfolio of assets)		
Capital adequacy		
Raising capital on the market		
Net full-time equivalent (FTE)		

² The full list of countries (54) covered by the survey is: Algeria, Angola, Benin, Botswana, Burkina Faso, Burundi, Cabo Verde, Cameroon, Central African Republic, Chad, Comoros, Côte d'Ivoire, Democratic Republic of the Congo, Djibouti, Egypt, Equatorial Guinea, Eritrea, Eswatini, Ethiopia, Gabon, Gambia, Ghana, Guinea, Guinea-Bissau, Kenya, Lesotho, Liberia, Libya, Madagascar, Malawi, Mali, Mauritania, Mauritius, Morocco, Mozambique, Namibia, Niger, Nigeria, Republic of the Congo, Rwanda, São Tomé and Príncipe, Senegal, Seychelles, Sierra Leone, Somalia, South Africa, South Sudan, Sudan, Tanzania, Togo, Tunisia, Uganda, Zambia, Zimbabwe.

Q3 | In Africa, regarding your group's access to funding...

	...How has it changed over the LAST twelve months?	...How do you expect it to change over the NEXT twelve months?
Total		
Deposits		
Interbank market		
IFIs		
Wholesale debt securities		
Loans or credit lines from the central bank		
Short-term funding (<=1 year)		
Long-term funding (>1 year)		

For each variable in Q2 and Q3, the following answers are possible: a. rising; b. stable; c. decreasing.

Q4 | Longer-term strategic approach (beyond 12 months): looking at operations in Africa, your group intends to...

Overall
To which of the following new products/services does your group give the highest priority for the next 12 months?
Market segment focus
<i>Specify different market segment focus if applicable:</i>

For Q4, overall, the following answers are possible: a. expand operations overall; b. maintain the same level of operations overall; c. scale down operations overall. As for new product and service focus, the following answers are possible: a. by rolling out mobile banking; b. by rolling out mortgage financing; c. by rolling out consumer credit/credit cards; d. by rolling out leasing products; e. by rolling out e-banking services; f. other, please specify below. The following answers are possible with respect to market segment focus: a. by focusing on large multinationals; b. by focusing on large local companies; c. by focusing on SMEs; d. by focusing on retail clients.

Q5 | Group total medium-term exposure to Africa: concerning cross-border operations to African countries, your group has/intends to...

	LAST 12 months	NEXT 12 months
Total Exposure		
Exposure to subsidiaries - intra-group debt funding		
Exposure to subsidiaries - capital		
Direct cross-border lending booked in the balance sheet of the parent company		
Funding to banks and other financial institutions (e.g. MFIs) not part of the group, booked in the balance sheet of the parent		

For Q5, the following answers are possible: a. expand(ed) exposure; b. maintain(ed) the same level of exposure; c. reduce(d) exposure.

Q6 | Profitability of operations in Africa: the return on assets (ROA) of the group has/is expected to...

	LAST 12 months	NEXT 12 months
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For Q6, the following answers are possible: a. increase(d); b. be(en) stable; c. decrease(d).

Q7 | Compared to the overall group and corrected for the cost of risk, profitability of operations in Africa: the return on assets (ROA) of your African operations has been/is expected to be ...

	LAST 12 months	NEXT 12 months
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For Q7, the following answers are possible: a. lower; b. equal; c. higher.

Q8 | What has been/is expected to be the most relevant form of funding for your subsidiaries in Africa...

	LAST 12 months	NEXT 12 months
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For Q8, the following answers are possible: a. deposits; b. credit from the parent bank; c. interbank market; d. IFIs; e. wholesale debt securities; f. loans or credit lines from the central bank; g. other short-term funding; h. other long-term funding.

Q9 | Funding conditions in your own subsidiaries in Africa have been/are expected to be...

	LAST 12 months	NEXT 12 months
Overall		
Pricing		
Maturity		

For Q9, overall, the following answers are possible: a. improving; b. deteriorating; c. stable. For Q9, pricing, the following answers are possible: a. less pricey; b. pricier; c. stable. For Q9, maturity, the following answers are possible: a. longer; b. shorter; c. stable.

Q10 | What is the share of your Africa operations (excluding operations in your HQ country if your HQ is in Africa), in your total group operations.

	...assets	...revenues
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For Q10, the following answers are possible: a. below 10%; b. 10-25%; c. 25-50%; d. 50-75%; e. above 75%.

Q11 | In Africa, in which currency do you...

	... plan to raise funds	... perceive demand for loans
Local currency		
USD		
EUR		
Other foreign currency		

Specify different currencies if applicable:

For Q11, plan to raise funds, the following answers are possible: a. certainly; b. probably; c. perhaps; d. probably not. For Q11, perception of loan demand, the following answers are possible: a. stronger than market trends; b. in line with market growth; c. below market trends.

Q12 | With respect to the development of your SME lending business,

	... to be
do you consider your portfolio guarantee needs ...	
do you consider your portfolio guarantee products ...	

For Q12, portfolio guarantee needs, the following answers are possible: a. met; b. partially met; c. largely met; d. irrelevant. For Q12, portfolio guarantee products, the following answers are possible: a. very important; b. important; c. somewhat important; d. irrelevant.

Q13 | In Africa, who was/were typically your strongest competitor(s) over the last 12 months for lending to...

	... SMEs	... mid-caps

Specify other if applicable:

For Q13, the following answers are possible: a. domestic state-owned bank(s); b. domestic private bank(s); c. foreign bank(s); d. cross-border lender(s); e. other.

Q14 | Group funding strategy: has your group raised/is your group planning to raise...

	... during the next 12 months?
Tier 1/regulatory capital?	
Subordinated debt?	

For Q14, about Tier 1 and regulatory capital, the following answers are possible: a. yes; b. no. About subordinated debt, the following answers are possible: a. certainly; b. probably; c. perhaps; d. probably not.

Q15 | Have you/do you plan to issue(d) bonds?

	LAST 12 months	NEXT 12 months
<i>If no: why is this the case? Too expensive, no need, no capacity?</i>		
<i>Local capital market constraints? Lack of access to capital market?</i>		
<i>If yes: what is the strategy? Diversify sources of funding?</i>		
<i>Lengthen the maturity of funding?</i>		

For Q15, the following answers are possible: a. yes; b. no.

Q16 | In Africa, how are you/how do you plan to expand(ing) mainly?

	LAST 12 months	NEXT 12 months
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For Q16, the following answers are possible: a. organically; b. acquisitions; c. greenfield/brownfield investment; d. no plan to expand; e. consolidating.

Q17 | In Africa, which sector of the economy do you most value for lending?

The most important
The second most important
The third most important

For Q17, the following answers are possible: a. agriculture, forestry and fishing; b. mining and quarrying; c. manufacturing; d. electricity, gas, steam and air conditioning supply; e. water supply; sewerage, waste management and remediation activities; f. construction; g. wholesale and retail trade; repair of motor vehicles and motorcycles; h. transportation and storage; i. accommodation and food service activities; j. information and communication; k. financial and insurance activities; l. real estate activities; m. professional, scientific and technical activities; n. administrative and support service activities; o. public administration and defence; compulsory social security; p. education; q. human health and social work activities; r. arts, entertainment and recreation; s. other service activities; t. activities of households as employers; undifferentiated goods- and services-producing activities of households for own use; u. activities of extraterritorial organisations and bodies.

Q18 | With respect to lending in Africa, what are your main medium-term technical assistance (TA) needs seen from HQ level?

Specify other needs if applicable:

For Q18, the following answers are possible: a. marketing; b. IT; c. operational risk management; d. credit risk management; e. lending technology; f. monitoring; g. other (please specify).

Q19 | Where does your group stand ...

... with respect to:

Investing in general IT infrastructure?
Deploying internet banking technology?
Deploying mobile banking technology?
Deploying fintech to streamline credit decisions?
Deploying gender-inclusive products and services?
Deploying Islamic finance products and services?

For Q19, the following answers are possible: a. fully deployed; b. in deployment; c. planning development; d. not an immediate priority.

Q20 | Do you consider your banking group ...

... to be:

Basel I
Basel II
Basel III

For Q20, the following answers are possible: a. compliant; b. working towards compliance; c. not an immediate priority. The corresponding figure illustrates the breakdown of the percentages of answers in each category.

Q21 | To what extent is SME lending a priority for your business in Africa?

For Q21, the following answers are possible: a. high priority; b. moderate priority; c. low priority; d. not a priority.

Q22 | Do you perceive that (lack of) demand for bank loans by bankable SMEs plays a key factor (to explain lending)?

For Q22, the following answers are possible: a. absolutely; b. partially; c. not so much; d. not at all.

Q23 | What do you perceive as the main obstacles to SME lending in Africa?

Please choose the most important:
Please choose the second most important:
Please choose the third most important:
Specify other obstacles if applicable:

For Q23, the following answers are possible: a. lack of collateral; b. high default rate; c. lack of credit reference bureaus; d. lack of managerial capacity of SMEs; e. lack of branch network; f. costly monitoring; g. lack of information (financial or ID); h. high competition; i. regulatory/legal barriers; j. quality of asset portfolio; k. other.

Q24 | In which area of fintech are you currently investing the most in Africa?

Specify other area if applicable:

For Q24, the following answers are possible: a. cybersecurity; b. blockchain; c. data analytics; d. personal finance; e. financial services software; f. lending; g. payment and settlements; h. regulatory technology; i. virtual currencies; j. cross-border payments; k. mobile money/e-transfers; i. other.

Q25 | In general, what is your perception of telcos in the mobile money space (please choose the most important)?

Specify other perception if applicable:

For Q25, the following answers are possible: a. telcos are typically direct competitors to banks in the mobile money area; b. telcos can usually form effective partnerships with banks to provide mobile money services; c. telcos are often better positioned than banks to offer mobile money services; d. other.

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Banking in North Africa: recent trends and developments

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Summary

The economic performance of North Africa is improving. The economies of the region expanded by 4% on average in 2019, according to the latest available IMF projections. GDP growth is expected to accelerate to 4.4% in both 2020 and 2021. Standard indicators suggest an improvement in the business environment. Yet further efforts are needed to ensure that the benefits of growth are broadly shared.

Financial inclusion in North Africa is more advanced than in many other regions on the continent. However, further efforts are needed to promote access to finance, especially among disadvantaged groups. To achieve this objective, the central banks in North Africa have put in place financial inclusion strategies.

A well-functioning financial sector is key for private sector development. The financial sectors in the region are dominated by banking activities. Banks, in turn, are well developed, and some have a pan-African vision. Non-bank financial institutions, on the other hand, are still at an early stage of development. Banking supervision has improved across the region owing to the adoption of internationally accepted prudential standards. Efforts to comply with the Basel III regulatory framework continue.

The region's banks have started to offer non-financial services to SMEs, micro firms and start-ups. The provision of non-financial services can improve the management practices of firms, and thereby promote entrepreneurship and innovation. Non-financial services comprise training and mentoring activities, participation in incubator networks and innovative formats such as hackathons, i.e. events where participants collaborate intensely on software development.

Access to finance can be further improved by reforming the institutional framework governing secured lending and by developing non-bank finance. First, a reform of secured transaction frameworks would benefit both banks and firms. Such reforms would make it easier for firms to pledge movable assets as collateral. This would help SMEs in particular, as they are more likely to lack high quality collateral. At the same time, banks can have greater confidence that their security rights will be enforced. Second, strengthening non-bank financial institutions will result in a greater range of financing options for firms, adequate to their position in the life cycle.

International financial institutions (IFIs) can contribute to further improving access to finance in the region by promoting greater diversification of financial intermediation in the region. This could be achieved by supporting private equity, microfinance and the development of financial markets. They can also offer technical assistance to SMEs to help them prepare a project likely to receive financing, overcoming information asymmetries that usually limit loans to SMEs.

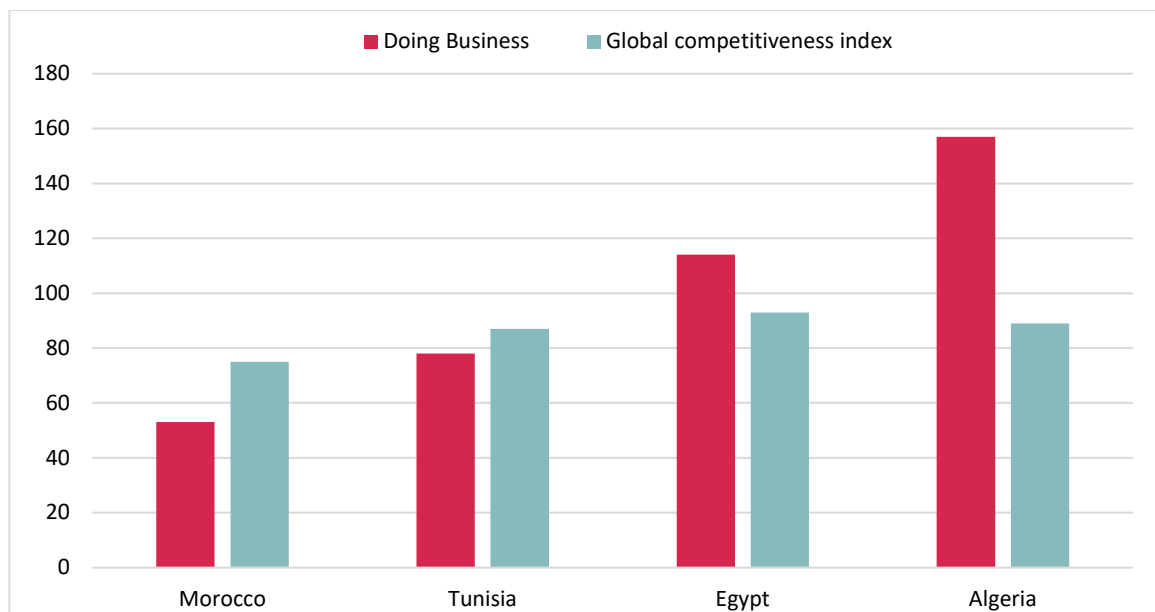
Macroeconomic overview

Structure of the economy

North African countries are undergoing a far-reaching economic transformation. This chapter discusses the financial sectors of Algeria, Egypt, Morocco and Tunisia, middle-income economies with a GDP per capita ranging from USD 3 047 in Egypt to USD 3 980 in Algeria (Table 1). The four countries have a total population of about 190 million people, which is expanding by 2% per year on average. The large number of labour market entrants necessitate political, social and economic reforms. For some time, restoring macroeconomic stability was a primary concern for the national authorities. More recently, however, reforms to promote private sector development have been implemented. These include reductions in energy subsidies but also improvements in the financial infrastructure. Yet further efforts are needed to achieve truly inclusive growth.

North African countries generally received better scores in the 2020 Doing Business report, but the rate of improvement in the business climate varies across the region (Figure 1). Morocco ranks highest (53rd, up from 60th) in North Africa. The report notes improvement in dealing with construction permits, getting electricity, protecting minority investors, paying taxes, trading across borders and enforcing contracts. Tunisia ranks 78th (up from 80th), benefiting from three business environment reforms. Egypt likewise improves its ranking (114th, up from 120th) on the back of four relevant reforms. Algeria comes in at 157th, as in the previous year.

Figure 1: Business environment, country rankings, from best to worst



Source: WBG, *Doing Business Report, 2020*; WEF, *Global Competitiveness indicator, 2019*.

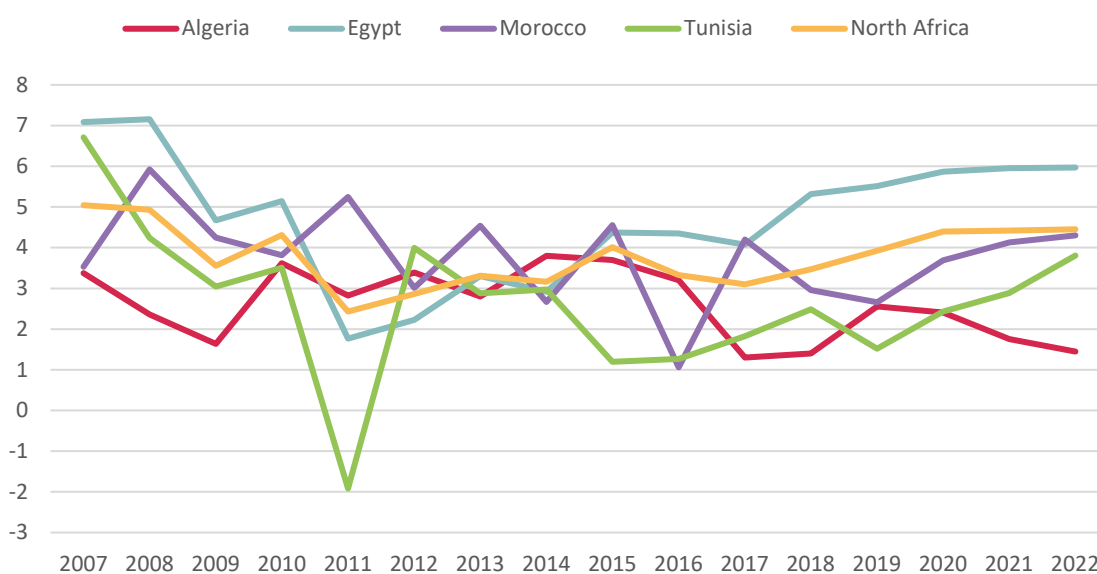
Note: The WBG *Doing Business Report* ranking includes 190 countries. The WEF *Global Competitiveness indicator* ranking includes 140 countries. A higher rank indicates a comparatively difficult business environment.

This business climate improvement is beneficial in a region that needs stronger investment and competitiveness, as highlighted by the World Economic Forum's Global Competitiveness Index (Figure 1). On average, North African countries rank 86th (out of 140 countries) in the WEF Competitiveness Index compared to 87th last year. Algeria rose three places compared to last year to reach 89th, while Egypt rose by one place to 93rd. Morocco and Tunisia were stagnant at 75th and 87th, respectively.

Recent macroeconomic developments and outlook

The economic performance of North Africa is improving (Figure 2). The economies of the region expanded by 4% on average in 2019, according to the latest available IMF estimates. GDP growth is expected to accelerate to 4.4% in both 2020 and 2021. Economic growth is particularly strong in Egypt, at roughly 5.5%. Economic performance is supported by an improving security situation and the implementation of structural reforms in Morocco, Tunisia and Egypt, according to the latest IMF Article IV reports. Over the medium term, economic activity stands to benefit from the implementation of the African Continental Free Trade Area (AfCFTA) (see box 1).

Figure 2: Real GDP growth, in %



Source: World Economic Outlook - IMF, October 2019.

Fiscal performance in the region is mixed. The fiscal deficit in Algeria increased from -4.8% in 2018 to -8.1% in 2019, whereas that of Egypt decreased from -9.4% to -7.6%. Government borrowing in Morocco (3.7% in 2019) and Tunisia (-4.4% in 2019) remained largely constant. As a result, government debt has increased in Algeria, has fallen - albeit from a high level - in Egypt, and is relatively stable in Tunisia and Morocco. Lastly, fiscal consolidation efforts are expected to continue, which bodes well for fiscal balances in the region.

Generating sufficient employment opportunities for the young populations of the four North African countries remains a challenge. This applies in particular to Tunisia, where the unemployment rate exceeds 15%. At the same time, Egypt and Morocco have made considerable progress in fighting unemployment. In Morocco, the unemployment rate is expected to fall from 9.8% in 2018 to 9.2% in 2019, while Egypt is set to achieve an even sharper drop from 10.9% to 8.6%.

Table 1: General economic overview, 2019

	Algeria	Egypt	Morocco	Tunisia	North Africa
Population (millions)	43.4	99.2	35.6	11.8	190.0*
Unemployment rate (%)	12.5	8.6	9.2	15.4	11.4
GDP growth (%)	2.6	5.5	2.7	1.5	3.1
GDP per capita (USD)	3 980.1	3 046.6	3 345.0	3 287.1	3 414.7
Investment (% GDP)	31.4	17.1	30.6	19.0	24.5
Fiscal deficit (% GDP)	-8.1	-7.6	-3.7	-4.4	-6.0
Government debt (% GDP)	46.1	84.9	65.3	74.4	67.7
External debt (% GDP)	2.2	34.1	32.5	92.8	40.4
Inflation, CPI (%)	2.0	13.9	0.6	6.6	5.8
Current account balance (% GDP)	-12.6	-3.1	-4.5	-10.4	-7.6

Source: World Economic Outlook - IMF, October 2019.

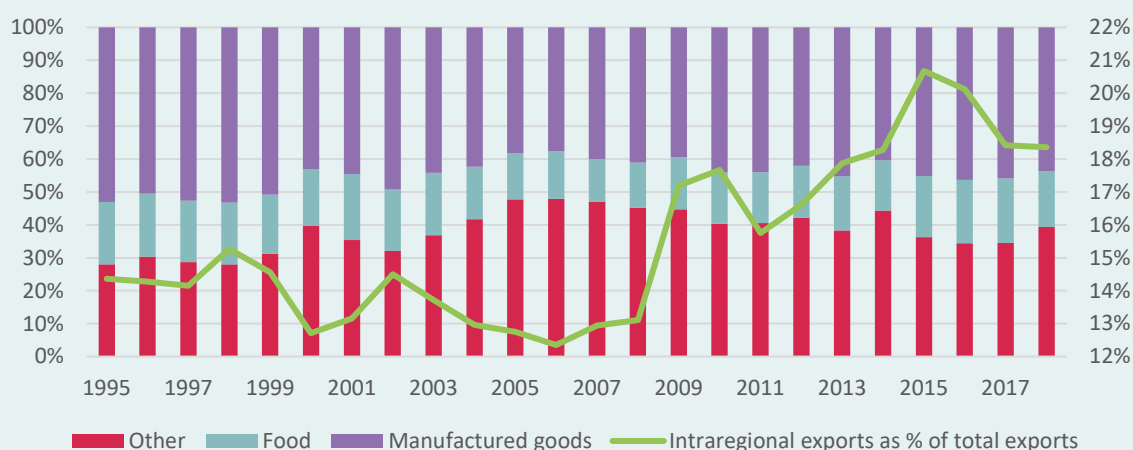
Note: The last column presents the regional average, * refers to total population instead of the average.

Libya, which is not included in the regional averages presented in this chapter, is characterised by instability and substantial macroeconomic fluctuations (World Bank Group, 2019). A stabilisation of economic activity is unlikely given its persistent internal divisions and inoperative institutions. Its GDP is projected to grow by 4% in 2019. Sustaining growth requires bold efforts to resolve the political strife and a comprehensive programme to rebuild the economic and social infrastructure. High inflation coupled with weak basic service delivery are likely to have raised inequalities. Inflation hit a record level of 28% in 2017, reflecting acute shortages in the supply chains of basic commodities, speculation in the expanding black markets and the strong devaluation of the Libyan dinar. Recurrent clashes around oil terminals and in large cities continue to weigh on the country's oil production (World Bank Group, 2019).

Box 1: The African Continental Free Trade Area (AfCFTA)

Fifty-four of the 55 African Union (AU) nations have signed the African Continental Free Trade Area (AfCFTA) agreement. The agreement was brokered by the AU in March 2018 and required all members to remove tariffs from 90% of goods, allowing free access to commodities, goods, and services across the continent. Only Eritrea has not signed the initial agreement that created the AfCFTA, due to tensions with Ethiopia. Nigeria, which did not sign the initial AfCFTA agreement due to concerns over the impact of the agreement on Nigerian entrepreneurship and industry, finally signed it in July 2019. However, the continent's other economic powerhouses South Africa, Kenya, Morocco, Egypt, Ethiopia and Algeria, which together with Nigeria are renowned for their strict protectionist policies restricting imports and exports, did sign. The agreement was set to come into force once 22 of the signatory states had ratified it in their national parliaments. Gambia became the 22nd state to ratify it in April 2019 and it came into force in May 2019. The AfCFTA is the largest free trade area in the world in terms of the number of countries participating since the formation of the World Trade Organization. If all 55 AU members sign up, it will create a bloc with a combined GDP of USD 2.5 trillion (EUR 2 trillion) and cover a market of 1.2 billion people. The AfCFTA is a key part of the AU's long-term development plan Agenda 2063, which calls for the easing of trade and travel across the continent.

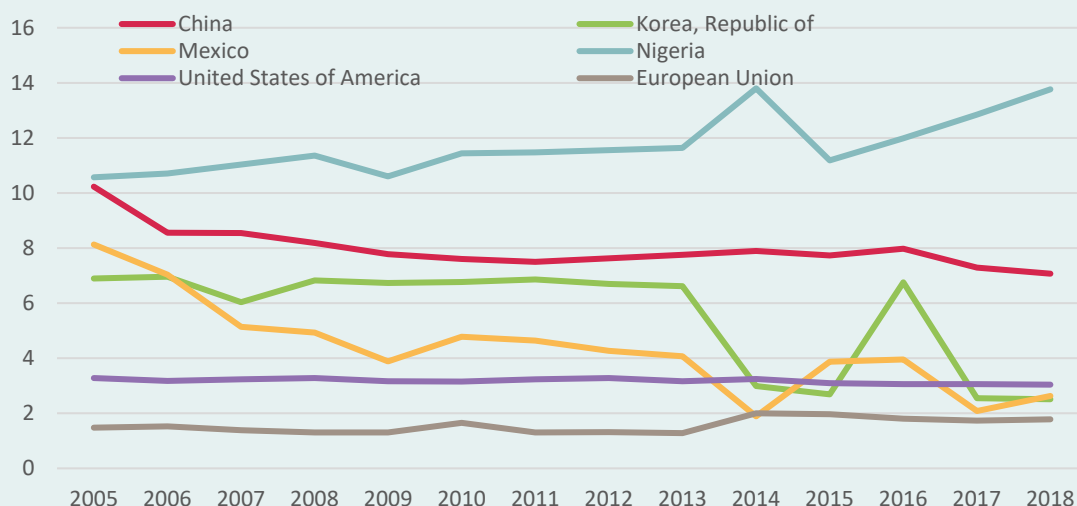
Figure 3: Africa intraregional trade (LHS, % of total intraregional exports by product; RHS, % of total exports)



Source: United Nations Conference on Trade and Development (UNCTAD).

The AfCFTA could improve intraregional trade in Africa, which remains weak due to protectionism. There is scope for application of the AfCFTA agreement as the share of intraregional exports relative to total exports is only 18% for Africa, compared to 70% for Asia (Figure 3). Intraregional exports in Africa are almost evenly split between manufactured goods and other goods (about 40% of interregional exports), followed by food (about 20%). According to the AU, removing customs duties by 2022 would increase the level of intra-African trade by 60%. However, many of the details of the agreement are still to be decided. Countries are supposed to eliminate tariffs on a list comprising 90% of products (although they have not yet agreed what will go on this list). In practice, however, that could allow them to leave duties unchanged on most of their current imports, which are concentrated on a narrow range of goods. As yet, African economies are charging import tariffs that are significantly higher than those charged by economies more integrated into global trade. For example, in 2018 Nigeria charged 13.8% of the value of imported goods in tariffs, compared to 7% charged by China, 3% by the US, 1.8% by the European Union and 2.6% by South Korea (Figure 4).

Figure 4: Import tariff rates on non-agricultural and non-fuel products (% of imported value)



Source: United Nations Conference on Trade and Development (UNCTAD).

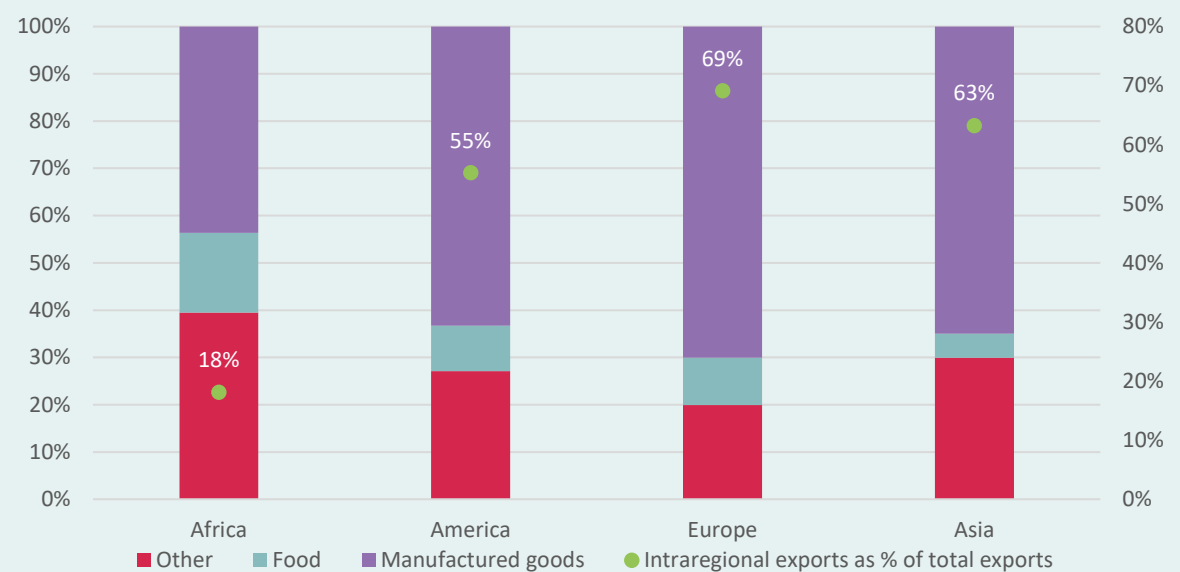
Poor road infrastructure could challenge the AfCFTA's success. A number of obstacles will have to be addressed for the AfCFTA to have a positive impact and advance intraregional trade in Africa. First, the quality of the transport infrastructure is important in order to improve connectivity among trading partners. However, the quality of infrastructure in general is poor among the AU members and is not conducive to international trade. The AU scores 56 out of 100, with higher values being better off, when graded by the quality of infrastructure in the World Economic Forum's Global Competitiveness Report 2019, while it scores 45 in terms of the quality of transportation infrastructure. By comparison, Europe and North America score 86 in the quality of overall infrastructure and 77 with regard to

transportation infrastructure, while East Asia, the hub of international trade, scores 79 and 70, respectively, indicating the distance that the AU needs to cover in order to improve its overall infrastructure. Improving the AU's infrastructure in general and transport infrastructure, in particular, could enhance AfCFTA's impact through improved connectivity.

The AfCFTA's future success depends on Africa's industrialisation. Secondly, the experience of other continents with greater intraregional trade reveals that the share of intraregional exports out of total exports is greater the higher the share of manufactured goods is in the mix of intraregional exports. For example, in Asia and Europe, which have the world's largest share of intraregional exports relative to total exports, the share of manufactured goods compared to total exports is also the highest (Figure 5). If the continents with the highest share of manufactured goods vis-à-vis total exports set the benchmark that Africa needs to meet, Africa has a long way to go: manufactured goods account for 65%-70% of total exports in Europe and Asia versus 44% in Africa. In order for the proportion of manufactured goods out of total exports in Africa to increase, the industrial policy on the African continent needs to be amended in order to accelerate the industrialisation of Africa's economies.

The AfCFTA will have to overcome different product standards and licenses among African countries. Third, standards and licenses differ across Africa. It is common for large retailers with stores throughout the African continent to take goods sold in one African country and repack them to comply with labelling rules in other African countries. In the same context, red tape also slows things down. The Trade Law Centre, a South African think-tank, looked at the time taken for customs and port handling in Africa compared to Singapore. It then calculated how the impact of this difference on intraregional trade compared to the impact of reducing tariffs. According to the Trade Law Centre, if the gap between the time taken for customs and port handling in Africa compared to Singapore were narrowed by a fifth, the resulting increase in intraregional trade would deliver economic gains roughly double those expected by eliminating tariffs.

Figure 5: Intraregional trade, 2018 (LHS, % of total intraregional exports by product; RHS, % of total exports)



Source: United Nations Conference on Trade and Development (UNCTAD).

Political commitment is needed in order for the AfCFTA to succeed. As yet, it is debatable to what extent such political commitment exists in the signatory parties. For example, in July 2019 Benin and Nigeria signed the AfCFTA agreement but a month later Nigeria decided to close its terrestrial borders, restricting trade. The border closure aimed at stemming flows of smuggled goods such as rice and tomatoes, effectively severing trade with neighbouring Benin, Niger and Cameroon. Benin is the most exposed economy to Nigeria relative to its West African Economic and Monetary Union (WAEMU) peers as it ships 9.3% of its exports to Nigeria. Niger is the second most exposed WAEMU economy to Nigeria as it exports 6.2% of its goods to Nigeria, and Togo is the third most exposed with 5.3% of its goods being exported to Nigeria. A continuation of the border closure would pose a significant downside risk to WAEMU's economic outlook.

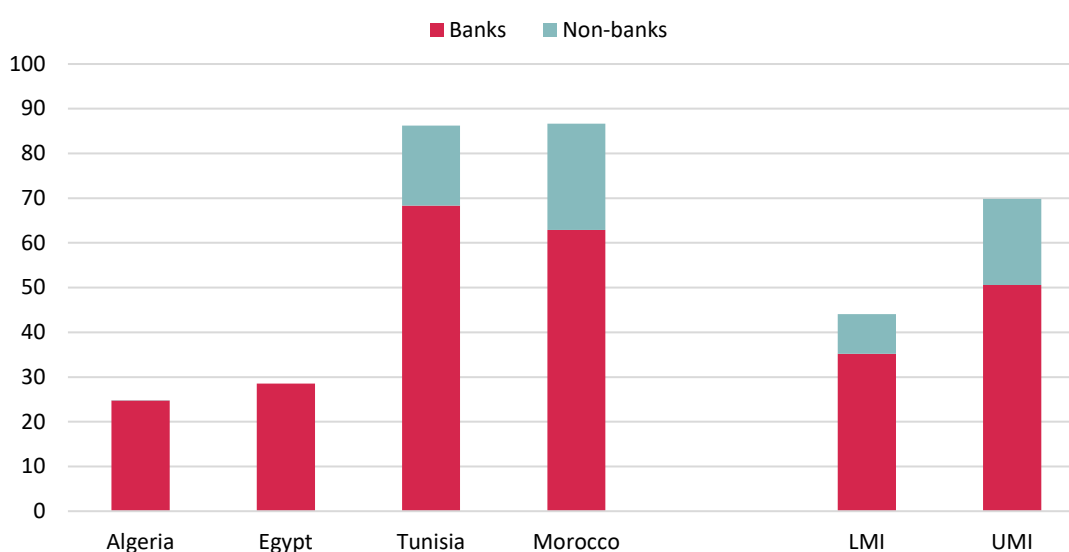
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Financial sector overview

A well-functioning financial sector can support private sector development. A well-functioning financial sector facilitates the exchange of goods and services, the diversification of risk, the mobilisation of savings, and the identification of good business opportunities (EBRD, EIB and World Bank, 2016). These functions are conducive to investment and entrepreneurship. They enable rapid accumulation of physical and human capital, boost technological advances, and thus promote faster growth and higher levels of employment⁴. Better access to finance can also push firms from the informal to the formal sector and promote the economic inclusion of disadvantaged groups.

The financial systems in the region are comparatively large and dominated by banks. Large banking sectors enable a relatively high proportion of firms to have a bank loan, notably in Morocco and Tunisia (Figure 6). In these two countries, credit to the private sector is above 80% of GDP and easily exceeds the average of upper-middle-income countries. Algeria and Egypt, on the other hand, have small financial systems even in comparison to other lower-middle-income countries. Non-bank financial institutions and capital markets are more developed than in most other parts of Africa, notably in Tunisia and Morocco. Non-bank financial institutions are particularly important for young SMEs, as they offer well-tailored financial products to SMEs that are often characterised by a short credit history, which makes it difficult for them to access bank finance.

Figure 6: Credit to the private sector, % of GDP, 2017 or latest available



Source: World Bank Group, Global Financial Development Database, World Development Indicators.

Note: LMI refers to the average of lower-middle-income countries, UMI indicates the average of upper-middle-income countries. For Egypt data on non-bank credit is not available.

Banking sector

North Africa's banking sector is one of the most developed on the continent and has significant financial intermediation potential. The region's banking sector comprises 116 banks and more than 13 000 branches, offering a broad range of financial products and services, with international groups featuring prominently (Table 2). On average, banks provide credit to the private sector equivalent to 46% of GDP (see

⁴ An extensive empirical literature provides country-level, industry-level and firm-level evidence to show that financial development is conducive to economic growth. See Levine (1997), Levine (1998) and Levine et al (2000).

Figure 6). In Tunisia and Morocco, the banking sectors are particularly large. Public banks continue to play a key role in Algeria and Tunisia.

Table 2: Banking sector structure, 2018 or latest year available

	Algeria	Egypt	Tunisia	Morocco	North Africa
Number of banks	29	40	23	24	116
Number of branches	1 489	4 000	1 913	6 503	13 905
Bank non-performing loans to total loans (%)	12.3	4.9	13.9	6.8	9.5
Bank provisions to non-performing loans (%)	51.4	98.7	63.3	69.1	70.6
Bank regulatory capital to risk-weighted assets (%)	15.2	15.2	11.9	14.0	14.1
Bank return on assets (%)	2.0	2.0	1.2	0.9	1.5
Bank return on equity (%)	17.8	30.9	13.9	9.5	18.1
Liquid to total assets (%)	23.7		6.1	12.0	13.9

Sources: Bank Al-Maghrib, IMF Financial Access Survey, IMF International Financial Statistics, IMF (2018a), IMF (2018b), IMF (2018c), IMF (2019a), WBG Global Financial Development Database.

Overall, the banking sectors in the region appear sound. As Table 2 shows, the ratio of non-performing loans in the North African economies is somewhat higher than on the continent as a whole. However, this is partly offset by higher provisioning levels. Moreover, banks in North Africa are better capitalised and exhibit on average higher profitability metrics when compared to the continental average.

Regulation of the financial sector is converging, albeit slowly, towards international standards. Banking supervision has improved across the region, owing to the strengthening of risk-based bank rating systems and the adoption of internationally accepted prudential standards. The authorities remain committed to preserving financial stability by further strengthening regulation and supervision as well as the macro-prudential framework. The central banks in North Africa have gained the necessary independence and built up the required expertise to supervise the banking sector. In terms of prudential norms, Basel III is being implemented in Egypt and Morocco, and other countries are taking steps to comply with it. North African countries are also continuing to step up their anti-money laundering/combating financing of terrorism (AML/CFT) measures.

Likewise, the region's central banks have beefed up the regulatory framework on capital. Egypt's new banking law, for example, requires a minimum capital of EGP 5 billion (EUR 280 million) compared to EGP 500 million (EUR 28 million) previously, while allowing for a three-year transition period. In Algeria, public banks' capital has been gradually increased since 2009, such that it comfortably exceeds the regulatory threshold.

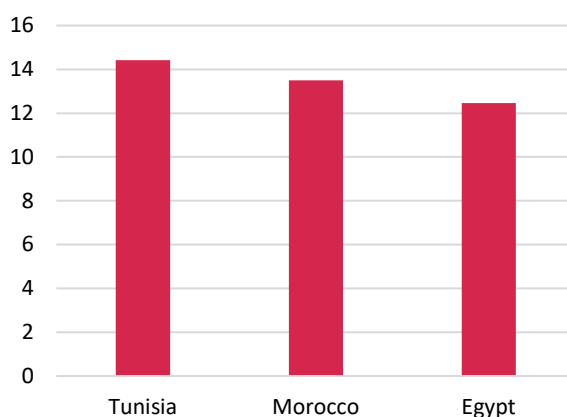
Non-bank financial sector

Non-bank financial institutions are more developed than in most other parts of Africa, but nonetheless account for only a small share of the financial sector's total assets. This provides an opportunity to develop and improve access to finance for the private sector and more specifically for SMEs.

Microfinance in the region is operating below potential (EIB et al., 2016; World Bank, 2016). Lending by microfinance providers in 2011 reached only 1.8% of the adult population. Even in Morocco, the country that has made most progress in developing the industry, microcredit loans still account for less than 1% of total bank credit. Algeria does not have a conventional microcredit sector comparable to its regional peers. However, the country has public programmes targeting microenterprises (ANGEM), young self-employed workers (ANSEJ) and unemployed adults (CNAC).

The availability of private equity and leasing solutions should be reinforced. Overall, the Emerging Markets Private Equity Association (EMPEA) recorded private equity investments of USD 261 million via seven deals in North Africa in 2018. Venture capital is on a par with lower- and upper-middle-income countries. Nonetheless, the availability of venture capital remains limited overall. In the region, leasing is most prevalent in Tunisia (Figure 7). Most leasing firms are banks or bank-related institutions, reflecting their easy access to deposit funding. Leasing is an effective instrument to finance machinery and equipment for firms.

Figure 7: Use of leasing in 2012, % of firms

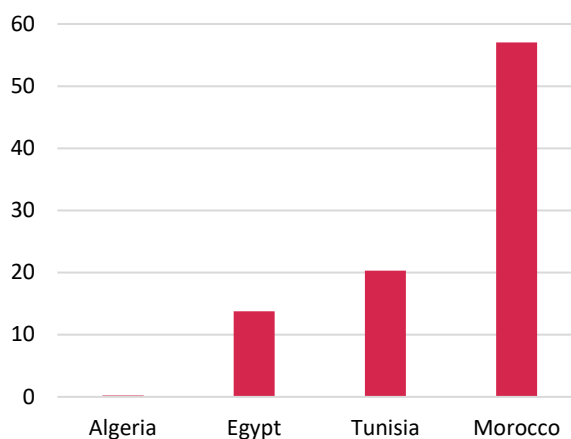


Source: EBRD/EIB/World Bank MENA Enterprise Survey 2013.

Capital markets can play a significant role in serving the specific financing needs of SMEs (IMF, 2019b). They can provide finance for fast-growing firms, and they can also improve access to finance indirectly, by helping to channel funding to intermediaries specialised in SME lending. Such intermediaries include banks, which raise funds on the capital markets and may intervene at various stages of the SME life cycle.

Capital markets in the region have experienced significant growth. Tunisia’s capital market is growing, with an increasing number of equity listings in recent years. The continuing development of the Casablanca Stock Exchange makes Morocco a regional financial centre and Africa’s third most important capital market, after Johannesburg and Lagos. Fixed-income markets in the region are dominated by government securities, although corporate bond trading is growing rapidly. However, market capitalisation is particularly low in Algeria, where only four listed companies exist (Figure 8).

Figure 8: Market capitalisation of domestic listed companies, 2017, % of GDP



Source: World Development Indicators, World Bank; For Algeria: CEIC Data.

Box 2: Non-financial services provided by banks in North Africa

To maintain their strong competitive position, North African banks have started to offer services that go above and beyond their traditional financing activities. Providing non-financial services enables banks to better meet the needs of SMEs, micro firms and start-ups, and make a positive contribution to promoting and supporting entrepreneurship and innovation.

Non-financial services respond to a need for SMEs, micro firms and start-ups to receive specific support in addressing their management issues as effectively as possible. Firms in the region frequently suffer from multiple - often structural - weaknesses, which can include a lack of expertise regarding the operating cycle, production tools and marketing techniques. Similarly, a large number of SMEs and micro firms are informal, making it difficult for them to access financing, and are only modestly integrated into the international markets. By providing non-financial services, banks can share their knowledge of the economic structure, regulations and even commercial practices in the firms' target markets. The information shared is far from just theoretical and covers practical and specific data such as expected profitability broken down by segment or difficulties that could affect operations on the ground.

But non-financial services also constitute a major opportunity for the region's banks. Any bank providing these services will stand out from the competition, and will also develop a pro-entrepreneurship image, increase its market share among SMEs and start-ups, encourage loyalty from its customers and gain access to information, thereby reducing credit risk.

Non-financial services are an increasingly widespread feature of SME banking in North Africa. Firms used to receive very little support from banks once a loan had been granted. However, following considerable development of specialised SME departments, the region's banks have launched several specific monitoring and support services. Though non-financial topics are becoming an increasingly important part of the relationship between banks and firms, the potential beneficiaries of these support services are often unaware of their existence. For example, a 2018 Global Entrepreneurship Monitor study in Morocco revealed that just 12% of entrepreneurs used the support structures, and that 62% of the people surveyed had not heard of this possibility.

Non-financial services can be delivered in different formats, including training/mentoring services, hackathons and incubators. Training and mentoring services aim to facilitate the learning and skills development of entrepreneurs, as well as improving company performance. Support programmes for entrepreneurs are springing up across the region, providing assistance for starting and growing businesses via training/mentoring packages that offer advice and guidance to young entrepreneurs. The following outlines several promising initiatives in this domain.

- ChangeLabs recently partnered with Blom Bank Egypt to organise a six-week programme to provide training, mentoring and support to innovative Egyptian start-ups, with the aim of transforming their ideas into sustainable commercial investments. From the more than 300 candidates selected, 10 start-ups from various sectors including education, transport, AgriTech, real estate and health graduated from the course.
- In Tunisia, Banque Internationale Arabe de Tunisie (BIAT) is a partner in the Riyeda programme, in which representatives from assistance and financing bodies, support structures, business leaders and experts meet to share their experiences, debate and propose concrete solutions to the challenges facing young Tunisian entrepreneurs.
- As regards Morocco, BMCE Bank launched in 2012 the SME Club in order to, among other things, strengthen the advice and support service to SMEs, optimise their knowledge of banking and financial practices, and establish a platform for exchange and experience sharing. Since its launch, the Club has awarded certification, in partnership with public universities, to more than 400 executive managers. Similarly, the Entrepreneurship Club involved, in its first year, 118 participants, of whom 47% were women. In terms of track record, 66% of the beneficiaries registered an increase in turnover of about 40% while 645 - seasonal and permanent - jobs have been created in Agadir, Marrakech, Chefchaouen and Casablanca⁵.

For an SME, taking part in a hackathon is a way to escape traditional innovation patterns. A place for self-expression and technological creativity, hackathons enable firms to free themselves from a project's assessment and analysis period by encouraging spontaneous cooperation and open innovation. Teams are formed and come together around an idea, working to develop an original solution. Interesting examples of hackathons include those organised by Hack & Pitch and the Smart Up hackathon.

- In Morocco, CIH Bank sponsors the Hack & Pitch association, which has been able to use university tours and hackathons to raise awareness of entrepreneurship, innovation and the importance of using IT development

⁵ Based on a sample of 35 participants.

tools with 20 000 students. Over 2 500 of these students had the chance to take part in hackathons producing 750 technological solution prototypes, 26 of which could be marketable.

- In 2017, Attijari Wafa Bank held the first Smart Up hackathon in Casablanca and four cities outside Morocco (Abidjan, Dakar, Paris and Tunis). Three hundred candidates took part in the first edition of this hackathon and worked effectively to develop innovative solutions under the topic 'To stimulate innovation, support entrepreneurship and promote start-up development.' The hackathon was live-streamed between the five countries to enable all participants to access the different technology workshops and compete with the international teams.

Incubators offer vital support to start-ups, SMEs and entrepreneurs. They reduce risks and help entrepreneurs to turn their inventions into technologies and strengthen the entrepreneurial ecosystem across the region, promoting an entrepreneurial spirit and SME growth. BMCE and Banque Misr are among the banks involved in incubators.

- In Morocco, BMCE Bank has developed its Blue Space programme supporting young project promoters from the design stage to the creation of their start-ups, in partnership with Moroccan schools and universities (ISCAE, Euromed and the Faculty of Law, Economics and Social Sciences of Ain Chock). Via these incubators, BMCE Bank trains, informs, coaches, provides assistance for seeking financing and gives those with new ideas access to an entire ecosystem.
- In July 2019, Egyptian bank Banque Misr signed a cooperation agreement with Al-Azhar and Ain Shams universities and the Arab Academy for Science, Technology & Maritime Transport to provide work spaces to entrepreneurs. This agreement falls under the Nile Pioneer initiative, a five-year agreement signed by the Central Bank of Egypt (CBE) and Nile University to train and provide qualifications to young entrepreneurs.

Private enterprises and SMEs

Overview

Among registered firms, firms with fewer than 100 employees account for roughly 87% of the total (Table 3). Many of them are active in the manufacturing sector and their integration into international markets appears limited, with only 14% on average being exporters. Furthermore, SMEs are predominantly domestically-owned. Female ownership is limited, particularly in Egypt.

Table 3: SME characteristics

	Algeria	Egypt	Morocco	Tunisia	North Africa
Proportion of all firms (%)	78	93.2	88.2	88.8	87.1
Manufacturing (%)		55	33.9	39.7	42.9
Average age (years)		13.7	19.1	18.7	17.2
Exporter (%)		6.1	10.6	25.6	14.1
Foreign-owned (%)		6.1	11.5	9.2	8.9
Female owner (%)		10.1	22.5	24.9	19.2
Product or process innovation (%)		15.9	36.9	34.8	29.2

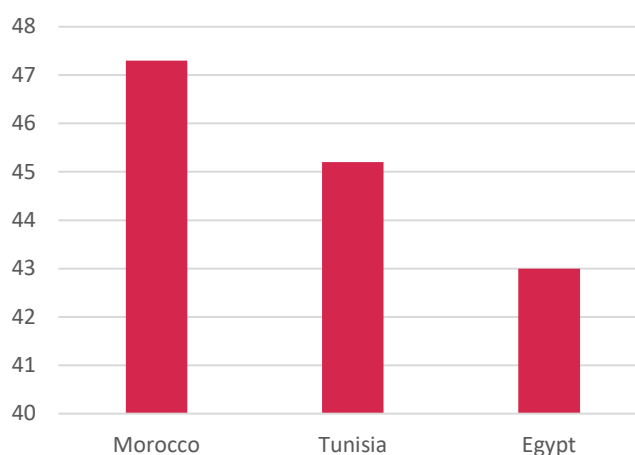
Source: MENA Enterprise Survey 2013; IFC Enterprise Finance Gap Data.

Note: SMEs refer to companies with fewer than 100 employees. Product or process innovation data give the percentage of firms that introduce a new product or process. North Africa is the simple average over the countries reported in the table. Numbers refer to 2010 for Algeria and to 2013 for the other three countries. Algeria is not included in the MENA Enterprise Survey. Data for Algeria are therefore from the IFC Enterprise Finance Gap Database.

Many small firms are informal which makes it difficult for them to access external funding sources. The above numbers exclude informal firms, even though informality seems to be an issue across the region. More than 40% of firms report that they have to compete against unregistered or informal firms in all

countries for which data are available (Figure 9). Informality is problematic for a number of reasons, including difficult working conditions or lack of legal employment contracts.

Figure 9: Competing against unregistered or informal firms, % of firms, 2013



Source: EBRD/EIB/World Bank MENA Enterprise Survey 2013.

Access to finance

Financial inclusion in North Africa has made substantial progress, but further efforts are needed to promote access to finance (Table 4). The share of accounts is frequently used to measure the outreach of the financial system. The share of adults with a bank account is highest in Algeria, followed by Tunisia, Morocco and then Egypt, but is still lower in North Africa than in the average lower-middle-income country. In Algeria, Egypt and Morocco, the share of individuals aged 15 years or above that has borrowed to start, operate or expand a farm or business is also lower than in the average lower-middle-income country. The same applies to borrowing for business reasons among females, poor individuals and in rural areas.

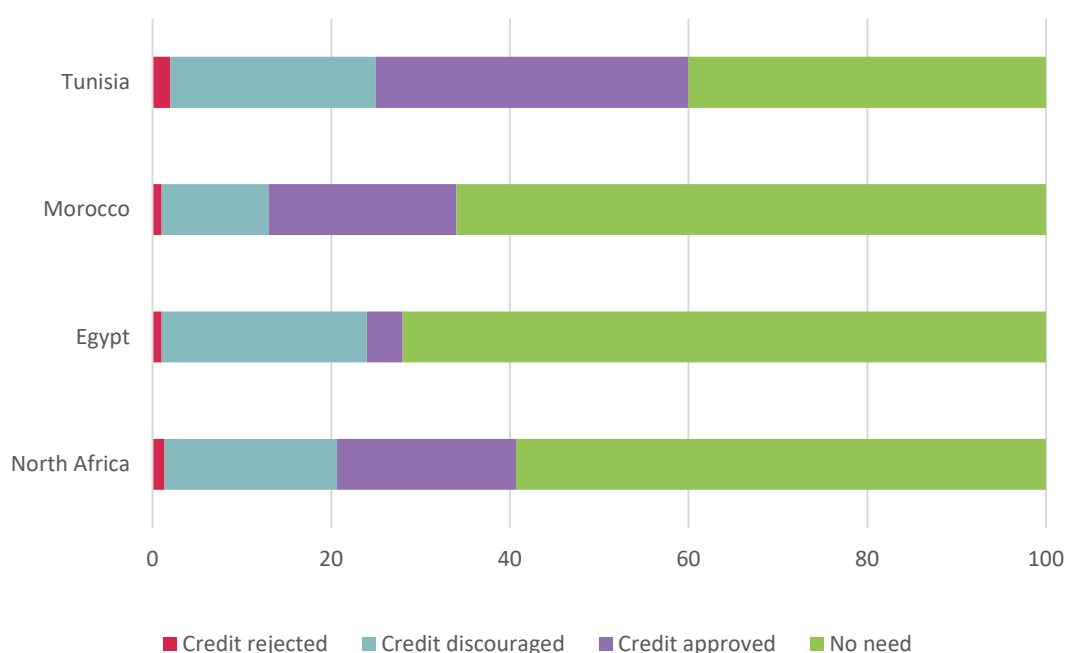
Table 4: Financial inclusion indicators, % of population or reference group aged 15+, 2017

	Algeria	Egypt	Morocco	Tunisia	North Africa	Lower-middle-income countries
Account, in labour force	58.6	38.3	43.6	48.9	47.4	63.4
Borrowed for business	4.7	3.9	2.8	8.0	4.8	5.0
Borrowed for business, female	2.1	3.0	1.8	5.5	3.1	4.0
Borrowed for business, poorest 40%	3.0	4.0	1.9	3.6	3.1	3.6
Borrowed for business, rural	4.7	4.3	1.6	6.3	4.2	5.3

Source: World Bank Group, Global Findex database, 2017.

In Morocco and Tunisia, banks are better able to meet credit demand than in Egypt. Survey data can be used to assess the extent to which existing credit supply is able to meet demand. Figure 10 divides the population of firms into credit-constrained and unconstrained firms. Unconstrained firms are those that either report a successful loan application or have no need for a loan. Credit-constrained firms are those that had their loan application rejected or were discouraged from applying in the first place. Only firms that need a loan can be credit-constrained. Figure 10 reveals considerable variation in financial intermediation capacity. Loan demand is highest in Tunisia, followed by Morocco and Egypt. Despite low demand, the vast majority of Egyptian firms needing a loan are unable to obtain one. Firms in Morocco and Tunisia, on the other hand, are much more likely to obtain a loan if they need one.

Figure 10: Firms' credit relationship with the financial sector, % of firms, 2013



Source: EBRD/EIB/World Bank MENA Enterprise Survey 2013.

The central banks in North Africa have put in place financial inclusion strategies and SME-focused policies to facilitate access to finance. The increasing importance of mobile banking is likely to help to improve financial inclusion (EIB, 2018b). Moreover, a number of governments in the region have taken initiatives to reinforce the links between banks, companies and individuals. For instance, in Morocco, the Caisse Centrale de Garantie (CCG) provides guarantees for MSMEs and individuals with little income, or co-finances 'non-bankable' projects. In Algeria, the Fonds de Garantie des Crédits aux PME (FGAR) and the Caisse de Garantie du Crédit d'Investissement pour les PME (CGCI-PME) provide guarantees to banks for SME loans. The Central Bank of Egypt (CBE) has launched an initiative incentivising banks to set aside 20% of their lending portfolio for SMEs.

Despite notable progress, further efforts are needed to improve access to finance in North Africa. First, institutional reforms, in particular of the secured transaction frameworks, can promote lending to SMEs. Second, non-bank financial institutions and capital markets need to further develop and expand the choice of financial products available to private companies. These challenges are discussed in more detail below.

Asymmetric information and capacity constraints of firms and banks hamper the access to finance of SMEs. Firms usually possess more accurate information about their prospects than financial intermediaries (see for instance Stiglitz and Weiss, 1981, or Holmstrom and Tirole, 1997). This makes it difficult for banks

to assess the credit risk that comes with extending a loan. This difficulty is particularly pronounced for SMEs that often lack the necessary relationships, collateral and financial track record (Bravo-Biosca, 2014).

Market failures can be aggravated by the capacity constraints of banks and SMEs (EIB, 2018a). Weaknesses in the corporate governance of SMEs, including financial literacy, accounting and auditing standards, can limit their ability to prepare a sound business case and access external funding. At the same time, banks often do not have lending technologies designed for SMEs in place, and as a result are reluctant to grow their SME portfolio. Therefore, in Morocco, the highest authorities are expecting the banking sector to reinforce its non- financial support to SMEs and implement new tools to assess SMEs’ risk. Indeed, the combination of information asymmetries and capacity constraints for both banks and SMEs is likely to result in a limited choice of financial instruments available, high collateral requirements, high interest rates and limited access to long-term funding.

Reforming secured transaction laws can improve access to finance for SMEs. Table 5 presents the getting credit dimension of the World Bank’s Doing Business index. This index measures the quality of the institutional framework governing SME lending. The strength of legal rights index measures the quality of the secured transaction framework that governs collateralised lending. The depth of credit information index measures the scope and accessibility of information distributed by credit bureaus and credit registries. Table 5 reveals considerable heterogeneity in institutional quality. Egypt, which has recently reformed its collateral laws, obtains the highest scores (ranked 67) and Algeria the lowest (ranked 181). Broadly speaking, the countries of the region have decent credit information infrastructure, whereas there is scope to improve the quality of secured transactions laws. In Algeria, the availability of credit information can also be improved.

Table 5: Doing Business - getting credit

	Getting credit rank (1-190 (worst))	Strength of legal rights index (0-12)	Depth of credit information index (0-8)	Credit registry coverage (% of adults)	Credit bureau coverage (% of adults)
Algeria	181	2	0	3.6	0
Egypt	67	5	8	9.5	31.3
Morocco	119	2	7	0	31.6
Tunisia	104	3	7	36.4	0
North Africa	117.8	3	5.5	12.4	15.7

Source: World Bank Doing Business 2020.

Further efforts are needed to promote the non-bank financial sector in North Africa. The small size of non-bank financial institutions and capital markets limits the variety of financial instruments available to enterprises. As a result, the available products may not be able to meet the needs of firms at all stages of their development. A number of initiatives have been launched with this in mind, including the June 2014 signature of a partnership between the Casablanca Stock Exchange and the London Stock Exchange Group (LSEG) which aims to develop the national and regional financial market, particularly via the launch of the Elite programme, which is tasked with creating a dynamic business ecosystem to foster innovation, entrepreneurship and growth. This programme aims to bridge the gap between capital market requirements and Moroccan business reality, especially for SMEs.

Governments in North Africa have recognised the need to address regulatory gaps that hamper the growth of the non-bank financial sectors in North Africa (IMF, 2019b). A number of government programmes target microenterprises (ANGEM), young self-employed individuals (ANSEJ) and unemployed adults (CNAC). However, highly subsidised programmes to promote non-bank financial institutions should be used cautiously to avoid crowding out competitors (IMF, 2014). In Tunisia, a rapid transformation of the microfinance market is ongoing, with a new Microfinance Law passed in 2011 and the creation of a new supervisory body (World Bank, 2016). Egypt has introduced new legislation to facilitate the involvement of investment funds in the microfinance industry. Moreover, regulatory frameworks for digital financial

services are being developed in most North African countries, which could improve access to finance for disadvantaged groups (IMF, 2019b).

Fintech provides opportunities to develop alternatives to traditional SME lending. New electronic platforms have emerged that have led to a scaling up of crowdfunding, peer-to-peer lending and other channels. Fintech solutions can also help to reduce compliance costs by embedding regulatory requirements into IT protocols and allowing for real-time compliance monitoring. However, fintech introduces new risks into credit activities and raises data privacy and cybersecurity concerns. In addition, the resilience of technologies used by fintech lenders has not yet been tested through an entire economic cycle. Further efforts are needed to develop the regulatory framework that would enable fintech to effectively address existing financing gaps, while containing the associated risks (IMF, 2019b).

Conclusions

Financial inclusion is improving in North Africa, but further efforts are needed. Banking sectors in the region are large, exhibiting significant financial intermediation potential. An ever-increasing proportion of adults in North Africa hold a bank account and this figure is expected to continue rising, although it currently remains below the lower-middle-income average.

This chapter suggests several avenues along which to improve access to finance. First, a reform of secured transaction frameworks would benefit both banks and SMEs. Such reforms would make it easier for firms to pledge movable assets as collateral. At the same time, banks can have greater confidence that their security rights will be enforced. Moreover, the provision of non-financial services can incentivise firms to seek external finance. Second, strengthening non-bank financial institutions will result in a greater range of financing options for SMEs that correspond to their specific needs.

IFIs can help to overcome constraints connected to limited access to finance in the region. This could be achieved via investment in equity and microfinance support funds - which still only have a modest level of development in the region - thereby helping to diversify the North African financial markets. IFIs can also provide technical assistance to SMEs via specifically targeted support initiatives, with the goal of helping them to prepare a project that is likely to get financed (examples of this include support initiatives offered by the region's banks). IFIs could therefore contribute to overcoming the market asymmetries that usually limit loans to SMEs.

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Banking in West Africa: recent trends and developments

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Summary

Amidst a challenging external environment, West Africa's real GDP growth is expected to slow to 3.1% in 2020 from 3.8% in the previous year, while averaging 3.9% over 2020-2024. The slowdown is largely explained by lacklustre growth in Nigeria, which accounts for two thirds of West Africa's GDP.

The main downside risks stem from significant uncertainty in the global economy. With growth slowing in most advanced economies and escalating trade protectionism, the global economy is entering a period of considerable uncertainty. Impacts on oil prices and trade could have a substantial impact on West Africa.

Micro, small and medium-sized enterprises (MSMEs) are at the core of the economies of West Africa. Yet, these firms in particular struggle to access finance, as banks consider lending to SMEs to be highly risky and allocate a significant portion of their investment to government assets.

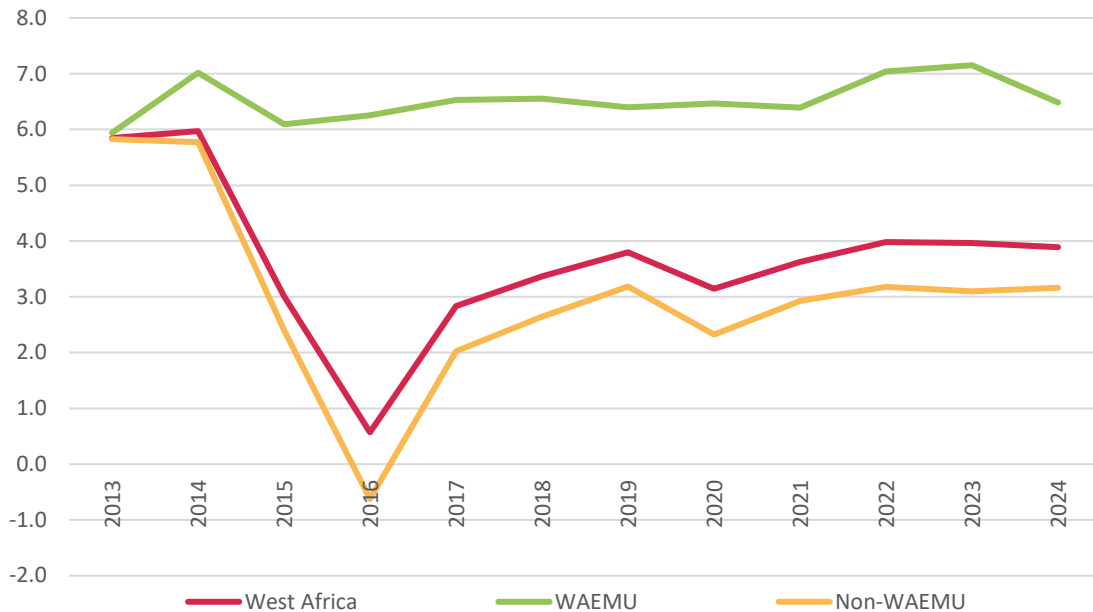
The soundness of the banking system in West Africa has room for improvement. The WAEMU banking sector remains sound aided by the entry into force of the Basel III capital requirements. Yet, a long-term domestic credit/savings mismatch impedes lending to SMEs in the zone. Elsewhere in West Africa, the proportion of non-performing loans on banks' balance sheets remains high, even though asset quality is improving. Improvements in regulation and the recent clean-up of the Ghanaian financial sector are expected to improve the situation in the medium term.

Macroeconomic overview

West Africa is a diverse region. It consists of the countries belonging to the West African Economic and Monetary Union (WAEMU, comprising Benin, Burkina Faso, Côte d'Ivoire, Guinea-Bissau, Mali, Niger, Senegal and Togo) and eight other countries (Cabo Verde, Gambia, Ghana, Guinea, Liberia, Mauritania, Nigeria and Sierra Leone). West Africa's population stood at 392 million people in 2019, of which more than half (201 million) live in Nigeria. Estimated GDP per capita averaged USD 5 497 (at purchasing power parity, PPP) in 2019, ranging from USD 1 106 in Niger to USD 6 055 in Nigeria. On the supply side, West African economies are mostly based on services, which account for 55% of GDP (2017 latest data). Industry contributes 23% of GDP and agriculture 22%. On the demand side, consumption accounts for 86% of GDP, investment 18% and net exports -4%.

Real GDP growth in West Africa is expected to rise to 3.8% in 2019, from 3.4% in the previous year (Figure 1). This was driven by the gradual recovery in the region's largest economy, Nigeria, and a continuation of robust growth in the second largest economy, Ghana. The WAEMU zone grew at above 6%, on average, annually. West Africa's real GDP growth is expected to moderate to 3.1% in 2020 and to average 3.9% over 2021-24, supported by a slight pickup in Nigeria's growth rate and a continuation of robust growth in the WAEMU zone countries, sustained by private investment and an increase in agricultural productivity.

Figure 1: Average real GDP growth (%)



Source: Authors' calculations and IMF.

Inflation is expected to fall in the medium term. Overall, inflation is expected to average 8.9% in 2019, increasing from 9.7% in the previous year, while it is expected to inch up to 9.3% in 2020 before averaging 8.7% over 2021-24. In the WAEMU zone, inflation fell to 0.6% in 2019 from 1% in the previous year as several economies recorded a deflation. Going forward, WAEMU inflation is expected to accelerate to 1.6% in 2020 and average 1.9% over 2021-24, below the 3% WAEMU norm. Inflation in the non-WAEMU countries is expected to average 10.9% in 2019 and 11.2% in 2020 before it drops to 10.6% over 2021-24, with the determinants varying by country. For example in Sierra Leone, increased exports are expected to increase the stocks of foreign exchange and reduce inflationary pressure to single digits by 2022. In Nigeria, a more stable exchange rate is expected to contribute to keeping inflation at around 11-12% up to 2024, although the recent border closures may cause inflation to overshoot this expectation in the short term. Since the main consumption item being smuggled was rice, the poor are likely to be particularly badly hit by price

rises. Despite the replenishment of foreign exchange reserves, monetary policy remains restrictive, with a view to stabilising the naira (NGN)/dollar (USD) exchange rate.

The fiscal balance is also expected to improve slightly in the medium term. West Africa's consolidated fiscal deficit is expected to average 4.7% in 2019 and 4.4% in 2020 (up from 4.5% in 2018). The fiscal deficit in the WAEMU zone is expected to have narrowed to the WAEMU's convergence criterion of 3% of GDP in 2019, while prudent fiscal management over the medium term is envisaged to maintain the fiscal deficit below 3% of GDP in 2021-24. The average fiscal deficit of the other West African countries is expected to reach 5.1% of GDP in 2019 before falling to 4.7% in 2020 and average 4.4% in 2021-24, mainly on account of low revenue mobilisation, which also makes debt service hard to sustain.

Public debt continues to rise to fund investment, although the risk of debt distress remains moderate in most of the economies, several of which are supported by an IMF programme. Public debt in West Africa is projected to increase from 36.6% of GDP in 2018 to 39.2% in 2019 and then to 40.2% in 2020 and 42.1% by 2024. This is well below the average for sub-Saharan Africa (SSA). However, this is because the regional average reflects the relatively low debt-to-GDP ratio of Nigeria (28.4%). Elsewhere in West Africa, the debt-to-GDP ratio varies from 39% (Guinea) to 128% (Cabo Verde). It exceeds 50% of GDP in 11 economies and averages 62% across the WAEMU. According to the IMF's most recent debt sustainability assessments, nine countries in West Africa are at moderate risk of debt distress (Benin, Burkina Faso, Guinea, Guinea-Bissau, Côte d'Ivoire, Liberia, Mali, Niger and Togo), whereas four are at high risk (Cabo Verde, Ghana, Mauritania and Sierra Leone). Gambia is already in debt distress. Senegal is assessed as being at low risk of debt distress. The IMF assesses Nigeria's debt levels as sustainable. However, Nigeria has an even weaker performance on revenue mobilisation than many other countries in the region, and debt servicing is projected to become unsustainable by 2022 if the trajectory does not change. Eleven of the 16 economies in West Africa are under an IMF programme, while Senegal and Guinea-Bissau have both agreed to or expressed their interest in a new programme.

Risks to West Africa's economic outlook are tilted to the downside with trade protectionism topping the list. Growth is slowing in most advanced economies and trade tensions between the US and other advanced economies and China are escalating. Overall, the global economy is entering a period of significant uncertainty. Trade protectionism is on the rise even in West Africa following the closure of Nigeria's terrestrial borders in August 2019, with the Government citing the need to stem illicit trade with neighbouring Benin, Niger and Cameroon. The closure took place only a few months after Nigeria had signed the African Continental Free Trade Agreement which is aimed at establishing the world's largest free-trading bloc: a single unified market of 1.2 billion people with a combined GDP of USD 2.5 trillion. Nigerian authorities have noted that there may be growth benefits of the border closures, in particular by encouraging domestic rice production. These benefits are, however, uncertain, and will evolve only in the longer term. In the short term, the closure is pushing up inflation in Nigeria and impacting the economies of its neighbours. The three WAEMU economies most exposed to Nigeria through bilateral trade are Benin, Niger and Togo, which ship 9.3%, 6.2% and 5.3%, respectively, of their exports to Nigeria. Ghana is also impacted, particularly its border regions, although Nigeria is not one of the country's top trading partners.

Global risk re-pricing in capital markets and political risk are also among the downside risks to West Africa's economic outlook. Other risks to the outlook relate to a generalised increase in risk premiums for frontier economies, which could spark a reversal in portfolio flows to the region. Such a reversal could constrain financing in many economies in the region, given the large amounts of international bonds maturing in 2020 and 2024-2025. In 2018, Nigeria issued USD 5.4 billion in bonds, and Côte d'Ivoire, Senegal and Ghana USD 2.1 billion each, accounting for the bulk of issuance in sub-Saharan Africa. Despite the oversubscription of international bond investors in the bond auctions, the asked yield increased significantly (an increase of 162.5 basis points for the 30-year bond issued by Nigeria in 2018 relative to the previous year), reflecting higher risk aversion. Finally, the political risk and the risk of fiscal slippages is high, particularly ahead of the elections in Burkina Faso, Ghana, Côte d'Ivoire and Togo in 2020. Other sources of risk include natural disasters, climate change, an Ebola outbreak and regional security.

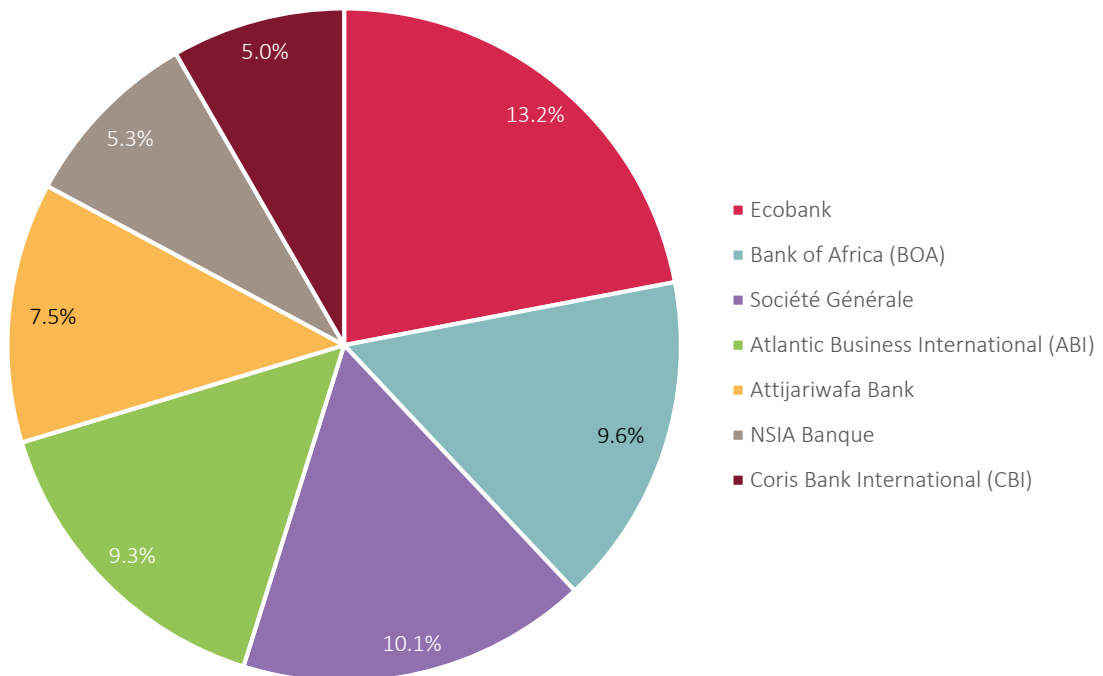
Banking sector

Banking sector in the WAEMU

The WAEMU's banking sector continued expanding in 2018. At end-2018, the Union's banking system had 142 authorised institutions (compared to 138 in 2017). The banking network expanded in 2018 in a favourable economic environment. At end-2018, there were 3 396 branches (+14.1% annually) and the number of automated teller machines (ATMs) had increased by 9.9% year-on-year to 2 976. The sector's total assets in the eight member countries rose by 6.8% year-on-year in 2018 to EUR 57.6 billion.

The WAEMU's banking sector included 29 banking groups with international or regional ownership at end-2018. Banking activity is dominated by these entities, which accounted for 86.8% of banking assets and 83.4% of customers' bank accounts. In terms of market share, the Ecobank and BMCE Bank of Africa groups held 13% and 9.6% of total assets, respectively (Figure 2).

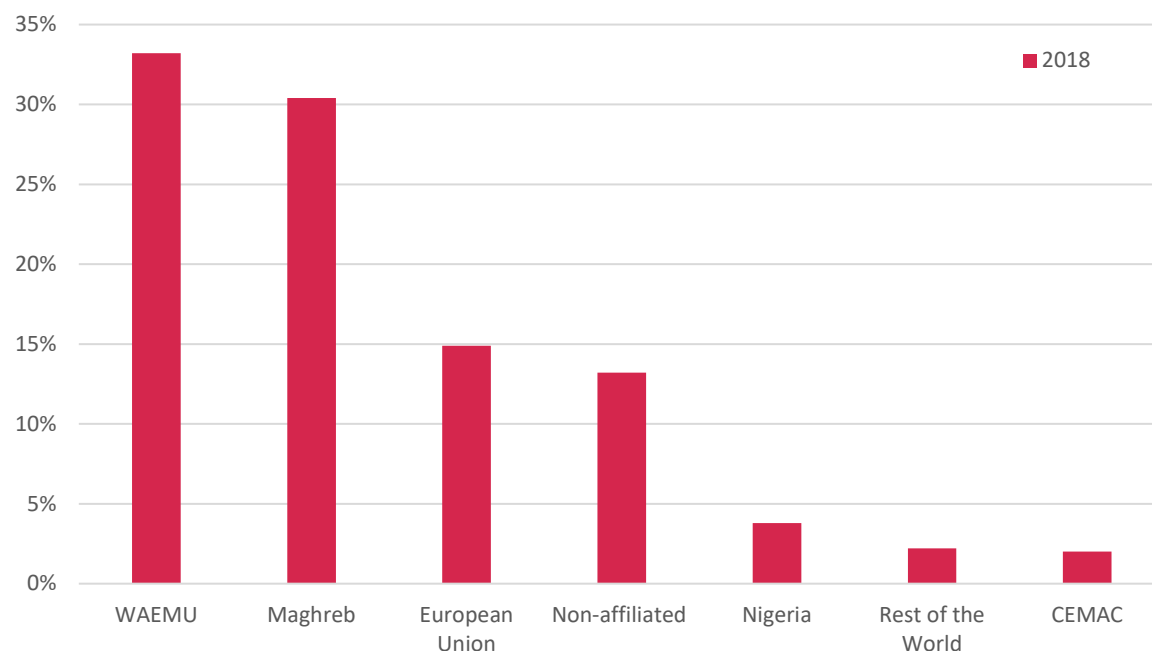
Figure 2: Market shares of the main banking groups in the WAEMU at end-2018



Source: WAEMU Banking Commission.

The West African and Maghreb banking groups dominated regional banking activity. West African banks contributed 33.2% of total regional assets and represented 26.4% of customers' accounts in 2018 (Figure 3). Maghreb banking groups included mostly Moroccan banks, and accounted for 30.4% of total assets, 29.4% of deposits and 31.5% of loans granted.

Figure 3: WAEMU: breakdown of banking operators by geographical area at end-2018



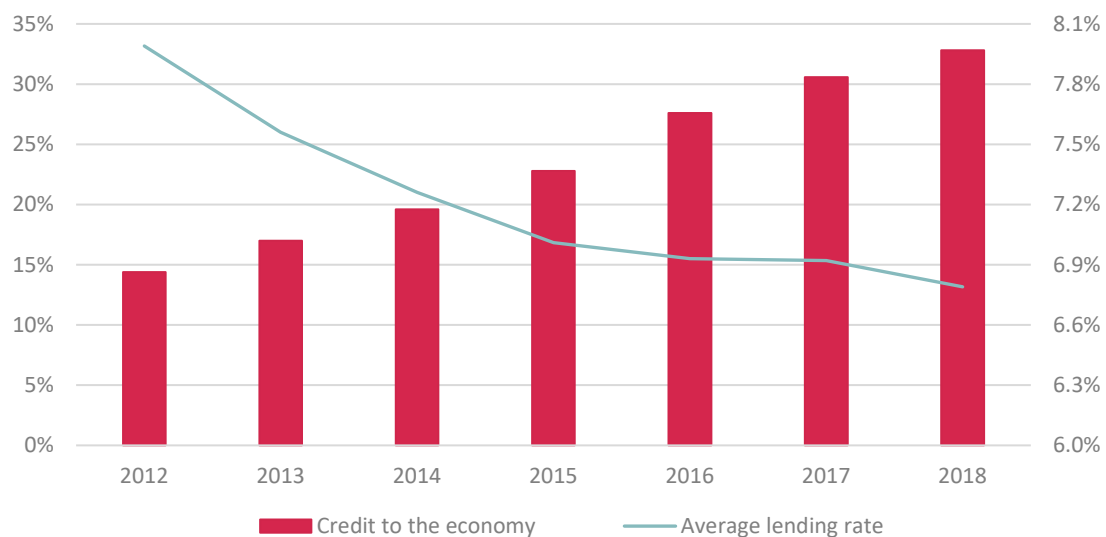
Source: WAEMU Banking Commission.

Ivorian banks dominate the WAEMU's banking sector. The annual growth rate of the WAEMU's total bank assets stood at 6.8% in 2018 after expanding from EUR 23 billion (41% of GDP) in 2012 to EUR 57.6 billion (53.1% of GDP) in 2018. Banks in Côte d'Ivoire and Senegal had the largest share of assets in the WAEMU. Specifically, Côte d'Ivoire with 29 institutions held 32.2% of total WAEMU banking assets, followed by Senegal (19.5% with 29 institutions), Burkina Faso (14% with 18 institutions), Mali (12.4% with 16 institutions), Benin (9.2% with 15 institutions), Togo (7.5% with 15 institutions) and Niger (4.5% with 16 institutions).

Banks' resources increased faster in 2018 than their uses, boosting credit to the economy. Banking assets reached EUR 45.5 billion at end-2018, up by 10.4% on a year-on-year basis. This uptick is chiefly attributed to the surge in customer deposits (demand deposits were 53.6% and term deposits 46.4% of total deposits), which rose by 10.4% year-on-year to EUR 38.2 billion at end-2018. The use of funds by the banking system continued an upward trend in 2018 (+7.3% year-on-year), reaching EUR 50 billion. This development can be explained by a 10.8% annual acceleration in bank loans (63.7% of use of funds) to EUR 31.9 billion. Deposits were the most important resource of WAEMU banks as they stood at 84% of total resources in 2018, unchanged relative to the previous year. As in 2017, banks in the WAEMU used 70% of their resources to grant credit to the economy in 2018, with credit at 83% of deposits in 2018. About 22% of WAEMU banks' resources were used to buy government bonds in 2018, down from 25% in the previous year, implying that more liquidity was available for credit to the rest of the economy. Under these conditions, the financing of the economy continued growing with bank loans accounting for 29% of GDP, compared to 22% six years earlier (Figure 4). This deepening of the financial sector involved most business sectors, in particular "trade, restaurants and hotels" (28% of total credit), manufacturing Industries (16% of total credit) and social services (16% of total credit).

Monetary conditions remain accommodative, fuelling credit expansion. In 2018, the Central Bank of West African States (BCEAO) maintained the official interest rate at 2.5% as inflationary pressures remained muted. Additionally, the marginal lending rate and the mandatory reserves coefficient remained unchanged at 4.5% and 3%, respectively. After remaining virtually constant in 2017, the average bank lending rate resumed the downward trend that began in 2010, falling from 6.92% in 2017 to 6.79% in 2018. This decrease concerned all the countries in the region except Burkina Faso (an increase of 22 basis points) and Togo (an increase of 6 basis points). Lending rates dropped the most for individuals (-48 basis points), private companies (-13 basis points) and state-owned companies (-11 basis points). Broken down by credit use, the fall in lending interest rates was the most pronounced for mortgages (-45 basis points) and exports (-26 basis points). In contrast, the deposit interest rate in the WAEMU increased to 5.41% in 2018 from 5.28% in the previous year, the increase being more pronounced in Guinea-Bissau (+35 basis points), Senegal (+33 basis points) and Togo (+27.8 basis points). Among the WAEMU members, the deposit interest rate declined only in Benin in 2018 relative to the previous year (-8.3 basis points), but it remains the highest deposit interest rate in the WAEMU at 5.76%.

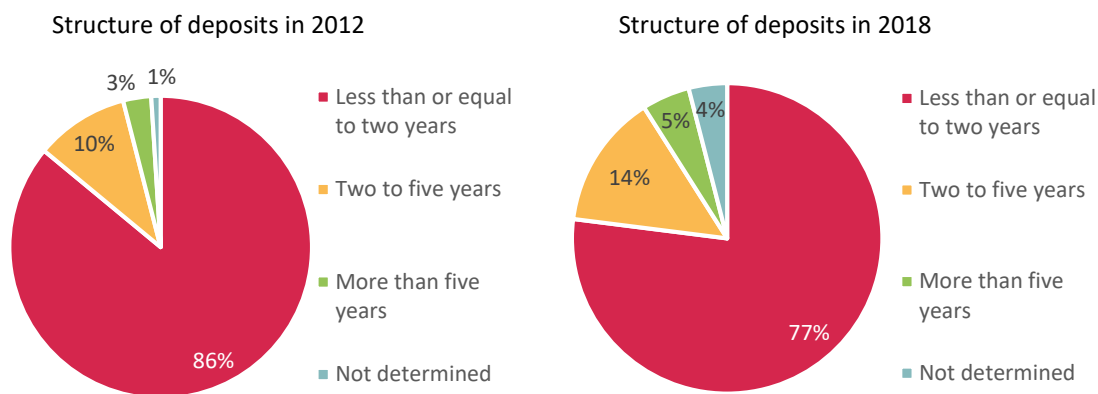
Figure 4: WAEMU - average lending rate trend (L - CFAF billion, R - %)



Source: WAEMU Banking Commission.

The WAEMU region has not escaped a long-term domestic savings deficit. This limits the lending process - particularly for SMEs - as it impedes the ability of banks to provide long-term loans (Figure 5). Term deposits at maturities less than or equal to two years remained dominant in 2018 and comprised 77% of total deposits at end-2018. Nevertheless, and since 2012, there has been a relative improvement in the share of deposits with a maturity of two to five years in relation to total deposits (+4 percentage points) and over five years (+2 percentage points).

Figure 5: WAEMU - change in structure of deposits by maturity (% of total)

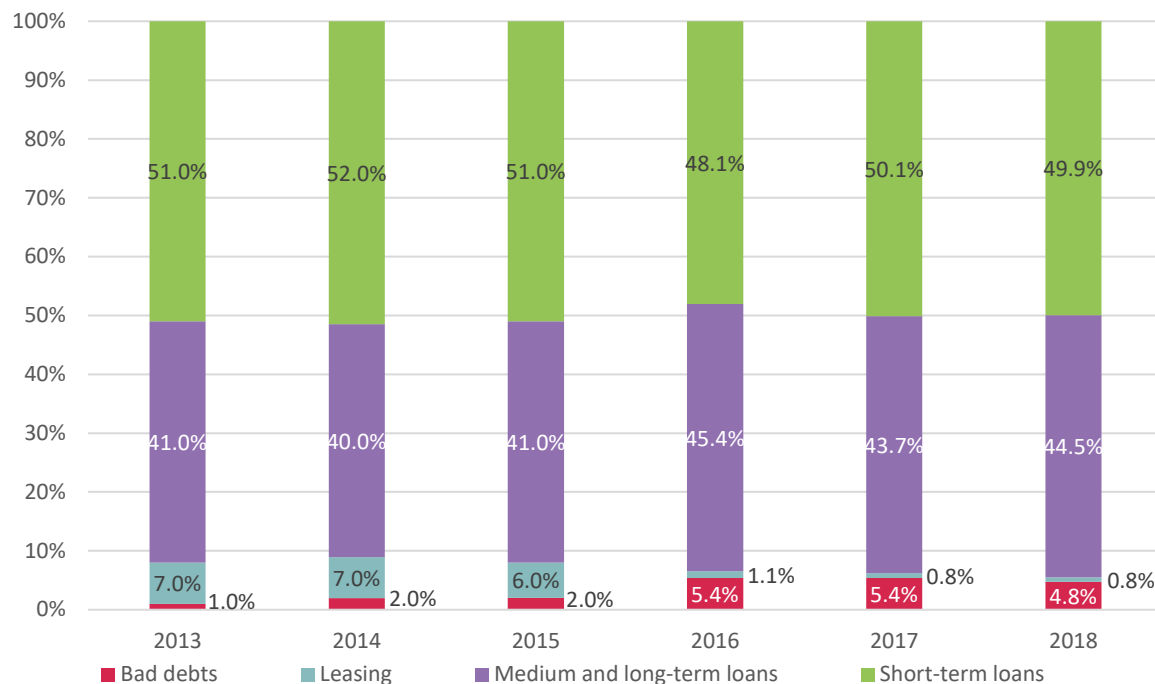


Source: WAEMU Banking Commission.

The improvement in medium and long-term deposits was reflected in the financing with similar maturities. At end-2018, medium and long-term loans made up 45% of total loans, an increase of 84 basis points on a year-on-year basis and 352 basis points compared to 2013 (Figure 6). This increase was partly at the expense of short-term financing, which fell to 49.9% of total loans in 2018, a decrease of 16 basis points year-on-year and 105 basis points since 2013.

SME financing is a priority for authorities. The authorities want to improve the financing of SMEs, which only receive a marginal share of the loans granted to companies. The main obstacles encountered by banking institutions in financing this segment include poor credit information quality, shortcomings in governance and a very high default rate. In this context, BCEAO has set up a facility to promote SMEs, improve their supervision and to refinance their banking debts. However, these initiatives will remain inadequate as long as a proportion of micro-enterprises and SMEs continue to operate in the informal sector.

Figure 6: WAEMU - change in structure of loans granted by banks at end-2017



Source: WAEMU Banking Commission.

The profitability of WAEMU banks remains resilient. The results of the WAEMU banking sector are consistent with the region's economic resilience, with return on equity (ROE) remaining high at 13.9% at end-2018, up from 12.5% in the previous year. The region's net banking income (NBI) was EUR 3 billion, up by 6% on a year-on-year basis. Against this background, the overall net result grew by 24% year-on-year, reaching EUR 697 million at end-2018. This performance is attributed to a 181.6% increase in foreign exchange-related operations. Yet, the downward trend in the operating ratio was interrupted in 2018, despite the continued strategy of banks to optimise costs and charges.

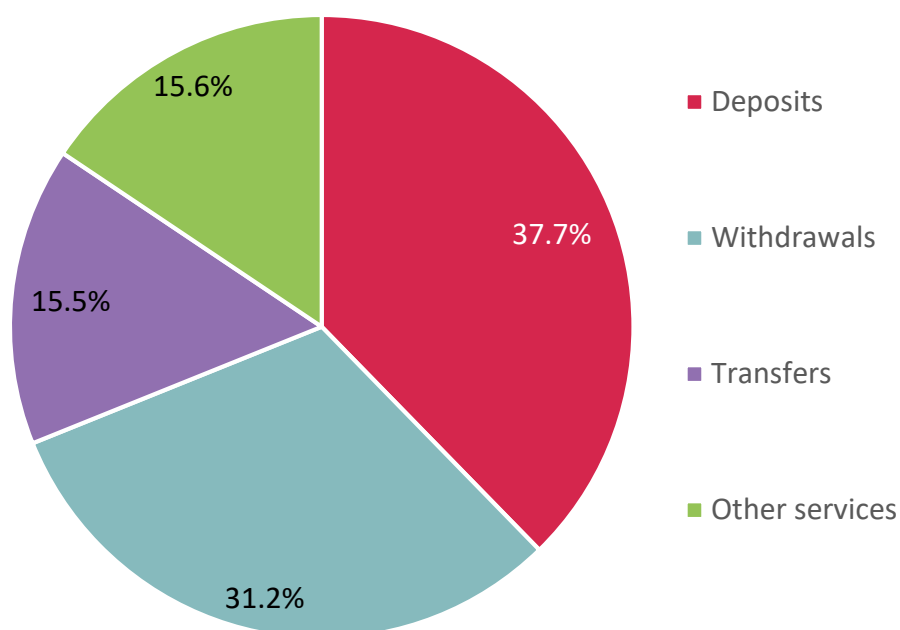
The improvement in the banks' efficiency was accompanied by an improvement in the quality of the loan book. Non-performing loans (NPLs) dropped to 12.3% of total loans in 2018 from 13% in the previous year as International Financial Reporting Standard 9 (IFRS9) accounting principles were phased in (Table 1). The introduction of IFRS9 in 2018 was instrumental in the fall of NPLs as they stipulated the writing-off of loans that had not been performing for more than five years. The adoption of IFRS9 also resulted in an increase in the provision coverage of NPLs to 63.2% in 2018 from 60.7% in the previous year, but this increase did not prevent an improvement in bank profitability. The capital adequacy of the system declined to 10.9% in 2018 from 12.1% in the previous year. Yet, it is still above the 8.6% regulatory norm and 80% of the institutions subject to the legal requirement met this threshold.

Several major reforms, initiated by the monetary and supervisory authorities in order to strengthen the soundness and the resilience of the banking sector, entered into force in 2018. These include the revised Annex to the Convention Governing the Banking Commission, the bank accounting principles and the new prudential framework applicable to credit and financial companies, based on Basel II and Basel III standards. In addition, the new bank crisis resolution mechanism came into force on 1 January 2018. As a result of this reform, the first meeting of the Resolution College, responsible for the implementation of the measures for the prevention and resolution of bank failures, was held on 17 September 2018.

The number of institutions offering electronic banking services rose in 2018. There were eight accredited institutions offering electronic banking services (Établissements de Monnaie Électronique, EMEs) in the WAEMU. Most of them were based in Côte d'Ivoire (three) and Senegal (two). The eco-system was dominated by four subsidiaries of the French mobile telephony company Orange. In 2018, EMEs issued

EUR 51 million in credit covered by deposits, 20.7% higher than in the previous year. There were 37 million accounts with EMEs in 2018, 10.6% higher than in the previous year, while 50.9% of these accounts were active. The value of transactions stood at EUR 31.1 billion in 2018, 30.4% higher than in the previous year. The volume of EME transactions was 1.6 billion in 2018 - a year-on-year increase of 44.3%. There was a total of 189 461 active service points in 2018 with at least one transaction over the last 90 days. Cash withdrawals and deposits were the principal operations performed via the EMEs in 2018 (Figure 7).

Figure 7: WAEMU - structure of mobile payments at end-2018



Source: WAEMU Banking Commission.

Box 1: Microfinance in the WAEMU

Microfinance provides financing to economic agents that are underserved by the traditional banking system because they are unable to get checking accounts, lines of credit or loans from traditional banks. Microfinance institutions are therefore significant in the promotion of financial inclusion and the development of the private sector as they provide loans and access to savings accounts to small business owners and entrepreneurs. Without microfinance, small and underserved prospective borrowers may have to resort to using loans or payday advances with extremely high interest rates or even borrow money from family and friends. Microfinance helps them invest in their businesses, and as a result, invest in themselves. Microfinance can also help women break the poverty cycle. In the WAEMU, it is essential to promote alternative financing structures capable of ensuring the mobilisation of small savings in rural and urban areas, and to create the necessary conditions for the gradual insertion of the informal sector into the modern economy. To this end, consultations with key stakeholders have highlighted the need to develop the regulatory system in place in order to confer legal status on other institutions that offer financial services to populations outside the traditional banking system (cooperative or mutual savings and credit, non-governmental organisations engaged in savings collection and/or credit distribution operations, and credit projects). Microfinance institutions appeared in the WAEMU in the late 1960s at the earliest. To help promote these institutions, which are aimed almost exclusively at low-income populations in both rural and urban areas, BCEAO, with the support of Member States and development partners, in addition to adopting specific regulations for these institutions, set up in 1992 support projects to assist the emergence and development of these local financing structures.

The WAEMU microfinance sector continued expanding in 2018. The number of microfinance institutions (MFIs) or *systèmes financiers décentralisés* (SFDs, decentralised financial systems) reached 158 at end-2018. The total balance sheet increased by 6.1% year-on-year in 2018 to EUR 3 billion. The best performances were achieved by Côte d'Ivoire (+10.5%), Senegal (+10.3%) and Niger (+8.6%). For their part, loans to microfinance clients increased by 7.3% year-on-year to a total of EUR 1.7 billion, of which 54% consisted of medium and long-term loans (EUR 941 million) and 43% short-term loans (EUR 751 million). These components posted year-on-year increases of 9.7% and 4.1% respectively in

2018. The Senegalese SFDs held the largest market share (by asset size) in the WAEMU (38% of total WAEMU assets), followed by those in Côte d'Ivoire (18.9% of total) and Burkina Faso (16.4% of total).

WAEMU SFDs are prudentially sound in principle. Of the microfinance institutions in the WAEMU, 141 SFDs had, in 2018, activities other than deposit-taking and lending less than the regulatory imposed limit of 5% of total activities. In the WAEMU 136 SFDs complied with the regulatory norm of 25% of equity with respect to the microfinance institution's participation in other firms. In 2018, 75 SFDs in the WAEMU could cover their short-term obligations (three-month) with their short-term resources (three-month). In the WAEMU, 128 SFDs had a single exposure of less than the regulatory imposed ceiling of 10% of equity. There is significant room for improvement with regard to the capitalisation of WAEMU SFDs, as only 101 SFDs had a capitalisation level in line with the regulatory norm (share capital of CFAF 300 million). The overall capitalisation of WAEMU SFDs stood at 20.2% in 2018 having improved from 15.6% in the previous year.

Table 1: WAEMU - Key profitability ratios (%)

	2013	2014	2015	2016	2017	2018
Gross margin (Return on loans - cost of capital)	7.9	6.7	6.5	6.8	5.4	5.2
Net operating ratio (General expenses + depreciation)/NBI	68.8	66.4	66.9	66.8	65.9	67.4
Net margin ratio (Net result/net banking income)	15.6	12.8	14.4	21.4	19.8	23.2
Return on equity (ROE) (Net result/own funds)	10.1	8.6	9.9	13.5	12.5	13.9
Non-performing loans ratio (Non-performing loans /total loans)	15.6	15.2	13.7	10.1	13	12.3
Non-performing loans provision ratio (Provisions/non-performing loans)	60.9	61	60.1	49.5	61.6	64.3

Source: WAEMU Banking Commission.

Banking sector in non-WAEMU countries

The Ghanaian banking sector went through a significant consolidation process during 2018, but the authorities have averted a systemic crisis. The recent consolidation is the culmination of a wave of sector reform by the Bank of Ghana (BoG) which began in 2015 with an asset quality review (AQR). The AQR uncovered substantial previously unrecognised impaired loans, many of which were loans to state-owned enterprises in the energy sector. The Government restructured much of the energy sector debt during 2017, and has strengthened the regulatory and supervisory framework for a more resilient banking sector. The most significant reform during 2018 was the imposition of a 230% increase in the minimum capital requirement, applicable from December 2018. According to the latest available data, 17 banks met the new minimum capital requirement through their own capital-raising efforts, mainly in the form of retained earnings and fresh capital contributions. Six banks that were unable to meet the requirement merged, and another one was converted to a savings and loans company (subject to a lower capital requirement). Ten other banks were found to be insolvent, and severe governance failings were discovered in a number of institutions, which had their licences revoked or were voluntarily dissolved. In addition, five banks received capital injections from private pension funds under a 70% government guarantee implemented through a special-purpose vehicle, the Ghana Amalgamated Trust. Overall, the number of Ghanaian banks fell from 34 in mid-2017 to 23 by early 2019. The BoG ensured the protection of depositors in all of these cases through bailouts, which has prevented any run on deposits. However, several creditors are facing haircuts, which has undermined investor confidence.

Reform and consolidation of non-bank financial institutions is also ongoing. Between mid-2017 and mid-2019, the BoG revoked the licences of 263 microfinance institutions and, in August 2019, the licences of 23 savings and loans or housing finance companies. This consolidation process is expected to continue, and banks which had lent to these companies will see an impact on their ratio of NPLs to total loans. The Government is likely to bail out small depositors of defunct microfinance institutions.

Nigeria's banking sector remained stable during 2018 and 2019, as the gradual economic recovery continued. The most recent intervention of the Central Bank of Nigeria (CBN) took place in 2016, with the takeover of Skye Bank. During 2018, Skye Bank was transferred to a bridge bank, Polaris, and recapitalised by the state Asset Management Corporation of Nigeria (AMCON). The sector now consists of 27 banks, including Polaris. It is highly concentrated, with five institutions holding 62% of the sector's total assets (in 2016). In addition to the recapitalisation of Polaris, AMCOM has continued debt restructuring across the sector.

Credit growth is gradually picking up in Ghana, but has remained negative in Nigeria. Against a backdrop of economic recovery and monetary policy easing, total assets in the Ghanaian banking sector increased by 14.7% year-on-year to EUR 17.6 billion at end-2018. This trend helped to boost outstanding bank loans, which increased by 11.1% in 2018 to EUR 6.1 billion. However, growth in lending to Nigeria's private sector remained negative in 2018 (-6%) despite the recovery in the oil sector, which accounts for 22.5% of total outstanding loans. The CBN has recently obliged banks to comply with a minimum loan-to-deposit ratio for companies and individuals, with the aim of boosting investment. On the other hand, banks in both Nigeria and Ghana are still rearranging their balance sheets to fully comply with IFRS9, which requires full provisioning of potential. This is likely to continue to constrain the rate of new lending.

Banking sector soundness is improving in both Ghana and Nigeria. As noted, in Ghana, the build-up of NPLs began in 2015 and was partly related to state-owned enterprises (SOEs), particularly in the energy sector. The bulk of energy sector debt was restructured during 2017 with support from the Government, and the banks were permitted to reclassify this debt as performing. After peaking at 21% of total loans in 2017, NPLs declined to 18.2% in 2018 (Table 2). In Nigeria, NPLs had increased from 3% of total loans in 2014 to 14.8% in 2017, driven by the situation in the oil sector, which was impacted by the fall in the oil price in 2014-15 and by security-related disruptions in the Niger delta region. The recovery in the oil price and the gradual economic recovery during 2018 boosted the repayment capacity of firms, and NPLs fell to 11.7% in 2018.

Profitability remains adequate in both countries. In both countries, banks have faced costs of provisioning to meet increasingly stringent prudential requirements under IFRS9, added to the costs of writing off NPLs. However, high yields on the government bonds in the banks' portfolios and large loan-to-deposit spreads have more than compensated for this. In late 2018, the loan-to-deposit-spread stood at over 12 percentage points in Nigeria and over 16 in Ghana, although it has subsequently fallen to around 7% in Nigeria. In 2018, ROE stood at 18.5% in Ghana, and 22.7% in Nigeria.

Table 2: Financial soundness indicators in Nigeria and Ghana

	2014	2015	2016	2017	2018
Ghana					
Statutory capital/risk-weighted assets	17.9	17.7	17.8	15.6	19.3
Core Tier 1 capital	15.3	14.5	14.4	13.5	18.3
NPLs net of provisions to capital	11.2	14.9	15.8	14.9	13.2
NPLs/total gross loans	11.3	14.9	17.3	21.6	18.2
Return on assets	4.7	3.1	2.5	2.4	2.3
Return on equity	32.3	21.4	18	18.7	18.5
Liquid assets/total assets	26.8	26.5	27.2	26	26
Nigeria					
Statutory capital/risk-weighted assets	18.6	17.7	14.8	10.5	15.2
Core Tier 1 capital	15.5	18.1	16.3	8.4	13.5
NPLs net of provisions to capital	3.8	5.5	36.2	23.9	0.1
NPLs/total gross loans	3	4.9	12.8	14.8	11.7
Return on assets	2.5	2.5	1.3	2.4	2
Return on equity	21.2	19.7	10	23.5	22.7
Liquid assets/total assets	11.4	18.5	16.2	18.8	22.6

Source: IMF country reports, April 2019.

Capital adequacy and liquidity improved in both countries. In Ghana, average capital adequacy reached 19.3% of total assets in 2018, compared to a prudential requirement of 10%. The ratio of liquid assets to total deposits reached 91.5%. In Nigeria, banks benefited from a three-year smoothing in the provisions required for IFRS9 compliance, which helped them to achieve an improvement in capital adequacy, from 10.5% in 2017 – just above the statutory minimum – to 15.2% in 2018. Liquid assets rose to 22.6% of total assets. The banking sectors in both countries rely largely on deposits for funding (66% of liabilities for Ghanaian commercial banks in early 2019, and 57% for Nigerian banks at end-2018), although the larger banks in both economies raise funds through domestic and international bonds.

In the longer term, the recent reforms are expected to strengthen financial sector stability in both Nigeria and Ghana. Reforms have gone beyond the implementation of the increased capital requirements mentioned above to address governance issues. For example, in 2018, the BoG introduced new directives on corporate governance and a “fit and proper” regulation for banks. This regulation governs who can take senior management positions in banks. This was an important step because governance failings played a key role, alongside structural economic issues, in most of the bank failures during the period 2017-19. Both the BoG and CBN demonstrated over 2016-18 the capacity and willingness to enforce compliance with governance and prudential requirements, while retaining the confidence of depositors. Both institutions regularly conduct stress tests to assess the liquidity and solvency of the financial sectors.

The expanded use of mobile financial services is transforming banking in Ghana, but the potential is underexploited in Nigeria. In Ghana, the use of mobile payment applications is the preferred means of payment of the unbanked population, which is poorly served by the traditional financial sector. The number of mobile accounts rose from 3.8 million in 2012 to 32 million in 2017 - an average annual growth rate of 42.6%. This trend was reflected by the increased value of mobile transactions, which reached EUR 33.6 billion in 2018, having gone up by 13.3% annually. The level of mobile telephone penetration, estimated at 127%, has contributed to the vitality of this segment, but a more important factor has been the supportive regulatory framework. For example, the introduction of a formal supervision and monitoring framework in 2015 created a more secure environment for users and boosted confidence in this type of payment. Nigeria, on the other hand, is lagging behind in mobile payments: barely 6% of adults have a mobile account, compared to the sub-Saharan average of 21%. The development potential in this segment

is considerable given the relatively high mobile telephone penetration rate (70%) and the fact that there are 35 million people who do not use the banking system. Mobile finance has been used predominantly by individuals to date. However, these technologies may have the potential to boost access to finance for firms too, particularly the smallest.

Although the banking sectors in Sierra Leone and Liberia are smaller and less sophisticated than those of Ghana and Nigeria, they face many similar challenges. In both countries, they are well capitalised and profitable, with capital adequacy ratios in 2018 at 28% in Liberia and 38% in Sierra Leone, and return on equity at 6.4% and 27.3% respectively. However, asset quality poses a risk in both markets. The NPL ratio stood at 13.8% in Liberia and 12.7% in Sierra Leone. NPLs are concentrated in domestic banks, and in state-owned banks in particular. Many NPLs arise from exposure to state-owned enterprises and private companies linked to public investment projects. The failure of the Government to make timely payments and clear existing arrears therefore poses a high risk to the profitability and stability of the respective banking sectors. For example, Government arrears represent 14% of total loans in Liberia according to IMF estimates. In both countries, efforts to improve supervision and risk management at commercial banks are ongoing, including the setup of a collateral registry and a liquidity support framework. However, significant deficiencies remain, in particular in terms of a long-term strategy for addressing NPLs.

Private enterprises and SMEs

Overview

Micro, small and medium-sized enterprises (MSMEs) are at the core of the economies of West Africa. The economic importance of MSMEs can only be estimated, because of the high levels of informality and other data issues. Nonetheless, based on the available data, it is clear that smaller companies account for the bulk of the region's private sector firms. For example, in Senegal 98% of private firms are classified as micro-enterprises (SME Finance Forum, 2017). MSMEs also account for the bulk of economic activity and employment. This is the case not only for low-income countries, but also for the region's economic giant, Nigeria, as explored in Box 1.

West Africa's firms are mainly domestically owned and focused, and most are under sole proprietorship. According to the most recent data from the World Bank Enterprise Surveys, summarised in Table 3, most firms (80%) are domestically registered and under sole proprietorship (63%). Most are active in the domestic markets: only 9% export more than 10% of their sales. Larger firms are more likely to be integrated into regional and global value chains: around 30% of firms with more than 100 employees export at least 10% of their sales. Companies employ on average 30 people, over 90% of whom on a permanent basis.

Table 3: Characteristics of West African firms (%)

	All	Small (5-19)	Medium (20-99)	Large (100+)
Percentage of firms with a legal status of sole proprietorship	63.31	73.96	45.01	31.29
Proportion of private domestic ownership in a firm (%)	80.33	84.79	75.84	59.87
Percentage of firms with female participation in ownership	22.26	20.72	25.03	23.36
Percentage of firms with a female top manager	13.39	15.54	11.25	4.67
Proportion of permanent full-time workers that are female (%)	21.49	23.68	17.72	16.86
Percentage of firms exporting directly (at least 10% of sales)	8.48	4.91	11.72	24.11
Number of workers	29.41	8.83	37.48	178.09

Source: World Bank Enterprise Surveys, most recent years.

West Africa's women are less likely to be engaged in entrepreneurship than men, and are underrepresented in the MSME workforce. On average, 20% of companies covered by the World Bank Enterprise Surveys have female participation in their ownership. However, this varies significantly by country. For example, in Liberia almost 40% of surveyed firms have a female owner. Furthermore, most staff in the formally registered firms surveyed by the World Bank are male. Women have slightly higher participation rates in smaller companies, both in management and in the workforce, but even in smaller firms they account for less than a quarter of full-time staff, and only around one sixth of managers. Based on the data for Nigeria (Box 1), it seems probable that their economic contribution is understated by these data, as, in Nigeria at least, women are concentrated in informal and micro-enterprises, which are not reflected in the World Bank Enterprise Surveys.

A number of challenges hinder West Africa's private enterprises from achieving their full potential. Based on the World Bank Enterprise Surveys for various years, access to finance was the most commonly cited constraint in more than half of the countries in West Africa, followed by political instability (the biggest concern for firms in Mali and Guinea) and the practices of the informal sector (the main problem in Cabo Verde and Niger). Although access to electricity was the most commonly cited problem only in Guinea-Bissau, a significant proportion of firms were challenged by this in almost all countries. There is significant variation between the countries. For example, while almost 50% of Ghanaian firms reported access to finance as their main obstacle, only 7% of firms in Guinea did so. Moreover, while 39% of firms in Guinea saw political instability as their main problem, in 12 countries in the region less than 10% of firms mentioned this as the main problem, in many cases less than 1%.

Access to finance

Access to finance is a constraint for West African firms. Although most firms have a bank account, few have accessed bank loans. As in the rest of sub-Saharan Africa (SSA), firms find it difficult to access bank lending. According to the World Bank Enterprise Surveys, over half of firms in West Africa perceive access to finance as a major constraint. This problem is most acute in WAEMU countries, where 57% of firms are concerned about financing, compared to 42% of firms in other West African countries. In 12 out of 16 West African countries, a lack of access to finance is more likely to be mentioned as a concern by smaller firms - companies employing 5-10 people - than larger ones. The widest gap between large and small firms is observed in Nigeria, with only 7% of larger firms, but 34% of small firms, listing access to finance as a major constraint.

While most firms are banked, relatively few have accessed formal loans, and even fewer use formal finance to support investment. On average, 88% of small- and medium-sized firms (up to 99 employees)

hold a bank account, but only 21% of surveyed firms have accessed a bank loan. When firms manage to get a loan, the funds are usually used to support shorter-term needs rather than long-term assets: 25% of small and medium-sized companies in West Africa make use of banks to finance their working capital needs, but only 18% have taken loans to support investments. As a result, almost 80% of firms rely on own resources and retained earnings for investment capital.

One factor behind weak lending to firms is that banks in the region see SMEs in particular as quite risky, and as a result ask for significant levels of collateral. The amount of collateral required in the region is, on average, twice the value of the loan and the situation could be more challenging for smaller firms. In Nigeria, for example, the data summarised in Box 2 suggest that high collateral requirements are a major constraint for the firms: not only are collateral requirements a common cause for rejection of loan applications, but they could also limit firms from resorting to external financing.

Other supply side challenges include the strong incentives for banks to invest in safe government assets, and the lack of complementary financial sector infrastructure. Government securities provide higher rates of return than the private sector, particularly small firms. For instance, in Sierra Leone, loans are less than 30% of total deposits, with the majority of assets invested instead in treasury bills, which are high-yielding and perceived as carrying zero risk. Furthermore, the lack of credit bureaux makes it difficult for banks to assess the risk of their clients: the majority of countries in West Africa reported a credit bureau coverage of less than 3% of the adult population. Even in Ghana and Nigeria, financial public records are collected for only 22% and 11% of adults respectively.

Demand side constraints also affect access to finance for SMEs. Pervasive informality among small and medium-sized enterprises is one of them. The 2018 African Economic Outlook of the African Development Bank highlighted that there are over 1.5 million informal enterprises located in the main economic capitals of the WAEMU region. According to the World Bank Enterprise Surveys, almost a quarter of small companies were not formally registered when they began their operations. A lack of formal and audited accounts hampers competitiveness and access to financial markets: only 41% of companies in the region have external auditors reviewing their financial accounts.

Box 2: MSME finance in Nigeria⁶

Micro, small and medium-sized enterprises (MSMEs) are the backbone of the Nigerian economy. On the basis of recent surveys of households and enterprises, designed to take into account both formal and informal enterprises, the Nigerian Bureau of Statistics (NBS) and the Small and Medium Enterprise Development Agency of Nigeria (SMEDAN) (2018) estimated that there are over 41 million firms with 199 employees or fewer in Nigeria, accounting for almost 50% of GDP. These MSMEs provide almost 60 million jobs, equal to 86% of the national workforce. The vast majority (99.8%) of these MSMEs have fewer than 10 employees, although larger SMEs account for 5% of jobs.

Men dominate ownership of and employment in formal sector SMEs, whereas almost half of informal sector firms and micro-enterprises are owned by women. Based on NBS data (NBS and SMEDAN, 2018), 78% of formally registered MSMEs under sole proprietorship are owned by men, and men account for 57% of employees. Around 49% of owners of informal and micro-firms under sole proprietorship are female. Most micro-firms have no employees (the average size is 1.37 people, including the owner), but 78% of the employees are male.

Nigerian MSMEs often struggle to access finance. A survey by the International Finance Corporation (IFC) and the CBN revealed that only 31% of MSMEs in Nigeria have ever obtained a loan from a financial institution, with the bulk of finance coming from commercial banks, followed by microfinance institutions (CBN and IFC, 2017). According to data from the most recent World Bank Enterprise Survey (2014), only 11% of firms have an outstanding line of credit, well below the average for sub-Saharan Africa (22%). The most common sources of business finance for MSMEs are personal savings and reinvested profits. The smallest firms are even less likely to have accessed formal credit. According to the IFC and CBN survey (ibid.), only 21% have borrowed from a formal financial institution, compared to 51% of medium-sized businesses.

A number of constraints prevent MSMEs from applying for and accessing credit. The CBN and IFC study (ibid.) found that few MSMEs apply for credit, even though 87% of MSME loan applications are successful. It seems that lack of collateral may be a particularly important constraint: 69% of firms who had not applied for credit stated that this was

⁶ This box is co-authored with Professor Joseph Nnanna, Chief Economist, Development Bank of Nigeria.

because they lacked collateral, while 48% of those who had been rejected cited lack of collateral as the main factor. The World Bank Enterprise Survey data reveal that Nigerian firms are asked for 228% collateral on average when taking a loan. But other constraints also play a role. The NBS and SMEDAN data (NBS and SMEDAN, 2018) revealed that 76% of micro-firms and 65% of SMEs lack a business plan, while 98% of MSMEs are unregistered. In addition, most firms lack complete credit histories. This is partly because so few firms have accessed formal credit, partly because the three credit bureaux were established relatively recently (2009) and partly because around 85% of firms are unaware of the credit reporting system (IFC and NBS, 2018).

Financial institutions are also discouraged from lending to MSMEs by a high perceived risk of default, compared to investing in government securities. Following the recession of 2016, government borrowing led to a dramatic increase in treasury bill rates, peaking at 18% in 2017. Treasury bill rates have more recently declined to just below 13% on the primary market, with higher yields on longer-term government bonds. The margin between this rate and the rate at which banks can lend to MSMEs is small, relative to expected losses and the administrative costs of lending to smaller businesses in the Nigerian environment. When Nigerian banks do lend to the private sector, they tend to reduce risk by observing a value chain business model: they deal with already established firms with track records of success.

As a result, MSMEs receive a limited share of total credit, and receive funds at high rates and with short tenors. In Q1 2019, the sectors where MSMEs operate - agriculture and trade/commerce - received just 4.2% and 7% of credit (NBS, 2019) respectively. 23% of total credit was allocated to the oil and gas sector, 15% to the manufacturing sector and 9% to the Government. MSMEs who do get loan approvals through deposit money banks often obtain those funds on unfavourable terms, and at short tenors. A 2016 study conducted by the organisation Enhancing Financial Innovation and Access (EFInA) found that the average loan size disbursed by deposit money banks to MSMEs was just over USD 16 000 (EFInA, 2018). The average interest rate offered to the lowest risk MSMEs was 20%, while the average loan maturity was just 12 months.

The past few years have seen some significant improvements in the operating environment, which may begin to ease access to finance for MSMEs. The use of credit bureaux had been limited due to lack of a unique identifier for borrowers. The Bank Verification Number (BVN) system was introduced in 2014 and enrolment for Nigerian residents with existing accounts closed in October 2018. The system should make it easier for the credit bureaux to provide credit histories for the individual owners of the smallest firms, although not all individuals possess a bank account. Furthermore, in a move to improve access to finance for MSMEs, the CBN in collaboration with the IFC has introduced a National Collateral Registry. This enables smaller firms to pledge moveable collateral to secure loans. Finally, the Government, with the support of International Financial Institutions including the European Investment Bank, has established the Development Bank of Nigeria (DBN). The DBN provides wholesale funding to commercial banks lending to MSMEs and to microfinance institutions. In its first full year of operation, the DBN disbursed over NGN 30 billion (USD 90 million) through 14 participating financial institutions to over 35 000 end-borrowers in the MSME segment. The DBN also offers partial risk sharing (credit guarantees) to financial institutions granting credit to MSMEs.

The emergence of the fintech sector has the potential to transform access to finance for Nigerian MSMEs. Fintechs have already impacted the Nigerian economy in the areas of mobile payments, banking, lending activities and financial management/literacy. A 2018 study (EFInA, 2018) noted that 3.4% of Nigerian adults (3.3 million individuals) have mobile money accounts, representing a 1.8 percentage point increase since 2016. The most common use of mobile money was for remittances (57% of users), but it is also used for paying bills and purchasing airtime among other things. However, the sector faces several constraints in expanding its services to MSMEs. Central Bank regulation currently precludes development finance institutions from partnering with fintechs.

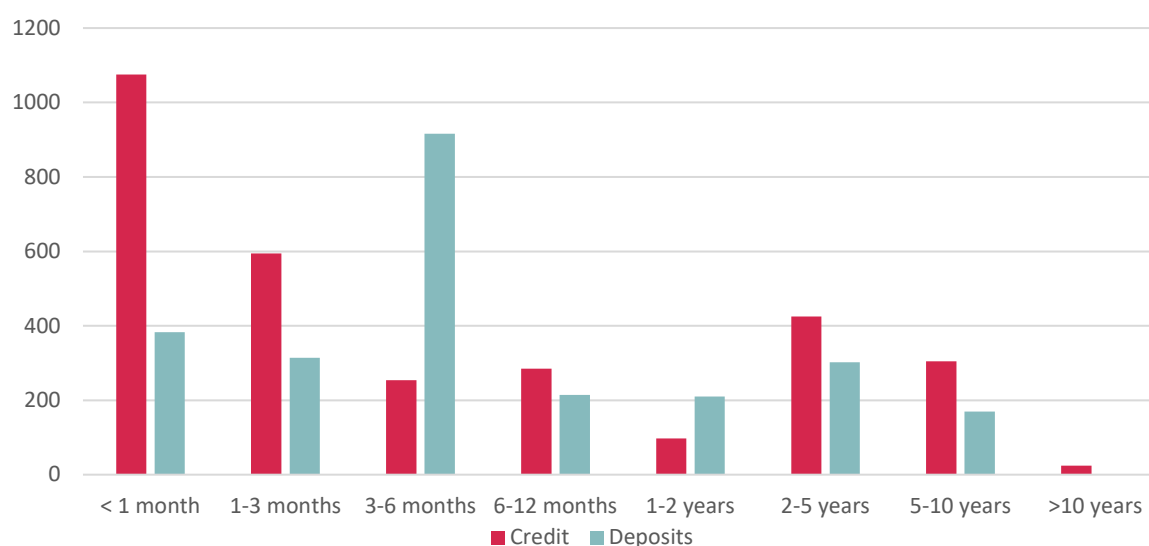
Focus on banking and microfinance in Senegal

Banks fund their credit expansion predominantly by deposits. There are 29 banks in Senegal that manage 80% of the country's total financial assets of EUR 11.2 billion or 56% of GDP in 2018. Senegalese banks are mostly owned by foreign investors or banking entities domiciled abroad: foreign investors held 65% of total capital, well above the average foreign capital ownership in the WAEMU (61%). The two largest banks in Senegal, CBAO-Groupe Attijariwafa bank and Société Générale de Banques au Sénégal, are among the 10 largest banks in the WAEMU, ranked by balance sheet size. Credit penetration in Senegal is the third highest in the WAEMU with credit to the private sector at 34% of GDP, compared to 29% on average in the WAEMU in 2018. Annual credit growth accelerated to 14.8% in 2017 from 9.9% in the previous year, but is expected

to have declined to 3.2% in 2018 as banks set aside capital in order to conform with Basel II/III and the transition to IFRS9.

Deposits cannot fund credit expansion at very short and long maturities. Services, transportation and communication account for 46% of the loan book followed by retail and wholesale trade and the industrial sector. Growth in credit to the economy is projected to accelerate to 7.7% year-on-year in 2019 and 13.5% in 2020. Banks fund their credit expansion using their domestic deposit base, signalling low liquidity constraints. Credit stood at 91% of deposits in 2018, unchanged relative to the previous year and above the WAEMU average of 89%. Yet, deposits are insufficient to fund credit growth at very short maturities of up to three months and at horizons of between two and 10 years (Figure 8). The prime lending rate charged by the various commercial banks ranges from 6.5% to 18% and the maximum lending rate is between 11% and 22%, which is not much different from the regional averages. Specifically, the prime lending rate in the WAEMU ranges from 5% to 18% and the maximum lending rate is between 10% and 22%.

Figure 8: Maturity structure of credit and deposits, Senegal (CFAF billion)



Source: Authors' calculations and BCEAO.

The banks are well capitalised and profitable with falling non-performing loan ratios. The profitability of banks in Senegal is high and resilient with ROE at 15.4% in 2018, compare to 16% in the previous year. Senegalese banks' profitability is close to that of the WAEMU region where average ROE stood at 14% in 2018. The quality of the loan book improved in 2018 relative to the previous year and NPLs dropped to 13.1% of total loans in 2018 from 15.1% in the previous year. Senegalese banks' NPLs are higher than those in the WAEMU as a whole (12.7% of total loans in 2018). Provisions were sufficient to cover 67.3% of NPLs in 2018 from 62.8% in the previous year and were above the WAEMU average of 63.2% in 2018. A new definition of NPLs is being introduced through the new IFRS9 chart of accounts which is expected to result in a lower NPLs-to-total loans ratio. NPLs are high because banks in the WAEMU were obliged not to write them off. Banks are well capitalised with capital at 12.3% of risk-weighted assets in 2018 (14.2% in the previous year), remaining above the 8.6% regulatory norm and the WAEMU average of 10.9% in 2018. Senegal is witnessing the phased introduction of Basel II and III with full compliance targeted within a five-year period from 2018.

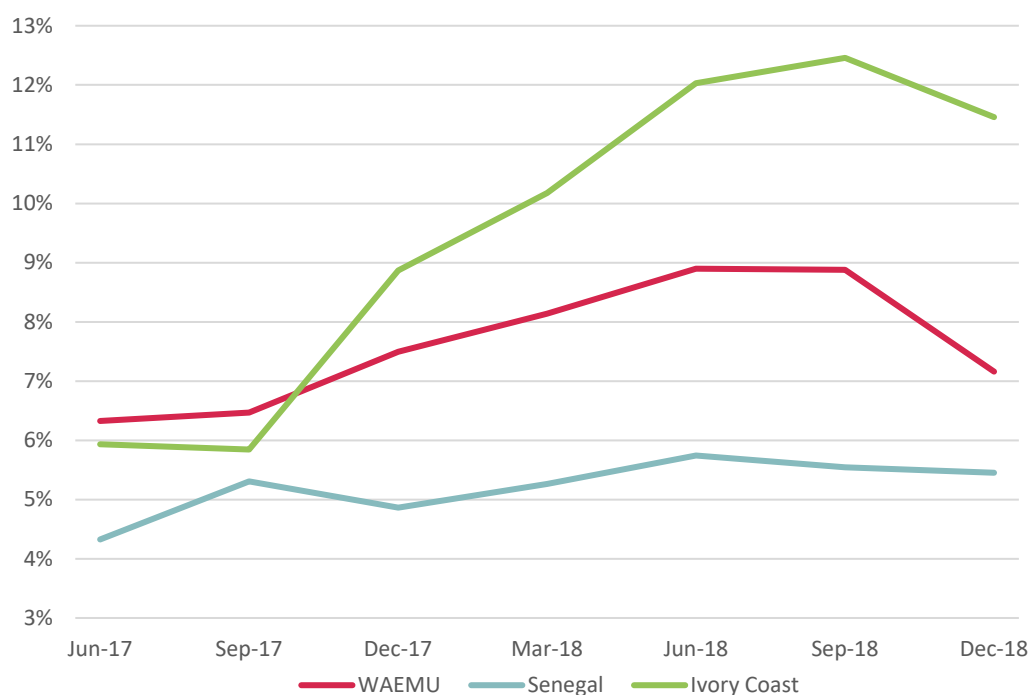
Senegal has the largest microfinance sector in the WAEMU zone. At end-2018, the country had 303 microfinance institutions (MFIs) or systèmes financiers décentralisés (SFDs, decentralised financial companies) and 898 service points. Nine of the microfinance institutions are sociétés anonymes (limited liability companies). Most service points are located in the capital Dakar (30% of service points), followed by Thies (16%), Louga (9%) and Saint Louis (9%). Three SFDs, namely FCCMS (Fédération des Caisses du

Crédit Mutuel in Senegal), Microcred and PAMECAS (Partenariat pour la Mobilisation de l'Épargne et du Crédit au Sénégal) comprised more than 75% of the membership of SFDs in the country in Q3 2018. They controlled 77% of outstanding total deposits, 60% of outstanding credit and 57% of equity in SFDs.

Microfinance sector penetration is increasing. In terms of sector penetration, the ratio between the number of SFD accounts and the total population was 19.4 at end-2018. Adjusting for account duplicates and inactive accounts, the adjusted access rate was 15.8% of the population aged over 18 in 2018, compared to 15.5% in Q3 of 2018 and 15.1% a year earlier. Deposits with SFDs stood at CFAF 335 billion, of which 85% were deposits of natural persons (the remainder were deposits of legal entities). The deposits were equivalent to 3.2% of GDP or 8.4% of bank deposits in 2018 and they consisted of demand deposits (1.4% of GDP) and term deposits (0.7% of GDP).

Microfinance credit is increasing but so are NPLs. Outstanding credit stood at CFAF 439 billion or 4.2% of GDP in 2018, up from 3.9% in the previous year. Credit for men stood at 50% of total SFD credit versus 34% for women and 16% for legal entities, revealing significant gender disparities in the access to finance. Credit by SFDs stood at 11.6% of total credit in the economy in 2018, compared to 11% in the previous year, and consisted mostly of medium-term credit (43% of MFI credit) and short-term credit (34%). Long-term credit accounted for 24% of MFI credit. The ratio of credit to deposits is on a downward trend and declining compared to the WAEMU and Côte d'Ivoire, Senegal's peer in the WAEMU, where the ratio is increasing over time. The quality of the loan book is deteriorating slightly, with NPLs hovering at 5.1% of total loans in 2018, up from 4.9% in 2017 and well above the regulatory threshold (3%). Yet, the deterioration in SFD loan quality is not as pronounced as that recorded in the WAEMU in general and in Côte d'Ivoire, the second largest SFD market in the WAEMU (Figure 9). In the WAEMU, non-performing SFD loans were 9% of total SFD loans in Q3 2018 compared to 12.5% in Côte d'Ivoire. About 4.3% of loans to women were non-performing in Q3 2018 (5.4% in the previous year), while 5.4% of loans to men were non-performing versus 5.2% in the previous year. The quality of the SFD loan portfolio is particularly disappointing as regards SFD credit to legal entities: 7% of SFD loans to legal entities were non-performing in Q3 2018, compared to 6% in the previous year. The stock of non-performing loans is attributed to the lack of financial training of the microfinance members rather than poor credit risk management.

Figure 9: Microfinance institutions' NPLs (% of total loans)



Source: Authors' calculations and BCEAO.

The Government strongly supports the microfinance sector. The Ministry of Solidarity, Economy and Microfinance was created in 2017 in order to promote financial inclusion in the country. Its budget for the financial year 2019 amounted to CFAF 11.5 billion against CFAF 2.8 billion in 2018. The Government decreed in 2005 the creation of the Fonds d'Impulsion de la Microfinance (FIMF). This is tasked to enable SFDs to offer financial and non-financial products and services tailored to the needs of members/clients in order to improve their access to finance, their living conditions and their economic empowerment. FIMF has an envelope of CFAF 150 million to distribute during 2015-2020 to eligible SFDs.

Conclusions

West African banks face a challenging and uncertain macroeconomic outlook. In a challenging external environment, West Africa's real GDP growth is expected to slow to 3.1% in 2020 from 3.8% in 2019, and to average 3.9% over 2020-24. The slowdown is explained largely by sluggish growth in Nigeria, which accounts for two thirds of regional GDP. Against a background of weaker global economic activity and rising uncertainty, the risks to West Africa's economic outlook are skewed to the downside and include trade protectionism, a potential increase in the risk premium and political risk. Nigeria closed its land borders in August 2019, citing the need to stem flows of smuggled goods. This is weighing on the economic outlook of West African economies exposed to Nigeria through bilateral trade, as well as pushing up inflation in Nigeria. A generalised increase in risk premiums for frontier markets could spark a reversal in portfolio flows to the region. Political risk and the risk of fiscal slippages are also high, particularly ahead of the elections in Burkina Faso, Ghana, Côte d'Ivoire and Togo in 2020. Other sources of risk include natural disasters, an Ebola outbreak and national and regional security.

The WAEMU banking sector is likely to remain resilient. The accommodative monetary conditions supported credit growth in 2018, while the profitability of the banking sector remained strong. The introduction of IFRS9 accounting principles in 2018 led to a drop in NPLs and increased provision coverage. Simultaneously the WAEMU banking sector remained well capitalised with a solvency ratio above the regulatory norm of 8.6% in 2018, while the profitability of the sector remained high.

The stability and soundness of the banking sectors in Nigeria, Ghana, Sierra Leone and Liberia appear to be improving following major consolidation in Ghana and reforms in all markets. The Bank of Ghana led a major clean-up of the Ghanaian banking sector during 2018, which reduced the number of banks by almost a third. All remaining commercial banks are now reported to be adequately capitalised. Regulatory reforms in a number of markets, including Ghana, and the implementation of IFRS9 should strengthen the sectors going forward.

However, further development of the financial sector infrastructure and framework are needed to improve access to finance for private sector firms and financial inclusion for individuals. This is particularly true for micro, small and medium-sized enterprises (MSMEs), which are at the core of the economies of West Africa. Many firms struggle to access bank credit, or are put off from applying, as lending rates and capital requirements are high. Banks consider lending to SMEs risky and allocate a significant portion of their investment to government assets. New technologies present opportunities to extend access to finance and promote financial inclusion, but require an appropriate regulatory framework.

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Banking in Central Africa: recent trends and developments

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Summary

There has been a notable acceleration in economic activity in the Central African Economic and Monetary Community (CEMAC) zone. However, growth remains below the average seen in recent years and should be strengthened to significantly improve the living conditions of the majority of the population. Although the IMF programmes agreed with the majority of countries in the region are bearing fruit, the improvement in the fiscal situation comes against a background of many external risks that might undermine a scenario of gradual acceleration in growth.

The balance sheet activity of the banking sector in the CEMAC zone has improved significantly, owing to the economic recovery. However, the quality of the zone's credit portfolio calls for vigilance. The liquidity of the banking system has continued to consolidate, and bank profitability has evolved positively. The sector's prudential situation has improved slightly, thanks to banks' capitalisation efforts. The regulatory and prudential arsenal continues to undergo changes and adaptations but the banking sector continues to be predominant in the financial activity of all CEMAC countries.

Businesses are using banking services less in CEMAC countries than in the rest of Africa. Some efforts are expected to strengthen banking infrastructure in the zone that will, in turn, ease SMEs' access to corporate financing. On the other hand, financial inclusion is experiencing very strong growth in CEMAC countries, thanks in particular to the advent of mobile banking, even though there is still significant room for improvement.

In the Democratic Republic of Congo (DRC), the political situation is normalising and growth is recovering. The authorities' declared intentions have had the effect of putting diplomatic relations between the DRC and its development partners back on track. Although banking activity is developing well, the quality of assets calls for some caution. Bank account penetration still has a long way to go to contribute to the country's economic diversification and to making growth more inclusive. A series of regulatory reforms could lead to profound changes in the sector.

Macroeconomic overview of the CEMAC zone

Structure of the economy

The main focus of this chapter is the CEMAC economic and monetary zone rather than more largely on Central Africa³. CEMAC stands for *Communauté économique et monétaire de l'Afrique centrale*, or Economic and Monetary Community of Central Africa. The treaty underpinning the CEMAC was signed in 1994 in N'Djamena, Chad. CEMAC is officially headquartered in Bangui, the Central African Republic, and has been chaired since 24 March 2019 by Cameroon's President, Paul Biya. It has six member states: Cameroon, Congo, Gabon, Equatorial Guinea, the Central African Republic and Chad. The member states share a common currency, the CFA franc (*franc de la coopération financière d'Afrique centrale*), also referred to as XAF, and a common central bank and banking regulator, the BEAC (*Banque des Etats de l'Afrique Centrale*). The zone's common currency has been pegged against the euro at the rate of 1 euro per 655.957 CFA francs.

Table 1: Size and level of economic development within CEMAC

Indicator / country (year = 2018)	Cameroon	Congo	Gabon	Equatorial Guinea	Central African Republic	Chad	CEMAC	Sub-Saharan Africa	Africa
Population (millions)	24.9	4.5	2.1	1.3	5.1	12.5	49.7	1 078.3	1 236.6
GDP (USD million, current prices)	38 502	11 264	17 017	13 317	2 380	11 303	93 783	1 699 462	6 764 685
Human Development Index*	151	137	110	141	188	186	n.a	n.a	n.a
GDP per capita (in current USD)	1 527	2 148	8 030	10 174	510	730	1 887	1 646	5 470
GDP per capita (in USD PPP)	3 771	5 652	17 912	23 473	872	1 965	4 389	4 112	n.a.

Source: World Bank (2019a), African Development Bank (2019), UNDP (2018), authors' calculations.

Note: * rank in 2017, out of 189 countries.

The CEMAC zone is as large as it is heterogeneous in terms of its demographics and economics (Table 1). Taken as a whole, it represents an economy of almost 50 million inhabitants and USD 94 billion. In terms of proportions, CEMAC represents 4.0% of the African population and 1.4% of the continent's GDP. However, the averages calculated for the zone often mask major differences between its economies. The level of socioeconomic development varies significantly from one member country to another. For instance, the annual GDP per capita varies between USD 430 in the Central African Republic and USD 10 453 in Equatorial Guinea.

³ Central Africa is a geographical concept comprising a larger set of countries; besides the CEMAC member countries, it also comprises Angola, the DRC and São Tomé and Príncipe. The banking sectors of these three countries are not well integrated with those of CEMAC. They are therefore not easily presented alongside those of CEMAC member countries. Hence, the section focusing on the Democratic Republic of Congo analyses the banking sector of the DRC separately. Space constraints prevent the authors from discussing the banking sectors of Angola and of São Tomé and Príncipe in the same edition. Future editions of this chapter may analyse the banking sectors of the latter two countries in a similar format.

Table 2: Economic performance in CEMAC

Indicator / country (year = 2018)	Cameroon	Congo	Gabon	Equatorial Guinea	Central African Republic	Chad	CEMAC	Sub-Saharan Africa	Africa
GDP growth (at constant prices; annual %)	4.1	1.6	0.8	-5.7	3.8	2.4	1.7	3.2	3.5
Real growth of non-oil GDP	4.4	-5.5	1.9	-3.8	3.8	0.50	1.1	3.3	n.a.
Real GDP growth per capita (annual %)	1.5	-0.9	-0.5	10.1	1.8	-0.1	-0.7	0.8	1.0
Gross national savings rate (% GDP)	26.0	23.8	28.0	6.6	7.1	18.8	22.2	20.4	n.a.
Investment (% GDP)	29.7	17.1	30.4	12.0	15.1	22.2	24.9	22.8	n.a.
Doing Business 2019*	47.8	39.8	45.6	41.9	36.9	39.4	n.a.	n.a.	n.a.

Source: IMF (2019a), World Bank (2019a), Doing Business indicators (World Bank, 2019c); authors' calculations; * distance to frontier score benchmarking economies with respect to regulatory best practice (100 = best).

Of CEMAC's member states, all but the Central African Republic are oil producers with rapidly growing populations. Real economic growth, particularly outside the oil sector, needs to accelerate for countries to achieve their aspirations to the status of emerging economies (Table 2). In fact, actual growth per capita in the zone was slightly negative in 2018. Economic growth also varies significantly across the countries: for instance, in 2018 it varied from -5.7% in Equatorial Guinea to +4.1% in Cameroon. Even Cameroon's 4.1% real growth rate in 2018 would need to accelerate to decisively tackle poverty and improve the living conditions of the majority of the population. To strengthen growth outside the oil sector, governments need to continue on their reform path in order to boost the competitiveness of the zone's economies further, particularly in the fields of access to credit, the business climate and infrastructure.

Table 3: Macroeconomic stability in CEMAC: selected indicators

Indicator / economy (year = 2018)	Cameroon	Congo	Gabon	Equatorial Guinea	Central African Republic	Chad	CEMAC	Sub-Saharan Africa	Africa
Inflation (CPI - average annual change, %)	1.1	1.2	4.8	1.3	1.6	4.0	2.1	8.5	10.9
General government balance (% GDP)	-2.5	6.6	-0.2	0.5	0.4	1.9	0.1	-3.7	-4.5
General government balance (excluding donations, % GDP)	-2.9	6.5	-0.2	2.8	-7.4	-1.3	-0.7	-4.1	n.a.
Current account balance (% GDP)	-3.7	6.7	-2.4	-5.4	-8.0	-3.4	-2.5	-2.7	-3.0
Government debt (% GDP)	39.1	87.8	60.7	43.3	49.9	48.36	50.9	49.0	53.0
Risk of overindebtedness (IMF)	High*	In deb distress*	--	--	High*	High*	--	--	--

Source: African Development Bank (2019), IMF (2019a), authors' calculations. * as of 18 December 2019.

The state of public finances has improved significantly since 2016, but some challenging national circumstances remain (Table 3). Cameroon, the Central African Republic and Chad are currently classified by the IMF as having a 'high risk of debt distress'. Excluding grants, the general government balance remains negative in the zone, and particularly in Cameroon and in the Central African Republic. In order to improve the cyclical recovery in revenues and reduce the debt burden as a proportion of GDP, aside from strengthening the mobilisation of domestic resources, the zone's countries need to maintain the pace of reforms aimed at accelerating growth.

Recent macroeconomic developments and outlooks

Overall, the zone's economic outlook is positive, and inflation remains under control (Table 4). Real growth in the zone has reached 1.7% in 2018 and it is projected to accelerate to 2.5% in 2019 and further to 3.0% in 2020. This is commendable, although still below the 3.9% average that prevailed from 2010 to 2015. While a very slight acceleration towards 2.4% is forecast for inflation in 2020, it remains quite moderate, thanks to the fixed exchange rate against the euro and to the domestic economic circumstances.

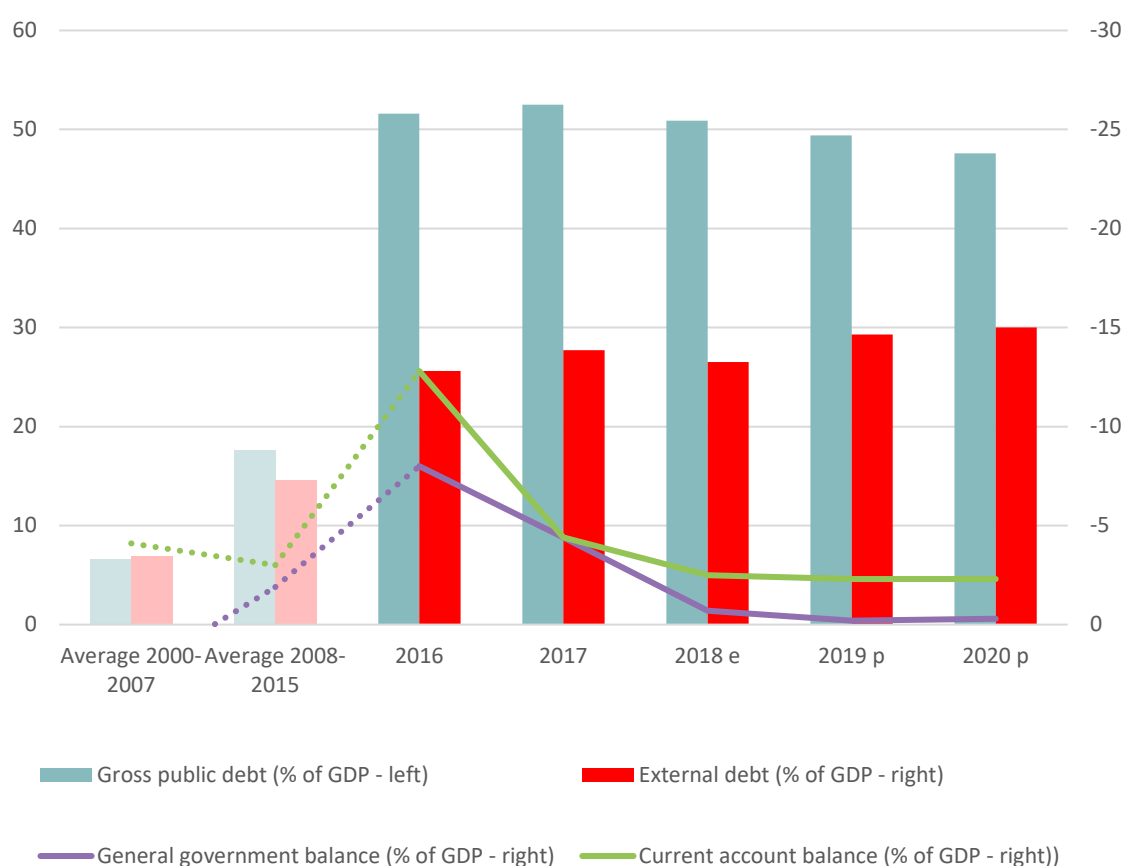
Table 4: Macroeconomic developments and outlooks in CEMAC

Indicator / year	Average 2010-15	2016	2017	2018 e	2019 p	2020 p
GDP growth (at constant prices; annual %)	3.9	-0.2	0.4	1.7	2.5	3.0
Inflation, CPI (% change at the end of the period)	2.5	1.2	0.8	2.1	2.2	2.4
Current account balance (% GDP)	-1.8	-12.8	-4.4	-2.5	-2.3	-2.3
Foreign exchange reserve (month of import)	5.2	2.3	2.3	2.7	3.3	4.0
General government balance (% GDP)	9.3	-7.3	-3.6	0.1	0.6	0.6
Government debt (% GDP)	26.5	51.6	52.5	50.9	49.4	47.6
External debt (% GDP)	16.2	25.6	27.7	28.5	29.3	30.0

Source: IMF (2019a).

From a public finance perspective, stabilisation efforts carried out as part of the programmes agreed with the IMF by the zone’s member countries are beginning to bear fruit, but some challenges remain (Figure 1). A drop of oil prices triggered an economic and fiscal crisis in 2016. Since 2017, the budget balance in CEMAC has been recovering. The current account balance also appears to be more or less under control. However, the 2016 crisis has medium-term implications. Government debt was estimated to stand above 50% of GDP in 2018, more than half of which is in the form of external debt, well above the 16.2% average seen in 2010-2015. Moreover, even if foreign exchange reserves have recovered from their 2016 nadir, it is estimated that they have not exceeded 2.7 months of imports in 2018, well below the 5.2-month average seen between 2010 and 2015. The fiscal situation is expected to continue to improve by 2020, and a positive primary balance is expected to emerge. However, this optimistic scenario is subject to commodity prices, and therefore global growth, remaining stable, including in China. This scenario also relies on a fairly scrupulous adherence to the public finance reform programmes signed with the IMF. Indeed, the challenge for the zone is to maintain the pace of reforms even when growth accelerates.

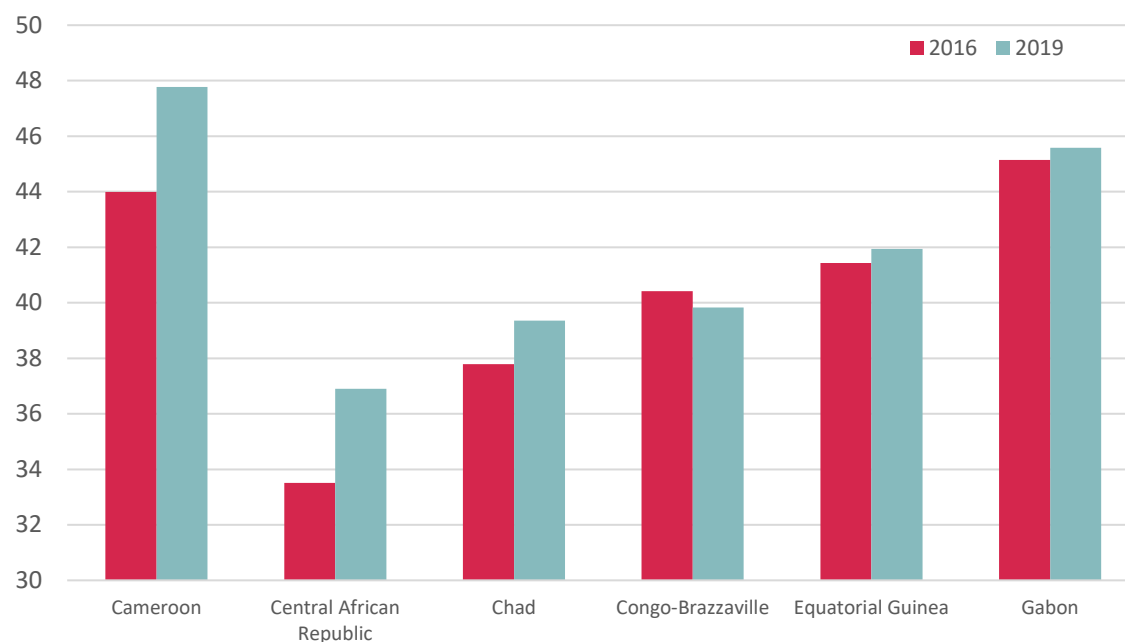
Figure 1: Evolution of public finances; external balance and debt



Source: IMF (2019a).

Moreover, budgetary consolidation in CEMAC countries needs to go on to meet expected targets. Widening the tax base would help to support much needed public investment. CEMAC’s income from taxation on economic activities outside the oil sector is still below the average for sub-Saharan Africa, and below the estimated fiscal potential for the countries concerned (IMF, 2019a). The reform of tax loopholes and an improvement in administrative capacity in the fiscal and customs fields would lead to growth. The impact on economic growth of this type of reform would in fact be less than the corresponding reduction in investment in equipment that would otherwise be necessary. In addition, revenue from outside the oil sector would provide a more stable financing basis for public investment.

Figure 2: Evolution of the business climate in CEMAC countries (2019 vs 2016)



Source: *Doing Business indicators* (World Bank, 2019c and 2016).

Note: World Bank 2015-19 *Doing Business* methodology; scores range from 0-100 with 100 representing the global regulatory best practice.

Some improvements in the business climate have taken place in most CEMAC countries and reforms are expected to continue to bear positive results (Figure 2). Cameroon and Chad have made the most notable progress in their *Doing Business* rankings between 2018 and 2019, while Congo-Brazzaville has slipped down the same rankings. In the coming years, economic competitiveness is expected to improve further in CEMAC, assuming further reforms aimed at improving governance and the business climate, and strengthening the financial sector. Non-oil growth is expected to be boosted further once budgetary consolidation and the repayment of government arrears have been concluded.

Table 5: Comparison of the business climates in CEMAC countries

Indicator / economy (year = 2018)	Cameroon	Congo	Gabon	Equatorial Guinea	Central African Republic	Chad	CEMAC
Business creation	86	61	64	56	83	52	72
Obtaining a building permit	62	41	64	55	59	57	58
Electrical connection	61	25	29	54	50	32	47
Obtaining loans	60	30	35	40	40	30	46
Transfer of ownership	38	42	38	44	37	53	42
Fulfilment of contracts	40	31	44	56	33	46	41
Minority investor protection	42	40	40	40	38	38	40
Insolvency settlement	37	28	38	0	36	28	33
Payment of taxes and duties	36	19	27	42	36	18	29
Cross-border trade	16	52	20	32	44	40	28

Source: Doing Business indicators (World Bank, 2019c).

Note: 2017-2019 Doing Business methodology; scores range from 0-100, with 100 indicating the best regulatory performance frontier worldwide.

Despite progress, there is still room for further improvement when it comes to the business climate (Table 5). This is particularly the case for the Central African Republic and Chad. The fields where most progress can be made by CEMAC countries relative to best global regulatory performance frontier (which corresponds to a score of 100) are cross-border trade, the payment of taxes and duties, and insolvency resolution. In contrast, CEMAC's regulatory performance ranks relatively well with respect to the ease of creating a new business. Cameroon's economy scores the highest in most criteria, followed by Gabon. CEMAC countries now score relatively well at a global level in terms of business creation and, to a lesser extent, in terms of obtention of construction permits.

Table 6: Governance indicators in CEMAC countries

Country / indicator	Combating corruption	Government effectiveness	Political stability and absence of violence / terrorism	Quality of regulations	Rule of law	Participation and accountability
Central African Republic	-1.17	-1.77	-1.94	-1.48	-1.73	-1.11
Cameroon	-1.18	-0.82	-1.08	-0.82	-1.02	-1.05
Congo-Brazzaville	-1.33	-1.19	-0.53	-1.33	-1.10	-1.12
Equatorial Guinea	-1.83	-1.44	-0.15	-1.40	-1.49	-1.97
Gabon	-0.81	-0.94	-0.09	-0.79	-0.68	-1.05
Chad	-1.43	-1.46	-1.34	-1.21	-1.30	-1.37
CEMAC*	-1.26	-1.13	-1.12	-1.04	-1.17	-1.17

Source: Worldwide Governance indicators (World Bank); UNDP; authors' calculations. * The CEMAC governance score is the GDP-weighted score for member states; the FDI amount is the total for the member states.

Note: The Worldwide Governance indicators are a compilation of the perceptions of a very diverse group of respondents, collected in a large number of surveys and other cross-country assessments of governance. The scores are derived as an unobservable component, and distributed as a standard normal random variable, i.e. with zero mean and unit standard deviation, ranging approximately from -2.5 to 2.5.

With respect to governance, efforts are still needed to offer a better institutional environment for growth (Table 6). Changing perceptions about corruption and governance in CEMAC countries is an essential prerequisite to attracting investment, boosting growth and making them more sustainable and inclusive (IMF, 2019a). Besides this, improving the security situation would also help on this front. Indeed, the several Boko Haram terrorist attacks, mainly in Cameroon and in Chad, as well as the events linked to the Anglophone secessionist movement in western Cameroon, contribute to worsen the violence / terrorism index.

Overview of the financial sector

The banking sector

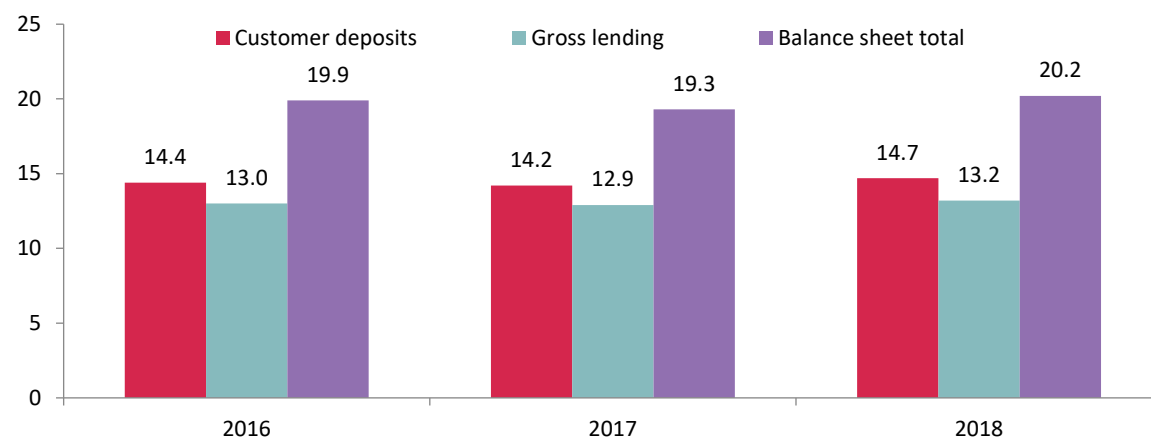
The banking sector continues to predominate in the financial activity of all CEMAC countries. It represented around 78% of the total assets of the zone's financial system in 2017. CEMAC's top 10 banks represented nearly EUR 10 billion in assets in the same year, i.e. 52.3% of the total assets of the zone's banking sector. The largest banks in terms of assets are BGFI Bank Gabon, Afriland First Bank and Société Générale Cameroun. By country, Cameroon is home to more than half of the 10 largest banks in terms of assets in the sub-region.

The concentration level of the banking system in the CEMAC zone is quite high. This is especially true in the Central African Republic and Equatorial Guinea. For their part, Cameroon and Chad have the lowest concentration levels, while Congo and Gabon are in a middling position. There were 51 banks in the sub-region⁴ in 2018, spread across the member states as follows: Cameroon - 15 banks; Central African Republic - 4 banks; Congo - 11 banks; Gabon - 10 banks; Equatorial Guinea - 5 banks; and Chad - 9 banks.

⁴ According to the latest indicators of CEMAC's bank activities, published by COBAC.

Beyond the banking sector, only Cameroon and Gabon are host to non-bank financial institutions, mostly in the former. At the close of 2017, there were 11 financial institutions, distributed between 8 institutions in Cameroon and 3 others in Gabon. In 2017, their activity saw a 2.7% decline in the balance sheet total compared to 2016, to EUR 717 million, an 8.3% decrease in gross lending to customers, to EUR 480.6 million, and a still high level of non-performing loans (49.8% of gross lending in 2017 vs 48.7% of gross lending in 2016). All in all, as of late 2017 financial sector assets across the zone as a whole accounted for 33.4% of sub-regional GDP, compared with 35.8% in 2016.

Figure 3: Evolution of the balance sheet situation of banks in the CEMAC zone (in EUR billion)

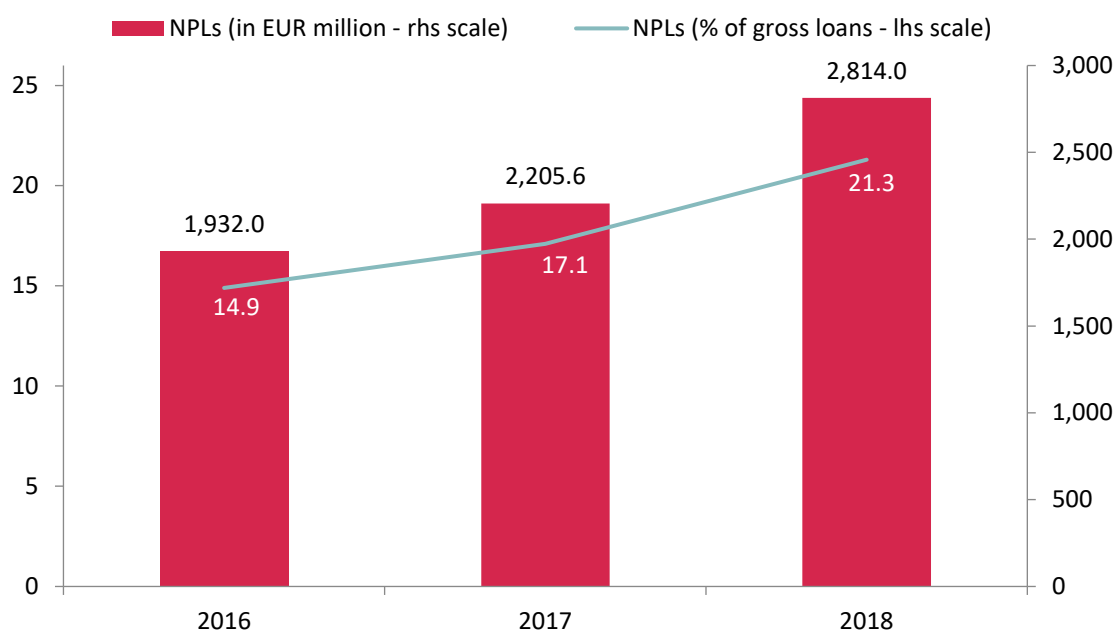


Source: BEAC (2019).

The banking sector's balance sheet activity has improved significantly as a result of the economic recovery experienced in most of the countries within the community, following the upswing in hydrocarbon prices. The balance sheet total stood at EUR 20.2 billion in 2018, up by 4.6% compared to 2017 (Figure 3). Gross lending grew by 2.5% in 2018 compared to its 2017 level, to reach EUR 13.2 billion. Most of this lending is short and medium term, and more than three-quarters - around 79% in late 2018 - was to the private sector. Bank financing in the economy has focused mainly on the tertiary sector. The breakdown of lending in the economy by branch of activity, as at 31 December 2018, shows the predominance of the 'transport and telecommunications' branch (20.1%), followed by the 'trade and hospitality' branches (19.3%) and 'construction and public works' (16.8%) branches.

The liquidity of the banking system has continued to consolidate in the sub-region and bank profitability has improved. In late December 2018, the deposit-to-loan ratio increased by 5.4 percentage points compared to the previous year's level, to reach 114% (BEAC, 2019a). In addition, the net result of the CEMAC banks reached EUR 211.4 million in 2018, an increase of 7% compared to 2017 (BEAC, 2019b). In the same year, net banking income also increased by 5.8% to EUR 1.4 billion, Equatorial Guinea not included. Return on equity - ROE - increased by 1.24 percentage points to 5.71% between June 2017 and June 2018. Return on assets - ROA - also improved from 0.42% to 0.60% over the same period.

Figure 4: Evolution of non-performing loans (NPLs), 2016-2018



Source: COBAC (2018a).

The quality of the zone's credit portfolio calls for greater vigilance (Figure 4). Non-Performing Loans (NPLs) have increased in 2018 to 21.3% of total loans, up from 17.1% one year earlier. This increase is mainly due to the accumulation of payment arrears by governments. In other words, governments have been slow to pay their suppliers and, in turn, these bank customers to pay down their debts, resulting in rising NPLs with banks. In 2018, the rate of NPLs provisioning stood at 58.3%, compared to 53.5% in 2017. However, the sector's prudential situation has improved slightly, thanks to banks' capitalisation efforts. A total of 30 banks - of the 51 that had declared their situation as at 31 December 2018 - had sufficient equity to comply with all prudential standards based on this aggregate, compared with 28 banks the previous year and 25 in 2016. There has also been an increase in bank reserves (+20.6% between late 2017 and 2018) and the coverage of loans by deposits (BEAC, 2019a). Despite the progress made, further efforts are therefore needed from banks in the area to further strengthen their capital base in order to successfully migrate to Basel II/III and transpose to IFRS standards.

The regulatory and prudential arsenal continues to undergo changes and adaptations. Several regulatory texts have been published, aimed at strengthening banks' financial stability and regulatory framework, including the introduction of new exchange rate regulations and the drafting of regulations on payment services, identification and arrangements for the supervision of systematically important institutions within CEMAC, procedures for obtaining authorisation as credit institutions by subsidiaries, and the classification, accounting and provisioning of the debts of credit institutions, etc. The Banking Commission has, in this same vein, decided to apply measures for the consolidation, restructuring and clearance of liabilities at certain regulated institutions, and to open disciplinary proceedings against other institutions, their corporate officers and auditors.

Box 1: New technologies: a key driver for optimising the potential of CEMAC's financial system

Technological innovations - mobile devices, tablets, smartphones, social media, big data, blockchains - have moved into all sectors of the economy, including financial activity, promoting a metamorphosis of its configuration and mode of operation. In CEMAC, the digitisation of financial services is also increasingly gaining ground, such as through the modernisation of payment methods (electronic transactions, magnetic-swipe cards, etc.), digital cash interoperability, and then the launch of mobile banking solutions by the zone's big banks (BGFIMobile for BGFIBank and NetFirst for Afriland First Bank).

This development is, however, still constrained by the high cost of this transformation and the lack of infrastructure. As a result, the expansion of digitisation remains limited, and many people in the zone are still without a bank account. The bank account penetration rate is estimated to be around 15%, compared to 43% for sub-Saharan Africa.

This transformation, from which the financial sector is not immune, brings major advantages for banking institutions in the zone, particularly in terms of reducing operating costs, paperless banking services, improving productivity and business growth. Faced with this metamorphosis, these banks are required to rethink their business model and forge more partnerships with fintechs to take advantage of their innovations and boost their customer base (see Chapter 1). Similarly, the proliferation of remote financial transactions via mobile phones or via the internet makes financial services more accessible to the most remote populations, improving their access to financial services in the zone.

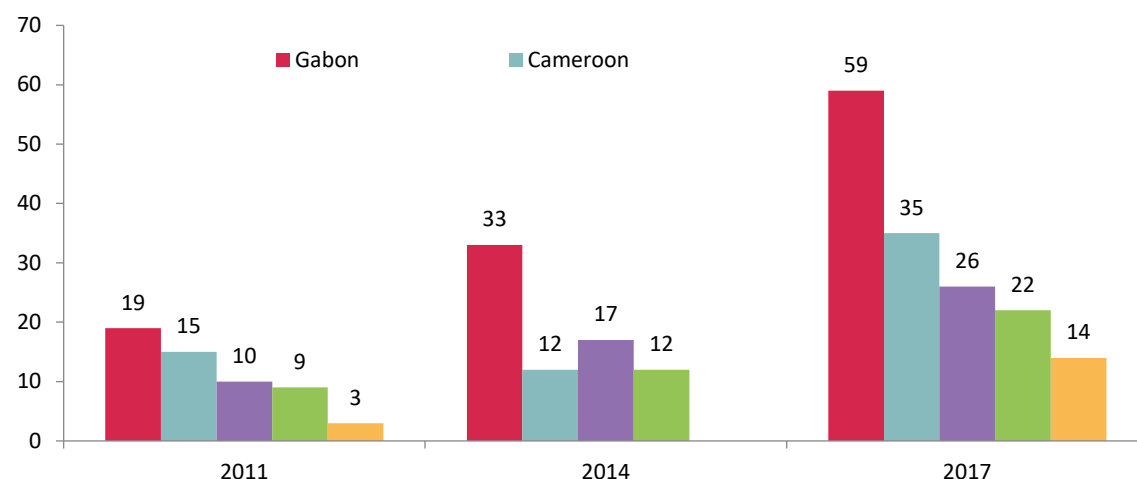
In microfinance, new technologies enable microfinance institutions (MFIs) in the sub-region to reach more remote customers in disadvantaged areas, helping to combat poverty and deprivation and social and financial marginalisation. Digital tools also make it possible to make transactions more secure and improve their transparency.

In addition, insurance companies have already begun to integrate digital channels into the marketing of their products. By way of illustration, Zenithe Insurance Cameroon offers 12 online products through its 'Zenithe E-insurance' platform. The increasingly widespread use of these tools should enable these companies to optimise their operating costs, reach a wider customer base and automatically develop their penetration rate in the zone.

Meanwhile, the optimal functioning of the Central Africa unified stock exchange would require the modernisation of its electronic platforms and the digitisation of its market access. The integration of new technologies would enable the regional financial market to reach more of the populations in the zone and accelerate financial inclusion.

Financial inclusion, on the other hand, has experienced very strong growth in the sub-region, thanks to the advent of mobile banking (Box 1 and Figure 5). This is even though there is still significant room for improvement. In this context, many banks in the sub-region have set up a range of digital services and mobile banking applications to optimise their operations and win new customers.

Figure 5: Evolution of financial inclusion in the CEMAC countries (% of adult population)



Source: Findex Database 2017 (World Bank, 2017); the Central African Republic was not included in the 2014 edition of the Global Findex Database.

Microfinance

Microfinance in CEMAC has been playing an increasing role in providing access to financial services for the poorest. Microfinance was launched in Cameroon in 1963, and in Chad and Congo in 1984. From the 1990s onwards, this activity expanded broadly, boosted by the economic and banking crisis that hit the sub-region. It is constantly adapting and innovating, to become a driver of economic development for countries

in the sub-region through, for example, the promotion of income-generating activities and the financing of micro-entrepreneurship. As at 30 September 2019, the sector had 619 licensed and active microfinance institutions (MFIs), including 412 in Cameroon, 122 in Chad, 57 in Congo, 14 in Gabon, 11 in the Central African Republic and 3 in Equatorial Guinea.

Many microfinance institutions have consolidated or withdrawn over time, as a result of regulatory requirements and stabilisation campaigns launched by the regional and national authorities. Against this backdrop, the number of bank branches and bank counters fell by 11% over the period analysed, from 1 963 in September 2017 to 1 738 in September 2018. The decline in this indicator is most pronounced in Congo (-48%) and in Chad (-13%).

Table 7: Evolution of the balance sheet situation of CEMAC's MFIs (in EUR million)

	31/12/2016	31/12/2017	30/09/2017	30/09/2018	Change (09/17 - 09/18)
Customer deposits	1 385.3	1 505.1	1 386.9	1 179.56	-15%
Gross lending	873.2	962.7	893.3	751.3	-16%
Non-performing loans	123.9	142.1	128.3	137.1	7%
Provisions	109.4	127.4	113.7	98.7	-13%
Balance sheet total	1 755.2	1 902.2	1 777.9	1 680.9	-5%

Source: BEAC (2019).

The quality of the credit portfolio still has room for improvement, however, even though the financing activity has contracted slightly year-on-year (Table 7). NPLs for approximately EUR 137.1 million were declared. As at late September 2018 they accounted for 18% of all gross lending compared with 14% one year earlier. At the same time, provisions now cover only 72% of NPLs, compared with 89% in late September 2017. The balance sheet total stood at around EUR 1.7 billion as at late September 2019, down 5% compared with late September 2017⁵. The stock of deposits and gross lending both fell, by 15% and 16%, respectively, year-on-year, as at late September 2018, to EUR 1.2 billion and EUR 751.3 billion. The former are primarily made up of demand accounts, while the latter primarily consists of short-term lending. The number of customers and members of CEMAC's MFIs fell from 2.7 million to 2.59 million between September 2017 and September 2018, a decrease of 9%; Cameroon and Congo held the largest number of customers, with 65% and 18% of the total, respectively.

As elsewhere in Africa, microfinance services remain relatively more expensive in CEMAC than banking services. The average lending rate for CEMAC as a whole rose from 12.1% to 13.3% between September 2017 and September 2018, while the prime rate for the zone remained stable over the period under review. According to the BEAC (2019a), the highest lending rates are applied mainly in Gabon (18.1%), Cameroon (14.8%) and Congo (13.4%), while the highest deposit rates are seen in Gabon (4%), Cameroon (3.6%) and Chad (3.6%).

MFIs still need to make a sustained effort to comply with current regulatory standards. These standards relate, inter alia, to solidarity funds, which needs to reach 40% of the paid-up shares, to the fixed asset coverage ratio, a minimum of 100%, and to the ratio of borrowing coverage through available funds, a minimum of 70%, and to the liquidity standard, a minimum of 100%. In order to improve the supervision of the management of these institutions in the zone, in 2018 COBAC adopted a new regulation governing microfinance activity with which the regulated institutions must comply, by 2020 at the latest. This new system covers a multitude of focus areas: supervision and auditing, authorised activities, categories of

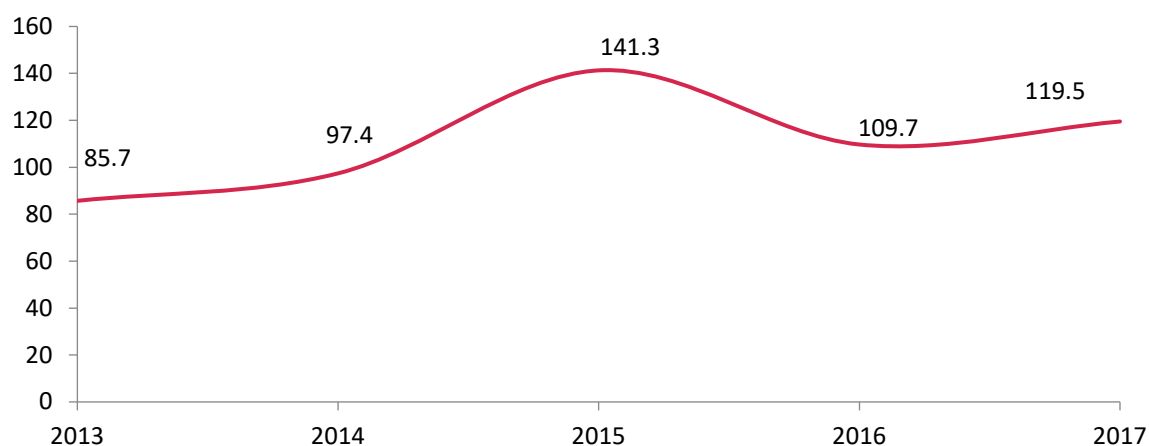
⁵ The decline in microfinance activity in the sub-region is believed to be due to the conversion or liquidation of some MFIs experiencing difficulty, such as Crédit Mutuel in Cameroon.

institution, organisation and legal forms, approval, officers and auditors, changes to legal status, treatment of MFIs in difficulty, organisation of professions, etc.

Leasing, private equity and insurance

Leasing activity holds significant potential at CEMAC level, but it is still far from having fully established itself as an alternative financing instrument, particularly for businesses. Total amounts outstanding for this financing method - EUR 119.5 million - accounted for barely 1% of total gross lending agreed at sub-regional level in 2017 (Figure 6). Leasing is regulated in CEMAC banking legislation as a lending operation, for example in the regulations governing credit institutions and microfinance activity.

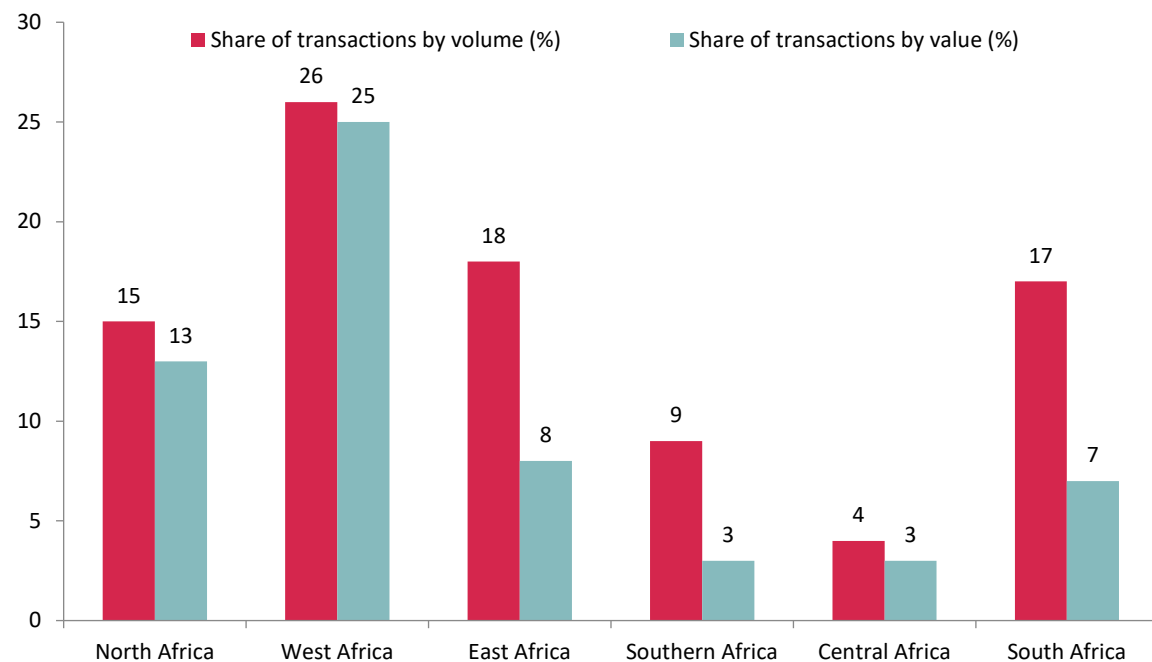
Figure 6: Evolution of outstanding leasing transactions (in EUR million)



Source: BEAC (2019).

Cameroon is the sub-region's leader in leasing. As at late 2017, this country alone accounted for more than 80% of the financial assistance via leasing in this area of the community. Gabon (14% of this assistance) and Congo (5%) trail far behind. Estimated at more than EUR 97 million, the Cameroon market remains well below its potential, estimated at around EUR 381 million. In Cameroon, this activity has only been regulated since 2010, although it has been practised in the country since 1978, with the creation of the Cameroonian Leasing Company, Socabail, a subsidiary of the Cameroonian Auto Loan Company, Socca.

Figure 7: Breakdown of private equity transactions in Africa by region, 2013-2018



Source: African Private Equity and Venture Capital Association (2019).

The private equity sector is still underdeveloped in Central Africa (Figure 7)⁶. It only accounted for 4% of transactions by volume and 3% of transactions by value carried out on the continent between 2013 and 2018. Central Africa stands far behind the volume and value of transactions of West Africa - 26% and 18% - and East Africa - 18% and 8%. However, given its geographical dimensions, these figures reflect a sector that is still young and embryonic, and they suggest a real potential for development and growth in the medium and long term.

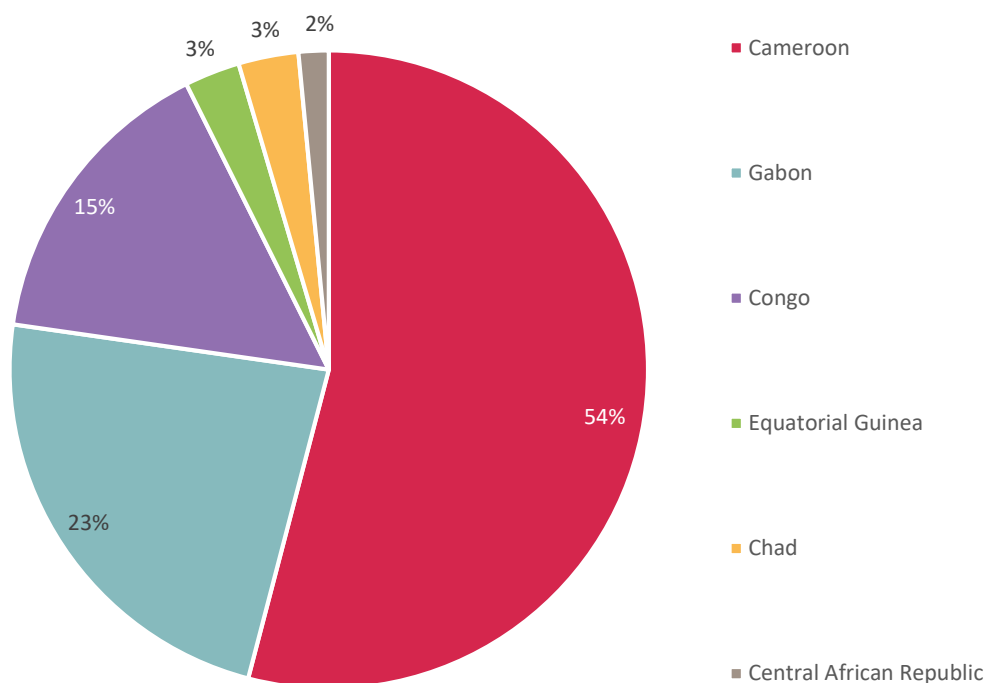
Because Central Africa continues to face challenges in terms of financing, private equity is an essential tool that could accelerate its economic development. In addition to the capital contribution, private equity funds could also have a positive impact on governance and best practices within businesses in Central Africa. They provide them with their know-how, networks and technical assistance.

The insurance sector is still in its infancy but is an important driver of economic development that could make a substantial contribution to CEMAC countries⁷. The sector's penetration rate in the zone (written premiums/GDP) is estimated at around 1%, compared with a global average of 6.2% and less than 3% for Africa as a whole, reflecting the wide margin for progress and the potential for this activity's growth in the zone. Demographic growth, the emerging middle class, and increasing infrastructure needs represent opportunities for the insurance sector in the sub-region. The sector has a negligible impact so far but it is expected to contribute to sustaining growth, increasing the resilience of local economies and households to extreme events, channelling domestic savings into the productive sector, and promoting redistribution and solidarity between individuals.

⁶ The change in the geographical scope of the chapter - from CEMAC to Central Africa - is due to the fact that the available data on leasing was classified by geographical region by the AVCA.

⁷ Several studies have highlighted the correlation between the insurance penetration rate and GDP growth.

Figure 8: Breakdown of insurance turnover in the CEMAC zone by country, 2018



Source: CIMA.

Cameroon is the sub-region's leader in the insurance sector (Figure 8). In late 2017, the zone had 58 insurance companies, distributed between Cameroon (28), the Central African Republic (3), Congo (8), Gabon (11), Equatorial Guinea (4) and Chad (4). It is supervised by the Inter-African Conference of the Insurance Markets (CIMA), the sole regulator for 14 countries spread across Central Africa and West Africa. In 2018, the total turnover of this activity in the sub-region reached EUR 588.4 million (compared to EUR 1.3 billion for the WAEMU zone⁸), a slight increase of 1.4% compared to 2017. Its breakdown by country highlights the predominance of Cameroon, which accounts for 54% of this sales volume, followed by Gabon (23%) and Congo (15%). The non-life class of insurance accounts for just over three-quarters of written premiums.

The current project to reform the sub-regional financial market, coupled with the implementation of a genuine investment policy, could help insurance companies to further diversify their investment portfolios. Dominated by bank deposits (40.6%), real estate assets (20.6%) and bonds (20.3%), the total amount of investments by insurance companies for the entire region rose from EUR 885.7 million in 2016 to 897.3 million in 2017, up by 1.3%. The regulatory changes recently introduced by CIMA should strengthen the sector, encourage the emergence of more stable players and encourage insurers and re-insurers to reinforce their technical capacities. These reforms included improving corporate creditworthiness and governance, the shoring up of insurer's equity⁹, ensuring fair treatment for policyholders and the supervision of micro-insurance.

All in all, insurance companies operating in the CEMAC struggle to adapt their offers to the characteristics of the market¹⁰ and to invent new, less costly, forms of distribution¹¹. Aware of the obstacles that prevent

⁸ This zone recorded an average growth of 10.1% between 2013 and 2018, compared with 2.4% for CEMAC.

⁹ Under this measure, which was introduced in 2016, insurance companies must increase their capital from EUR 1.5 million (XAF 1 billion) to EUR 4.6 million (XAF 3 billion) in 2019, then to EUR 7.6 million (XAF 5 billion) by 2021.

¹⁰ For example, micro-insurance products designed for the assets of the informal economy or insurance systems, known as index-tracking insurance, for the benefit of small farmers.

¹¹ Mobile telephony networks are an efficient distribution tool on the continent, where the mobile penetration rate exceeds 70%.

the zone from achieving full growth in this sector, CIMA has launched a series of regulatory forms, with which players in this segment must comply.

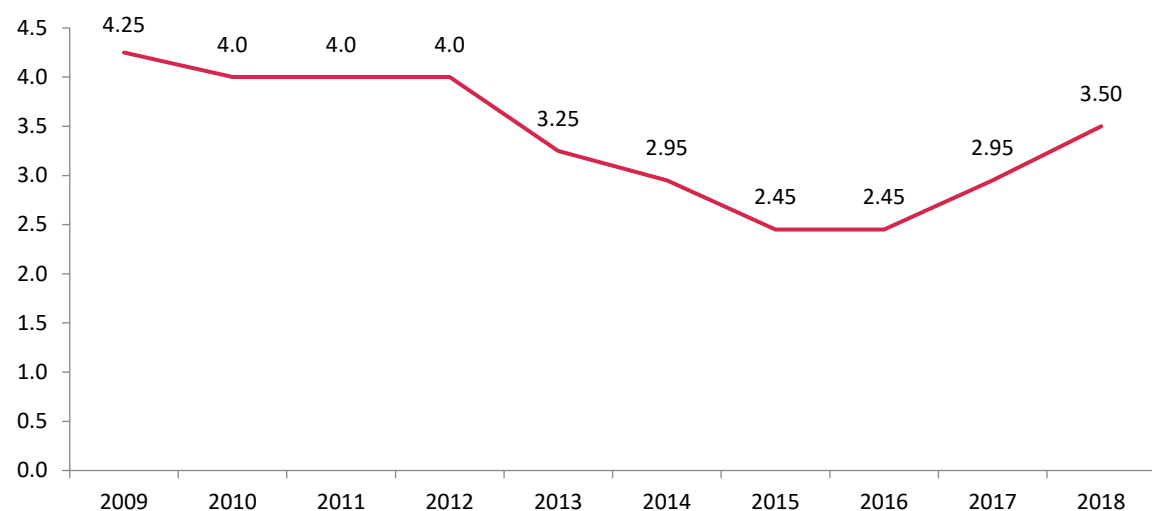
The social security sector, meanwhile, is far behind but nevertheless growing strongly. The number of organisations specialising in this type of coverage in CEMAC as at end-2017 amounted to eight, with one OPS per country, with the exception of Gabon, which has three. The total assets of these organisations amounted to EUR 2.3 billion, up 10.2% compared to 2016. The portfolio of their investments increased by 5.3% to EUR 436.4 million as at late 2017. This is made up of 75.8% term deposits in banks and financial institutions.

Financial markets

The development of the financial markets plays a significant role in fund mobilisation and is a catalyst for economic growth. Aware of this challenge, the leaders of CEMAC countries decided to accelerate the unification of the stock exchanges of Douala (BVMAC) and Libreville (DSX), and of the regulatory authorities and existing depositories. This process should lead to a new configuration of Central Africa’s financial market, with a single regulator, Commission de Surveillance du Marché financier de l’Afrique Centrale (supervisory commission for the financial markets of Central Africa, COSUMAF), based in Libreville, a single stock exchange, whose headquarters are located in Douala, and a single central depository for the financial market temporarily housed in the central offices of the Bank of Central African States (BEAC), in Yaoundé.

This convergence is a fundamental step towards deeper financial integration and should contribute to further boosting the financial market in the sub-region. According to Roland Berger’s¹² estimates, this merger could generate almost EUR 1.5 billion (XAF 1 000 billion) of issues by 2020. In addition, market depth is expected to increase tenfold by 2025, from about XAF 250 billion in 2015 to between XAF 2 150 and 2 450 billion (between EUR 3.3 and 3.7 billion). This transformation would make it easier to mobilise the funds needed for development and to offer less costly financing alternatives for governments and for businesses, while promoting larger investment projects, particularly at regional level.

Figure 9: Evolution of the official BEAC interest rate (tender interest rate at the end of period, %), 2009-2018



Source: BEAC (2019).

At sub-regional money market level, the BEAC decided to keep its official interest rate unchanged, after increasing it from 2.95% to 3.5% in late October 2018 (Figure 9). At the same time, the volume of interbank transactions increased sharply in late 2018, to reach EUR 1.4 billion, compared with 38.7 million two years

¹² A strategy consulting firm.

earlier. Finally, the central bank gradually reduced the volume of its interventions, in line with the still high level of surplus reserves and in accordance with the restrictive stance of the monetary policy adopted. Despite its short-term securities concentration, the market for government securities issued by auction has become increasingly active in recent months. Issues of government bills and bonds increased by 58.8% between May 2018 and May 2019, to reach EUR 1.5 billion.

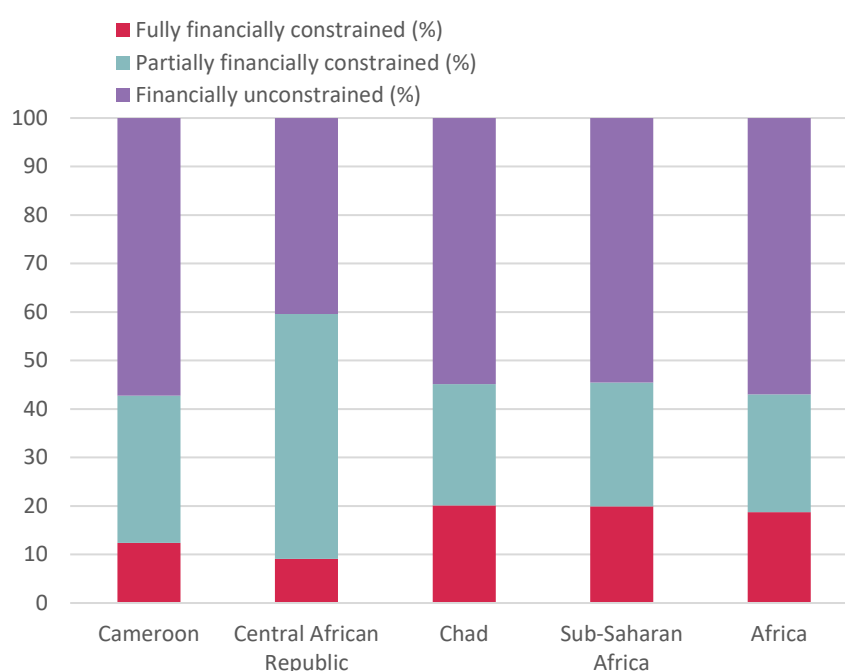
The success of the financial market of Central Africa, which is in the process of consolidation, will depend on the continuation of the reforms launched, namely the adaptation of the regulatory and fiscal framework, the strengthening of market players and the development of the offer. Indeed, the contribution of new securities, particularly from dynamic companies operating in sectors with high growth potential, would strengthen the depth and liquidity of the market, improve its image and attract more investors. Similarly, participation in this market by insurance companies, pension funds and non-resident investors (diaspora, etc.) would provide a further boost to the unified stock exchange.

Private enterprises and SMEs

Overview

Micro, small and medium-sized enterprises (MSMEs) make up the majority of the industrial fabric in CEMAC countries, yet they suffer from a chronic financing deficit. According to BEAC (2019c), 63.5% of bank lending was taken up by large companies in the CEMAC zone in the second half of 2018. SMEs were only able to take up 18.8% of bank financing during the same period.

Figure 10: SME financing constraints



Source: Enterprise surveys (World Bank, various editions).

SMEs in CEMAC are facing similar constraints to those encountered in sub-Saharan Africa or on the continent as a whole (Figure 10). For example, 43% of Cameroonian SMEs (46% of Chadian SMEs) are financially constrained, compared to 45% in the region. The situation is even more difficult (60%) for SMEs in the Central African Republic. Additionally, in CEMAC as in the rest of the region, micro-enterprises are generally even more constrained than SMEs. A majority (61%) of micro-enterprises in Cameroon (78% in

the Central African Republic) are either fully or partially financially constrained. In comparison, 53% of micro-enterprises in sub-Saharan Africa are fully or partially financially constrained.

Access to financing

CEMAC countries have to work more to close the gap with other sub-Saharan African countries in terms of loans to the private sector. However, the situation differs notably across countries in the zone (Table 8). Cameroon performs better than sub-Saharan Africa on average in terms of financial infrastructure, while Gabon and Equatorial Guinea are more or less in line with the regional average. Meanwhile, Congo, the Central African Republic and Chad have some catching up to do with the rest of the region. Although CEMAC's credit register coverage is well above that of sub-Saharan Africa, the quality of information on credit can be improved in the zone, with the exception of Cameroon, which stands well above sub-Saharan Africa in this respect. BEAC seeks to strengthen financial transparency throughout the zone and its financial information strategy foresees a regional credit register, a regional balance sheet database and credit information offices.

Table 8: Access to financing in CEMAC countries

Series / economy	Cameroon	Congo	Gabon	Equatorial Guinea	Central African Republic	Chad	CEMAC*	Sub-Saharan Africa
Obtaining loans, rank (1-190, least favourable)	73	134	124	124	144	144	124	115
Distance from the border (0-100, most favourable)	60	35	40	40	30	30	39	42
Strength of legal rights, index (0-12, most favourable)	6	6	6	6	6	6	6	5
Quality of credit information, index (0-8, most favourable)	6	1	2	2	0	0	2	3
Credit register coverage (% of adults)	11.1	12.4	29.0	8.7	4.6	2.6	11.4	7.0

Source: World Bank: *Doing Business (Obtaining credit indicators)*; authors' calculations.

Note: * CEMAC score is the arithmetical average for the monetary zone.

Table 9: Business lending and banking infrastructure in CEMAC countries

Series / economy	Cameroon	Congo	Gabon	Equatorial Guinea	Central African Republic	Chad	CEMAC*	Sub-Saharan Africa	Africa
Number of commercial banks	15	11	10	5	4	9	9.0	15.9	16.7
Number of commercial bank branches	303	94	97	37	14	70	103	522	731
Number of commercial bank branches per 1,000 km ²	0.7	0.3	0.4	--	0.0	0.1	0.3	9.9	9.7
Number of commercial bank branches per 100,000 adults	2.2	3.7	9.2	--	0.7	1.0	3.4	6.7	7.3
Total SME deposits with commercial banks (% GDP)	2.9	6.6	--	--	3.4	3.3	4.1	4.6	4.6
Total SME loans with commercial banks (% GDP)	4.7	2.2	--	--	5.7	5.1	4.4	2.9	3.6
Private sector credit (% GDP)	14.5	21.4	10.2	16.3	11.9	9.9	14.0	47.1	42.5
Bank credit ratio: bank deposits (%)	95.9	60.4	71.3	104.6	102.9	98.9	89.0	72.8	71.9
Lending to government and public enterprises (% GDP)	5.0	8.8	3.6	1.4	5.8	6.5	5.2	9.3	11.3

Source: IMF Financial Access Data, World Bank's World Development indicators and Global Financial Development; authors' calculations.

Note: * series for CEMAC are the arithmetical average for the monetary zone.

CEMAC countries still need to catch up with the rest of sub-Saharan Africa in terms of credit to the private sector (as a share of GDP) but surplus liquidity does not seem to be the problem anymore (Table 9). Banks hold significant shares of government securities in their balance sheets, presumably crowding out lending to the private sectors and SMEs. The bank credit-to-bank deposit ratio indicates that there is no longer surplus liquidity in banks across the zone, and certainly less than on the rest of the continent. In fact, SME loans are higher than SME deposits by the equivalent of 0.3 percentage points of GDP in the CEMAC.

Scaling up banking infrastructure and digitisation in the CEMAC region would go a longer way in boosting business financing in the zone, even more so than in sub-Saharan Africa and on the African continent as a whole. The banking sectors of CEMAC member countries are typically small, both in terms of absolute size and in terms of density. With the exception of Cameroon, the number of banks and branches in the CEMAC countries is lower than the average for the rest of SSA. The density of the bank branch network is also lower in Central Africa than in sub-Saharan Africa, both per km² and per number of adults. Generally speaking, SMEs are better served in the rest of Africa than in the CEMAC zone.

Table 10: Gaps in the market in access to finance by SMEs in CEMAC

Series / economy	Cameroon	Congo	Gabon	Equatorial Guinea	Central African Republic	Chad	CEMAC	Sub-Saharan Africa	Africa
Businesses with a savings or current account (%)	79.0	86.7	83.6	--	98.5	95.9	72.9	84.0	84.2
Businesses using banks to finance investment (%)	15.8	9.7	6.3	--	25.3	4.2	12.3	19.6	19.7
Businesses using banks for their working capital (%)	20.2	--	8.5	--	25.3	16.1	17.5	22.9	23.6
Businesses with an outstanding loan or line of credit (%)	14.2	12.8	9.0	--	26.0	20.6	31.3	23.9	24.9
Small businesses with an outstanding loan or line of credit (%)	11.3	15.1	4.1	--	27.7	25.4	16.7	17.2	18.1
Businesses identifying access to financing as a major constraint (%)	41.1	7.7	30.4	--	46.0	46.5	34.3	39.3	38.6
Businesses whose loan applications have been rejected (%)	35.5	12.8	--	--	23.8	--	24.0	14.9	14.6
Businesses that do not need a loan (%)	41.3	44.8	48.9	--	25.3	42.9	40.6	37.9	38.8

Source: *Findex Database 2017 (World Bank, 2017)*.

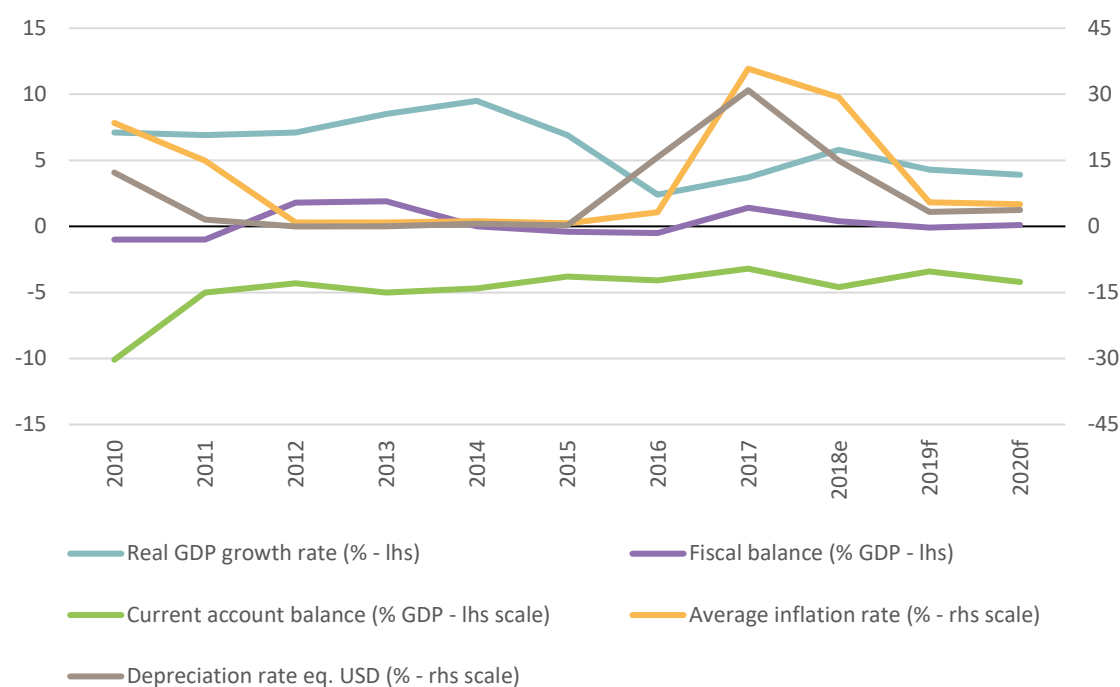
Businesses use banking services less in the CEMAC countries than in the rest of the African continent (Table 10). Cameroon performs well within the zone in terms of use of bank lending by businesses, but its situation remains inferior to that of sub-Saharan Africa on average. At the other extreme, some figures from the Central African Republic appear to be too optimistic to be correct and do not tally with anecdotal evidence. The lack of statistics for Equatorial Guinea suggests a very complicated situation in terms of access to financing for businesses.

Focus on the Democratic Republic of Congo

The political situation of the Democratic Republic of Congo (DRC) is normalising, and the intentions declared by the authorities have put its diplomatic relations with its development partners back on track. The inauguration of former opposition candidate Félix Tshisekedi as president of the DRC and the formation of a new coalition government reflect positive developments in the country's political environment. The government nevertheless faces many challenges, including restoring order in the East. The country remains dependent on budget support, i.e. donor financing, to achieve its development ambitions, particularly in the field of education and IMF support to ensure the stability of its external balance.

The DRC economy has its potential strengths, but growth remains non-inclusive and dependent on the country's mining revenues. The DRC is one of the richest countries on the African continent in terms of natural resources, with two-thirds of Africa's tropical forests, huge hydroelectric potential (100 000 MW), 80 million hectares of arable land, and over 1 100 minerals and precious metals. With nine bordering countries, the DRC occupies a strategic position on the continent. It is also the largest country in French-speaking Africa in terms of population - nearly 95 million inhabitants - and the second-largest country in Africa in area - 2.3 million km². The DRC has an economy that mainly relies on extractive industries, and it is the world's largest producer of cobalt and the fifth-largest producer of copper. Yet, growth remains highly dependent on commodity prices and on Chinese demand for the country's minerals.

Figure 11: Key macroeconomic indicators in the DRC



Source: IMF (2019a); authors' calculations.

Although macroeconomic stability has been undermined by the monetisation of the budgetary deficit, growth has been strengthening since 2017 (Figure 11). The inflation and depreciation seen in 2017, coupled with political uncertainty, have caused a shrinkage in credit to the private sector and an increase in the economy's 'dollarisation'¹³. The economy hit a low point between 2016 and 2017 but it has started to stabilise since 2018. Official foreign exchange reserves fell from 1.7 months of imports of goods and services to less than 2 weeks in 2017 as the central bank was sterilising the growth of money supply. A minimum of three months' coverage is usually viewed as required to ensure balance of payments stability. Economic growth is expected to reach 4.3% and 3.9% in 2019 and 2020, respectively, compared with 3.9% in 2018. Additionally, growth outside the extractive sector is also expected to be strong and is forecast to be 4.4% and 3.9% in 2019 and 2020, respectively. These improvements are taking place despite an inflation rate that reached 35.8% in 2017 and was accompanied by a depreciation in the national currency of 31% against the US dollar.

¹³ The Congolese banks are highly 'dollarised'. The majority of their balance sheets are expressed in US dollars. Similarly, deposits, like loans, are primarily made up in this currency.

Table 11: Evolution of the main macroeconomic indicators in the DRC

Indicator / year	2016	2017	2018 (e)	2019 (p)	2020 (p)
Private sector credit/GDP	6.0%	7.0%	5.0%	5.1%	4.8%
Growth in private sector credit	22.6%	-4.3%	-23.1%	40.4%	4.3%
Loans/Assets	44.2%	45.7%	35.6%	38.7%	35.1%
Public debt (% GDP)	19.3	18.1	15.7	14.0	13.2

Source: Central Bank of the Congo, IMF (2019b); authors' calculations.

The IMF considers the debt sustainability risk to be moderate and, after declining in 2018, credit has risen again (Table 11). The DRC does have some sustainable indicators, for example in terms of public debt, which stood at 15.7% of GDP in 2018, and budgetary deficit, which was contained at 0.5% of GDP. The country has enacted a new mining code to increase its mining royalties, but its tax revenues - representing 9-10% of GDP - remain low in relation to the quantity of minerals it produces.

Table 12: Performance indicators for the banking sector in the DRC

Items / year	2015	2016	2017	2018	June 2019
Adequacy of capital					
Regulatory capital/risk-weighted assets	20.4%	9.0%	16.0%	14.2%	14.8%
Tier 1 regulatory capital/risk-weighted assets	16.7%	12.0%	14.2%	11.9%	12.5%
Asset quality					
Non-performing loans/gross lending	18.3%	18.1%	16.1%	16.8%	16.0%
Non-performing loans net of provisions/capital	56.1%	67.80%	45.8%	39.8%	34.2%
Income and profitability					
Return on assets (net income/total assets)	1.5%	-1.4%	-0.1%	1.1%	0.3%
Return on equity (net income/equity)	17.3%	-21.3%	-0.6%	14.2%	3.9%
Interest margins on gross income	37.6%	35.8%	35.4%	31.3%	43.9%
Expenditure exclusive of interest on gross revenue	77.9%	76.4%	73.5%	78.0%	76.1%
Liquidity					
Liquid assets, of total assets	53.4%	47.5%	55.8%	50.2%	52.9%
Liquid assets, of total short-term deposits/liabilities	117.7%	119.0%	125.6%	153.9%	159.3%
Sensitivity to market risks					
Net open position in foreign currency/equity	0.0	0.0	0.0	-6.6%	5.87%
Liabilities denominated in foreign currency/total liabilities	81.8%	82.8%	77.2%	74.6%	74.4%
Loans denominated in foreign currency/total loans	85.6%	85.1%	93.7%	93.5%	93.8%

Source: Central Bank of the Congo.

Banking activity is developing favourably against a background of fairly significant challenges, and financial stability indicators in 2018 were above the minimum regulatory requirements (Table 12). The banking landscape in the DRC features 17 banks, representing most of the financial sector, concentrated in

the major urban centres. Two banks experiencing difficulties were, however, forced to cease operating. These are BIAC, which had to be dissolved, and Byblos Bank RDC, which has remained 'inactive' following the withdrawal of its majority shareholder. The top 10 banks in the DRC account for nearly EUR 3.9 billion in assets. The three largest institutions are owned by foreign entities: Rawbank (Rawji family), Banque commerciale du Congo (Equity group) and Trust Merchant Bank (Robert Levy). However, the rise of major pan-African banks (Ecobank, Bank of Africa, Equity Bank, etc.) could change this situation in the medium term. In June 2019, the overall capitalisation ratio was 14.8% against a standard of 10%; 12.5% for basic capitalisation (Tier 1) against the 6% standard, and 159.3% for the overall liquidity ratio, above the minimum of 100%.

Table 13: Evolution of banking sector assets in the DRC (in USD million)

Items / year	2015	2016	2017	2018	June 2019
Customer loans	2 308.5	2 210.1	1 873.5	2 591.7	2 817.2
of which long-term loans	209.3	212.0	126.6	247.2	272.4
of which medium-term loans	706.5	575.1	604.9	743.8	908.4
of which short-term loans	1 149.2	1 209.9	942.1	1 394.3	1 495.2
Loans and advances to credit institutions	431.0	375.4	796.7	941.5	1 488.2
of which loans and advances to local banks	48.3	3.0	8.8	16.1	60.9
of which loans and advances to foreign banks	382.7	372.4	787.9	925.4	1 427.3
Deposits with Congo Central Bank	430.4	371.3	303.1	488.6	792.3
Congo Central Bank Bonds	15.9	7.0	14.6	26.0	27.4
Other assets	29.8	45.9	112.0	229.5	197.9
Total assets	5 220.6	4 837.9	5 267.2	6 695.2	8 032.1

Source: Central Bank of the Congo.

Key indicators of banking activity saw good progress in 2018 and increased at various levels (Table 13). The balance sheet total grew by 30.6% annually to USD 6.9 billion. Deposits collected increased by 28.7% and amounted to around USD 4.7 billion. Gross lending for cash disbursement grew by 44.5% and amounted to USD 2.9 billion. This lending was primarily directed towards the trading sector.

However, bank profitability could still be improved, and the quality of assets also calls for greater caution. The net cost-to-income ratio stood at 73.54% in 2018, compared with 78.02% in 2017, against a usual average of 60%. Similarly, the return on assets and that of core capital stood at 1.07% and 13.09%, compared with acceptable standards of 3% and 10%, respectively. The NPL ratio rose to 17% in 2018, from 16% in 2017, while the regulatory standard is 5%. That being said, provisions set aside to cover non-performing loans as at end of December 2018 were 67%, compared with 45% in late December 2017.

There is still considerable room for improvement in the bank account penetration for the country's financial institutions. Despite bank account penetration for civil servants' payroll, only around 6% of adults have a bank account, well below the 25% average for sub-Saharan Africa (Deloitte, 2018). In this respect, agency banking and digitisation are major assets for the expansion of bank account penetration¹⁴. According to the latest figures available from the Congolese Postal and Telecommunications Regulatory Authority, the mobile penetration rate would have reached 41% in the third quarter of 2018.

A series of regulatory reforms could finally lead to profound changes in the sector. The Central Bank of the Congo has issued several regulatory texts: the minimum capital requirement of USD 30 million¹⁵, which came into force from 1 January 2019, a list of banking services offered free of charge, amendments to

¹⁴ This is a strategy of outsourcing certain simple banking activities to third-party agencies or retailers.

¹⁵ Compared to USD 10 million previously.

prudential rules on internal control and compliance, etc. With a new organic law, this authority also intends to cap foreign currency transactions at USD 10 000 in order to initiate the 'de-dollarisation' of the Congolese economy.

Conclusions

Notable progress has taken place in CEMAC with respect to the business climate but there is still a significant margin for improvement, in particular with respect to the quality of public governance. For the zone' countries to improve their standings in the UNDP's human development index, growth would need to become more inclusive and inequalities within the region's countries would need to be tackled more systematically. For example, Gabon is ranked as an upper-middle-income country by the World Bank, but UNDP ranks it 110th out of 189 countries in 2017 in terms of human development, with an average number of years' schooling of just over 8 years. Meanwhile, Cameroon is ranked as a lower-middle-income country by the World Bank, but UNDP ranks it 151st, with an average number of years' schooling of just over 6 years. Non-oil growth acceleration is key to CEMAC countries meeting their aspirations to the status of emerging economies and to meaningful poverty reduction. In turn, the key to strengthening growth outside the oil sector is the continuation of reforms aimed at boosting competitiveness, particularly in the field of access to credit, the business climate and infrastructure.

Despite some progress, there are still numerous challenges to be overcome to enable the region's financial sector to fulfil its role as a catalyst for growth, and to support the zone's economic and social development objectives. In this context, the region's banking sector remains exposed to shocks in the oil sector, particularly in connection to the rise in NPLs. It also faces other challenges related to prudential regulation, specifically the transposition of Basel III. In addition, capturing long-term savings should contribute to the development of long-term financing, both of which are key instruments for meeting the investment and diversification needs of the zone's economies. Insurance companies operating in the sub-region, for their part, struggle to adapt their offers to the characteristics of the market and to invent new, less costly, forms of distribution. The success of the financial market in CEMAC depends on the adaptation of the regulatory and fiscal framework, the strengthening of market players and the development of the offer.

The digitisation of financial services is increasingly gaining ground in CEMAC, such as through the modernisation of payment methods (electronic transactions, magnetic-swipe cards, etc.), digital cash interoperability, and then the launch of mobile banking solutions by the zone's big banks. This development is still limited, due to the high cost of this transition and the lack of infrastructure. The bank account penetration in the zone is still only around 15%.

From the economic and political perspectives, the DRC is at a crossroads. These two perspectives are currently particularly closely linked. The new government, and in particular the new head of state, has created expectations among Congolese citizens and among development partners. Citizens expect to see an improvement in their purchasing power, and more generally an improvement in their economic well-being, including public services such as education. For its part, the Congolese banking sector has once again demonstrated its resilience. However, financial inclusion has significant room for improvement in the country. Indeed, the country's financial sector has a key role to play in making the growth more inclusive and less dependent on commodity prices.

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Banking in East Africa: recent trends and developments

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Summary

Economic growth is expected to remain solid across East Africa. GDP growth is expected to accelerate at close to 6% in 2020 and 2021 - up from 5.5% in 2019 and above the average for sub-Saharan Africa (SSA) - as infrastructure investments across the region (particularly in Ethiopia, Rwanda and Tanzania) give an extra boost to domestic demand.

However, public finances are expected to continue to deteriorate over the coming years. Slow growth in the recent past and the impact of electoral cycles have led to an increase in budget deficits in the region and a corresponding increase in public debt. Despite the acceleration of GDP growth, public deficits remain high and government debt stocks continue to grow. Most countries, even those with more comfortable debt positions, are increasingly vulnerable to shocks.

All in all, risks to the outlook are tilted to the downside. In the short run, the main risks stem from potential external shocks: i) a halt or decrease in foreign capital flows due to an increase in global risk aversion; ii) a negative impact on exports and investment due to a more pronounced slowdown of the global economy; and iii) generalised depreciation pressure on local currencies, which could in turn increase inflationary pressures and also deteriorate the regional fiscal position.

Financial inclusion has improved more significantly in East Africa than in other regions, but access to finance remains the main bottleneck for companies throughout the region, although less so in the bigger economies. This is particularly the case for small and medium-sized enterprises (SMEs) and micro-enterprises. In some countries, lending to the public sector is crowding out private credit. Mobile accounts and financial inclusion are improving unevenly across the region. Despite generalised access in countries such as Kenya, in some countries less than 5% of the population uses digital banking or payment systems.

The financial sector in East Africa remains stable. In recent years, the performance of the banking sector in East Africa has been underpinned by a favourable economic outlook and regulatory developments. Macroeconomic policies have been broadly sound and supportive of solid performance of the financial sector. The improvement in economic activity in 2018 and 2019 dispelled some of the fears that followed the deceleration in 2016 and 2017. Going forward, the performance of the regional banking sector will continue to depend on the extent to which the banks address not only the downside risks to the economic outlook, but also the challenges related to regulation and digitalisation.

Macroeconomic overview

East Africa is a diverse region but has common development obstacles. The unweighted average per capita GDP in the region is USD 2 616 (in PPP-adjusted terms) ranging from USD 753 in Burundi to USD 4 675 in South Sudan. Countries in the region also vary widely in population size, with Ethiopia being the most populous with 93 million inhabitants, followed at some distance by Tanzania with 49 million and Kenya with 47 million, while other countries like Burundi (10 million) are sparsely populated. With the exception of Kenya, East African countries are low-income and low-human development economies, heavily dependent on agriculture. The rate of population growth is relatively high, exerting pressure on youth unemployment. Still, on a more positive note, the private sector is more buoyant than other regions in Africa and has great potential for development and job creation, while facing several constraints, of which access to finance is a major example.

The business climate is uneven across the region. Business conditions in Rwanda and Kenya are already better than in most African countries and improved further in 2019 as some of the World Bank's recommendations, particularly regarding land and company registration, have been implemented. On the other hand, in Tanzania and Uganda business conditions are lagging behind and have actually slightly deteriorated in recent years. Ethiopia, Sudan, South Sudan and especially Eritrea compare even less favourably: business conditions in these countries are among the least supportive on the continent and barely improved in 2019. Improving business conditions is critical for attracting foreign investment, which remains subdued at 1.5% of GDP (even in Kenya, it only reached 1% of GDP in 2018).

Economic growth is expected to remain solid across the region. East Africa remains the best performing economic region in SSA. GDP growth in the region is expected to reach 5.5% in 2019, down from 6% in 2018. This deceleration stems mostly from the fact that the 2018 figure represented a strong rebound, when most economies expanded substantially as the impact of severe droughts and political instability registered in the previous year faded away. Still, Ethiopia, Rwanda and Uganda are all set to record GDP growth rates above 6% in 2019 with Rwanda leading at 8.5% (Figure 1). Tanzania is expected to be the worst performer, with growth decelerating to 5.5%, the lowest since 2009. Going forward, regional economic growth is projected to pick up to 5.8% in 2020, and to accelerate further to 6.2% in 2021, as infrastructure investments across the region but particularly in Ethiopia, Rwanda and Tanzania give an extra boost to domestic demand.

Figure 1: Real GDP growth (%)

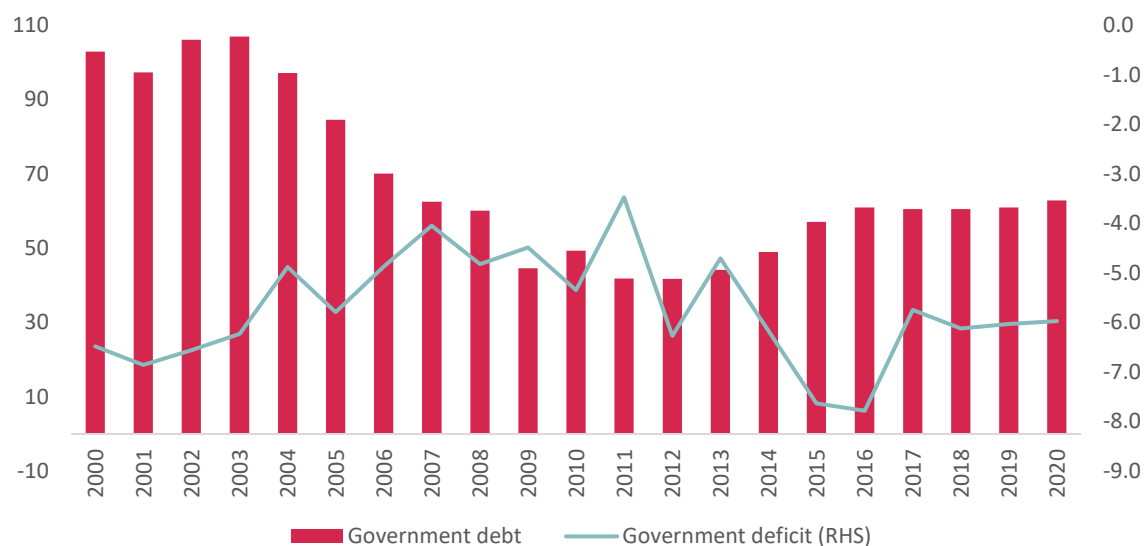


Source: IMF, World Economic Outlook.

The recent deterioration in public finances is likely to continue in the coming years. The deceleration in economic activity that took place between 2014 and 2017 and the impact of electoral cycles led to an increase in the average budget deficit in the region to close to 8% of GDP in 2015 and 2016 (Figure 2). The fiscal deficit declined to 6% of GDP in 2017 but has remained unchanged since then. This trend is common across the region, with the exception of Ethiopia, where the fiscal deficit is expected to decline significantly over the next few years from 6% of GDP in 2018 to close to 3% by 2020. Persistent fiscal deficits have, in turn, increased the average public debt by 23 percentage points since 2011. The IMF expects public debt as a share of GDP to reach 63% in 2020 and to continue to increase to 65% by 2023. And while this level is still substantially below the maximum of 100% reached in the early 2000s (before the debt relief under the Heavily Indebted Poor Countries (HIPC) initiative), this recent trend is already undoing some of the positive results achieved under the HIPC initiative. Furthermore, this level of debt is subject to significant risks. According to the IMF, debt sustainability risks are higher in Ethiopia, Kenya, Rwanda and Sudan. Overall, most countries in the region, even those with more comfortable debt positions, remain highly vulnerable to shocks, emanating from exchange rates, interest rates or the price of oil. As a result, the long-term sustainability of public finances in the region depends on the swift implementation of credible fiscal reforms.

Inflation decelerated across the region as monetary policy remained neutral and weather conditions improved in 2018 and 2019. Severe draughts in 2016 and 2017 led to poorer crops and less agricultural production, which in turn pushed inflation higher. Still, this increase in prices was much more subdued than in the past as macroeconomic policies implemented across the region were able to contain second-round effects so that inflation remained substantially below the figures seen during previous price level spikes. In 2018 and 2019, inflation declined across the region, in some countries, like Rwanda and Uganda, to below 4%. More recently, in 2019, the introduction of new taxes on fuel and telecommunications in Kenya and Uganda led to a short-term spike in prices but given the conservative monetary policy stance, this has not led to any second-round effects.

Figure 2: Average government debt and deficit in East Africa (% of GDP)



Source: IMF, World Economic Outlook, authors calculations.

All in all, economic risks are tilted to the downside on the back of higher public debt, increasing uncertainty surrounding the global economic outlook and the region’s exposure to external shocks. The first potential shock could come from a halt or decrease in foreign capital flows due to an increase in global risk aversion. The second relates to a negative impact on exports and investment stemming from a more pronounced slowdown of the global economy than is currently forecast. Finally, an increase in global risk aversion and a halt in foreign capital flows might also lead to generalised depreciation pressure on local currencies, which could in turn increase inflationary pressures and also deteriorate the regional fiscal position.

Banking sector

Overview

Countries in East Africa enjoy varied levels of financial sector development. However, all countries share a common feature: they have bank-led financial sectors. The relative importance of the Kenyan banking system in the region is demonstrated by the level of domestic credit as a share of GDP, which is substantially higher than in the other economies (Table 1).

Table 1: Domestic credit to the private sector (share of GDP)

	2013	2014	2015	2016	2017	2018
Burundi	20.3	18.9	17.4	16.7	16.4	16.7
Kenya	30.6	29.5	31.7	34.1	34.4	32.8
Rwanda	16.0	18.5	19.2	20.8	21.1	21.2
South Sudan	0.4	1.3	1.6	1.9	2.7	-
Tanzania	12.6	13.0	13.0	13.8	15.2	14.3
Uganda	15.8	14.0	13.9	14.9	15.6	15.9

Source: World Development Indicators, World Bank.

Market dynamics in each of the economies - and especially how they relate to cross-border banking operations - demonstrate the unique characteristics of the market. For international banks, cross-border banking is usually seen as a means of entering new, often less-developed markets and fostering enhanced competition, financial stability and increased access to credit (World Bank, 2018). East Africa is no exception to this rule. Even in the context of sub-Saharan Africa, the nuances that make the East Africa market distinct from the general situation are not immediately apparent. For instance, the implicit assumption that the leading pan-African banks - notably South Africa's Standard Bank and Togo's Ecobank - are the core drivers of cross-border banking momentum in East Africa is not borne out in reality. Kenyan-domiciled banks have the biggest footprint in the region and play a more significant role there than other pan-African banks, as the size of the Kenyan economy has provided them with the scale necessary to do so (Table 2).

Table 2: Number of banks relative to the size of the economy

	Nominal GDP - USD bn (2018)	Number of banks
Burundi	3.4	10
Kenya	79.5	43
Rwanda	9.2	11
South Sudan	2.9	22
Tanzania	51.7	40
Uganda	26.3	24

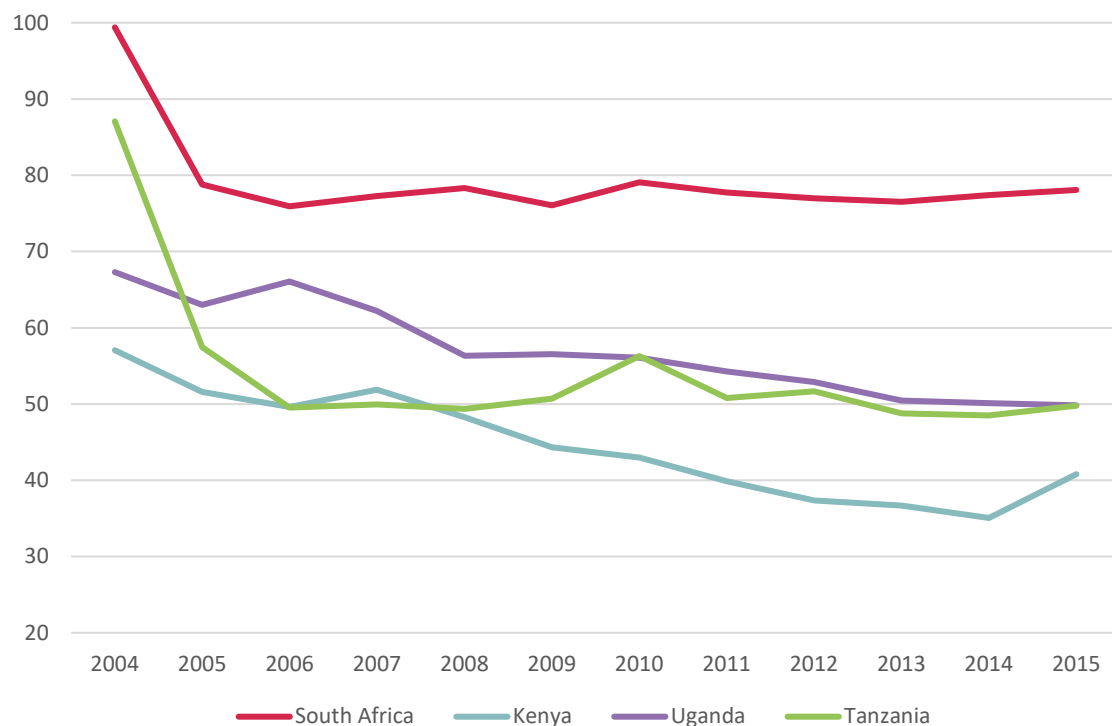
Source: IMF World Economic Outlook, National Central Banks.

Kenyan banks have increasingly looked for cross-border opportunities. This is due to several factors such as increasing regional integration, competition in the local market and the presence of strong local banks that have supported Kenyan banking by becoming important players in the region. The position of the Kenyan banking sector is underpinned by the dominance of local players, unlike in Uganda and Tanzania where the banking systems are dominated by foreign bank ownership.

The banking sector in East Africa has a lower concentration than other regions on the continent. If we take the concentration ratios - defined as the share of banking assets held by the largest three banks in a

given economy - the banking sectors of the three largest regional economies are less concentrated than the most advanced market in Africa (Figure 3)³. Less concentration is by no means an indication of relatively more market competition given that the nexus between concentration and competition is tenuous (Berger et. al., 2004). In Rwanda, concentration is higher but has been declining. The central bank indicates that the assets of the largest three banks have declined from 57% in June 2009 to 46% in June 2019, a trend largely attributed to the entry of new players to the market. The influence of foreign (mostly Kenyan) institutions on this trend is evident as they accounted for 48% of the total assets of the banking system by the end of June 2019 compared to 25% by the end of June 2009. Still, despite the low concentration, more needs to be done to increase competition. The competition-enhancing measures continually being implemented in East Africa include regulatory initiatives to improve pricing transparency, legal reforms to address property rights and freedom to compete in the economy.

Figure 3: Market concentration (%)



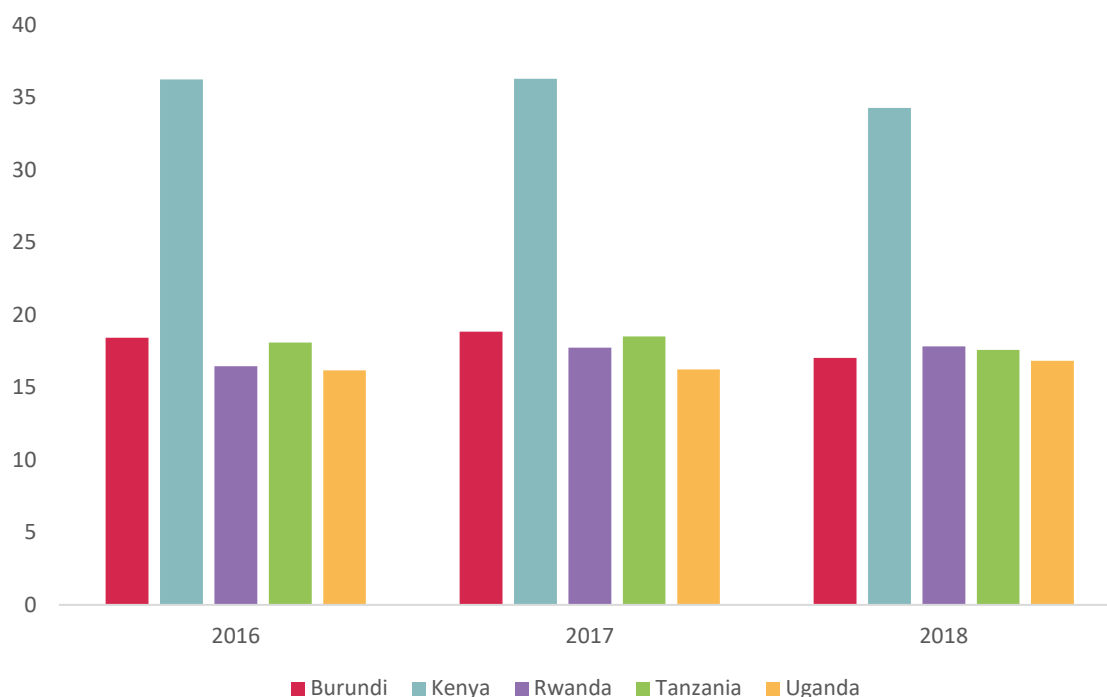
Source: World Bank Financial Structure Database (June 2018 version).

Note: Concentration is measured as the share of banking assets held by the three largest banks.

³ Notably, whilst the financial systems of Tanzania and Uganda are considered less developed than those of a middle-income country such as South Africa, they are still less concentrated.

The financial systems of East African economies are all dominated by banks. However, system depth differs from country to country. While the Kenyan economy has the highest nominal output, the level of deposits mobilised by the system is significantly higher than that of the other economies (Figure 4).

Figure 4: Financial system deposits, % of GDP



Source: World Bank Financial Structure Database.

Performance

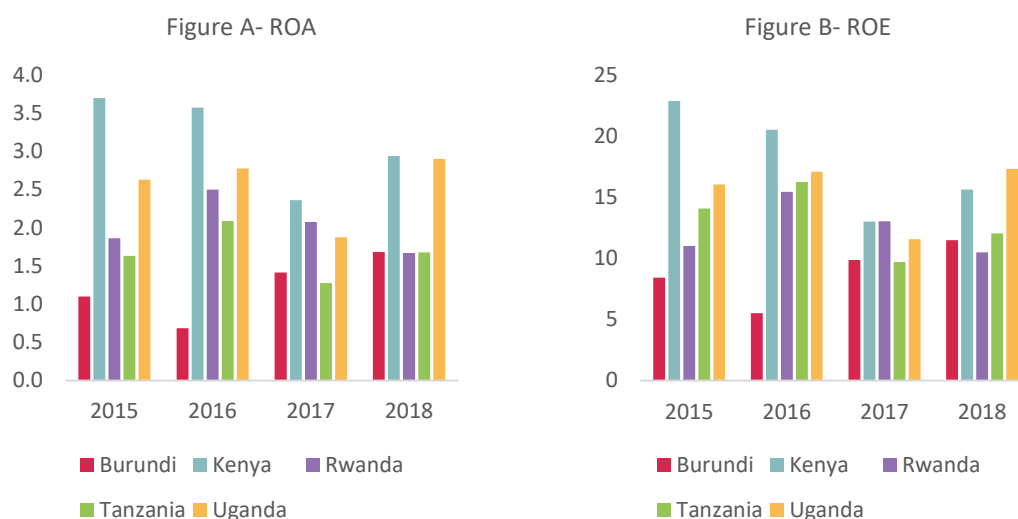
In recent years the performance of the banking sector in East Africa has been underpinned by largely favourable macroeconomic developments. The performance of any banking sector is a function of the interplay between the economy, the broader macroeconomic policy environment and regulatory developments that influence market stability. East Africa is no exception. In recent years, macroeconomic policies have been broadly sound and supportive of strong financial sector performance. The deceleration in economic growth in 2016 and 2017 led to a deterioration of banking sector performance (including the closure of relevant domestic banks in Kenya and Uganda). However, the subsequent improvement in economic activity in 2018 and 2019 helped to contain risks, while regulation played a more negative role. This was particularly true in Kenya, with the interest rate caps that were introduced in 2016 and removed in October 2019 leading to a significant reduction in interest margins and credit growth⁴.

The profitability of the banking industry in East Africa is mixed. A historical perspective of banks' return on assets (ROA) and return on equity (ROE) shows a banking industry that is generally profitable, albeit with mixed performance over time and across countries (Figure 5a and Figure 5b). Instances of very high ROE during the earlier part of the new millennium in Rwanda, Uganda and Tanzania are attributed to market imperfections associated with relatively limited depth compared to Kenya, where such returns have been fairly consistent except in 2002 when economic shocks jolted banks' performance. More recently, the sector's profitability has been stable. The evolution of the sector's ROE over time reflects the gradual

⁴ According to estimates from several institutions including the Central Bank of Kenya, IMF and World Bank.

improvement in market depth associated with deliberate efforts being made to address imperfections in the form of capital, product design and the extent of market competition.

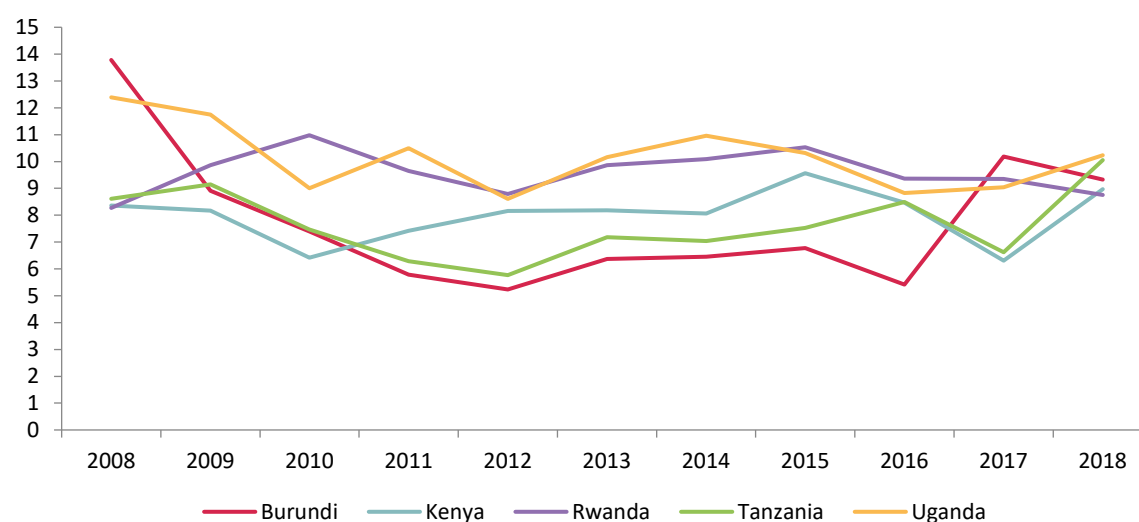
Figure 5: Banking profitability indicators



Source: World Bank Financial Structure Database.

Interest rate margins have largely remained within the upper single digit range (Figure 6). The net interest margins in Uganda and Rwanda have consistently been higher than those of the other three economies, although this figure has been declining in Rwanda more recently. Kenya's banking sector registered a net interest margin somewhat below the other economies in the region, but that is likely to change over the next few years following the removal of the interest rate cap that was in place between September 2016 and October 2019.

Figure 6: Net interest margin, %



Source: World Bank Financial Structure Database.

The recovery of private sector credit growth was accompanied by a decline in non-performing loans (NPLs) across the region. According to the IMF data, as of December 2018, Burundi had the highest NPL ratio at 12.7% followed by Kenya with 11.7%, and Tanzania and Rwanda with 9.9% and 6.5% respectively. Uganda had the lowest NPL ratio at 4.3%. And while these ratios are still high, NPLs have come down from their highest levels during 2016 and 2017, when they reached 19%, 14%, 11.1%, 7.7% and 5.5% in Burundi, Kenya, Tanzania, Rwanda and Uganda, respectively. The main driver of the decrease in NPLs was the economic performance that led to an improvement in asset quality but also faster credit growth. The high level of NPLs in Burundi is particularly worrisome. Not only is the Burundian economy small by regional standards, but it has also been growing at the slowest pace in East Africa due to political challenges and uncertainty.

Challenges

Maintaining macroeconomic stability remains critical across the region. The stable macroeconomic environment and inflation outlook have enabled central banks in East Africa to cut their reference interest rates to accommodate negative external shocks, without leading to significant currency depreciations. While the transmission of monetary policy to the real economy through the credit market has been impaired by the control of interest rates in Kenya, in the other economies, lower central bank policy rates led to a reduction in lending rates. The National Bank of Rwanda (2019), for instance, signalled an accommodative monetary policy in December 2017 by lowering the central bank rate from 6.0% to 5.5%, and lowering it further to 5.0% in May 2019. This was met with a positive response both in the outstanding credit to the private sector and in new authorised loans. The Bank of Uganda has also pursued an accommodative monetary policy stance with a positive impact on private sector credit demand.

The deterioration of public finances across the region is likely to crowd out private sector resources in favour of government financing needs. Higher public debt ratios and funding needs will increase the supply of government debt in the market. This increase in competition for funding could in turn influence not only private sector credit growth but also banking sector funding, since governments, private companies and banks will compete for funds. This crowding out effect could be further exacerbated in the next few years as the banking sector is moving beyond 2018 - the year of the transition to the IFRS9 asset classification - which will be particularly significant in Kenya.

The adoption of new technologies will also be a challenge for banks in the East African region. Banks will need to continue deploying technology for efficiency and cost management together with product designs that utilise the analytical capability provided by abundant data. In line with global practice emerging in the period following the global financial crisis, the regulation of bank compliance will go beyond monitoring personnel to also include complementary algorithms – so-called RegTechs. This will expand the use of information technology to enhance regulatory processes. Investments in technology are therefore expected to remain critical to ensuring that banks remain compliant with regulations – covering issues ranging from capital, corporate governance and all disclosures to anti-money laundering and combating the financing of terrorism (AML/CFT).

Country in focus: Kenya

In recent years, the Kenyan banking sector has experienced some country-specific developments. First, the Kenyan banking system is emerging from the volatility experienced in 2015 and 2016 arising from the collapse of three banks. Second, the economy has been registering strong output but with a noticeable slowdown in private sector credit growth. Third, the banking sector had to adjust to the interest rate controls that do not apply in the other economies in the East African region.

I) First, the Kenyan market has settled following the cyclical volatility of 2015-2016. Kenyan banks are emerging from the volatility experienced in 2015-2016 due to the collapse of three banks. The return to

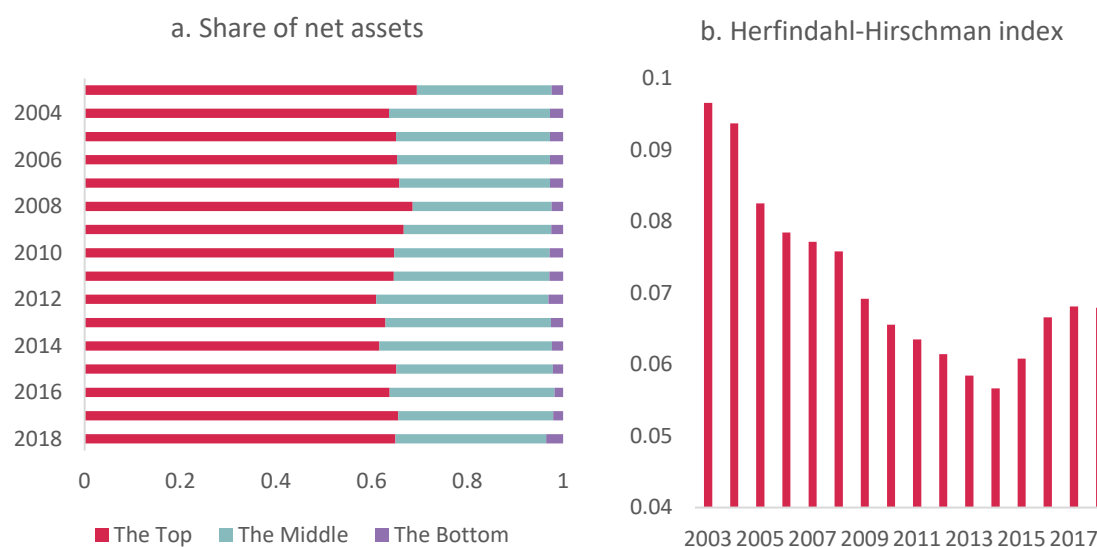
stable market conditions is a testament to the Central Bank of Kenya's (CBK) supervisory framework, which prevented market challenges from becoming systematic. With the resolution of one of the banks under receivership in 2018 and the positive strides taken in the resolution of the other bank under receivership, the market is progressing towards full normalisation. However, the disparities in access to finance by small banks and big banks are such that in the event of a market shock, liquidity flow is disrupted as the inter-bank market almost ceases functioning (Osoro and Muriithi, 2017). The CBK's lender-of-last resort window is available. However, the *Bagehot conditions* - the central bank disposition to (i) lend without limit (ii) to solvent but illiquid financial market players (iii) against good collateral (iv) at high rates - increase the funding costs to lower-tier banks that are more likely to have to resort to this window.

II) Despite CBK's accommodative monetary policy stance, credit conditions have remained tight (IMF, 2018). Real economic output has been on an upward trajectory, but real growth of bank credit to the private sector has remained negative. This creditless growth (World Bank, 2019) may, in turn, have implications for banks' financial performance and the growth outlook going forward. A balancing act by the CBK is needed to avoid a growthless credit recovery (Juselius and Dremann, 2014). The evolution of asset quality and lenders' risk-taking attitudes are crucial variables in this connection. The banking sector's non-performing loans (NPLs) have been on the rise, especially over the past three years. Their gross level as a proportion of gross loans has entered double digits in two of the last three years, around 12% in 2017 and 2018, up from 9.4% at the end of 2016.

III) The Kenyan banking sector had to adjust to the introduction of caps on lending rates that were recently removed. These have seen the market: (i) gradually shift away from segments considered riskier; (ii) seek to optimise on investments that balance returns and asset quality; and (iii) respond to both risk and return balance depending on liquidity positions, which in themselves are a function of size of the bank and the chosen market segment. In turn, the shift away from risky segments, and the risk-return balance have influenced banks' increased investment in government securities. Additionally, Kenya's fiscal deficit has remained high and its public debt is increasing, clouding medium-term growth (IMF, 2018) and potentially crowding out private sector lending and investment (Lidiema, 2017; Chebet and Kiemo, 2017).

Kenya's banking system can be characterised as relatively concentrated. Figure 7a shows that between 2003 and 2018, the share of net assets for the top 10 banks in the economy has consistently exceeded 60% of the entire sector while that of the bottom 10 banks has consistently been below 4%. The middle pack, consisting of more than 20 intermediaries, takes up the rest of the share. The average asset share of nearly three-quarters of market players is therefore small. This indicates how small average asset size is for nearly 30 banks in the Kenyan system. Figure 7b tracks the extent of market concentration as measured by the Herfindahl-Hirschman Index (HHI) and indicates that its downward trend from 2003 to 2014 reversed in the subsequent period.

Figure 7: Kenya's banking sector concentration indicators



Source: Kenya Bankers Association Database.

Note: a) Top represents the top 10 Kenyan banks, bottom represents the bottom 10 banks and middle represents the remainder of banks.

b) Herfindahl-Hirschman Index is computed as the sum of the squares of market shares of all the banks. An increase in the index means a higher market concentration.

Private enterprises and SMEs

SMEs and micro-enterprises are the backbone of economic activity in East Africa, even more so than in other regions. East Africa is less resource-dependent than other regions on the continent, and the private sector therefore plays a more critical role, generating close to 40% of the different countries' economic output and roughly the same share of average gross value added. The contribution of this sector to employment is substantially more important as it is estimated to account for more than 80% of total employment.

Table 3: Characteristics of East African firms, %

	All	Small (5-19)	Medium (20-99)	Large (100+)
Percentage of firms with a legal status of sole proprietorship	59.15	73.96	48.05	33.59
Proportion of private domestic ownership in a firm (%)	83.45	88.21	73.84	55.87
Percentage of firms with female participation in ownership	18.54	20.72	25.03	25.26
Percentage of firms with a female top manager	11.91	15.54	11.25	3.47
Proportion of permanent full-time workers that are female (%)	24.56	28.68	17.72	19.25
Percentage of firms exporting directly (at least 10% of sales)	14.32	6.89	15.37	28.41
Number of workers	25.45	10.12	35.87	150.23

Source: World Bank Enterprise Surveys, most recent years.

Companies in East Africa are mainly domestically owned and focused, and most are under sole proprietorship. According to the most recent data from the World Bank Enterprise Surveys, summarised in Table 3, most firms (84%) are domestically registered and under sole proprietorship (59%). Most are active in the domestic markets: only 14% export more than 10% of their sales. Larger firms are more likely to be more externally exposed: 28% of firms with more than 100 employees export at least 10% of their sales. Companies employ an average of 25 individuals, with small firms employing an average of only 10 workers.

East Africa’s women are less likely to own a firm than men and are underrepresented in the workforce. On average, close to 19% of companies covered by the World Bank Enterprise Surveys have female participation in their ownership. However, this varies significantly from country to country. For example, in Rwanda almost 45% of surveyed firms have a female owner, whereas in Uganda this number only reaches 20%. Furthermore, most staff in the formally registered firms surveyed by the World Bank are male (75%). Women have higher participation rates in smaller companies, both in management and in the workforce, but the share of ownership still only reaches 25% for medium companies and the proportion of female workers is less than 30% for small companies.

Table 4: Main obstacles to investment, %

	All	MSMEs
Access to finance	22.1	26.3
Access to land	4.4	2.1
Business licensing and permits	2.8	2.6
Corruption	6.1	5.8
Courts	0.4	0.3
Crime	1.8	1.1
Customs and trade regulations	4.6	2.1
Electricity	15.1	16.9
Educated workforce	1.7	0.8
Labour regulations	0.6	0.4
Political instability	4.7	3.5
Practices of the informal sector	12.2	8.5
Tax administration	4.3	5.1
Tax rates	15.9	17.3
Transportation	3.4	7.2

Source: World Bank Enterprise Surveys, most recent years.

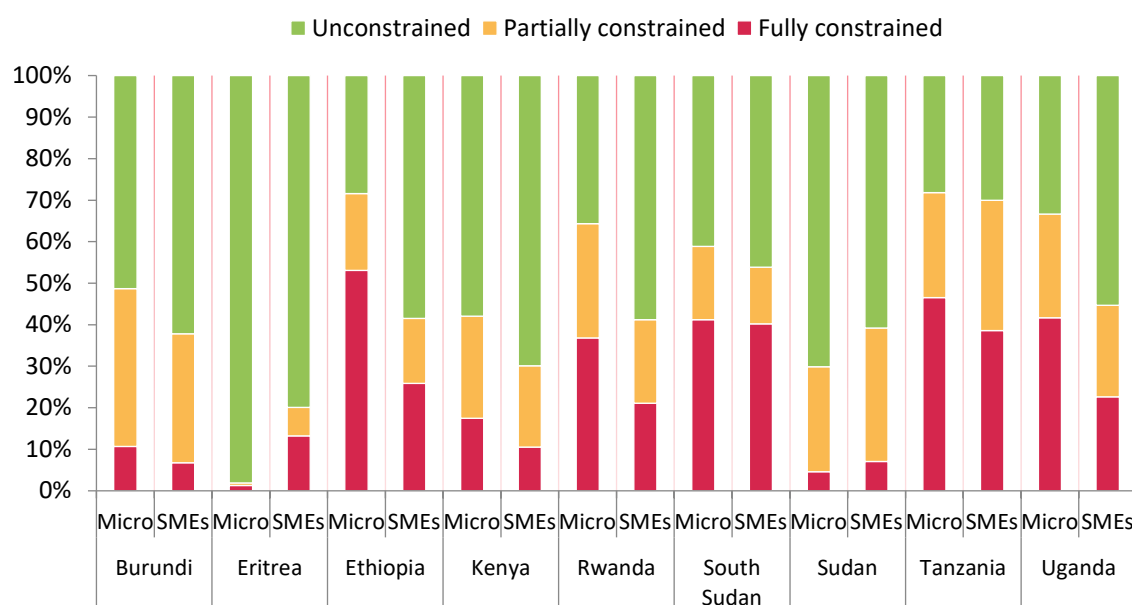
Access to finance is the greatest obstacle to investment faced by East Africa’s private enterprises. According to the World Bank Enterprise Surveys, access to finance was the most commonly cited constraint in most countries, followed by tax rates and access to electricity. However, this aggregate picture masks major differences across countries. Access to finance is only the fifth obstacle reported by enterprises (including SMEs) in Kenya (10%), with practices of the informal sector reported by 24% as the main hurdle.

Access to electricity is mentioned as a major obstacle in most countries but it is seen as less of a problem in Kenya (cited by only 9% of enterprises) and is virtually not a problem at all in Rwanda (0.6%).

Access to finance

Access to finance remains less than ideal, particularly for micro-enterprises. In Eritrea and to a lesser extent in Kenya, SMEs and micro-enterprises can obtain credit when needed (Figure 8). However, in the other countries the situation is not as supportive of investment and economic activity in general. Micro-firms face the largest difficulties, particularly in Ethiopia where 70% of these businesses report difficulties in accessing credit, whereas only 40% of SMEs report the same impediment. In Tanzania, both micro- and small enterprises report major constraints in accessing credit (almost 70% in both cases). As asset quality deteriorated due to the economic slowdown, banks tightened their credit standards. In addition, many banks increased lending to the public sector in the face of persistently high government deficits and increasing rollover needs of the expanding debt stock. In some countries, higher interest rates on sovereign paper reduced the attractiveness of lending to the private sector.

Figure 8: Access to finance by micro, small and medium-sized enterprises



Source World Bank, MSME Finance Gap, 2017.

While most firms are banked, less than half of firms have accessed formal loans, and even fewer use formal finance to support investment. On average, 92% of small and medium-sized firms hold a bank account, but only 45% of the firms surveyed have accessed a bank loan. In addition, once firms get a loan, it is mostly used to support shorter-term needs rather than long-term assets: 23% of small and medium-sized companies in East Africa make use of banks to finance their working capital needs, but only 15% resorted to loans to support longer-term investments. This means that almost 70% of firms rely on own resources and retained earnings for investment, hampering their growth prospects.

Digitalisation has helped financial inclusion in some countries in the region. Given the low level of development and high population growth in most of these economies, rapid access to new technologies has allowed some of them to leapfrog steps towards improved financial inclusion. However, access to financial services varies significantly across the region and in some countries it is still residual. In Kenya, more than 80% of the population over 15 has an account at a bank or other kind of financial institution, but in many countries this share is much lower, even below 10% in Burundi or below 20% in Sudan. In all the

countries, women have less access to bank accounts than men, and the difference in access between the poorest and the richest sections of the population remains substantial across the region.

The regional differences in access to mobile payment systems are even more striking. In Kenya, often quoted as one of the main references worldwide for digitalisation in the financial services, almost 80% of the population over 15 uses digital payment systems or has a mobile bank account. This contrasts with the other countries in the region. In Tanzania and Uganda, around half of the adult population uses mobile banking or mobile payments. In Rwanda, the share drops to 30% and in the remaining countries it is considerably smaller and sometimes almost negligible, with less than 5% of the population using digital banking or payment systems.

Conclusions

Economic growth is likely to remain solid over the coming years. However, public finances have deteriorated and are not expected to improve. The past deceleration in economic activity and the impact of electoral cycles led to an increase in budget deficits in the region and a corresponding increase in public debt. Most countries, even those with more comfortable debt positions, remain highly vulnerable to shocks. Risks to the outlook are rising and, in the short run, stem from potential external shocks.

Despite major improvements, access to finance remains a bottleneck for companies throughout the region, although less so in Kenya, particularly for SMEs and micro-enterprises. In some countries, lending to the public sector is crowding out private credit. Mobile accounts and financial inclusion are improving unevenly across the region. In some countries, less than 5% of the population uses digital banking or payment systems.

The financial sector in East Africa remains stable mostly due to the improvement in economic growth momentum. Going forward, the future performance will be influenced by the extent to which the banks address the downside challenges stemming mostly from the external shocks that could affect the region. The key policy message is that sustainable growth can only be achieved by keeping macroeconomic and regulatory stability. In the recent past, the region has experienced both policy and market shocks with interest rate regulation in Kenya and a spate of bank failures putting the market in the spotlight. This has provided a wake-up call for both market regulators and players to be vigilant while pursuing growth opportunities.

Banks in the East African region are expected to continue deploying technology for efficiency and cost management as well as product designs that utilise the analytical capability of abundant data. As that happens, financial resources, personnel and technology investments are expected to remain in the spotlight, helping to ensure that banks stay compliant with regulations – covering issues ranging from capital, corporate governance and all disclosures to AML/CFT.

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Banking in Southern Africa: recent trends and developments

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Summary

Economic developments in Southern Africa in recent years have generally been characterised by low growth, increasing fiscal deficits and sharply rising public debt levels, and the expected recovery remains vulnerable. Growth has remained subdued during 2019, but is expected to pick up gradually in the coming years, although domestic and external risks to this outlook remain substantial. Fiscal consolidation is reducing the pace of debt accumulation. However, the high level of public debt leaves several states vulnerable to external shocks and reduces or even blocks access to external financing. In most countries, private-sector development is supported by recent improvements in business conditions, although governance in the region has often not been strengthening in line with the global pace.

Southern Africa's banking sectors vary widely, but some themes of recent years cut across borders. Firstly, the weakening government finances in several countries put pressure on the sector as banks have had to fund budget deficits, sometimes at the expense of lending to the private sector. Secondly, the weak economic performance has fed an increase in non-performing loans (NPLs) in most markets. Thirdly, banking supervision and regulation are improving. Fourthly, concerns regarding anti-money laundering (AML) and combating financing of terrorism (CFT) have triggered a decline in international correspondent relationships, which has reduced the region's access to the international financial system.

The outlook for the banking sector is generally positive, but SMEs will continue to face bottlenecks when looking for financing. Despite the beneficial impact of the gradually improving economic conditions, the situation in some markets might get worse before recovering. In general, banks have good capital and liquidity positions, which are closely linked to their conservative risk appetite and management. However, the flipside is that SMEs consider high interest rates and strict collateral requirements as obstacles in accessing finance. The absence of credible credit reference bureaux also pushes up interest rates. First-time borrowers often consider the application procedures complex and cannot provide adequate financial statements or records. In Malawi and Zambia, the high (real) interest rates on government bonds push banks to invest in such "risk-free" investments, crowding out lending to SMEs.

Macroeconomic overview

Structure of the economy

Economic development and living conditions vary widely across the region. Based on the gross domestic income (GDP) per capita (Table 1), Madagascar, Malawi and Mozambique are considered low-income countries, Angola, Comoros, Eswatini, Lesotho, Zambia and Zimbabwe lower-middle-income economies, Botswana, Mauritius, Namibia and South Africa upper-middle-income economies and Seychelles a high-income country. Living conditions, as measured by the UN Human Development Indicators, are closely correlated, with Seychelles and Mauritius performing best (62nd and 65th out of 189) and Madagascar, Malawi and Mozambique worst (161st, 171st and 180th).

Table 1: Selected macroeconomic indicators

	Population - million 2019	GDP per capita - USD 2019	Agriculture		Growth		Inflation - % 2019	Budget deficit % of GDP 2019	Public debt % of GDP 2019	Debt distress Latest
			Employment share 2018 (%)	GDP share 2018 (%)	% 2019	% 2020-23				
Angola	30	3 038	49	10	-0.3	2.9	17.0	0.8	95	
Botswana	2	7 859	23	2	3.5	4.5	2.7	-3.1	12	
Comoros	1	1 350	57	30	1.3	3.7	4.8	-3.3	24	Moderate
Eswatini	1	4 177	13	8	1.3	0.6	2.3	-8.8	41	
Lesotho	2	1 339	67	6	2.8	2.3	6.0	-4.1	46	Moderate
Madagascar	27	464	68	20	5.2	5.0	6.4	-2.3	46	Moderate
Malawi	20	371	72	26	4.5	5.8	8.6	-4.9	65	Moderate
Mauritius	1	11 361	7	3	3.7	3.9	2.0	-2.3	69	
Mozambique	31	484	72	21	1.8	5.8	8.5	-6.5	109	In debt distress
Namibia	2	5 842	20	7	-0.2	2.8	4.8	-5.5	49	
Seychelles	0	17 052	0	2	3.5	3.8	2.3	0.9	54	
South Africa	59	6 100	5	2	0.7	1.5	4.7	-6.2	60	
Zambia	18	1 307	54	7	2.0	1.6	12.0	-4.8	92	High
Zimbabwe	15	860	67	8	-7.1	2.5	182.9	-2.7	18	In debt distress

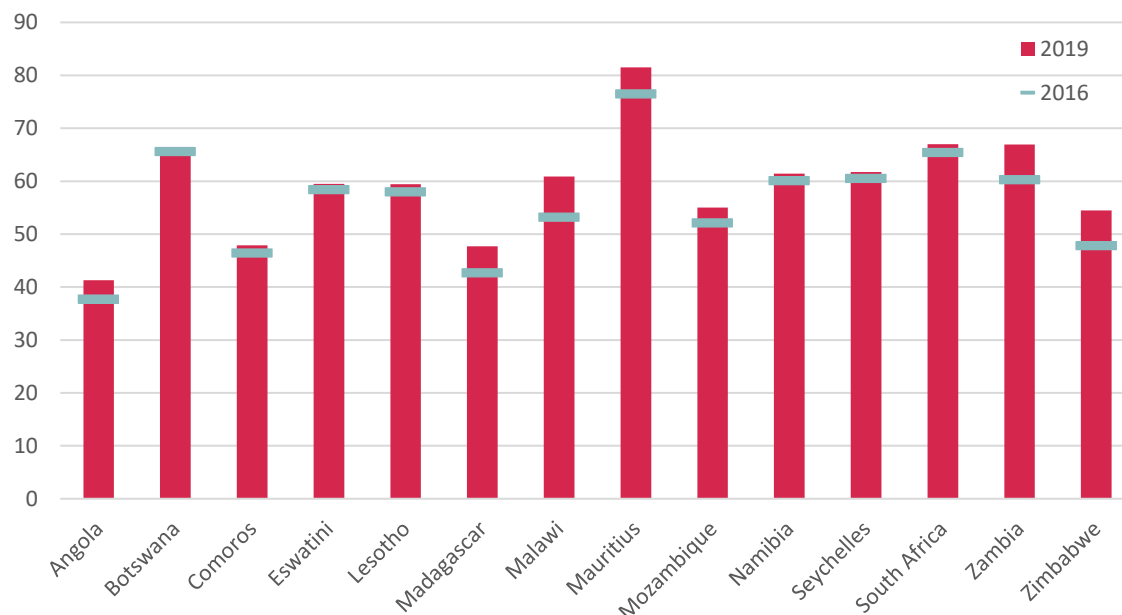
Source: IMF, World Bank.

Agriculture and commodities are the economic backbone of many countries in the region. Seychelles relies on tourism and tuna fishing, and Mauritius is an international financial centre, but also has a well-diversified economy. However, agriculture remains the main economic activity in low-income and lower-middle-income countries, and accounts for some 40% of employment and 11% of GDP in the region (Table 1). Commodities are important for several countries: for example, Angola is an oil exporter, while in Mozambique the exploitation of large gas fields is expected to start in 2023, causing annual growth to be in double digits. Botswana (gems), Namibia (gems, copper), Zambia (copper, cobalt) and Zimbabwe (gems, nickel, ores) are other resource-rich countries.

Private-sector development is supported by recent improvements in business conditions. Mauritius is the best performer in sub-Saharan Africa (SSA), according to the World Bank's Doing Business Indicators, and is 13th in the global ranking. Although the next best country in Southern Africa is at 84th position (South Africa),

seven out of the top-10 SSA countries are from this region. While in many countries governments have had limited fiscal space to support businesses or have even had to increase tax rates, they have all made conditions more conducive to economic activity between 2016 and 2019 (Figure 1). Malawi has made the most progress, followed by Zimbabwe and Zambia. Mauritius is already the best performer in SSA, but managed to make further substantial improvements as well. On the other hand, progress in Botswana, Comoros, Eswatini, Lesotho, Namibia, Seychelles and South Africa has been limited.

Figure 1: Ease of Doing Business score



Source: World Bank.

Note: 100 indicates the best performer; an increase in the score between 2017 and 2020 indicates an improvement; scores for 2019 are from the 2020 edition, scores for 2016 from the 2017 edition.

Governance in the region varies widely and has not been keeping up with global developments. The interaction between the authorities and businesses is manifold and includes such diverse issues as government effectiveness, regulatory quality, rule of law and control of corruption. According to the World Bank's World Governance Indicators, the upper-middle-income and high-income countries all score relatively well in this respect, having rankings in the fourth quantile. However, Zimbabwe, Angola and Comoros remain well behind in the first quantile. Malawi stands out as a country with relatively good governance given its income level. During 2014-18, the rankings of Mozambique, Lesotho, Zambia and South Africa deteriorated considerably, while the rankings of Angola and Seychelles improved most. Overall, the ranking of Southern Africa has deteriorated recently.

Recent macroeconomic developments and outlook

Growth has remained subdued during 2019, but is expected to pick up gradually in the coming years. Average growth in the region is expected to have bottomed out in 2019 (Table 2). Although the economic contraction of Zimbabwe weighs heavily on the average, growth slowed down in almost all countries, except for Malawi, where it picked up, and Angola where the economy shrank less than the year before. Cyclones at the beginning of 2019 hampered growth in Mozambique and several of its neighbours, while droughts in the region reduced agricultural output and held back economic activity as reduced hydropower capacity led to electricity blackouts. In the coming years, Botswana, Madagascar and Malawi are expected to continue their robust economic performance. Mozambique will experience a huge growth boost in 2023 when liquefied natural gas (LNG) production will commence. On the other hand, growth will remain lacklustre in South Africa, Eswatini and Zambia. The economic situation remains volatile in Lesotho and, in particular,

Zimbabwe. Inflation reached 40% in Zimbabwe in 2018 and increased further throughout 2019. Average inflation in the other countries remains around 6% as faster price growth in Zambia, Mauritius and Mozambique was only partly offset by slower rises in Angola and Malawi.

Table 2: Past and expected growth rates

	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023
Angola	4.8	0.9	-2.6	-0.2	-1.2	-0.3	1.2	2.9	3.3	4.1
Botswana	4.1	-1.7	4.3	2.9	4.5	3.5	4.3	5.9	3.9	3.9
Comoros	2.1	1.1	2.6	3.0	3.0	1.3	4.2	3.6	3.5	3.5
Eswatini	0.9	2.3	1.3	2.0	2.4	1.3	0.5	0.6	0.5	0.6
Lesotho	2.7	2.1	2.7	0.5	2.8	2.8	-0.2	3.7	4.5	1.4
Madagascar	3.3	3.1	4.2	4.3	5.2	5.2	5.3	5.1	4.9	4.8
Malawi	5.7	3.0	2.3	4.0	3.2	4.5	5.1	5.5	6.0	6.5
Mauritius	3.7	3.6	3.8	3.8	3.8	3.7	3.8	3.9	4.0	4.0
Mozambique	7.4	6.6	3.8	3.7	3.3	1.8	6.0	4.0	4.0	9.2
Namibia	6.4	6.1	1.1	-0.9	-0.1	-0.2	1.6	2.4	3.2	3.9
Seychelles	4.5	4.9	4.5	4.3	4.1	3.5	3.3	4.1	4.0	3.8
South Africa	1.8	1.2	0.4	1.4	0.8	0.7	1.1	1.4	1.8	1.8
Zambia	4.7	2.9	3.8	3.5	3.7	2.0	1.7	1.7	1.6	1.5
Zimbabwe	2.4	1.8	0.7	4.7	3.5	-7.1	2.7	2.5	2.5	2.2
<i>Average*</i>	3.9	2.7	2.3	2.7	2.8	1.6	2.9	3.4	3.4	3.7

Source: IMF.

Note: *Unweighted average.

Risks to the growth outlook remain substantial. The election cycle and, relatedly, reform appetite will continue to be major domestic risks, as will weather conditions given the high reliance of several countries on agriculture. Commodity prices, and more generally, global economic conditions have a considerable effect on the region's economy. The performance of South Africa, the regional economic powerhouse, will have immediate spill-overs to neighbouring countries through trade channels, remittances (see Chapter 9) and the distribution of customs union revenues.

Fiscal consolidation and the uptick in growth are reducing budget deficits across the region. The average budget deficit amounted to some 3.8% of GDP in 2019, down from some 5.0% in 2016. However, the deficit has remained at over 8% of GDP in Eswatini, 6.5% in Mozambique and South Africa, and around 5% in Malawi, Namibia and Zambia (Table 1). On the other hand, Angola and Seychelles ran a surplus. Overall, the decline in public deficit is likely to continue very gradually, reaching 2.7% of GDP in 2023.

The public debt situation has continued to deteriorate in most countries. The declining public deficits have not yet led to falling public debt levels, although the pace of debt accumulation has slowed down. Average debt stood at 56% of GDP at the end of 2019, up from 40% five years before. Mozambique and Zimbabwe have been in debt distress for some time. The IMF classifies the risk of debt distress in Zambia as very high and the risk in Comoros, Lesotho, Madagascar and Malawi as moderate. The average debt is expected to fall gradually, driven by improvements in Angola, Mozambique and Seychelles. Nevertheless, the still considerable budget deficits and debt levels (with the exception of Botswana) leave these states highly vulnerable to external shocks.

As government finances have weakened, the IMF has been playing an increasing role in an effort to support state budgets and stabilise macroeconomic policies. An informal agreement between Zimbabwe and IMF staff (a Staff-Monitored Program) was agreed to monitor the implementation of the authorities' economic programme as the country is in full economic crisis mode: inflation reached 500% according to some estimates, heralding a second phase of hyperinflation for the country in two decades. Zimbabwe is an

outlier, but Angola has also entered a programme and Mozambique has received emergency funding after typhoons struck in the first half of 2019. Seychelles and Malawi also have IMF programmes in place, while the programme in Madagascar ended in late 2019. Meanwhile, Zambia has re-engaged with the IMF but no programme has been agreed yet.

The region's main civil conflict has ended, but in many countries the political situation has become more challenging. The peace accord in Mozambique between the Government and the main opposition group ended the region's main civil conflict. An Islamist insurgency in the north of the country poses a security risk, but so far the impact on the gas projects located in the area has been limited. In several countries, political parties with thin and declining majorities have tried to appeal to the public through popular spending on public goods like roads as well as higher wage bills. However, after several years of running sizeable deficits, they now have to implement unpopular reforms to rein in spending, which fuels public discontent across the region. For example, people demonstrated in Eswatini against the low wage increases for civil servants and the distribution of government expenditure, while general discontent in Zimbabwe caused widespread protests and strikes. In addition, demonstrations took place in Malawi related to election outcomes, while violence against women and foreigners in South Africa triggered public protests at home and abroad.

Financial sector overview

Southern Africa's banking sectors remain generally resilient with high levels of capital and decent profitability, although funding needs weigh on the balance sheets of many banks. Although banking sectors vary widely across the region, they have several features in common. One is the pressure placed on the sector as government finances have weakened in several countries including Zambia, Angola, Zimbabwe, Namibia and South Africa, with banks having to fund budget deficits through loans to the Government and state-owned enterprises. In some cases this has crowded out lending to the private sector, with pro-cyclical consequences as private-sector investment declines due to a lack of funding.

The weak economic performance has fed an increase in non-performing loans (NPLs) in most markets, but banking supervision and regulation have improved. The region has been mostly free of banking failures in the last three years with an Angolan state-owned bank being the only notable exception. Across the region a clear theme has been improvements in the risk-management frameworks applied by bank supervisors, increasing supervision capacity, and more stringent liquidity and capitalisation rules. Collectively these are improving the risk outlook for banks in the region, though most markets are still some way from complying fully with global standards like Basel III.

Another very important factor facing the region has been its weakening international correspondent relationships that ensure its banks are tied into the international financial system. Angola, for example, has lost all of its US dollar correspondent relationships and must now trade via more expensive correspondents in Europe. Seychelles, Namibia, Angola and Mauritius all saw a decline of a third in correspondent banking activity in the five years up to 2017, according to data collected by the Financial Stability Board. Correspondents weigh up profitability against risk in such relationships and have increasingly decided to terminate them under pressure from domestic regulators, which in turn are concerned about countries' compliance with anti-money laundering and combating financing of terrorism regulations. Urgent reforms are being implemented in most markets (South Africa leads on compliance with the global standards) in an effort to protect linkages to the global financial system. This is a serious risk to the banking systems of the region and multilateral institutions have been active in driving reforms in the region's banking markets to protect their access.

The outlook is generally positive, though some markets will get worse before recovering. In South Africa, promises of structural reforms are very slowly being delivered by the Government, resulting in modest growth. Banks are nevertheless well equipped to deal with the situation. Funding pressures will remain high in Malawi and Zambia, and the increasing inflation in the latter risks eroding the profitability of banks

holding longer-term sovereign paper. Zimbabwe will take some time to work through its current economic debacle and prospects remain bleak, which will weigh on its banks' business opportunities. On the other hand, the growth recovery in Mozambique will push up demand for loans and financial services, while the transformation of Mauritius' financial sector poses both challenges and opportunities. As a result, banks' performances in the region will remain a mixed bag.

SMEs and access to credit

Differences in definitions and limited data availability complicate a cross-country comparison of the SME sector. Definitions typically take number of employees as the main criterion, with turnover often as a secondary criterion. The thresholds for the number of employees vary considerably across countries, reflecting to some extent their different sizes and development stages (Table 3). Cross-country comparisons are further complicated by turnover thresholds being expressed in local currency. Some countries also have different definitions depending on purposes, e.g. eligibility for specific programmes or tax purposes, and do not systematically collect data on the number of firms. A large degree of informality would cause additional uncertainty about the number of firms, as different estimation methods could lead to very different aggregate numbers.

Available figures regarding the number of firms can currently only provide a rough picture of how countries differ. Data from the World Bank Enterprise Surveys could provide comparable figures, but apart from Mozambique (2018), Eswatini (2016), Lesotho (2016) and Zimbabwe (2016), the data are at least five years old and are thus likely to no longer be representative. Based on the different, country-specific definitions, Madagascar stands out as having a large number of micro-firms compared to SMEs, and together with Eswatini the number of micro-enterprises relative to the population is high. Angola has the fewest firms when adjusted for population size, while in South Africa the number of small and medium-sized enterprises is high compared to that of micro-enterprises.

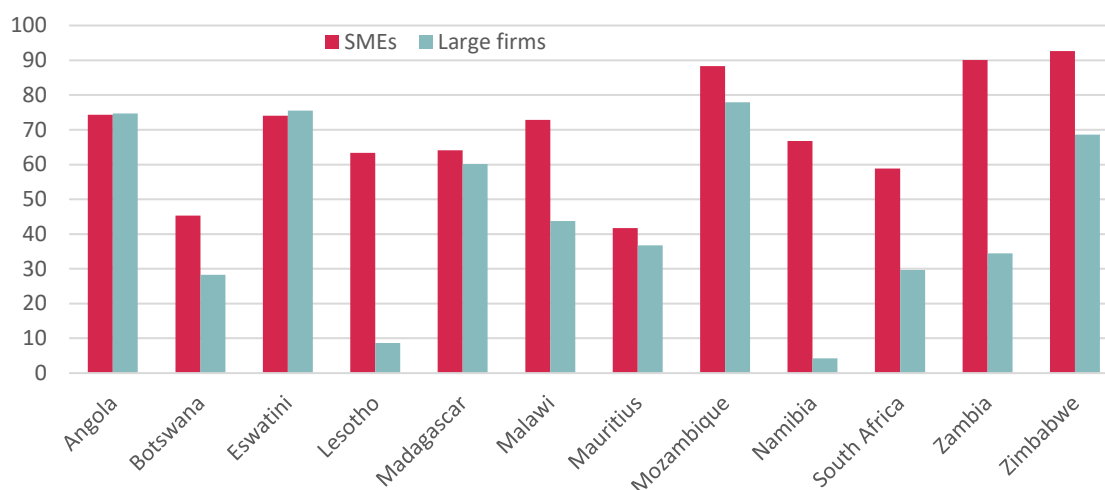
Table 3: MSME definitions and numbers

	Definitions (number of employees)				Number of firms					
	Micro	Small	Medium	Large	Micro	Small	Medium	SMEs	<i>MSMEs</i>	Large
Angola	1-9	10-19	>19		14 428	7 836				
Botswana	1-4	5-29	30-49	>49	7 376	6 077	438	6 515	13 891	726
Eswatini	0-3	4-10	11-50	>50	12 336	685	685	1 371	13 707	
Lesotho	1-4	5-9	10-49	≥50	7 299	935	500	1 435	8 734	110
Madagascar	<10		<200	≥200	203 581			7 337	210 918	397
Malawi	1-4	5-20	21-100	>100					987 480	
Mauritius	1-5									
Mozambique	0	1-9	10-99	≥100		39 873	1 798	41 671	41 671	1 338
Namibia	1-10	11-30	31-100	>100						
South Africa ¹	≤5	6-50	51-200	>200	302 940	510 819	131 008	641 827	944 767	
Zambia	<11	11-50	51-100	>100						
Zimbabwe	1-9	10-40	41-75	>75						

Source: SME Finance Forum.

Note: ¹For medium and large-sized firms in agriculture, the number of employees is 51-100 and >100.

Figure 2: Credit-constrained firms



Source: World Bank.

Access to credit remains a major bottleneck for enterprises, especially smaller ones. The ratio of domestic credit to GDP for Southern Africa peaked in 2014 at 41%¹, but has been falling gradually since then, and is now 37%. The average conceals large differences across countries: credit in South Africa, Mauritius and Namibia is well above the average (148% of GDP, 80-100% and 60% respectively), but among the other countries it is only above 30% in Botswana and the Seychelles. In most countries, over half of the SMEs are credit-constrained, and in Mozambique, Zambia and Zimbabwe this share is even higher at around 90% (Figure 2). Large firms typically find it easier to arrange credit, and the difference with respect to smaller firms is particularly large in Lesotho, Malawi, Namibia and Zambia. Credit constraints are loosely linked with the development of the financial sector, as countries such as Botswana, Mauritius and South Africa have a lower share of credit-constrained firms. This link is confirmed when considering the access to finance of people (Figure 3).

Figure 3: Financial access strands (share of adult population)



Source: Finmark Trust.

¹ Unweighted average, excluding Zimbabwe due to data limitations.

In general, SME finance in the region is held back by the different risk perceptions of SMEs and financial institutions. Banks have good capital and liquidity positions, a situation which is closely linked to their conservative risk appetite and management. However, the flipside is that banks can be seen as hesitant to lend, as they lack lending opportunities with appropriate risk-return profiles. Hence, interest rates might be relatively high and unattractive to SMEs. In particular, strict collateral requirements often pose an obstacle for many SMEs. Companies without a proven track record find it hard to access financing, especially in the absence of credible credit reference bureaux. This is, in particular, a problem for smaller companies that would like to access financing for the first time, as they often cannot provide adequate financial statements or records, and in addition often consider the application procedures complex. Even when loan applications are successful, SMEs often receive sub-optimal financing as financial institutions frequently lack access to long-term funding in local currency. In Malawi and Zambia, the high (real) interest rates on government bonds push banks to invest in such “risk-free” investments, crowding out lending to SMEs.

Several market segments could benefit from targeted interventions. Smaller firms usually struggle more to access financing due to the limited and often low-quality collateral available. Financial institutions often have a limited appetite to finance these firms because of the high risks involved, but increasing mutual understanding - starting with saving accounts to build up a track record - could help to improve financial access for this group (see the discussion in Chapter 8 on smallholder farmers). Furthermore, some fintech innovators are building risk scoring systems based on unorthodox metrics such as purchase behaviour and mobile phone usage, which may also improve access. While the growth ambitions of many firms are low, those that would like to expand often struggle to obtain the financing required due to the substantial risks. Developing the private equity and venture capital industry would provide an alternative to bank financing for these companies.

Focus on selected markets

Angola

Oil has played the central role in the recent history of Angola’s banking system. As the country ramped up production, driving GDP to expand tenfold in the decade after the end of the civil war in 2002, the banking sector grew from total assets of USD 3 billion in 2003 to USD 39 billion by 2018. The sector is heavily driven by oil, with significant exposures to oil projects that are directly exposed to oil price volatility. The last four years have presented the banking sector with significant challenges as oil prices fell precipitously from over USD 100 per barrel in 2014 to a range of USD 40-80 since then. That has led to an overall contraction of GDP for the last three years, with 2019 likely to show a flat GDP performance. As a result, the Angolan banking sector has faced a spike in NPLs, particularly at state-owned banks, triggering distress at the second-largest state-owned bank, Banco de Poupança e Crédito (BPC), which has required a resolution process after heavy exposures to oil developments.

There is a mixed bag of performances across the sector. Overall, the sector has an NPL ratio of 28.3% of gross loans, though this is heavily swayed by BPC’s 75% NPL ratio. Privately-owned Banco Angolano de Investimentos (BAI) reported a return on equity of 25.3% (Table 4). That was dwarfed by Banco de Fomento - Angola (BFA), Banco de Desenvolvimento de Angola (BDA) and Standard Bank of Angola, which all reported returns on equity (ROEs) of above 60% for their 2018 financial years. Those three banks are also highly efficient, with cost-to-income ratios ranging from 25% to 36%. However, other banks show less compelling metrics with ROEs below 20% and efficiency ratios of 50-80%. At the same time, it is likely that these do not fully reflect the impact of weaker oil prices that are gradually damaging the performance of assets. The IMF has called for further asset quality reviews to shake oil-related bad debts out of the system, and stipulated the need, particularly for the state-owned banks, to improve the efficiency of operations as a precondition for any recapitalisations.

Table 4: Major banks in Angola

	Latest year	Total assets USD m	Return on average equity %
Banco Angolano de Investimentos	2018	6 625	25.4
Banco de Poupança e Crédito	2018	6 188	-17.4
Banco Económico SA	2017	5 545	13.1
Banco de Fomento - Angola, SA - BFA	2018	5 521	60.2
Banco Millennium Atlântico	2018	4 403	20.7
Banco BIC, SA	2018	4 237	28.9
Banco Sol	2018	1 725	12.0
Banco de Desenvolvimento de Angola	2018	1 516	65.7
Standard Bank de Angola SA	2018	1 436	62.9
Banco de Negócios Internacional SA	2018	1 384	14.0

Source: *Bankscope*.

Oil prices also affect the revenues and funding needs of the Government. Low oil prices drive it to seek greater funding from the domestic banking sector, causing a pro-cyclical crowding out of private-sector lending which coincides with weaker economic activity. The fall in oil receipts undermined the Government's fiscal position, with government revenues falling by half between 2014 and 2017, driving public debt up to 80% of GDP in 2018. Angola has entered into a three-year IMF programme to rescue the Government's funding position with USD 3.7 billion in loans, a move which is entrenching positive macroeconomic reforms. GDP still contracted by some 0.3% in 2019 but is expected to expand again in 2020 at a rate of 1.1%.

Angola's central bank (Banco Nacional de Angola - BNA) has been focused on improving the stability of the sector with a three-fold increase in capital requirements at end-2018. It has also made a concentrated effort to reduce foreign currency balance sheet mismatches that had evolved with the growth in USD oil receipts. The increase in the capital buffer has been key to ensuring banks can withstand the NPL spike. Foreign currency risks are complicated by Angola's managed exchange rate which keeps the currency at a premium to the parallel black market rate. The banks are unable to access the required liquidity freely and have to participate in central bank auctions in which volumes are restricted.

Banking reforms have mirrored wider economic reforms in Angola under President João Lourenço, who took office in 2017. These reforms are gradually turning around the country's economic performance, particularly by stimulating the private sector, though the oil sector remains an outsized contributor to the economy. Public patience has to be sustained while the structural shift of the economy takes hold. The banking sector will need to adjust to support the private sector's increased role, shifting asset accumulation outside of oil and into other sectors. An improvement in the legal system to improve the recovery of collateral and enforcement of contracts would greatly help the banking industry's ability to do so.

Angola has also been working to restore its access to the global financial system after it was cut off from all US dollar correspondent banks in 2016, following negative reviews of its anti-money laundering (AML) and combating financing of terrorism (CFT) compliance. The sector has managed to maintain access to the international system but only through expensive euro correspondent relationships. BNA has been working hard to improve the standing of the sector in the global financial system with a view to restoring access to US dollar correspondents. The Financial Action Task Force is set to review Angola's AML/CFT compliance in 2020 which may lead to an improved opinion on the quality of its compliance, opening the way to potentially restoring US dollar correspondent relationships. However, the IMF points out that there are still important steps to be taken to ensure that Angola is applying AML/CFT regulations and supervision to the required standard.

Botswana

Botswana's Government sports one of the best fiscal positions on the continent thanks to regular budget surpluses driven by revenue from diamond sales. However, this position has been compromised by three years of budget deficits at around 3.5% of GDP with the State spending to drive aggregate demand in the economy while diamond prices have trended weaker. This has had some effect, with a GDP growth of 4.5% in 2018 and an estimated 3.5% in 2019, leading the finance ministry to expect a return to budget surpluses from 2020.

The banking sector is healthy, with return on equity averaging some 20%, and capital adequacy at 17.7% of risk-weighted assets (Table 5). NPLs have been at a relatively high level following the weaker economic performance of the past few years but are slowly recovering and were at 4.7% of gross loans in the second quarter of 2019. Supervision is being improved on several fronts and Botswana is also working to improve compliance with anti-money laundering and combating financing of terrorism standards. Banking legislation is being amended to bring the country more in line with Basel III supervision standards, improve cooperation between regulators and impose a crisis resolution framework.

Table 5: Major banks in Botswana

	Latest year	Total assets USD m	Return on average equity %
First National Bank of Botswana Ltd	2018	2 391	22.1
Barclays Bank of Botswana Limited	2018	1 586	23.0
Standard Chartered Bank Botswana Ltd	2018	1 547	2.5
Stanbic Bank Botswana Limited	2018	1 349	21.4
Letshego Holding Limited	2018	993	12.2
African Banking Corp of Botswana Ltd	2018	851	12.6
Bank Gaborone Limited	2018	479	11.2
Botswana Building Society	2017	441	4.4
First Capital Bank	2018	268	17.5
Botswana Savings Bank	2017	267	5.5

Source: *Bankscope*.

Botswana has long aimed to diversify its economy from its heavy reliance on diamond proceeds. One area of strategic growth has been the financial sector, yet credit extension in Botswana is relatively limited and focused on low-credit-risk public-sector employees. In part due to high levels of liquidity in the economy generally, the demand for credit is relatively low, but efforts to improve the contributions of manufacturing and services to the economy will require greater investment. The IMF recommends that Botswana strengthens its legislation underpinning credit bureaux to improve lenders' access to historical performance information, and to smooth the process of enforcing defaults and claiming security. Such moves would help bank growth and profitability, as well as support the efforts aimed at economic diversification.

Mauritius

Mauritius is the region's most sophisticated banking market after South Africa and includes an international financial centre that intermediates significant flows of direct and portfolio capital into the rest of Africa. Its domestic credit extension and financial inclusion indicators show a robust onshore banking sector as well (Table 6). Economic growth was at 3.8% for the last two years and is set to repeat the same performance this year. Almost all bank indicators, from NPLs to liquidity levels have been gradually

improving while private-sector credit extension has trended upward to support growth, increasing 6% in 2018. Mauritius is a predominantly services-based economy (though it has sizeable textile, sugar and fishing industries), and tourism and financial services have been strategic growth areas for the island nation.

Table 6: Major banks in Mauritius

	Latest year	Total assets USD m	Return on average equity %
Mauritius Commercial Bank Ltd (The)	2018	10 119	17.2
SBM Holdings Ltd	2018	6 610	8.1
HSBC Bank (Mauritius) Limited	2017	4 246	12.9
Afrasia Bank Ltd	2018	3 528	12.0
Barclays Bank Mauritius Limited	2018	3 246	20.8
Standard Chartered Bank (Mauritius) Limited	2018	2 345	15.8
Investec Bank (Mauritius) Limited	2018	1 786	8.5

Source: Bankscope.

The challenge now is to develop its financial services strategy to ensure Mauritius is adding value to services rather than acting as a conduit of flows from the rest of the world. Historically, the attractiveness of the island has been premised on favourable tax treatment, with little value-adding activity in the country. Recent reforms have been spurred by revisions to the India-Mauritius tax treaty, which has been a key motivator for Indian flows via the country, but Mauritius will no longer be as attractive under the revised treaty. Mauritius is also being spurred by global tax justice activism, although it has remained clear of global black lists.

For the banking sector, the main problem is excess liquidity. The large offshore sector means banks hold high liquid balances of both foreign currency and Mauritian rupees. Efforts to mop up excess liquidity and sterilise foreign exchange flows have been undertaken at considerable expense to the Bank of Mauritius and the finance ministry. The central bank has partly implemented Basel III supervision standards and continues to work toward complete implementation. Indeed, one of the reasons for the large growth in foreign currency liquidity in the system is to meet liquidity coverage ratios in foreign currency, a move that has substantially diminished the risks of currency mismatches in bank balance sheets. Banks in Mauritius remain solidly profitable and efficient with returns on equity all in the mid-teens and cost-to-income ratios under 50%.

A further issue for the sector has been to address deficiencies in its anti-money laundering and combating the financing of terrorism regime. It is improving processes across the business sector and creating a centralised know-your-customer system. It is also improving the transparency of its offshore sector by making beneficial ownership details more easily available. This is part of a wider effort to ensure that Mauritius remains in the clear under several international anti-money laundering and secrecy assessments.

Mozambique

Mozambique had been on track for reasonable economic growth in a low inflation environment before a natural disaster struck in the form of tropical cyclones Idai and Kenneth in the first half of 2019. This damaged economic output and set back the country's efforts to recover growth rates that had been among the highest in the region over the two decades up to 2015. Growth is expected to be 1.8% in 2019, below population growth, thanks to the demand shocks of the hurricanes. A reconstruction effort has diverted government spending from longer-term investment for now.

The banking sector is robust and generally quite profitable and highly capitalised, with a few exceptions. It is highly concentrated with the three largest banks holding about two thirds of assets, and each

commands a return on equity in the mid-20% range (Table 7). However, NPLs have grown and, according to the IMF, accounted for 11% of total loans in February 2019, in part due to reclassifications of outstanding loans to state-owned enterprises as non-performing. This high level has nevertheless been stable since late 2017. Credit growth has been weak, falling consistently from 2015 to 2018 and managing modest growth since then, coming in at 5% in the first quarter of 2019.

Table 7: Major banks in Mozambique

	Latest year	Total assets USD m	Return on average equity %
BCI-Fomento SA	2018	2 499	25.1
BIM Banco Internacional De Moçambique	2018	2 453	21.9
Standard Bank SA	2018	1 626	28.9
Barclays Bank Mozambique SA	2018	613	22.7
Moza Banco SA	2018	592	-9.4
Banco Unico SA	2018	422	12.9
Fnb Mozambique SA	2018	251	-19.3
African Banking Corporation (Mozambique) Limited	2018	205	7.8
Letshego Financial Services Mozambique SA	2018	133	17.3
Bayport Financial Services Moçambique (Mcb), SA	2018	124	22.4

Source: Bankscope.

The central bank has been tightening bank supervision and introduced tighter prudential requirements.

The measures include higher reserve requirements on foreign currency deposits to shift the sector more toward a domestic asset/liability mix after dollar balances had grown for some time. This de-dollarisation arguably weakened Mozambique's foreign exchange market and represented a second-prize strategy compared to improving domestic fiscal indicators. The central bank has been improving supervision capacity and aligning standards to international expectations and it still intends much further development.

Namibia

Namibia is part of the Common Monetary Area, alongside Lesotho and Swaziland, using South Africa's rand as a common underlying currency, and its banking sector is dominated by subsidiaries of South Africa's large banks. Three of the four systemically important banks are South African, and Namibia's economy tends to track South Africa's with a similar mix of resources and services. Growth has been lacklustre, in tandem with South Africa, and the banking system has exhibited a sharply deteriorating credit performance, though NPLs remain within comfortable levels at 4% of loans. GDP growth was slightly negative in 2018 for the second year in a row, and is expected to be negative again in 2019 before recovering to a zero per-capita growth rate.

Namibia's banking market has a highly developed home loans sector, which forms the biggest slice of the banks' assets at 39.2% of loan books. A period of rapid growth in home lending from 2010 to 2015 contributed to a spike in property prices that has been unwinding over the last few years. There is limited unsecured lending in Namibia compared to South Africa, owing to a less accommodative regulatory regime, so Namibia has avoided the stress of unsecured lending that neighbouring South Africa and Botswana have experienced. But the home loan market has been a source of difficulty with housing price growth down and wider consumer pressure leading to a weak credit performance. Lending volumes have also declined as consumers have sought to reduce their relatively high indebtedness. Despite the increase in bad debt provisions, Namibian banks remain reliably profitable with the big four sporting returns on equity in the mid-teens or above (Table 8). Efficiency ratios have also been fairly good in the mid to upper 50% range.

Table 8: Major banks in Namibia

	Latest year	Total assets USD m	Return on average equity %
FNB Namibia Holdings Limited	2018	2 911	22.2
Bank Windhoek Limited	2018	2 758	17.5
Standard Bank Namibia Holdings Limited	2018	2 190	17.3
Nedbank Namibia Holding Limited	2018	1 350	13.7
Development Bank Of Namibia	2018	663	6.6
Agricultural Bank Of Namibia - Agribank	2017	239	1.2
SME Bank Ltd	2014	64	-39.0
Bank BIC Namibia Holdings Limited	2017	23	-9.2

Source: *Bankscope*.

Banks have had to pay closer attention to risk management as the central bank has conducted stress tests and pursued an overhaul of financial sector regulation. The biggest problem is the relatively high proportion of wholesale deposits in the liability mix, particularly from money market funds and asset managers. This leads to a highly integrated financial sector, and institutional investors' relatively high exposure to foreign assets creates channels for global shocks to work their way into domestic bank balance sheets. The central bank has not gone far in implementing Basel III risk-management standards and has also been slow to implement a proposed macro-prudential policy framework and crisis resolution framework, according to a recent IMF Article IV assessment.

The Government's finances have deteriorated along with the broader economy. Debt grew to about 60% of GDP in 2018 (up from 47% in 2015) despite some efforts by the Government to reduce spending. Spending cuts have been focused on non-wage items including capital investment, which has a negative pro-cyclical impact. However, government revenue receipts have fallen along with economic growth and a decline in the share of revenue from the Southern African customs union. The Government's funding demands have meant the banking sector has increased its lending to the public sector and such loans now account for 10% of banking assets, up from 7% in 2016 according to the IMF.

Seychelles

Seychelles is committed to embracing cutting-edge financial technology as a global financial centre to ensure finance plays a role in diversifying its tourism-based economy. The central bank and finance ministry have also created e-money regulations and are attempting to develop a world-class regulatory environment for fintech. The island nation boasts the second highest per-capita GDP in Africa (after Equatorial Guinea) and has made some efforts to promote itself as a regional financial centre, setting up its own securities exchange, Trop X, which it recently renamed Merj Exchange, to attract African listed instruments. It has 29 equity and two debt listings in several currencies and is now introducing blockchain-based trading, becoming the first exchange in the world to provide a regulated primary and secondary market for tokenised digital securities.

The banking sector is well entrenched domestically with almost 100% coverage of the domestic population (the exception being hard-to-reach islands in the archipelago). It remains small, however, with total banking assets of USD 1.3 billion (Table 9), considerably lower than fellow island nation Mauritius, which has USD 61 billion of banking assets. Its efforts to gain relevance by embracing technology represent a good strategy to differentiate it from the African market, but one that has yet to translate into significant growth of the banking sector.

Table 9: Major banks in Seychelles

	Latest year	Total assets USD m	Return on average equity %
Seychelles International Mercantile Banking Corp. Nouvobanq	2017	462	35.4
MCB Seychelles Ltd	2018	361	21.1
Barclays Bank (Seychelles) Limited	2016	331	22.4
Seychelles Commercial Bank Limited	2017	105	9.3
Development Bank Of Seychelles	2018	75	8.0

Source: Bankscope.

The country has to remain vigilant on anti-money laundering and combating financing of terrorism, with peer reviews having highlighted capacity limitations at relevant agencies in the Seychelles. This is a critical risk for the banking sector, which must maintain correspondent banking relationships with the rest of the world, some of which have already been lost. According to the Financial Stability Board (2018), Seychelles saw the fourth largest decline in foreign correspondent bank relationships in the world between 2012 and 2017. Global banks terminate such relationships where they perceive the risks being greater than the rewards, driven by perceptions of lax regulatory oversight and reputational concerns. The Seychelles authorities are attempting to improve the institutional oversight of the sector, though some elements of its international business strategy, particularly secrecy provisions on company directorships, stand as obstacles in the effort to promote Seychelles as a compliant and transparent jurisdiction.

South Africa

South Africa's banking sector remains the largest on the continent, but has lost its first place in the wider region to Dubai which has overtaken it in terms of total assets. That is due to currency weakness that has shrunk the South African sector in hard currency terms, as well as lacklustre domestic asset growth. The economy has been unable to grow for several years and banks have had to endure limited growth opportunities amid a challenging credit environment.

The weak economic growth has been driven by policy uncertainty on several fronts, including the protection of property rights. While South Africa's constitution unambiguously protects property, political rhetoric has created uncertainty amid various calls for constitutional amendments, with some politicians advocating for radical expropriation without compensation. Naturally, the banking system depends on security of tenure as an underpinning for much of the collateral it holds for loans, so a threat to property rights could be systemically damaging. The uncertainty has been a spill-over of factional battles within the governing African National Congress in the aftermath of a period of widespread corruption under former president Jacob Zuma. Property rights are only one among several issues facing investors, which include mining regulations, regulations over mobile network spectrum allocations, and the country's visa regime both for tourists and for skilled workers. Rapid resolution has been promised on all of these, but little progress has been made.

Given the environment, it is almost surprising that bank NPLs have only recently begun to increase and remain range-bound below 4% of gross loans and advances, coming in at 3.7% in July 2019 compared to 3.6% a year earlier. Loan performance has been resilient thanks to the banks' efforts at improving credit quality after the economy slid into recession in 2012. Return on equity has weakened to 15.35% for the sector as at July 2019, down 50 basis points compared to a year earlier and far off the 20%-plus levels of the period before 2012 (Table 10). Capital adequacy remains strong with the sector at an average of 16.62%, though the larger banks have tightened capital levels to boost returns. Improvements in profitability have been driven by cost containment rather than top-line growth, with the major banks implementing digitisation strategies to improve efficiencies while reducing headcount and branch square meterage.

The regulatory architecture of South African financial sector has been thoroughly reformed over the last several years with further reforms in the offing. South Africa has introduced a “Twin Peaks” regulatory model with prudential regulation conducted by the Prudential Authority (PA) housed in the central bank and conduct regulation by a Financial Sector Conduct Authority (FSCA), which has replaced the Financial Services Board (FSB). The PA has taken over some aspects of insurance regulation from the FSB while the FSCA refocuses on conduct issues. The latter role will be governed by the Conduct of Financial Institutions bill, currently working its way through the legislative process, which is expected to add to the compliance costs faced by banks. A mooted deposit insurance scheme is also being developed to cover banks and simplify future resolution processes. It has been spurred by the collapse of African Bank in 2015 and VBS Mutual Bank in 2018, both of which turned out to be insolvent. African Bank has since been restructured through a good/bad bank split and a new viable bank was launched, but VBS is being liquidated.

Table 10: Major banks in South Africa

	Latest year	Total assets USD m	Return on average equity %
Standard Bank Group Limited	2018	147 784	17.6
Firststrand Limited	2018	111 268	23.7
Standard Bank of South Africa Ltd	2018	94 513	16.1
Absa Group Limited	2018	89 544	13.4
Nedbank Group Limited	2018	72 532	16.9
Investec Limited	2018	45 674	14.0
Capitec Bank Holdings Limited	2018	7 195	26.2
Land Bank	2017	4 170	3.9
HSBC Securities (South Africa) (Pty) Limited	2017	3 000	27.5
African Bank Holdings Ltd	2018	2 162	10.6

Source: Bankscope.

The Government’s fiscal position is highly precarious with state-owned enterprises, particularly the electricity monopoly Eskom, in a debt trap. Banks have regularly been leaned on to provide finance while the Government attempts to find sustainable solutions for state-owned entities like South African Airways. Generally, banks have resisted the pressure to increase exposure and in fact have mostly reduced exposure as the creditworthiness of state-owned enterprises (SOEs) has declined. Some policy mandarins in the governing party have suggested that banks should be compelled to fund strategic industries like coal, despite it becoming a global no-go investment area. Banks have been called to the table in government efforts to find a sustainable solution for Eskom, among others, and will no doubt have to play a role in restoring its balance sheet, which is solvent only due to continual government bailouts and guarantees.

Ultimately, the banking sector desperately needs a return to economic growth that would see a recovery in consumer balance sheets and an increase in investment. South Africa has long relied on consumer demand as a key pillar of economic activity. The more sustainable hope is that the recovery will underpin a growth in fixed investment spending, particularly to improve South Africa’s energy and transport infrastructure as well as basic public infrastructure ranging from water to sanitation networks. Banks can play a key role in funding such future infrastructure, and the Government has promised a ZAR 100 billion infrastructure fund to co-invest with the private sector in infrastructure.

Zambia

The Zambian Government’s fiscal position has been deteriorating as economic growth has fallen below population growth, leading to stress in the financial system. The Government has tapped the banking system to finance spending after bond auctions failed to raise budgeted amounts from mid-2018,

constraining private-sector credit extension. This has accompanied a more negative outlook for the country after several years of optimism about Zambia’s potential to achieve middle-income status in the medium term. Negative sentiment has accompanied a policy shift toward resource nationalism, with threats of expropriation of large foreign-owned mining interests, tax increases and large tax assessments, compounded by drought and its knock-on impact on electricity production. After pioneering the issuing of Eurobonds as a developing African sovereign, its three Eurobonds are now trading at distressed levels. The nearest one matures in the third quarter of 2022 when over USD 800m in principal will be due, and Zambia’s ability to roll or settle this debt currently looks low.

In this context the banking sector has remained resilient, though pressures are building. It remains highly profitable with the largest banks earning returns on equity well in excess of 20% on the back of substantial interest margins (Table 11). Despite attempts to relax monetary conditions by lowering the monetary policy rate and loosening the statutory reserve ratio, bank lending rates have risen in line with increasing yields on government bonds. Non-performing loans trended upward from 2015 when economic conditions shifted on the back of a sharp decline in the prices of copper, the country’s main commodity, and reached a peak of 14% in the first quarter of 2018. Since then, there has been a modest recovery to just over 10% as banks have taken a more conservative stance. Credit extension has fallen along with that stance, from year-on-year growth of 10% in the third quarter of 2018 to 6% in the first quarter of 2019.

Table 11: Major banks in Zambia

	Latest year	Total assets USD m	Return on average equity %
Stanbic Bank Zambia Limited	2018	1 249	23.2
Barclays Bank Zambia Plc	2017	940	25.1
Zambia National Commercial Bank Plc	2018	890	19.9
Standard Chartered Bank Zambia Plc	2018	817	32.6
Bank of China Zambia Limited	2018	587	16.9
First National Bank Zambia Limited	2018	553	6.4
African Banking Corporation Zambia Ltd	2018	521	-2.3
Indo-Zambia Bank Limited	2018	372	17.0
Citibank Zambia Ltd	2017	267	22.3
Izwe Loans Zambia	2018	86	66.4

Source: *Bankscope*.

Banks’ liquidity and the credit worthiness of clients is also being complicated by high government arrears to suppliers. The Government has also held back pension contributions and in some cases delayed salaries in state-owned organisations. Intellidex estimates that these arrears now amount to 5.5% of GDP, which would come on top of the official budget deficit of 5% of GDP. Arrears feed into bank NPLs which would be performing better otherwise.

The outlook for Zambia’s debt sustainability is a key concern for the banking sector, and the possibility of an IMF bailout is clear. For now the sector is hunkered down, trying to accommodate further government funding while holding onto liquidity to accommodate a worsening credit performance.

Zimbabwe

Zimbabwe’s banking sector shares the country’s wider economic woes. Despite much optimism in 2017 when Emmerson Mnangagwa took over the presidency, the country has not been able to escape multiple economic problems including a chronic shortage of foreign exchange, daily power cuts, fuel shortages and an emerging food crisis. It has de-dollarised in an effort to escape the currency shortage, but is now facing

a rapid spike in inflation and a collapse of exchange rates as the money supply has ballooned. The Government has financed increasingly large fiscal deficits by borrowing from commercial banks and from the central bank while failing to deliver fundamental human rights and property rights reforms that would allow its re-admittance into the international financial system. The IMF began a staff-monitored programme in April 2019 to oversee economic reforms over the next year to restore macroeconomic stability, including the monetary system. But by September 2019, the trend was still sharply negative and the IMF is expecting the economy to shrink by 5.2% this year.

The banking sector is now facing conditions reminiscent of the hyperinflation years of former president Robert Mugabe. It is additionally complicated by its exclusion from the international financial system - counterparty banks have mostly terminated relationships with Zimbabwean entities. In February 2019, all banks were made to switch their functional currencies to Real Time Gross Settlement system dollars (RTGS\$), but the 1:1 official conversion ratio makes the exercise fraught. Within days of the introduction of RTGS\$, it was trading in the interbank market at 1:2.5 and by September had reached 1:18 on the black market. Banks must still hold any foreign funding or Nostro accounts in US dollars, but any domestic asset or liability must be converted to RTGS\$ at 1:1, creating potentially large balance sheet currency mismatches, depending on the banks' sources of funding. Some will face a significant diminution of capital as a result of the change, even though the sector as a whole had a substantial capital buffer of over 30% prior to the change and the central bank is providing some financing to cover losses. The RTGS\$ was made the only legal tender in the country in June 2019, but its high inflation complicates the analysis of banks' performances and balance sheets, hence the country has adopted hyperinflation accounting standards.

Given the inflation rate, the banks' asset yield is negative in real terms even though interest margins are over 10%, and lending rates are increasing fast, doubling from August to September 2019 to 17.2%. While banks have been able to maintain robust levels of profitability on paper (Table 12), the ability to realise these profits in an exchangeable currency is looking increasingly unlikely. Moreover, the combination of low demand for loans, modest profitability and high inflation causes the banks' balance sheets and capital to shrink relative to the nominal size of the economy. The future of the sector depends substantially on the IMF staff programme and whether it can successfully navigate the Government into a stable macroeconomic position.

Table 12: Major banks in Zimbabwe

	Latest year	Total assets USD m	Return on average equity %
CBZ Holdings Limited	2018	2 450	23.1
Stanbic Bank Zimbabwe Limited	2018	1 769	25.8
Central Africa Building Society	2018	1 469	25.7
FBC Holdings Limited	2018	1 114	27.5
Ecobank Zimbabwe Limited	2018	1 050	43.0
Steward Bank Limited	2018	941	27.5
First Capital Bank Ltd	2018	699	23.8
ZB Financial Holdings Limited	2018	664	19.8
NMBZ Holdings Limited	2018	527	37.2

Source: Bankscope.

Conclusions

The banking sectors in Southern Africa have, in general, well withstood the economic slowdown of the past few years. Banks have good capital and liquidity positions, which is closely linked to their conservative risk appetite and management. The outlook is generally positive, though some markets will get worse before recovering, with credit performance still in a weakening phase of the cycle. Themes across the region include the pressure on the banking sector from weakened government finances, rising NPLs due to weak economic performance, and fewer international correspondent relationships. Markets like Angola and Zambia have turned, or are near to turning, to the International Monetary Fund for programmes. Others are rapidly reforming their financial systems to meet global standards in order to maintain international financial linkages, although populist political pressure in some markets means this is not a reliable trajectory across the region. A recovery in underlying economic growth is a prerequisite to improving the health of most banking markets. Commodity prices, including oil in the case of Angola, are already supporting recoveries in most markets, South Africa and Namibia being notable exceptions.

Financial institutions continue to be interested in funding from abroad, but the demand for risk-sharing mechanisms is growing. Liquidity provision remains the main tool for supporting financial intermediation. Long-term local-currency funding at rates that are both appropriate and attractive is in demand too, and stepping up the provision of such funding could be achieved through blending with grants. Often, financial institutions have good liquidity positions, but are hesitant to increase lending because of the perceived relative risks as well as institutional weaknesses in domestic markets. In these cases, risk-sharing schemes provided by development partners are a more effective tool for increasing SME financing, and demand for such schemes has been rising. In countries such as Mozambique, the pick-up in economic activity comes with an increase in bank lending, which causes banks themselves to look for funds. Access to credit for micro-firms and first-time borrowers is held back by informality, lack of financial and identification records, and conservative risk-management practices, and could benefit from targeted interventions. In addition, technical assistance would help these SMEs to access financing and could help banks to tailor their risk assessments to specific segments of prospective clients.

Investing sustainably in Africa's cities

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Summary

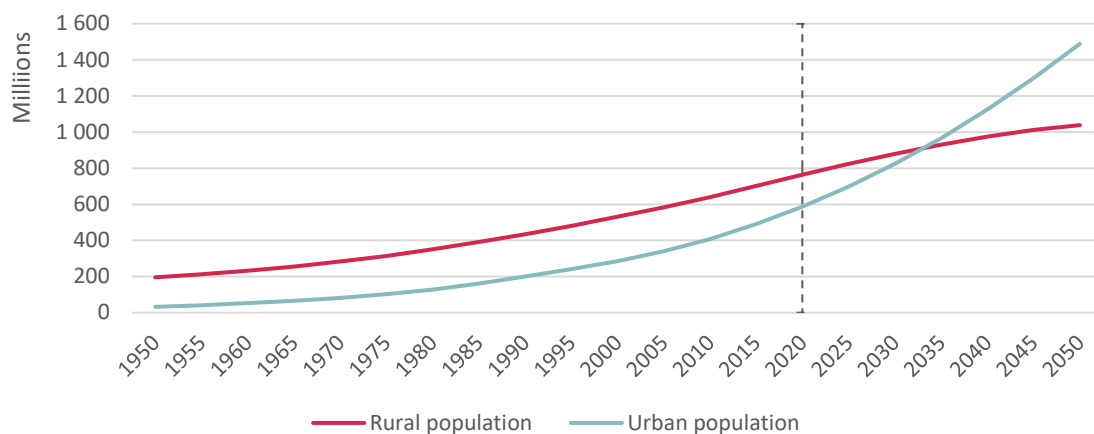
The main challenge for African cities is to ensure that they provide opportunities for all. Africa's rapid urbanisation represents a unique opportunity to contribute to achieving the Sustainable Development Goals (SDGs). Urban areas are expanding in size without higher population density, making it more difficult to provide infrastructure, services and jobs. In addition, climate change when combined with internal migration and infrastructure gaps can exacerbate poverty and social conflicts. The lack of effective urban planning has long been the root of the uncontrolled development of African cities and of higher investment costs for infrastructure and services. Municipal authorities often lack institutional capacity and are financially constrained. Few African cities have significant revenues of their own and many of them are not allowed to issue debt. The growing urban populations are amplifying governance challenges and the urgency of land reforms. Inefficient land allocation systems are fuelling conflict due to the inability to properly allocate and manage land rights and interests.

Adopting a territorial and inclusive approach is key to unleashing the potential of urbanisation in Africa. In particular, secondary cities are expected to play a special role in eradicating poverty, facilitating structural transformation and unlocking the potential of Africa's agricultural value chains (see Chapter 8). Inclusive approaches that secure the involvement and buy-in of all stakeholders, including the population, can generate smart solutions, resilience, and cost and energy efficiency. Social and affordable housing is a key sector for sustainable urbanisation and African authorities and local financial intermediaries have a critical role to play. Strengthening the fiscal autonomy and the capacity to borrow of cities could improve urban development planning but capacity constraints at municipal level have to be taken into consideration and addressed. Successful African examples of land reforms and land title systems exist and can serve as a benchmark. They can have significant cross-cutting effects on the business environment.

The challenge of rapid and extensive urbanisation in Africa

Countries in sub-Saharan Africa are struggling to meet the challenges of urban population growth. The typical emerging city lacks control of land use or provision of adequate services. This means that traffic congestion wastes productive time and pollutes the air; poor populations are concentrated on sites subject to a myriad of hazards; and disparities between rich and poor create social tensions and insecurities that can turn the hopeful vision of life in a modern city into a painful disappointment, especially for the poor.

Figure 1: Urban and rural population in Africa, 1950-2050



Source: World Bank, World Development Indicators (2019).

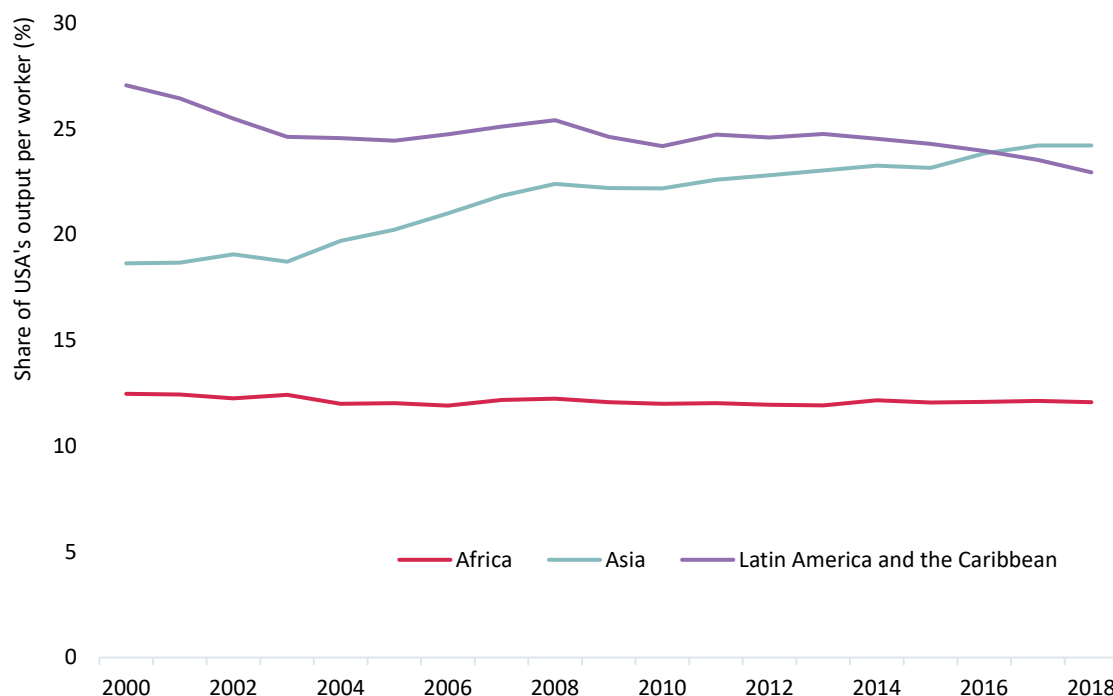
Africa's urbanisation is characterised by its rapid pace, its strong connection to rural areas, and its magnitude. Africa's urban population will more than double, reaching 824 million by 2030, with cities with fewer than 1 million inhabitants capturing 77% of that growth. The African population is about 40% urban today (Figure 1), and will become predominantly urban by the mid-2030s. Africa is urbanising twice as fast as Europe did. It took Europe 110 years to move from 15% urban in 1800 to 40% in 1910. Africa has achieved the same transformation in almost half the time: 60 years. Africa's urbanisation also differs from experiences in other developing regions. Unlike other world regions experiencing urbanisation, the rural population will continue to grow beyond 2050 (Figure 1).

Urban areas have often expanded in size without higher density, making it more difficult to provide infrastructure, services and jobs to new urban settlements. In other words, the growth of urban areas size-wise has not been accompanied by an increase in population density that typically characterises urbanisation. The Atlas of Urban Expansion shows that 12 sub-Saharan African cities have a low density at 81 inhabitants/km², while six North African cities have densities similar to South-East Asian cities at 155 inhabitants/km². The African cities studied have built up rapidly at more than double the rate of national population growth. Several cities, such as Kampala, have achieved rapid population growth at 4.3% a year with even faster physical expansion at 10.6% a year, reducing their density level (Angel et al, 2010a).

At current rates of population growth and urban sprawl, African urban areas will continue to expand quickly. Sub-Saharan Africa's urban areas will likely grow at least fourfold between 2010 and 2050, even if the rate of land expansion remains constant. However, if the consumption of land per capita increases at 1% or 2% per annum, the land area of cities is likely to increase six- or eightfold, respectively. Such high rates of urban expansion generate transport pollution and bring high environmental risks as they reduce the supply of ecosystem services such as arable land, fresh water, vegetation cover and waste absorption. The spatial mismatch between where the poor live and where economic activities are to be found may also

risk disconnecting workers from jobs, exacerbated by the lack of affordable transport systems, raising the cost of urban services due to low density expansion, and increasing pressure on social services.

Figure 2: Labour productivity in Africa, Asia and Latin America and the Caribbean compared to the United States' level, 2000-18



Source: Authors' calculations based on Conference Board Total Economy Database (2019).

Despite the opportunities brought by rapid urbanisation, Africa's productivity is not catching up with the global frontier. The Africa-to-USA labour productivity ratio remained at 12% between 1990 and 2018 (see Figure 2). In contrast, countries in developing Asia have been catching up as the Asia-to-USA labour productivity ratio increased from 19% to 24% over the same period. The labour productivity gap is even more pronounced in agriculture, but it is also occurring in market services such as transport, financial activities, construction and manufacturing (AUC/OECD, 2018).

Urban areas are not creating enough good jobs. The high rate of urbanisation so far has not created employment outside the informal sectors or low value-added services. Non-tradable informal service activities make up most urban livelihoods. The informal economy accounts for at least 61% of urban employment and is the source of 93% of newly created jobs (Kessides, 2005). The demand for more and better jobs will increase in the future as 29 million young people will reach working age every year between today and 2030. By comparison, there were 14 million new entrants per year between 2000 and 2015.

'Slum urbanisation' has become a growing risk. Africa has higher rates of urban poverty than any other continent: its urban Multidimensional Poverty Index (MPI) is 0.151, twice the level of South Asia (Minsat, 2018). About 62% of sub-Saharan Africa's urban population lives in informal settlements. Due to rapid urban population growth, many African cities face the challenge of their slum populations tripling by 2050 (UN-Habitat, 2008). People living in informal settlements often have low mobility rates, as high transportation costs can account for at least 20% of low-income households' disposable incomes. The poor living conditions inside the cities pose serious challenges to realising the targets of SDG 6 (Ensure availability and sustainable management of water and sanitation for all) and the Africa Union's Agenda 2063 on extending access to water and sanitation.

Weak urban infrastructure reduces the competitiveness of African cities due to high congestion costs and limited economies of agglomeration. Energy is the most commonly cited constraint to doing business for African firms. Many African cities lack the basic infrastructure, urban planning and management capacity to boost their competitiveness (Castells-Quintana, 2017). The cost of financing basic urban infrastructure and service delivery in sub-Saharan Africa is, according to various estimates, at least between USD 29-60 billion a year (AfDB/OECD/UNDP, 2016). This amount is equivalent to 5-7% of their GDP, higher than the estimated need for Asia at 4.4% of GDP and similar to the estimated need for Latin America and the Caribbean (LAC) at 3-8% of GDP (Fay et al., 2017; Oxford Economics, 2017).

New environmental risks are also emerging due to rapid urbanisation. Premature deaths from outdoor air pollution in Africa have increased by 73% between 1990 and 2013. Outdoor and indoor air pollution already costs the equivalent of one-third of Africa's GDP. Mortality from air pollution cost Africa an estimated USD 447 billion in 2013, a third of its GDP (AfDB/OECD/UNDP, 2016). Resource use of such as water and other natural resources is straining local environments. Many African countries, particularly in the Western and Central areas, are vulnerable to weather disruptions such as severe floods (Kendon et al., 2019). Half of African cities with 1-5 million inhabitants lie in low-elevation coastal zones and are vulnerable to flooding (Kamal-Chaoui and Robert, 2009). Moreover, desertification already affects two-thirds of Africa's land and 65% of its population. It contributes to rural-urban migration since African agriculture depends on rainfall.

Insufficient infrastructure investment is also a challenge for the sustainability of African cities which face significant climate change risks. For instance, although Cape Town is often praised as one of the African cities with more and better investment in urban development, a three-year drought resulted in severe water shortages in 2017 and 2018. The city had to announce a 'Day Zero' when it expected to run out of water, short of significant water restrictions. The crisis highlighted the city's almost total reliance on surface water and its lack of investment in back-up or complementary sources. 'Day Zero' was eventually averted but economic growth in the city and its region was significantly affected. Without a substantial ramp-up in infrastructure investment across the African continent, other such urban crises are expected as a result of the combination of climate change and rapid urbanisation.

Turning challenges into opportunities for job creation, productivity growth and poverty reduction

In recent years, the development of cities has been prioritised by many African governments. The urgency of public policies addressing rapid urbanisation and of the volume and cost optimisation of related investments will increase further in the coming years due to the pressure exercised by urbanisation on basic services and the environment. Although the speed at which urban policies are implemented is country-specific, many African countries have understood the challenges of rampant urbanisation. They are rapidly implementing ambitious programmes aimed at economic and social space management, governance, investment financing and institutional collaboration.

Table 1: Target indicators related to urbanisation in sustainable development goals and agenda 2063's 10-year implementation plan

Target indicators	
SDG 2030 targets	<ul style="list-style-type: none"> • Ensure universal safe and affordable drinking water • Ensure sanitation services • Ensure access for all to adequate, safe and affordable housing and basic services and upgrade slums • Enhance inclusive and sustainable urbanisation and capacity for participatory, integrated and sustainable human settlement planning and management in all countries • Reduce the adverse per capita environmental impact of cities, including by paying special attention to air quality and municipal and other waste management
Agenda 2063's 2013-23 targets	<ul style="list-style-type: none"> • At least 50% of urban waste is recycled • At least 10% of all urban buildings are certified as energy smart • At least 15% of all urban mass transport operates on low renewable and low emissions fuel • Safe drinking water and sanitation will be available to nine out of ten persons

Source: Author's compilation.

Sustainable cities will be key for Africa's development, as emphasised by African aspirations and the global development agenda (Table 1). Agenda 2063, notably through its Goal 1 aspiring to high standards of living, quality of life and well-being for all African citizens, highlights the need to harness the urban transition for sustainable development on the continent. These needs and ambitions are echoed at the global level by the 11th SDG, to 'Make cities and human settlements inclusive, safe, resilient and sustainable'. The United Nations' New Urban Agenda, which was laid out at the Third Habitat conference in October 2016 in Quito, Ecuador, underscores the linkages between sustainable urbanisation, job creation and improved well-being.

Table 2: Selected cases of recent clusters of firms in Africa

Kigali Special Economic Zone (Rwanda)	<ul style="list-style-type: none"> • Firms moving into the KSEZ are associated with a 206% increase in sales, a 201% increase in value added and a further 18% increase in the number of permanent employees compared to the trend of similar firms that did not move there.
Tangier-Med (Morocco)	<ul style="list-style-type: none"> • A world-class automotive and aeronautics cluster that produces many parts and components for European manufacturers. • Tangier-Med region's close geographic proximity to European markets, strong local universities and existing infrastructure to support the development of its automotive and aeronautics industry are advantages for Morocco.
Hawassa Industrial Park (Ethiopia)	<ul style="list-style-type: none"> • Textile, leather, agrifood processing and pharmaceutical. • 60 000 people employed, with an export capacity of USD 1 billion per year. • Has attracted manufacturing firms in the textile, garments and shoe manufacturing industry. Eco-industrial parks with 35 production sites using green energy.

Source: Author's compilation.

African cities create new activities, especially in manufacturing and modern services. Global experience shows that higher rates of urbanisation are associated with higher levels of income per capita, since countries that pass a USD 10 000 per capita threshold are at least 40% urbanised. This tendency also manifests itself in Africa, where the more urbanised countries in Northern Africa and South Africa have higher GDP per capita than more rural countries. The agglomeration of people and firms can facilitate their access to a wider range of skills, inputs and services that boost productivity (see Box 1). A high density of firms and ideas also facilitates innovation. For example, 49% of African start-ups are concentrated in five

cities: Cape Town, Lagos, Johannesburg, Nairobi and Cairo (AU/OECD, 2019). Urbanisation is conducive to the development of clusters that can have higher productivity (Table 2). In the case of Kigali SEZ, much of its success derives from its proximity to a burgeoning consumer base and relatively diversified supplier network in Kigali (Steenbergen and Javorcik, 2017).

Box 1: A Brief literature review on the links between urbanisation and prosperity

Urbanisation has long been associated with higher prosperity and growth, through better sharing, matching and learning (Duranton and Puga, 2004). Countries with higher urbanisation rates generally have higher GDP per capita (World Bank, 2009). Early 'dual economy' models recognised cities as potential engines of structural transformation. Non-agricultural activities in the cities draw surplus farm workers into more productive jobs (Lewis, 1954; Johnson & Mellor, 1961). 'New economic geography' emphasised the role of agglomeration economies in accelerating economic growth (Fujita, Krugman, & Venables, 2001). Urbanisation can generate agglomeration economies by bringing industrial producers closer to labour markets and customers as well as to one another. A system of cities emerges as these agglomeration economies are balanced out by congestion costs due to higher density such as higher real estate prices and transportation time (Henderson, 1974).

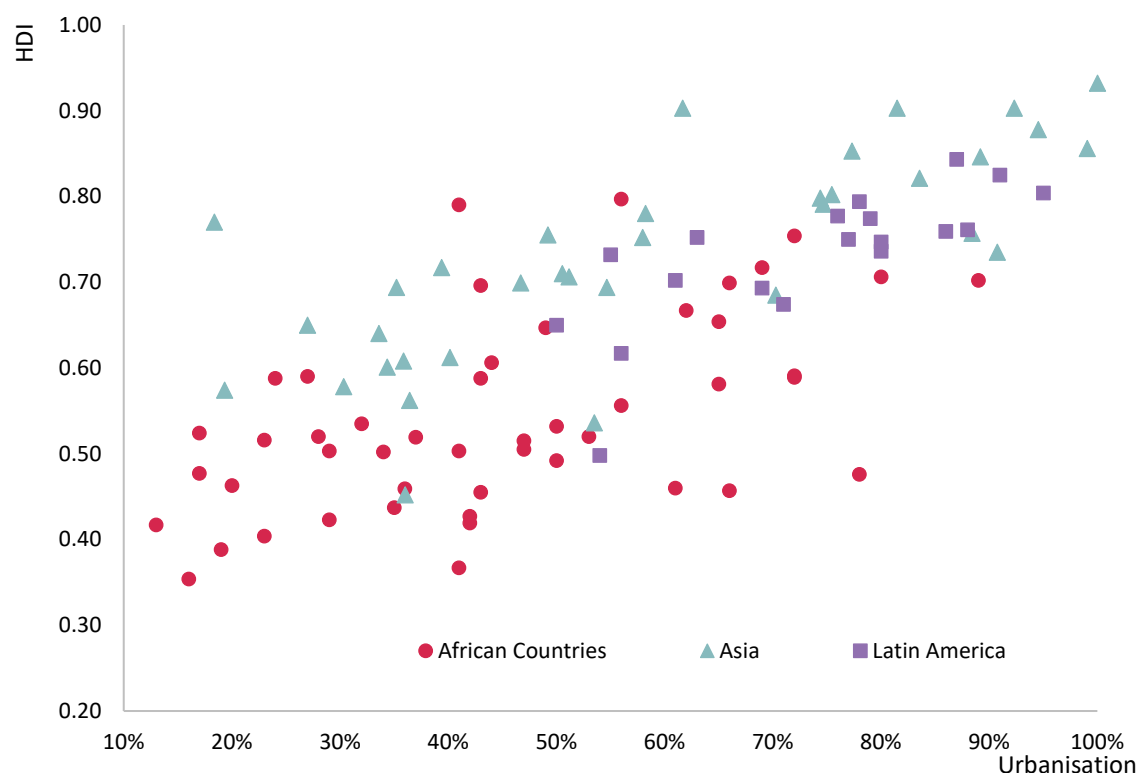
Cities are generally known as the places with the potential to attract the most productive activities and to allocate resources efficiently. The concentration of workers and firms helps spread the cost of goods with high fixed costs among many users, such as investments in infrastructure. Cities also facilitate better matching among firms, workers, producers and suppliers thanks to a large and diversified pool of labour, easier access to suppliers and specialised services, and a larger local market. Close proximity also lowers the information and transaction costs of sharing new knowledge, facilitates more diversified contacts and creates an environment conducive to innovation (Romer, 1990).

More recent research highlights that the link between urban concentration and prosperity is not automatic. Urban infrastructure is crucial to the functioning of cities, to reduce congestion diseconomies and lead to economic growth (World Bank, 2011; Castells-Quintana, 2017). An environment conducive to investment is necessary, including business-friendly regulations, multi-level governance frameworks enabling local governments to attract investment, a skilled workforce and a well-functioning financial sector.

Another stream of recent policy research emphasises the importance of secondary cities in facilitating structural transformation (AfDB/OECD/UNDP, 2016; Losch, Freguin-Gresh, & White, 2012). Secondary cities can provide the agglomeration economies necessary for low-skill manufacturing to emerge while also ensuring strong rural-urban linkages. Migration to secondary cities is also more conducive to poverty reduction than migration to large cities (Christiaensen, De Weerd, & Todo, 2013). Migrants going to secondary cities are more likely to find gainful jobs that help them exit poverty.

Many African cities are attracting more and more foreign direct investment (FDI), with 42 African cities having attracted a total of USD 583 billion in greenfield FDI between 2003 and 2016, equivalent to 58% of all greenfield FDI to the region during this period. Cairo, Johannesburg, Tangiers and Lagos are Africa's top destinations for greenfield FDI (UN-Habitat, 2018). These foreign investments can bring new knowledge and technology to the local community, and enhance the growth of local firms through backward and forward linkages.

Figure 3: Human development index and urbanisation in selected countries of Africa, Latin America and Asia, 2017



Source: UNDP, Human Development Data (2019); World Bank, World Development Indicators (2019a).

The agglomeration of the African population into urban areas provides opportunities for expanding access to basic services. This process creates the scale necessary to provide basic services at a lower cost. For example, 232 million more urban residents in Africa have access to improved water in 2014 than in 1990; 128 million urban residents have gained access to water and sanitation over the same period (AfDB/OECD/UNDP, 2016). Public goods such as education and health can be distributed across cities of various sizes and to their surrounding hinterland more efficiently. The more urbanised countries in Africa and other regions also exhibit higher levels of human development (Figure 3).

Linking rural and urban areas via secondary cities

Africa's urban markets generate a demand pull for local producers. The middle class, broadly defined as those spending USD 5-20 a day and highly concentrated in cities, increased from 108 million people in 1990 to 247 million in 2013 (AUC/OECD, 2018). The dietary changes associated with urban lifestyles increase the consumer base for African food producers. The urban sector accounts for 40% of the total population but 50% of total food consumption and 60% of the food market⁶ (Reardon et al., 2013; see also Chapter 8). The Sahel and West Africa Club estimated the West African food economy in 2010 at USD 178 billion, making it the largest sector of the West African economy with 36% of regional gross domestic product (Allen and Heinrichs, 2016).

The process of urbanisation helps to increase agricultural productivity, and create rural non-farm jobs along the value chain (as discussed in greater depth in Chapter 8). Agglomerations can help reduce the cost of distributing agricultural input, credits and market information to rural producers. Farmers close to

⁶ A significant share of food consumption is self-produced (auto-consumption), and not all food produced is brought to the market.

urban areas can also take advantage of employment opportunities in urban and peri-urban areas. Jobs in sectors such as food manufacturing, wholesaling and retailing, logistics and marketing, can diversify their income sources and generate incomes five to seven times higher than farming jobs (Tschirley et al., 2015).

Yet, the urban and rural markets are still poorly connected due to weak logistic and storage infrastructure. Rural producers are often limited to serving their local vicinity and they miss out on the rising consumption of the urban middle class. African exports of consumption goods to other African markets decreased from USD 12.9 billion to USD 11.8 billion between 2009 and 2016 (AUC/OECD, 2019). In contrast to the decline in intra-Africa trade of consumption goods, new global competitors are also putting competitive pressure on African producers. Africa's imports of consumption goods from the rest of the world grew from USD 11.2 billion to USD 19.0 billion between 2009 and 2016.

The inequality gap between urban and rural areas and within big cities is widening. The available evidence suggests that Africa is the second most unequal continent in the world after Latin America (Ravallion and Chen, 2012). Close to 40% of asset inequality in Africa is related to spatial factors, some of which create 'spatial poverty traps' (AfDB/OECD/UNDP, 2015). The disparities overlap with the rural-urban gap. Within cities, the new development of large gated communities can heighten spatial segregation and hampers social cohesion. One example is Eko Atlantic City on an artificial island five kilometres away from Lagos that offers exclusive amenities to upper class and expatriate elites. A different example is Kibera, Africa's largest slum, which sprawls in the vicinity of Nairobi's residential areas (AfDB/OECD/UNDP, 2016). In contrast, such inequality gaps are much less common in secondary cities.

Africa's urban system consists of a range of towns and cities of all sizes. Whereas much policy interest in urbanisation in Africa has often focused on the megacities such as Cairo and Lagos, smaller cities and towns play an important role in absorbing population growth and internal migration. Eighty-one per cent of Africa's population, almost 1.1 billion inhabitants, live in a rural-urban interface consisting of rural villages, towns and cities of fewer than 500 000 inhabitants. These cities of fewer than 500 000 inhabitants account for two-thirds of the urban population growth since 2000 (AUC/OECD, 2018).

Secondary cities are important to strengthen rural-urban linkages and to eradicate poverty. They offer key drivers of growth for rural livelihoods, notably by creating local markets for local rural products and providing basic services. Migration to secondary cities can be a better strategy for rural migrants moving out of agriculture thanks to the lower migration costs. Migrants from rural Kagera in Tanzania are seven times more likely to exit poverty when they migrate to secondary cities than when they migrate to primary cities (Christiaensen et al., 2013). Globally, poverty reduction is stronger where there is an increase in the share of population in rural non-farm and in urban agglomerations of fewer than 300 000 inhabitants.

Offering basic services and creating jobs in these smaller agglomerations are key to tackling the continent's development challenges. The knowledge base on secondary cities in Africa is thin, but existing evidence suggests that the provision of services in secondary cities lags behind that in capital cities (Roberts, 2014). Secondary cities depend highly on central governments and regional authorities for financing both infrastructure and services. In nine African countries, the governments of secondary cities spend on average less than USD 1 per capita per year in total (AfDB/OECD/UNDP, 2016). They also face difficulties in accessing external finance. Less than one in 20 agglomerations below 100 000 inhabitants benefit from urban-focused Official Development Assistance (ODA) (OECD/SWAC, forthcoming).

Participatory and integrated urban regeneration and development projects

To fully unlock the economic potential of cities, local governments need both the tools to manage the development challenges they face and the human and financial resources to improve economic, environmental and social conditions. New needs arise from rapid urbanisation, population and economic growth as well as making the infrastructure resilient to climate change. Therefore, the challenge for all

stakeholders is to accommodate and reconcile the rapid pace of urbanisation on the African continent with sustainability imperatives and the global challenge of climate change. The unplanned existing urbanisation hampers structural transformation to sustainable cities in Africa (Sustainable cities and structural transformation, African Economic Outlook, Part III, 2016, AfDB, OECD, UNDP). This should lead to a rethink about urban development, cut across sectoral silos, and propose adapted financing solutions.

The lack of effective urban planning has long been at the root of the uncontrolled development of African cities. Most countries have failed to update or even adapt their urban plans inherited from the colonial era, leaving urban development subject to informal growth. The successful implementation of urbanisation policies calls for the active participation of all stakeholders. Indeed, engaging customary authorities, civil society, development partners and also the private sector in this process serves a dual purpose. Not only does it empower stakeholders to exercise their power in determining priorities for their communities but it also ensures the sustainability of the urban projects at stake by clarifying the roles, ownership and accountability of the stakeholders.

The key to success, particularly in sub-Saharan Africa, is not only better urban planning but also more integrated urban projects. Transport, water/wastewater, energy, telecommunications, etc. are all key to successful urbanisation. Yet, many other parameters need to be taken into consideration: social and affordable housing, new cities and urban developments, urban regeneration, industrial zones, wholesale markets and other economic activities, informal settlement upgrading, cultural heritage, etc. Indeed, urban infrastructures are generally based on network economies. Effective urban planning can alleviate peak demand and support social inclusion, which is very cost-efficient in the context of scarce resources and the population's weak capacity to pay. Further, demand management measures can also be very cost-efficient and link urban infrastructure development to land use. For instance, transport demand can be managed through differentiated tariffs according to the time of the day or according to traffic volumes, information provided about the availability of services, efficient devices such as for lighting, etc. Finally, building climate change resilience in urban areas requires a holistic, comprehensive and multi-sectorial/dimensional approach.

In a collaborative and iterative approach to urban development projects, the constant monitoring of the implementation of urban development programmes becomes essential. Monitoring is the key to effectively adjusting urban policies wherever necessary. The lack of instruments to monitor the execution of urban plans stems mainly from weak technical and coordination capabilities. Yet, in many cases, corrective actions have identified obvious deficits in the information and data needed for good planning. These inadequacies are being resolved through technology, particularly with the advent of mobile telephony, which generates a large flow of usable data. For instance, Kenya, in a bid to boost its urban planning policy by basing it on reliable and detailed data, has committed to investing in data collection, monitoring and evaluation mechanisms. In other cases, the exploitation of information sources has led to the development of secondary cities (see previous Section).

Integrated urban projects take more time to prepare and implement but they have a very high social and economic impact and greater cost-effectiveness. Designing and implementing an integrated urban project is more difficult than a sectorial one. There are multiple stakeholders and interactions to bear in mind, and the issues at stake are not only technical but also political and sociological. Public participation in the design is to be encouraged. The stakes are even higher in the case of major urban projects, such as new cities. When properly designed and executed, these projects can ease the pressure on old cities not initially designed for large populations.

An integrated approach and the involvement of stakeholders are key to generating smart solutions, resilience and cost and energy efficiency. In particular, residents often have and take the appropriate solutions and initiatives. Conversely, in some cases, the informal sector can oppose a project if its interests are not taken into consideration. Under these conditions, urban projects do enhance social cohesion, local economic development, job creation and the integration of the informal economy, which are of the greatest importance for successful urbanisation. This can enable cities to fully play their role in territorial development, in particular through transport nodes and food market and processing.

Box 2: The Global Climate City Challenge

The Global Climate City Challenge is a joint initiative of the European Investment Bank and the Global Covenant of Mayors (GCoM). It represents over 9 000 cities from six continents. The aim is to provide technical assistance that helps prepare and fast-track financing of urban climate action projects. The GCoM and the EIB collaborate on this challenge with global and local city networks, including Local Governments for Sustainability (ICLEI), the C40 Cities Climate Leadership Group as well as the Deutsche Gesellschaft für Internationale Zusammenarbeit (GIZ). The Challenge is part of a new partnership under the umbrella of Global Urbis, an ambitious global initiative announced during the One Planet Summit in Paris in December 2017 that provides cities and local governments around the globe with technical assistance and financing for climate action.

The Challenge targeted municipal and local authorities or entities such as municipal companies, utilities and local banks with an interest in addressing climate change. Applications for the Challenge closed on 28 February 2019. More than 100 municipal and local authorities – of which 29 were African – presented for the EIB-GCoM Global Climate City Challenge more than 140 projects with a view to receiving technical assistance and financing from the EIB.

Six selected projects will be taken through the EIB's appraisal process with the objective of obtaining financing for their project and free project preparation and technical assistance support. The applicants had to fulfil several technical criteria. They had to demonstrate a strong commitment towards implementing climate action investments. Projects were also required to present an integrated urban development plan, an urban climate strategy or equivalent, a project or a pipeline of climate action projects stemming from the city's climate strategy or other relevant plans and strategies. In addition, projects needed to prove sufficient institutional capacity to develop, manage and implement an investment. The expectation was the availability of a dedicated project team acting as a counterpart and sufficient autonomy and capacity to borrow and repay debt through revenue-generating capacity at the project level, through municipal budget or other sources of finance.

The selected cities benefit from an integrated toolbox of support. The selected projects will benefit from grant support for project preparation to improve the quality of the projects. Support will go beyond financial backing and will include access to EIB expertise in state-of-the-art technology and innovative project financing in the different sectors of urban infrastructure, and support in identifying complementary financing opportunities. The projects will also have access to knowledge-sharing through GCoM, and third-party experts will work alongside the project developer to finalise the projects.

Updated information on:

<https://www.eib.org/en/projects/sectors/urban-development/city-call-for-proposal/index.htm>

An important key to sustainable urbanisation is financing of economic development in urban areas. This can be done through industrial parks or areas dedicated to economic activities providing the necessary services. Moreover, the rehabilitation and promotion of cultural heritage, particularly in old cities (e.g. the medinas project in Tunisia) can support local economic activity, including through tourism.

Even if medium-size cities face challenges in terms of capacity, their decision process can sometimes be smoother than in bigger cities. Small- and medium-sized urban projects can be technically easier to design and implement. On the financing side, they can be reached through framework loans which collect at national level small- and medium-sized projects in various cities. Some private or public/private funds could be interested in investing in such projects and cities, for example in the housing sector. Nevertheless, there is quite some scope for exchanging lessons learnt and best practices from large cities.

Effective decentralisation and funding autonomy

The shortage of bankable projects is well recognised as a major barrier to investment in African cities. Municipal authorities often have insufficient planning, design and preparation capacity to develop a solid pipeline of technically and financially sound projects. A mix between top-down and bottom-up approaches is essential: while national support is key, including in terms of guarantee schemes, it is equally important to identify sustainable projects to develop a strong pipeline of local investments. The role of technical

assistance in strengthening the capacity of municipal and local governments as well as the technical feasibility and bankability of urban projects is therefore crucial. While there are several sources of technical assistance addressing these needs, a clear gap emerges in the availability of support for moving from urban and climate action plans and project ideas to the feasibility stage under existing project preparation facilities.

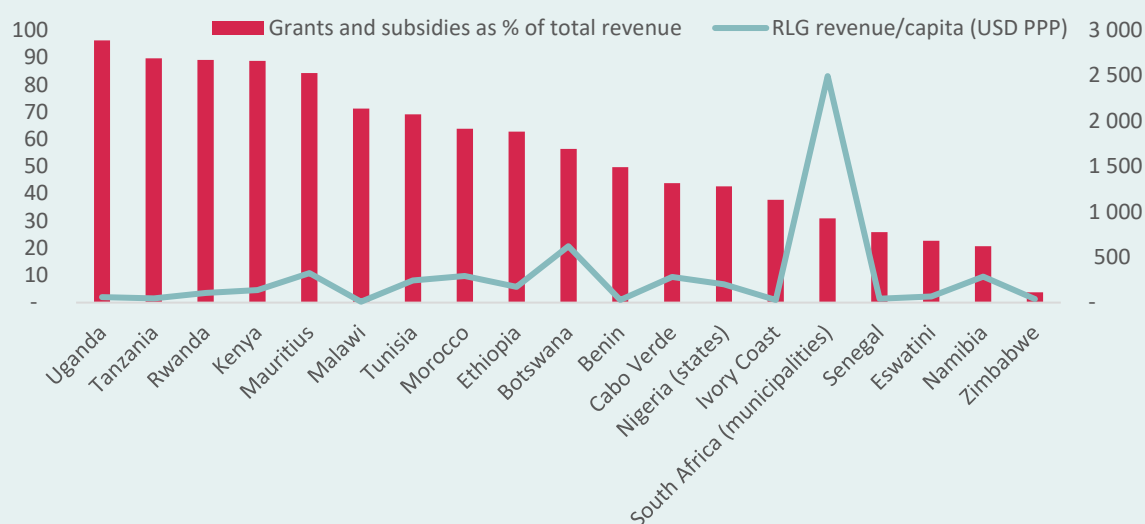
International financial institutions (IFIs), city networks, investors and donors are increasingly aware of this gap. It is precisely with this challenge in mind that the EIB and the Global Covenant of Mayors (GCoM) launched the Global Climate City Challenge in 2018 (Box 2). The creation of the City Climate Finance Gap Fund (Gap Fund) will address the critical lack of grant funding necessary to mature pipelines of projects from a concept to a stage where they can be advanced towards full feasibility analysis and ultimately investment. This will significantly increase the pipeline of high-quality, bankable, climate-friendly, urban infrastructure projects that must be moved forward to meet the urgency of the climate crisis. The Gap Fund aims to raise more than EUR 100 million in grants in order to unlock at least EUR 4 billion worth of projects.

As mentioned earlier, rapid urbanisation, weak institutional capacity and political pressures are additional factors hampering the implementation of urban projects. To mitigate this kind of risk, there is a need to reinforce the legal and institutional set-up, and its enforcement, and to support participatory processes. It also helps to strengthen the monitoring and evaluation of the results of urban projects. Because financial institutions supporting urbanisation want to be reasonably confident in their decisions about long-term capital investments, the establishment of a transparent and sound regulatory framework for investment is a prerequisite for attracting capital flows.

Box 3: Local governments' fiscal capacity and creditworthiness in Africa

Despite rising fiscal decentralisation, regional and local governments (RLGs) in many African countries are highly dependent on grants and subsidies, with limited own-source revenues. Increasing urbanisation across Africa has led to an increase in decentralisation - the shifting of administrative, political and fiscal powers from national or central governments to lower levels of government. Political decentralisation is now relatively advanced in Africa - most countries have substantial numbers of sub-national entities with elected local authorities. Administration - shifting administrative and executive functions and responsibilities to lower levels of government - has been more limited.

Figure 4: Revenues, grants and subsidies at the regional and local government level in Africa



Source : Moody's (2020).

However, fiscal decentralisation – the transfer of responsibility for government expenditure and revenue-generating capacity to lower governmental levels – has significantly lagged behind political and administrative decentralisation (Figure 4). Only Ethiopia, South Africa and Nigeria have very strong revenue decentralisation. So far, (limited) fiscal decentralisation has mainly constituted transfers from national governments, which are often ring-fenced for specific purposes. This limits RLGs' ability to fund local priorities. As African cities are often dependent on budget transfers from the state, their creditworthiness also depends on the economic and fiscal strength and stability of the respective state,

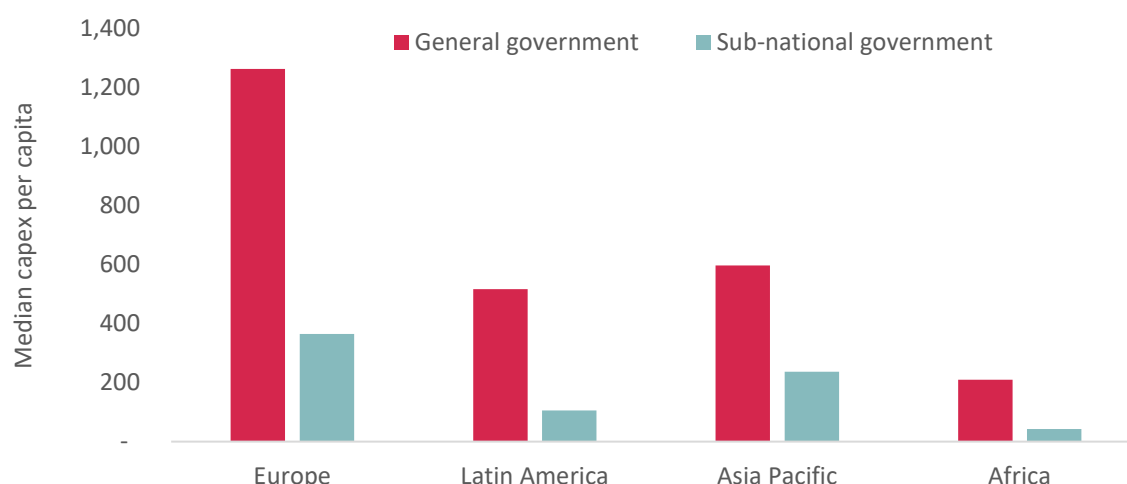
which is often weak. However, this is not the case for all African RLGs. South African municipalities benefit from both a stronger sovereign (as reflected in its credit rating) and higher level of fiscal decentralisation. Not only are South African municipalities less subsidised but they are also able to collect taxes in order to finance urban investments. There are other African RLGs that could also benefit from the higher credit quality of their sovereigns, e.g. Botswana, Mauritius, Morocco, Namibia and Tunisia.

African RLGs have very low debt levels compared to RLGs in other regions. This is due to two main factors: first, many African RLGs are forbidden to accumulate debt (as established in their respective country's constitutions) and second, most have weak fiscal capacity and creditworthiness, limiting their ability to access capital markets. The only African RLGs with material levels of debt are in South Africa and Nigeria. If you exclude these countries from the sample, other African RLGs only have 0.8% of total public sector debt on average, demonstrating the sector's limited capacity for external funding at present.

Source: Moody's (2020).

On the financing side, public authorities are confronted with increasing constraints. Debt burdens are rising throughout African countries, resulting in public debt limitations, budgetary constraints and austerity measures that, in some countries, act as a brake on economic growth. Several African countries are at high risk of debt distress according to the IMF and are constrained by their credit rating in terms of access to debt financing. The indebtedness capacity of African cities is all the more constrained (Box 3).

Figure 5: General vs sub-national government capital expenditure



Source: Moody's (2020).

As a result, African countries spend significantly less on capital expenditure at the regional and local government level when compared to other regions of the world (Figure 5). To get around these financing constraints, the focus has to be put on projects with immediate financial returns. These returns can flow directly, as in the case of transport and energy, or indirectly, through fiscal revenues, when a fiscal system is in place or is set up specifically for the project. However, tolls and tariffs can make access to quality infrastructure unaffordable to a large proportion of the population, worsening inequalities. Finally, blending can also play a role, with grants that are tailored to the economic and financial needs of the project in order to smooth its implementation. The role of grant financing can be very important to back capital investment in cases where projects are not fully financially viable based on the revenues that the project can generate or the resources which the city can mobilise.

Another option is to reinforce the creditworthiness of local authorities but capacity constraints and limited fiscal autonomy loom large. Short of some preconditions, self-financing by local authorities is probably neither possible nor advisable; in other words, municipalities with limited administrative capacity should prioritise better infrastructure planning and coordination together with their regional

and national authorities. Giving a credit rating to the local authorities could increase transparency but it is higher decentralisation and more fiscal autonomy over taxes and levies that can improve fiscal strength and therefore the creditworthiness at the city level. Other mechanisms include guarantees, bonds dedicated to specific investments and local currency loans, including from public municipal banks. The preparation of such initiatives generally presupposes the selection of sound projects, transparency and the strengthening of the authorities' capacity to design, implement and monitor projects. Meeting these preconditions is a structural benefit of its own for the city, beyond the resulting financial pay-off.

The effective monitoring by the state of the actions and mode of governance of the municipal authorities is key to the successful transfer of administrative power from the state to cities. When this delegation becomes effective, the role of the central government changes from executive power to counselling, supervising and controlling municipalities. Yet, political power decentralisation in favour of local authorities is a relatively recent phenomenon in Africa. In most countries, regulatory texts specify how resources and powers are transferred from the state to decentralised bodies.

Besides enhancing the credibility of the decentralisation process, strengthening the financial autonomy of cities is a prerequisite to improve urban development planning. Laws and regulations should provide a framework for the expansion of municipal prerogatives to raise taxes or at least benefit from a greater share of the resources derived from the taxes collected in their jurisdiction. Unfortunately, initiatives to generate city-specific resources are also hampered, in many cases, precisely by the fragility of such regulatory framework, where it exists.

The experience of African cities with using municipal bonds launched on the financial markets to help bridge the urban infrastructure gap is diverse and mixed. In South Africa, a body of legislation oversees municipal fundraising. In 2004, the country passed a law on the management of municipal finances that defines very precisely the financial activities authorised and prohibited for cities. They are not allowed to borrow for their operating expenses but rather for long-term investment projects. This law has thus helped to facilitate the intervention of pension funds, insurance companies and other institutional investors in the financing of urban infrastructure, through the municipal channels. These players have, on the basis of the existing texts, full knowledge of the prerogatives and limitations of municipal authorities; further, such regulations cannot be interpreted or modified under political pressure. On the whole African continent, only a handful of decentralised administrations have managed to issue municipal bonds, almost all in South Africa.

Although until recently the majority of infrastructure funding came from the public sector as regulatory instability and a lack of realistic programmes held back private investment, the role of the private sector is set to strengthen. Despite annual spending on basic infrastructure in Africa fluctuating between USD 130-170 billion, the continent still faces funding shortfalls ranging annually between USD 68-108 billion. To date, about two-thirds of the investment in urban infrastructure needed on the continent by 2050 has not yet been provided. The private sector is called upon to fill this infrastructure gap. To make its role sustainable, the private sector should make the investments necessary to create jobs, which in turn will sustain incomes for the population that will eventually support the sustainability of infrastructure.

Private sector involvement assumes that the local authority has the capacity to deal with the private sector and that rent-seeking behaviour will not undermine the public objectives of the project. Additionally, private investors tend to prefer large ticket investments at the national level whereas most urban infrastructure investments are smaller and subject to additional political and other risks. However, aside from the big infrastructure projects - energy, transport, water, telecommunications - where public-private partnerships (PPPs) or private investments can be arranged relatively easily, there are some encouraging cases in urban services, such as waste management and social/affordable housing.

The role of intermediaries such as municipal banks and agencies is critical in many African countries. Lending to and strengthening this kind of financial intermediary is essential to aggregate small investments into a package of a size sufficient for international lenders as well as to diversify risks. For instance, a Tunisian agency named the Agency for Urban Rehabilitation and Renewal (ARRU), financed by the EIB and Agence française de développement (AFD), is managing an urban project covering 150 urban districts across

the country. The Fonds d'Équipement Communal (FEC) in Morocco is a good example of what a municipal bank can do to support urban and local development.

Land reforms and access to housing

Urban land ownership is of strategic importance and there is a strong link between urban land reforms and urban development, access to finance and social peace. Not only do urban land reforms incentivise private investment in urban areas but they are often a prerequisite for municipal governments to be able to collect property taxes and to use other fiscal tools to capture the rising value of urban land. Between the 20th century and the beginning of the 21st, no fewer than 40 attempts at comprehensive land system reforms in various African countries were undertaken (Anseeuw and Alden, 2010). However, very few of them have succeeded and, unfortunately, all too often debates about land reform are not handled with the necessary urgency and priority, due to underlying contradictory and powerful interests. Although it is essential for sound urban development policies, the issue of urban land ownership tends therefore to be overshadowed by other issues related to urban development, such as housing, planning and municipal finances.

An inefficient land allocation system fuels conflict due to the inability to properly allocate and manage land rights and interests. This is especially the case where land values are rising rapidly due to the growing demand for land, as is the case in most of the large urban centres. When it involves long waiting periods at all stages of the process, from investigation to land title issuance, it forces people to adopt alternative means of accessing land including invasions, informal markets and rent seeking. In Zambia for instance, 60% of land titles are traded in informal markets. The resulting conflicts are numerous because land rights may not be clearly defined or delineated by these informal transactions.

Box 4: The case of land ownership reforms in Rwanda

Land ownership reforms have been initiated by the Rwandan government since the end of the 1994 genocide to resolve recurrent land ownership disputes and prevent conflicts. These reforms were all the more urgent as they were meant to prepare for the arrival of some 1.2 million refugees and displaced persons. Due to the country's recent history of violent conflicts, the fundamental texts, including the 2003 Rwandan Constitution and the revised 2015 Constitution, the 2004 National Land Policy and the 2005 Organic Land Act, all incorporated the concept of land ownership and gave it a formal legal basis. The Land Regulation Programme was set up to register and manage land ownership in Rwanda.

Rwanda's efforts to secure land tenure and to improve land governance have attracted the attention not only of foreign governments but also of development institutions. Today, all land over 0.25 hectares is listed and registered, and land transfer is facilitated. The systematic registration of all plots of land and free access to the electronic land registry have undoubtedly improved the transparency of the land title issuance system. Previously, it took a month to process a land title. With the introduction of the new administrative procedures, this processing time has been reduced to three days and by the end of June 2017, 7.16 million landowners had entered into possession of land titles compared to slightly over 900 000 in March 2012. The digitisation of the land registry has also increased the efficiency of property taxes and reinvested a significant portion of this revenue in basic social infrastructure.

Source: MFW4A.

However, successful African examples of land reforms and land title systems exist and can serve as a benchmark. In Tanzania, an innovative and flexible urban land regime and the establishment of formal systems for issuing title deeds have helped to provide appropriate answers to land issues. A particularly instructive case is that of Rwanda (Box 4). The most direct effect of land reforms is more efficient treatment of land titles and of transfers of ownership. In addition, land reforms also contribute towards increasing the income of the state, of local governments and of the population. However, *in-situ* upgrading - with the government providing the infrastructure (regardless of land titles or not), depending on the needs of the

local community - can actually be a low-cost and pragmatic solution to urban upgrading that preserves the fabric of the community, in particular when this can be accompanied by some kind of cost recovery system.

Urban land reforms, if they are carried out in a fair and efficient fashion, can also have significant cross-cutting effects on the business environment. For instance, Rwanda rose from 61st place in 2012 to 4th in the world in 2017 under the criteria for transferring ownership in the World Bank's Doing Business ranking. For local populations, land reforms are an important negotiating tool, particularly in the process of divesting land ownership to foreign investors. So, although they were originally introduced to improve tax revenues and protect citizens' land rights, land reform programmes have also proven to be important catalysts for access to finance by local populations.

In Africa, governments can contribute to enhancing access to credit to finance housing by creating an enabling regulatory and institutional environment. Housing financing in sub-Saharan Africa is still in its infancy and there is a shortage of financing mechanisms tailored to people's needs, while at the institutional level the mortgage market remains embryonic. Persistently low incomes, limited access to financial services and inadequate financial infrastructure often hamper access to housing financing. For financial institutions, the financing of mortgage portfolios depends largely on customer deposits. Limited access to long-term resources and institutional and legal constraints, such as difficulties in obtaining ownership titles and cumbersome eviction procedures in the event of default, have held back the growth of the mortgage sector in Africa. The perception of high credit risk, excessive transaction costs and the high concentration of the banking sector in most sub-Saharan African countries have also led to higher margins and interest rates on loans rising to 25% in some markets. In addition, very few financial institutions have developed mortgage products without a guarantee requirement. The products on offer come with high interest rates and short tenors, making them appropriate only for renovation projects, not for new construction projects.

In most sub-Saharan African countries, the housing funding gap is acute and mortgages, when they are offered, are reserved for a relatively affluent segment of the population with comfortable incomes. As a result, poor households and even middle-class households looking for housing often rely on the informal financial sector. Pilot projects on microfinance products dedicated to the housing sector are being implemented on the continent to address the housing funding gap. However, these should come in addition to traditional instruments that can be mobilised by relatively large formal structures.

Important initiatives to restructure housing financing are being piloted on the continent. These include the creation in 2013 of the Nigeria Mortgage Refinance Corporation (NMRC) and the reform of the Tanzania Mortgage Refinance Corporation. South Africa is also beginning to tackle the constraints to its mortgage and housing markets. Meanwhile, several other African countries are working to reform their housing subsidy systems. In West Africa, for example, the interventions of the Regional Mortgage Refinancing Fund (CRRH-UEMOA) in the regional financial market have enabled refinanced banks to grant more mortgage loans at more attractive rates and with longer maturities. Since 2012, this regional institution has mobilised a total amount of 162.3 billion CFA francs, about USD 300 million, on maturities ranging from 10-15 years through eight public issuances on the sub-regional financial market. Instead of financing themselves on domestic or sub-regional financial markets, some institutions turn to development finance institutions (DFIs), whose role as a technical partner and funder (of last resort) remains crucial for a strong supply of long-term financing on the continent. Alternative solutions such as hire-purchase systems can be also developed, including by specialised institutions.

Conclusions

The urbanisation process will have a profound impact on Africa's development trajectory in the coming years. The majority of Africa's population will live in urban areas by 2035. This agglomeration of population into megacities, secondary cities and smaller towns can boost productivity growth, reduce poverty and create jobs. Developing sustainable cities is thus key to realise Africa's development aspirations and commitments as outlined in Africa Union's Agenda 2063 and the UN's Sustainable Development Goals.

However, the current pattern of urbanisation in Africa poses serious challenges especially with regard to urban employment, slums and urban sprawl due to the lack of urban infrastructure, weak urban planning and coordination, and inefficient land rights systems.

Stronger investment into African cities today is key to harness Africa’s “urbanisation dividend”. Providing basic urban infrastructure and services delivery in sub-Saharan Africa is estimated to cost between USD 29-60 billion a year, or 5-7% of the region’s GDP. Urban infrastructure that alters the urban forms can have long-term consequences far beyond the individual project’s life cycle due to path dependence. Investing in high-quality infrastructure today can also avoid the cost of retrofitting in response to climate change in the future and generate higher social returns in the long run. Better matching of investments and needs calls for increasing urban investments to secondary cities where most of the urbanisation occurs.

Because it is still urbanising, Africa can reap the benefits of investing in sustainable infrastructure for the future. Two-thirds of urban investments are to be made between now and 2050 to meet Africa’s ambitions and needs and achieve the SDGs. Africa can also take advantage of new opportunities to leapfrog to the green economy, especially in the energy sector. The continent’s enormous potential in renewable energy can help address its energy shortage. Half of sub-Saharan Africa’s growth in electricity generation until 2040 will come from renewables (OECD/IEA, 2014). Investments in renewable energy would come at a time when alternative energy costs are decreasing rapidly. The cost of solar energy fell by 80% between 2008 and 2015. For sub-Saharan Africa in particular, decentralised systems, led by photovoltaic off-grid systems and mini-grids, are the least-cost solution for the majority of additional connections needed (OECD/IEA, 2017). This applies not only to natural resources and energy efficiency in urban development and housing but also implies promoting smart cities and technologies and climate mitigation and adaptation.

While rapid urbanisation is quite challenging for the design, financing and implementation of urban projects, it also provides many opportunities for development in many active and busy African cities. History shows that the capacity of African people to find solutions at the ground level to urban challenges is impressive. Countries could find ways to address their challenges, through local skills and initiatives, young people, start-ups and small enterprises, etc. Famously, African urban centres are well ahead of advanced countries in their use of smartphones and mobile money. African cities can also be a source of inspiration for ideas about how to make urbanisation a sustainable and inclusive success.

For development partners, opportunities to support urban development in Africa span a very wide spectrum of interventions. African cities need not always to reinvent the wheel but rather to adapt it to their particular terrain. There is a strong case for sharing best practices from other regions, particularly related to institutional capacity building, project and programme development and innovative financing mechanisms. One of the key functions of development partners in the field of urban development remains evaluation assistance, without which reform planning cannot be implemented, let alone be effective. Other key functions include funding diagnostic studies, supporting the adoption of new building codes and facilitating licensing procedures for construction. Development partners can also support greater competition in key sectors in order to reduce construction costs for cities. For instance, in Ethiopia, the liberalisation of the cement industry has encouraged the entry of new players, boosted the supply of cement and significantly reduced construction costs.

Some pan-African donors have liberally supported public initiatives to improve urban projects. Several studies have been conducted to diagnose African cities, to determine needs in a collegial manner and to set priorities for implementation, with the support of donors such as the European Investment Bank (through the Urban Project Finance Initiative, the Global Climate City Challenge and other initiatives under preparation, in particular focusing on secondary cities), the African Development Bank and other donors. The role of technical assistance in strengthening the capacity of municipal and local governments as well as the technical feasibility and bankability of urban projects is crucial. The promoters can also take advantage of the pan-African and worldwide experience of the donors. The value of these diagnoses goes beyond a simple stock-taking exercise; they are meant to facilitate the mobilisation of resources for the financing of urban projects.

Development partners can support the long-term financing of urban development in many ways. They cannot only support financial institutions (such as commercial banks, dedicated municipal banks and funds) but also real estate and urban developers, urban regeneration and development agencies or promoters directly. DFIs and IFIs can also support urban infrastructure development directly by offering equity financing, lines of credit, technical assistance, credit enhancement and guarantee programmes. Risk-mitigating instruments can increase the involvement of stakeholders, boost their ownership of urban development projects, and therefore enhance the sustainability of urbanisation in Africa.

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Mobilising agricultural value chain financing in Africa: why and how

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Summary

Raising agricultural productivity is key for sustainable economic development in Africa.

Agriculture accounts for a large share of GDP and employment throughout the continent, and especially so in countries with lower income levels. As food security is deteriorating in many regions, raising productivity along the value chain would help end hunger and malnutrition, and meet the growing food demands. It would also improve the incomes of the often poor smallholder farmers and allow the export of products that are less price-sensitive and more profitable. However, besides non-financial obstacles a considerable financing gap holds back agricultural development, which reflects the fact that lending to the agricultural sector is often deemed particularly risky.

The perceived high risks can be mitigated by well-structured agricultural value chain financing.

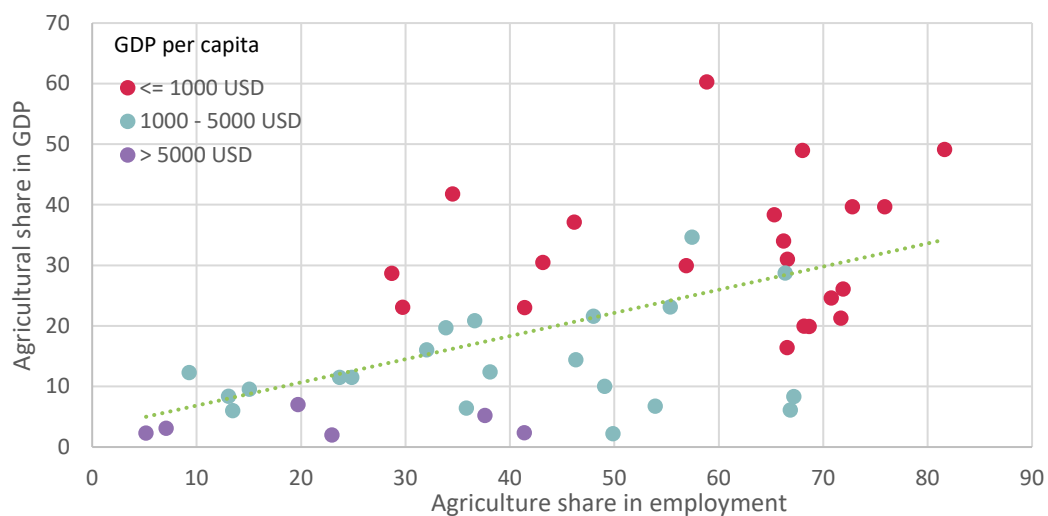
However, too often, agricultural value chain finance (AVCF) schemes are set up with the best of intentions and theoretical background knowledge but fail to address the realities on the ground. Past experiences provide guidance on the characteristics that could determine the success of AVCF: getting the right expertise and partners, creating the right structures and procedures, tailoring financial products to the specific needs of farming activities as well as its up- and downstream sectors, training farmers and building trust, and the smart use of digital solutions all help reduce risks and lower transaction costs, thereby making AVCF work for providers of finance and their users. Policymakers can further support AVCF through, e.g., setting the right conditions for financial innovations and investing in capacity building, while development partners can play an important role in the identification and organisation of promising value chains.

Agricultural value chains and sustainable development

Agricultural development and the role of value chains

Agriculture is the economic backbone of many African countries. On average, the primary sector alone accounts for some 21% of a country's GDP, but there are many countries on the continent for which the share is over 30%, and in e.g. Sierra Leone it even reaches 60% (Figure 1). The agricultural sector is even more important in terms of employment as it provides work to almost half of the employed people. Again, the differences between countries are large, with the employment share of agriculture ranging from single digits to over 80% for Chad and Burundi (not shown in the chart as no GDP share available).

Figure 1: Agriculture is a pillar of economic activity



Source: IMF World Economic Outlook; World Bank World Development Indicators database.

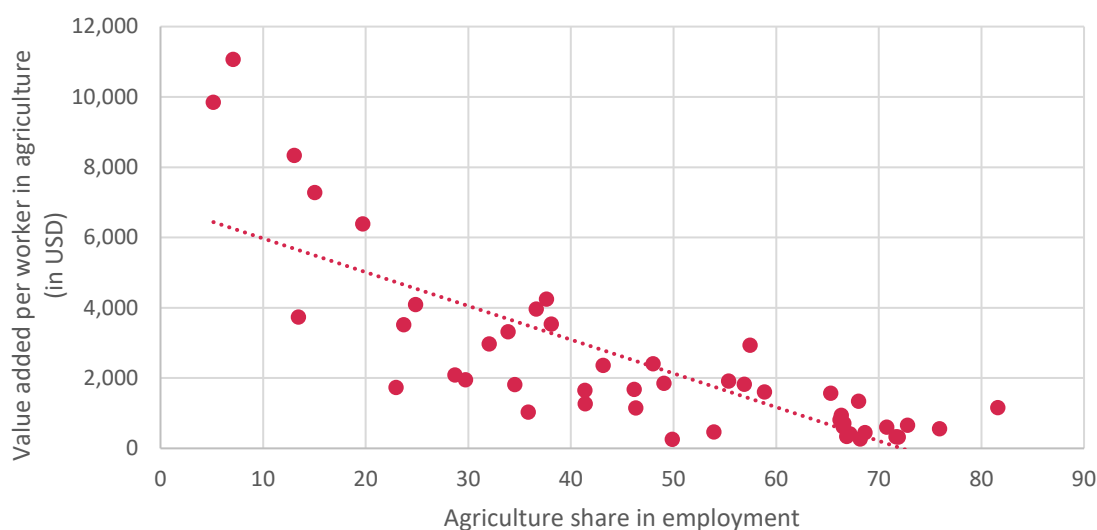
Notes: Data for 2018, except for the agriculture share in GDP, which is from 2017. Based on 48 out of 54 African countries. The r -squared of the trend line is 32%.

Raising productivity is key to supporting economic development. In countries with lower income levels (as measured by GDP per capita), agriculture accounts for a higher share of GDP while employment in agriculture is also higher (Figure 1). This reflects the fact that the value added per worker in agriculture tends to be inversely related to the employment share of agriculture⁸ (Figure 2). Raising agricultural productivity would directly raise the incomes and living conditions of farmers, but would also cause higher demand for non-agricultural goods and services, thereby supporting the growth of other sectors and creating new job opportunities outside agriculture, thus lifting general living standards (Jayne and Ameyaw, 2016). The scope for productivity increases is substantial, as the continent accounts for some 18% of the world's agricultural land⁹, but produces just 9% of the world's food (FAO, 2018b).

⁸ Ideally, the analysis would adjust for the relative price levels across countries and factors such as informality.

⁹ The continent also has vast amounts of uncultivated agricultural land, in particular in Sudan and the Democratic Republic of Congo. However, 'available' land could in practice already be used for grazing, foraging or hunting. In addition, substantial differences in climate and soil conditions affect potential yields.

Figure 2: Productivity and employment in agriculture

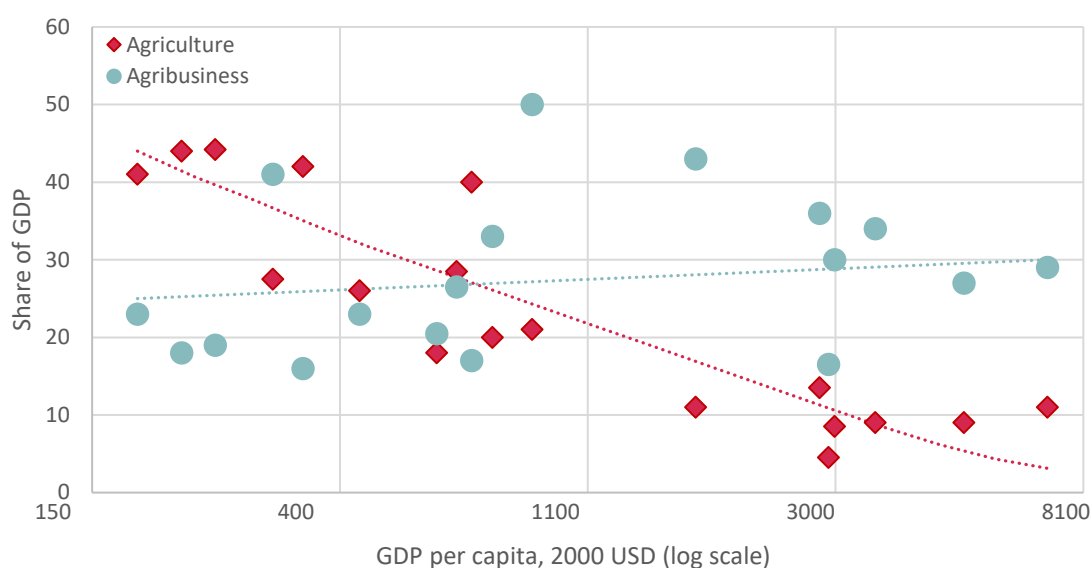


Source: ILO ILOSTAT; IMF World Economic Outlook; World Bank World Development Indicators database; own calculations.

Notes: Data for 2018. Based on 47 out of 54 African countries. The r-squared of the trend line is 63%.

Developing the agricultural sector goes hand-in-hand with developing its value chains. When farmers become more productive, opportunities are created for related activities such as processing, storage, transport, trade and retail. Moreover, with a better functioning value chain, farming becomes more efficient and profitable. It is difficult to overstate the economic importance of value chains: globally, farming accounts for just 22% of value added in the agricultural value chain, behind retail (25%) and input supply (23%), but ahead of processing and logistics (15% each; World Bank, 2016). Few statistics are available on agricultural value chains in Africa, but the available data generally confirm the considerable scope for raising the value added of farming in agriculture (e.g. VCA4D, 2019). This would be consistent with economic evidence which found that the relative importance of agribusiness tends to increase with rising incomes (Figure 3).

Figure 3: The role of non-primary activities in the agricultural value chain



Source: World Bank World Development Report 2008.

Note: Data for various developing and emerging countries.

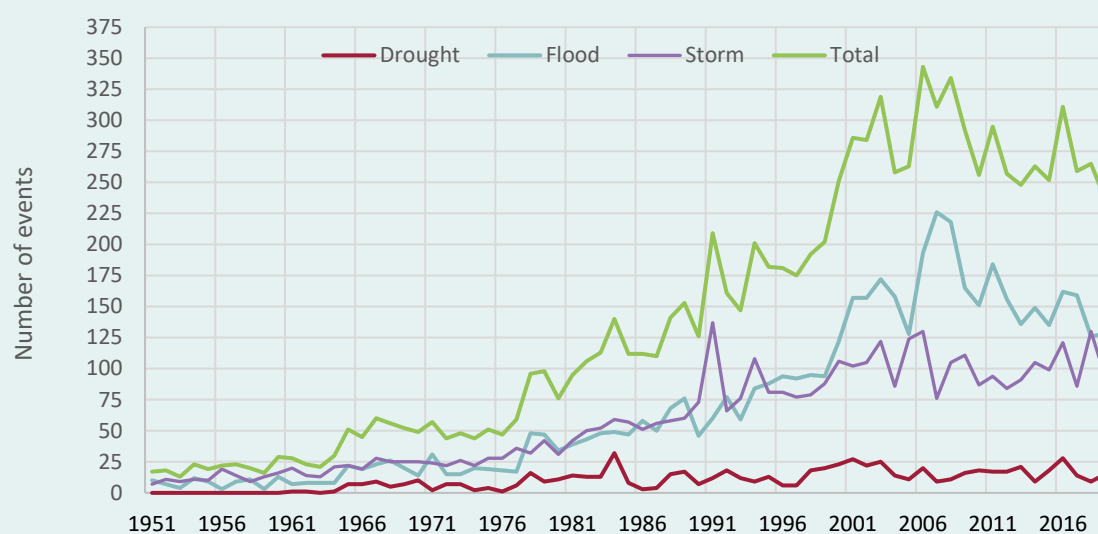
Improving the functioning of agricultural value chains

Raising productivity along the agricultural value chain is key to ending hunger and malnutrition across the continent. Around 20% of people in Africa are undernourished, especially in Eastern and Central Africa (FAO, 2019). Ending hunger and achieving food security are the objectives of Sustainable Development Goal (SDG) 2. However, the prevalence of undernourishment has been increasing in recent years. Raising the productivity of farmers and improving distribution channels¹⁰ are necessary to reduce hunger and malnutrition and achieve this SDG, as is well recognised by policymakers¹¹. The need for changing, e.g., practices, processes and even cropping patterns, is underlined by the increased occurrence of more extreme climate events (Box 1).

Box 1: Climate change and the resilience of food systems

Agriculture is increasingly exposed to more complex and intense climate extremes, which are threatening to erode gains made in poverty alleviation, ending hunger and malnutrition. Extreme climate events have become more common (Figure 4) and are a key driver of the increase in food insecurity and severe food crises in recent years (FAO, 2018a). In addition, extreme climate events also have a large impact on nutrition, as they affect nutrient quality and dietary diversity of foods produced and consumed. They also have a negative impact on water availability and its quality. The most common extreme climate events affecting agriculture are droughts and floods. Africa is disproportionately affected by the impact of climate change because of agriculture's overwhelming exposure to the vagaries of weather.

Figure 4: Extreme climate-related disasters worldwide



Source: EM-DAT: The Emergence Events Database.

The high impact of Cyclone Idai in Mozambique and neighbouring countries in March 2019 is a case in point. The torrential rains and flooding caused rivers to overflow, a dam to burst, the destruction of over half a million hectares of crops, and fisheries infrastructure and livestock assets were washed away in Mozambique, where over 80% of the population depends on agriculture for their livelihoods. This raises serious concerns for food security in the immediate and longer term for hundreds of thousands of households. At the other extreme, the impact of drought on food security

¹⁰ For example, the African Postharvest Losses Information System estimates that in sub-Saharan Africa between 10% and 20% of the grain harvest is already lost between harvesting and processing (i.e. during threshing, storage and transport).

¹¹ For example, the four goals of the Strategy for Agricultural Transformation in Africa are to contribute to ending extreme poverty, eliminate hunger and malnutrition, become a net exporter of agricultural commodities and move to the top of key agricultural value chains (AFDB, 2016).

is higher in those countries where agricultural systems lack infrastructure to provide irrigation and where a high proportion of the population is engaged in agriculture.

Awareness, involvement and buy-in of farmers, large and small, is essential to strengthen the resilience and adaptive capacity of food systems. Adaptation strategies need to be accelerated and scaled up in order to meet the great challenges posed by climate variability and extremes (FAO, 2018a). This will require partnerships, enhanced risk management capacities and multi-year, predictable large-scale funding of disaster risk reduction and management, as well as climate change adaptation policies, programmes and practices. Response options to climate change based on agricultural value chain management include on the demand side reducing post-harvest losses, promoting dietary change and reducing food waste (at the consumer or retailer level); and on the supply side: sustainable sourcing, improved food processing and retailing, and improving energy use in food systems (IPCC, 2019). All these options hold promising mitigation and/or adaptation benefits, but most require substantial financing to materialise.

Linking smallholders to value chains promotes inclusive growth. Smallholders constitute the vast majority of farmers across the continent, e.g. they manage some 80% of farmland in sub-Saharan Africa and produce some 70% of the total food. However, most of them live in poverty. Raising yields would improve their own food security, and would also raise their income as they could sell more excess produce, thereby helping to attain the SDG 1 objective of no poverty (and thus indirectly also SDG 2 of zero hunger). Indeed, economic studies confirm that growth generated by agriculture is one of the most effective ways to reduce poverty (World Bank, 2008; Christiaensen, 2011). Linking smallholders to value chains will help them grow as they would have better access to seeds, fertilisers, pesticides, veterinary medicines, tools and knowledge about, for example, resilient agricultural practices and water management. In addition, smallholders would have more incentive to grow due to enhanced access to storage facilities and better transportation as well as reduced off-taker risk¹².

Higher agricultural productivity and improved value chains are also necessary to meet the increased demand for food, especially processed foods. The population of Africa is expected to grow from 1.3 billion now to 1.7 billion in 2030 and 2.5 billion in 2050 (United Nations, 2019), which will push up demand for food. In addition, due to the ongoing trend of urbanisation, an increasing share of agricultural products will be consumed far away from where they are produced: already now people in urban areas account for some 38% of the population in sub-Saharan Africa, but they consume 50% of the total food and even some 65% of the processed food. At the same time, the growing middle income class will continue to raise the demand for processed food, meat, dairy products and premium cereals and rice (FAO and AFDB, 2015).

Developing agricultural value chains would also make exports to non-African markets more profitable and less price-sensitive. Currently only a quarter of African exports leaving the continent are non-extractive products, including agricultural products. While the main African exports are commodities such as palm oil, cocoa, coffee, tea, sugar, cashew nuts or cotton, the level of local processing is in general minimal. Increasing the proportion of value addition within the continent is of paramount importance to supporting the improvement of farmers' incomes. When moving up the value chain is enforced through export tariffs or other market interventions, this could create some additional employment in agro-processing but typically at the cost of reduced domestic competition for raw commodities and hence lower prices for farmers. Alternatively, entrepreneurial activity to explore market opportunities could be encouraged, e.g. through creating conducive business conditions, supporting local investment in agro-processing, negotiating supportive trade relations and ensuring policy stability. Maintaining diversified farm production including high-value crops and food crops remains essential in economies that experience frequent fluctuations in prices, particularly of agricultural commodities. The large decline in global commodity prices during 2011-16 (FAO, 2019) makes the case for policies to increase local processing in the producing countries in order to partially protect value chain actors from commodity price fluctuations.

¹² Smallholders will continue to face many challenges to scale up their participation in markets, including insecure rights to land and natural resources, lack of access to quality inputs and financial services, and high transport costs (ASFG, 2013). For women farmers, the challenges are even larger.

Agricultural value chain development: a challenging process

Agricultural value chain development requires concerted efforts by the various stakeholders involved.

The value chain of a given agricultural product includes ensuring access to credit, quality seeds and fertilisers, mechanisation, irrigation services, extension services, harvesting equipment, transport and warehouse facilities and other related infrastructure as well as food and bio-material processing/manufacturing, packing, distribution and retailing. Therefore, establishing working links along the entire value chain is a long process that requires coordination and cooperation among farmers, agribusinesses, financiers, governments and civil society. As the value chain links the commodity production stage with the final consumers and users, targeted interventions at specific points of a value chain can result in the generation of added value across the chain as a whole and therefore achieve a range of positive outcomes for the various value chain actors (for an example see Case Study 1).

Case study 1: Moldova: an integrated approach to value chain development

- *Target group: Farmers growing grapes, wineries, support service providers, universities and related agribusinesses*
- *Financial service provider: Public entities and private financial intermediaries*
- *Development partner: European Investment Bank (loan from own resources plus Eastern Partnership Technical Assistance Trust Fund) and the European Union (Neighbourhood Investment Facility)*
- *Country: Moldova*

Some concerted efforts to develop agriculture along the value chain have been successful across Africa, but, as in other regions, they often focus on a particular segment of the value chain. Few support ventures have been as broad as the Wine Value Chain Upgrading in Moldova, which since its launch in 2012 has achieved numerous improvements. The project aims to contribute to wine value chain modernisation and to develop the production of wines with geographical denomination by (i) improving the quality and consistency of wine produced in Moldova, from the quality of vineyards to the final bottling and dispatch of products, (ii) revitalising the wine industry through targeted investments and (iii) diversifying the country's export markets. Two financial instruments are utilised: credit lines and leasing. The project involves a large number of value chain actors supported and coordinated by the government, represented by the Ministry of Finance, the Ministry of Agriculture and Food Industry and the Ministry of Education, which established an intense inter-ministerial dialogue. The EIB loan was given to the Ministry of Finance and on-lent to commercial banks, which appraise projects prepared with the support of a technical assistance provider, paid by the project. The TA provider identified interested value chain actors and bankable projects along the value chain.

The project has four thematic components: (i) viticulture sector development - renew old vineyards, and introduce new technologies and equipment at the farm level; (ii) winemaking enterprises development - upgrade equipment and facilities; (iii) support industrial enterprises development - upgrade equipment and facilities; and (iv) quality control laboratories, research institutions, training, upgrading, extension services and education including through private and public vocational schools, colleges and universities.

The project has been instrumental in aiding the revival of the wine value chain in Moldova. After the first year, the technical assistance had already supported wineries in improving their business plans and gaining access to finance to renew their assets. After the third year investments in renewed vineyards with improved varieties started to pay off, and wine exports have grown by 6% per annum since 2015.

Due to their complexity, the causes of underperforming agricultural value chains are not always evident.

For agricultural value chains to work for all those involved, multiple challenges need to be tackled simultaneously along a number of linkages in the chain. In addition, agricultural value chains must be economically, financially, socially and environmentally sustainable (FAO, 2014). Potential solutions to address these challenges include the upgrading of products, technologies, business and financial models and policy environments. However, some of these interventions may not achieve the intended impact, while others could succeed in improving the system at scale and in a sustainable manner, and improvements are typically incremental and often slow.

Specific attention is required to integrate smallholder farmers successfully into agricultural value chains.

Efforts made to integrate smallholder farmers into value chains have shown that in many cases the weakest link is between the producer and the first buyer, which decreases the chances of building a competitive and inclusive value chain. Therefore, an agricultural value chain can be reinforced through the adoption of an

inclusive business model approach that links smallholder farmers. Smallholder business models include traders, farmer organisations, agrifood processors and large buyers (FAO, 2015).

For a durable improvement in living conditions, smallholder farmers linked in to value chains should be aware of the new challenges and risks. For example, when smallholder farmers engage in producing crops for export, they expose themselves to the fluctuations of international prices, and they should therefore develop strategies to cope with these fluctuations (FAO, 2019). One such strategy is diversification of agricultural production in order to limit dependence on any single crop. Similarly, smallholders should include in their cropping pattern food crops that can help them cope with periods of low commodity prices without slipping back into situations of food insecurity. Ensuring that smallholder farmers have a good understanding of these issues would increase the inclusiveness and sustainability of agricultural value chain development.

Financing needs of agricultural value chains

Lending for agricultural activities is relatively limited. Ideally lending volumes could be broken down according to the use of financing, but unfortunately the only publicly available data are typically on overall bank lending, which includes, for example, the financing of investment and of working capital. Keeping in mind that definitions and reporting standards differ across countries, bank lending to the primary sector is found to be on average below 1% of GDP in Africa (Figure 5, Panel A). An important exception is Mauritius, where it reaches almost 5%, which is higher than the sector's contribution to GDP of 3%, while the value added per worker is also higher than anywhere else in Africa. This partly reflects the specificities of the agricultural sector (which is dominated by a few large players in the sugar industry)¹³, but is aligned with the broader notion that high productivity and financing are closely related¹⁴.

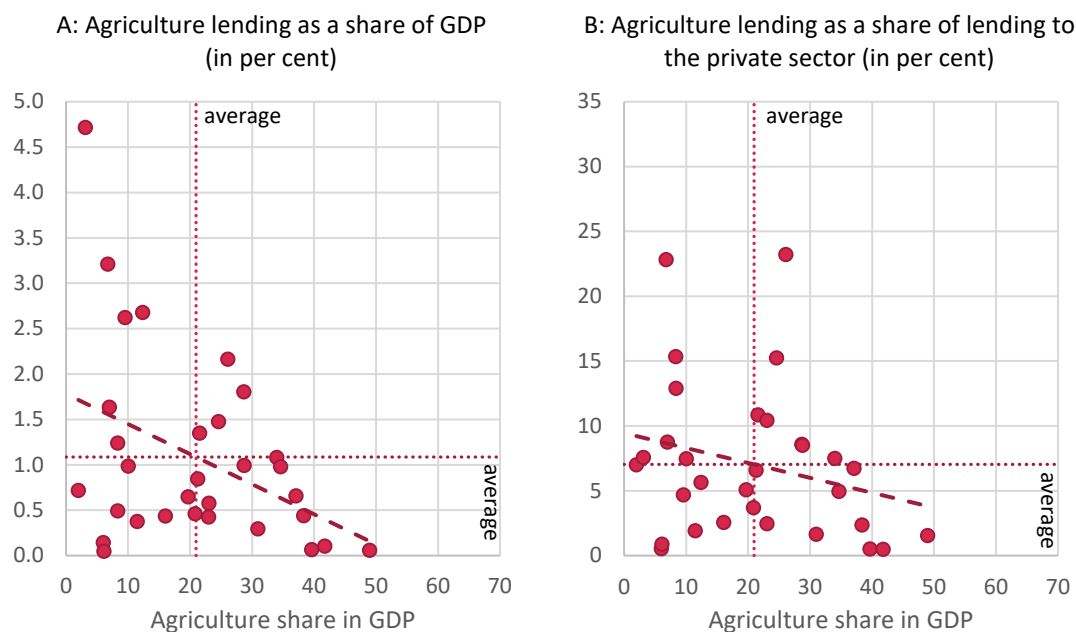
The primary sector accounts for a small share of bank lending. The different capital intensities across sectors complicate a full analysis, but primary agriculture has a smaller share of bank loans than might be expected based on its GDP share (Figure 5, Panel B)¹⁵. However, bank lending to the agricultural sector in Malawi and Zambia is relatively large and exceeds a quarter of the loan book (compared to GDP shares of 26% and 7% respectively), reflecting lending to commercial farmers. Bank lending is not the only external source of financing, as many farmers have access to other financing sources, including microfinance institutions, off-takers, relatives and other informal sources, although often at a high price, but there are no good, agriculture-specific data that are comparable across countries.

¹³ The high level of bank lending relative to GDP and the diversification motives of banks are also likely to play a role.

¹⁴ The figures show a negative relationship between bank lending to agriculture and the sector's GDP share, which seems to confirm that banks are becoming more interested in lending to agriculture when the economy matures and agriculture has become more productive. However, the correlation found is weak, and a more thorough analysis is needed to obtain stronger support for this hypothesis.

¹⁵ Note that GDP also includes the added value of the public sector.

Figure 5: Bank lending to primary agriculture



Source: IMF World Economic Outlook; national banks; World Bank World Development Indicators database; own calculations.

Notes: Data for 2017 or financial year 2017-18. Based on 31 out of 54 African countries. The *r*-squared of the trend line is 16% in Panel A and 6% in Panel B.

The investment gap for agricultural value chains is large. An often quoted figure is USD 940 billion (in 2009 USD) for the agricultural investment needs until 2050 (UNIDO et al., 2010). About a third of this amount is needed for the primary sector, and two-thirds is required for agro-processing, in particular first-stage processing; mechanisation, other equipment and power sources; rural and wholesale market facilities; and cold and dry storage. A recent study estimates the financing gap faced by African agribusiness to meet food security demands by 2050 to be USD 11 billion annually (World Bank, 2016). Additional investment would be needed to improve the sector's resilience against climate change.

Governments, multilateral and bilateral organisations, and development finance institutions can provide part of the financing, but most of it would need to come from the private sector. Farmers in low- and middle-income countries invest more than four times as much in the capital stock of their own farms each year as their governments invest in the agricultural sector (FAO, 2012). Farmers' investment also exceeds by far that of international donors and private foreign investors. The overwhelming dominance of farmers' own investment means that they must be central to any strategy aimed at increasing the quantity and effectiveness of agricultural investment.

Agricultural value chain finance and risk mitigation

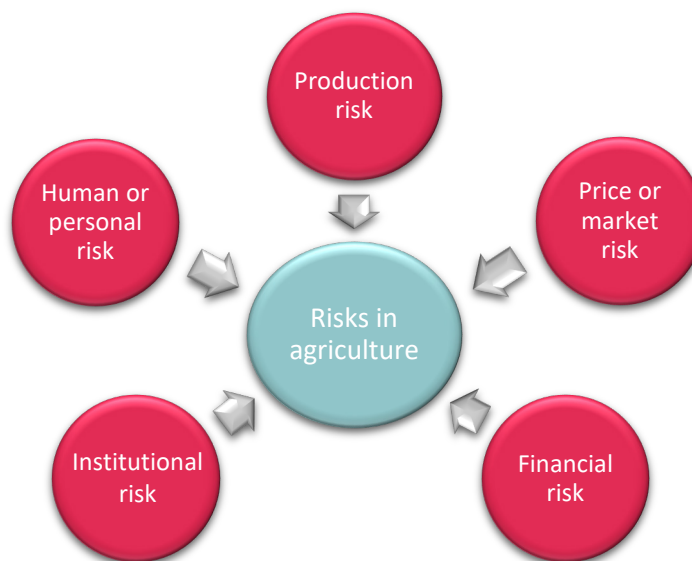
Risks constrain agriculture lending

Financial institutions are hesitant to lend to agriculture value chain actors, in particular for small scale agriculture. The perceived high risks of agriculture, combined with low levels of financial literacy among smallholder farmers, the small loan amounts required, the specific product requirements due to the seasonality of agriculture, as well as the lack of collateral of small farmers and businesses, hamper lending. Commercial banks are generally reluctant to lend to the agriculture sector, especially small producers, and whenever they do the interest rates are often double digits and in some countries prohibitive, while loans have short-term maturities, leaving the sector without access to affordable long-term finance. As a result,

finance for agriculture is largely insufficient to stimulate efficiency in production and the adoption of better technologies.

Risks in agriculture have always been a source of major concern as farmers have to cope with numerous uncertainties. The literature on the subject explains how difficult it is to evaluate and manage risks in agriculture (Hardaker et al., 2004; Ladanyi, 2008). However, the basic principles of risk management are common knowledge: managing risk starts with identifying the most crucial risks the activity is exposed to; then understanding the potential drivers and assessing the impacts and likelihood of undesirable consequences; and finally, identifying and taking possible mitigation measures to lessen the impacts. Five major types of risk are prevalent in agriculture (FAO, 2008): production risk, price or market risk, financial risk, institutional risk, and human or personal risk (Figure 6).

Figure 6: Risks in agriculture



Source: FAO (2008).

Production risk in agriculture relates to the uncertain natural growth processes of crops and livestock. For various reasons, there is always the possibility that yield or output levels are lower than projected. Weather conditions, diseases and pests, and other factors such as failure of equipment or inexistence of irrigation systems affect both the volume and quality of the commodities produced, with the possibility of a total loss of harvest and hence no revenues. On top of this, extreme weather events are becoming more frequent due to climate change (Box 1). The high dependence on weather conditions and risks associated with working with organic and living materials, such as livestock, seeds and their biological processes, are the main reasons that agriculture is perceived as more risky than most other sectors.

Price or market risk, also known as marketing risk, refers to the uncertainty of input/output prices or simply that the market for the producers may be lost. The nature of price risk varies significantly from one crop to another. Agricultural commodities are very sensitive to market conditions. Excess in production levels and lower demand due to changing consumer preferences are common sources of marketing risk often resulting in the collapse of commodity prices. Financial speculation with primary products can also lead to sudden price changes. Market risk can also arise from losing access to the market due to an aggregator or processor failing to meet its purchasing commitments, or if the product fails to meet new market or agreed quality standards.

Financial risk results from production and marketing risks when farmers borrow money and create an obligation to repay debt. The possibility that revenues generated from the sale of commodities are not enough or available on time to meet expected obligations is a source of risk for the farmer, who could lose

the collateral provided. Other aspects of financial risk are rising interest rates, excessive borrowing, higher cash needs for household expenses, lack of adequate cash or credit availability, and unfavourable exchange rates.

Institutional and legal risks relate to uncertainties surrounding government actions and fulfilling business agreements and contracts. Laws and regulations governing farm activities, price or income support policies and quotas are examples of government decisions that can have a major impact on agriculture. Legal risk is often closely related to a failure in meeting laws and regulations. For instance, farmers are weakly protected in the case of disputes with off-takers or input suppliers concerning lack of performance of their contractual obligations. Nowadays, environmental concerns and the failure to respect established rules to protect the environment increasingly carry a high cost. Policy changes in all these domains pose another risk.

Finally, human or personal risk pertains to risks associated with individuals, namely family members, farm employees and customers. It relates to relationships, but also to health problems that can affect the farm business. As agriculture in Africa often depends on the family and on day labourers, human resource risk often arises from the occurrence of one of the following events: divorce, death or disability (the 'three D's'). The impact of any of these events can be devastating for a farm. Human resource risks also include the negative impacts arising from a lack of people management skills and poor communications.

Agricultural value chain finance (AVCF) as risk-mitigation mechanism

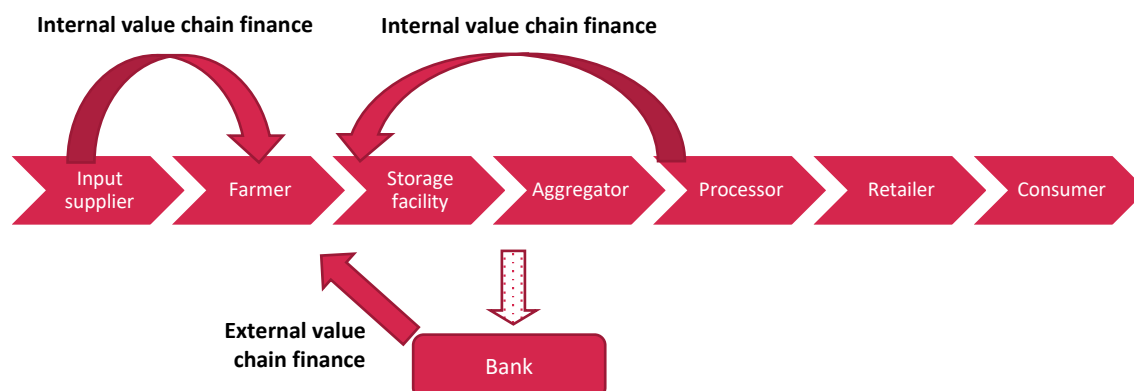
Agricultural value chain finance (AVCF) emphasises the vertical dimension of agricultural finance as a risk-mitigation mechanism. AVCF is defined as 'financial services and products flowing to and/or through value chain participants to address and alleviate constraints to growth', setting it apart from conventional agricultural financing that does not have a direct link with the value chain (IFAD, 2012). AVCF can build on established relationships, use effective guarantees and utilise expert knowledge of the value chain to de-risk agricultural lending and expand the financing opportunities for agriculture. In broader terms, AVCF can be in the form of credit facilities (cash or in kind), guarantee schemes, outgrower schemes¹⁶, contract farming¹⁷, access to insurance and other financing means such as warehouse receipt systems to unlock direct/indirect lending. It includes credit for agricultural input suppliers, producers (farmers), transporters, processors, wholesalers/retailers and marketing agents. AVCF also includes investments in projects and models seeking to protect and expand farm viability and move up the value addition chain.

AVCF can involve internal or external financing sources. Internal value chain finance takes place when, e.g., an input supplier provides credit to farmers or agricultural cooperatives, or when an off-taker provides pre-finance through non-cash loans to acquire high yield resistant seeds and inputs at lower costs (Figure 7; Box 2). Aggregators could also prepay insurance coverages by bundling services, which typically increases the uptake of agricultural insurance. External value chain finance relies on value chain linkages to allow an external actor to make available finance: for example, a bank issues a loan to farmers based on a contract with a trusted buyer or a warehouse receipt from a recognised storage facility. In addition to providing financing, the external actor also needs to perform tasks related to risk management, in particular the selection of borrowers and the management of outstanding loans. Having an additional actor in the AVCF structure increases its complexity, but the vast majority of potential issues and bottlenecks are the same as for internal value chain financing.

¹⁶ Outgrower schemes are amongst the most popular examples of value chain financing arrangements whereby an agroprocessing enterprise would make available fertilisers or seeds to farmers in kind to secure the supply of its primary commodity.

¹⁷ The Food and Agriculture Organization of the United Nations (FAO) has set up a 'Contract Farming Resource Centre' as interest in contract farming has grown recently, in view of the trend towards tighter alignment in agri-food supply chains.

Figure 7: Examples of internal and external value chain finance



Source: Authors.

Box 2: Internal AVCF: non-banking channels providing financial products for farmers

Off-takers and input providers can be in a good position to provide financing to farmers. In some cases, financial institutions cannot extend financial services to farmers, find it too risky or perceive it as too complicated. In such cases, actors within the value chain can take up this role. Off-takers and input providers, for example, often have a well-developed outreach structure and close relationships with farmers. They also have a good understanding of the farmers’ needs and constraints and the risks involved in the business. Transaction costs and (perceived) risks are thus much lower for them. Many off-takers and input providers typically already provide financing to their farmers, but this is mostly informally and on a short-term basis, and could make the farmer dependent on the off-taker.

Off-takers and input providers require support to institutionalise and scale up their financing schemes. Most off-takers and input providers are not financial experts. They require external expertise and support to develop sustainable models, structures, procedures and products and to build the necessary internal (or get additional external) capacity. Usually, they also need additional working capital and refinancing in order to be able to extend financing opportunities to larger groups of farmers and for longer periods. As they are not regulated financial institutions, they are not allowed to take savings and can only offer loan products. Also, as opposed to formal financial institutions, they may not be subject to consumer protection or data protection regulations.

Example: Ibero’s Farmer Financing Unit

In Uganda, the Neumann Kaffee Gruppe with its coffee importer, Bernhard Rothfos, and its Uganda-based off-taker, Ibero, has identified a need for smallholder coffee farmers in Central Uganda to access financing for inputs in order to increase their productivity. As this need was not adequately catered for by financial institutions in the region, they set up a Farmer Financing Unit, NKG BLOOM Uganda, with the support of GIZ and other partners in 2017. NKG BLOOM Uganda is a department of Ibero Uganda Ltd. with 36 staff members and a highly professional set-up. The unit offers fertiliser advances and cash advances to coffee farmers who have a track record of coffee sales to Ibero. Farmers can repay their advances in coffee or cash. Farmers accessing advances are trained in good agricultural practises (GAPs) and financial literacy. Farmer- and business-friendly data protection models have been tested and are being implemented. Within the first two years of operation BLOOM has provided more than 6 000 farmers with input advances. Eventually, they aspire to work with around 50 000 coffee farmers in Central Uganda (Case Study 7).

AVCF can unlock the agricultural potential

Where access to finance is improved, substantial benefits are achieved for farmers and the agricultural eco-system. Although AVCF is relatively new, its potential to reduce risk is increasingly recognised and can already be illustrated by many practical experiences (e.g. Case Study 2). The findings of a recent evaluation report on projects supported by the African Development Bank concur with this analysis (AFDB, 2018a). For

instance, in Rwanda, support was provided to dairy cooperatives to access finance to support their members. To reduce the risk of financial losses, finance was provided in kind to 16 072 poor families (one cow per family), with repayments deducted through the cooperatives. The project contributed substantially to an increase in dairy production in the country of 59.6% and to the reduction of the poverty rate (from 44.9% to 39.1%) in beneficiary families (AFDB, 2018a).

Case study 2: Nigeria: enhancing agricultural value chains through risk sharing

- *Target group: Farmers and agribusinesses*
- *Financial service provider: NIRSAL*
- *Country: Nigeria*

The Nigerian Incentive-based Risk Sharing System for Agricultural Lending (NIRSAL), launched in 2011, was designed by the Central Bank of Nigeria to reduce risks to commercial lending (AFDB, 2018b). NIRSAL is based on five pillars: a risk sharing facility, an insurance facility, a technical assistance facility, a holistic bank rating mechanism and a bank incentives mechanism. Currently, only the first pillar (risk sharing facility) is fully operational. It has contributed to the increase of agricultural lending from 1.4% to 5% (about USD 5 billion) of total bank lending in Nigeria (NIRSAL, 2016).

The NIRSAL model is based on encouraging lending all along well-defined agricultural value chains. If a bank is to lend to rice farmers, for example, it also lends to input suppliers and rice processors at the same time, thus connecting the farmers to the agribusinesses and markets. Despite challenges, this approach has also helped to significantly reduce transaction costs and risks embedded in agricultural value chains. NIRSAL is now established as a fully independent non-bank financial institution, and the model is being replicated in other countries.

Various financial instruments can be used to support agricultural value chains. Some of them are standard, while others are more novel to the value chain actors or the financial institutions. While the exact shape of the tools depends on the target group, their financial situation, the revenue structure and the risks, the instruments can be broadly classified as:

- **Saving and payment products:** typically provided by actors within the value chain, e.g. saving and credit cooperatives (SACCOs);
- **Loans:** either from actors within the value chain or from external sources such as banks or microfinance institutions;
- **Equity investments:** attractive to a wide range of investors from both within and outside the value chain, including private and public parties at home and abroad;
- **Guarantees:** typically arranged by national institutions or with external support from development partners;
- **Leasing:** growing in popularity as it facilitates the purchase of tangible assets (the leasing entity, normally a financing institution, remains the legal owner of the asset, but the lessee can benefit from its use);
- **Weather-index insurance:** becoming more common due to its simplicity of application. Rather than assessing actual losses, the insurance payments are triggered when a weather index, commonly rainfall or temperature, exceeds pre-established limits. As this index can be remotely assessed, e.g. through the use of satellite data, the cost of monitoring the index over a vast area and a large number of farmers is relatively low.

During the last decade, agricultural investment funds have been growing in importance as a financing source. These funds typically invest in the agribusiness segment of the value chain, where the investment, expertise and market linkages of the investors can have an optimum effect. The impact of such funds depends largely on the quantity and quality of the technical assistance provided with the financing – initially for identifying and setting up fundable projects and then for following up and monitoring during the implementation. A recent example is the Agri-Business Capital (ABC) Fund initiated in 2019 by IFAD and supported by the EU. The ABC fund provides loans and equity investments adapted to the needs of rural SMEs, farmers' organisations, agripreneurs and rural financial institutions in developing countries. Other funds are more specific and focus on a particular target group (e.g. smallholders) or issue (e.g. increasing resilience to weather conditions). In general, the specific expertise and networks of the fund managers and shareholders create a win-win situation for investors and entrepreneurs.

Lessons learnt: how to make AVCF work better

Mutual understanding and long-term perspective

Engaging in AVCF requires both financial and agricultural expertise. One major reason why agricultural financing initiatives sometimes failed in the past was the unilateral approach taken: they were started either from the financing side or from the agriculture side, each lacking insight into and neglecting the other side's perspective. As a result, financial products were developed which fitted perfectly into the banks' product portfolio but were not taken up by farmers, while at the same time farmers approached financial institutions with unrealistic expectations and consequently did not obtain the financing sought. Hence, in addition to cooperation, capacity building is essential: financial institutions need to be trained on agricultural value chain topics, while farmers need to be trained on managing their personal and business finances. An integrated approach could help get all the parties required on board (Case Study 3).

Case study 3: Malawi: an integrated approach to making the value chain more inclusive

- *Target group: Agriculture value chain actors*
- *Financial service provider: Financial intermediaries*
- *Development partner: European Investment Bank*
- *Country: Malawi*

Under the Kulima Access to Finance Project, the EIB offers a credit line that includes a risk-sharing facility financed by the European Union to selected banks in Malawi to promote agriculture value chain development and the integration of smallholder farmers into their value chains. This project was developed in cooperation with the European Commission and the EU Delegation in Malawi, and is integrated into the wider 'Kulima - Promoting Farming in Malawi' programme of the EC, which fosters sustainable agricultural growth to increase incomes, employment and food security in the context of a changing climate.

The project itself aims to address market failures in the agriculture value chains by providing access to finance and technical assistance (TA) for private agriculture value chain actors (a range of anchor and off-take entities, agri-food entrepreneurs and farmer groups/cooperatives), as well as TA to financial intermediaries. In particular, with the grant from the European Union it combines long-term loans with credit-risk guarantees to increase the lending to agriculture value chain actors. The Union grant also finances the TA programme to strengthen the capacity of participating banks in financing agriculture projects and to support private value chain actors in developing bankable products. Enhancing access to finance by agriculture enterprises indirectly benefits smallholders, as investments and the expansion of operations by agriculture value chains yield opportunities for smallholders to expand their business relationships with the private sector.

Selecting the right partners and managing these partnerships is crucial. To reduce risks and costs, engaging in AVCF usually requires multiple partnerships ranging from cooperating with farmers' organisations (e.g. for increased outreach) and input providers to agreements with off-takers (e.g. for purchase guarantees), warehouse operators (e.g. for warehouse receipt systems), mobile money providers (e.g. for mobile payments), training providers, extension services, NGOs or development partners. Usually, these are new partners and often new kinds of partnership for financial institutions. Selecting, approaching, negotiating, structuring and managing such agreements can be overwhelming for financial institutions and is ideally accompanied by someone with experience in this area.

For AVCF to be successful, it needs to be approached from a long-term perspective. It usually takes a lot of effort and investment, and several years, before AVCF pays off. A financial institution which starts to engage in AVCF typically needs to build up the necessary (digital) infrastructure to successfully manage field operations. They also have to first develop, test and adapt new approaches with small groups of farmers in order to generate learning and build trust before scaling up successful approaches to larger groups. For farmers who take out a loan to invest in their business, income usually only increases gradually, often with the adoption of GAPs and increased financial literacy. Raising unrealistic expectations with regard to the potential gains and the time horizon can be detrimental to the project. Having business plans that are thoroughly researched and realistic for both sides helps to provide a realistic picture of the potential available and the timeframe required to realise them.

Banks have to find ways to offer longer-term loans at affordable prices to agro-processors. While agro-processing is perceived as less risky than primary production, the usual loan available is for covering working capital needs. However, establishing and expanding an agro-processing facility requires access to capital that is long-term enough and at lower rates when compared to the more common seasonal agricultural lending. Local commercial banks often have difficulties offering such long-term affordable loans as their balance sheet is often mostly funded by short-term deposits. Obtaining financial resources abroad is not always an option for the banks, as the commercialisation of agricultural products is often done in local currency and the risk of currency exchange fluctuation, caused by macro-economic and political factors, is too high when the tenors are long (Case Study 4).

Case study 4: Kenya: supporting long-term bank lending for integrating farmers into value chains

- *Target group: Smallholder farmers*
- *Financial service provider: Equity Bank Kenya, and other potential financial intermediaries*
- *Development partner: European Investment Bank*
- *Country: Kenya*

Under the Kenya Agriculture Value Chain Facility signed in 2019, the EIB provides loans in Kenyan Shillings (KES) to financial intermediaries in Kenya for on-lending to private sector entities undertaking investments that promote the integration of smallholder farmers into agricultural value chains. This facility is integrated into the wider EU-Kenya programme of 'Support to productive, adapted and market integrated smallholder agriculture' and is therefore supported by a grant from the Africa Investment Platform (AIP). Part of the grant will be used to support local currency hedging with the implementing partner TCX Fund. This facility thereby enables the provision of long-term KES lending at rates that allow the investments of agricultural entities to be feasible, without those entities having to take on exchange rate risk.

Solid business cases for the supply and the demand side are a prerequisite for engaging in AVCF. Sometimes, financial institutions are tempted to engage in AVCF due to the availability of specifically earmarked external funding without knowing the specifics of the respective value chain(s) and without having properly analysed their and their potential clients' business cases. It only makes sense to engage in AVCF when it pays off for both the financial institution and the farmers. This requires a thorough understanding of the value chain(s) and its dynamics and potential within the country, as well as rigorous and realistic analysis and calculations on both sides.

AVCF includes more than lending: saving products can be a good starting point. Farmers need a variety of financial products, starting from saving products, to payment and money transfer, to insurance and loan products for different purposes (e.g. investments, working capital, inputs). For financial institutions, starting with saving products is a relatively risk-free way of engaging with this new group of clients, getting to know them, familiarising them with the formal financial sector and building a relationship with them. For farmers, the threshold towards saving is usually lower than for taking a loan. The many successful saving groups prove that farmers can save (Finscope Uganda, 2018), and that smaller investments could often be covered by own funds if saving is supported. Such groups can be promoted, if necessary adapted to better fit the farmers' needs and eventually be linked to formal financial institutions. The current lack of smart saving products specifically targeted at farmers presents an opportunity for financial institutions wanting to engage in this area.

Adopting a new mindset

AVCF is not a simple add-on but requires different structures, processes and approaches. When little time or resources are available for AVCF, financial institutions sometimes try to simply add it on to what they already have and do. However, AVCF differs from traditional finance in many ways – and this needs to be reflected in the organisational structure, processes, and approaches through, e.g., a new department, specific appraisal procedures and documentation requirements, changes to the management information system, a tailor-made communication strategy, enhanced flexibility in repayment policy, and specific

incentives for loan officers and branch managers. Such major changes require everyone to be involved in the process and convinced of its benefits, from top management to the finance and human resources department, to the branch manager, the loan officer and the cashier. People who do not feel involved or are not on board can easily (actively or passively) block implementation. It is thus recommended to analyse potential bottlenecks and actively involve these people or departments from the very beginning to create joint ownership.

Financial institutions need to be willing to create products which significantly differ from traditional financial products. AVCF is different from traditional financing and, instead of rebranding existing products, it requires products with specific features: products need to be adapted to the agricultural calendar of the specific crop and region. Loans need to be disbursed at exactly the right time (e.g. before planting or harvesting) as any delay in disbursements can render the loan useless. Similarly, as farmers can often only pay back after harvesting time, bullet repayments typically make sense. Features catering for agricultural risks (e.g. weather risks or pests), like agricultural insurance or flexible rescheduling policies, need to be included. Finally, the collateral requirements need to be flexible to increase access and avoid the danger of underfinancing.

For agricultural loan products to work, they need to consider the entire cash flow of a farmer. Most smallholder farmers do not separate household from business finance. As money is mostly tight, when borrowing, the risk of the diversion of funds is high. In Uganda, out of 335 farmers who had taken out agricultural loans interviewed during a review process, 50% used part of the loan money for household needs and even more for school fees, leading to underfinancing of the intended target – even though the loans had been clearly earmarked for agricultural purposes (GIZ, 2018b). Ibero's Farmer Financing Unit resolved the issue by adding a cash advance to their fertiliser advance product, mimicking an overdraft available on farmer's mobile money accounts and freeing up the actual loan amount for the intended investments (Case Study 7).

Providing the actual input often leads to better results than providing the funds for it. Many farmers lack not only the finance for, but also the access to, high quality inputs, be they seeds, fertilisers or machinery. By linking borrowers to trustworthy input providers, financial institutions can add value to their offer and reduce the risk of default due to poor or fake inputs. This requires an extra effort which they need to be ready to make; they have to look for trustworthy providers, negotiate agreements (while avoiding monopolistic power), manage the relationship, and function as a broker between the input provider and the farmers. The direct provision of inputs also helps avoid the diversion of funds (even though farmers could still resell the fertiliser when in urgent need of cash), which is especially relevant to women as their funds are often diverted by their spouses (GIZ, 2018b). The provision of actual inputs rather than cash requires full transparency from the financial institution regarding the value and characteristics of the inputs.

Product features need to be communicated in simple, clear and transparent ways. A survey of 335 Ugandan agricultural finance borrowers showed that around a third of clients (45% of women and 26% of men) did not know the full cost of the product when signing their loan agreement (GIZ, 2018b). Hidden fees and a complicated fee structure can result in farmers losing trust in the financial institution, in them not being able to make the planned investment and, in the worst case, not being able to pay back the loan. To help those with limited financial literacy, costs should be communicated in total amounts rather than in percentages. Marketing and communication materials need to be translated into the local language and simplified to increase the readability for farmers. Before publishing they should be tested with (potential) clients.

Just as in any other financing area, AVCF tends to forget women, thereby risking the exclusion of 50% of potential clients. Many products and processes inadvertently exclude or disadvantage women. If a financial institution wants to avoid this, it needs to actively consider both men and women and their characteristics during product development and marketing. Specific issues relate to the accessibility of selected value chains, collateral requirements (land, when formally titled, is often owned by men), marketing material (e.g. marketing material sometimes depicts only male farmers, which is mostly a simple oversight and easily rectified) or the compatibility of daily household chores with loan obligations (e.g. travelling long distances to a branch to withdraw or deposit money).

Effective demand side measures

Farmers need to be empowered to turn their investments into an increase in income and wellbeing. At a minimum, farmers need to be empowered in applying GAPs and financial literacy. GAPs differ from crop to crop and usually include all the different steps in the crop cycle so that the return on the investment is not lost along the way and can eventually result in increased productivity (e.g. topics like diversification and intercropping, efficient planting and harvesting techniques, weeding and the right use of fertilisers, post-harvest handling, etc.). Financial literacy trainings should include the basics from budgeting, financial planning and saving, to how to interact with banks, understanding financial products, etc., so that increased productivity can actually translate into an increase in income (e.g. Case Study 5). It is recommended to also include gender aspects in the training (e.g. joint planning, budgeting and decision-making) so that the increase in income eventually translates into an increase in wellbeing for the entire household. At the same time, attention needs to be paid to not overwhelming farmers with more information than they can digest and to align the information given with the time of the year so that it can be put into practice directly.

Case study 5: Benin: increasing the profit margin of microenterprises along the soya value chain

- *Target group: Tofu producers (microenterprises)*
- *Financial service provider: RENACA (National Union of Savings and Credit Cooperatives)*
- *Development partner: Deutsche Gesellschaft für Internationale Zusammenarbeit (GIZ)*
- *Country: Benin*

The GIZ Project 'Promotion of Agricultural Finance for agri-based enterprises in rural areas' in Benin has identified three profitable business models within the soya value chain: one for soya production, one for mechanisation (service provision for threshing and cleaning) and one for microenterprises processing soya into tofu. Tofu is mainly processed by women who buy soya in small quantities throughout the year. Due to a lack of access to appropriate financing, they do so regardless of price fluctuations. Together with the microfinance cooperative RENACA, the GIZ programme has developed a loan product for the purchase of an annual stock of soya right after harvesting time, when prices are lowest, thereby considerably increasing the microentrepreneurs' profit margins. The product contains an integrated savings component, which instilled a habit of saving and allowed the financial institution to detect and react to potential repayment problems early on.

RENACA and the entrepreneurs were both provided with training and coaching measures. The training topics for the entrepreneurs included good production and hygiene practices, business management, cash flow management, assessment and planning of agricultural investments and loan management including financial negotiations. RENACA received technical assistance for the development and integration of the new product, for training the loan officers on the new product, and for setting up a new agricultural finance unit.

The product was piloted with RENACA in 2017/18 with 30 women. As all loans were fully paid back and renewed, the cooperative has now integrated the new product into its portfolio and is in the process of scaling it up. At the same time, the project accompanied almost 1 500 soya producers in getting access to loans from partner financial institutions. The total loan amount, some EUR 335 000, was entirely repaid.

Developing and implementing impactful training for smallholder farmers requires experience, skills and a substantial investment in terms of time and money. For training courses to be impactful, they need to be simple and context-specific (i.e. tailored to the specific crop and local context), interactive and practical, and involve the participants as shown in a randomised control trial on financial literacy training in Uganda in 2016 (Kaiser, 2016). However, the financial institution does not always have the right resources and capacity to deliver the training courses in a product-neutral way over a longer period, and a cooperative, farmer organisation, extension service or development partner might be better placed to do so. Digital solutions could be used to increase scale or reduce costs (See section on digital solutions below).

Trust between farmers and bankers has to be built. Many smallholder farmers have never been personally in contact with formal financial institutions, may have heard negative stories about them, and lack trust in them. It is thus especially important for loan officers to be approachable and (e.g. no intimidation at loan repayment), transparent (e.g. clearly state terms, conditions, expectations and procedures from the outset),

reliable (stick to agreements), communicate at eye-level and take seriously the farmers, their way of life, their businesses, their needs and their concerns.

Well-managed farmer associations and cooperatives can play an important role as intermediaries between farmers and financial institutions. In the triangular relationship between the farmer, financial institution and farmer organisation, the latter can play an important role as ‘trusted agents’ in pooling the purchase of inputs, in storing commodities and facilitating bulk selling, in building the capacity of farmers as well as in mobilising and identifying suitable farmers as potential clients. After the financial institution has established a client relationship with the farmer, the farmer organisation can still support the monitoring of the client’s performance. However, farmer organisations are very heterogeneous in terms of governance and organisational structures. Involving them requires a thorough due diligence beforehand, close interactions and often strengthening later on. Capacity needs can include the areas of good governance and leadership, book-keeping, accounting, bulking, marketing, GAPs, etc.

Simple and practical approaches to reduce financial risks

Individual risks can be mitigated by a good structure of the overall portfolio. Risks differ from crop to crop and region to region. The better a financial institution knows and understands the risks related to a certain crop, the better it can structure its portfolio to keep the overall risk down. For instance, when the world price of raw cashew nuts went down by about two-thirds from 2018 to 2019, some banks in Benin which had only focused on cashew lending had a badly performing agricultural loan portfolio, discouraging them from further investing in the sector, while banks with a more diversified agricultural loan portfolio could mitigate the losses from cashew lending via other value chains.

Close contact between lender and borrower might be the best risk-management tool available. When the portfolio at risk of a financial institution increases, loan officers tend to increase pressure on farmers rather than looking for dialogue. Similarly, when farmers experience troubles repaying their loans, they may tend to avoid contact with loan officers rather than discussing the issue with them. However, rather than working against each other, financial institutions and farmers can work together to find joint solutions. For instance, some agricultural programmes in Benin drastically intensified their presence in the field when the raw cashew nut price fell, and project staff kept meeting with the farmers, listening to them, looking through their contracts, allowing them to talk and express their fears and frustrations, but also confronting them with the consequences of defaulting on their loans. The loan officers often joined them in the field and got involved in the talks. Eventually, different repayment strategies were found which worked for both sides, and the default rate was less than 5%.

Agricultural insurance can be an effective way of transferring those risks which cannot be prevented. Even with the best preparation, training and dialogue, certain risks remain (e.g. natural hazards, weather risks, pests, disease, fire, theft, death). Life insurance covers the loan amount in case of death of the borrower and is often a mandatory element of agricultural loans. Agricultural insurance (e.g. weather index-based insurance, livestock insurance, insurance for specific animals, crops or natural hazards) can help cover the remaining risks. Agricultural insurance can either be taken up at the level of the financial institution (to insure their portfolio) or at the level of the farmer (to insure their investment or their prospective harvest). In many African countries, however, there are no comprehensive solutions available yet or they are very expensive. Different regional and international organisations work together with insurance companies, financial institutions and farmer organisations to improve the offers (e.g. Case Study 6).

Case study 6: Zambia: different models linking input loans with climate risk insurance

- *Target group: Small-scale producers of legumes*
- *Financial service provider: VisionFund Zambia*
- *Development partner: Deutsche Gesellschaft für Internationale Zusammenarbeit (GIZ)*
- *Country: Zambia*

In Zambia, the MFI VisionFund Zambia offers credit lines to smallholder farmers for investments and inputs. The agricultural loans have a longer grace period than conventional loans and allow farmers to repay the loan amount all at once right after harvesting (bullet repayment). As the increasing occurrence of extreme weather conditions has made agricultural planning more difficult and lending riskier, VisionFund has linked the product to a weather index insurance, protecting farmers against drought and excess rainfall. In the agricultural season of 2018/19, a pilot initiative in three provinces in Zambia was started, insuring the loans of 180 farmers. A total sum of ZMK 608 579 (around EUR 40 000) was insured for a premium of ZMK 36 515 (around EUR 2 500). The insurance could be offered to small-scale farmers at a low cost as it uses satellite data according to GPS coordinates instead of assessing the damage at each farm physically.

The insurance immediately paid off, as in the same season of 2018/19 a long dry spell was experienced in two of the three pilot provinces, leading to crop losses and inability to repay the loans. According to specifically agreed triggers, the compensation amount per farmer was calculated and the MFI received compensation from the insurance (ZMK 94 616, corresponding to EUR 6 500) which allowed it to offset the affected loans. At the same time, the farmers were relieved of their burden of needing to repay a loan which they could not afford anymore and remained trusted clients of the development partner.

A smart use of digital solutions to reduce risks and costs

The scoring of clients can be facilitated through digital solutions. The scoring of agricultural clients is complex and requires many data points, some of which are very laborious to collect. The range of possible automation is wide, ranging from the use of transaction records (Case Study 7) to the use of tech-cards or remote-sensing data as a basis for assessing farmers' creditworthiness. Issues to be considered include data protection and consumer protection requirements, the inadvertent exclusion of certain groups of farmers, the institution's capacity to maintain the solution, ease of use and affordability for smaller financial institutions.

Case study 7: Uganda: digitalisation of the advance process

- *Target group: smallholder coffee farmers*
- *Financial service provider: Ibero Uganda Ltd (Ugandan-based off-taker of the Neumann Kaffee Gruppe), through its Farmer Financing Unit 'NKG BLOOM Uganda'*
- *Development partner: Deutsche Gesellschaft für Internationale Zusammenarbeit (GIZ) and Mastercard Foundation*
- *Country: Uganda*

In Central Uganda, the Farmer Financing Unit 'NKG BLOOM Uganda' offers input and cash advances to smallholder coffee farmers. For this purpose, a smartphone-based supply chain management tool was developed, which digitally registers coffee deliveries and payments. With the application, farmers can build a track record which is used as proof of income and a basis for credit risk analysis. Together with personal recommendations from the farmers' group and cooperative, it replaces conventional collateral and is a prerequisite for farmers' advance applications. The advance application process is also digitised, reducing transport costs for farmers and risk officers. Once approved, the input is distributed and the advance money is available directly through the farmer's mobile money account. Repayment is made either via coffee sold or in cash via mobile money. Farmers have the possibility to check their outstanding balance using a USSD code, the protocol used to send text messages over mobile networks. Additionally, a dedicated hotline for complaints and further information has been put in place.

While the system is not yet perfect and some users still struggle with the new tools, digitalising parts of the process has allowed Bloom to considerably scale its product and reach more than 6 000 farmers within the first two years of operation. They are now looking at expanding their product portfolio in Uganda and at replicating the model in other countries.

Digital solutions for transferring money can significantly reduce costs for clients and thereby increase the attractiveness of financial products. In rural areas with poor infrastructure, transaction costs can constitute a significant part of loan costs, and outweigh the benefits of saving products. In the Ugandan survey (GIZ, 2018b), transport and communication costs with clients amounted to 28% to 40% of annual interest for large loans (EUR 1 200) and 73% to 177% for small loans (EUR 50), making them a real burden for borrowers. In countries and areas with a functioning mobile money network, these costs can be brought down to a fraction of the initial amount. In Western Uganda, FINCA provided a mobile payment solution for the clients of their banana production loan, reducing reimbursement costs from 20 000 Uganda Shillings (transport costs, plus 10 hours of travel time) to 2 000 Uganda Shillings (money transfer fees plus 10 minutes of transfer time; GIZ, 2018a).

Digitalisation can help reach scale and reduce costs for training purposes. On the supply side, agricultural (finance) training for staff of financial institutions can be delivered via e-learning tools or blended learning, depending on the level of digitalisation of the institution. On the demand side, there is a wide range of solutions available on the market: from fully-fledged training apps which can be linked to credit scoring systems, to simple add-ons, to face-to-face training courses (e.g. in Uganda, GIZ is testing an interactive voice response system complementing their face-to-face training approach).

Digital solutions bring many opportunities for AVCF but the local context and personal contact remain important. Before rolling out a new digital solution, the local context needs to be considered and consumer testing needs to be done to avoid a reduction of its uptake due to a limited electricity supply, connection issues (especially in rural areas network coverage is often low or slow) or the digital illiteracy of the potential users. Digital solutions should also not be left to stand on their own: in order to bridge the gap between bankers and farmers and to build sustainable relationships and trust, personal contact (e.g. talking to farmers as in Case Study 7, or going to a farm and seeing crops, animals and machinery) will always play an important role.

The role of policymakers and development partners

Policies influencing AVCF are not isolated to any single policy sector, requiring policymakers wanting to engage in AVCF to coordinate with policymakers in various sectors. Supportive policy interventions are context-specific and differ from country to country. To identify the challenges, regulatory bottlenecks and opportunities for policy interventions, policymakers need to engage in a dialogue with the relevant stakeholders, i.e. actors along the agricultural value chains, financial service providers and digital service providers. Below is a selection of possible interventions which contribute to a more AVCF-friendly environment.

- **Promote innovation which allows for more effective and efficient AVCF:**
 - Provide appropriate regulatory frameworks for innovative delivery channels which can significantly reduce transaction costs, like agency banking and mobile banking.
 - Put in place specific legislation for alternative financing mechanisms along agricultural value chains like warehouse receipt systems.
 - Promote further innovation in financial service delivery to actors along agricultural value chains while guaranteeing a minimum of stability by launching sandbox initiatives to drive innovation.
- **Adapt existing models and regulations to the needs of rural and agricultural clients:**
 - Promote safe savings models for rural areas like linkage banking, mobile savings, or the extension of deposit protection systems to rural financial service providers.
 - Ensure that Know Your Customer (KYC), data protection and consumer protection regulations and guidelines are in place and adapted to the needs of rural clients.
- **Invest in the collection and sharing of data which facilitate AVCF:**
 - Invest in digitalised land registries to provide proof of land ownership to rural dwellers so that they can secure their investments and gain access to finance.

- Provide infrastructure and databases for information-sharing amongst financial service providers for improved risk management (moveable collateral registries, credit reference bureaus, or alternative platforms for information-sharing on clients' track records).
- Invest in data generation, collection, analysis and distribution: Make use of new technological developments to gather, analyse and distribute data (e.g. area yield data, satellite-based weather data, prices for agricultural produce and products, but also data regarding outstanding and new financing to the agricultural value chain).
- **Invest in capacity building:**
 - Develop training systems to help bank staff understand the world of agriculture, for instance by integrating AVCF into the curriculum for the concerned bank staff.
 - Strengthen farmer and (agricultural) business organisations and associations so that they can act as strong intermediaries between smallholder farmers and financial service providers.
- **Provide targeted financial support:**
 - Ensure that any subsidies, grants, guarantees and funds have transparent procedures and processes, have a sufficiently long horizon (i.e. exceeding the next elections), involve financial institutions in loan assessment procedures, are complemented with technical support facilities, and do not distort the market.

Development partners are in a unique position to support AVCF. A major challenge for AVCF lies in the high set-up costs due to the need to customise contractual arrangements and procedures to the local context. The development partners' support can play an instrumental role in identifying and organising promising value chains (e.g. convening key value chain actors, providing capacity development services to strengthen industry associations, farmer organisations and financial institutions, and assisting specialised service providers). The development partners can support AVCF in various ways.

- Demonstrate the effectiveness and viability of AVCF by participating in AVCF schemes.
- Provide tailor-made financial support, potentially accompanied by technical assistance that complements or enhances the involvement of local financial institutions – e.g., depending on the situation, provide hard currency loans, local currency funding, (first-loss) guarantees or a combination of these.
- Enhance trust among value chain actors through building relationships by participating in AVCF schemes, especially in countries where the legal framework and administrative procedures for enforcing contracts are weak.
- Reduce entry barriers for financial institutions by enhancing their capacity to understand agricultural value chains, assess risks and opportunities, identify entry points for finance, and design effective tools to monitor and mitigate risks.
- Improve the bankability of the different actors along the value chain through capacity building;
- helping governments to implement policy recommendations (see above).

Conclusion

Increasing agricultural productivity is key for the sustainable development of the African continent, and AVCF can play a crucial role. Ending hunger and malnutrition, reducing poverty, addressing the increasing demand for food and increasing the profitability of agricultural exports all require vast investments in the sector. AVCF can play a crucial role in mobilising financing, as it provides an efficient mechanism to mitigate the risks involved.

AVCF is often complex, but practical experience from the field provides guidance on how to design effective schemes. Sustainable AVCF requires thorough analysis, a willingness to engage with and understand a new target group and adapt structures, processes, approaches and products in order to be able to effectively serve their needs. At the same time, outreach and efficiency can be increased and transaction costs and risks reduced with a thorough calculation of business cases, well-structured partnerships with the right actors within and outside of a value chain, well-targeted training activities, simple but effective risk reduction and mitigation measures and the smart use of digital solutions, rendering AVCF a profitable endeavour for financial institutions to engage in.

Policymakers and development partners could help unlock the full potential of AVCF. Policymakers can raise the efficiency of AVCF schemes and reduce their cost by creating conducive framework conditions and providing the right incentives. In addition, development partners are in a unique position to develop AVCF schemes and show their effectiveness and viability.

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Remittances and financial sector development in Africa

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Summary

This chapter focuses on the links between remittances and the financial sector in Africa. It discusses the aspects of financial sector development that are required to maximise the development potential of remittances, mainly by enhancing productive investment. After a brief review of the patterns of remittances to and from African countries, the chapter examines the relationships between remittances and financial sector development, financial inclusion and investment. It discusses, for example, how remittances are bringing the unbanked into contact with formal financial institutions. The final section explores how measures to enhance financial sector development and, in particular, to reduce the costs of sending money to and within Africa, could boost the development impact of remittances.

Introduction

Remittances, the funds sent back by international migrants to their countries of origin, are a major source of development finance. The World Bank estimates that global remittance flows reached USD 689 billion in 2018, USD 529 billion (77%) of which went to low- and middle-income countries (LMICs) (World Bank, 2019a). Africa received an estimated USD 82 billion of remittances in 2018. This makes these flows larger - by 1-2 percentage points of Gross Domestic Product (GDP) - than both foreign direct investment (FDI) and overseas development assistance (ODA) inflows to Africa.

The importance of remittances is likely to continue increasing in the future. The volume of remittance flows to LMICs is expected to increase to USD 550 billion in 2019 (World Bank, 2019a). ODA is on a declining trend, while international migration is increasing. Policies and technological advances are also making it easier and cheaper to send remittances, which could boost volumes.

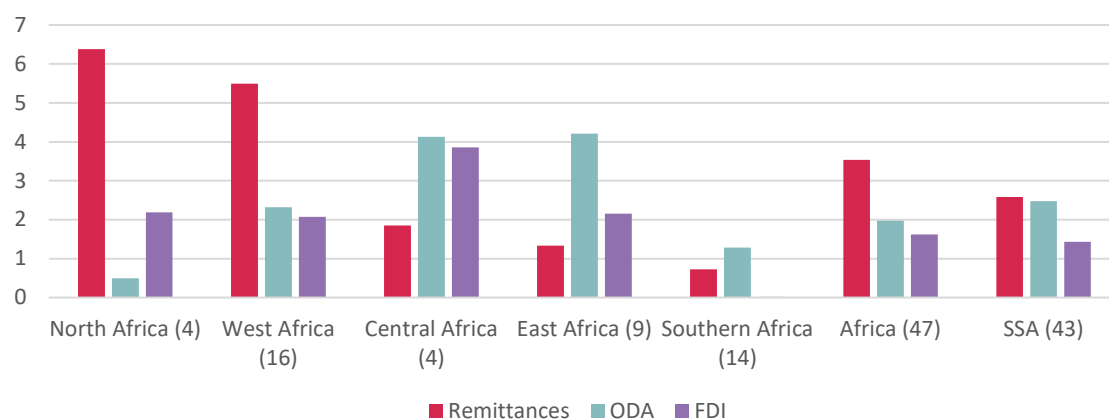
Remittances contribute to the achievement of the Sustainable Development Goals (SDGs). The international community has acknowledged the strong potential development impact of remittances by integrating related objectives into the 2030 Agenda and the SDGs. SDG target 10.c aims to reduce the average cost of sending remittances to less than 3% of remittance amounts and eliminate corridors with costs higher than 5%. Reaching this target would have the potential to save USD 4.3 billion for households sending remittances to Africa, based on current volumes and costs. In addition, SDG 17 aims to mobilise additional financial resources for developing countries from multiple sources, which includes remittances (United Nations, 2015).

The impact of remittances largely depends on how they are used, and particularly the extent to which they are channelled towards productive investment. Migrant remittances are associated with economic development and poverty reduction, with the effect underpinned not only by capital investment and entrepreneurship but also by investments in human capital, education and health (OECD, 2017). However, this also depends on whether and how remittances are intermediated through the financial sector. Africa remains the most expensive continent to which to send money and the costs of sending money between African countries are even higher. The financial sectors of most African countries, including remittance services, remain underdeveloped, limiting the development impact of remittances.

Remittances in Africa

Remittances are a crucial source of external finance for Africa. In 2017, remittances represented 3.5% of GDP across 47 African countries, while ODA represented 2% and FDI 1.6% of GDP (Figure 1). This represents an important shift since 1990, when remittances accounted for 2% of GDP, ODA 5% and FDI 0.5% (World Bank, 2019a). Challenges with the available data and the empirical measurement of remittances make it hard to make a definitive judgement on the importance of remittances relative to other external sources of finance (see Box 1)⁴. However, it is clear that remittances are a large source of external funding for Africa.

Figure 1: The relative share of different forms of external finance by African sub-region, 2017 (% GDP)



Source: Authors' calculations based on the World Development Indicators (accessed in July 2019): Net official development assistance received (current USD); foreign direct investment, net inflows (BoP, current USD); personal remittances received (current USD); GDP (current USD). Data for GDP in South Sudan are from the IMF World Economic Outlook. Data on remittances sent to Gabon are from the World Bank's remittance inflows database. The figure uses the most recent complete FDI and ODA data which are available up to 2017. All data are for 2017.

Note: Regions are defined according to the regional definitions used elsewhere in this publication. The figure includes data for 47 African countries; numbers in parentheses indicate the number of countries included in the sub-regional average. Data are missing for the Central African Republic, Chad, Equatorial Guinea, the Republic of Congo (all Central Africa), Eritrea, Somalia (both East Africa) and Libya (North Africa).

Box 1: Data challenges

The measurement of remittances is challenging for a number of reasons. The challenges are briefly reviewed here, but more detail can be found in reports by the Global Migration Group (2017), Alvarez et al. (2015), IFAD (2017), Irving, Mohapatra & Ratha (2010), Mohapatra & Ratha (2011), Ratha & Shaw (2007) and World Bank (2016).

This chapter relies largely on data published by the World Bank. The main basis for the World Bank estimates of remittance flows is the IMF balance of payments statistics, supplemented in some cases by data from central banks or other relevant official sources (World Bank, 2003). The measures published include compensation of non-resident (temporary) workers, income from non-resident employers such as international institutions, embassies and foreign companies, and personal transfers sent abroad, including traditional worker remittances (IMF, 2009).

The available measures do not fully match the conceptual definition of remittances. For example, it is rare for the income earned by a temporary worker to be transferred in full to the country of origin, yet it is counted in full in total remittances. The available data also omit components including: social benefits received from abroad, financial investments, real estate investments and assets that a returning migrant brings back (IMF, 2009; Plaza, Navarette &

⁴ On the one hand, official data almost certainly underestimate remittances, for the reasons summarised in Box 1. On the other hand, a number of countries have been excluded from the regional averages in Figure 1 because they lack data on remittances. Excluding these countries may be biasing the relative importance of remittances in Africa slightly upwards for at least two reasons: (i) in most of these countries, ODA and/or FDI are relatively high as proportions of GDP; and (ii) these countries have relatively few migrants living abroad, making it probable that their remittance receipts are relatively small.

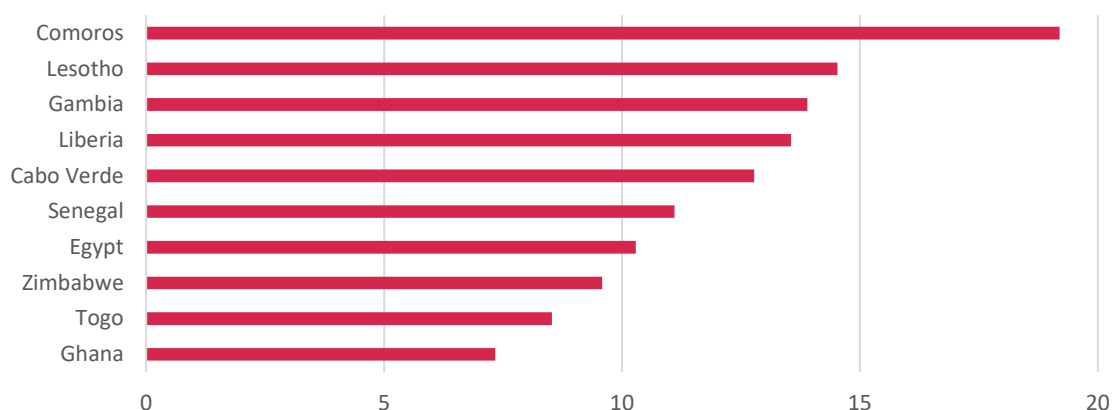
Ratha, 2011; Migration Data Portal, 2019). Data on capital transfers (which involve a transfer of non-cash assets) between households are missing for most countries. Furthermore, the coverage of funds sent by channels such as money transfer operators (MTOs), post offices, savings cooperatives, microfinance institutions and mobile payments systems varies by country.

Purely informal channels are not captured in the available measures. Informal channels include carrying money over the border or moving money through unlicensed networks such as hawala systems (a community-based network). Estimates of the size of unrecorded flows vary wildly (Global Migration Group, 2017; IFAD, 2017; Irving, Mohapatra & Ratha, 2010; Plaza, Navarette & Ratha, 2011). Based on econometric analysis and available household data, the World Bank concluded in 2005 that informal channels may add 50% or more to recorded flows. They suggested that informal flows are largest in sub-Saharan Africa (SSA), the Middle East, North Africa, Europe and Central Asia (World Bank, 2005). More recent evidence suggests that the importance of informal channels remains high. For example, informal channels accounted for 76% of remittances sent from South Africa to countries in the Southern African Development Community region (a region comprising 16 Southern African member states) in 2016 (Truen, Kgaphola & Mokoena, 2016) and 81% of remittance flows into the Democratic Republic of Congo in 2018 (FinMark Trust, 2018).

Estimates of remittance flows between specific countries have a sizeable margin of error, and may be biased. Official data do not distinguish remittances based on country of origin or destination, so bilateral flows must be inferred from other data. Ratha & Shaw (2007) developed a methodology to estimate bilateral remittance flows using total remittance inflows, weighted by migrant stocks in the destination country and the income levels of destination and origin countries. The resulting bilateral matrix is the best available information on bilateral remittance flows. However, it cannot account for differences in propensity to remit based on unobserved factors. As a result, remittance flows will always be estimated to be larger for countries with large migrant populations and for richer sending and receiving countries, all else being equal. This may lead to systematic biases. If, for example, intra-African migrants (migrating from and to relatively poor countries) have a higher propensity to send remittances than African migrants living in richer countries outside Africa, the estimated importance of intra-African remittances will be understated relative to the reality.

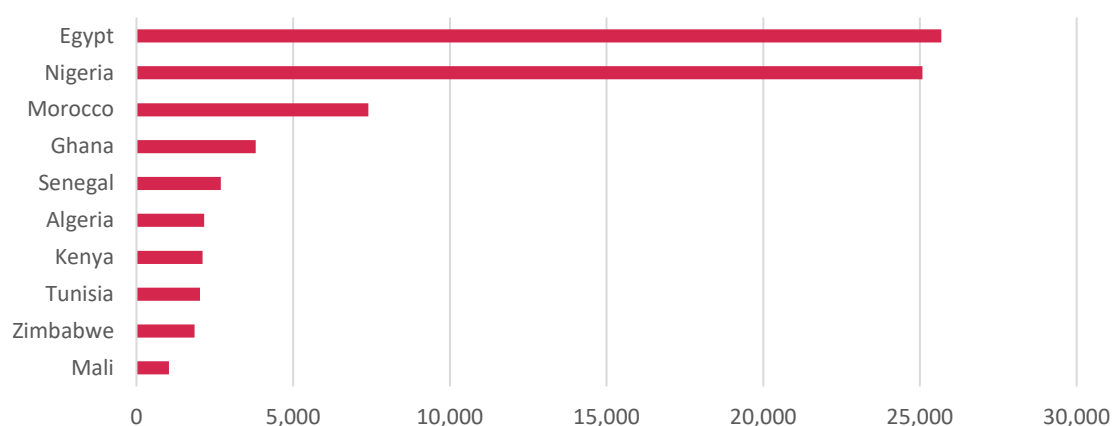
The relative importance of remittances varies across countries within Africa. Remittances are the most important source of external finance in North Africa (6.4% of GDP) and West Africa (5.5%). However, ODA remains significant for most African countries and is the dominant external financial flow in East and Central Africa (around 4% of GDP in both regions compared to below 2% for remittances) and in some West African countries (Benin, Burkina Faso, Liberia, Niger and Mali). In South Africa, FDI is the largest external financial flow (0.6% of GDP). Relative to their respective GDPs, Comoros, Lesotho and the Gambia receive the largest remittance flows (Figure 2). The largest receiving countries in absolute terms include Africa's largest economies, Egypt and Nigeria (Figure 3), while some smaller economies, such as Zimbabwe, Mali and Senegal, enter the top 10 because they receive a high proportion of GDP in the form of remittances. Egypt and Nigeria also figure amongst the world's top 10 receiving countries.

Figure 2: Top 10 African remittance receiving countries, 2018 (% of GDP)



Source: Authors' calculations based on the World Bank's annual remittance data and GDP data from the IMF World Economic Outlook.

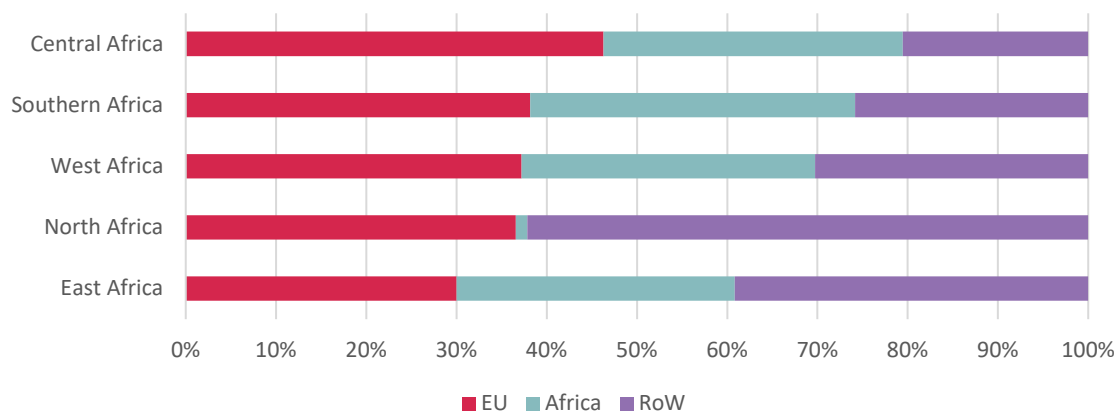
Figure 3: Top 10 African remittance receiving countries, 2018 (USD million)



Source: Authors' calculations based on the World Bank's annual remittance data.

African countries receive significant remittances from other African countries and from the rest of the world, including the European Union. Based on the World Bank's estimates of bilateral remittances, around 36% of remittances to Africa come from the European Union and 45% from the rest of the world (Figure 4). Central Africa receives the largest proportion of its remittances from the European Union (46% of remittances). North Africa receives a lower proportion of intra-African remittances than the other sub-regions, reflecting the fact that migrants from these countries are more likely to move to countries in the neighbouring Middle East ('rest of the world') than to other countries on the continent.

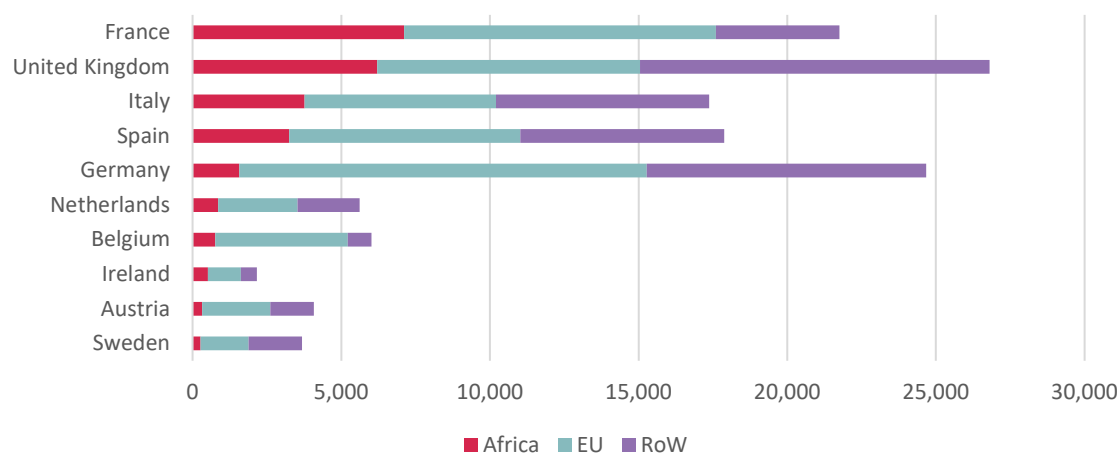
Figure 4: Sources of remittances by sub-region, 2017 (% of total remittances received)



Source: Authors' calculations based on the World Bank's bilateral remittance matrices data.

The volumes estimated to be sent from individual EU countries to Africa reflect the large size of the diasporas and the income levels in the migrant-sending countries. Based on the estimates, the major remittance sending countries are France, the UK and Italy (Figure 5). Nevertheless, the amounts sent from these countries to Africa are dwarfed by intra-EU transfers and, in all of the top 10 countries other than France, by transfers to the rest of the world. The most active remittance channels between the European Union and Africa in 2017 were estimated to be the United Kingdom to Nigeria, France to Morocco and Spain to Morocco. These top three channels have dominated EU-African channels since the estimation exercise began (2010 data), reflecting the large size of the African diasporas in the UK, France and Spain and the relatively high per capita GDPs, and thus earning potentials, in these countries.

Figure 5: The 10 EU Countries sending the most remittances to Africa in 2017 (USD million)



Source: Authors' calculations based on the World Bank's bilateral remittance matrices data.

The importance of intra-African remittance flows is likely to be underestimated. Intra-African remittances account for 18% of total official flows to Africa, based on the available data (Figure 6). This may, however, understate their importance, both because intra-African migrants are more likely to use informal channels to send money and because of the method behind the estimation of bilateral remittances (see Box 1). Based on the World Bank's estimates, the largest bilateral channels within Africa in 2017 were from Cameroon, Ghana and Benin to Nigeria (Table 1). This reflects the fact that Nigeria, the most populous country in Africa, is the main source of intra-African migrants. At the same time, Nigeria is a major receiving country of migrants from other African countries, such as Ghana. Nigeria also has a relatively high GDP per capita, so the estimates show Nigeria to be a major source of intra-African remittances.

Table 1: Major remittance corridors EU to Africa and intra-Africa, 2017 (USD million)

EU to Africa			Intra-Africa	
1	UK to Nigeria	4119	Cameroon to Nigeria	2510
2	France to Morocco	2292	Ghana to Nigeria	874
3	Spain to Morocco	1848	Benin to Nigeria	652
4	France to Algeria	1713	Gabon to Nigeria	414
5	France to Tunisia	1119	Nigeria to Ghana	412
6	Italy to Nigeria	1047	South Africa to Lesotho	399
7	Italy to Morocco	1027	South Africa to Nigeria	324
8	Spain to Nigeria	771	Niger to Nigeria	307
9	Germany to Nigeria	699	South Sudan to Uganda	273
10	UK to Kenya	663	The Gambia to Senegal	264

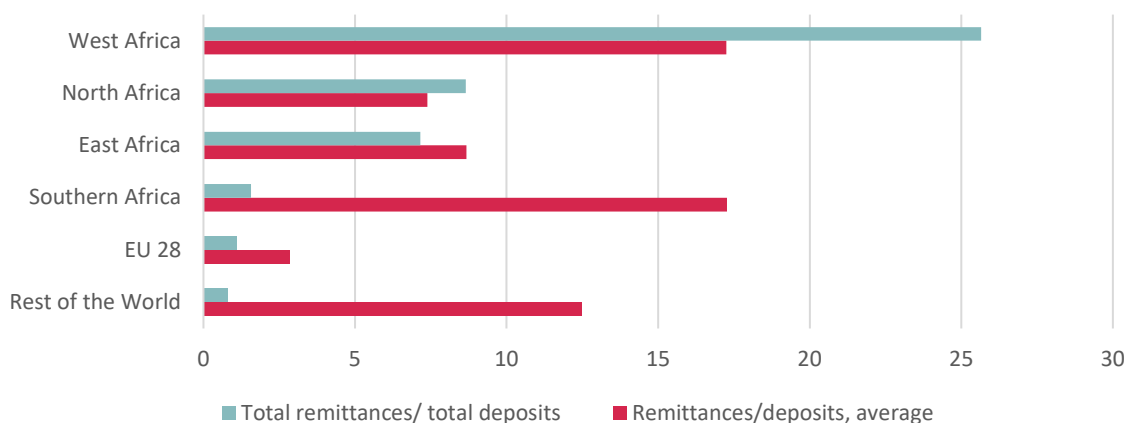
Source: Authors' calculations based on the World Bank's bilateral remittance matrices data.

Remittances and Africa's financial sector

Policymakers have long been interested in harnessing the development potential of remittances. Increasing the share of remittances used for investment compared to consumption is believed to be one of the largest opportunities to boost economic growth in Africa (OECD, 2016; OECD, 2017; AUC/OECD, 2018). The financial sector plays a crucial role in unleashing that potential. The characteristics of the financial sector influence how migrants transmit their funds, how much they send, where they send funds to, and how people receiving remittances use them.

Remittance flows are large in comparison to the size of Africa's financial sectors. Most African countries have relatively shallow financial sectors and remittance flows are large in comparison to the volume of deposits (Figure 6). This is particularly true for West Africa where the total remittances received account for 26% of deposits with commercial banks (17% when averaged over individual countries). As an illustration, Nigeria, the largest economy in the region, has a ratio of deposits to GDP of just 17%, compared to remittance receipts equivalent to 6% of GDP. In eight of the 11 West African countries for which data are available, remittances account for over 20% of deposits. North African countries receive significant remittance flows but tend to have deeper financial sectors, meaning that remittances are less important on average as a source of funding for banks, compared to the size of deposits, than in West Africa. Some countries in East and Southern Africa, such as Namibia, Mauritius and the Seychelles, report a high ratio of deposits to GDP, and remittance receipts are also lower on average in these regions than in West Africa. On the other hand, remittances account for over 20% of deposits in Comoros, Lesotho, Uganda and Zimbabwe.

Figure 6: Remittance inflows as a percentage of deposits with commercial banks, by region, 2017 (%)



Source: Authors' calculations based on IMF Financial Access Survey (deposits as % of GDP), IMF World Economic Outlook (GDP) and World Bank annual remittance data.

Note: São Tomé and Príncipe was excluded from the figure as it reports deposits to be only 0.03% of GDP, which may represent a data error.

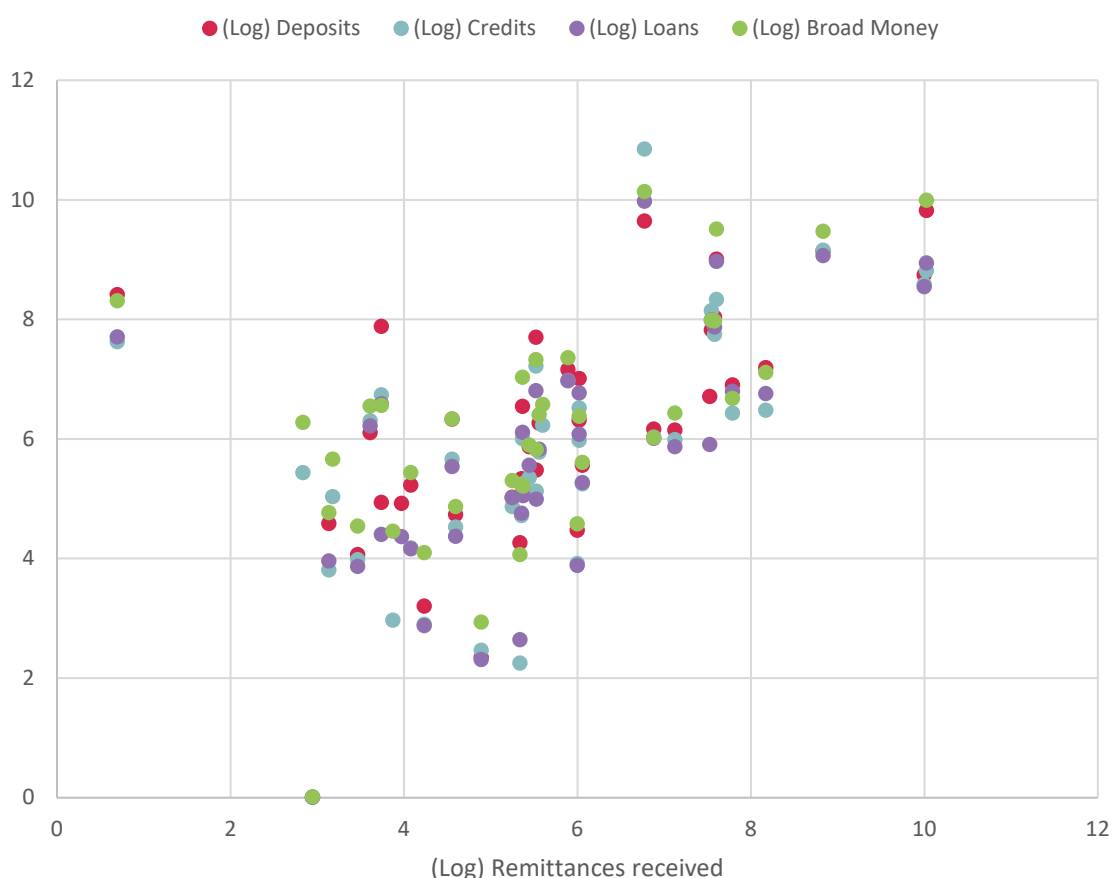
Where remittances enter formal financial institutions as deposits, this boosts their capital. Because of the relatively low level of capital market and financial development in Africa, African banks tend to be highly dependent on deposits for funding. For example, in 2017, 63% of African banking groups saw deposits as their main source of funding for their subsidiaries (EIB, 2018). Some African banks have been successful in securitising future expected remittance receipts in order to raise capital on the markets, further leveraging their impact in the financial sector (Shimeles, 2010). Less directly, banks that can count on reliable and significant receipt of hard currency remittances (or other reliable sources of hard currency) pose a lower currency convertibility risk to foreign investors, which can improve their credit rating.

Whether or not the receipt of remittances promotes lending to the private sector depends on a number of factors, including the risk appetite of banks and the extent to which government borrowing is crowding

out private sector credit. If banks prefer to invest in government securities or to keep liquid assets, remittance deposits will not be translated into credit to the private sector (Gupta, Pattillo & Wagh, 2009; Aggarwal, Demirgüç-Kunt & Pería, 2011; Ambrosius & Cuenca, 2016; Inoue, 2018). The crowding out of private sector lending by public sector debt increased in several countries in Africa between 2014 and 2018 (see, e.g., Betz, Ravasan and Weiss, 2019 for evidence on North Africa). This was partly because of an increase in the supply of public debt and partly because of a perception by banks that lending to the private sector is high risk, which leads them to prefer government securities. Crowding out is particularly severe in Ghana, Niger, Tanzania and Zambia (EIB, 2018).

The receipt of remittances is associated with financial sector development, although it is difficult to establish the direction of causality. There is a positive relationship between remittances and various indicators of financial sector development in Africa (Figure 7). This evidence is consistent with the findings of a number of other studies which use various econometric approaches to address issues of measurement error, selection bias, reverse causation and omitted variables (Gupta, Pattillo & Wagh, 2009; Aggarwal, Demirgüç-Kunt & Pería, 2011).

Figure 7: Relationship between remittances and financial development indicators in Africa



Source: Authors' calculations based on the World Bank's annual bilateral remittance matrices data, World Development Indicators and IMF Financial Access Survey.

The potential impact of remittances on financial market development is constrained because a large proportion of the flows does not enter the formal financial system. As discussed in Box 1, informal flows are believed to be large in volume. Informal channels do not require a bank account or involvement with formal bureaucracy and are therefore accessible and anonymous. In addition, since informal systems are often based on mutual connections and cultural affiliations, they can often be reliable, fast and cheaper

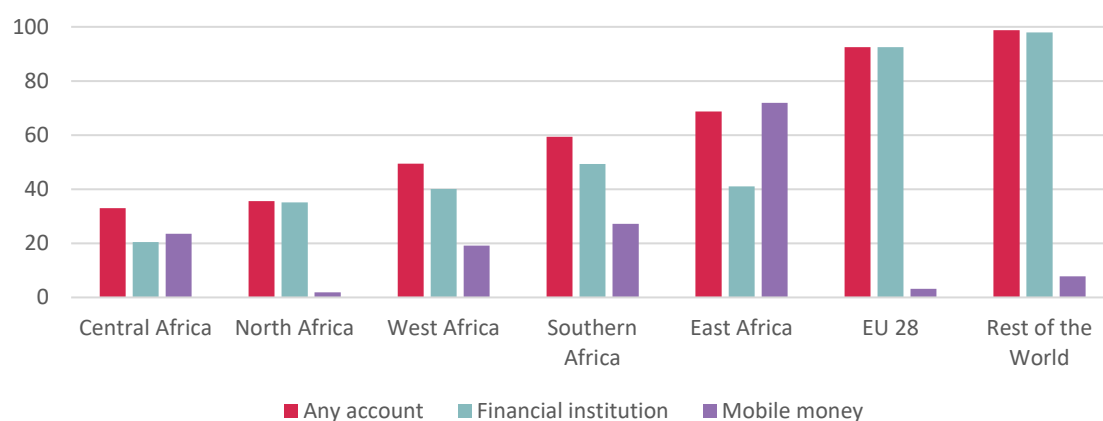
than formal channels. Informal remittance flows tend to prevail in regions with poor infrastructure, low levels of competition, tight regulation and high taxation of remittance flows (IFAD, 2017). The use of informal channels limits the potential impact on savings, investment activity, financial sector development and economic growth (Nyamongo, Misati, Kipyegon & Ndirangu, 2012). The fact that informal flows are not recorded or supervised elevates the risks that they may facilitate money laundering or the financing of terrorism. More research on the magnitude and nature of informal flows is needed.

Remittances as a driver of financial inclusion

Remittances can promote financial inclusion, directly supporting the achievement of SDGs 1 and 8⁵. The impact on financial inclusion could also contribute indirectly to the achievement of other SDGs, while boosting the proportion of funds channelled through formal institutions. By sending or receiving remittances, the unbanked can come into contact with formal financial services. At the first stage, this may encourage them to open deposit accounts to safely store the funds. This can happen even when remittances are received informally (Gupta, Pattillo & Wagh, 2009; Aggarwal, Demirgüç-Kunt & Pería, 2011; Ambrosius & Cuenca, 2016; Inoue, 2018). Previously unbanked remittance receivers may start using an account purely for savings. At later stages, these new account owners may then begin accessing other products, including loans and insurance.

Account ownership in Africa has been increasing in recent years, although it still lags behind the global and EU averages. Based on data of the Global Financial Inclusion (Global Findex) database, 24% of adults in Africa had access to an account in 2011, compared to 87% of adults in the EU. By 2017, 53% of Africans had an account, compared to the EU average of 92% (Figure 8). An even smaller proportion of the population of Central and West Africa has an account. Much of the expansion of account ownership has been due to the emergence of mobile money. The use of a mobile money account is far more common in most African regions than elsewhere in the world.

Figure 8: Proportion of households with financial accounts in 2017, by sub-region (%)



Source: Authors' calculations based on the Global Findex database, 2017 data.

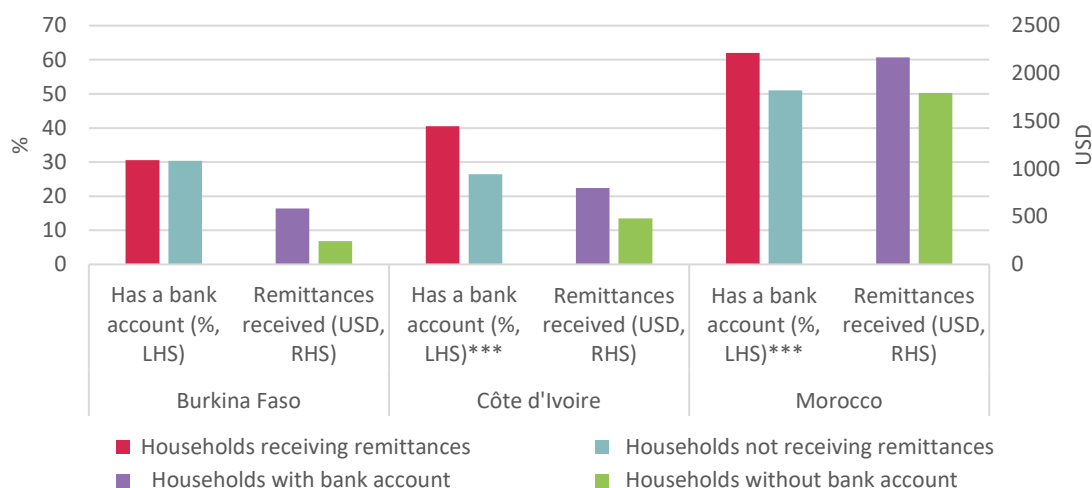
Note: Data refer to percentage of total adult population of the region (aged over 15).

A connection between receipt of remittances and financial inclusion exists in a number of countries, including in Africa, though the direction of causality remains unclear. Based on the data analysed in a recent OECD study (OECD, 2017), households receiving remittances are significantly more likely to have

⁵ SDG Target 1.4: By 2030, ensure that all men and women, in particular the poor and the vulnerable, have equal rights to economic resources, as well as access to basic services, ownership and control over land and other forms of property, inheritance, natural resources, appropriate new technology and financial services, including microfinance. SDG Target 8.10: Strengthen the capacity of domestic financial institutions to encourage and expand access to banking, insurance and financial services for all.

bank accounts in Morocco and Côte d'Ivoire (Figure 9). But there is no significant difference among Burkinabe households. The same study found a significant association for several other countries outside Africa. When households have access to bank accounts, they tend to receive larger volumes of remittances than households without access to a bank account, although the difference is not statistically significant for the African countries surveyed. It is difficult to assess the direction of causality behind these statistical relationships. Receipt of remittances may encourage households to set up an account, but migrants may also be more likely to send remittances to households with bank accounts. It is also possible that migrant-sending households have other characteristics in common that would have made them more likely to have a bank account even in the absence of remittance receipts.

Figure 9: Access to bank accounts by receipt of remittances and amount of remittance receipts by ownership of a bank account (% and USD)



Source: OECD (2017).

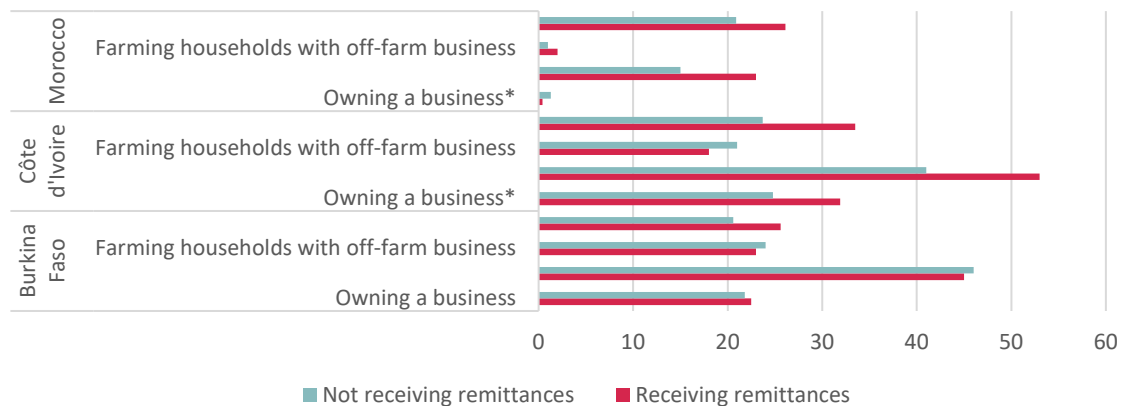
Note: Statistical significance calculated using a chi-squared test is indicated as follows: ***: 99%, **: 95%, *: 90%. The sample for the OECD survey was designed to oversample migrant households and did not provide national coverage in Morocco. As such, the statistics are not directly comparable with statistics from nationally representative survey data.

Remittances as a driver of investment

Remittances can help households overcome credit constraints. This means that a significant share of remittances received is commonly used for private investments, in addition to consumption (Lartey, 2013). A recent study estimates this share to be about 25% of the received remittances of a household (IFAD, 2017). This may include investment in human capital such as healthcare or education, which will have economic returns in the long run (Mohapatra & Ratha, 2011) and in productive assets such as land, property or agricultural assets (Giuliano & Ruiz-Arranz, 2009; Nyamongo, Misati, Kipyegon & Ndirangu, 2012). Remittances can thus support economic growth by fostering private investment. In addition, the use of remittances for consumption can contribute to growth by boosting the demand for goods and services and stimulating production via a multiplier effect (Durand, Kandel, Parrado & Massey, 1996).

Household data make it possible to examine whether remittances, including from informal sources, drive household investment in various types of assets. Figure 10 examines the relationship between household investment and receipt of remittances in three African countries using household-level data. There are several caveats such as data quality and endogeneity when linking remittances or migration to household outcomes such as investment (McKenzie and Sasin, 2007). The analysis of the OECD survey (2017) addresses some of these concerns by adding controls for household characteristics including size, education, wealth and location - although the analysis cannot control for all unobserved factors⁶.

Figure 10: Household investments by receipt of remittances in three African countries (percentage of households surveyed)



Source: OECD (2017).

Note: Statistical significance calculated using a chi-squared test is indicated as follows: ***: 99%, **: 95%, *: 90%. The sample for the OECD survey was designed to oversample migrant households and did not provide national coverage in Morocco. As such, the statistics are not directly comparable with statistics from nationally representative survey data.

Remittances can boost investment in some types of assets, in some contexts. A significant link between remittances and investment in real estate - housing or land assets other than the main dwelling - exists in all three African countries surveyed by the OECD (2017). For Morocco and Côte d'Ivoire, this relationship is robust to controlling for household characteristics, whereas in Burkina Faso the observed relationship disappears when controls are added, suggesting that it may have been driven, for example, by wealthier families, who are more likely both to send migrants and to buy real estate. In both Côte d'Ivoire and Morocco, remittance recipients are significantly more likely to have invested in agricultural assets over the last twelve months, and to own an off-farm business. In Burkina Faso, the positive link between remittance receipts and non-agricultural entrepreneurship applies only in urban areas. As such, there is no evidence that the receipt of remittances is systematically promoting the diversification of income sources for rural households (OECD, 2017).

The receipt of remittances can encourage or help households to access credit, if appropriate financial sector conditions are in place. Remittances can facilitate borrowing via a number of channels. The receipt of remittances can lower risk aversion, as receiving households know that they will be able to use remittance flows to service a loan, and boost willingness to take up debt (Aggarwal, Demirgüç-Kunt & Pería, 2011; Ambrosius & Cuecuecha, 2016; IFAD, 2017). To the extent that account holders are more likely to learn about and demand other financial products, the financial inclusion impact of remittances can play a role in bringing the previously unbanked into contact with opportunities to borrow. Access to financial services also enables them to build up a credit history, and remittances deposited within the financial system can serve as collateral on loans. Expected future remittance flows can be used to demonstrate loan repayment capacity, or as a form of collateral. Home loan products using future remittances as collateral have been

⁶ The full set of control variables is: household size and household size squared, dependency ratio (share of children and elderly to working age population in the household), mean education level of adults in the household, urban/rural location, household headed by male or female, number of children in the household, region in which the household is located, and household wealth (measured by an asset index).

piloted by a number of financial institutions (Hall, 2010). Studies within Africa, for example Mbaye (2015) for Senegal, have found evidence that the receipt of remittances increases the probability of a household accessing a loan. But in some contexts, remittances do not necessarily encourage borrowing from the formal financial system. For example, a study of Mexican household data concluded that remittances increase the likelihood of a household borrowing (Ambrosius & Cuecuecha, 2016). However, these loans are provided informally, often by friends or family members, rather than going through the formal financial system.

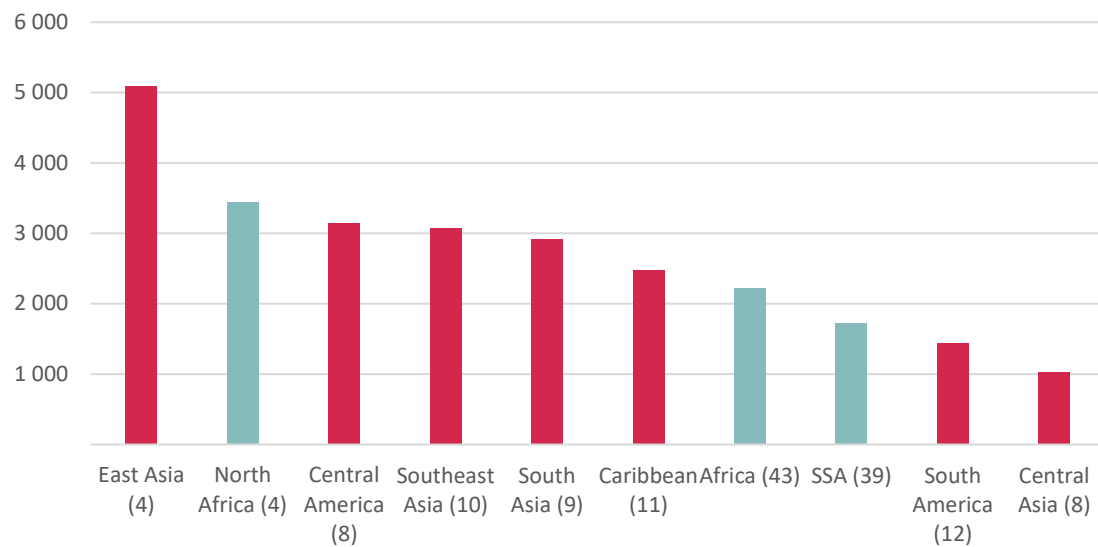
Remittances can boost macroeconomic stability by improving funding options for governments. The most direct channel through which remittances can enhance public finances is the formal securitisation of future remittance receipts as collateral for remittance-backed bonds (Mohapatra & Ratha, 2011). Some LMIC governments have also issued ‘diaspora bonds’. These bonds are not formally tied to remittances but are marketed to and targeted at diaspora individuals or households. The theory is that the diaspora may be particularly motivated to invest in their countries of origin and thus more patient than purely commercial investors. These bond issues are generally tailored to make them attractive and accessible to the diaspora. For example, they may retail at small denominations in order to target less wealthy households or individuals, and the proceeds may be designated to projects that are believed more likely to appeal to members of the diaspora. Nigeria successfully raised USD 300 million with its first diaspora bond, issued in 2017, but the Ethiopian ‘millennium corporate bond’, issued in 2008, did not meet revenue expectations. A later bond issue, in 2011, was more successful, drawing on the lessons learned in 2008. Further research would be needed to determine the conditions under which such schemes can succeed in Africa, drawing on the experience of Nigeria and Ethiopia, as it is likely that the potential has been underexploited (Shimeles, 2010).

Remittances can improve the cost at which governments access finance. Documented receipt of remittance flows can improve a country’s creditworthiness and sovereign rating (Ratha, 2005). Remittances tend to be less impacted by economic crises than FDI and ODA: they are countercyclical on average for the receiving countries (Frankel, 2011; Bettin, Presbitero & Spatafora, 2017) and can help smooth consumption (Duval & Wolff, 2016). This means that they can have a stabilising impact on income at household and country levels. Mohapatra & Ratha (2011), for example, note that the stability of remittance flows was an important factor in enabling the government of the Philippines to maintain market access at the time of the global financial crisis. Overall, remittance receipts can support the diversification of government funding sources and the reduction in the cost of financing sovereign debt via a number of direct and indirect channels.

How financial sector development can catalyse the contribution of remittances to Africa’s development

Remittances to Africa are relatively low, considering the size of the global African diaspora. In 2017, the recorded remittances sent by people from sub-Saharan Africa living outside their countries of origin were lower, on average, than those sent by emigrants from almost all other emerging or developing country regions worldwide (Figure 11). At the same time, the amounts sent by North African emigrants were among the highest. Low volumes per emigrant partly reflect the fact that informal flows are not captured - informal flows are believed to be particularly high for SSA. It is also possible that African emigrants earn less than their peers from other continents or move to countries where they face higher costs of living and taxes which constrain the amounts they can remit. However, factors such as cost and difficulty of sending remittances are also holding back remittance flows to Africa and their productive use. This section explores how addressing these obstacles could catalyse the contribution of remittances to sustainable development.

Figure 11: Annual remittances sent to each country, per person living outside their country of origin (emigrant), averaged by region (USD)

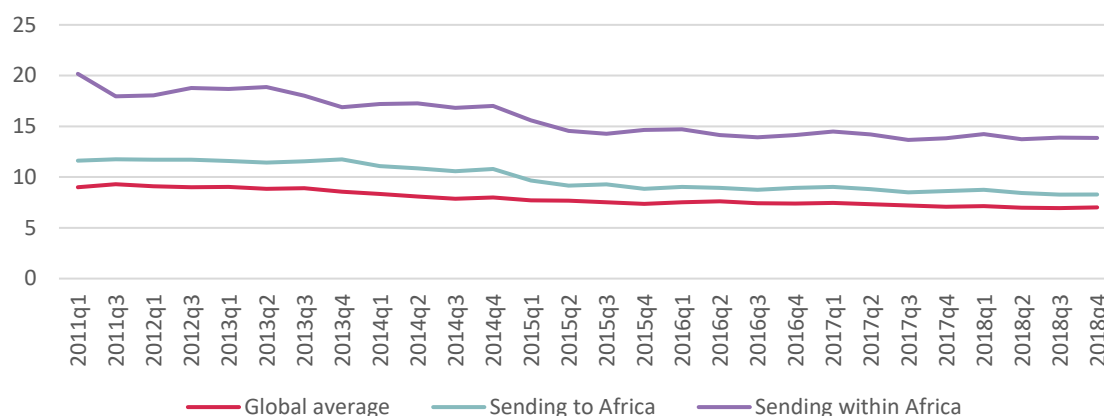


Source: Authors' calculations based on the World Bank's bilateral migration matrices data 2017 and the World Bank's remittance inflows data (April 2019 update) (both accessed in August 2019). Numbers in parentheses indicate the number of countries included in the regional average. All data are for 2017.

Reducing the costs of remittances to and within Africa could boost remittance volumes and encourage migrants to use formal channels, benefiting the financial sector. High transfer costs reduce the amount that receiving households can collect and tend to push migrants to send money through informal channels, which limits their ability to save and borrow money in the formal financial system. The costs of sending remittances have decreased only gradually since the World Bank began systematically monitoring them in 2011 (World Bank, 2019b). The cost of sending remittances to Africa is particularly high (Figure 12). The average cost at the end of 2018 was just above 8%, far off track from SDG target 10.c. With flows to Africa at USD 82 billion in 2018, reaching the target of 3% would have the potential to save USD 4.3 billion for households sending remittances to Africa. The costs of intra-African transfers are even higher, averaging almost 14%⁷.

⁷ The Remittance Prices Worldwide database collects data on a total of 365 corridors in 105 receiving and 48 sending countries. Remittance service providers (RSPs) are asked about the fees of sending two amounts, the equivalents of USD 200 and USD 500 (World Bank, 2019a). The total costs are made up of three components: a sending fee, an exchange rate margin and a receiving fee (Global Migration Group, 2017). The data are available from <https://remittanceprices.worldbank.org/en>.

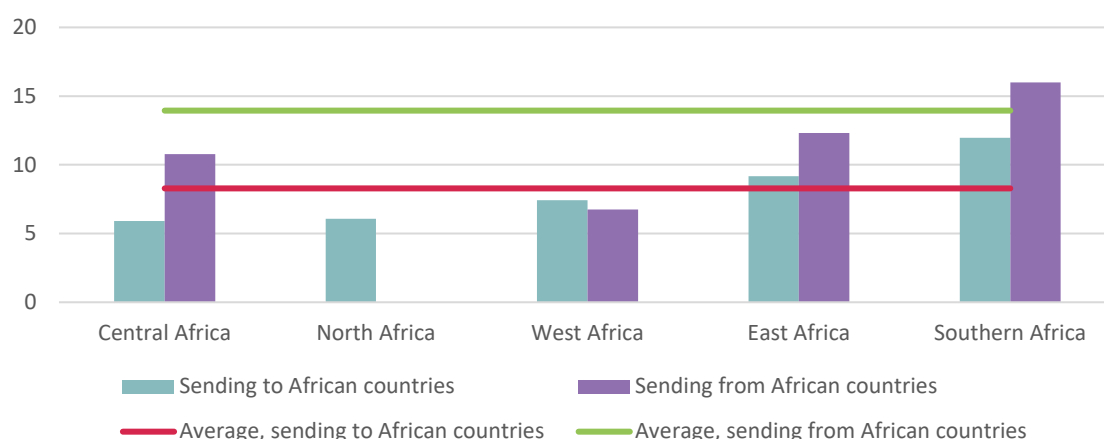
Figure 12: Cost of sending remittances, by destination (cost as % of total remittance value)



Source: Authors' calculations based on the World Bank's remittance prices worldwide data. The global average total cost is calculated as a simple average of the total cost of sending USD 200 for each quarter excluding former Soviet countries and in transparent transactions, as suggested by the World Bank.

The lack of an integrated remittance market in Africa leads to large differences in the cost of sending remittances to and from the different African countries and regions. The 'market' consists of a loose network of hundreds of individual corridors linking two countries. Cost differences between corridors are large. Sending to East Africa and Southern African countries is particularly expensive, on average, despite the fact that South Africa is the cheapest country in Africa to send funds to (Figure 13). The costs of sending funds to Central and West Africa are relatively low, partly because of the use of the West or Central African franc in many of these countries. The currency is pegged to the euro, which brings down exchange rate costs of transfers. Transfers to North African countries are relatively cheap.

Figure 13: Average cost of sending remittances to and from African countries, by sub-region, Q4 2018 (% of total remittance value)



Source: Authors' calculations based on the World Bank's remittance prices worldwide data.

Note: The World Bank does not collect data on the costs of sending remittances from North African countries.

The average cost of sending remittances from an African country is higher than the average cost of sending remittances to that same country, with the exception of the sub-region of West Africa. This partly reflects the fact that south-south corridors, which are often low volume, tend to be more expensive than

higher-volume corridors (IFAD, 2017). Of the 10 most expensive corridors worldwide, seven are intra-African (Figure 14).

Figure 14: The most expensive remittance corridors in 2018 (average costs as % of total remittance value)



Source: Authors' calculations based on the World Bank's remittances price worldwide data. The red bars denote corridors where the receiving or sending country is in Africa.

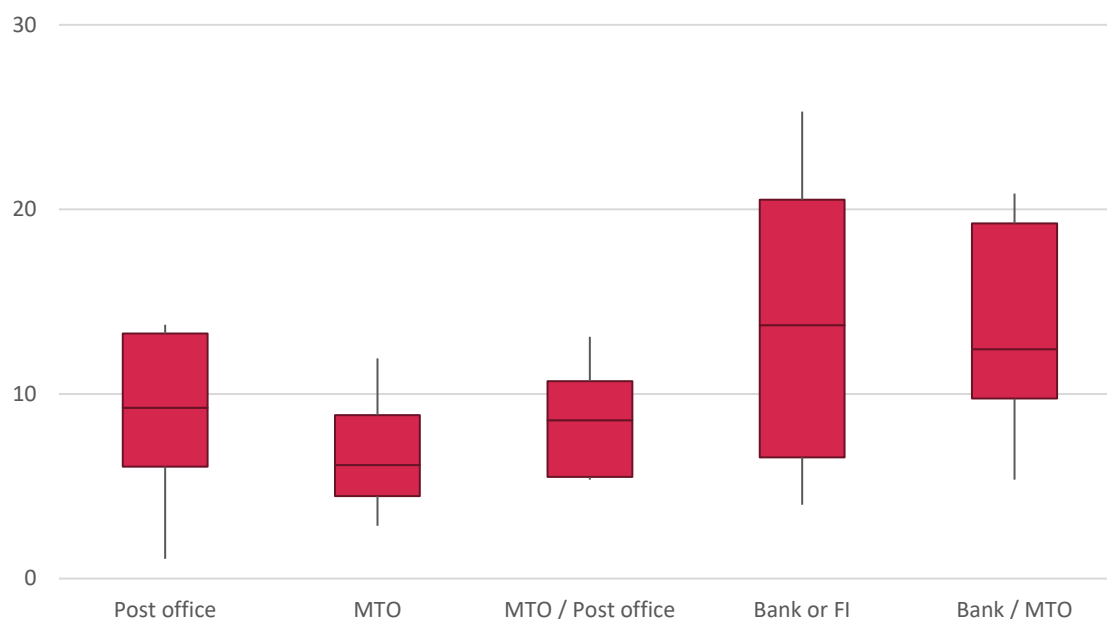
Developing financial sector infrastructure can increase the amount and flow of remittances being sent.

According to a recent report, diaspora members in the UK from countries where domestic payment systems were least developed were least likely to invest in their countries of origin - in this case the Democratic Republic of Congo, Zimbabwe and Sierra Leone (FSD Africa, 2018).

Promoting competition in remittance markets could help to bring down costs by attracting more services and different actors.

The average costs of remittance services differ markedly by provider type (Figure 15). The costs are lowest for post offices (3.2% of total remittance value on average), followed by money transfer operators (MTOs). Exclusive partnership agreements between post offices and MTOs drive up the prices of transfers (World Bank, 2019a) - the costs of using this method averaged 8.6% for African countries. Bank transfers have an average cost of 10.4% and costs appear, again, to be driven up by exclusive partnerships with MTOs.

Figure 15: Cost of sending remittances to African countries by provider, Q4 2018 (% of total remittance value)



Source: Authors' calculations based on the World Bank's remittance prices worldwide data.

Note: The figure shows the 10th, 25th, 50th, 75th and 90th percentiles of the cost distribution by provider.

Remittance senders often have limited opportunities to select between different providers for their particular corridor. For example, direct post office transfers were recorded for only 10 corridors to African countries. In other countries post office services were only available via partnerships with MTOs. Competition can also be limited within a class of provider, explaining the large spreads in recorded costs, particularly for MTOs and financial institutions. Three MTOs (MoneyGram, Ria and Western Union) make up 25% of the global market, and much more in single corridors (IFAD, 2017), which may indicate that competition is, in reality, limited. A number of new developments such as hybrid/multi-channel providers, mobile network operators (MNOs) or hubs for MTOs may hold the potential to increase the dynamism of remittance markets and help bring down costs (IFAD, 2017).

The increased use of mobile money systems may provide an opportunity to increase financial inclusion and reduce remittance costs in Africa. Africa is the only region in the world where the share of adults with a mobile money account exceeds 10%, with rates as high as 30% in Côte d'Ivoire and Senegal, and 40% in Gabon (Demirgüç-Kunt, Klapper, Singer, Ansar & Hess, 2018). The use of mobile money for international transfers has so far been limited. Mobile money users can initiate international remittances directly from their mobile phones in only a limited number of countries (GSMA, 2019; Demirgüç-Kunt, Klapper, Singer, Ansar & Hess, 2018; IFAD, 2017). However, several African operators have been active in this field recently. M-Pesa, Kenya's major domestic money transfer operator, launched M-Pesa cross-border money transfer in 2015, following a partnership between Tanzania (Vodacom) and Kenya (Safaricom), and has been progressively expanding this service to other countries. Zeepay, a leading Ghanaian fintech company, recently announced that it was seeking to reach more than 150 million mobile money users across 20 African countries, and began partnering with global remittance companies to do so. MFS Africa is another platform catering to the development of digital remittances. Tanzanians, Ghanaians and Kenyans have been particularly active in using digital online platforms for transfers from the UK to their home countries (FSD Africa, 2018).

Distributed ledger technology (DLT, of which blockchain is the best known example) also has the potential to make remittance transactions faster, cheaper and to reach areas that are currently difficult to get to or underserved by formal financial systems. It has also been suggested that DLT solutions could help bring down compliance costs and improve the transparency and traceability of transactions, addressing concerns

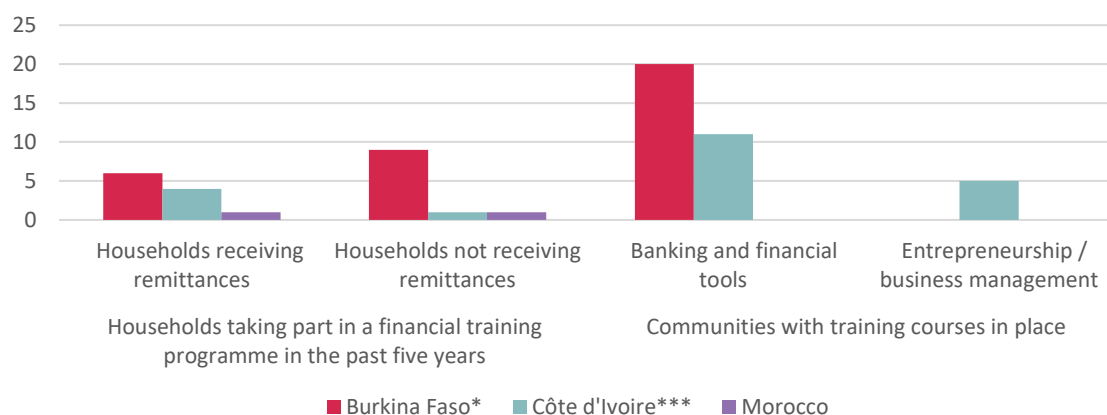
about money laundering and the financing of terrorism (Meija-Ricart, Tellez & Nicoli, 2019). A recent survey by the World Economic Forum shows that many banks plan to adopt a blockchain-based system for at least some of their activities (World Economic Forum, 2019). DLT-based solutions are being actively tested in the remittance markets (Meija-Ricart, Tellez & Nicoli, 2019).

At the same time, the need to address the risks inherent in remittance services pushes up their cost and even threatens the availability of remittance services in some places. Given the range of products and services offered, the variety of distribution channels, the high transfer speed and the fact that these are often cash-intensive businesses, remittance services can provide opportunities for money laundering and financing of terrorism unless appropriate safeguards are in place (FATF, 2010; FATF, 2013). Since 2010, the anti-money laundering and countering financing of terrorism (AML/CFT) regulations dealing with remittance providers have become more stringent and increasingly harmonised among countries. Authorities have also improved the enforcement of these regulations on remittance service providers (FSB, 2019). The implementation of these regulations is time consuming and costly. Unless ‘know your customer’ (KYC) processes are tailored based on the size and source of transfers, the administrative costs of compliance can be very high in comparison to the profits that the institutions can earn from the relatively small transfers involved. A trend has emerged among large banks of dealing with AML/CFT compliance costs by ‘de-risking’: terminating relationships with MTOs in order to avoid the legal and reputational risks associated with serving them. The de-risking process has threatened in particular the availability of remittance services from and to countries affected by conflict or in fragile situations. This approach reduces the risks and compliance costs for those specific banks, but is likely to increase the overall risks, by driving remittance flows into informal channels (Global Migration Group, 2017; IFAD, 2017).

African countries are gradually putting frameworks in place that can bring down remittance costs while mitigating risks. Ghana in particular has experienced a rapid increase in the use of cross-border digital remittances since its central bank established new regulations on e-money. The central banks of Nigeria, South Africa and Uganda have also taken steps to facilitate the use of digital technologies for remittances. But further steps will be needed. A risk-based approach to AML/CFT regulation by banks and regulators could help to reduce the costs of compliance. National governments could also help alleviate concerns about ML/FT by providing remittance senders and recipients with better access to adequate identification papers and documentation of residence.

Further financial sector development, including improvements in financial literacy, can boost the development impact of remittances. Kratou and Gazdar (2018) analyse the links between remittances and economic growth in a panel of 30 African countries. They show that remittances and financial sector development are complementary: a functioning financial sector boosts the positive development impact of remittances, as does a good governance system. Lartey (2013) also finds evidence, for SSA, of a threshold level of financial development, after which the effect of remittances on growth is positive. Financial literacy may play a particularly important role (IFAD, 2019). Many countries have begun developing financial literacy curricula and new technologies may help, but household data indicate that access to and take up of training on banking, financial tools and entrepreneurship remain limited (Figure 16).

Figure 16: Availability and take-up of training courses related to finance and entrepreneurship (% of households or communities surveyed)



Source: OECD (2017).

Note: Statistical significance calculated using a chi-squared test is indicated as follows: ***: 99%, **: 95%, *: 90%. The sample for the OECD survey was designed to oversample migrant households and did not provide national coverage in Morocco. As such, the statistics are not directly comparable with statistics from nationally representative survey data.

Policy implications and conclusions

International organisations and international financial institutions have a key role to play to maximise the development impact of remittances. For instance, the recently established platform for multilateral development banks aims to step up collaboration to address challenges and opportunities arising from economic migration and forced displacement, including those related to remittances⁸. The objective is to ensure strategic coordination and dialogue with national authorities and other partners, advance cooperation on operational priorities (including the development of new instruments and products), facilitate an agreed approach on technical assistance and strengthen data collection and quality.

Multifaceted collaboration is needed to enhance financial sector development and harness the development potential of remittances in Africa. The areas of intervention with local financial institutions include capacity development (e.g. the joint initiative of the EIB and the IMF to promote financial development and financial inclusion⁹) and investment support to develop tailored products (specific remittance-linked savings and insurance products), increase outreach (including mobile payment solutions) and identify partnership opportunities with different types of providers to increase competition between banks and non-bank financial institutions. This should help to reduce transaction costs and decrease the share of remittances sent through informal channels.

The impacts on migration and remittances should be considered when developing financial sector policy. Similarly, the impact of remittances on the financial sector should also be taken into account when developing migration policies. This is particularly relevant for Africa, where most people work and conduct business informally, and therefore formal sector development may not be enough. Typically, migration policies are developed by a few actors, usually migration experts, who may lack an overview of the impact on the financial sector. It is equally important to include migration experts in discussions about financial sector regulation and policies, as financial experts may not always have an awareness of the links between their work and migration and remittances, especially in the informal sector (OECD, 2017).

⁸ <https://www.eib.org/en/press/all/2018-100-mdbs-launch-new-platform-to-coordinate-support-for-economic-migration-and-forced-displacement>

⁹ <https://www.eib.org/en/infocentre/open-learning/financial-development-inclusion>

The dialogue with public authorities, regulators, other partners and their respective stakeholders should focus on making improvements in the regulatory and policy environments, payment infrastructure development, financial literacy and consumer protection. Renewed efforts to improve methodology and data collection are also needed. Supported by the ongoing regional integration process, the adoption of more coherent, comprehensive and better coordinated approaches to remittances will help Africa to take advantage of the opportunities presented by international migration, while mitigating the challenges.

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The European Investment Bank in Africa

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The EIB's investment in Africa

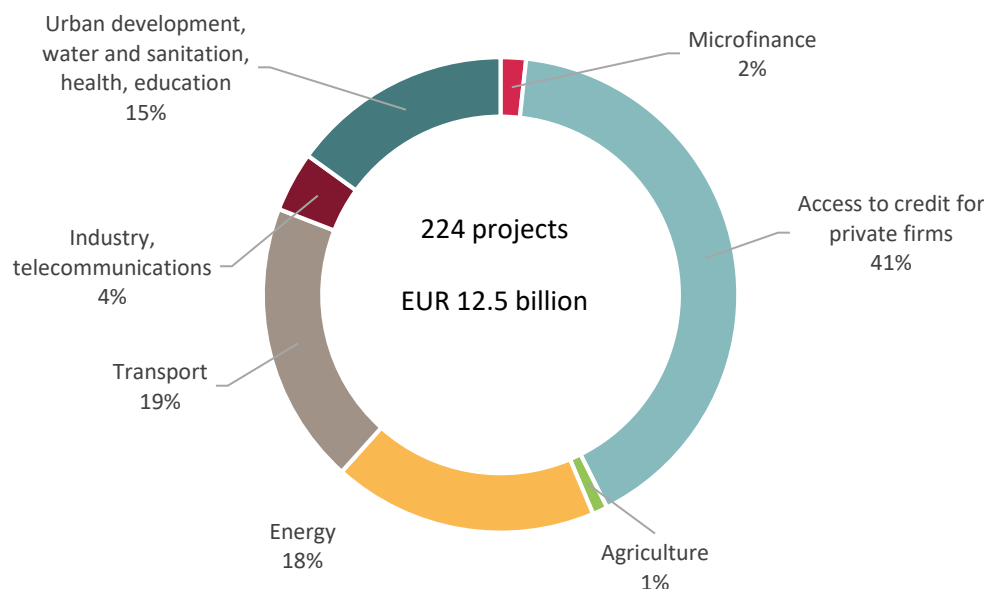
The European Investment Bank has been investing in sustainable development across Africa since 1963.

The EIB has invested more than EUR 44.9 billion in African countries, reaching 52 of the 54 African states, including many of the poorest countries on the continent, as well as countries which have reached middle-income status. Our partner countries include least developed countries, fragile states and countries recovering from conflict. EIB financing for these countries amounts to some EUR 2.6 billion mobilizing some EUR 7 billion of total investment. Lending volumes per country and region respond to the mandates that the EIB has received from the European Union (EU) and its Member States.

The EIB partners with the African private sector and public sectors. In 2019, 58 of the 122 new projects signed outside the EU will benefit Africa. These projects are worth EUR 3 billion (including a portion of regional projects expected to benefit African countries), which accounts for almost 40% of the EIB's lending outside the EU. Private sector partners accounted for 59% of the lending in Africa. This was mostly intermediated through financial sector institutions in order to reach smaller companies and individual entrepreneurs, supporting the creation of employment.

In accordance with the Cotonou mandate, the EIB's financial sector operations in Africa target two complementary objectives: promoting financial sector development and enhancing access to finance. Achievement of these objectives will boost the prospects of private sector development, in line with the EU's priorities for Africa and contributing directly or indirectly to the elimination of poverty and other Sustainable Development Goals (SDGs). Operations in other sectors help to create the conditions for inclusive and sustainable economic growth and private sector development, which in turn complements the EIB's financial sector-focused operations.

Figure 1: EIB lending for new projects signed in Africa, 2015-2019



Supporting the EU-Africa partnership

The EIB's activities in Africa are fully aligned with EU policies and values while responding to national priorities and market needs. In Africa, the EIB finances operations using its own resources, including under

the External Lending Mandate (ELM), and under the Africa, Caribbean and Pacific Investment Facility (ACP-IF), a revolving fund established under the ACP-EU Partnership Agreement (Cotonou). All investments are implemented according to EU standards and values, including through the implementation of the EIB's Environmental, Social and Governance standards.

Figure 2: Expected results supported by projects signed in African countries in 2018



EIB investments aim to combine high development impact with financial sustainability (Figure 2). Projects signed in 2018 are expected to contribute to giving 2.8 million people access to the internet, providing 350 000 people with an improved water supply and enabling 12.3 million people to use sustainable urban transport. As these results demonstrate, the Bank is helping the European Union to remain a frontrunner in implementing the 2030 Agenda and supporting Africa's Agenda 2063.

Promoting financial sector development in Africa

The EIB tailors its investments and technical assistance programmes to meet the needs of its clients and to generate the desired impact on the ground. Each operation is designed to help EIB partner countries deliver on the SDGs, while paying attention to other EU priorities like climate action and gender equality and crowding in finance from other market players. The products used include direct loans and equity investments, intermediated lending via banks and microfinance institutions (MFIs) and investments in private equity or venture capital funds. The EIB also uses innovative risk-sharing products to catalyse private sector finance. A significant portion of the EIB's lending, in sub-Saharan Africa in particular, is carried out in local currency. Local currency finance helps project promoters and final beneficiaries avoid or reduce exposure to currency risk.

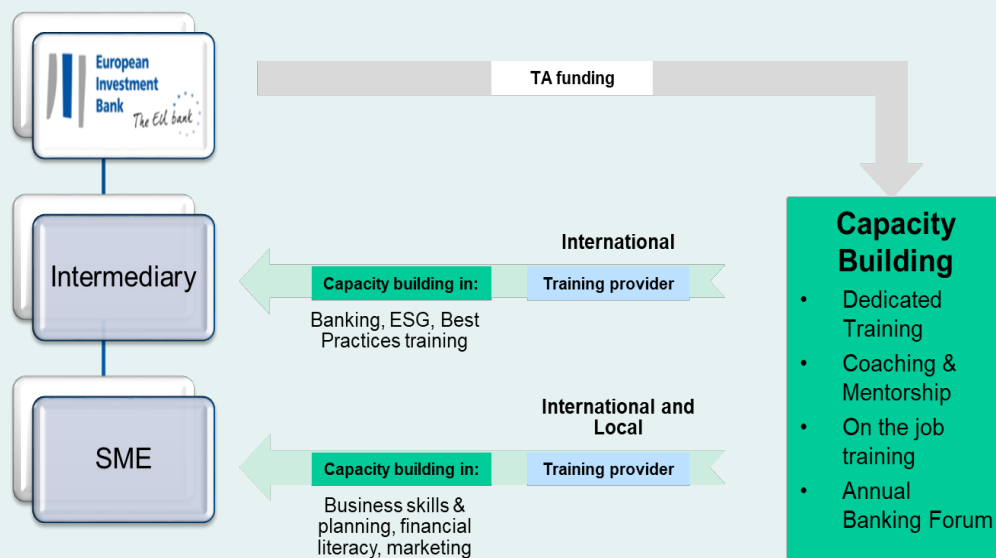
The EIB reaches out to African private sector firms directly and through financial intermediaries. As this publication has highlighted, private enterprises across Africa struggle to access finance for productive investment, particularly at longer tenors. It is smaller, younger firms and innovative companies that are often the most affected by financial market gaps. The EIB works with intermediaries to reach these firms.

The EIB's intermediated investments allow the underlying beneficiaries to invest, innovate, create and sustain employment. For example, new credit lines provided in 2018 will enable local and regional banks to provide around 770 loans to African SMEs and mid-caps. The average tenor of these loans is expected to exceed five years - a significant increase relative to the typical loan durations available in the local markets. Beneficiary companies are expected to sustain around 98 000 jobs. EIB lending to microfinance institutions enables the EIB to also reach the smallest firms. In 2018 the EIB supported the Women's Entrepreneurship Development Project in Ethiopia. Around 15 000 micro-businesses, all of them led by women, are expected to benefit. Finally, investments in private equity and venture capital funds enable the EIB to support early-stage companies, or those moving into innovative industries or new markets, which are generally perceived as highly risky. The investee companies of private equity funds supported by the EIB in Africa and the neighbouring Mediterranean countries in 2018 are expected to create 19 800 jobs.

Box 1: EIB technical assistance to financial sector operations (SME and microfinance lending and equity operations)

A significant proportion of EIB Technical Assistance (TA) operations in sub-Saharan Africa are offered in the form of project implementation assistance and capacity building. This trend is particularly relevant to financial sector operations where the TA is not only allocated to knowledge transfer to financial intermediaries but also to building the managerial capacities of final beneficiaries, often through local training institutions. Furthermore, recent TA programmes have increasingly offered targeted support for local training providers including universities and banking institutes. The intention of this is to ensure that training and capacity-building services can be provided locally beyond the tenure of the EIB TA programmes.

Figure 3: Delivery model of the EIB’s financial sector TA for intermediated lending



In 2019, the EIB approved five financial sector TA operations totalling EUR 9.3 million and supported 20 active financial sector TA operations across 48 countries in sub-Saharan Africa. The bulk of these operations were dedicated regional programmes for the financial sector in Southern Africa, East Africa and, more recently, in West and Central Africa. These include direct support for financial intermediaries and their clients benefiting from EIB intermediated lending (Figure 3).

The capacity-building operations are aimed at strengthening financial intermediaries, in particular microfinance institutions, small business banks and portfolio companies, but also their final beneficiaries (MSMEs). In total, training provided under the new financial sector operations is expected to benefit 4 570 people while on-the-job-training is expected to benefit around 2 000 banking staff. Training of trainers is also now playing a more significant role as a means of enhancing the local knowledge base.

In terms of knowledge products developed, the main deliverables tend to be new procedure and policy handbooks and other training materials. In particular, the TA programmes for lending in West & Central Africa and Southern Africa (total of EUR 4.2 million), alongside the training for the financial institutions, focus on improving the financial literacy of the SMEs financed and on providing training at local universities, fostering entrepreneurship and the sustainability of MSME-supported investments.

Example 1: Technical assistance programme for North African banks under the Economic Resilience Initiative (ERI)

EIB is using the resources provided by the ERI to provide tailored support to financial intermediaries. The TA is designed to help them to expand sustainable lending to SMEs, with particular focus on previously unserved and underserved segments. Two TA operations are already being implemented under ERI, while another was signed in 2019. The support is helping the partner banks - the Export Development Bank of Egypt, the Egyptian Gulf Bank and the Bank of Alexandria - to design and adapt products to reach underserved groups. It also helps the banks to identify relevant end-beneficiaries. This TA is expected to enhance the outreach of EIB lending and to deepen its impact on innovation, growth and job creation.

Example 2: Technical assistance programme for various EIB financial sector operations in East and Central Africa

Since 2014 the East and Central Africa technical assistance programme has worked with 31 financial intermediaries in the region with 424 training courses attended by over 9 000 bank staff and 160 specific capacity-building activities which were tailored to the needs of the banks. In addition, an EIB banking academy on best banking practices is now organised on an annual basis for the benefit of the financial intermediaries as an opportunity to share concepts and ideas with the EIB and network with peer institutions in the region. Over the same period, over 238 training events targeting MSMEs have been organised, benefiting over 17 000 individual MSMEs. The programme promotes the long-term sustainability of activities by cooperating with local training providers and enhancing their capacities.

Example 3: Collaboration with the University of Dar Es Salaam in Tanzania

This TA programme aims to enhance the entrepreneurship and business skills of local MSMEs through collaboration with local service providers. Under a partnership with the EIB, the University of Dar Es Salaam's Business School of Innovation and Entrepreneurship Centre (UDIEC) provides Tanzanian MSMEs with training on financial literacy, business planning, and business modelling. The aim of the training is to enhance business skills, increase competitiveness and facilitate access to finance. The programme is delivered together with local financial intermediaries. It is coupled with training of trainers courses for UDIEC lecturers, in order to strengthen local capacity to deliver these courses.

The EIB also promotes the development of the financial sector to sustainably improve access to finance and financial inclusion. Many EIB clients receive Technical Assistance (TA) alongside an EIB loan. The EIB's TA offering is described in more detail in Box 1. It helps to strengthen both the firms receiving funding and the local and regional financial sectors. The EIB also partners with the International Monetary Fund (IMF) to support capacity development for financial sector development, with a particular focus on Africa (see Box 2).

Box 2: The EIB-IMF capacity development partnership

The three-year partnership supports the delivery of capacity-building and training programmes to selected target groups on topics of special interest to the EIB and where the IMF has strong technical capacity. The Bank's total financial contribution amounts to EUR 3 million and builds on three components:

- **An EIB-IMF online course on financial inclusion and financial development.** The aim of the course is to build the capacity of both policymakers and financial intermediaries so that they can do more and better to deliver on financial sector development and financial inclusion. This initiative brings together the complementary expertise of the IMF and the EIB. The IMF contributes its expertise on macroeconomic and financial sector policies. The EIB focuses on financial and non-financial instruments and how to use them to support financial inclusion and private sector development. The course was launched in April 2019 and is available on a continuous basis. It will be accessible for a minimum of three years.
- **Support to the IMF's five regional technical assistance centres in sub-Saharan Africa (AFRITACs) and the Africa Training Institute (ATI).** The goal of the AFRITACs is to strengthen the formulation and implementation of policies, including for financial sector stability and development. The centres provide policy-oriented training, support and capacity development in macroeconomics and financial management, including financial sector supervision and regulation. The ATI delivers standardised training aimed at strengthening institutional and human capacity for effective economic policymaking and macroeconomic management.
- **Support to the Financial Sector Stability Fund (FSSF).** The main goal of the FSSF is to strengthen financial sector policies in low and lower and middle-income countries. The focus of the FSSF is to perform a number of diagnostic assessments detecting risks and vulnerabilities in country financial sectors and to provide dedicated services to address those issues.

The EIB delivers all its investments through partnerships. Partnerships and country ownership are crucial for delivering lasting results. The European Commission and the European External Action Service, as well as African governments, are key partners for all operations in Africa. Other partners include the European bilateral development finance institutions, other multilateral development banks, UN agencies, the African Union and philanthropic foundations.

The EIB's knowledge base

The EIB's understanding of African financial sectors is based on in-depth sector knowledge, much of which is summarised in this publication. The EIB also collaborated with partners to analyse constraints to private sector development in North Africa², and has analysed the economic resilience context in Africa³. Knowledge underpins the EIB's intervention logic and strategic engagement in Africa, as elsewhere. The Bank also contributes to the country strategies coordinated by the European External Action Service for African countries. These strategies serve as a guide for selecting investments that best meet the EU objectives for each country. The EIB maintains nine external offices in Africa, which provide it with up-to-date information on the situation in the countries where they are located and across the region.

The EIB is investing in filling data gaps. A lack of data hinders understanding of the status of the private sector in Africa and the constraints to its development. The EIB is partnering with other institutions to carry out enterprise surveys in Africa⁴. These will provide an updated view of the constraints facing private sector firms. The data will be used by the EIB in analysis and will be made publicly available. The Bank also carries out bank lending surveys in North Africa.

The EIB monitors its contribution to development impact in order to enhance development effectiveness. The EIB's objectives go beyond financial return, so the EIB goes beyond tracking monetary, physical and capacity-building inputs. The Bank's results measurement system is applied to all operations outside the European Union and tracks the outputs the operations created, the outcomes they contribute to, and the relationship between those outcomes and the Bank's higher-level goals. The expected results are assessed during project appraisals and achievements are reported on across the life of each project. Knowing what has worked allows the Bank, over time, to enhance its contribution to sustainable and inclusive development.

The EIB is investing in in-depth research, at the level of final beneficiaries, on selected projects or portfolios (Box 3). For example, in a pilot programme carried out in partnership with the Global Development Network (GDN), the EIB assembled a set of researchers from Africa and the Caribbean to carry out impact studies of private sector projects in Africa, focusing on impact investment. GDN brought in globally renowned experts to provide technical advice to the programme, to ensure that the studies are carried out with the maximum appropriate rigour and using the most up-to-date methods. This approach has boosted the capacity of the research communities in Africa and the Caribbean, and has been a valuable learning experience for the EIB and for its clients. So far, the programme has supported researchers from Cameroon, Ethiopia, Gambia, Ghana, Kenya, Mali, Nigeria, Rwanda and Senegal, and four studies have been published⁵.

Box 3: Insights from impact studies into the effects of EIB's financial sector operations on final beneficiaries⁶

Residents of a low-income area of Nairobi, Kenya reported improved quality of life and better access to information as a result of the provision of affordable internet. However, the study found no evidence of improvements in learning outcomes for students in schools receiving free Wi-Fi. Poa International Limited is a portfolio company of Novastar East Africa Ventures, a venture catalyst firm that has received investment from the EIB's Impact Financing Envelope (IFE)⁷ and the DFID Impact Fund, managed by the CDC Group⁸. poa! internet provides wireless broadband in low-income communities in Kenya. The service is delivered through a Wi-Fi network, and this technology has allowed poa! to bring more affordable, unlimited internet access to underserved individuals and small businesses. poa! has also been providing free internet access to selected community institutions, including schools, in return for these facilities hosting

² <https://www.eib.org/en/publications/econ-mena-enterprise-survey.htm>

³ <https://www.eib.org/en/publications/resilient-africa>

⁴ Enterprise surveys for North African countries are carried out jointly with the European Bank for Reconstruction and Development and the World Bank.

⁵ <https://www.eib.org/en/publications/the-impact-of-private-sector-projects-in-africa.htm>

⁶ The detailed studies behind these insights are available at: <https://www.eib.org/en/publications/the-impact-of-private-sector-projects-in-africa.htm>

⁷ <https://www.eib.org/en/publications/impact-financing-in-acp>

⁸ https://www.get-invest.eu/_funds/dfid-impact-fund/

the infrastructure used to provide some of their services. The EIB and CDC worked together to study the impact of poa!'s internet offer in low-income areas of Nairobi⁹. The key findings were:

- The majority of poa! internet home broadband customers recorded quality of life improvements due to increased affordability of internet services and a more reliable internet connection. This allowed them, among other things, to work or study from home.
- Users reported being better informed about the world and having access to information as the greatest benefits of internet access at home.
- Improved access to unlimited data has changed the way students and teachers use the internet for teaching and learning.
- Students using poa! internet at school are more likely to benefit from information and communications technology (ICT) training during school hours and made more use of internet for private purposes, including accessing educational content.
- However, there was no evidence that the internet was being used to enhance learning outside of ICT training. Improvements in school ICT infrastructure may be needed to translate better internet access into enhanced student achievement.

Entrepreneurs in rural areas of Côte d'Ivoire achieved better business outcomes as a result of microfinance lending. However, the evidence suggests that female entrepreneurs need more support to reap the full benefits of access to finance. *Première Agence de Microfinance Côte d'Ivoire* (PAMF) provides financial services to more than 17 000 micro-entrepreneurs and small-scale farmers in northern and central Côte d'Ivoire who are excluded from commercial banking services. PAMF has been supported by the Luxembourg Microfinance Development Fund, which received funding under the IFE. A study investigated the impacts of PAMF's solidarity-group lending (solidarity-group lending is a practice where small groups borrow collectively and the members encourage one another to repay). The results showed that:

- PAMF is one of the few institutions reaching clients in some of the poorest areas of Côte d'Ivoire. The average client is uneducated or poorly educated and lives in a household of eight members.
- PAMF contributes to increased financial inclusion. More than 94% of borrowers were financially excluded prior to gaining access to a PAMF loan.
- Clients are satisfied with PAMF products and services. Repeat clients are more likely than new clients to recommend PAMF to friends and family. This suggests that the overall levels of satisfaction increase alongside client loyalty.
- PAMF loans provide a springboard to economic expansion and diversification. Most clients (80%) reported that their loan was used for business purposes and one in three claimed to have developed at least one additional income-generating activity.
- PAMF loans have enhanced business outcomes. The study revealed a positive and statistically significant impact of successive borrowing on the economic and financial performance of microenterprises.
- PAMF lending increases subjective well-being and decreases vulnerability. Repeat borrowers report higher economic well-being (a combination of perceptions of income security and improvements in living standards) and have a higher probability of being able to deal with unexpected adverse conditions.
- However, the impact of PAMF lending is less pronounced for women entrepreneurs - the institution's main customers. Women are more likely to have more positive perceptions of their own economic well-being, but male borrowers earn 47% higher profits than women. This may reflect wider social norms and market conditions affecting the success of female micro-entrepreneurs in Côte d'Ivoire.

The results of these studies illustrate how the EIB's work with financial intermediaries contributes to development impact. Early-stage, innovative firms like Poa are making a difference to the lives of people living in low-income areas, who have been underserved by established businesses, while MFIs such as PAMF are successfully reaching out to the financially excluded. The EIB's support to funds such as Novastar and LMDF clearly has a strong potential to contribute to development impact. The studies also provided the EIB and its clients with insights into the kind of complementary investments that would be needed to help individuals and communities access the full benefits of the services.

⁹ https://assets.cdcgroup.com/wp-content/uploads/2019/08/27073116/2312_Insight_REPORT_Practical-solutions_v5_AW_HIGH.pdf

The way forward

The EIB continues investing in Africa, aiming to mobilise EUR 100 billion over seven years. These investments will help EU and African countries make the most of opportunities for sustainable and inclusive economic growth. As explored in a recent EIB publication¹⁰, Africa's labour base and potential to adopt modern technologies can create significant opportunities for EU companies. More broadly, Africa offers the European Union opportunities for trade, influence, political alliances, investment and the fostering of common ideas on global issues like climate change. However, African countries should become more resilient to external shocks so that their economies will grow sustainably, creating jobs and improving lives. By promoting financial sector development and the underpinning of a flourishing private sector, the EIB will continue to contribute to economic resilience.

The EIB will continue to develop knowledge and understanding of African markets. This publication will be updated in 2020, and will include thematic analyses of pressing issues facing African financial sectors. Up to 10 further impact studies will be completed during 2020-21 under the EIB-GDN programme and analysis of the enterprise survey data collected in partnership with EBRD and the World Bank is already underway. Surveys and data gathering will also be conducted, with the support of local universities, through EIB's regional SME banking and Microfinance Academies.

¹⁰ <https://www.eib.org/en/publications/resilient-africa>



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