

Mlachila, Montfort et al.

Research Report

Banking in sub-Saharan Africa: Challenges and opportunities

Regional Studies and Roundtables

Provided in Cooperation with:

European Investment Bank (EIB), Luxembourg

Suggested Citation: Mlachila, Montfort et al. (2013) : Banking in sub-Saharan Africa: Challenges and opportunities, Regional Studies and Roundtables, European Investment Bank (EIB), Luxembourg

This Version is available at:

<https://hdl.handle.net/10419/88938>

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Banking in sub-Saharan Africa

Challenges and Opportunities

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January 2013



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The articles in this document were discussed at a roundtable event hosted by the EIB's Economics Department in Luxembourg on January 23rd, 2013.

About the Economics Department of the EIB

The mission of the EIB Economics Department is to provide economic analyses and studies to support the Bank in its operations and in its positioning, strategy and policy. The Department, a team of 25 economists and assistants, is headed by Debora Revoltella, Director of Economics.

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The views expressed in this document are those of the authors and do not necessarily reflect the position of the EIB.

PREFACE

Sub-Saharan Africa is a continent with significant problems on the one hand and great potential on the other. Its past has been difficult and formidable challenges to further development remain. Poverty is pervasive, human development is low, and growth has not been inclusive. The region faces an enormous infrastructure gap, while the investment climate and regulatory environment are relatively poor. There are still weaknesses in governance and institutional capacity.

However, significant differences exist among individual countries, and those that have seized the opportunity – and implemented far-reaching reforms – are now harvesting better results. Thanks to the reformist economies, transition and progress on the continent is real and well established. Over the last ten years, real economic growth in the region has averaged 5 to 7 percent per year, consistently above the world average. Some of the fastest-growing countries in the world have been from sub-Saharan Africa. Last year, five sub-Saharan African countries outgrew China and 22 outgrew India. Commodities, while important for the region, have not been the only source of sustained growth: working-age population is growing, urbanization is rising, technological advances are emerging in many layers of the economy, labour productivity has increased, investment has outpaced aid with increased interest in the region, while macroeconomic and structural policy implementation and institutional capacity have improved. Sustained growth in sub-Saharan Africa has led in part to financial deepening, while financial sector development has also played a significant supporting role in the growth process.

Yet, sub-Saharan African financial and banking systems remain underdeveloped. The banking systems in the region are highly concentrated and generally inefficient at financial intermediation; they are characterized by their small size and low intermediation, and despite little barriers to entry and exit – as evidenced by the dominant market share of foreign banks – competition is still limited. In this context, access to finance in sub-Saharan Africa is among the lowest in the world and presents one of the key obstacles to the activity and growth of enterprises. This in turn constrains the region from achieving its full growth potential.

However, the relatively stable macroeconomic and financial environment, together with the current reform momentum and expected strong economic growth in many countries in the region, bode well for further development of the banking system. Moreover, the on-going structural changes in the banking sector, such as the emergence of mobile and agency banking as well as Pan-African banking groups, have a great potential to transform the existing business models, improve competition and efficiency, as well as access to finance and financial inclusion.

This study was prepared for the EIB's Roundtable Discussion on Banking in sub-Saharan Africa. It was put together by the EIB's Economics Department to support the Bank's new initiatives in the region's banking sector and to contribute to a better understanding of the recent market developments in the sector. The study was a collaborative effort with contributions from several key players active in the region, namely international financial institutions, some of the leading banks and academic researchers. It provides an overview of the recent developments and trends in the sub-Saharan banking sector, as well as the challenges and opportunities that lie ahead. As such, it is a key starting point for understanding future actions needed to improve financial deepening in sub-Saharan Africa.



Pim van Ballekom

EIB's Vice President responsible for sub-Saharan Africa

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Introduction

SABINA ZAJC

Sub-Saharan Africa has been on a sustained growth path for the last two decades. This trend represents a significant change compared to previous years. The positive developments could be attributed to many factors, most notably to continuous reforms and improved policies, debt relief, vast natural resources, and increased investment. Thus, the resilience of sub-Saharan African economies has increased, as witnessed by a modest impact of the recent global economic crisis on the region. However, the preconditions for social and economic development vary significantly among the countries, and this has contributed to the uneven pace of growth across the continent.

Since the 1990s, financial sector reforms in many sub-Saharan African countries have contributed significantly to the development and efficiency of their financial - and particularly banking systems. Consequently, commercial banks' capital bases have strengthened and their risk management practices have improved; credit to the private sector has risen, albeit from a low base; and most of the sub-Saharan African banking systems have proved resilient to the recent events of global financial stress.

At the same time, there is potential for a significant change in the landscape for banking in many sub-Saharan African countries, such as the expansion of mobile banking and regional banking groups. This bodes well for enhanced competition in national banking sectors and facilitates the spread of new technologies. It should be noted, however, that these developments have brought about also challenges for regulators and supervisors in the region.

Despite reforms and strong economic growth, the banking systems in most of the sub-Saharan African countries are still underdeveloped, with low and inefficient intermediation and limited competition. Impediments to the banking sector development include the small national markets, low income levels and weak creditor rights and judicial enforcement mechanisms.

Consequently, sub-Saharan Africa still lags behind the rest of the world in financial depth and access to finance remains among the lowest in the world, both for individuals and enterprises. However, an important contribution that the financial sector can have to economic growth and poverty reduction in sub-Saharan Africa is the provision of credit and other financial services to enterprises, especially small and medium ones. Yet, among enterprises, "the missing middle" – enterprises that are too small for microfinance institutions and too big for banks – are particularly at a disadvantage when it comes to access to finance. These enterprises could greatly benefit from new providers, new lending techniques, new products and services as well as better financial and business skills.

Although access to finance is one of the biggest hurdles to the activity and growth of sub-Saharan African enterprises, financing itself is only one among many obstacles faced by entrepreneurs across the region. Business activity is particularly hampered by the

inadequate physical infrastructure. A symptomatic example are the constant power cuts due to a shortage of electricity – or alternatively, the number of power generators operating in any sub-Saharan African city.

There is no doubt that (inadequate) infrastructure and its financing present one of the key, if not the biggest development challenge faced by the region. The African Development Bank has estimated that USD 93 billion per year would be needed to address the deficiencies in the region's infrastructure, which implies a doubling of the existing investment levels and presents an enormous challenge for sub-Saharan African economies. Therefore, large and innovative finance will be required if the region is to realize its economic potential. Against this background, regional integration and innovative products present an opportunity for commercial banks to play a more important role in infrastructure financing, but their small size constrains their contribution to this process.

The structure of this report is as follows. The first chapter by Montfort Mlachila et al. (IMF) provides the macroeconomic context of sub-Saharan Africa and gives an overview of common issues in the region's banking sector. The next three chapters, respectively by Dennis Dykes (Nedbank), Sabina Zajc (EIB) and Paul-Harry Aithnard et al. (Ecobank), present the main banking sector developments in recent years in three sub-regions of sub-Saharan Africa, namely Southern Africa, East Africa and West and Central Africa. Some specific issues related to access to finance for enterprises, especially small and medium ones are addressed by Thorsten Beck (Tilburg University) in the fifth chapter. The sixth chapter by Mthuli Ncube (AfDB) presents the state of infrastructure development, the level of investment needed to address existing deficiencies, and innovative ways of financing infrastructure projects in sub-Saharan Africa, including by multilateral development banks. The last chapter by Oskar Nelvin presents the EIB's activities in the region, with the focus on operations supporting financial sector development and access to finance, as well as infrastructure development.

Banking in Sub-Saharan Africa: the Macroeconomic Context

MONTFORT MLACHILA, SEOK GIL PARK, MASAFUMI YABARA^{1 2}

Executive Summary

- This note discusses the main features of growth and macroeconomic performance in sub-Saharan Africa (SSA) in recent years and the outlook for the coming years; it then reviews the main features of SSA banking systems and how they were affected by the global economic crisis, while flagging some factors that could influence financial sector developments in SSA in the period ahead. The main messages are:
- SSA's sustained strong growth since the mid-1990s represents a sharp break with previous years; contributory factors include improved macroeconomic policies, trade and regulatory reforms, favorable commodity price trends and new resource discoveries, debt relief, and reduced levels of armed conflict in the region.
- Most SSA economies showed significant resilience during the global economic crisis, with annual growth of regional GDP now running at some 5¼ percent per annum. Adverse new developments in the global economy would slow the pace of SSA growth, but the impact, in most countries, should be modest rather than severe.
- Banking systems in most of SSA remain underdeveloped as compared with other developing regions, but gradual financial deepening is underway in most countries. Impediments to development include the small size of national markets, low income levels, and weak creditor rights and judicial enforcement mechanisms.
- Recent developments, such as the expansion of mobile phone-based banking and the spread of pan-African banking groups, have the potential to significantly change the landscape for banking in much of SSA, but also introduce new challenges for financial regulators.

¹ African Department, International Monetary Fund.

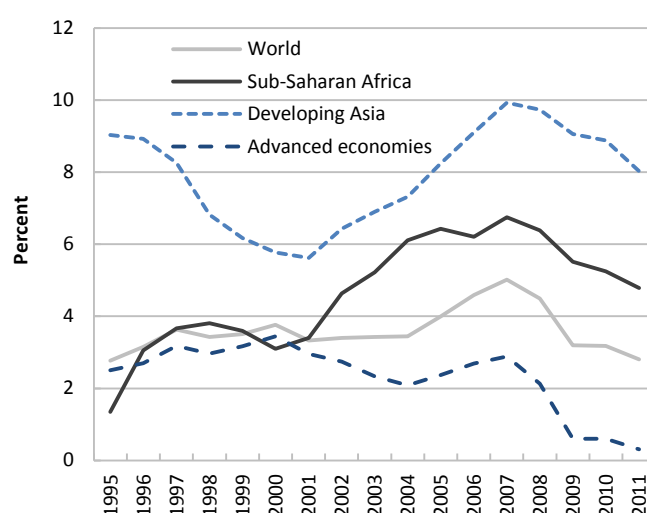
² The views expressed in this document are those of the authors and do not necessarily reflect the position of the IMF, its Executive Board, or its management.

1. Economic Growth in Sub-Saharan Africa

1.a. SUB-SAHARAN AFRICA'S LONG-DELAYED GROWTH SPURT

For the first time since the 1970s, a large number of countries in sub-Saharan Africa (SSA) have been enjoying an extended period of strong economic growth.³ The pick-up in growth began in the mid-1990s and has been maintained in good part during the extended global slowdown since 2008 (Figure 1). The acceleration in growth has been accompanied, and facilitated, by a sharp reduction in consumer price inflation: most SSA economies now typically record single-digit annual inflation, although inflation rates remain vulnerable to food and fuel price shocks.⁴

Figure 1: Real GDP Growth (4-year moving average)



Source: IMF, World Economic Outlook database.

The pace of growth recorded in SSA since the mid-1990s is not exceptional by developing country standards, but still represents a sharp break with the experience of falling living standards and macroeconomic instability in SSA during the previous two decades – a period when the region fell behind developing countries in other parts of the world. Key factors contributing to this turnaround in economic fortunes include:⁵

- *Improved macroeconomic policies*, including the strengthening of fiscal positions, the enhanced emphasis given to containing inflation, the liberalization of exchange controls and unification of exchange rates, and the building of foreign reserves to help contain the impact of adverse external shocks. These shifts in domestic policy were facilitated by international debt relief initiatives, which freed up fiscal space and eased external payments pressures.

³ The definition of sub-Saharan Africa used here follows that employed in the IMF's bi-annual publication, *Regional Economic Outlook: Sub-Saharan Africa*, available at www.imf.org. Most of the data cited excludes South Sudan, now included in SSA, due to lack of data availability.

⁴ Twelve-month inflation over the course of 2012 is set to be in single digits in thirty six of SSA's forty-five economies, exceeding 20 percent in only one case.

⁵ For elaboration on these issues, see IMF (2008), chapter 2 and IMF (2012a), chapter 1.

- *Trade and regulatory reforms, with an associated scaling back of direct state participation in economic activity.* Trade liberalization and regulatory reforms increased domestic competition and reduced inefficiencies, as did the privatization or commercialization of poorly-managed state enterprises. But there is still much more that can be done to improve the business climate in many countries, and intra-regional trade, though rising, remains at modest levels.
- *Increased capital spending,* in both natural resource and other sectors, helped by an increase in domestic savings rates. The infrastructure deficit still remains very wide in many countries, acting as an important bottleneck to growth – but also providing opportunities for boosting output and productivity levels through appropriately selected and effectively executed investment projects.
- *Improvements in institutional capacity.* While most indicators of good governance still show sub-Saharan Africa lagging behind the rest of the world, the region is making up ground in some aspects, including in regard to public voice and accountability. And stronger governance has been an important feature of fast-growing SSA economies that are not resource rich.
- *Favorable commodity price trends and new resource discoveries,* which have provided an important stimulus to growth in many mineral-rich economies. But growth has also been strong in numerous non-resource-rich countries whose terms of trade were adversely affected by surging oil prices; examples include Burkina Faso, Ethiopia, Mozambique, Rwanda, and Uganda.
- *Reduced armed conflict and social turmoil.* The incidence of armed conflict and civil turmoil has declined significantly over the past two decades, although security tensions still pose threats to growth in several countries.
- *Improved financial sector performance.* While financial systems in most countries remain poorly developed relative to other regions, there has been significant financial deepening in most countries over time. Moreover, the incidence of systemic banking crises in SSA has come to a near-halt since the mid-1990s (see Section 2 below).

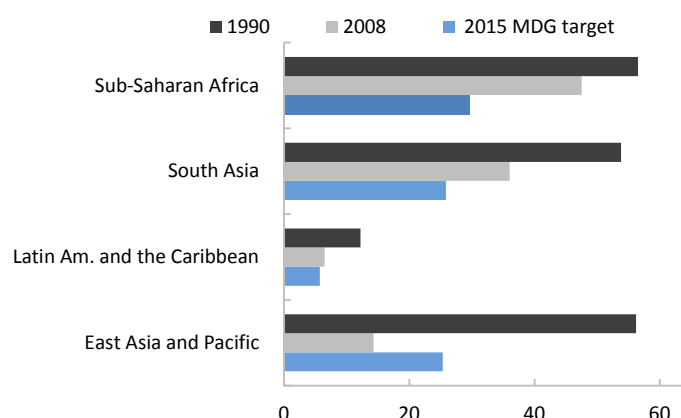
In discussing trends for SSA as a whole, it is important to keep in mind the striking diversity of the region, whose forty-five countries vary markedly in terms of population size, income levels, resource endowments, access to international transportation corridors, and the extent of socio-political stability.⁶ These diverse conditions have had significant effects on the pace of growth over the past two decades – although, in some cases (e.g., land-locked versus coastal, resource-rich versus non-rich), the impact on growth has been less marked than one might have expected. Specific points worth noting include:

- South Africa, the region's largest and most developed economy, has grown at a significantly slower pace than the region as a whole, reflecting both post-apartheid challenges and the reduced opportunity for "catch-up" given already-high productivity levels.

⁶ One feature of import: South Africa and Nigeria together account for about one half of SSA GDP, thus playing a very important role in influencing the evolution of the macroeconomic aggregates for the region as a whole.

- Countries affected by internal conflict and enfeebled governments (“fragile states”) have done much less well than others in the region, typically experiencing stagnant or falling living standards (e.g., Côte d’Ivoire, Democratic Republic of Congo (DRC)).⁷
- Leaving aside oil exporters, low-income countries not classified as fragile have experienced above-average growth by regional standards, averaging annual growth of 5.5 percent during 1995-2010, as compared with 3.4 percent for other non-oil SSA economies and 1.8 percent for fragile states.

Figure 2: Sub-Saharan Africa: Headcount Poverty Index Using the \$1.25 a Day Poverty Line



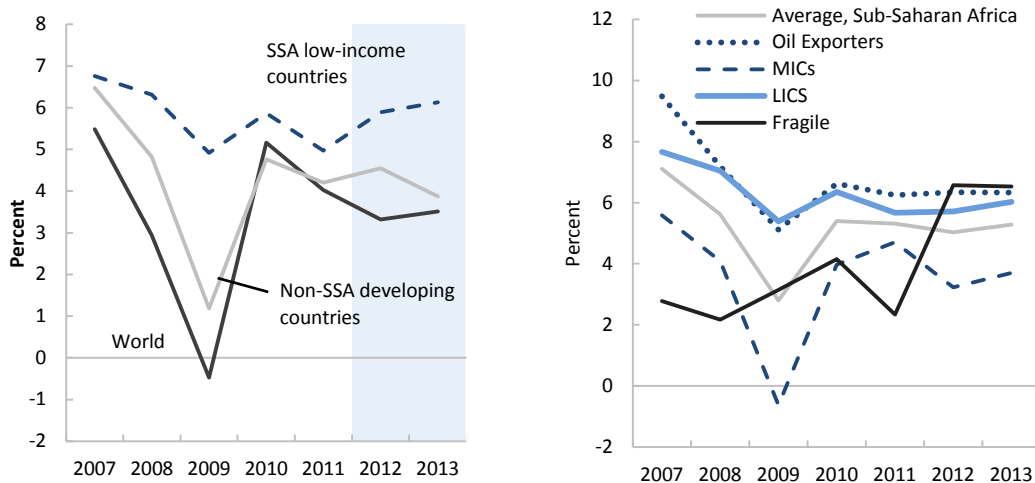
Source: World Bank, World Development Indicators.

1.b. RECENT MACROECONOMIC DEVELOPMENTS AND NEAR-TERM OUTLOOK

The onset of the global economic crisis in late-2008 saw a marked slowdown in the pace of global economic growth, most notably in the advanced economies. Global growth, running at about 5 percent per annum in the pre-crisis period, fell to below 3 percent per annum during 2009-12, with an absolute decline in output recorded in 2009. The near-term outlook is for a marginal pick-up in activity in 2013, with growth of the order of 3½ percent for the global economy and some 1½ percent in the advanced economies, with the balance of risks continuing to be tilted towards the downside.

Most SSA economies (Figure 3) have shown significant resilience in the face of these adverse external developments. Growth slowed noticeably in the region in 2009 – but there were marked differences between the experience of many middle-income countries (notably South Africa), where closer integration into international markets resulted in a sharp adverse shock to GDP, and non-oil low-income countries, where the slowdown was quite modest. Oil exporters were hit by the sharp drop in world prices in 2009, although growth was sustained in Nigeria by the use of sizeable oil revenue savings accumulated in previous years to support public spending levels and non-oil activity. Since 2009, growth has been strong – albeit below pre-crisis levels – across most of the region, with the exceptions including South Africa, where sluggish demand growth in Europe has contributed to a muted recovery, and a number of politically fragile states.

⁷ For a listing of fragile states, based on the World Bank’s IDA Resource Allocation Index, see IMF (2012b).

Figure 3: Sub-Saharan Africa and Other World Regions: Real GDP Growth, 2007–13

Source: IMF, World Economic Outlook database.

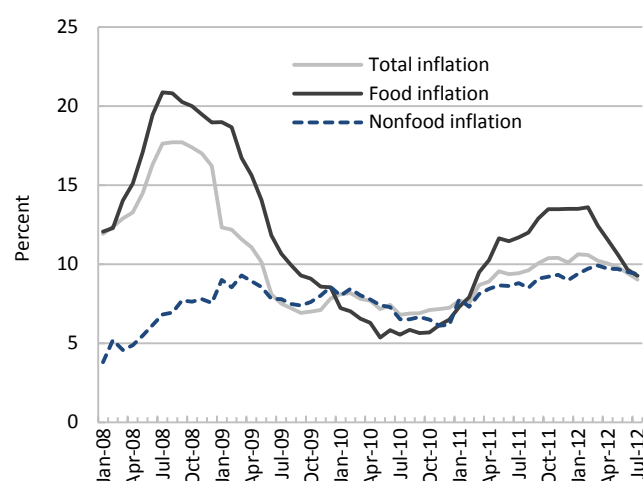
What explains the resilience of economic activity in SSA during the crisis, a marked contrast with the region's experience in previous global downturns? Contributory factors include:

- The build-up of solid fiscal positions in the pre-crisis period allowed many countries to support domestic demand by maintaining or increasing public spending levels; declines in budget revenues were instead reflected in higher fiscal deficits.
- Key prices for SSA commodity exports, including oil, have remained at relatively high levels since 2010, helped by continued strong demand from Asia.⁸
- Supply-side factors have been generally favorable – natural resource discoveries, continued agricultural output growth, dynamism in selected service activities – although adverse climate shocks have seen sharp fluctuations in food production in the Sahel and eastern Africa.
- SSA financial systems were relatively insulated from the global financial turmoil (see Section 2 below), ensuring that few countries were significantly affected by disruptions to credit availability.

Inflation in SSA has shown significant volatility since 2008, mainly due to movements in world food and fuel price levels, although domestic food supply conditions played an important contributory role in some sub-regions (Figure 4). The volatility has been most marked in low-income countries, where food and fuel products account for a larger share of the consumer price index and where central banks, in many cases, have more limited capacity to influence the pace of inflation. Of late, easing price pressures in global commodity markets, coupled with the impact of monetary tightening (notably in East Africa) and recovery from drought in the Sahel and the Horn of Africa, has contributed to a significant slowing of inflation, which is set to fall to a (weighted) average rate of some 8 percent as of end-2012, with some further easing expected in 2013.

⁸ For discussion of the reorientation of SSA trade and investment towards non-traditional partners, most notably China, see IMF (2011), chapter 3.

Figure 4: Sub-Saharan Africa: Food and Nonfood Inflation, Jan-07 – Jul-12



Source: IMF, African Department database

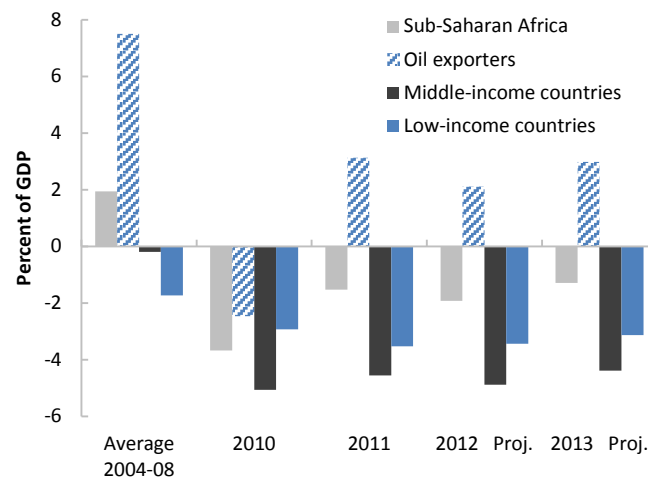
Table 1: Sub-Saharan Africa: Macroeconomic Indicators

	2004-08	2009	2010	2011	2012	2013
Real GDP growth	(Percentage change)					
Sub-Saharan Africa (Total)	6.5	2.8	5.3	5.2	5.3	5.3
<i>Of which:</i>						
Oil-exporting countries	8.6	5.1	6.6	6.3	6.7	6.0
Middle-income countries	5.0	-0.6	3.8	4.5	3.4	3.8
<i>Of which: South Africa</i>	4.9	-1.5	2.9	3.1	2.6	3.0
Low-income countries ¹	7.3	5.4	6.4	5.5	5.9	6.1
Fragile countries	2.5	3.1	4.2	2.3	6.6	6.5
Memo item: World GDP growth	4.6	-0.6	5.1	3.8	3.3	3.6
Inflation, end-of-period	8.8	8.6	7.2	10.1	8.0	6.9
	(Percent of GDP)					
Fiscal balance	1.9	-5.4	-3.7	-1.6	-2.2	-1.4
<i>Of which: Excluding oil exporters</i>	-0.7	-4.6	-4.3	-4.1	-4.5	-3.6
Current account balance	0.7	-3.2	-1.3	-2.0	-3.1	-3.5
<i>Of which: Excluding oil exporters</i>	-5.0	-5.3	-4.5	-4.9	-7.3	-7.0
	(Months of imports)					
Reserves coverage	4.8	5.1	4.2	4.4	4.7	4.9

Source: IMF, World Economic Indicators database.

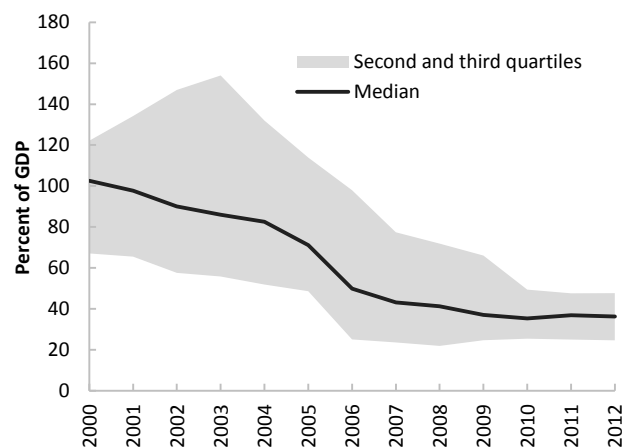
¹Excluding fragile countries.

Fiscal positions have weakened across most of SSA since 2008, reflecting policy decisions to support economic activity by maintaining public spending levels notwithstanding revenue erosion and, in several cases, to take advantage of post-debt relief borrowing space to finance new public investment projects (Figure 5). Oil exporters have seen a return to fiscal surpluses since 2010, helped by stronger world prices, but significant fiscal deficits remain the norm in the other country groupings. Sluggish economic recovery continues to constrain the scope for fiscal consolidation in South Africa, while political factors (e.g., resistance to scaling back energy subsidies) and public investment needs are constraining fiscal tightening in many other countries.

Figure 5: Sub-Saharan Africa: Overall Fiscal Balance, 2004–13

Source: IMF, World Economic Outlook database

The impact of larger fiscal deficits on public debt burdens across the region as a whole has been limited (Figure 6), although experience at the country level has been varied. Debt burdens in several middle-income countries have risen significantly since 2008, given the conjunction of larger deficits and slower growth. South Africa's public debt rose from 27 percent of GDP at end-2008 to 41 percent of GDP by end-2012. For low-income countries, debt burdens have fallen sharply in several cases (such as Côte d'Ivoire, DRC, and Liberia) with the completion of multilateral debt relief processes – but have drifted upwards since 2008 in a number of post-debt relief cases (such as Tanzania and Uganda).

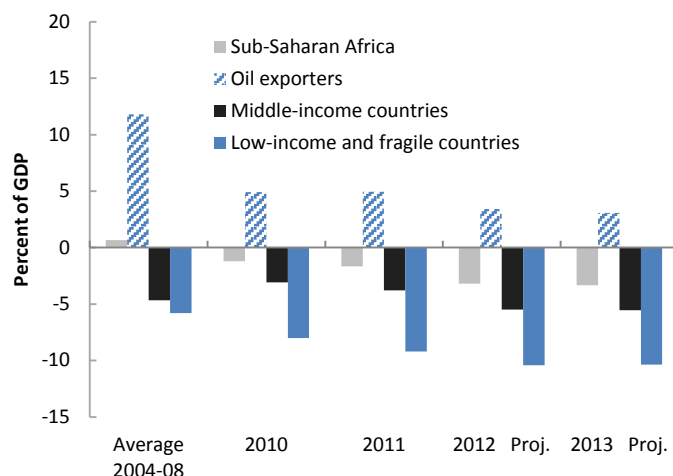
Figure 6: Sub-Saharan Africa: Government Debt Ratios, 2000–12

Source: IMF, African Department database

The weak external environment since 2008 has adversely affected exports from the region, contributing to a weakening of external current account positions in many countries, although rising investment levels and associated imports of capital goods have also made an important contribution (Figure 7). Service exports and remittances have generally remained quite strong across the region. Helped by ongoing capital inflows, foreign reserve levels have

risen in absolute terms in most SSA countries, but import coverage ratios (foreign reserves divided by monthly imports of goods and services) have typically fallen, given fast-growing import levels.

Figure 7: External Current Account Balance, 2004–12



Source: IMF, World Economic Outlook database

Looking ahead to 2013, the near-term outlook is for SSA growth to continue at its current pace of around 5½ percent, with middle-income countries continuing to expand at a slower pace than other country groupings. The main risks to the outlook come from the external environment, although domestic political and security risks pose specific threats in several countries (as highlighted by developments in Mali and, more recently, the Central African Republic). Further weakening of the global economy would undoubtedly have an adverse effect on prospects for SSA – but the experience since 2008 suggests that, absent some major destabilizing shock, the impact on regional growth should be moderate rather than dramatic.

1.C. LONGER-TERM CHALLENGES: DIVERSIFICATION AND STRUCTURAL TRANSFORMATION

The strong growth recorded in much of SSA since the mid-1990s has been based in part on the gathering of “low-hanging fruit”: reversing the policy errors of the past, containing or recovering from internal conflict, taking advantage of expanded aid flows, and debt relief. But progress in achieving significant structural transformation and diversification of production and exports has been modest.⁹ Productivity growth in agriculture has been high in relatively few countries. Manufacturing sectors – the driver of growth in most versions of the “Asian miracle” – have shown dynamism in very few cases. Service sector growth has seen the expansion of high productivity sectors (such as telecommunications) but also of low-productivity informal sector activities.

Demographic trends point to a surge in the working-age population in the region in the coming years – a stimulus for growth, in the form of expanded labor supply, but also a

⁹ For further discussion of the issue of structural transformation, see IMF (2012b), chapter 3.

challenge to policy-makers to create the appropriate environment for rapid job creation. What are the prospects for meeting this challenge?

On the positive side:

- The price outlook for SSA's main commodity exports is broadly favorable, given expectations of continued strong growth in China and other large emerging market economies – although “rebalancing” of demand within these countries could adversely affect commodities, such as copper, that are closely linked to construction.
- Exports of non-renewable natural resources look set to rise in many countries, given new discoveries in both established producers (such as Angola) and new producers (such as Mozambique and Tanzania).
- Crop yields in most SSA countries are very low by international standards, providing opportunities to boost agricultural productivity through effective water management, expanded use of fertilizers, and improved extension services.
- Rising wage levels in China and other established producers of labor-intensive manufactures in the coming years are likely to push large numbers of jobs offshore, including to competitive low-wage economies in SSA.

But taking full advantage of these opportunities and achieving broad-based inclusive growth will require that governments deliver in several key areas:¹⁰

- Infrastructure deficits, notably in electricity provision and transportation, will need to be overcome. Financing the required investments will need a mix of fiscal measures to free up budgetary resources and judicious external borrowing, preferably on concessional terms, while government capacity in such areas as project appraisal and management will need strengthening if investments are to deliver the desired results.
- Skill/productivity levels will need to be improved, including through better education and basic health services; this in turn will require both additional budgetary resources and improvements in the quality of service delivery.
- Promoting agricultural development, key to ensuring growth is inclusive, will require policy initiatives to improve water management and access to fertilizers, new seeds, and knowledge – pointing to the need to build capacity to deliver such services.
- Private sector expansion at a pace needed to absorb the labor force in higher productivity jobs will require significant improvements in the business climate, including further deregulation and active measures to strengthen judicial systems, professionalize tax administration, and appropriately-targeted measures to enhance access to finance in a sustainable manner for small/mid-sized enterprises.

Of course, maintaining the track record of sounder macroeconomic management, greater reliance on markets over administrative controls, and expanded integration with the

¹⁰ For an interesting recent discussion of these challenges, placing emphasis on the importance of policy reforms to improve public service delivery, see Devarajan and Fengler (2012), echoed in World Bank (2012).

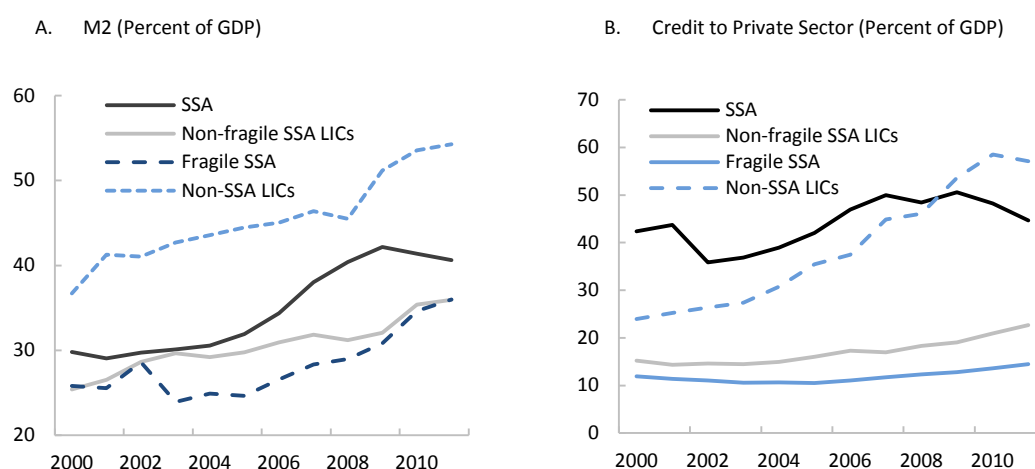
international economy will remain essential if the current pace of growth is to be sustained. Finally, addressing the special challenges faced in fragile states, where development partners have an important supporting role to play, is an imperative if SSA's growth is to be truly inclusive, in the sense of delivering growth in living standards across the region as a whole.

2. The Banking Systems of Sub-Saharan Africa

2.a. STYLIZED FEATURES

Financial sectors are generally underdeveloped in SSA, with banking systems accounting for the preponderance of financial sector assets and activities.¹¹ Helped by reform efforts (Kasekende (2010)), the depth and coverage of financial systems – as measured by the ratios of broad money (M2) and private sector credit to GDP – has been gradually increasing over the past decade, albeit from a low base (Figure 8, Panels A and B). But the scale of financial intermediation in the region remains significantly lower than in other developing regions of the world, while access to financial services is also relatively low, reflecting a combination of low income levels, small absolute size, and infrastructure weaknesses (Figure 8, Panel C). Confirming these observations, a recent World Bank study notes that SSA typically scores lowest among the world's developing sub-regions on various dimensions of financial development, such as depth and efficiency of financial institutions (Čihák and others, 2012).

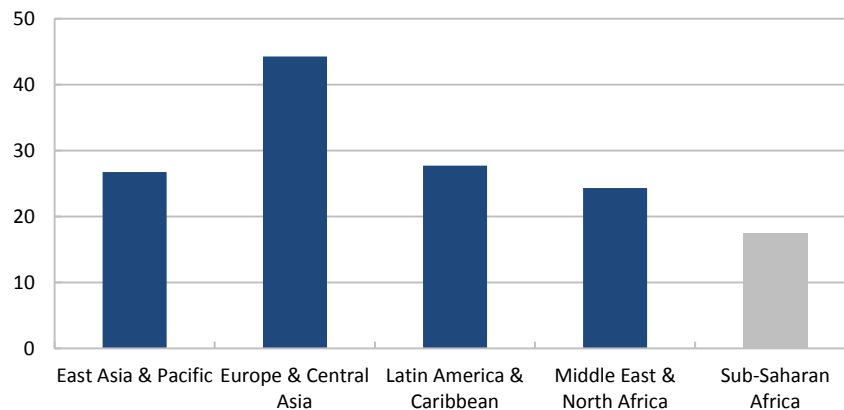
Figure 8: Financial Depth and Access to Financial Services



¹¹ The discussion here focuses primarily on banking and financial systems in SSA's low-income countries. The level of financial sector development is significantly more advanced in a number of middle-income countries in the region – including South Africa, its smaller partner countries in the Southern African Customs Union (SACU), and Mauritius.

Figure 8: Financial Depth and Access to Financial Services (cont.)

C. Adults with an Account at a Formal Financial Institution, 2010 (percent of total adults)



Sources: World Bank, World Development Indicators; and Global Financial Development Database.

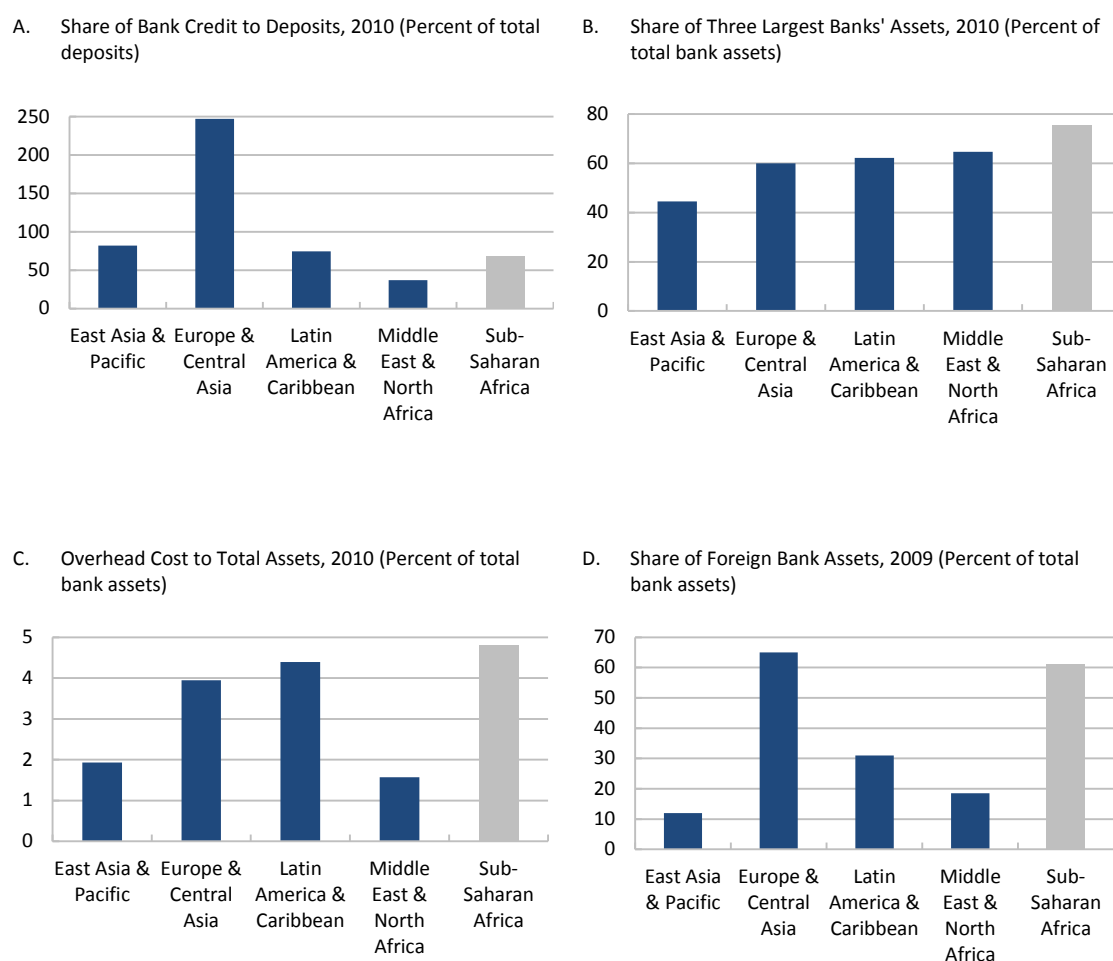
Note: Zimbabwe is excluded from Panels A and B. High-income countries are excluded from Panel C.

Most banking systems in sub-Saharan Africa are small in absolute and relative size.¹² They are characterized by low loan-deposit ratios (Figure 9, Panel A) and, as a corollary, large shares of assets held in the form of government securities and liquid assets. Lending is mainly short-term in nature, with about 60 percent of loans having a maturity of less than one year. Market structures are typically oligopolistic, as indicated by the high share of total assets accounted for by the three largest banks (Panel B), which tends to constrain the intensity of competition. SSA banks are typically high-cost operations (Panel C), notwithstanding the concentration of branches in a small number of urban centers. As a corollary, interest rate spreads and service fee levels are comparatively high. Foreign banks play a key role in SSA banking systems (Panel D), having recovered market share as banking systems were restructured and state banks privatized under reform programs in the 1980s and 1990s. Finally, banking systems are characterized by modest reach in terms of providing financial services to the population; the share of the population that is unbanked is very large, with SMEs typically tightly constrained in their access to any form of credit.

These stylized features of SSA banking systems reflect a combination of factors, including the small absolute size of banks and banking systems; low income levels, large informal sectors, and low levels of financial literacy; weak contractual frameworks for banking activities, including weak creditor rights and judicial enforcement mechanisms; and political risk (McDonald and Schumacher, 2007; Andrianaivo and Yartey, 2009; Beck and others, 2011).

¹² For a fuller discussion of SSA banking systems, see IMF (2006, chapter 4) and Beck and others (2011, chapter 2).

Figure 9: Commercial Bank Indicators

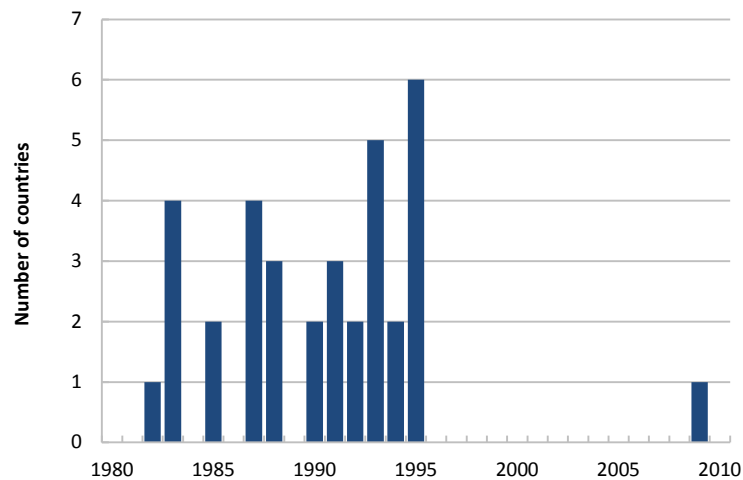


Source: World Bank, Global Financial Development Database.

Note: High-income countries are excluded.

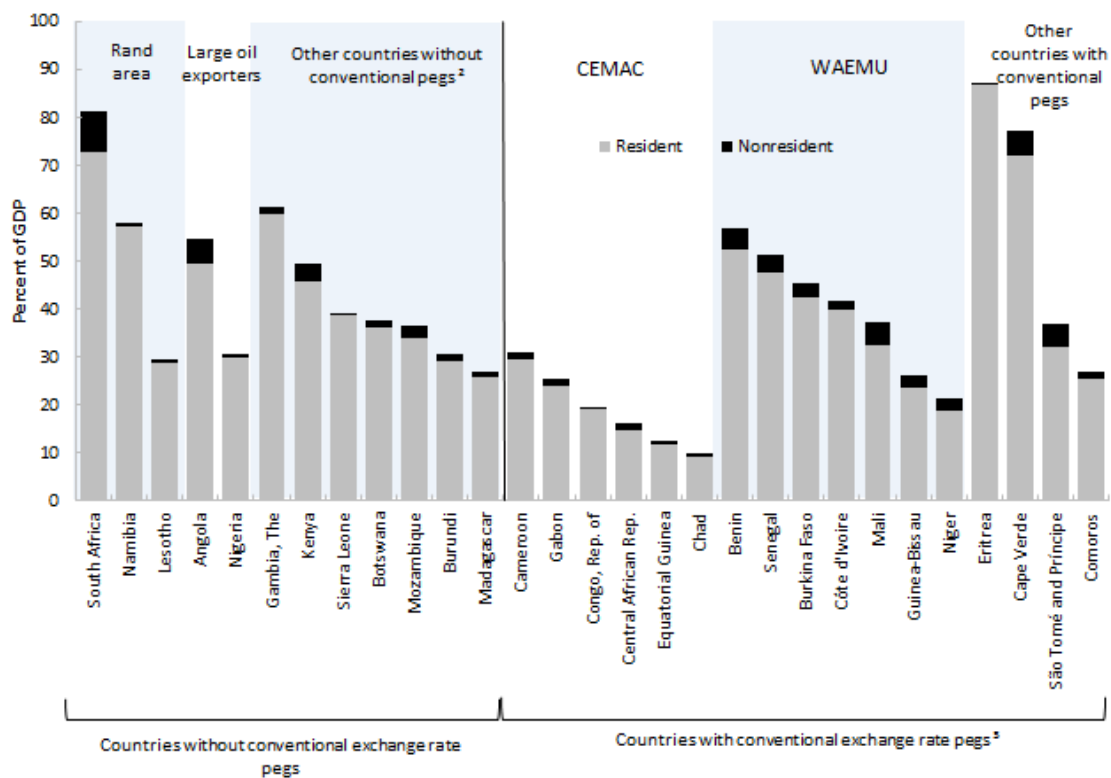
Other features that warrant mention include:

- In many countries, banking systems are characterized by significant excess liquidity, reflecting the scarcity of what banks deem to be credit-worthy borrowers. In such circumstances, monetary policy is relatively ineffective as a tool for influencing lending conditions and the broader monetary aggregates (and, by extension, economic activity and inflation).
- Following reform programs introduced in the 1980s and 1990s, banks have moved to strengthen their capital bases and improve risk management (Mlambo, Kasekende, and Murinde, 2012). In addition, the reduced role of state-owned banks or, in some cases, their reorientation towards operating on commercial lines has contributed to the strengthening of banking systems' financial health. As a result, the incidence of systemic banking crises – a relatively common event in SSA in the 1980s and early 1990s – has declined markedly, with only one major crisis recorded since 1995 (Figure 10).

Figure 10: Sub-Saharan Africa: Systemic Banking Crises, 1980–2010

Sources: Laeven and Valencia (2008); and IMF staff estimates.

- African banking systems rely on the domestic economy for their funding base, with funding from non-residents a very minor source of funds in almost all cases (Figure 11). This is in many ways a demand-side phenomenon: as noted, the limited supply of what banks deem to be credit-worthy borrowers is a binding constraint on the growth of lending activity in most countries.

Figure 11: Sub-Saharan Africa: Banking System Funding, June 2011¹

Source: IMF, Statistics Department, International Financial Statistics database.

Notes: ¹ Includes banking system data from disaggregated information submitted to the IMF for the preparation of monetary statistics and the compilation of summary data presented at the IFS. About half of the sample is reporting under the new standardized format.

² Includes all SSA countries whose exchange rate regime is classified as either a conventional peg or a currency board, according to the IMF's 2011 *Annual Report on Exchange Arrangements and Exchange Restrictions* (AREAER).

³ Excludes countries in the rand area, which in the chart are grouped along with South Africa for analytical purposes.

- Even controlling for the role of income levels, the economic importance of banking systems in SSA economies varies significantly across countries – reflecting not merely differences in public policies, but also in economic size, population density, legal code (common versus civil law), resource dependence, and history.¹³

2.b. BANKING SECTOR DEVELOPMENTS DURING THE GLOBAL ECONOMIC CRISIS

SSA banking systems were well-positioned to handle the financial turmoil created by the onset of the global financial crisis in 2008, given low leverage, generally healthy capitalization levels, ample liquidity, little reliance on external funding, and little if any exposure to toxic financial assets.¹⁴ Systemic financial stress was recorded only in Nigeria, where the flight of foreign portfolio capital contributed to the collapse of a stock market bubble that had been fuelled, in good part, by margin lending by banks to equity investors.¹⁵ The Central Bank of Nigeria eventually took control of ten banks, collectively accounting for one-third of banking system assets, which had suffered large losses on their loan portfolios. Some major international banks with a significant African footprint experienced stresses during the crisis period, but the spillover impact on their (largely self-funded) African operations was very modest.

Banking systems in SSA, in the main, came under pressure indirectly via international trade linkages, as the global economic downturn fed into reduced exports and slower domestic economic growth, in turn adversely affecting borrowers and contributing to rising levels of non-performing loans (NPLs). These effects were more marked in countries where income growth slowed substantially, as happened in several middle-income countries, but also occurred in some countries where aggregate growth remained robust throughout, such as Zambia. Also, sharp exchange rate depreciations in a number of countries during 2008–2009 created difficulties for bank clients with significant net open foreign exchange positions.

The impact of these developments on financial sector soundness in the region was relatively modest in the aggregate, although banks in some countries experienced significant adverse, albeit not destabilizing, shocks (e.g., Liberia, Zambia). Available financial soundness indicators point to a modest decline in reported capital adequacy ratios in 2010, with rising NPLs taking a toll on profitability (Figure 12).¹⁶ There was some recovery in capital adequacy ratios in 2011, along with a reported drop in the NPL ratio – but the latter may in part reflect the impact of loan write-offs and rapid expansion of the loan portfolio itself. While bank

¹³ See Beck and others (2011), chapter 2.

¹⁴ For further discussion of the issues covered here, see IMF (2012a), chapter 2.

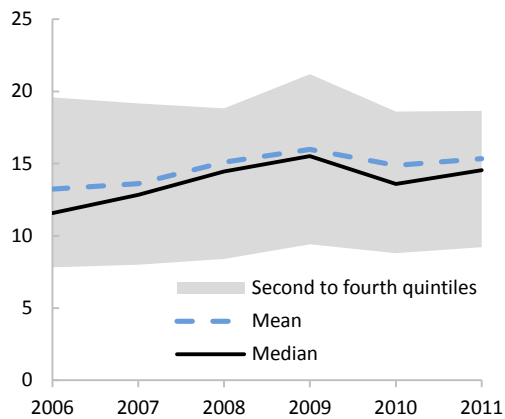
¹⁵ Other factors contributing to the difficulties faced by several Nigerian banks included fraud and mismanagement, poor internal governance, and weak financial disclosure practices.

¹⁶ The data reported in Figure 12 are of uneven quality; caution is warranted in interpreting trends.

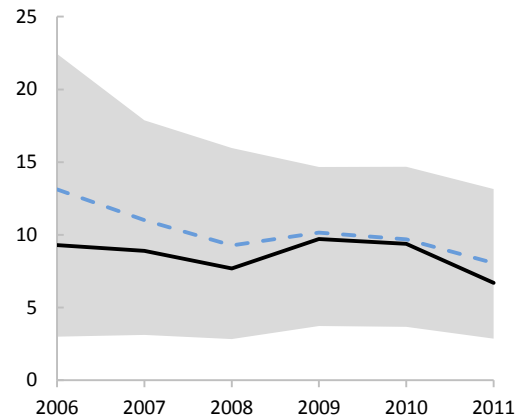
profitability levels in the region have typically been quite high, the data point to a trend decline in returns on assets and on equity over the past several years, with 2009, unsurprisingly, being a particularly bad year.

Figure 12: Sub-Saharan Africa: Financial Soundness Indicators (Selected Countries*)

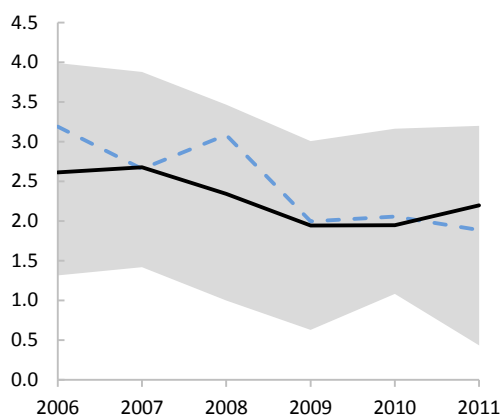
A. Capital Adequacy Ratio (Percent)



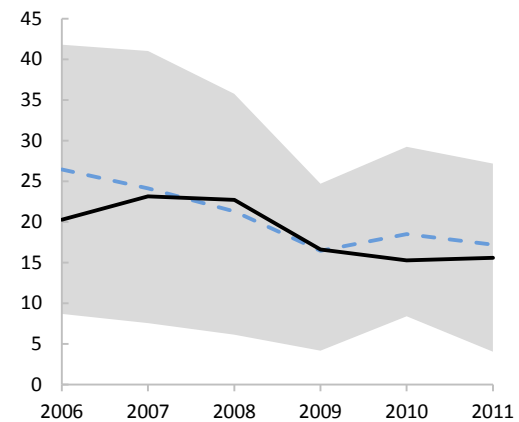
B. Non-performing to Total Loans (Percent)



C. Return on Assets (Percent)



D. Return on Equity (Percent)



Source: IMF, African department database; and country authorities.

*The official definition of financial soundness indicators varies by country. The sample includes up to 33 out of the 45 countries in sub-Saharan Africa.

Looking ahead, the relatively sluggish global economy and ongoing European financial stresses should not, absent seismic shocks, pose major risks for SSA banking systems in light of the experience during 2008-12.¹⁷ Home-grown risks may prove to be a greater cause of concern, especially in those countries that have been experiencing sustained rapid growth in

¹⁷ Intensified pressures on Portuguese-domiciled banks could have adverse spillover effects on banking systems in some Lusophone countries. Reliance on domestic funding sources should provide solid protection for most subsidiaries, although supervisors would need to be proactive in tracking developments.

private sector credit. Nigeria's experience in 2009 provides a good example of how the conjunction of governance weaknesses and a sluggish supervisory response to macro-financial developments can produce a full-blown banking system crisis – one that, even if well-managed, is likely to impose significant economic costs and disruption.

2.c. SSA BANKING SYSTEMS: NEW FORCES AT WORK

Financial systems expand and evolve as the economies they serve develop over time, with the pace of change subject to influence by targeted policy reforms (e.g. support for payment system infrastructure, improvements in creditor rights). We note briefly here new forces at work in SSA that can help accelerate the pace of financial sector development, expand its reach to new segments of the population, and enhance its contribution to economic growth.

Evolving Information and Communication Technologies

The evolution of information and communication technologies (ICT) has already shown its potential to widen access to financial services in SSA, especially for rural populations. The rapid diffusion of mobile phone technology has produced “real-time” connectivity between cities and hitherto remote rural areas and provided the infrastructure for new payment systems and basic banking services. The recent experience of Kenya, with the rapid expansion of its mobile phone-based payments system, M-PESA, is often cited as an illustration of how new ICT can produce striking financial innovation.¹⁸ Launched in 2007, M-PESA enables customers to transfer money quickly and cheaply without needing to have a (costly) bank account; money can be uploaded and withdrawn from a network of agents and used for transfers, bill payments, and airtime purchase. More recently, a partnership between the leading telecommunications company and a commercial bank has seen the introduction of M-kesho, mobile phone-based deposit accounts, providing a financial savings instrument with low transactions costs to customers that do not have physical access to a bank. By now, more than 80 percent of adult Kenyans have made use of mobile money services (Fengler, 2012), and mobile money is gaining popularity in neighbouring countries such as Uganda and Tanzania, albeit at a more gradual pace. The development of mobile payments systems in some other sub-regions, such as Central Africa, has been less successful, pointing to the important role of “enabling” conditions in determining the impact of financial innovation.

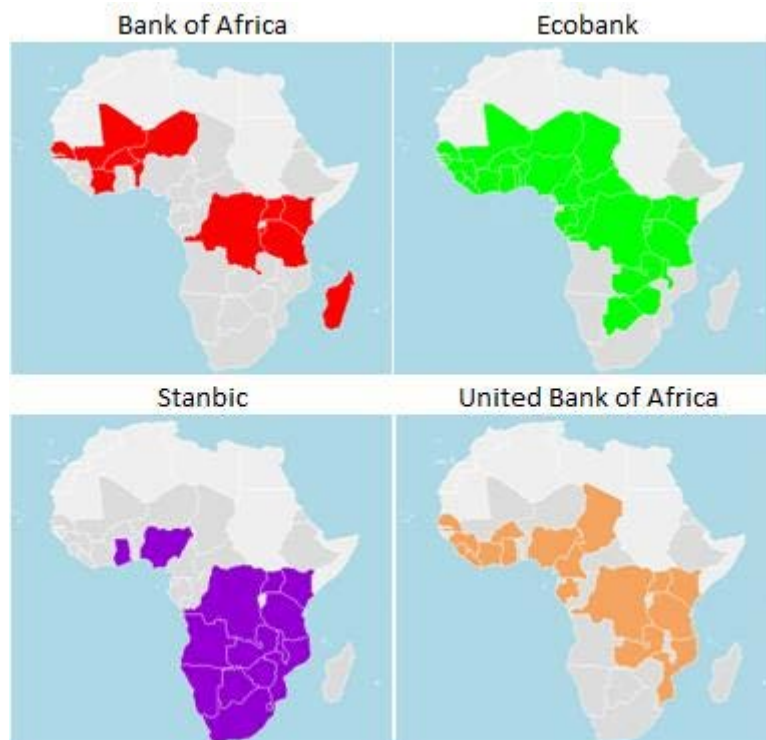
The growth of cell-phone based banking provides opportunities for banks to expand their operational reach while also introducing new competitors in the form of the telecommunications companies. The benefits from these developments to consumers have been sizeable, but they also pose challenges from both a financial stability and consumer protection perspective. It is noteworthy in this context that the Central Bank of Kenya was involved from the outset in the development of M-Pesa, and hence had both the capability and knowledge to oversee developments and, where warranted, facilitate system development via the modification of pre-existing regulations (e.g., enabling third parties (agents) to conduct banking activities on behalf of financial institutions).

¹⁸ For a fuller discussion of the M-Pesa experience and related references, see IMF (2012c), chapter 1.

Pan-African Banking Groups

A striking feature of SSA banking developments in recent years has been the rapid expansion across borders of pan-African banking groups, most often based in Nigeria and South Africa, the region's two largest economies.¹⁹ By now, at least nine SSA-domiciled financial groups operate banks in seven or more other SSA countries; Ecobank, domiciled in Togo but with close to half of its business originating in Nigeria, has the broadest footprint in the region, with a presence in some 33 of the 45 countries and featuring as one of the five largest banks in 18 countries. Several South African and Nigerian banking groups have also expanded aggressively in the region, including Standard Bank/Stanbic (South Africa) and United Bank for Africa (Nigeria). The Bank of Africa group, originally established in Mali, currently operates in 11 sub-Saharan African countries. Collectively, these four banking groups are managing more than 30 percent of deposits in at least 13 SSA countries (Figure 13).

Figure 13: Sub-Saharan Africa: Selected Pan-African Banking Groups, June 2011



Source: IMF, African Department database.

The spread of pan-African groups has enhanced competition in national banking systems and facilitated the spread of new technologies: regional banking groups may be better positioned to compete in the general banking market (as distinct from the 'high end' of multinational companies and high wealth individuals) than non-African-domiciled banks, given their experience in serving this wider market in home markets. The expansion of such groups also raises supervisory challenges for regulators in the region, who need to expand cooperation and information exchanges as these groups extend their reach. Analysts have

¹⁹ For further discussion of the growth of pan-African banks, and the supervisory challenges posed by this development, see IMF 2012a, chapter 2.

noted important supervisory weaknesses in SSA in the areas of consolidated banking supervision and of coordination between home and host supervisors (Beck and others, 2011; Lukonga, 2010).

Regional financial integration

The development of SSA banking systems continues to be impeded by the small economic size of national markets. Regional economic integration holds out the prospect for escaping the disabilities of small domestic market size – but the pace of financial sector integration, even within common currency areas, has been disappointing to date. Initiatives such as the development of WAEMU regional securities market, which became operational in 1999, have contributed to increased financial depth in some segments of the WAEMU financial system (e.g., the market for government securities), but have not significantly affected the operation of domestic banking systems. By contrast, the diffusion of South African banks across the four countries of the common monetary area in Southern Africa has produced effective financial sector integration in the sub-region, albeit with the same limitations in reaching the under-banked segments of the economy, including small and medium-sized enterprises, that is observed in South Africa itself.

Looking ahead, efforts to harmonize bank regulatory frameworks in sub-regions, integrate payments systems, and promote cross-border operations of sub-regional banks can collectively help to overcome the disabilities of small national markets. However, as the European experience has shown, this will require strong political will in the various sub-regions, including overcoming the vested interests of those currently benefiting from limited competition in domestic markets. Country blocs sharing a common currency have a head-start in pursuing integration efforts – but significant progress can be achieved in sub-regions lacking a common currency (such as the East African Community) if there is sufficiently strong political commitment to realizing the benefits of integration.

Portfolio Flows to Frontier Markets

International investors have begun to show increased interest in investing in government bonds and equity markets in frontier markets, including in SSA. Such inflows can help promote the development of domestic capital markets – but, with adequate market size and liquidity a pre-condition for attracting most investors, the bulk of such inflows are likely to be concentrated in a small number of the more advanced frontier markets in SSA (such as Nigeria and Kenya). The deepening of capital markets in these countries will, over time, help to reduce the dominant role of the banks in their national financial sectors, but this process is likely to be gradual.

2.d. POLICY CHALLENGES FOR REGULATORY AUTHORITIES

In framing banking sector policies, SSA governments have to balance the distinctive priorities of promoting financial sector development, innovation, and inclusion; limiting risks to financial sector stability; and providing adequate protection to potentially ill-informed

consumers.²⁰ While compromising on the objective of ensuring financial sector stability would be dangerous, policy-makers and regulators also need to be open to financial innovation, allowing experimentation and encouraging competition from various sources.

The experience gleaned from the joint IMF-World Bank financial sector assessments in SSA points to several areas where actions are currently needed to strengthen regulatory oversight in SSA countries.²¹ Supervisory capacity is weak in many countries, reflecting both under-resourcing of supervision activities and deficient legislative arrangements: increased resourcing of supervision and the provision of adequate legal protections and corrective powers to supervisors are a pressing reform priority in such cases. Even where such weaknesses have been addressed, there is typically a need to give more attention to consolidated supervision of financial conglomerates, covering both bank and non-bank operations. As noted earlier, the spread of pan-African banking groups implies a need for home country regulators to give full attention to the foreign operations of these groups and to coordinate actions and share information with host country supervisors.

²⁰ Given space constraints, the brief commentary here is selective rather than comprehensive.

²¹ The financial sector assessments jointly undertaken by the IMF and the World Bank under the Financial Sector Assessment Program (FSAP) seek to give due attention to both the stability and developmental aspects of financial sector regulation and oversight.

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Banking in Southern Africa

DENNIS DYKES^{1 2}

Executive Summary

- Banking services in Southern Africa have expanded strongly over the past decade, linked to rapid economic growth and financial deepening.
- Economic prospects are favourable as the region catches up with other emerging regions, helped by significant resources of raw materials and large populations. Better economic policies and lower external debt following debt forgiveness programmes should help to sustain and support the improvement.
- The decade ahead should see even stronger expansion in banking as economic activity strengthens and broadens and as more are drawn into the financial system, helped by technological advances and increased foreign investment in the sector.
- Significant challenges still exist, however. In many countries there is very little credit information available to banks, legal environments are unhelpful to creditors, there is a lack of physical infrastructure, and the regulatory climate is variable. Corruption and uncertain policy environments also remain a deterrent. Even in countries that have sophisticated infrastructures and advanced regulatory frameworks progress towards banking the unbanked will be difficult given uneven income distribution, limited credit information and a lack of financial literacy.

1. Overview

This review gives a brief overview of banking conditions in Southern Africa, taken here to include those in the Southern African Development Community (SADC). The SADC has 15 member states, Angola, Botswana, Democratic Republic of Congo, Lesotho, Madagascar, Malawi, Mauritius, Mozambique, Namibia, Seychelles, South Africa, Swaziland, United Republic of Tanzania, Zambia and Zimbabwe. Economies and banking structures vary greatly in the region, with the larger economies dominating and levels of financial development differing significantly. South Africa and Angola make up around 77% of regional GDP and six countries enjoy per capita incomes in excess of \$5000. In contrast, the region also contains some of the world's poorest, making regional development and integration a challenge. This paper will sketch conditions across the region before considering some of the key countries in some more detail.

¹ Economic Unit, Nedbank.

² The views expressed in this document are those of the author and do not necessarily reflect the position of Nedbank.

Table 1: Key Indicators

	GDP (US\$ bn)	Real 3-year GDP growth %	GDP per capita US\$	Population (million)
Angola	114.83	4.7	5681	20.2
Botswana	17.64	5.3	9407	1.9
Democratic Republic of the Congo	17.70	7.1	237	74.7
Lesotho	2.62	4.8	1340	2.0
Madagascar	10.05	1.4	449	22.4
Malawi	4.49	5.1	270	16.6
Mauritius	11.93	3.9	9199	1.3
Mozambique	14.64	7.3	652	22.5
Namibia	12.15	5.2	5635	2.2
Seychelles	0.97	4.9	10572	0.1
South Africa	390.92	2.9	7636	51.2
Swaziland	3.65	-0.2	3119	1.2
Tanzania	27.98	6.7	650	43.0
Zambia	20.68	6.9	1486	13.9
Zimbabwe	10.80	8.0	858	12.6

Source: IMF World Economic Outlook, October 2012, 2012 estimates

The past decade has seen rapid growth in the banking sector in many countries in the region. Countries experiencing strong growth have naturally seen strong credit expansion. These would include Angola, where real credit growth to the private sector has exceeded an annualized 32.8% in the past 10 years and 15.6% in the past three years; Mozambique (12.4% and 9.9%); and Tanzania (18.1% over 10 years but more recently this has slowed to under 10% in the past three years). Lesotho has also shown strong growth over the past three years (20.2% real), coming off a low base and helped by a firmer economy. The more established sectors of Botswana and Mauritius have seen steady real growth of just under 10% over both periods.

The laggard has been South Africa, where strong double-digit real credit growth was experienced ahead of the global financial crisis in 2008, but annualized growth of less than 1% has been seen over the past three years. This has partly been due to tighter risk practices following large losses in the residential mortgage market, but also due to more subdued credit demand from both corporations experiencing overcapacity following a slump in export volumes due to the global crisis as well as households burdened by already high levels of debt and increased unemployment. However, there has been a strong expansion in unsecured lending to households, which, while small as a percentage of total credit, has prompted some investigation by the regulatory authorities.

New entrants into the sector have also been attracted by solid returns and strong upside potential. Banks are generally well capitalized and in many cases have low loan-to-deposit ratios, suggesting that financial resources are not the key limitation on even higher growth.

Table 2: Selected Banking Sector Indicators

	Domestic credit to private sector as a % of GDP	Access to finance (% of firms identifying this as a major constraint)	Loan to deposit ratio %	Regulatory capital to risk weighted assets	Non-performing loans to gross loans	Return on equity	Cost to income	Private credit bureau coverage (% of adults)
Angola	20.9	38.5	59.5	14.8	2.4	24.2	37.4	0.0
Botswana	23.3	25.5	60.8	20.5	2.4	5.9	47.8	59.6
DRC	6.6	73.3	n/a	15.0	10.6	4.2	68.0	0.0
Lesotho	13.7	28.6	41.0	15.3	4.4	28.9	52.8	0.0
Madagascar	11.7	39.4	59.5	12.7	8.7	9.6	63.0	0.0
Malawi	19.0	51.0	72.8	20.3	3.9	29.4	57.4	0.0
Mauritius	87.9	46.3	65.1	15.8	2.8	16.2	47.2	0.0
Mozambique	26.8	50.1	76.0	17.1	1.9	21.9	61.2	0.0
Namibia	49.9	18.4	82.2	14.0	1.5	15.0	52.3	61.5
Seychelles	27.9	n/a	34.8	21.5	5.5	23.4	42.0	0.0
South Africa	145.6	15.5	92.3	14.9	4.7	13.3	57.5	52.0
Swaziland	23.0	32.9	74.9	20.1	8.0	18.2	60.2	43.2
Tanzania	16.2	40.6	65.9	18.5	7.5	13.1	62.4	0.0
Zambia	11.5	20.1	53.3	19.2	11.4	25.5	64.8	4.3
Zimbabwe	44.5	n/a	85.2	12.9	7.9	21.7	88.0	n/a

Sources: International Monetary Fund, World Bank, Central Banks, own calculations

Notes: 1. Statistics are the most recent available on a comparable basis.

2. n/a: not available

Banking in Sub-Saharan Africa is set to experience another vibrant decade. There is a growing consensus that the continent will experience above average growth as it increasingly adopts growth-friendly policies and integrates more rapidly with the global economy, helped by lower levels of foreign debt, increased foreign interest, and the exploitation of natural resources. Higher growth alone would stimulate the need for financial services. However, financial deepening is also likely as previously unbanked populations' needs are serviced. Table 3 shows the wide variance of financial inclusion between countries, with the region as a whole underserved, which can be seen as an opportunity as well as a challenge. New technologies such as mobile banking will help to close the gap and are already transforming the way that individuals and small businesses operate in some of the countries.

Table 3: Financial Inclusion Indicators

	Adults with an account at a formal financial institution (%)	Adults using mobile money in the past year (%)	Adults saving in a formal account in past year (%)	Adults saving using a community-based method in past year (%)	Adults originating a new loan from a formal institution in past year (%)	Adults originating a new loan from family or friends in past year (%)	Adults with a credit card (%)	Adults with an outstanding mortgage (%)
Angola	39	26	16	8	8	26	15	4
Botswana	30	9	16	14	6	47	11	1
DRC	4	2	1	8	2	30	2	0
Lesotho	18	7	8	16	3	51	2	1
Madagascar	6	1	1	0	2	58	0	1
Malawi	17	1	8	10	9	44	1	5
Mauritius	80	9	31	6	14	6	14	5
Mozambique	40	3	17	23	6	35	4	1
South Africa	54	11	22	14	9	34	8	4
Swaziland	29	20	18	8	12	51	13	6
Tanzania	17	23	12	8	7	46	4	4
Zambia	21	5	12	7	6	42	4	1
Zimbabwe	40	4	17	11	5	57	6	1

Source: World Bank Global Findex Database

Many governments in the region are also helping financial development by issuing benchmark-rate setting sovereign bonds with more widespread use of international credit rating agencies. This will allow companies to tap global markets more easily. At central bank level there is more cooperation through bodies such as SADC's Committee of Central Bank Governors. Finally, regulatory environments are either already compliant or are moving towards full international compliance in key countries.

The challenges facing the sector in many countries in Southern Africa are still considerable, however. On one end of the scale South Africa has deep, sophisticated financial markets with considerable foreign participation, technologically advanced banks and globally respected bank supervision. Other countries that have relatively advanced sectors include Mauritius, Botswana and Namibia. Even within this grouping access to finance is not universal and balancing expansion with increased risk remains challenging. Even so this group's relative sophistication is positive for the region as lessons learnt can be duplicated elsewhere.

In less developed banking sectors in the region the key problems are a lack of consumer information (credit bureaus are scarce – see Table 2 – and information on asset prices is limited), challenging legal environments (that increase recovery costs in the event of default), a lack of physical infrastructure, limited skills, and uneven regulatory functions. Corruption and uncertain policy environments also hamper operations, reduce the likelihood of increased foreign participation and therefore increase the cost and limit the expansion of financial services in many countries. However, the problem of corruption is not universal.

Botswana, for example, consistently scores well against many developed countries in international surveys.

In all countries financial services are more readily geared towards established business and emerging middle and upper-income households, which mostly form a relatively small proportion of the total population. The problems outlined above provide part of the explanation for this, but the key to a sustainable economic and financial environment is to widen inclusion. This will require further implementation of pro-growth and investment policies to encourage more and better employment opportunities.

2. Selected Countries

2.a. ANGOLA

The Angolan banking sector has grown exponentially over the past decade in line with strong economic expansion and increased foreign interest. Much of the stimulus has come from the peace dividend following the 2002 Accord and booming oil revenues that have fuelled a construction and retail boom. Over the past decade the number of banks has grown to 23 from nine. The banking sector is dominated by five banks, which together account for about 79% of the sector's total assets. Portuguese banks are strongly represented in the banking sector and three of the banks are state owned.

Credit growth to the private sector has consistently outperformed that in other large economies in the region, remaining strong even in the wake of the 2008 global financial crisis. Although it has eased from the heady pace experienced until 2010, annual growth still remains over 10% in real terms. The retail and wholesale sectors have been the major recipients.

Profitability of banks has been good, with return on equity consistently above 20%. While non-performing loans are relatively low, the IMF has had issues with the treatment as current all loans that carry government guarantees (which are mainly in the construction and infrastructure sectors) whether they are being serviced or not. The sector is also well capitalized. As at March 2012, the sector capital adequacy ratio was 19.2%, nearly double the statutory minimum of 10%.

The key challenge for Angola is to diversify away from its dependence on oil, which makes up over 90% of export revenue and has strong linkages into manufacturing activity and the services industry. This leads to strong event risk for the banks that could be exposed to increasing bad loans if there are unforeseen developments in energy markets. On the positive side the regulatory environment continues to improve and the environment is becoming less opaque.

2.b. BOTSWANA

Botswana has experienced consistently strong economic growth over the past two decades, with some interruption only following the global financial crisis and the collapse in the diamond market. The banking sector in Botswana is well developed and regulated. From only two banks in the early 1980s the sector has now grown to 10 commercial banks, two

statutory banks and one building society. The commercial banks are dominant in deposits, holding a 98% average market share over the past decade, according to the IMF, and have maintained an 89% market share of the total sector loans over the same period. The four largest banks, First National Bank of Botswana Ltd, Barclays Bank of Botswana Ltd, Standard Chartered Bank Botswana Ltd and Stanbic Bank Botswana Ltd, hold more than 80% of the assets in the sector.

Credit growth slowed in 2009 but has recently started to accelerate back into double-digit territory in real terms. Traditionally the sector has excess liquidity, with much of this being absorbed by the issuance of Bank of Botswana paper which has helped the sector's profitability. However, there is a drive to get the banks to lend more to the real economy. Much of the lending – over 50% – is to the household sector, which has been more under pressure than usual due to public sector wage freezes, a vulnerability highlighted in a recent IMF's 2012 Article IV report. Even so, the banks have relatively well-diversified loan portfolios. In 2011 private sector enterprises made up 43% of all loans and were distributed as follows: trade, restaurants and bars 27%, manufacturing 11%, mining and quarrying 10%, real estate 20%, community and personal services 9%, construction 9%, transportation, communication and storage 6%, business services 4%, and other 4%.

Profitability has been squeezed since 2009 with return on equity falling into single digits. This followed several years of strong returns in excess of 40% per annum. Despite this, non-performing loans as a ratio of total loans have come down to the current 2.4% from a peak of 6.1% in 2010.

Banks have to adhere to a minimum capital adequacy ratio of 15% and a minimum Tier 1 ratio of 7.5%. The sector remains well capitalized at 20.5%, with all banks reporting in excess of the regulatory minimum.

Botswana remains overly dependent on its natural resources but has excellent growth potential given its encouraging business-friendly environment and good governance. The country also has largely untapped resources in the energy sphere that could come to the fore over the next decade.

2.C. MOZAMBIQUE

Mozambique is another fast-growing economy that, like Angola, has experienced a peace dividend combined with a boost from natural resources. Although it is not quite as well-endowed, it does enjoy the advantage of being close to South Africa's industrial heartland, with the so-called Maputo corridor generating mutual benefits for the two economies.

The banking sector is made up of 16 banks of which the largest four are majority foreign-owned and which make up 90% of the sector's total assets. Of the four banks, two are subsidiaries of Portuguese banking groups, one is a subsidiary of a South African banking group and the last is a subsidiary of British banking group, Barclays.

Real credit growth is starting to accelerate once more, but remains in single digits after strong performance was interrupted in 2010. Most credit is to the corporate sector as low per capita incomes limit opportunities in the retail market. There is also high concentration risk. According to a June 2011 IMF report, sector stress testing indicated that should each bank's largest borrowers default, both their and the sector's capital adequacy ratios could be jeopardised because primary borrowers account for about 65% of banks' regulatory capital. The banks are profitable, with average returns on equity in excess of 20% prevailing since 2002 and non-performing loans consistently relatively low.

Banks are required to maintain minimum capital requirements of 8% of total risk-weighted assets. The sector remains well capitalised.

Mozambique remains hampered by extensive poverty and an undiversified economy. However, recent resource finds could mean that this economy's growth trajectory will be exciting in the next decade, with benefits spreading more evenly to the relatively large population.

2.d. NAMIBIA

The Namibian economy has experienced solid growth over the past three years, but structurally it is constrained by its small population, extensive geography and lack of economic diversification. However, per capita incomes are relatively high and banking sector services are sophisticated and competitive. Given the small size of the economy it is unsurprising that the sector is concentrated, made up of five banking institutions, three of which are subsidiaries of South African banks (FNB, Standard and Nedbank) given the strong historic and geographic links, one a locally-owned bank (Bank Windhoek) and the fifth bank, FIDES Bank Namibia, a microfinance bank.

Credit has grown in upper single-digit territory in real terms since late 2010 and has recently regained some momentum, rising to 9.5% in October 2012. Most credit is directed at households (over 60%) with mortgage finance dominating. Credit to the commercial and services sector makes up around 34% of total credit, followed by farming (4.9%), and fishing (2.1%). Mining, manufacturing and construction all make up less than 2% of total credit each. Recently, growth in credit extension to businesses (up by a nominal 17.3% year-on-year in September 2012) has outstripped that to households (up 14.7%).

Total deposits are adequate to fund the sector's loan book, with stress tests conducted by the Bank of Namibia during 2011 confirming that available sources were sufficient to meet commitments.

The banking sector is very profitable, with returns on equity regularly around 40%, although recently this has declined to the mid-twenties. Non-performing loans are low, declining to around 1.4% of total loans by mid-2012, having peaked at 3.8% in 2008.

Capital adequacy is well above required minimums of 10% regulatory capital to risk-weighted assets and 7% Tier 1 capital. In 2011 these ratios were respectively at 14% and 7.8%, having eased from higher levels in the three preceding years.

Prospects for the banking sector are very dependent on whether the economy can become more inclusive. Income distribution is very uneven and unemployment massive, while household debt levels are high at around 89% of disposable income. This suggests that the formally-banked population is already highly indebted. The challenge will be to grow and diversify the economy and create more upward mobility in society. The danger is that government tries to address the problems legislatively rather than by attracting businesses to invest and employ.

2.e. SOUTH AFRICA

South African economic growth has been more moderate than most of its neighbours, given its relative maturity and the negative impact of the 2008 global financial crisis. Although the banking sector was not directly affected by the subprime crisis, credit growth contracted and losses rose as manufacturing activity was badly hurt due to close ties with Europe. Higher unemployment in the wake of the crisis also hurt the residential mortgage market. The banking sector is highly developed and well regulated. Over the past few years there has been a concerted effort to extend services to the previously unbanked through mechanisms such as the Financial Sector Charter. This has been partially achieved through the use of technology through cellular banking and smart card solutions as well as through mobile banking units and the use of shopping chains' physical infrastructure. There has also been an effort to provide basic transactional banking services at affordable rates.

The South African banking sector is made up of 17 registered banks, 2 registered mutual banks and 12 registered branches of foreign bank. However, the sector is still fairly concentrated, with the largest four banks holding around 86% of total assets.

Table 4: Financial Highlights for the Large Four Banks

Name of Bank Financial Year End	SBSA 31/12/2011	Absa 31/12/2011	FirstRand 30/06/2012	Nedbank 31/12/2011
Total Assets (Rand billions)	922	742	690	614
Net Profit After Tax (Rand billions)	9.5	8.2	9.3	5.5
Return on Equity %	18.3	14.9	20.7	7.0
Cost to Income %	54.7	58.0	59.2	58.2
Market Share of Total Assets %	26.0	22.0	20.0	18.0
Market Share of Total Deposits %	24.6	21.9	19.2	21.0
Capital Adequacy Ratio %	13.5	16.2	14.8	15.8
Impaired Loans / Total Loans %	4.5	6.9	3.6	4.2
Loan Loss Reserves / Impaired Loans %	47.1	33.2	60.0	52.3
Net Loans / Total Assets %	59.6	74.7	69.6	75.3
Loans/ Customer deposits %	90	87	94.8	102.4

Source: Banks' financial statements

Credit expanded strongly from 2004 to 2008, with annual real growth exceeding 10% over the whole period and peaking at 20% in late 2006. Although most categories of credit expanded rapidly over the period, it was mortgages, which made up around 48% of loans and advances to the private sector, (currently 45%), that grew most rapidly. Banks cut back activity in the wake of the crisis in response to changed economic conditions, higher regulatory requirements and changed risk assumptions. Credit has since expanded only mildly in real terms but the composition of credit has changed significantly, with unsecured loans both to companies but mainly to households rising strongly over the period. While this has caused some concern for the regulatory authorities it remains a relatively small part of total loans and advances.

Overall liquidity in the banking system is adequate, but banks typically depend largely on wholesale funding, which is normally less stable than household deposits. Household deposits amounted to just 24% of total deposits in September 2012, while company deposits were 51%. However, deposits by non-residents made up only 4% and the banking system's liquidity held up well during the 2008 event.

Profitability in the sector declined post 2008, but has recently recovered as the quality of banks' loan books has improved. Return on equity is currently around 17%. Non-performing loans remained relatively high at 4.7% at the end of 2011, but this ratio has been improving steadily. Banks' capitalization ratios have consistently been well above minimum regulatory requirements of 9.5% for risk-weighted capital and 7.0% for Tier 1 capital. In June 2012 the sector stood at 14.1% and 11.8%, exceeding future Basel III requirements of 14% and 11%.

Table 5: Sectoral Distribution of Credit (%)

	2010 December	2011 December	2012 September
Agriculture, hunting, forestry and fishing	1.7	1.7	1.7
Mining and quarrying	2.9	3.7	3.7
Manufacturing	4.1	4.3	4.4
Electricity, gas and water supply	0.9	0.9	0.7
Construction	1.2	1.2	1.2
Wholesale and retail trade, hotels and restaurants	3.9	4.0	4.3
Transport, storage and communication	3.6	3.4	3.4
Financial intermediation and insurance	24.8	25.2	24.7
Real estate	6.4	6.3	5.1
Business services	3.4	3.7	3.7
Community, social and personal services	5.2	5.4	6.4
Private households	35.1	34.3	35.9
Other	6.8	6.0	4.9
Total	100	100	100

Source: Financial Stability Review September 2012

Prospects for the banking sector remain good, although growth rates are unlikely to match those of less mature markets in the region. Uneven income distribution and high unemployment has hampered deeper penetration of services and loan expansion, suggesting that more inclusive and rapid economic growth would benefit the industry

greatly. The challenge for the sector will be to find financial solutions for those micro-businesses that have little collateral and credit histories but workable business ideas. Given the dual nature of the economy, any solutions can be exported to other countries in the region, partly explaining the current drive of South African banks into the rest of sub-Saharan Africa.

2.f. TANZANIA

The Tanzanian economy has grown strongly over the past decade and prospects for further gains are favourable. Unfortunately, the banking sector remains relatively undeveloped, with most banks' incomes derived from interest on government securities, trade finance and trading. Interest rates for borrowers are high, credit information is limited – although a credit bureau was licenced late in 2012 – and redress for creditors is limited. The very low level of credit relative to GDP (16%) and low use of bank services suggests that there is considerable upside potential for growth in banking.

The sector is made up of 45 banking institutions. The banks hold a combined 75% market share of total financial sector assets. The sector is highly concentrated with the three largest banks by total assets (namely, FBME Bank Ltd, CRDB Bank Plc. and National Microfinance Bank Ltd) accounting for 48% of total sector assets.

Credit growth has been variable, with strong periods being punctuated by sharp slowdowns. After a strong recovery in 2010 following weakness post the global financial crisis, growth in real credit again slowed, easing to just 2.7% year-on-year in September 2012. Loans go predominantly into the retail and wholesale trade sector (19.4% of total), agriculture (12.9%), mining (12.5%), building and construction (8.7%) and transport and communication (7.9%).

The banking sector is highly liquid as banks have significant investments in government securities. In March 2012 the liquid assets to total short-term liabilities ratio stood at 39.2%, well above the minimum regulatory limit of 20.0%, as set by the Bank of Tanzania.

Profitability in the sector is relatively moderate (returns on equity rising to 17.4% in the first quarter of 2012), held back by uneven loan growth and high non-performing loans (non-performing loans were 7.5% of gross loans in March 2012 after peaking at just under 10% in 2010). Tanzanian banks are required to maintain a minimum capital adequacy ratio of 12.0% and a Tier 1 ratio of 10.0%. Banks typically exceed these by some margin. As a whole the sector stood at 18.5% and 17.6% in March 2012.

Prospects in the sector will depend on how quickly government can institute the necessary reforms to ensure property rights and stimulate economic growth. The country has significant potential both in its own right and given its strategic position between Southern and East Africa.

2.g. ZAMBIA

Zambia's economy has bounced back well after the global financial crisis, helped by a rapid pickup in commodity prices during 2009. The banking sector is profitable and well regulated

but despite this, financial inclusion is low. Zambia has 19 banks, with the largest four banks accounting for about 65% of total assets. Thirteen banks (accounting for 69% of total assets) are foreign owned, two of which (about 21% of total assets) are partly state owned and a further four (9.7% of total assets) are locally owned. Subsidiaries of international banking groups present in the sector include, in order of systematic importance, Barclays Bank Zambia Plc., Standard Chartered Bank Zambia Plc., Stanbic Bank Zambia Ltd, Bank of China Zambia Ltd, Citibank Zambia Ltd and First National Bank Zambia Ltd.

Credit contracted significantly in the wake of the crisis in 2008, but started expanding rapidly in 2010 and was back above pre-crisis peaks in real terms by mid-2011. In early 2012 growth eased off but has recently accelerated strongly once again. Banking is generally very profitable, with returns on equity in excess of 20%. The sector has high levels of excess liquidity as a result of impediments to extending loans to underserved areas of the economy.

The sector remains well capitalised, with a capital adequacy ratio of 19.2% in 2011, nearly twice the statutory minimum requirement of 10%. In the first quarter of 2012 the Bank of Zambia increased the statutory minimum capital requirement for foreign banks to \$100 million from \$2.4 million and for local banks to \$20 million from \$2.4 million. However, in line with reservations expressed by the IMF it has extended the December 2012 deadline for those banks requesting it. The move was designed to force lending in the real economy but this could also have the unintended effects of expanding certain credit areas too aggressively and forcing small niche banks to close.

Zambia will grow strongly over the next decade, but much of this growth will be concentrated in the mining sector. While this will provide government with needed resources to improve infrastructure and services, fundamental reforms will be needed to reduce the high cost of doing business and to encourage investment in different sectors of the economy. The country has tremendous potential to expand in agriculture, where most of the population currently derives its income. The growth in banking services will depend on government's ability to encourage more entrepreneurial activity.

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Banking in East African Community

SABINA ZAJC^{1 2}

Executive Summary

- The financial system of East African Community (EAC) countries³ is dominated by the banking sector, where the share of public interest is rather low and foreign banks account for a relatively large share of total banking sector assets, deposits and loans. In addition, there are many players in the market, which may call for some consolidation in the near future. Yet, the banking sector exhibits a relatively high concentration level.
- Financial sector reforms over the last fifteen years have contributed to impressive growth of credit to the private sector. In addition, innovation in financial services and products has significantly improved access to finance. However, financial intermediation remains low and access to finance is still a key constraint to private sector development.
- The banking sector in EAC remains sound, profitable and liquid, while non-performing loans have increased slightly in recent months from a low/moderate level. The banking regulatory and supervisory framework has improved significantly on account of recent reforms, yet important areas still need to be addressed in order to bring the framework closer to best international standards. In this context, near-term risks to the stability of the banking sector appear limited.
- Against this background, many opportunities for further growth and development exist in the EAC banking sector, which in turn would contribute to better access to finance and economic growth. Among them, financial innovation has a great potential to spread across the region and transform the existing business models for providing services to currently underserved population and reduce the cost of mobilizing savings.

1. Introduction

The banking sectors in East African Community countries dominate their financial sectors. However, the development and sophistication level of the banking sectors varies significantly across the region, with Kenya having one of the most dynamic and largest

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² The views expressed in this document are those of the author and do not necessarily reflect the position of the EIB.

³ East African Community consists of Burundi, Kenya, Rwanda, Tanzania and Uganda.

banking sectors in sub-Saharan Africa, and a significant presence in the other EAC countries. The banking sectors of the other four countries are concentrated on their local markets.

The sophistication of capital markets in EAC differs across the region, but in general, they remain underdeveloped. There are important cross-country differences, with some markets at an early stage of development, while Kenya's market is reasonably well-developed in sub-Saharan African context. The less developed domestic debt markets are shallow and narrow. They are characterized by short-term maturities, limited investor base, and illiquid secondary markets, among others, and are dominated by government securities. Stock markets also remain underdeveloped, with secondary markets either illiquid or non-existent. In general, EAC capital markets have not played a major role in resource mobilization and long-term financing of their economies. They are yet to be developed to a level that could make them a significant complement and/or an important alternative to banking intermediation.

Similarly, insurance companies and pension funds in the EAC region remain underdeveloped and offer only a limited array of financial instruments to a limited set of clients. Thus, there is potential for these business lines to be developed further to better serve the needs of the individuals/enterprises and their economies in general. In addition, as they grow and become more and more interlinked with banks, insurance companies and pension funds are increasingly contributing to the potential risks to the stability of the financial systems.

2. Market Structure and Competition in the Banking Sector

The banking sectors in EAC consist mainly of commercial banks, while Rwanda and Burundi also have a development bank (Table 1). In addition, the EAC members also share a common development bank, the East African Development Bank (EADB). Furthermore, all five countries have brought some microfinance institutions (MFIs) under the regulation of their central banks, which have become a part of the banking system. These institutions may either be microfinance banks, deposit or non-deposit taking MFIs or SACCOs (savings and credit cooperatives).

EAC banking sectors are rather concentrated (Table 1) and empirical evidence suggests that the banking sectors are most accurately characterized as monopolistic competition (Sanya and Gaertner, 2012). While there are no regulatory barriers to competition *per se*, in most countries across the region former state-owned/legacy banks retain a very large market share despite steps to reduce regulatory barriers to entry and exit and to attract increased participation from foreign banks. The latter indeed have a very significant market share in the region, which makes it difficult for (non-dominant) local banks to compete as they typically have access to lower cost of financing and superior technology from parent banks. In this context, it is not surprising that the empirical evidence shows that foreign banks have not increased competition in the region (Sanya and Gaertner, 2012). In order to improve competition and access to finance, empirical evidence further suggests that the region will have to tackle obstacles such as legal infrastructure (collateral, foreclosure, bankruptcy), financial infrastructure (credit bureaus, payment systems), and market segmentation due to

a large legacy and foreign-bank presence. Against this background, it is not surprising that interest-rate spreads and the cost of finance remain high.

Table 1: Banking Market Structure in EAC, August 2012

	Kenya	Uganda	Tanzania	Rwanda	Burundi
Commercial banks (number)	43	25	30	9	9
Foreign banks (number)	13	21	22	6	
% of banks' assets	35.2				45.0
Local banks (number)	30	4	8	3	
Private local banks (number)	27	3	6	2	
% of banks' assets	60.0				34.0
Public local banks (number)	3	1	2	1	2
% of banks' assets	4.7				22.0
Market share of total assets (%)					
Top 3 banks	> 50.0				
Top 4 banks	55.0				
Top 6 banks	54.4				
Top 10 banks	80.0				
Other banking institutions (number)					
Development banks	-	-	-	1	1
Regional unit banks	-	-	8	-	-
Financial institutions	-	-	5	-	-
Regional unit financial institutions	-	-	2	-	-
Mortgage financial institutions	1	-	-	-	-
Microfinance banks	-	-	-	3	-
Cooperative banks	-	-	-	1	-
Habitat bank	-	-	-	-	1
Banking institutions (Banking Act)	44	25	45	14	10
Number of banks operating abroad	10	1			
Number of branches abroad	223				

Sources: EAC Central Banks

Notes: Market share data: Kenya: December 2011; Tanzania: December 2010; Burundi: 2009; Rwanda: March 2012 (all banking institutions included)

Kenya: Banks operating abroad: December 2011

Somewhat contrary to the empirical evidence, banks in the EAC region report and perceive competition in many market segments as high. This is not the case just for corporate and retail clients, but also for micro, small and medium enterprises (MSMEs) as well as the unbanked population. Competition and a desire for growth have driven EAC banks to scale down their activities, and it is not unusual for a large and/or leading commercial bank to be heavily involved in microfinance. In addition, banks are competing for the unbanked population, which has led to the introduction of innovative and cost-effective financial services, with Kenya being the leader and exporting its ideas to the neighbouring countries through its bank subsidiaries operating abroad. In particular, mobile and agent banking services have been a great success and have significantly contributed to financial inclusion, reaching the poor and the rural areas (Table 2).

Table 2: Banking Sector Depth and Infrastructure in EAC

	Kenya	Uganda	Tanzania	Rwanda	Burundi
Total bank assets-to-GDP (%)	67.4	33.2	36.1	29.2	32.3
Total bank deposits-to-GDP (%)	49.6	22.7	29.6	19.8	17.6
Broad money-to-GDP (%)	52.0	23.0	33.2	20.9	22.3
Domestic credit to private sector-to-GDP (%)	38.2	17.9	17.9	13.5	21.1
Number of bank branches	1161	455	397	638	
Bank branches per 100,000 adults	4.4	2.5	1.8		
Number of bank accounts				2.03M	172K
Bank loan accounts	2M				4.3K
Bank deposit accounts	14.3M				
Credit reference bureaux	2	1	0	2	0
Private	2	1		1	
Credit reports accessed by banks	> 1.5M				
Credit reports accessed by individuals	> 7,600				
Number of enquiries	> 1.5M	129,615			
Negative information shared	yes	yes			
Positive information shared	yes	yes			
Customers get free report	yes	yes			
Institutions sharing information	yes	yes		yes	
ATMs	2,205	637	1,117	170	
ATM-to-branches ratio	1.89	1.46	1.87	0.25	
Banks with agents	8	yes	1 request	3	
Active agents	10,066			1,600	
Banks offering mobile banking	13	yes	yes	7	
People using mobile phone platforms	> 18M	> 2.8M	21M	> 600K	
Banks offering internet products	23	yes	yes	2	
Cheque truncation system	yes			yes	
Days to clear cheque	2	3			
EAC cross-border payment system	yes		yes	2012	
Deposit insurance scheme	yes	yes	yes	no	
Population (million)	40.9	35.2	42.2	10.9	8.4

Sources: EAC Central Banks, IMF, World Bank

Notes: Kenya, Uganda, Rwanda: December 2011; Tanzania: December 2010

Broad money-to-GDP: 2012

Domestic credit to private sector-to-GDP: 2011

3. Recent Banking Sector Developments, Intermediation and Access to Finance

Recent years have seen a very vibrant banking activity in all EAC countries. Banking sector reforms introduced at the beginning of the last decade as well as restored stability in Burundi and Rwanda have contributed to a sharp acceleration in credit to the private sector. The reforms included the liberalization of state-controlled banking systems, restructuring of loss-making institutions, write-offs of non-performing loans, as well as improved governance and financial sector supervision. While this expansion in credit to the private sector has taken place from a very low initial volume, the rate of growth has been impressive. Except for Rwanda, credit to the private sector has grown at an average annual rate of over 20% in the last years. Consequently, credit to the private sector as a share of GDP has increased significantly over the last ten years, from 26% in 2002 to 38% in 2011 in Kenya, and from 8% and 6.8% to 17.9% in Uganda and Tanzania, respectively (Table 2).

Concurrently, banks' balance sheets have grown in absolute terms and as a percentage of GDP; they have transformed such that loans and advances now represent banks' main assets, while investments in government securities have lost importance (Table 3). Most loans are concentrated in personal/household as well as trade sector. Nevertheless, agriculture, which is a key economic sector in the region, receives relatively more credit than in many other sub-Saharan African countries, with Tanzania having the largest exposure to agriculture in the EAC region.

Furthermore, banks have also been successful in mobilizing new deposits, which remain their main source of funding. As most deposits are of a short-term maturity, banks in EAC face a well-known maturity transformation/mismatch problem.

Table 3: Balance Sheet of Commercial Banks in EAC

	Kenya	Uganda	Tanzania	Rwanda	Burundi
Total assets (bn local currency)	2,020.8	12,982.4	12,570	1,083.3	959.9
Total assets (bn USD)	23.3	5.2	7.9	1.8	0.7
Loans and advances (%)	57.0	53.8	44.1	53.8	65.1
Government securities (%)	15.1	16.0	19.0	6.8	8.5
Placements (%)	5.8			21.7	
Due from financial institutions (%)		13.4	3.5		
Liabilities and shareholders' funds					
Customer deposits (%)	73.6	68.6	82.0	67.9	54.5
Borrowed funds (%)	2.9		2.6		
Due to financial institutions (%)		5.6			
Foreign Liabilities (%)					15.6
Capital and reserves (%)	20.0	15.4	12.1		19.9

Sources: EAC Central Banks

Notes: Kenya, Rwanda: December 2011; Uganda: April 2012; Tanzania: December 2010; Burundi: February 2012

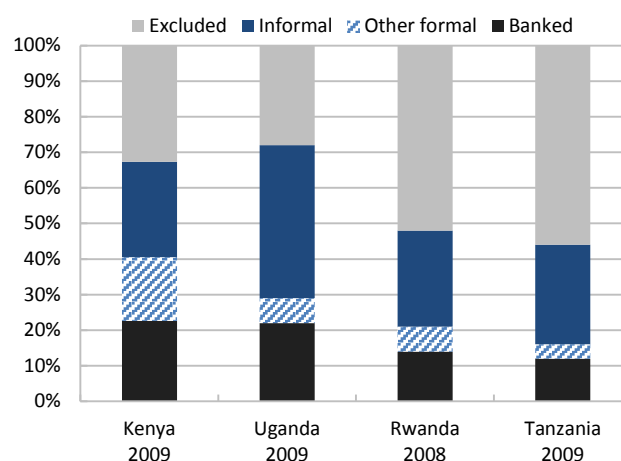
Table 4: Distribution of EAC Banks' Loans by Sector (Percent)

	Kenya	Uganda	Tanzania	Rwanda	Burundi
Agriculture	5.2	6.8	12.9	3.4	0.6
Manufacturing	13.2	14.1	12.0	6.0	-
Mining and quarrying	1.4	0.4	-	0.0	-
Industry	-	-	-	-	4.8
Industry and energy	-	-	-	-	-
Small equipment	-	-	-	-	23.0
Building and construction	3.5	-	8.7	-	-
Building, mortgage, construction, real estate	-	21.9	-	-	8.3
Real estate	12.3	-	-	-	-
Energy and water	3.1	-	-	0.6	-
Electricity and water	-	1.0	-	-	-
Transport and communications	8.2	7.5	7.9	-	-
Transport and warehousing	-	-	-	8.0	-
Trade	19.5	19.8	19.9	-	56.8
Tourism, restaurants, hotels	2.3	-	-	-	1.9
Commercial and hotel	-	-	-	33.9	-
Hotels and restaurants	-	-	-	-	-
Financial services	4.6	-	-	1.3	-
Business, community, social, other services	-	13.2	-	-	-
Service sector	-	-	-	4.0	-
Other services	-	-	-	-	-
Personal/Household	26.8	15.3	21.0	-	-
Mortgage industries	-	-	-	30.4	-

Source: EAC Central Banks

Notes: Kenya, Rwanda: December 2011; Uganda: April 2012; Tanzania: March 2012; Burundi: February 2012

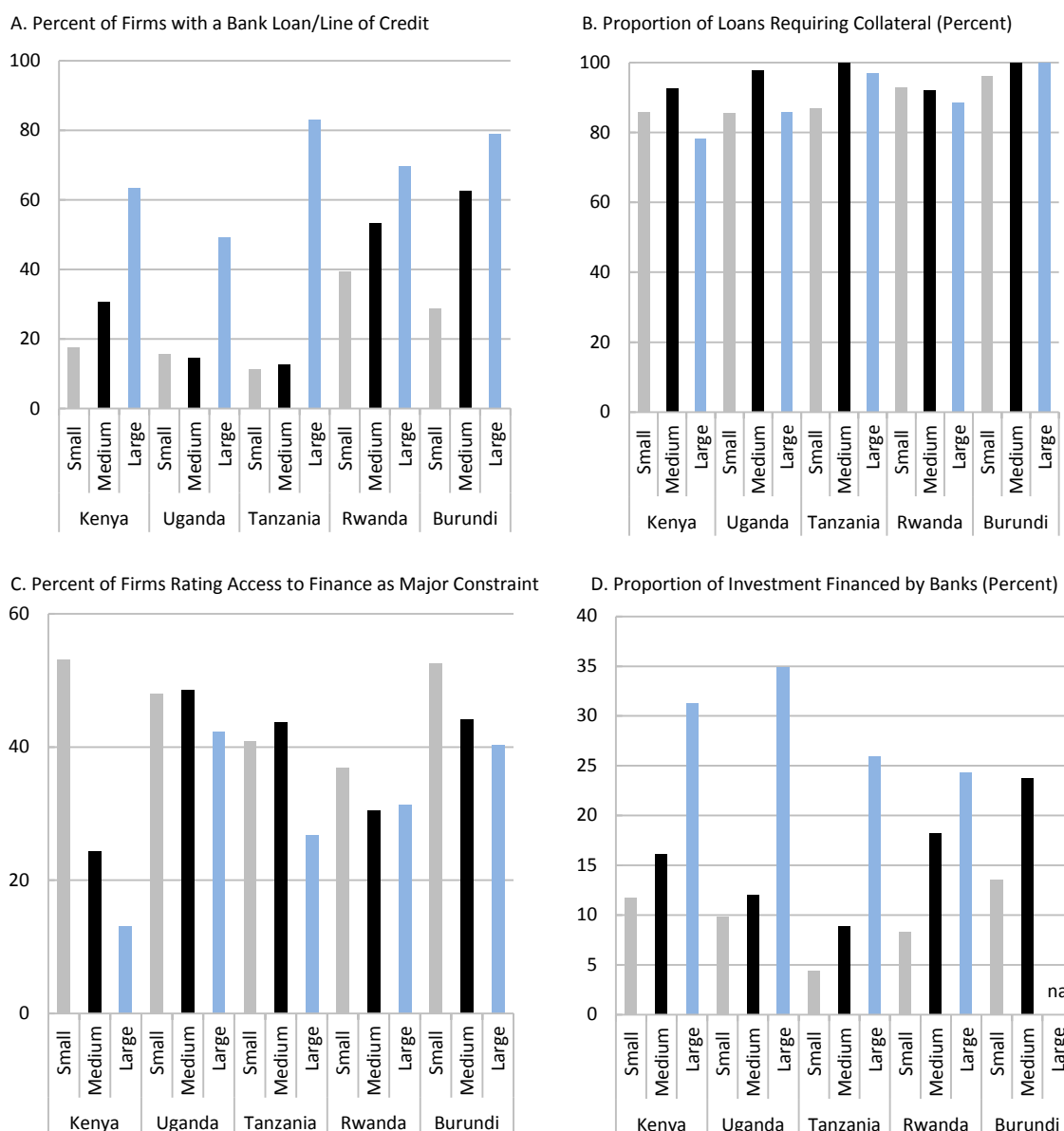
However, despite the impressive increase in credit to the private sector, the level of intermediation is low (Table 2) and access to financial services remains limited, especially in rural areas. Finscope surveys show that more than 50% of the population are excluded from any financial services in Tanzania and Rwanda, while in Kenya and Uganda the same is true for about 30% of the population (Figure 1). In addition, the African Economic Outlook reports that in Burundi only about 2% of the population has a bank account, and the IMF data show that only 7.2% of Burundians have access to formal financial services.

Figure 1: Access to Financial Services in EAC Countries

Source: Finscope

The finance gap is equally important for micro, small and medium enterprises in the EAC region. According to the World Bank Enterprise Survey, small firms in the region are at the highest disadvantage, rating access to finance as a major constraint to their growth and development more often than other firms (Figure 2).⁴ In addition, the percentage of SMEs with a bank credit line is much lower than that of large firms. Finally, the proportion of investments financed by banks is much lower for SMEs than it is for large firms. Not surprisingly, access to finance ranks highly among major constraints to private sector development. Rwanda rates it the number one constraint, Kenya, Tanzania and Burundi as number two, and Uganda as number four.⁵

Figure 2: SME Access to Finance in EAC



Source: World Bank Enterprise Survey (Kenya: 2007; Uganda, Tanzania, Burundi: 2006; Rwanda: 2011)

⁴ The Survey does not include microenterprises. However, microenterprises are in general more constrained than SMEs.

⁵ The other two top constraints in the region include tax rates and electricity.

Box 1: Banking Sectors in East African Community

Kenya

Kenya has the most developed banking (and financial) system in the region. Its banking sector is the fourth largest in sub-Saharan Africa, behind South Africa, Nigeria and Mauritius. There are 43 commercial banks, of which 13 are foreign, and have set up 1,161 branches across the country. Kenya is the only country in the region with significant banking activities abroad, mainly in the neighbouring countries. Ten Kenyan banks have established 223 branches outside the country and have spread their innovative and cost-effective banking activities around the region. Microfinance has played a significant role in the evolution of Kenya's financial services, with four banks (including two large and one medium) having roots in microfinance. In addition, six deposit-taking microfinance institutions have been licensed by the central bank and present a healthy competition to commercial banks in the lower, microfinance segment.

Uganda

Uganda's banking (and financial) sector is benefiting from the authorities' efforts to strengthen and deepen the entire system and is relatively well developed. The banking sector in Uganda has expanded significantly since a moratorium on licensing new banks was lifted in 2005. Eleven new banks have been established since, bringing the total number to 25, of which 21 are foreign banks. The number of branches has almost quadrupled since and climbed to 455. Two commercial banks have their roots in microfinance. In addition, a relatively advanced microfinance legal and regulatory framework has supported the establishment and/or growth of several microfinance institutions that now fall under the supervision of the central bank.

Tanzania

The banking sector in Tanzania has grown significantly since 2003, but remains dominated by a top tier of larger domestic legacy and foreign banks, which cater mainly a small group of large corporates, leaving the retail market underserved. Weak legal system, including weak ownership rights, is an important constraint on further development of the banking system. There are 30 commercial banks, including 22 foreign. With 397 bank branches, Tanzania lags behind some EAC countries in the number of bank branches per capita. In addition, growth in the take-up of mobile banking is slower than elsewhere in the region. Nonetheless, mobile banking is expected to increase access to finance among Tanzania's large rural population. Microfinance activities in Tanzania have increased five-fold in the past decade, but the licensing of microfinance institutions has not really taken off. Thus, revisions of microfinance legislation are foreseen to encourage more institutions to become registered and supervised by the central bank.

Rwanda

Significant progress has been made in reforming and modernizing Rwanda's banking (and financial) system. Its stability, structure and efficiency have improved. The banking sector has recovered from a period of restructuring and cleaning-up legacy problems and now consists of nine commercial banks, of which six are foreign, one development bank, three microfinance banks and one cooperative bank. It is highly concentrated, but competitive in key markets. Innovation such as mobile and agency banking has the potential to transform existing business models for providing services to currently under-served population and reduce the cost of mobilizing savings. Rwanda also has one of the smallest and least developed microfinance sectors in the region. Twelve microfinance institutions and over 460 savings and credit cooperatives (SACCOs) are licensed by the central bank.

Burundi

Burundi's banking (and financial) sector is the least developed in the region and operates in a weak institutional and regulatory environment, preventing it from developing faster. There are nine commercial banks, of which foreign banks account for 45% of total assets. In addition, Burundi has a development and a habitat bank. Although trade is an important sector for bank financing in the region, the high share of trade financing in Burundi (over 56%) reflects low economic development on the one hand and a significant risk for banking sector stability on the other hand. The central bank also supervises ten deposit-taking microfinance institutions and eleven SACCOs. These are often the only financial entities operating in rural areas, yet they have a weak market penetration (7% for credit, 26% for savings). Access to finance thus remains severely limited. Innovation in financial services has a potential to significantly improve financial inclusion.

4. Performance and Soundness of Banks

The EAC banking sectors are solvent, profitable and liquid, but non-performing loans have recorded a slight increase in recent months.

- Capital adequacy ratios (CAR) are comfortably above prudential requirements in all EAC banking sectors, with banks' high profitability providing an additional cushion against adverse developments (Table 5). In addition, capital requirements are being increased in several countries in the region with the view to ensure the sector's stability. However, none of the countries currently applies Basel II definitions for the CAR. All countries also apply zero weights to sovereign assets, whereby the sovereigns that are rated by external rating agencies are rated in the B category. In addition, banks in several countries appear to be underprovisioning for expected losses. Consequently, the CAR reported by banks may be higher than what it would have been under stricter international standards. There has been no assessment of the magnitude of the effect these deficiencies may have on the CAR. However, it seems that the current relatively high levels reported for CAR would pass a solvency test even under more stringent norms.
- Furthermore, the level of banks' liquidity is not a concern in the context of prudential requirements. However, during the recent monetary policy tightening, liquidity risk has increased in Uganda and Rwanda, where some banks are exposed to a sudden drop in deposits.
- Non-performing loans have declined over the recent years and now stand at low (Kenya, Uganda) or moderate (Tanzania, Rwanda, Burundi) levels. Non-performing loans (NPLs) have decreased on account of enhanced appraisal and recoveries standards. However, credit risk is currently emerging in all EAC countries due to high inflation and interest rates and/or exposures to large borrowers and selected sectors. Once inflationary pressures have eased and interest rates fallen, pressures on NPLs should subside.
- Cross-border risks and foreign-exchange rate risk appear contained. Yet, unfavourable conditions in home countries of EAC foreign subsidiaries from outside the region could adversely affect funding from their parent banks, while the depreciation of local currencies could hurt borrowers who borrow in foreign currency and have an income stream in local currency.
- Linkages between commercial banks on the one hand and insurance companies and pension funds on the other appear to be significant and increasing. Therefore, contagion risk may have become relevant in the financial systems, but the lack of data prevents any analysis of its potential impact.
- The EAC public sectors present some risk to the stability of the banking sectors through banks' exposures to the state (government paper and/or loans to state), although this risk appears relatively small.

Table 5: Financial Soundness Indicators for Banks in EAC, 2012 (Percent)

	Kenya	Uganda	Tanzania	Rwanda	Burundi
Total capital/risk-weighted assets	20.5	20.3	18.5	24.1	19.8
Capital adequacy ratio	12.0	12.0	12.0	15.0	
Core capital/risk-weighted assets	17.6	18.3	16.8		17.3
Core capital adequacy ratio	8.0	8.0	10.0	10.0	8.0
Liquid assets/short-term liabilities	41.2		39.2	19.6	
Liquid assets/short-term commitments					88.6
Liquid assets/total deposits	44.1	38.9		40.2	
Total loans/total deposits	76.7	74.2	65.9	67.6	
Gross NPLs/gross loans	4.8	3.9	7.5	6.2	8.1
Specific provisions/NPLs	54.2	31.6		49.6	76.7
Return on assets	3.7	4.4	3.0	2.3	0.7
Return on equity	32.0	29.5	17.4	11.1	4.6
Spread b/w lending and deposit rate	9.8		3.3		
Net interest margin		12.8		12.6	
Net open position in FX/capital	3.4		-6.9		
FX exposure /tier 1 capital		-5.2		0.0	
FX denom. assets/total assets	13.1	33.3			29.1
FX denom. liabilities/total liabilities	22.0				
FX loans/FX deposits		67.1		5.3	
FX assets/FX liabilities		103.4		114.8	
Large exposures/total capital		111.6		42.3	20.8

Sources: EAC Central Banks and IMF

Notes: FX: foreign exchange.

Large exposures for Rwanda are measured as a share of core capital.

Kenya: September 2012; Uganda: June 2012; Rwanda: September 2012/*March 2012*; Tanzania, Burundi: March 2012

5. Banking Sector Supervision and Regulation

The central banks of EAC countries are responsible for the regulation and supervision of their respective commercial banks. In addition, the central banks also regulate and supervise national development banks as well as selected microfinance institutions and/or other financial intermediaries.

Like the countries of the region and their financial systems, the national regulatory and supervisory frameworks differ significantly across countries, but they do share some common features. Their level of development and sophistication is strongly correlated with the development of their financial systems, with Kenya clearly being a forerunner, while Burundi lags behind. In general, none of the regulatory frameworks is fully compliant with best international practices. However, all of the EAC countries have implemented significant regulatory and supervisory reforms which have helped the development of their financial systems, and will bring them in line with best international standards. The reforms continue to be implemented and the following are current common areas in which the regulators in the region are active: joint consolidated supervision; national payments system legislation; microfinance regulations; AML/CFT legal framework; mobile and agent banking regulation; credit reference bureau regulation.

Nevertheless, many regulatory and supervisory challenges remain. Capital adequacy ratios are not following Basel II definitions; none of the countries is fully compliant with Basel Core Principles (BCPs) for effective banking supervision, although Kenya, Uganda and Tanzania do largely comply with most of them; risk and macroprudential analysis is weak, which reflects the lack of skills, the lack of financial sector data, as well as the fragmented regulatory and supervisory framework and/or weak coordination among national regulators; supervision departments do not have sufficient resources to carry out their tasks properly, although most countries do apply risk-based supervision; enforcement of prudential norms needs to be improved; regulatory developments are lagging behind market developments, especially regarding mobile and agent banking; and consolidated supervision has only been implemented in Uganda.

6. Conclusions

Financial sector reforms that have been implemented in the EAC region over the last 15 years have significantly contributed to the development of the banking and the entire financial system. Consequently, the region's banking sector has become one of the most dynamic and innovative ones in sub-Saharan Africa. Moreover, it has transformed to better serve the needs of individuals and the corporate sector, thus increasingly contributing to social and economic development and growth.

Yet, significant challenges in the banking sector remain. Despite impressive growth in private sector credit, banking sector depth and intermediation remain low, with a large share of the population not having access to any financial services and access to finance being one of key constraints on growth and development of enterprises. At the same time, the banking sector remains concentrated, although bankers perceive competition as high, while skills represent a general constraint on financial and banking sector development. Finally, there is still room for improvement in the area of financial/banking legislation, regulation and supervision in order to ensure an environment conducive to banking sector development.

Nevertheless, there are many opportunities for growth and development in the EAC banking sector. The relatively stable macroeconomic and financial environment as well as the current reform momentum can further contribute to the development of the banking sector. In addition, the economies of the region are expected to continue growing at a strong rate, increasing household income and consumer sophistication. This in turn would further boost growth and development of financial services. Furthermore, regional integration within EAC has the potential to create a larger and more unified market. More competition and further consolidation is expected across the region, while public interests in the sector are expected to be privatized. Increased competition, better risk assessment, the establishment of credit reference bureaux and the growing sophistication of monetary policy should lead to a decline in lending rates. Finally, increased innovation, including in the form of new products and lending techniques, is expected to continue supporting the growth momentum in the banking sector and to improve access to finance for existing customers as well as for financially excluded and underserved population.

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Banking in Central and West Africa: A Growth Story

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Executive Summary

- West African Banking sector consists of three main terrains: Nigeria, Ghana and the WAEMU bloc. Nigeria's banking sector remains the most robust with total assets worth US\$123.545 billion as at 2011 while Ghana banking sector's assets totalled US\$13.39 billion in the same period. The WAEMU region's banking sector had total assets totalling to US\$31.917 billion as at 2011.
- In Central Africa, Cameroon and the Democratic Republic of Congo 'DRC' remain the key players. Total assets in DRC stood at US\$4.81 billion while Cameroon's gross loans and advances stood at US\$6.11 billion.
- Consequently, the market structure in these two sub-Saharan regions continues to remain a growth story and with the advent of mobile banking, we believe there exists significant headroom for accelerated financial inclusion. Additionally, with Sub-Saharan Africa expected to grow by 5.7% in 2013 (IMF projections), these two regions should continue to post robust credit growth both in the medium and long term.

1. Nigeria: Balance Sheet Repairs Continue

1.a. NIGERIA – THE ISLAND

The Nigerian Banking sector has waded through winding transformations over the last decade, including the key 2005-2006 consolidation and the subsequent 2009 banking crisis. While coincidental with the 'Lehman collapse', Nigeria's banking crisis was primarily seen as a massive absence of corporate governance. This was at odds with its sub-Saharan African 'SSA' peers, whose banking sectors remained quite resilient during the period, a phenomenon that consequently rendered the Nigerian banking sector as an island in the region.

Amidst the 2005-06 consolidation and a sustained expansionist monetary stance by the Central Bank of Nigeria 'CBN', the money creation momentum surged in the subsequent two years with the ratio of M2 to non-oil GDP increasing from 38.5% to 67.2% (while M2/GDP rose from 28.1% to 43.6%); additionally, the ratio of the banking system's assets to GDP surged to a high of 112.2%. However, a significant chunk of the credit originations and subsequent disbursements came from margin traders (who took positions on equities) and oil importers who took unhedged positions. With the global financial crisis ripples spreading far

¹ Research, Ecobank.

² The views expressed in this document are those of the authors and do not necessarily reflect the position of Ecobank.

wide, the sector could not withstand the shocks and consequently most of the exposures ended up being 'toxic'. This prompted the CBN to crack down on lending 'malpractices' and consequently initiated a second round of consolidation.

Figure 1: GDP and Private Sector Credit Growth

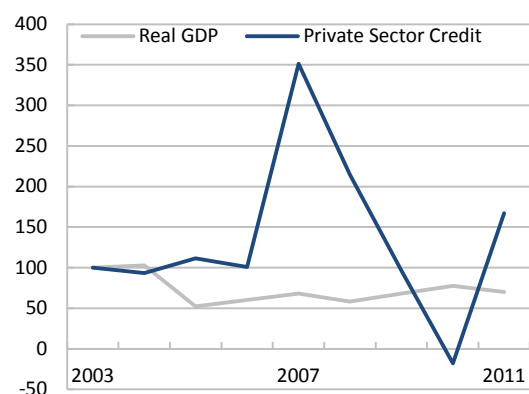
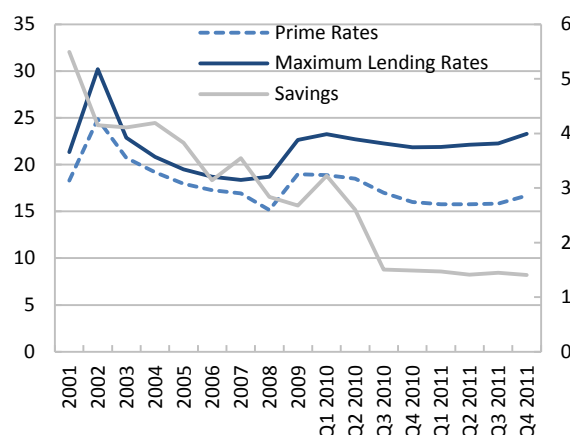


Figure 2: Selected Interest Rates

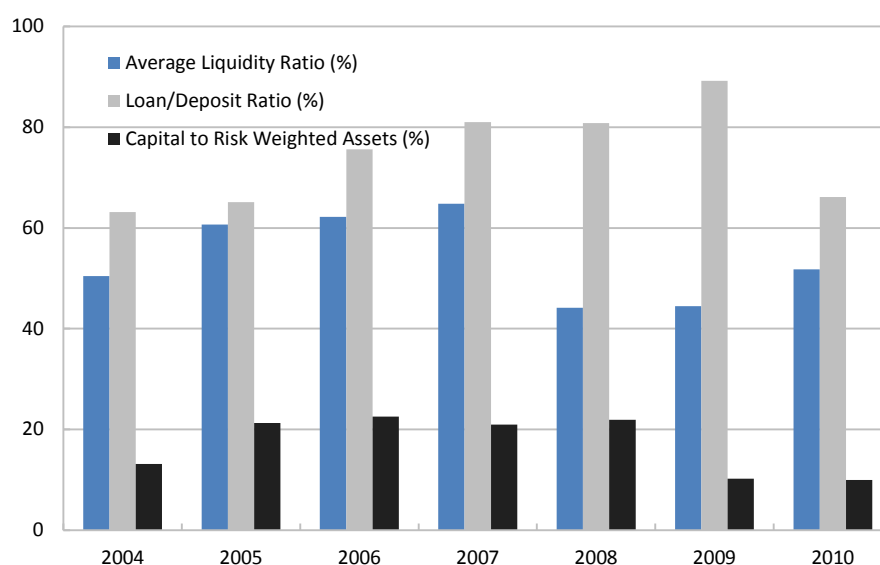


Source: Ecobank Research, CB

Source: Ecobank Research, CBN

Note: Prime rate on the left hand side, maximum lending rate and savings rate on the right hand side.

Figure 3: Soundness Indicators



Source: Ecobank Research, CBN

1.b. MARKET INFRASTRUCTURE

The banking sector consists of the CBN as the Apex bank, Deposit Money Banks 'DMBs' and Non-Bank Financial Institutions 'NBFI'. The mainstream banking sector now consists of 20 DMBs, down from a high of 89 in 2004. In response to the collapse of several banks and the wiping out of depositors' savings, the regulatory scene was tweaked further with the formation of the Nigerian Deposit Insurance Corporation 'NDIC'. This is an independent agency of the Federal Government with a sole mandate of protecting depositors and

guaranteeing the settlement of insured funds when a ‘distressed’ deposit-taking financial institution loses its ability to meet depositor obligations.

1.c. INTEREST RATE LIBERALIZATION

Interest rate regime in Nigeria has remained liberalized since 1987 and the CBN only adopted the policy of fixing its minimum rediscount rate to signal the desired direction of interest rates. This market determination of key lending rates has consequently accelerated the credit money creation momentum over time.

1.d. PROFITABILITY – HIGH INEFFICIENCY LEVELS GOBBLE ALL THE MARGINS

The operational profitability of the mainstream sector has continued to wobble weighed down by surging inefficiency levels. For the FY2011, DMBs recorded a combined loss of NGN6,710 billion compared to a profit position of NGN607.34 billion in FY2010. Between 2004-2011, the sector’s operating expenses grew 76.4%, with the growth in operating income trailing. Between 2004-2010 alone, net interest income grew 32.8%, as the sector’s overall funding base continued to rise; interest expenses rose 82.9% in the same period; total non-funded income grew 45.4%.

1.e. KEY CHALLENGES

Asset Quality – Balance Sheet Repairs Continue

Nigeria’s banking sector has continued to struggle with high levels of ‘toxic’ non-performing loans ‘NPL’. Between 2004-2010, asset quality, as measured by the ratio of NPL to total loans, averaged 16.7%. In 2009 alone, the sector’s aggregate loan book quality stood at 34.6%. Since then, the CBN undertook a number of major steps in a bid to repair the sector’s balance sheet and bring it back to normalcy; first, it injected approximately US\$4.2 billion into the troubled banks and then moved in to guarantee all interbank transactions, foreign lines and pension deposits. The CBN then set up the Asset Management Company ‘AMCON’ to swap all the NPLs with tradable zero-coupon FGN bonds. These actions have contributed to shred the majority of the NPLs (as of the first half of 2012, NPLs have reached 5% of the total loan book).

Operational Risks

According to Deposit Insurance Corporation’s ‘NDIC’ 2011 annual survey results, Nigerian banks lost NGN28 Billion through fraud and forgery cases, a 33.4% y-o-y increase compared to NGN21.29 billion recorded in 2010. Similarly, the Central Bank also reported an increase in ATM-related cases; specifically in the first half of 2011, 116 ATM-related cases were reported, against the 411 cases reported in the full year 2010. Effectively, non-ATM and ATM-related forgery and fraud cases remain an operational challenge to the sector and subsequently calling water-tight surveillance systems in a bid to curb the growing number of reported cases going forward.

1.f. OPPORTUNITIES

Elimination of COT

In Q4 2012, CBN announced plans to consider a reduction of the 5% cost of transaction (COT) or its entire removal from transactions between banks and customers. Currently, a

maximum 5% COT is levied per every NGN1 Million worth of transaction. This presents a great growth opportunity for the sector in as far as inclusion is concerned.

AMCON

The Asset Management Company 'AMCON' was set up in 2009 by the CBN to swap all the NPLs with tradable zero-coupon FGN bonds. In November 2010, AMCON Board approved the purchase of all margin loans in the banking sector and all the NPLs of rescued banks, both totalling in excess of NGN2.2 trillion. This has led to the cleaning up of the sector and it gives banks the leeway to concentrate on building new lending models without having to worry about legacy issues.

2. Ghana: A Second Wave of Recapitalisation in the Offing

2.a. MARKET STRUCTURE

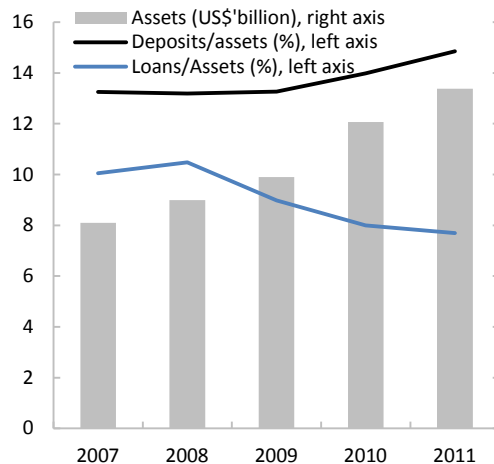
The Ghanaian financial system consists of 26 universal banks (Royal Bank latest to be licensed in 2012 and yet to start operations), 135 rural and community banks, and 49 non-banking financial institutions including savings and loans, leasing and mortgage firms. In addition, there are over 402 credit unions and financial cooperatives as well as thousands of *susu* collectors who serve people in a specific area or organisation. Eleven of the 25 banks currently operating in Ghana are locally owned whilst the rest are foreign majority-owned by Nigerian, African, European and American investors. However, we expect local investors to cede control of more banks to foreign investors as some banks continue to search for capital to meet a new minimum capital requirement of GH¢60.00 million by the close of December 2012. The top five banks consisting of two local banks (Ghana Commercial Bank and Agriculture Development Bank) and three foreign banks (Ecobank Ghana, Stanchart and Barclays) control a significant portion of the market share. The five banks accounted for 45.6%, 39.0% and 46.3% of the total industry assets, loans and deposits respectively at the close of 2011.

2.b. ASSETS AND LIABILITIES DYNAMICS

Since 2007, the total assets of the Ghanaian banking industry grew at the annual rate of 28.2% to GH¢21.23 billion in 2011 (US\$13.39 billion) on the back of economic expansion, the emergence of the oil and gas sector and regulator driven capital raising programme. Ghanaian banks mainly keep their assets in loans and advances, government securities and cash with the central bank. However, the ratio of loans to assets has been on a downward trend in the past five years, declining from 52.4% in 2008 to 38.5% in 2011 as banks preferred to invest in high yielding risk-free Government instruments. Consequently, the ratio of investment in government securities to total assets rose to 20.6% in 2011 from 7.8% in 2008. Overall, during the same 4-year period the loan book of Ghanaian banking industry grew at an average rate of 19.9% to GH¢8.17 billion (US\$5.15 billion) in 2011 due to increased credit to the private sector and households. Interest income moved from GH¢1.17 billion in 2008 to GH¢2.08 billion (US\$1.31 billion) in 2011 due to a higher loan book plus widening of the interest rate spread range in 2011 (16.9% - 26.9%) compared with 2007 (14.9% - 19.6%).

Deposits continued to be a major funding source for Ghanaian banks. The ratio of deposits to assets grew from 66.0% in 2008 to 74.3% in 2011. In addition, there was significant growth in stated capital from GH¢446.11 million in 2008 to GH¢1.58 billion (US\$993.80 million) in 2011 due to the recapitalisation of the Ghanaian banking sector.

Figure 4: Asset and Liability Dynamics: 2007-2011



Source: Ecobank Research

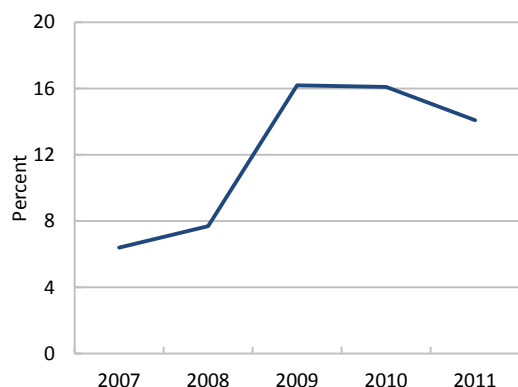
2.c. PERFORMANCE, SOUNDNESS AND STABILITY

Asset quality deteriorated sharply in 2008 and 2009, as the NPL ratio worsened from 6.4% in 2007 to 16.2% in 2010 with indigenous private enterprises accounting for a significant portion of NPLs. Since 2010, however, there has been a significant turnaround on the back of enhanced recovery and adoption of prudent risk management techniques. Accordingly, the quality of the loan book improved to 14.1% in 2011 and this trend continued in 2012.

Asset quality issues notwithstanding, the Ghanaian banking industry remained solvent during the past five years. The capital adequacy ratio (CAR) for the Ghanaian banking sector jumped from 14.8% in 2007 to 19.1% in 2010 as a result of a recapitalisation exercise. Although the CAR fell to 17.4% in 2011 due to substantial increase in risk weighted assets (loans), it was still significantly above the 10.0% threshold for the Ghanaian banking sector.

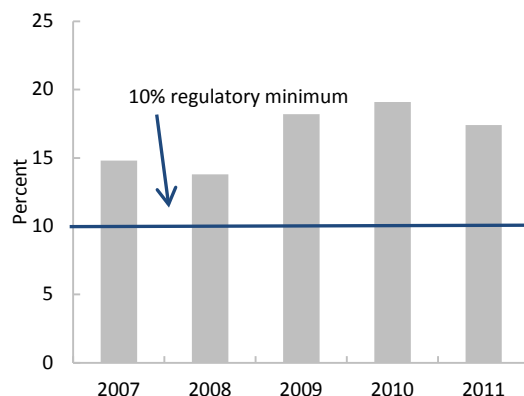
During the past five years liquidity improved due to the conservative approach to lending adopted by some banks. This resulted in a gradual decline in the ratio of loans-to-assets in favour of increased investment in short-term government instruments. The liquidity of the industry was further boosted by the restructuring of the Tema Oil Refinery (TOR) debt that bolstered the liquidity of Ghana Commercial Bank in 2010. The ratio of liquid funds-to-liabilities for the Ghanaian banking sector rose from 41.6% in 2008 to 62.1% in 2011 while the ratio of liquid funds-to-assets improved from 37.3% to 53.6% over the same period. All commercial banks met the central bank's primary reserve requirement of 9.0% at the end of 2011. The average industry domestic and foreign primary reserve ratios were 10.6% and 12.3% respectively in 2011.

Figure 5: NPL Ratio Trend for Ghana's Banking Sector



Source: Ecobank Research

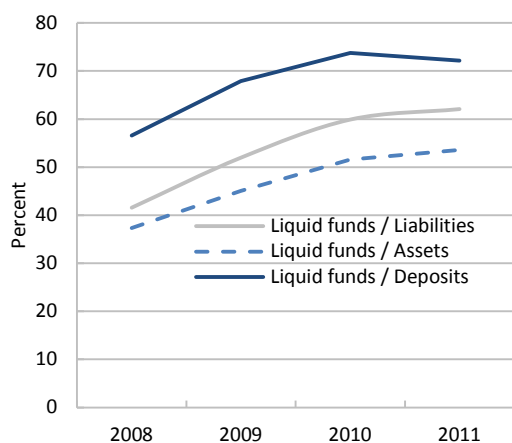
Figure 6: Capital Adequacy Ratio



Source: Ecobank Research

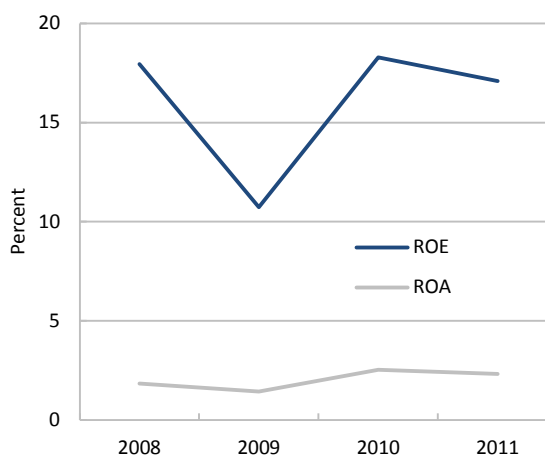
The Ghanaian banking sector remained profitable despite the global financial crisis and the entry of new players who posted losses during the past five years. The profit after tax for the industry jumped from GH¢200.25 million (US\$165.04 million) in 2008 to GH¢494.81 million (US\$311.99 million) in 2011. However, this did not translate into better dividend paid to investors as banks retained a substantial amount of earnings to bolster their reserves in light of a new minimum capital requirement. The dividend pay-out ratio for the industry dropped to 23.0% in 2011 from 30.0% in 2009. With the recapitalisation exercise set to end in 2012, we expect an improvement in the pay-out ratio in 2013 and by which time investors may be pressuring banks for better dividends. Return on equity (ROE) dropped slightly to 17.4% in 2011 due to the 159.0% surge in shareholders' funds to GH¢2.90 billion (US\$1.83 billion) as a result of capital injections into the industry.

Figure 7: Liquidity Trend for Ghana's Banking Sector



Source: Bank financial statements, Ecobank Research

Figure 8: Profitability Trend: ROE and ROA



Source: Ecobank Research

2.d. REGULATORY ENVIRONMENT

The Bank of Ghana (BoG) has been empowered by the Bank of Ghana Act 2002 (Act 612) and Banking Act 2004 (Act 673) to have supervisory and regulatory oversight over the Ghanaian banking sector. The central bank executes this responsibility via its Banking Supervision Department that conducts off-site supervisions based on regular submission of reports in addition to a minimum of one onsite supervision per year. The central bank recently moved from a compliance-based to a risk-based system of supervision.

Significant capital has been injected into the Ghanaian banking sector in the past four years following a central bank directive requiring all banks to increase their stated capital from GH¢7.00 million in 2008 to GH¢60.00 million (US\$31.96 million) by the end of 2012. The capitalisation of the industry grew more than threefold from GH¢446.11 million (US\$367.66 million) in 2008 to GH¢1,576.16 million (US\$993.80 million) in 2011 via capital injections by parent companies of foreign banks operating in Ghana, rights issues and private placements as well as mergers and acquisitions. However, some local banks are yet to meet the deadline due to the keen competition for local and global capital within the set timeframe. We believe that some of these banks will fail to meet the December 2012 deadline and will likely explore the central bank approved option of listing on the Ghana Stock Exchange between 2013 and 2015.

2.e. RECENT DEVELOPMENTS

The central bank started deliberating on raising the minimum capital requirement for banks from GH¢60.00 million (US\$31.96 million) to over GH¢100.00 million (US\$53.26 million) prior to the end of the recent recapitalisation exercise in December 2012. In our opinion, a minimum capital of the equivalent of US\$100 million will better position the Ghanaian banking sector to finance capital-intensive sectors such as oil and gas. This will inevitably lead to a consolidation of the Ghanaian banking sector via mergers and acquisitions to create bigger, well-capitalized banks that can effectively participate in developing a growing Ghanaian economy. We believe that these banks can better contribute to fast tracking Ghana's infrastructure investment, which is estimated to post a deficit of US\$1.10 billion per year.

2.f. CHALLENGES AND OPPORTUNITIES

One of the major challenges facing the Ghanaian banking sector is the lack of matured credit referencing bureaus that banks can rely on for customer credit data. We expect this to ease in the future as the central bank licensed Hudson Price Data and issued a provisional license to Dun and Bradstreet in 2011 in addition to the existing XDS Data Ghana. All banks began sharing credit data and the number of credit checks improved from 13,490 in 2010 to 79,200 in 2011. Another challenge facing the banking sector is the tendency for banks to maintain high lending rates despite reductions in inflation and the central bank's policy rate. Most banks have indicated that their reluctance to reduce the lending rates stems from the existence of low quality loans written in previous years that has become a burden on their books.

The World Bank Financial Inclusion data shows that 29.4% of the adult population in Ghana have access to financial services, indicating that there is a huge opportunity for further penetration of the banking sector. However, there is an ongoing proliferation of non-bank financial institutions and microfinance institutions competing with banks to reach the unbanked segment of the population. In addition, we expect opportunities for loan syndication in the nascent oil and gas, the cocoa and the telecom sectors. For instance, MTN raised GH¢410.00 million (US\$221.27 million) in 2012 through a syndication comprising 16 Ghanaian banks led by Stanbic Bank Ghana, the local arm of Standard Bank (South Africa).

3. WAEMU: Cote d'Ivoire: The Banking Hub of Francophone West Africa

3.a. MARKET STRUCTURE

Cote d'Ivoire is the largest economy in the WAEMU region (West African Economic and Monetary Union, consisting of eight francophone West African countries) with a GDP of US\$24.1 billion, equivalent to 31.2% of the regional GDP in 2011. The country is also the banking hub of francophone West Africa and accounted for 27.8% of aggregate assets for the regional banking industry in 2011. Cote d'Ivoire has a competitive financial system that consists of 23 commercial banks, 72 credit unions and financial cooperatives as well as 10 deposit-taking microfinance institutions. Most of the banks are subsidiaries of French and Nigerian banks while others are owned by the Ivorian Government, African, American and United Kingdom investors. The Ivorian banking market is dominated by four banks including Société Générale de Banques en Côte d'Ivoire – SGBCI (the Ivorian subsidiary of Société Générale Group), Banque Internationale Pour Le Commerce Et L'industrie De La Côte D'Ivoire – BICI CI (the Ivorian subsidiary of BNP Paribas), Ecobank Côte d'Ivoire (the Ivorian subsidiary of Ecobank Group) and Banque Internationale Pour L'Afrique Occidentale (BIAO-CI). The four banks collectively accounted for about 48.8% of the industry deposits and 56.9% of industry loan book in 2011. Although the state-owned Caisse Nationale Des Caisses D'Epargne (CNCE) has a huge retail customer base, this has not translated into a significant market share in terms of deposits and loans.

From a regulatory perspective, the country's banking sector is regulated by the Central Bank of West African States 'BCEAO', which also regulates other member countries within the West African Economic and Monetary Union. The region is also sometimes referred to as the CFA Franc zone because of the common currency in use, the CFA Franc. In total, the WAEMU region currently consists of 96 banks and 10 non-bank financial institutions. The BCEAO is in charge of all aspects of monetary operations in Senegal, but presently does not fix interest rates.

3.b. ASSETS AND LIABILITIES DYNAMICS

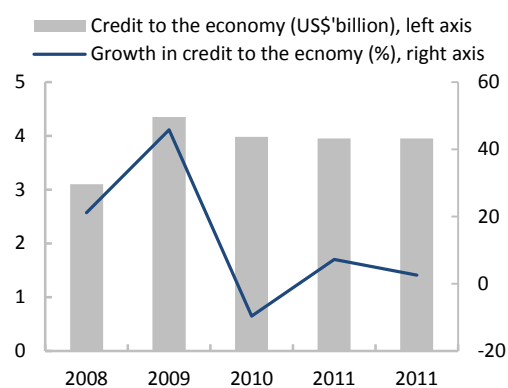
The asset base of the Ivorian banking sector grew by 15.4% (y-o-y) to CFA 4,453.48 billion (US\$8.61 billion) in 2011. The asset composition of the Ivorian banking sector includes reserves, foreign assets, investment in public securities, and credit to the economy. Credit to the economy as a percent of total assets fell from 51.7% in 2010 to 46.0% in 2011. This was driven by two main factors. Firstly, financial intermediation came to a halt in the country following the post-election violence in late 2010 and early 2011 as banks suspended their

Ivorian operations. Although banks eventually reopened their operations in mid-2011, most of them were sceptical about rapidly expanding their loan books due to increased non-performing loans (NPL) traced to the political crisis that disrupted the whole economy. Non-performing loans rose by 58.7% (y-o-y) to CFA126.87 billion (US\$245.22 million) in 2011. Secondly, Cote d'Ivoire's required reserve ratio was raised from 5% to 7% following the decision by the regional central bank (BCEAO) to raise the required reserve ratios to a uniform level of 7% in all countries in December 2010. Since 2007 credit to the Ivorian economy grew at an annual rate of about 12% to CFA 2,047.30 billion (US\$3.96 billion) in 2011, equivalent to 26.2% of the total credit for the WAEMU region. The preference to give short-term loans that constituted 64.8% of the total credit to the Ivorian economy was likely due to political risk and the short-term nature of bank funding. Private sector businesses engaged in manufacturing, tourism, wholesale and retail trade as well as transportation and communication were the key beneficiaries of the expansion in credit to the economy over the past five years.

Deposits remain the main funding source for the Ivorian banking sector. The ratio of deposits to assets grew from 70.9% in 2010 to 74.4% in 2011, with deposits reaching CFA 3,314.12 billion (US\$6.41 billion) in 2011. This was equivalent to 30.3% of the aggregate deposits for the WAEMU region.

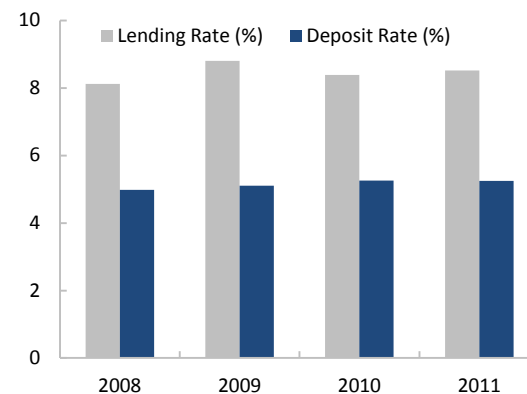
Interest rates have remained fairly stable in Cote d'Ivoire largely due to the pegging of the local currency (CFA franc) to the euro, the currency of its main trading partner (EU). This helps to eliminate exchange rate volatility and imported inflation thereby promoting a stable interest rate environment. Cote d'Ivoire had effective lending rate range of 8.1% to 8.8% in the past four years while deposit rate range was 3.1% to 3.7% over the same period. The effective interest rate spread for the past four years peaked at 3.7% in 2009 before slowing down to 3.3% in 2011.

Figure 9: Credit to the Ivorian Economy



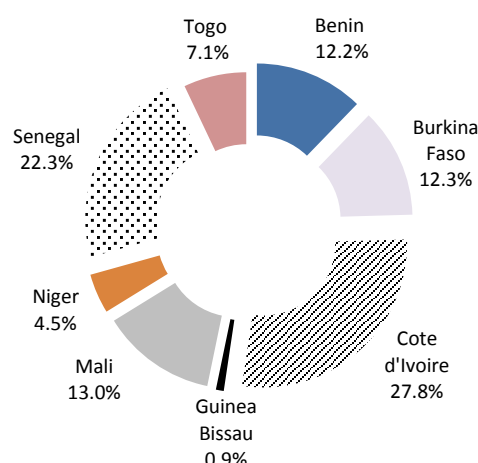
Source: Ecobank Research

Figure 10: Average Lending and Deposit Rates



Source: Ecobank Research

Figure 11: Distribution of WAEMU Banking Assets in 2011



Source: Ecobank Research

3.c. PERFORMANCE, SOUNDNESS AND STABILITY

The Ivorian banking sector is relatively well capitalised. In 2011, the capital adequacy ratio reached 13%. However, the sector remained vulnerable to credit risk mainly due to legacy issues and the unwillingness of banks to write down NPLs for fear that this may cripple recovery. At the regional level, the banking sector of the WAEMU region remained well capitalised in the past five years despite the inability of some banks to meet a new minimum capital requirement at the end of 2011. The capital adequacy ratio progressively improved from 6.8% in 2007 to 13.0% in 2010. However, stress tests conducted by the IMF indicated that the region remained vulnerable to credit risk partly due to legacy issues. Banks were also unwilling to write down NPLs for fear that this may cripple recovery. However, the provisioning rate remained relatively high during the past five years, ending 2010 with a 64.5% provisioning rate. Although the banking sector remained profitable during this period, there were fluctuations in the level of profitability partly due to the high NPLs and the entry of new players. Overall, the return on equity (ROE) improved from 4.8% in 2007 to 10.4% in 2010.

Figure 12: WAEMU: Capital Adequacy

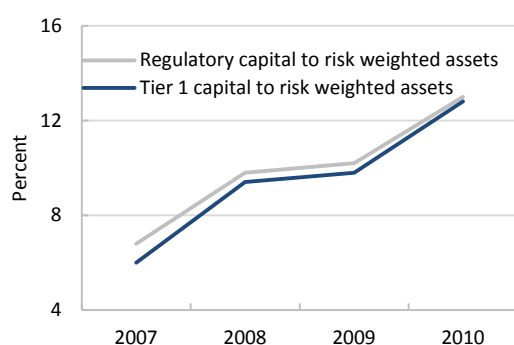
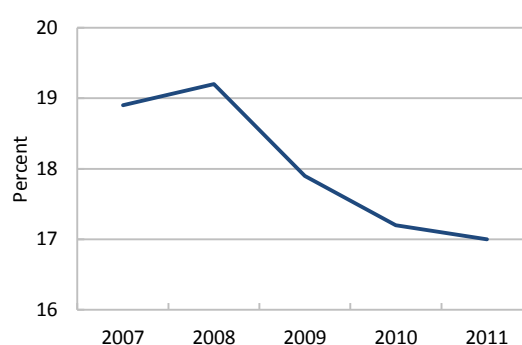
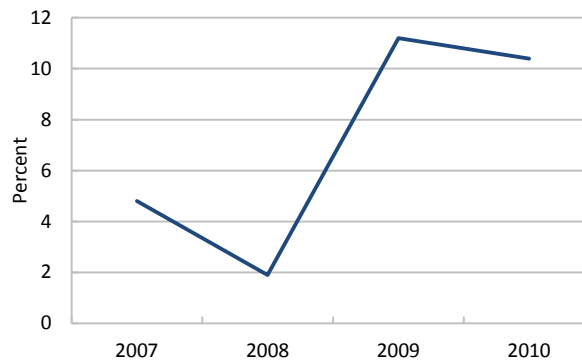


Figure 13: WAEMU: NPL Ratio



Source: Ecobank Research

Figure 14: WAEMU: ROE Trend

Source: Ecobank Research

3.d. REGULATORY ENVIRONMENT

The Ivorian banking industry is regulated by WAEMU regional central bank, Central Bank of the States of West Africa (BCEAO) that executes this responsibility via the Banking Commission of the Monetary Union of West African. A recent study conducted by the IMF indicated that compliance with prudential banking regulations were weak in the region. We think that the central bank needs to allocate more resources to the banking supervision department that will enable it to ensure compliance with prudential regulations and push for the adoption of a good credit risk management framework in a bid to lower the current high NPLs in the region.

3.e. RECENT DEVELOPMENTS

Although the regional banking system contained the recent temporary closure of Ivorian banks in response to the 2010/11 political crisis, the authorities are now discussing ways of better dealing with such situations in the future. Regional authorities are contemplating the establishment of a financial stability fund with the sole aim of addressing such systemic crises. We expect the financial stability fund to boost investor confidence in the region upon fruition.

There is an on-going debate in Cote d'Ivoire on whether there is a need for the privatisation of state-owned banks that are usually faced with a myriad of problems including liquidity shortages and bad management. Privatisation of the banks would help the government to generate revenues and potentially boost its future tax income as private investors revive the fortunes of the banks. The state-owned banks include BNI (Banque nationale d'investissement), BFA (Banque pour le financement agricole), BHCI (Banque de l'habitat de Côte d'Ivoire), CNCE (Caisse nationale des caisses d'épargne) and Versus Bank.

3.f. CHALLENGES AND OPPORTUNITIES

Political instability is the major challenge facing the Ivorian banking sector and the economy at large and stabilisation of the political environment could bring significant growth to the Ivorian banking sector in the next decade. The sector would benefit greatly from capital inflows for the reconstruction of the Ivorian economy following the 2010 post-election

violence. Political stability could also boost investor confidence in the Ivorian economy and this could favourably affect foreign investment. In addition, a potential development of the country's oil and gas resources could provide attractive syndicated lending opportunities for the Ivorian banking sector.

However, another episode of political instability in the next five years could lead banks to scale back their investments in the Ivorian economy. This could potentially place the Ivorian banking sector in a vulnerable position of losing its status as the banking hub of WAEMU to Senegal, the current second largest banking sector in the region.

Further, like most countries in Middle Africa, the lack of collateral and good credit risk assessment framework remain challenges to small businesses and individuals wishing to access credit. The absence of credit referencing bureaus means that Ivorian banks directly evaluate borrowers and are unwilling to share information among them. This has contributed to the current low access to credit and high NPLs in the country.

4. WAEMU: Senegal: Is Mobile Banking the Way to Go?

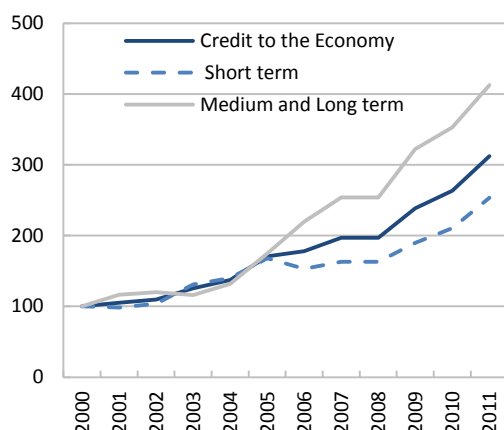
4.a. MARKET INFRASTRUCTURE

Senegal's banking sector is the second largest in the WAEMU zone and it consists of 16 commercial banks and 4 non-bank financial institutions.

4.b. MONETARY GROWTH

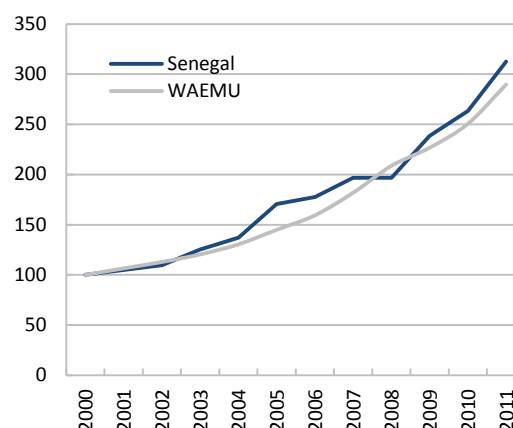
The sector has recorded strong growth levels in both assets and liabilities; specifically, M3 grew by 23.3% between 2004-2011. The economy remains cash-intensive and currency in circulation accounted for 38.2% of the total available money. Credit growth in the region has remained wobbly with credit to the economy in Senegal growing by 31.6% in the 2004-2011 period. Much of Senegal's private sector credit remains short term, typically under two years.

Figure 15: Credit in Senegal



Source: Ecobank Research, BCEAO

Figure 16: Credit in WAEMU



Source: Ecobank Research, BCEAO

4.c. FUNDING

In line with some of the key regional markets, Senegal and the rest of its WAEMU peers, does indeed suffer from liquidity mismatch that has constantly bedevilled its Sub-Saharan peers (especially Nigeria, Ghana and Kenya). Between 2010-2011, demand deposits constituted 50% of the WAEMU region's total deposits (typically demand deposits have a shelf-life of 7-120 days). It is the same case in Senegal with 50% of deposits being demand and consequently implying a funding a mismatch. However, a large portion of the deposits originate from private sector enterprises with Government deposits only accounting for 12.0% of total sectoral deposits on average terms in the same period.

4.d. INTEREST RATES AND SPREADS

Interest rates continue to vary from one lender to another with prime lending rates oscillating between 7-9% across the sector and the maximum lending rates oscillate in the count of 13-18%.

4.e. MONEY MARKET LIQUIDITY AND PRICINGS

The BCEAO manages the entire liquidity operations in the region via 1-week and 1-month securities. Between 2009-2012, 1-month maturities oscillated between 3.50% and 4.25%; this, in our view, implies relative stability on the liquidity front, partly owing to BCEAO's robust liquidity management initiatives. However, the intended pass-through effects of these money market operations by the BCEAO continue to have wide lags and there exists a negative divergence between money market pricings and lending rates. Average base rates on Senegalese banks circle at 8.3%, while lending rates hover at 15.2% on average terms; in our view, these pricings imply spreads of above 10%. Apart from BCEAO's open market operations, the general market liquidity in Senegal remains very high, compared to its WAEMU peers. Despite these liquidity levels in the market, there is a general disconnect in the pricing of lending rates.

4.f. KEY CHALLENGES

Financial Literacy

With a population estimated at 13 million, only 1.56 million people have bank accounts, corresponding to a bank penetration level of 12%. The provision of financial services will remain a big challenge for the sector, especially to the rural population which accounts for 58.5% of the country's total population. Like in the vast majority of sub-Saharan countries, financial services are clustered around major urban concentrations.

4.g. OPPORTUNITIES

Mobile Financial Services (MFS)

While bank penetration remains low at 12%, mobile phone penetration is quite high at 77%, providing a tremendous opportunity for MFS services to widen financial inclusion in the country. Senegal has three mobile network operators which currently provide money transfer and money wallet services in partnership with banks.

5. Democratic Republic of Congo: Asset Quality Remains a Concern

5.a. MARKET OVERVIEW

The financial system in DRC remains small, underdeveloped and scarce despite incorporating commercial banks (20 operational), microcredit finance institutions (28) and other financial institutions. There are approximately 104 branches across the country – giving a ratio of one branch per one million inhabitants. This network of conventional bank agencies is however supplemented by partnership arrangements and ATMs (107). Bank penetration remains below 2%, with the number of customer accounts estimated at around 650,000. Financial sector breadth remains limited as loans accounted for 3.6% of GDP in 2011, below the threshold of 25% for countries in SSA while both stock and corporate bonds are still absent. The demand side is dominated by the informal economy as a combination of adverse economic shocks and economic mismanagement contributed to low confidence in the financial services sector. Consequently, a substantial portion of savings (45.5% of deposits in 2011) is kept out of the economic circuit and remains unavailable for investment by private production enterprises, thus constituting an additional obstacle to general economic growth in the country.

Lending rates have remained high

Lending rates in DRC are exceptionally high averaging 51% for the period 2007 to 2011. The combined effects of the absence of credible credit databases and the government's large borrowing needs are factors that squeeze credit for consumers and keep rates high. In addition, we believe the relatively fresh memory of extraordinarily high inflation rates still has a profound impact on banks' tendency in overestimating medium-term inflation risk. DRC's inflation was estimated 18.4% in 2011 following 26.2% in 2010 and 55.0% in 2009 when the effects of the global financial crisis were deepest. However, bank lending rates have been slow to react to the on-going disinflationary process. Instead, DRC banks have shown a certain viscosity brand behaviour at the cost of customers.

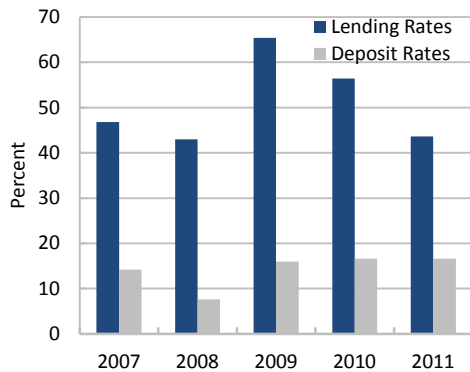
The upward pressure on interest rates is also partly explained by the shortage of savings to finance investments. In the future, we do not expect significant change in savings patterns as they appear to be mostly structural (from the low employment levels due to the narrow production base). Deposit rates have averaged 14.2%, giving spreads of above 30%.

5.b. PERFORMANCE, SOUNDNESS AND STABILITY

Total assets and loans & advances have recorded growth above inflation to reach US\$4.81 billion and US\$1.77 billion in 2011. This has been supported by the growth in deposits (US\$3.00 billion in 2011), retained profits as well as the entrance of new market players. While the majority of loans are very short term, a shift toward medium-term credit has recently been observed as the ratio of long term loans improved to 32.5% in 2010 from 23.6% in 2009. However, the diversity of credit services provided is limited and focuses on loans to the distribution and agriculture sectors. The relative weight of lending in the national currency fell by 7.1% to 10.3% in 2010 as foreign currency loans continued to dominate. The banks in DRC have maintained moderate to low capital ratios in relation to

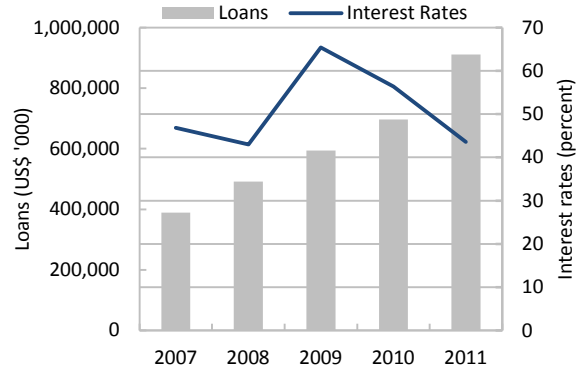
the minimum statutory requirements. The total capital to total assets ratio declined from 12.8% in 2007 to 9.9% in 2011 owing to the increase in the level of distress in some banks.

Figure 17: Interest Rate Trend



Source: Ecobank Research

Figure 18: Credit Growth vs. Interest Rates



Source: Ecobank Research

High cost of credit is not a major impediment to credit finance

Despite high interest rates, credit to the private sector has increased between 2007 and 2011. On the other hand, loans account for only 3.6% of GDP in 2011, reflecting uncertainty associated with the war, as poor capillarity (i.e. the absence of bank branches in rural areas and cities outside Kinshasa); and credit rationing (i.e. banks lend primarily to specific-low risk sectors and large international companies).

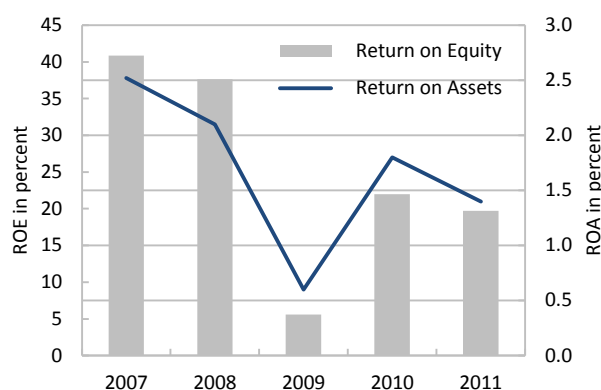
Liquidity in the domestic market remains ample

The ratio of liquid assets to demand liabilities which averaged 76.5% (above the regulatory minimum limit of 20 %) are sufficient to insulate the system from extreme liquidity risk. Research shows that the difficulties faced by banks in enforcing their legal rights as lenders, volatility of deposit holders and cash preference are the main contributors to excess liquidity in commercial banks. In addition, the legacy of hyperinflation and fiscal mismanagement might also explain the risk-averse behaviour of the banks in extending credit (the loans to deposit ratio averaged 36%).

Asset quality remains a concern

Non-performing loans increased significantly to 10.6% in 2009 from 2.8% in 2008, reflecting in part improvements in the accuracy of the reporting system and also the contagion effects of the global financial crisis.

Figure 19: ROE and ROA Trend



Source: Ecobank Research

Table 1: Industry Liquidity Levels

	2007	2008	2009	2010	2011
Liquid assets to total assets	79.8	74.8	75.0	51.4	42.7
Liquid assets to short term liabilities	338.0	326.0	270.0	245.0	196.4
Loan deposit ratio	52.0	75.6	46.3	60.2	59.0

Source: Ecobank Research

5.c. CHALLENGES

Fiscal dominance and dollarization – limiting effectiveness of the monetary policy

Monetary effectiveness has been limited by the high degree of dollarization and the dominance of fiscal policy owing to increased government borrowing from the central bank partly related to the lingering conflict in the eastern provinces.

Infrastructure

The years of war and instability reinforced the failure of the transport network by destroying the infrastructure, blocking key pathways and limiting navigation. In response to the infrastructure bottlenecks, the banking system has been developing “at the borders” while the main industries are establishing production centres next to the urban centres along major roads. Moreover, the fact that vast areas within each province are unreachable from the provincial capitals and from Kinshasa poses a severe limitation for DRC’s growth and for its overall capacity to attract private investment. We however expect the use of mobile money to accelerate access to banking services.

Poor risk management systems

The majority of risk-management systems in the banking sector are not sufficiently robust as there is a heavy reliance on manual systems. Only a handful of international banks operate risk-management processes effectively.

Credit history

The DRC has one credit bureau, supervised by the Central Bank, but its operation is manual and widely viewed as ineffective, where only relatively few clients and mainly corporate clients with large loans are being included.

The above interrelated issues will need to be addressed before banking can become a real engine of growth for the country. Increasing bank coverage across the country will not remove the main binding constraint to access to finance such as weak contract enforceability.

Opportunities

The current level of SOL in DRC is approximately US\$5.0 million against our threshold of USD 100 million needed to sustain the mining sector. DRC banks however still lack the balance sheet muscle to support this SOL growth while international banks, Stanbic, Ecobank and Citi, will adopt the loan syndication model, leveraging parent company experience and funding base to actively support the mining industry. There is still a great need for increased USD financing. Overall growth in the banking sector lies in the DRC's low bank penetration of around 1-2%, amidst a fast growing population of 68 million people.

6. Cameroon: Compliance with the Prudential Norms has Declined

6.a. MARKET STRUCTURE

Cameroon's financial sector is comprised of 13 licenced commercial banks (majority of these banks are owned by non-nationals; subsidiaries of European and other African countries); five financial non-deposit institutions, 500 microfinance institutions (MFI's), 28 insurance companies and four specialised financial institutions. However, despite the diversified financial structure, banking penetration is still low in Cameroon. The Professional Association of Credit Institutions in Cameroon indicated in 2011 that about 4.5% of the adult population in Cameroon had access to formal financial services; a low ratio compared with 24% in sub-Saharan Africa. The industry is largely oligopolistic, principally due to the fact that Afriland First Bank, Banque Internationale du Cameroun pour l'Epargne et le Crédit (BICEC) and Société Générale des Banques au Cameroun (SGBC) dominated both the loans and deposits market in July 2012 having combined market shares of 50.8% and 52.9% respectively.

Despite the growth in numbers, MFI's play a relatively minor role, accounting for less than 5% of total loans in 2011, reflecting insufficient mastery regulations. The situation is compounded by the fact that they are regulated by three different laws: the national law, the Economic and Monetary Community of Central Africa (CEMAC) law and the Organization for Harmonization of Business Law in Africa (OHADA) law.

6.b. ASSETS AND LIABILITIES DYNAMICS

The aggregate deposits for the Cameroon banking industry have grown at around 13% a year since 2007 to US\$6.11 billion at the close of 2011, reflecting increased holdings in Special Drawing Rights from the IMF and the improvement in economic activity from the rise in main export products. During the same period, growth in loans and advances was

significantly larger, averaging 35% a year to reach US\$3.02 billion owing to a surge in bank borrowing by companies involved in public investment projects and by the national oil refinery to compensate for delayed payments of fuel subsidies by the government.

6.c. PERFORMANCE, SOUNDNESS AND STABILITY

The banking sector is in a fragile state as compliance with the prudential norms has declined over the years. In 2011, 9 banks were in violation of the limits on large exposures, a significant increase from two and four non-compliant banks in 2009 and 2010 respectively. In the majority of cases, credit concentration risk is primarily linked to the national oil refinery (SONARA), which turned to bank financing when confronted with liquidity problems on account of protracted delays by the government in settling its payment obligations. The government settled some of its obligations to SONARA through a combination of cash payments, cancellation of taxes, and securitization, but it still owed SONARA CFAF 163 billion (US\$345 million or 1.4% of GDP) at end-2011.

In our view, risks in lending to the private sector are increased by uncertain property rights and weak enforcement of creditor rights and hence the viscous cycle of concentration of credit risks in a few large companies and related-party lending.

Figure 20: M2 Growth vs. Credit Growth

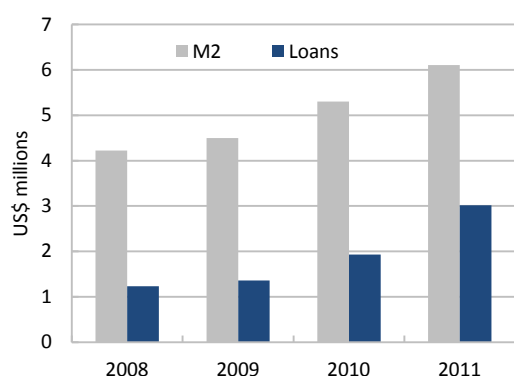
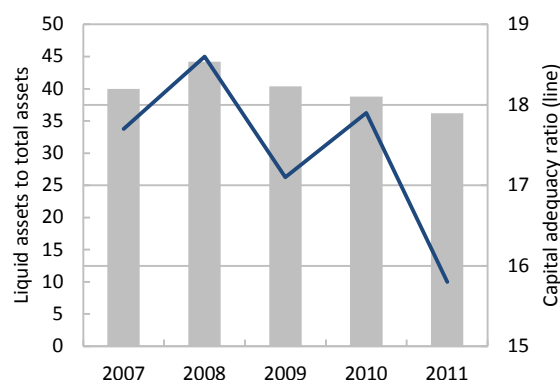


Figure 21: Liquidity and CAR ratios



Source: Ecobank Research

The number of banks below minimum capital requirements rose to five in 2011 from four in 2010 while nearly a third of the banks were in violation of capital adequacy ratios (CAR). The industry CAR declined from 17.7% in 2007 to 15.8% in 2011 mainly owing to the increased number of banks in distress. Noteworthy, the overall CAR numbers however mask major divergences in the position of international banks and regional and domestic banks, with the former reported to keeping buffers well in excess of the statutory limit, while the majority of regional and domestic banks either have low buffers or hold negative equity.

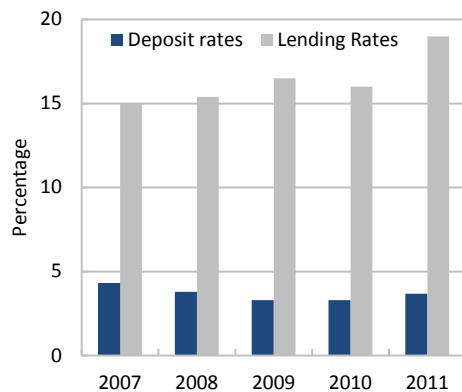
6.d. ASSET QUALITY REMAINS A CONCERN

Nonperforming loans remained high, increasing from 12.5% in 2007 to 14.8% in 2011 in line with the increase in the number of banks in the sector facing insolvency rises. A report from IMF in 2010 reflects the gravity of this issue: the negative equity related to losses on NPLs

associated with one of the larger domestic banks was estimated at CFAF 60 billion (compared to assets valued at CFAF 113 billion). Provisioning for NPLs is reported to have increased to 96.7% of gross NPLs in 2011 from 89.2% in 2010; however, the infrequency of on-site supervisory visits affects the reliability of the data.

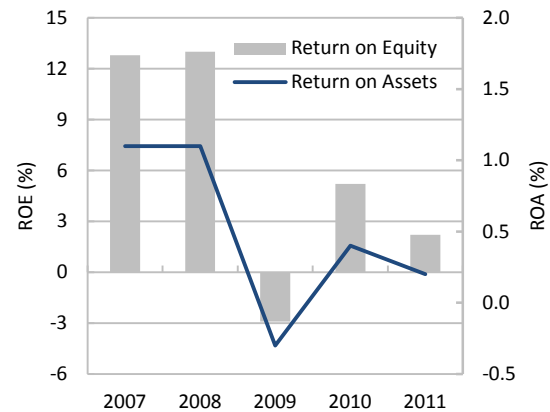
Reflecting the low asset quality level and the impact of the financial crisis, banking system profitability deteriorated, with the ROE dropping from 12.8% in 2007 to 2.2% in 2011. Similarly, ROA fell from 1.1% to 0.2% over the same period. Net interest income accounted for 74.8% of total income in 2008 (latest available income breakdown), reflecting a combination of predominance of non-interest bearing demand deposits and high lending spreads in excess of 8%.

Figure 22: Interest Rate Trend



Source: Ecobank Research

Figure 23: Profitability Trend



Source: Ecobank Research

6.e. LIQUIDITY LEVELS REMAIN HIGH

The banking sector recorded high liquidity levels as reflected by the average ratio of liquid assets to total assets which remained above 35% between 2007 and 2011. The high liquidity goes hand in hand with a low loan to deposit ratio at below 50%, partly attributable to the combined effect of banks mostly financing important or big enterprises and leaving out small-size enterprises. The nature of the deposits remained transitory with more than 75% on the short end.

6.f. RECENT DEVELOPMENTS

Central African Cashless Interbank Group (GIMAC) was launched in 2012 to increase access to banking services in Cameroon and the Central African Economic and Monetary Community (CEMAC) region. The sub-regional platform enables clients of Central African banks to withdraw cash from ATMs in any CEMAC member country. The project is meant to improve access to banking services by lowering transaction costs and facilitating banking platform usage.

6.g. CHALLENGES AND OPPORTUNITIES

The most important weaknesses are situated in the regulatory framework, and more specifically in the insufficiency of the available human resources. The Central African Economic and Monetary Community (CEMAC) created a banking division COBAC - to have the power of administration, regulation, supervision and sanctioning over banks that sought a license. COBAC is understaffed; this resource constraint limits the frequency of on-site inspections, resulting in flaws in offsite supervision and hinders early detection of problems in distressed banks. The situation is further compounded by the failure to assemble viable restructuring plans for the banks already in distress. Another major challenge is the deficit in corporate governance in both, banks and MFIs as the ratio of loans to be granted to the managers is not respected, while internal controls are not effective in most MFIs. Furthermore, the inadequacy of the land tenure rights constitutes a serious obstacle for the registry of collateral by banks.

Growth opportunities for Cameroon lie in two key areas: firstly, restoring central government's capacity to strengthen its supervisory role, while also improving enforcing robust risk management frameworks. Thereafter, the financial sector will be set to improve by taking advantage of Cameroon's strategic position in the integration process in Central Africa through support for infrastructure via syndicated loan structures. While we are of the view that local conditions remain tepid (owing to high lending rates and weak balance sheets), international banks such as Standard Chartered and Citibank will therefore probably adopt these loan syndication models, leveraging parent company experience and funding base to actively support infrastructure growth.

SMEs Finance in Africa: Challenges and Opportunities

THORSTEN BECK^{1 2}

Executive Summary

- It is by providing credit and other financial services to enterprises that the financial sector can have its main impact on helping African economies to grow and reduce stark poverty levels.
- But it is not so much the overall level of credit, but rather the allocation of credit to the most credit-needy and – more importantly – credit-worthy that matters.
- And as I will discuss in the following, it is the smaller firms that often lose out in terms of access to credit, especially in countries with shallow financial systems.
- Financial innovation, in the form of new providers, new lending techniques and new products, however, can help overcome this size gap and help the missing middle emerge.

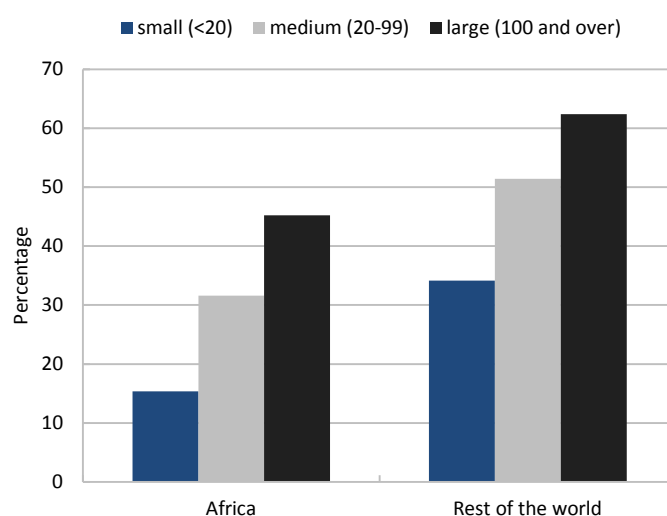
1. The Size Gap in Corporate Finance

One striking characteristic of financial underdevelopment is the limited access of firms to external funding, be it debt or equity. While most firms – even in Africa and even the small ones – have access to deposit and thus payment services from banks, the picture on the credit side is a different one. And alternatives to bank credit are few and far between. Few firms are listed and even fewer have used the possibility to issue corporate bonds. This reduces firms' financing choices to retained earnings, funds from family and friends and supplier credit. Cross-country comparisons have in addition shown that there is also a size gap in corporate finance, with small firms having a more difficult access to external finance than medium-sized firms that in turn have a harder time accessing external finance than large firms. In line with the general shallowness of financial markets, this size gap is larger in African countries than in other developing countries (Figure 1), while the size gap in deposit services is about the same in Africa as in non-Africa developing countries (Figure 2). The other striking observation is that – on average – use of deposit services is as high or even higher in Africa, while access to credit is significantly lower in Africa, across all firm size groups.

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² The views expressed in this document are those of the author and do not necessarily reflect the position of Tilburg University.

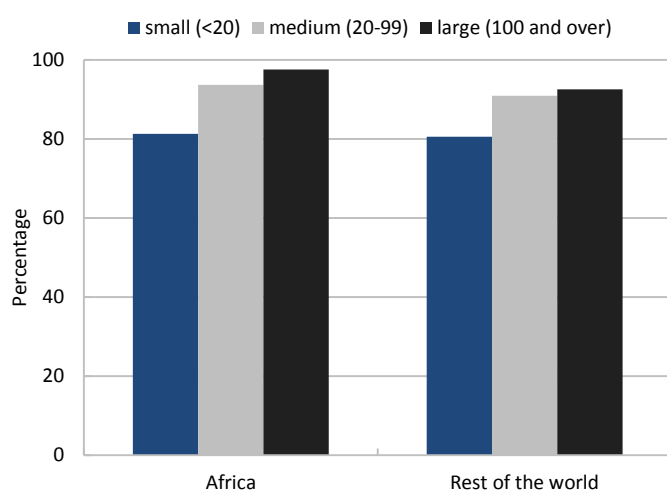
Figure 1: Size Gap in Corporate Finance



Source: Beck et al. (2011), based on Enterprise Surveys

Note: Sample size: 90 countries

Figure 2: Size Gap in Deposit Services



Source: Beck et al. (2011), based on Enterprise Surveys

Note: Sample size: 90 countries

The financing of small and medium-sized enterprises continues to pose significant challenges not only for African financial systems. First of all, however, it is important to distinguish between different segments of small enterprises that have different financing needs and different profiles. A large share of enterprises in Africa are informal microenterprises whose establishment is often the result of lacking alternative economic opportunities. Not being able to produce formal financial accounts or formal guarantees, it is hard to see this segment of the enterprise population becoming bankable over the medium to long term, at least not for credit services. They seem a natural target group for microcredit institutions and rely more heavily than other enterprises on informal finance providers. A second segment are

medium-sized enterprises, often well established and often export-oriented companies that in most cases have access to bank finance, but struggle to get access to equity finance, including through financial markets. Finally, there are small formal enterprises, some of which might have high growth potential. These firms – often also referred to as missing middle – are usually too big for microfinance institutions, but not formal or established enough for banks. It is this group of small enterprises that I will focus on in the following.

The World Bank/IFC Enterprise Surveys provides further insights into the financing structure of enterprises of different sizes and the constraints they face. Small firms consistently report higher financing obstacles than medium and large enterprises, as do younger firms throughout the developing world. Firms' limited access to external finance can be explained both with supply as with demand-side constraints. Banks typically impose high collateral and documentation requirements, citing information barriers and deficiencies in the contractual framework, as well as lack of applicant capacity to prepare clear business plans. There is a tendency towards cash and personal guarantees, as land and machinery are more costly assets to be used as collateral, given deficiencies in the legal system, in collateral registries and the court system. Audited financial statements are a *sine-qua-non* for most banks, though they are not a sufficient condition for banks to grant credit. Finally, there is a tendency towards short-term credit for working capital rather than medium to long-term credit for fixed asset purchases.

Most small firms and even many medium-size firms face high hurdles complying with banks' requirements in terms of collateral and documentation. And the opportunity costs of doing so might be very high, given the high cost of finance and other costs of formality that the business environment imposes. Accordingly, it is not surprising that banks often explain their high liquidity with the lack of bankable projects, while firms complain about the lack of financing for investment projects. Policy has to address the market frictions that drive a spread between supply and demand.

One important area in this context are accounting and auditing standards. Most African countries have weak accountancy professions, partly due to weak education and training programs in accountancy and auditing practices, partly explained by weak oversight institutions. This calls not only for capacity building and development, but also for assistance with institution building. Beyond these important issues, however, is the question whether the standard accounting rules are too much of a burden or even necessary for SMEs. There seems to be a need for the development and implementation of simplified accounting standards, both for micro-enterprises and for small and medium-sized enterprises. This still leaves the question of acceptance of proper financial reporting and the costs this involves on the side of enterprises. Only if enterprises see the benefit of increased access and lower cost of external finance, will they be willing to incur such costs. Financial literacy and business development services can again help to a certain extent in this area.

2. SME Finance and Growth

These deficiencies stand in stark contrast to the growth dividend Africa could reap in the area of SME finance. While a large literature has established a positive impact of financial

deepening on economic growth and poverty alleviation, especially and foremost in developing countries, recent evidence using firm-level data has pointed to SME finance as an important channel. The literature has identified three specific channels.

- The availability of external finance is positively associated with the number of start-ups – an important indicator of entrepreneurship – as well as with firm dynamism and innovation. Klapper, Laeven and Rajan (2006) show that high firm registration costs hamper new firm creation and growth, while property right protection and regulations fostering access to finance are conducive to firm creation and growth. Beck, Lin and Ma (2011) show that banking systems with more effective credit information sharing and higher branch penetration can help reduce informality of enterprises. In addition, access to financial services can help new entrepreneurs survive beyond the first year, as evidence from Bosnia shows (Demirgüç-Kunt, Klapper and Panos, 2009) and can help enterprises innovate at a faster rate (Ayyagari, Demirgüç-Kunt and Maksimovic, 2011).
- Finance also allows existing firms to exploit growth and investment opportunities, and to achieve larger equilibrium size. Beck, Demirgüç-Kunt and Maksimovic (2006) show that firms are more likely to be able to choose the optimal boundary and size of the firm in countries with better-developed financial and legal systems. Small firms do not only report higher financing obstacles, they are also more adversely affected by these obstacles in their operation and growth (Beck et al., 2005, 2008).
- Firms can safely acquire a more efficient productive asset portfolio where the infrastructures of finance are in place, and they are also able to choose more efficient organizational forms such as incorporation. For example, Demirgüç-Kunt, Love and Maksimovic (2006) find that firms are more likely to operate in incorporated form in countries with better-developed financial and legal systems, strong creditor and shareholder rights and effective bankruptcy processes. Incorporated firms have thus a comparative advantage in countries with institutions that support formal contracting, while unincorporated firms are more adapted to operate in countries with less developed formal institutions where firms have to rely on informal institutions and reputation.

3. Bank Finance – Relationship vs. Transaction Lending

In the absence of a functioning contractual and informational framework, banks have found alternative mechanisms to manage credit risk and reinsure repayment. Where credit registries do not exist, information about existing borrowers is exchanged informally among bank executives, obviously, only feasible in small and concentrated banking systems with old-boys networks that in turn strengthen the oligopolistic nature of such banking systems. There is a tendency towards personal and bank guarantees where real estate and mobile assets cannot serve as collateral. Long relationships between a financial institution, or even a specific loan officer, and the borrower allow overcoming problems of information asymmetry and thus risk (Berger and Udell, 1996). Recently the more nuanced view has been put forward that large and foreign banks, relative to other institutions, can have a comparative advantage at financing SMEs through arms-length lending technologies, such as asset-based lending, factoring, leasing, fixed-asset lending, credit scoring, and centralized

organizational structures (see Berger and Udell, 2006 and De la Torre, Martinez Peria and Schmukler, 2010).

The debate on relationship vs. transaction based lending techniques has also implications for which institutions can cater cost-effectively to SMEs. Relationship lending might be better done by small, community based financial institutions, while transaction-based lending is more cost-effectively done by large financial institutions that can exploit the necessary scale economies that investment in technology implies. In many developing countries, this debate has an additional dimension, as smaller banks are often owned by domestic shareholders, while large financial institutions are often foreign-owned. Using data for 91 banks across 45 countries, Beck, Demirguc-Kunt and Martinez Peria (2011) find that foreign banks are more likely to use transaction-based lending techniques and more centralized business models than domestic banks. However, they also show that foreign banks do not tend to lend less to SMEs than other banks. Beck, Ioannidou and Schäfer (2012) show for Bolivia that foreign and domestic banks do indeed cater partly to the same clientele, but with different lending techniques; foreign banks' lending depends, however, on the existence of credit registries and effective collateral protection, an observation confirmed on the cross-country basis (Claessens and van Horen, 2013). It thus seems that both relationship and transaction-based lending techniques are appropriate for SME lending and that both domestic and foreign-owned banks can cater to SMEs.

4. Financial Innovation

New players and new lending techniques are important dimensions of financial innovation. While financial innovation has obtained a bad reputation in many developed financial systems, Africa critically depends on innovative activity by existing and new financial institutions. Other innovations include psychometric assessments as a viable low-cost, automated screening tool to identify high-potential entrepreneurs and evaluate risk and future potential, which have proven very successful in initial pilots in South Africa and other countries. Complementing credit services with other “extension-type” services, such as business development or entrepreneurial training can also be helpful. In general, taking a page from the microfinance lending manual might prove helpful in approaching smaller firms, which face not only financing, but an array of other business constraints.

It is important to note that financial innovation does not arise by itself, but is a consequence of a competitive financial system with not too overburdening regulation. It requires an open and flexible regulatory and supervisory approach that balances the need for financial innovation with the need to watch for fragility emerging in new forms. Such an approach has to take into account the unexpectedness of innovation, in terms of needs, technical possibilities and origin.

5. Looking beyond Bank Finance

Africa's financial systems are heavily bank-based, in line with its level of economic and financial development and the small size of most financial systems on the continent. However, new providers, techniques and products might as well come from outside the banking system and bring competitive pressures on incumbent banks. In the following, I will

discuss a few new lending techniques and financing forms that currently lack in Africa, but might go an important step towards closing the gap.

Leasing can be a prominent instrument for SME financing, especially for Africa. First, collateral requirements have been well documented as one of the main impediments that prevent African SMEs from accessing traditional forms of financing needed to acquire machinery and equipment. Leasing is asset-backed and its applications are often assessed based on the project's capacity to service lease payments. Accordingly, businesses and entrepreneurs that are denied traditional banking and commercial credit due to their lack of credit history and inability to provide sufficient guarantees can find a new financing alternative in the leasing market and also bring more businesses into the formal sector (IFC, 2009). Second, unlike bank credit, leasing provides directly the asset instead of financial resources needed to acquire it, which reduces the possibility to divert funds from their intended purposes. Leasing contracts involve less paperwork and more relaxed credit requirements as well, which leads to shorter waiting periods than for bank loans.

In spite of these advantages, the African leasing market is still in its infancy, representing a tiny one percent share of the world leasing volume (White, 2009). Most leasing markets in Africa are either inexistent or small and underdeveloped, with annual leasing volumes that do not exceed USD 500 million. Even in larger African markets, such as Egypt, Morocco, South Africa, Nigeria and Tunisia which exceed this threshold, penetration rates – measured as annual leasing volume to GDP – is below two percent, compared to ratios above three percent in many markets in Central and Eastern Europe (White, 2009).

Similarly, factoring, the discounting of sales receivable, is attractive for small suppliers of large credit-worthy buyers, as it does not rely on information about the “borrower”, but rather on the obligor (Klapper, 2006). Under a factoring contract, the factor purchases the seller's accounts receivable, with or without recourse, and assumes the responsibility to collect repayments. Originally limited to domestic contracts, international factoring has become popular as it eases the credit and collection burden created by international sales for exporters. Several African middle-income countries have factoring industries, though they are focused more on domestic than international factoring. As leasing companies, factoring companies can only function with a legal framework governing these transactions, but rely to a lesser extent on the contractual framework of a country, so that they can help push a financial system towards the frontier of SME lending, even if this frontier is low.

One important constraint on bank finance is the lack of equity in enterprises. High leverage can prevent enterprises from pursuing more debt, so that lack of equity rather than lack of debt is the binding constraint. On a more general level, equity can be a potentially beneficial financing source for enterprises in their early years and for enterprises with a high risk profile. On the other hand, there are few if any instruments and vehicles for equity finance available in most African countries. Increasingly, there are some equity funds across Africa that specialize in SMEs. Business Partners International (BPI) Kenya SME Fund is a private fixed-life fund established in 2006, which invests in equity, quasi-equity and debt of Kenyan SMEs and has been very successful, ultimately attracting external financing from donors and

private sources. There are several Aureos Capital Funds, focusing on East, West and South Africa, respectively, set up with support from several donors.

6. Demand-side Constraints

While supply constraints are important for SMEs' access to finance, demand-side constraints should not be underestimated. Table 1 presents data from the Enterprise surveys where we explore different categories of banked and unbanked enterprises, for Africa and for non-African developing countries. A first remarkable result is the low number of African enterprises that have a loan. But maybe even more striking is the fact that only 23% of the African enterprises without a loan have actually applied for one as opposed to 40% in other developing countries. Considering the reason for not applying shows additional interesting differences. The share of enterprises that quote the lack of demand as the reason for not applying is significantly lower in Africa (41%) than in other developing countries (64%), suggesting that the lack of demand is less of a problem in Africa than elsewhere. The reason of high interest rates (17% in Africa vs. 12% in other developing countries) as the reason of not applying can have two interpretations. On the one hand, the return on investment projects could be too low. On the other hand, and as noted by many observers of African finance, is that the cost of credit impedes the use of bank finance. Even more striking is the difference in the application procedures as reason for not applying. 18% of non-applicant enterprises in Africa quote this as a reason for not applying as opposed to 6.5% in other developing countries. Collateral requirements also seem more of an impediment in Africa than in other regions of the developing world (9.5% vs. 5%), as is the need for bribes (5.7% vs. 1.8%).

Table 1: Enterprise Credit Demand – Comparing Africa with other Developing countries

<i>Do you have a loan?</i>		
Region	Yes	No
Africa	22.44	77.56
Rest of the world	47.59	52.41

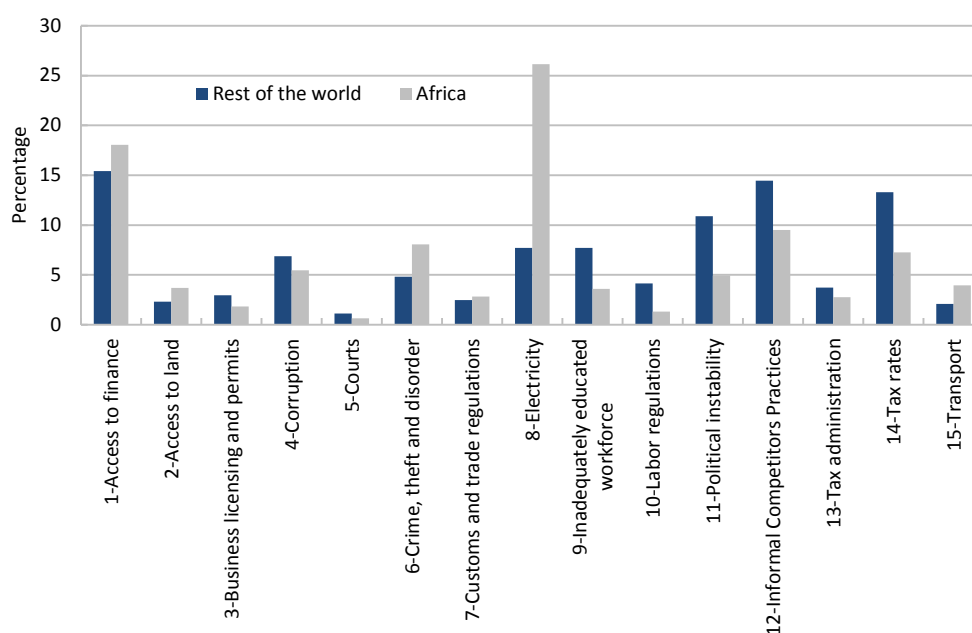
<i>Did you apply for a loan?</i>		
Region	Yes	No
Africa	22.82	77.18
Rest of the world	40.01	59.99

<i>Why did you not apply?</i>		
	Africa	Rest of the world
No need for a loan	40.8	64.44
Application procedures are complex	17.96	6.51
Interest rates are not favourable	16.74	12.48
Collateral requirements are too high	9.55	5.18
Size of loan or maturity are insufficient	2.25	1.68
Necessary to make informal payments to get bank loans	5.69	1.75
Did not think it would be approved	6.92	6.42
other	0.1	1.54

Source: Beck et al. (2011), based on Enterprise Surveys

It is important to stress that financing is only one of the many obstacles that African enterprises face in their operation and growth. As indicated by Figure 3, African firms report not only higher obstacles than firms outside Africa in financing, but also in access to land, customs and trade regulations, transport and – most strikingly – in electricity. This points to the decrepit physical infrastructure that African enterprises have to deal with as well as deficiencies in the broader regulatory environment.

Figure 3: Obstacles in Africa and Elsewhere



Source: Beck et al. (2011), based on Enterprise Surveys

Notes: Sample size: 90 countries

Percentage of firms that rate each item as the most serious obstacle

7. The Role of Government

The discussion of government's role in fostering financial deepening has gone through long cycles over the past 40 years, ranging from market-replacing financial repression over a market-oriented laissez-faire approach in the 1980s and 90s to a more nuanced approach on government's role in the financial sector in more recent years. The modernist agenda has focused on macroeconomic stability and institution building, including upgrading the contractual framework and credit registries (Honohan and Beck, 2007). Credit registries have been heralded as major policy tool to deepen and broaden financial systems by providing more competition and allowing more entrepreneurs and households into the bankable population. Djankov, McLiesh and Shleifer (2007) point to credit registries as a better tool to deepen financial systems than the reform of the contractual framework. However, one has to be realistic about what can be achieved in which timeframe. Negative information sharing will lead to more effective screening of borrowers by lenders with access to information, which – in the first instance – can lead to a reduction in access rather than expansion. Only including positive information can lead to a build-up of reputation capital for existing borrowers and might have an effect on competition and even this can only be felt over time rather than immediately.

While most observers agree on the critical role of governments in building the necessary institutional framework for financial service provision, the discussion on a more activist approach is still on-going. While government entities as financial service providers, especially on the retail level and in credit services, have failed almost everywhere, it is also important to discuss the role of development finance institutions in a wholesale and policy function in alleviating both supply-side and demand-side constraints.

Similar as government-owned financial institutions, direct lending schemes that forces banks to lend a certain part of their portfolio to certain borrower groups have shown limited success and are often open to arbitrage and abuse. A somewhat more promising tool is partial credit guarantee schemes, which can help overcome the lack of collateral of most SMEs. Institutional details, however, are critical to ensure both the sustainability and additionality of such schemes. The design of the scheme can be critical for reaching these two goals, including eligibility, coverage ratio, pricing, and management. There are only a few rigorous impact assessments of such schemes, but such evaluations are urgently needed given the popularity of this policy tool.³

There are other areas for a more activist role of government, as discussed by de la Torre et al. (2008) for Latin America, including helping set-up the necessary platform for factoring or subsidizing fixed costs for banks' expansion into rural areas. While difficult to judge on a broad basis, there is a general lesson coming out of these experiences: Specific government development of new institutions and products should be (i) limited to wholesale facilities, (ii) have strong private sector buy-in and participation, and (iii) have clear sunset clauses and be managed using sound corporate governance structures in the interim.

8. Conclusions

Many of the obstacles facing all users of financial services in Africa weigh especially strong on small and medium-sized enterprises. In order to achieve the financial deepening necessary to benefit these enterprises, Africa's financial policymakers need to think beyond the incumbent players in the banking system and foster competition to foster the financial innovation necessary to close the size gap in corporate finance. The main challenges will be to look beyond banks as credit providers to new players, including financing companies and equity funds, new products, such as leasing and factoring, and new lending techniques such as transaction-based lending.

Competition will be critical to enable the financial innovation necessary to get there. Such competition requires a regulatory framework open to new players and products and which does not stifle innovation with overburdening regulatory restrictions. Government's role has to be redefined, moving from direct provision of financial services to a more wholesale and policy function. While moving beyond institution building towards a more activist role, such policy moves have to be done carefully to create rather than replace non-existing markets.

³ See Lelarge, Sraer, and Thesmar (2010) for an assessment of the French credit guarantee scheme and Larraín and Quiroz (2006) for Chile. See Beck, Klapper, and Mendoza (2010) for a survey of credit guarantee schemes around the world.

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Accessing Local Markets for Infrastructure

MTHULI NCUBE^{1 2}

Executive Summary

- Sub-Saharan Africa suffers from a critical shortage of infrastructure, which condemns it to perform below its potential. Several obstacles constrain infrastructure development and maintenance, including inadequate financing, institutional inefficiencies and poor management of existing infrastructure assets.
- Addressing the deficiencies in sub-Saharan Africa's infrastructure will require investments of about US\$ 93 billion per year, which implies a doubling of existing investment levels. This presents a significant challenge given constrained domestic resources, unpredictable aid flows and financing from emerging markets, as well as a dearth of bankable infrastructure projects.
- Developing sub-Saharan Africa's economic infrastructure at the pace necessary to realize its economic potential will require, among other things, access to large and innovative financing, local and foreign. Local innovative financing that has emerged in the region includes, among others, government infrastructure bonds, diaspora bonds, resource-backed infrastructure financing, specialized infrastructure funds and commodity-linked debt instruments.
- In addition, multilateral development banks have supported infrastructure financing and capacity building on the continent. They have refined their instruments to enhance their intervention in areas of comparative advantage and to unlock restrictions to individual country's borrowing.

1. Introduction

Infrastructure development is critical for and contributes to economic activity by lowering the costs of doing business, improving the competitiveness of local production, and facilitating trade and foreign direct investment. Firms with reliable power supply are able to produce more. Those with access to a world-class highway network can reach their customers faster and cheaper, while those with easy port access are able to source their inputs and export their finished products at a lower cost. The Development of infrastructure has the added benefit of directly contributing to economic output. Hence, in addition to being a factor of production that influences a firm's production and location decisions, infrastructure contributes to the development of both upstream and downstream industries as well as financial markets.

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² The views expressed are those of the author and do not necessarily reflect the views of the AfDB.

This positive relationship is supported empirically³. African countries with the most advanced manufacturing export industries, such as South Africa and Mauritius, have benefited from world-class infrastructure to support their industries⁴. Several studies find a positive correlation between foreign direct investment in Africa (other than investments in extractive industries) and a critical mass of favorable factors, including good quality infrastructure in particular⁵. Both volume and quality of infrastructure also appear to be positively correlated with marginal productivity of capital and with private sector investments⁶. With adequate infrastructure, African firms could achieve productivity gains of up to 40%⁷. And bringing Africa's infrastructure stock to the level of Mauritius' could enhance Africa's GDP growth by as much as 2.2% percent per year⁸.

This paper examines the access to sources of local market finance for infrastructure development in Africa. The remaining sections of the paper are as follows. The next section examines the state of infrastructure access in the continent. Section 3 presents a snapshot view of the constraints to infrastructure development in Africa. Section 4 discusses innovative local sources of infrastructure finance in the continent. Section 6 concludes with the role of the multilateral development banks.

2. State of Infrastructure Access in Africa

Africa suffers from a critical shortage of infrastructure, with a funding gap of the order of US\$50 billion per year. Africa's infrastructure coverage lags behind other developing countries, particularly regarding access to electricity, transport networks, water and sanitation, irrigation, and information and communication technologies (Figure 1).

Power deficits are the continent's biggest infrastructure challenge: per capita power generation is less than half the rest of the developing world's and declining. Not only has electricity access stagnated, but supply has also become less stable, with regular outages reported in at least 30 countries by 2007. Power outages are estimated to cost Africa between 1 and 2% of GDP.

Transportation bottlenecks are equally critical. While Africa's road kilometers per capita have been on the rise thanks to the traditionally extensive public investments into the sector, the continent's highways remain largely fragmented. In addition, road infrastructure in African low-income countries is still plagued by poor quality, as well as low connectivity to ports and international commercial centers. Paved roads account for as little as 5% or less of total roads in some of the least developed countries and Fragile States. In these markets, poor road infrastructure forces some firms to serve only the local market⁹.

³ Anyanwu and Erhijakpor, 2009.

⁴ Soderbom and Teal, 2001.

⁵ Basu and Srinivasan, 2002; Asiedu, 2002.

⁶ Ayogu, 2007.

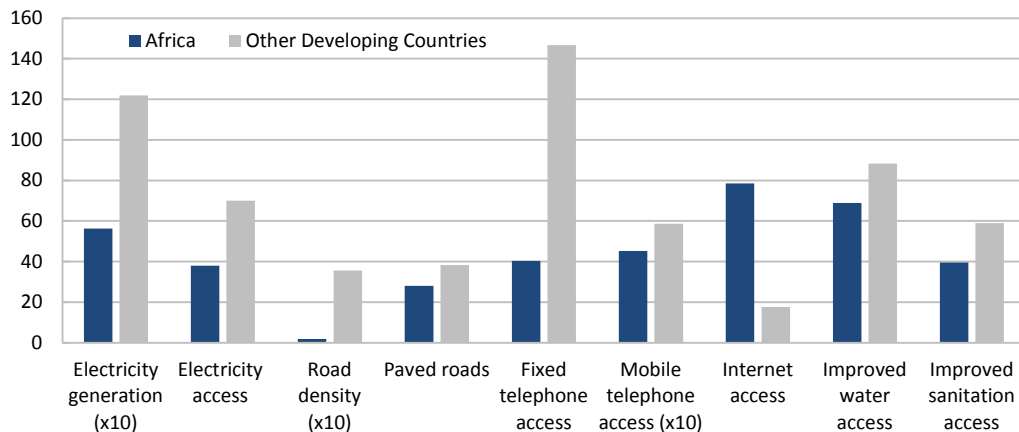
⁷ Escribano et. al., 2008.

⁸ Africa Infrastructure Country Diagnostic (AICD), 2010.

⁹ Ramachandran et al., 2009

Rail infrastructure is, by comparison, far less developed. Only 33 countries have operational rail networks, which are geared toward long-haul general freight, mineral freight, and non-urban passenger services. Most of these countries operate single track, un-electrified systems. Decades of under-capitalization, poor management and general neglect of railways on the continent has rendered some networks defunct, while the majority of operational networks experience a variety of capacity, efficiency and safety problems. When they exist, however, railways tend to be linked to ports and carry lower long-haul costs per unit of freight relative to roads.

Figure 1: Africa's Infrastructure Stock



Source: AICD /2010) and AfDB (2011b)

Note: Electricity generation is measured in kilo watt hours per capita; road density in kilometers per 100 square kilometers of land; paved roads in percentage of total roads; electricity, improved water and improved sanitation access in population percentage; fixed telephone, mobile telephone and internet access in users per 1000 people

Maritime transport in Africa suffers from limited berth and storage capacity. African ports struggle to efficiently handle vessels exceeding 2,000 twenty-foot equivalent units (TEUs), compared to East Asian ports, which have enough capacity to handle vessels of up to 11,000 TEUs. In 2007, African vessels accounted for less than 0.6% of the world's merchant fleet. In the same year, Port Said (Egypt) and the Port of Durban (South Africa) were the only African ports ranked in the top 50 for container traffic, and the continent's containerized cargo throughput was half the volumes handled by large ports in China and Singapore. Africa's ports are also running out of capacity. While port throughput has grown by about 10% annually since 2007, reflecting growing interest from emerging market economies in Africa's natural resources, capacity expansions have not grown as fast.

Air transport services also remain largely inefficient and expensive. Most African airlines' fleets are aging, airports struggle to meet international security standards, and air travel within the continent is among the most costly in the world. The air transport industry, however, is making significant strides. The sector is estimated to have grown by 5.8% per year between 2001 and 2007. Three major hubs have emerged in sub-Saharan Africa – Johannesburg, Nairobi, and Addis Ababa – dominating both international and domestic

markets. New budget airlines are also gaining ground in deregulated markets such as Nigeria, Kenya, the DRC and South Africa, improving service and reducing prices¹⁰.

Access to clean water has improved over the past two decades. While only 49% of sub-Saharan Africans had access to clean water in 1990, the rate had improved to 67% by 2009. Africa still lags behind other developing regions, however. Access to improved water sources is significantly higher in Latin America and the Caribbean (91%) and in South Asia (87%) than in Africa (69%). In addition, 60% of the population has no access to improved sanitation, and only 5% of agriculture is under irrigation.

Access to Internet and Communications Technology (ICT), on the other hand, has not only dramatically improved in the past decade, but also exceeds levels observed in some other developing regions. The proportion of Africans with access to mobile telephones has risen from about 1% in 2000, to over 40% by 2009, well above the access rates for South Asia (33%). Access to internet services is also higher in Africa (11%) than in Latin America (3%), East Asia (2%), and South Asia (less than 1%).

These measures mask significant regional and cross-country differences. The AfDB's Africa Infrastructure Index, which ranks countries on the basis of electricity generation per capita, share of population with access to mobile or fixed phone line, percentage of roads paved and share of population with access to improved water and sanitation, illustrates this diversity (Table 1).

Table 1: Africa Infrastructure Development Index

Rank	Country	Index	Rank	Country	Index	Rank	Country	Index	Rank	Country	Index
1	Seychelles	100	14	Comoros	43	27	Ghana	28	40	Burkina Faso	18
2	Mauritius	90	15	Swaziland	39	28	Cote d'Ivoire	27	41	Togo	17
3	South Africa	81	16	Namibia	38	29	Uganda	26	42	Mozambique	14
4	Libya	80	17	Djibouti	37	30	Rwanda	25	43	Liberia	13
5	Egypt	80	18	Senegal	34	31	Burundi	24	44	Tanzania	12
6	Tunisia	77	19	Malawi	31	32	Angola	24	45	CA R	12
7	Algeria	71	20	Zimbabwe	30	33	Sudan	21	46	Eritrea	11
8	Morocco	59	21	Guinea	29	34	Benin	21	47	Madagascar	7
9	Cape Verde	58	22	Mauritania	29.4	35	Guinea-Bissau	21	48	Niger	6
10	Botswana	57	23	Zambia	28.6	36	Kenya	20	49	Chad	5
11	Gambia, The	49	24	Congo, Rep.	28.6	37	Nigeria	20	50	Sierra Leone	5
12	Gabon	45	25	Lesotho	28.5	38	Equatorial Guinea	19	51	Congo, Dem. Rep.	5
13	Sao Tome and Principe	43	26	Cameroon	28.0	39	Mali	18	52	Ethiopia	4
									53	Somalia	-

Source: AfDB (2011c)

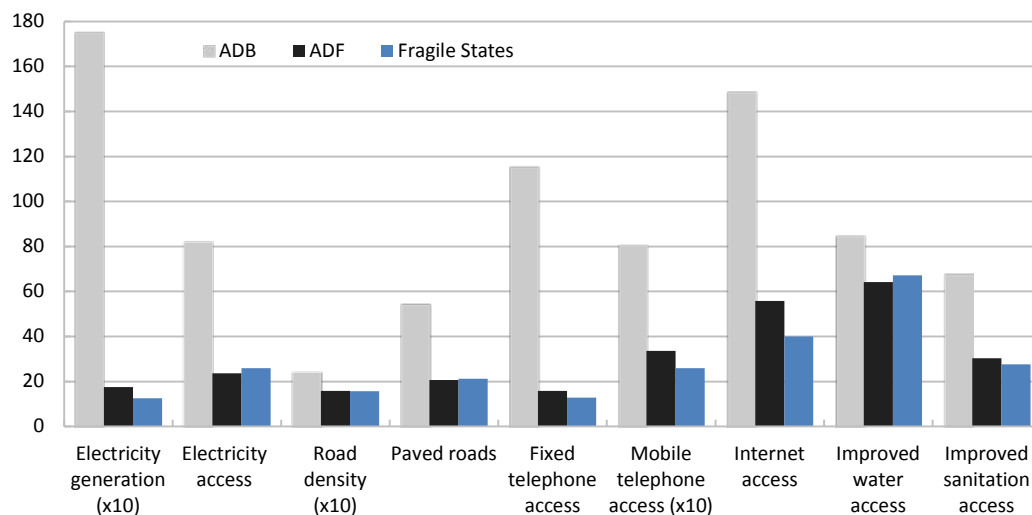
There is wide variability in performance across eighteen access, quality, and cost dimensions. As may be expected, the infrastructure deficit in low-income countries is worse than in middle-income ones, and fragility further weighs on most dimensions. Differences

¹⁰ The Economist, 2011.

are particularly marked with regard to power generation, the density of paved roads and access to landline and mobile telephones as well as the internet, but less so for access to improved water and sanitation (Figure 2). Low-income countries perform better than middle-income ones only on two cost dimensions: charges for general cargo handling and for fixed telephone. This is due to high business telephone prices in South Africa, Morocco and Botswana and to the high cargo handling charges in South African ports.

The divide between rural and urban areas is generally even more pronounced. Access to improved water, for example, is almost twice as high in cities compared to rural areas¹¹. Only one in 10 Africans living in rural areas have access to grid electricity, compared to well over 50% of the urban population. Mobile phones, on the other hand, are shattering the isolation of rural areas, with one out of every two rural Africans now in range of a mobile signal. However, the cost of ICT services, including mobile telephony, remains high in Africa relative to other developing regions.

Figure 2: Access to Infrastructure by Income Level and Fragility



Source: AICD (2010) and AfDB (2011c)

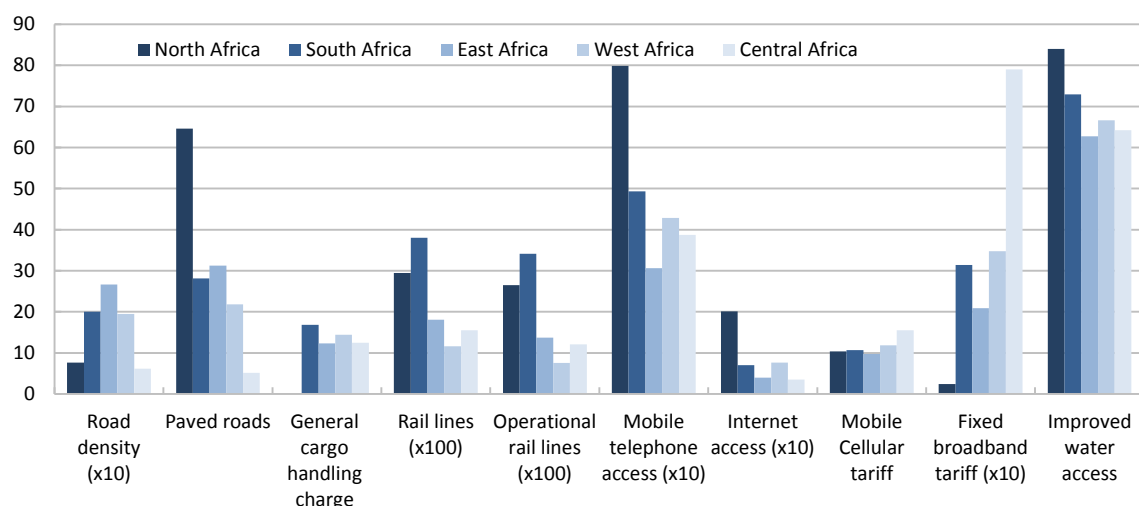
Note: Electricity generation is measured in kilo watt hours per capita; road density in kilometres per 100 square kilometres of land; paved roads in percentage of total roads; electricity, improved water and improved sanitation access in population percentage; fixed telephone, mobile telephone and internet access in users per 1000 people.

Performance across African sub-regions is less variable, although some patterns are noteworthy (Figure 3). North African countries lead in overall performance, but are out-ranked by Southern African countries on density and quality of rail infrastructure. This is principally due to South Africa's extensive rail system, which accounts for 32% of the continent's total rail infrastructure. South Africa is also the only country with a dual track for part of its network and an operating inner-city fast train passenger service. North Africa's rail network, on the other hand, is largely electrified, while only part of Southern Africa's network – including in South Africa, DRC, and Zimbabwe – is so.

¹¹ United Nations, 2011.

Southern Africa outperforms the rest of sub-Saharan Africa except when it comes to the quality of roads, mobile phone and internet user fees, as well as general cargo handling fees, which are the highest on the continent. The latter is explained by South Africa's relatively high cargo handling fees, which are based on cost recovery¹². Central Africa, on the other hand, trails other regions on most measures.

Figure 3: Access to Infrastructure by Region

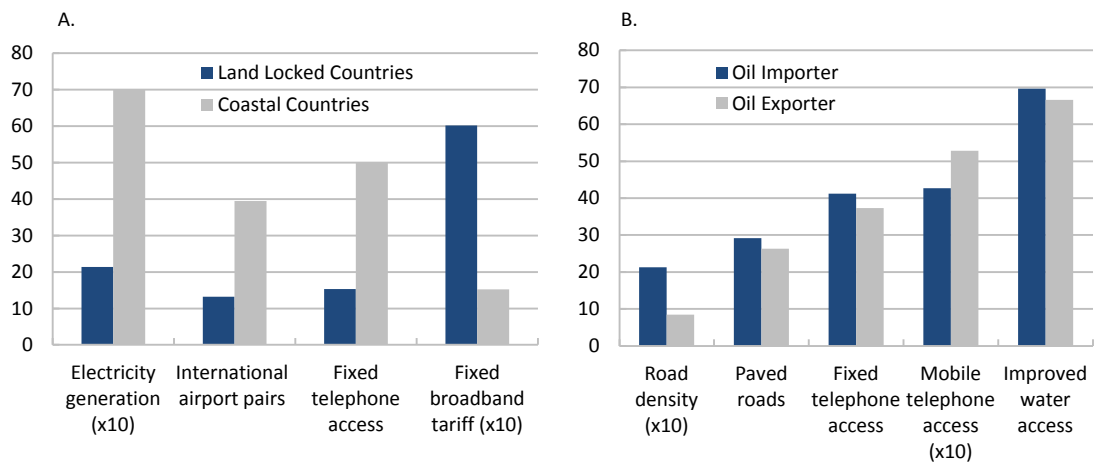


Source: AICD (2010) and AfDB (2011d)

Note: Road density is measured in kilometres per 100 square of land; paved roads in percentage of total roads; general cargo handling charges in US dollars per ton; rail lines in kilometres; improved water and sanitation access in population percentage; mobile telephone and internet access in users per 1000 people; mobile cellular and fixed broadband tariffs in US dollars per month.

Performance in landlocked countries is below Africa's average on all measures. Coastal countries outperform landlocked countries by a factor of three or more on measures such as electricity generation, fixed telephone line access, and airport connectivity. Broadband tariffs in landlocked countries are four times those in coastal countries on average (Figure 4a). Infrastructure stock in oil importing countries, while mostly worse than in oil exporting ones, is on par with the continent's average on measures such as access to clean water, quality of road infrastructure, and access to fixed and mobile telephony (Figure 4b).

¹² South African ports are operated by state-owned Transnet, which operates on a cost-recovery basis (AICD, 2010).

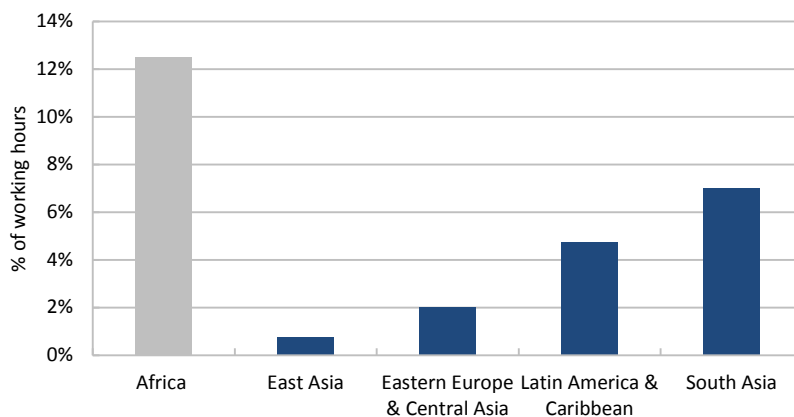
Figure 4: Access to Infrastructure by Location and Oil Resources

Source: AICD (2010) and AfDB (2011d)

Note: Electricity generation is measured in kilo watt hours per capita; road density in kilometers per 100 square kilometers of land; paved roads in percentage of total roads; fixed telephone mobile telephone and internet access in users per 1000 people; business telephone, mobile cellular and fixed broadband tariffs in US dollars per month; water outages in hours.

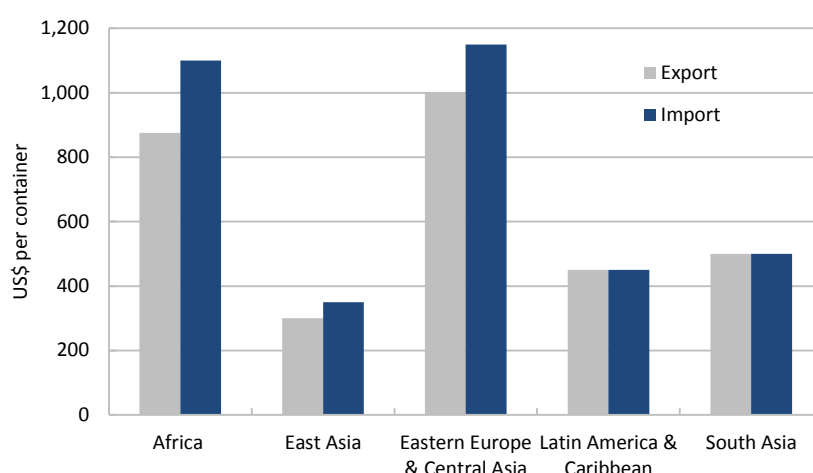
3. Constraints to Infrastructure Development in Africa

The infrastructure deficit condemns Africa to perform below its economic potential. Power shortages, for example, cost the region 12.5% in lost production time, compared to 7% in South Asia (Figure 5). The shortage and poor quality of infrastructure, added to the lack of competition in service delivery, have also resulted in exorbitant connection and user costs when compared to other developing countries. Infrastructure services in Africa cost twice as much on average as in other developing regions and are exceptionally high by global standards. In the transport sector, for example, East Asia, South Asia and Latin America enjoy a significant comparative advantage, with East Asian firms saving close to 70% in transportation costs, while Latin America and South Asian firms save approximately 50% relative to their African counterparts (Figure 6). These costs weigh heavily on Africa's competitiveness.

Figure 5: Productivity Loss from Power Outages

Source: Iarossi (2009)

Figure 6: Inland Transport Costs



Source: Iarossi (2009)

African countries face several constraints regarding infrastructure development and maintenance. These include geographical constraints, deficiencies in planning, poor management of existing infrastructure assets, institutional inefficiencies and regulatory bottlenecks, demand side constraints, and inadequate financing for project preparation and implementation.

Addressing the deficiencies in sub-Saharan Africa's infrastructure will require investments of about US\$ 93 billion per year¹³. In most countries, infrastructure investment needs far exceed available public resources. Fragile States would require the equivalent of 37% of their GDP per year, stable low-income countries 23% of their GDP, and sub-Saharan middle-income countries the equivalent of 10% of their GDP. While spending on Africa's infrastructure had swelled to US\$ 45 billion a year in 2008, the financing burden still falls disproportionately on government budgets, which shoulder 66% of the expenditures, while the private sector covers 20% and traditional development partners and emerging markets (i.e., fast-growing economies outside of the OECD) another 14%.

Doubling existing investment levels will be a significant challenge. Domestic resources are constrained by low savings rates in most African countries, especially oil importers, a narrow tax base, ineffective budget administration, and under-developed capital markets. Traditional official development assistance remains low relative to the continent's extensive needs, is pro-cyclical, and tends to fluctuate in response to changes in donor's development aid agendas. Infrastructure financing from emerging markets is growing, but remains largely unpredictable. Private investments in infrastructure, on the other hand, are hampered by

¹³ This figure pertains to an investment and maintenance program to develop the following infrastructure in sub-Saharan Africa: (1) 7,000 megawatts a year of new power generation capacity (about half through multipurpose dams); (2) Cross-border transmission lines with a capacity of 22,000 megawatts; (3) Fiber optic cable to complete the intraregional fiber-optic backbone network and continental submarine cable loop; (4) Good quality road network to interconnect capitals, ports, border crossings, and secondary cities; (5) All-season road to access high-value agricultural land; (6) Irrigation infrastructure to more than double Africa's irrigated area; (7) Infrastructure to meet the Millennium Development Goals for water and sanitation; (8) Electricity network to raise household electrification rates by 10 percentage points; and (9) Network to provide global systems mobile voice signal and public access broadband to 100 percent of the population (AICD, 2010).

regulation and a dearth of bankable projects on the continent. Meeting Africa's infrastructure financing needs will require innovation to address these barriers.

Innovative local sources of financing infrastructure development in Africa

Developing Africa's economic infrastructure at the pace necessary to realize its economic potential will require, among other things, access to large and innovative financing, local and foreign. In this paper, our focus is on local financing.

Financing for Africa's infrastructure has been predominantly from public resources. The public sector has been most prominent in water, sanitation and transport, where it contributed above 50% of capital investments in the sector in 2001-2006. Private investment, on the other hand, accounted for over 75% of capital investments in ICT over the same period¹⁴. Infrastructure financing in Africa, however, has been changing in recent years, and a new mix of sources—including increasingly private and innovative ones—is emerging. There is no “one size fits all” solution. The right financing mix will depend on a number of factors, including the country's level of financial sector development, indebtedness and business environment. As traditional strategies and sources of finance are not enough, closing Africa's infrastructure gap requires innovations on the part of the public sector, development partners, and the private sector.

Domestically, African governments can increase and channel private savings to productive uses by facilitating the development of local capital markets. Instruments such as corporate bonds or government infrastructure bonds are limited to countries with sufficiently developed domestic bond markets. Other schemes such as sovereign wealth funds and resource-backed infrastructure financing are better tailored for resource-exporting countries (Box 1).

In addition to large institutional investors, local infrastructure investment increasingly includes investors with a stake in the developed asset, such as extractive industries companies that need infrastructure to conduct their operations. The benefits of investments tied to mining can be enhanced if access to developed infrastructure is not limited to the resource extraction operations. New private investors are also emerging in sectors where infrastructure-related revenue streams from off-take agreements are not the only source of revenues. This includes co-generation in the power sector, where electricity is generated as a by-product of sugar and ethanol production in countries like Tanzania, Kenya, and Mozambique, and oil sector gas-powered electricity in Nigeria and Tanzania.

¹⁴ Biau et al. (2008); OECD (2010).

Box 1: Local Innovative Instruments for Infrastructure Financing	
<i>Innovative Government Financing Instruments</i>	
<p>Government infrastructure bonds: These are government bonds issued on the domestic market to finance public infrastructure projects. Since February 2009, Kenya has issued three such bonds with a total value of US\$1 billion, which, in turn, paved the way for corporate bond issues by private and state-owned companies. Kenya's success is partially attributed to its use of incentives, such as allowing the bonds to be used as collateral for bank loans and exempting bond holders from tax on the interest earned.</p>	<p>Diaspora bonds: These are government bonds targeted at a country's diaspora, but can also be offered to the local population. Ethiopia pioneered diaspora bonds with its <i>Millennium Corporate Bond</i> in 2007. The bond raised capital for the state-owned Ethiopian Electric Power Corporation. Other sub-Saharan African countries with large diaspora could raise up to US\$ 5-10 billion per year through the issuance of such bonds.</p>
<p>Sovereign wealth funds: These are government investment funds capitalized from the proceeds of resource exports. When well designed and implemented, these funds can be a significant source of finance for both domestic and foreign projects. The Libyan Arab African Investment Company, which invested US\$ 800 million in 13 African countries in 2008, is a best-practice example.</p>	<p>Resource-backed infrastructure financing: These are loans for infrastructure backed by natural resources. For example, Chinese investments in Angola, Nigeria, and Sudan are backed by oil, in Gabon by iron, in Ghana by cocoa, and in the Democratic Republic of the Congo by copper. It is critical that African governments negotiate equitable deals that correctly value the resources assigned and environmental externalities. The share of royalties and dividends should also be robust to fluctuations in world commodity prices. This form of financing can be re-configured for local investors.</p>
<i>Innovative Private Financing Instruments</i>	
<p>Corporate bonds: These are domestic bonds issued by private firms. South Africa's private sector has been able to tap local capital markets to finance infrastructure projects in water, transportation, and power. The country's capital markets are well developed and long-term credit is available, as well as expertise to arrange more complex transactions such as the EUR 2.5 billion Gautrain project.</p>	<p>Private equity funds: These funds mobilize financing primarily from both international and local institutional investors and traditional financiers, such as Development Finance Institutions. The Africa Infrastructure Investment Fund, for example, was able to mobilize US\$ 5 billion in additional financing in addition to its initial fund of US\$ 500 million.</p>
<p>Specialized infrastructure funds: These are funds created by established infrastructure firms, including upstream industries that invest in various infrastructure projects. They provide a mix of financing instruments, such as equity, senior debt, subordinated debt, or mezzanine finance with exposure ranging from about US\$ 5 to 120 million per project and longer tenors (up to 15 year). The Emerging Africa Infrastructure Fund is an example.</p> <p>Source: Brixiova et al. (2011)</p>	<p>Commodity-linked debt instruments: These are domestic notes linked to specific commodities that can be traded on local exchanges. In August 2010, for example, South Africa's Standard Bank Group offered Rand-denominated notes traded on the Johannesburg Stock Exchange whose returns were linked to the performance of precious metals. The capital was protected and the notes had specific redemption dates. Commodity exporters across Africa could potentially use such instruments to raise funds and hedge against commodity price fluctuations.</p>

In playing its role as financier, the public sector should seek to improve efficiency in the delivery of infrastructure finance. Public savings from efficiency gains can be achieved in part by planning for timely delivery of projects to avoid costly emergency measures, maintenance of existing infrastructure to limit expensive rehabilitation, improving efficiency of utilities, and strengthening medium-term expenditure frameworks, accounting frameworks and auditing procedures.

African governments should also mobilize other domestic resources. Removing exemptions and strengthening tax administration would increase public tax revenues. In low-income countries, where the large informal sectors impede effective direct taxation, excises, value-added taxes, and other indirect taxes can be relied upon. Post-conflict countries may consider utilizing trade taxes and other simplified direct tax structures, before a balance between indirect and direct taxes can be reached.

Given the abundance of natural resources, African countries can tap carbon finance markets to finance low-carbon infrastructure (Box 2). So far though, access to carbon credits by clean technology projects in emerging markets and developing countries has had mixed results across regions, with Africa lagging substantially behind.

Box 2: Tapping Carbon Finance Markets

Africa's reserves of renewable energy—solar, hydro, wind and geothermal—are the highest in the world. On a global ranking of countries by renewable energy reserves, 17 out of the top 35 countries are African. Given its abundant natural resources, Africa is able to embark on a low-carbon infrastructure development path. This would unlock financing from carbon-credit markets through the Clean Development Mechanism and other clean technology funds. The former has the advantages of being market-based, legally enforceable and generally more predictable than concessional financing sources. The latter are crucial to reduce the costs and risks of such investments. Examples include the Clean Technology Fund which supports the adoption of low-carbon technologies in middle-income countries. It is expected to leverage at least five times its value in clean energy solutions, including energy efficiency, renewable energy, and sustainable transport investments. The Global Environment Facility provides grants to low-income countries for projects that promote sustainable development. The challenge for African countries is poor capacity to tap these global funds to adapt to, and mitigate, climate change. To facilitate access, the AfDB is leading resource mobilization into the Africa Green Fund, which will provide direct financing towards qualifying projects on the continent.

Source: Duarte et al., 2010 ; Buys et al 2007

To mobilize private savings, formal financial institutions could offer long term saving instruments, and governments could provide corresponding tax incentives. African governments can also remove regulatory barriers that discourage institutional investors such as pension funds from relying on long-term savings instruments. Moreover, they can help diversify capital markets by developing institutional frameworks encouraging Islamic finance institutions and private equity funds.

African governments also have a critical role to play in providing incentives for private investment in infrastructure projects¹⁵. Such incentives could include risk mitigation

¹⁵ Anyanwu (2009).

instruments, such as viability gap financing¹⁶, among others. Adding “sweeteners” to risky partnerships, such as guaranteed floor returns and tax holidays, could also increase the private investors’ appetite in infrastructure transactions. Such a strategy was recently employed in the Dakar Toll Road project¹⁷.

To unlock private infrastructure finance, Africa needs to increase the number of bankable projects. In addition to project preparation championed by MDBs and donors, private investors should develop and bring projects to the market. In most African countries, however, this is constrained by the absence of relevant procurement processes, rules for handling unsolicited proposals, or mechanisms for competitive bidding. In such an environment, the risk that private investors who bring forth proposals lose proprietorship is high. MDBs and the donor community should consider supporting the development of an enabling environment for project identification and development by private partners.

Aside from reforming procurement rules, consolidating project preparation financing from grant facilities could generate immediate gains. Combining official development assistance in upstream project preparation activities with private finance in project preparation can also be seen in the case of Infraco (Box 3): development assistance is channeled through a commercial vehicle that, because of its higher risk tolerance, is able to absorb project preparation costs and risks.

Box 3: Infraco – Innovation in Project Preparation Finance

Infraco is a donor-funded infrastructure development company that acts as an ‘honest broker’ to link finance providers, the private sector, and host governments in low-income developing countries. Infraco is mostly involved in early stage project development activities and, hence, shoulders much of the upfront costs and reduces entry costs for private sector infrastructure developers. After securing in-principle commitments from providers of finance to support an investment, Infraco will offer the structured investment opportunity to the private sector through a competitive bidding process and in return will get compensated for its time, effort, and cost in the form of a minority carried interest in the venture. Over time, Infraco may sell its interest to national, institutional, and public investors. Infraco is managed as a private sector infrastructure development company with its capital provided by way of share subscription by the Private Infrastructure Development Group (PIDG) which is made up of the development agencies of Austria, Ireland, the Netherlands, Sweden, Switzerland, and the UK, and the World Bank.

Source: www.infracoafrica.com

With improvements in investment climate and project processes, private investments are scaling up, including in sectors traditionally dominated by the public sector, such as roads. Total private investment into African roads grew from a cumulative US\$ 1.4 billion in 1990-1999, to more than US\$ 21 billion between 2000 and 2005. A new wave of private road projects in South Africa, Mozambique, Kenya, Senegal, Cote d’Ivoire adds to the list. The toll road model in particular has now been successful on the continent under both public (South Africa, Tunisia, Morocco, and recently, Zimbabwe) and private systems (South Africa)¹⁸. The

¹⁶ This is a subsidy that can be used as partial capital cost financing for up-front investment needs to encourage private operators’ involvement in critical infrastructure projects with high economic benefits, but low financial returns. Competitive pricing of the viability gap is crucial if such subsidies are to be utilized successfully.

¹⁷ AfDB (2011a).

¹⁸ Brixiova et al. (2011).

strongest recent growth in private investment, however, has been in electricity generation through independent power producers (IPPs) (Box 4).

Box 4: Private Sector Participation in Power Generation

The evolution of IPPs demonstrates opportunities for private sector participation both as financiers and as developers of infrastructure on the continent. Cote d'Ivoire was among the first African countries to attract foreign investors via IPP concessions (the Build Own Operate and Transfer model), soon followed by Egypt, and later Ghana, Morocco, Kenya, Tanzania, Tunisia and Uganda, among others. IPP funding on the continent peaked in 1997 with US\$ 1.8 billion worth of private investment. IPPs contributed US\$ 5.6 billion, or 75% of cumulative investments in Greenfield power sector projects in sub-Saharan Africa, over the period 1990-2008. The trend parallels the power sector reforms implemented across Africa in the past two decades, which liberalized power generation and facilitated regulated competition in the sector.

Private sector participation in the power sector, while offering encouraging potential, also carries some risks, however. The expected benefits of private participation (competition, efficiency, cost recovery, innovation) are not always realized, and competitive bidding processes, competitive pricing and protection of intellectual property rights are necessary. In Cameroon, for example, private participation has not fostered competition; instead market power is concentrated in one public-private entity, AES-Sonel, which limits the potential benefits of regulated competition.

Source: Mutambatsere and Mukasa (2011); Gratwick and Eberhard (2007).

Fostering a regional approach to infrastructure is another source of infrastructure financing through efficiency gains. Indeed, Africa's geography demands a regional approach to regional infrastructure development to ensure efficiency in service provision and maximize resources. The continent could save US\$ 2 billion a year in energy costs by utilizing the existing regional power pools to their full potential¹⁹. Developing the continent's largely untapped hydropower potential through investments in regional infrastructure such as the Grand Inga Project (Box 5) would generate financial returns for Africa's power pools of 20 to 30%, and as high as 120% for the Southern African Power Pool. Similarly, developing a transnational highway network linking all capitals in sub-Saharan Africa could result in trade gains of up to US\$ 250 billion over fifteen years²⁰. Developing regional hubs, particularly in maritime and air transport infrastructure (Box 6), would also boost efficiency.

¹⁹ AICD (2010).

²⁰ Buys et al. (2006).

Box 5: The Grand Inga Project

The ambitious Grand Inga Project, worth US\$ 80 billion, will develop 39,000 MW of hydropower capacity on the Congo River in the Democratic Republic of Congo. The Inga Falls' power-generation potential are second only to the Amazon's. The project's target power generation capacity is equivalent to a third of Africa's total electricity generation capacity in 2009; it also exceeds the capacity of the largest hydropower project in the world, the 18,000 MW Three Gorges Dam in China, which became operational in 2009. The project has been identified as a priority by the Southern African Development Community (SADC) and the New Partnership for Africa's Development (NEPAD). At completion, the dam is expected to supply power to African consumers in Angola, Egypt, Nigeria and South Africa. While the project is far from reaching financial closing, it has drawn considerable interest from leading players in the energy industry, including power companies and development finance institutions such as the World Energy Council and the World Bank, which are leading project development. Issues surrounding the environmental and social impact of the project, as well as the potential exclusion of poor local households, still have to be addressed, however.

Source: <http://www.internationalrivers.org/en/africa/grand-inga-dam>

Box 6: Developing Regional Hubs – Ethiopian Airlines

Regional hubs improve efficiency not only in capital investments, but also in operation and asset maintenance. In air transport, Ethiopian Airlines has emerged as a hub on the east coast and a major African carrier dominating international and domestic markets. In sub-Saharan Africa, Ethiopian Airlines shares intercontinental and intra-African traffic with two other carriers: South African Airways and Kenya Airways. Its intra-African network already spanned more than 20 cities in 18 African countries in 1991, and the company has added new destination to its portfolio, such as Brazzaville in Congo and Kano in Nigeria. As of 2008, Ethiopian Airlines had the highest number of destinations, serving 35 African cities in 26 countries, and accounted for 45% of the traffic on sub-Saharan African '*routes served by only one carrier*'. Ethiopian Airline's aviation training center, established in 1956 to train domestic technicians and pilots, has become a regional hub servicing numerous African carriers. Ethiopian Airlines is currently increasing and modernizing its fleet to increase passenger traffic by about 175% by 2018.

Source: Mutambatsere and Mukasa (2011); AfDB (2011d).

While cross-border infrastructure projects are transformative, they are also challenging relative to single-country projects. Differing priorities across borders and poor coordination of national projects with a regional dimension, among other factors, explain the slow progress in completing strategic investments such as the Trans-African Highways initiative. Inadequacies in project preparation are also particularly evident in regional projects. In addition, these projects have markedly higher transaction costs and complex risk factors for potential financiers. Given their financial scale, they involve multiple financiers, requiring careful coordination to ensure that transactions are efficient and effective. Moreover, execution of multinational projects requires full, effective cooperation among countries and in some cases, harmonization of policies, rules and regulations.

Regional infrastructure operations thus require innovative planning, procurement, and financing. Initiatives such as the Presidential Infrastructure Champion Initiative (also known as the 'Zuma initiative') and the Programme for Infrastructure Development in Africa (PIDA) have taken significant steps towards spotlighting regional integration projects and national projects with regional significance. Success of such regional planning instruments will depend primarily on political commitment and buy-in at multiple levels of government.

It will also depend on the extent to which regional plans are harmonized with national ones in terms of funding priorities, and balancing growth and pro-poor infrastructure investments.

Support for project preparation is making notable progress thanks to technical assistance funds, such as the NEPAD-sponsored Infrastructure Project Preparation Facility IPPF (Box 7). In addition, the Infrastructure Consortium for Africa (ICA), in partnership with the IPPF, EU-Africa Infrastructure Trust Fund, and the Development Bank of Southern Africa, is developing the “Tunnel of Funds” concept, whereby project preparation activities and costs necessary to advance priority regional projects from concept to bankable prospect are identified, and financing packages assembled. The concept is still at a nascent stage, however, and its effectiveness yet to be proven. Facilities to support regional infrastructure projects are also increasingly being established by regional economic communities including the Economic Community of West African States (ECOWAS) and the SADC.

Box 7: The Infrastructure Project Preparation Facility

The IPPF is a multi-donor fund established to assist African countries, regional economic communities (RECs) and their specialized institutions to (i) prepare high-quality and viable regional infrastructure projects, and (ii) develop consensus and broker partnerships for their implementation through public, private or other sources of finance. IPPF is a NEPAD initiative managed by the AfDB with project preparation financing of up to US\$ 15 million per year. The Facility supports regional infrastructure development in the energy, transport, water resources and ICT sectors. In 2010, IPPF contributed about US\$ 9 million toward the development of 10 projects, including two in the energy sector, three in transport and three in capacity building. IPPF prepared regional infrastructure projects worth around US\$ 4.7 billion between 2005 and 2010. While the Facility is a step in the right direction, committed resources—currently standing at US\$ 42 million—are not nearly enough to meet the regional project preparation for the continent.

Source: AfDB (2010e).

Innovation in funding regional infrastructure is also required to ensure an equitable allocation of risks and rewards among partnering countries. Investing in regional infrastructure may represent a disproportionately high, even prohibitive, cost for small economies, while geography often dictates that investments be concentrated in one country.

Challenges to the development of regional infrastructure can be addressed by MDBs providing a higher proportion of their financing towards cross-border projects. Progress at the country level includes the creation of national units in Kenya, Malawi, Mozambique, Nigeria, and Tanzania to help develop multinational projects involving private operators and investors. Such projects are inherently more complex, and often require instruments to help “right-size” the high upfront risk borne disproportionately by private investors. Coordinating PPP regulatory frameworks across sub-regions would facilitate the implementation of such projects. Countries such as the Central Africa Republic are experimenting with innovative PPP models to improve access to clean water in small towns on cost-recovery basis. Overall, infrastructure development strategies must seek to balance pro-growth with pro-poor investments if the current bias in access is to be redressed.

4. The Role of the Multilateral Development Banks

In addition to financing infrastructure and supporting capacity building on the continent, MDBs like the African Development Bank, have refined their instruments to enhance involvement in areas of comparative advantage and unlock restrictions to individual country's borrowing. This includes provision of blended financing packages and risk management instruments to catalyze private finance, building capacity and country systems, and brokering complex regional projects.

Box 8: AfDB's Infrastructure Development Activities	
Lending <ul style="list-style-type: none"> US\$3.7 billion to infrastructure projects in 2010 (60 % approvals) <ul style="list-style-type: none"> US\$ 1.9 billion for transport US\$ 1.2 billion for energy US\$ 650 million for water and sanitation US\$ 50 million for communication US\$1.7 billion earmarked for regional operations for the period 2011 to 2013 	Technical assistance <ul style="list-style-type: none"> Fund for African Private Sector Assistance (US\$ 16 million per year for private operations). NEPAD Infrastructure Project Preparation Facility (US\$ 15 million per year for regional projects). MICs Technical Assistance Fund (US\$ 16 million for operations in middle income countries). Technical Assistant for bond issues in RMCs.
Risk management instruments <ul style="list-style-type: none"> Guarantees <ul style="list-style-type: none"> Partial credit guarantee Partial risk guarantee Hedging products <ul style="list-style-type: none"> Currency swaps Interest rate swaps, caps, collars Commodity/index swaps Indexed loans 	Support to access climate finance <ul style="list-style-type: none"> Setting up the Africa Green Fund to mobilize resources. Supporting pioneer development of clean energy projects at commercial scale (i.e., Cabeolica wind farm in Cape Verde.) Financing energy efficiency projects (reached USD 5 billion for MDBs collectively in 2009) Improving uptake from existing facilities (i.e., Climate Investment Funds, Global Environment Facility).
<p>Between 2008 and 2011, total sovereign and non-sovereign approved investments in infrastructure operations represented 60.4% of the AfDB's total investment in the four core areas. Energy and power received the largest share (47%), followed by transportation (39%), water supply and sanitation (12%), communications (1%) and other infrastructure (2%). In 2011 the AfDB committed UA 5.72 billion toward its operations in all sectors²¹. The largest share of the AfDB Group interventions was targeted at building infrastructure, which comprises transportation, water supply and sanitation, energy, and information and communication technology. This amounted to UA 1.57 billion, representing 38.1 percent of total AfDB Group loan and grant approvals for the year.</p> <p>Source: Source: AfDB (2010f).</p>	

Indeed, the AfDB is involved in financing infrastructure and catalyzing funds through traditional and innovative methods for both the public and private sectors in order to facilitate private sector development (PSD) (Box 8). Over the past six years, the AfDB has increased the volume of financing for infrastructure projects, as well as the proportion of financing that goes to regional projects. The AfDB has also been utilizing blended financing packages and risk management instruments to attract private finance, build capacity in RMCs (Regional Member Countries), and broker complex regional projects. In addition to

²¹ UA: Units of Accounts - AfDB moving average exchange rate.

providing loans for infrastructure development projects, the AfDB has also introduced the use of quasi-equity instruments, such as subordinated loans, to raise the overall return on investment, and/or to enhance credit structures to acceptable risk levels. To address exchange rate risk, the AfDB has contributed to the development of the innovative Currency Exchange Fund. The AfDB has also become increasingly more involved in issuing bonds in local currencies, providing guarantees, and participating in currency swaps markets. In addition, it is promoting capacity building in RMCs to build efficient and sustainable institutions and regulatory frameworks that are robust enough to develop even the most complex projects. The AfDB is also working closely with the African Union through the recently launched PIDA (Programme for Infrastructure Development in Africa), and is developing a road map for the execution of a priority set of regional integration infrastructure projects.

Several instruments have emerged to improve the bankability of projects in high risk environments. Some projects are able to attract a blend of concessional funding and private investment that either raises the overall return on investment or enhances credit structures to acceptable risk levels. Such financing is required for projects where up-front investment is high and the time until revenues are generated is long. Blended financing is also crucial to improve the bankability of complex regional projects, such as the Kenya-Uganda Railways (Box 9).

Box 9: MDBs in the Kenya-Uganda Railways Concession

In 2006, the Kenyan and Uganda governments jointly concessioned their rail networks to a private operator under a 25-year concession agreement. MDBs provided most of the support to bring the projects to closure. The IFC acted as transaction advisor and, in partnership with AfDB, KfW, FMO and BIO, as a financier of the project. The IFC's early involvement catalysed additional financing from the World Bank Group. Concessional funds from IDA financed the environmental and social impact management plans, including a retrenchment plan for the Kenya Railway Corporation. IDA also provided partial risk guarantees to cover the concessionaire and lender from possible failure by the two governments to fulfil their contractual obligations. IDA support to the residual railway corporations also acted to prepare them to take on regulator roles. In addition to financing, the AfDB prepared the resettlement action plans covering the full network, both of which were financed by IDA. MDBs were also able to use their convening power to draw new interest and salvage the concession when the concessionaire faced possible termination of the concession agreement in 2008 after failing to meet performance targets and to pay concession fees.

Source: Mutambatsere et al. (2011).

MDBs can also ramp up risk management support. Commercial and political risk premium can be covered by both debt and equity insurance and by guarantee instruments. While commercial instruments exist, concessional ones such as partial risk guarantees (PRGs) offered by the International Development Agency (IDA) and the African Development Fund (ADF), and political risk insurance offered by the Multilateral Investment Guarantee Agency (MIGA), are more suitable for African Development Fund (ADF) countries. PRGs, for example, have been shown to generate as much as ten times the value of the guarantee in additional financing²². Political risk management instruments also provide governments with incentives to implement reforms that address performance risk. Partial credit guarantees (PCG) have

²² Ramachandaran et. al. (2009).

been used to cover losses in the event of a debt service default caused by either political or commercial risk. PCGs improve the borrowers' access to financial markets by sharing the borrowers' credit risk vis-à-vis the lenders and guarantors. Full credit guarantees or wrap guarantees may also be applied to provide full debt-service cover.

The AfDB is proposing to cover country risk premiums through first-loss guarantees for a portfolio of transactions supported by the AfDB. A portfolio guarantee mitigates the cost of the country risk premium affecting low-income countries and Fragile States. The risk capital freed up could be used exclusively for low-income countries. This option would allow these countries to leverage at least five times the value of the guarantee in additional financing from a non-sovereign pool of lending sources.

MDB-led syndications and B-loans are intended to enable project-level risk mitigation for commercial lenders, spurred by MDBs' preferred creditor status²³. But risk capital utilization and institutional constraints may not allow these institutions to take on this role to significantly match market demand. The same holds for direct equity participation in projects. MDBs can mitigate the equity risk premium arising primarily from political uncertainties through direct or indirect equity participation in infrastructure projects. Indirect participation through equity funds focusing on infrastructure is ongoing, but on a small scale so far²⁴. MBD sponsorship of such specialized funds can influence geographic reach, and facilitate the adoption of international best practices.

In addition, MDBs are experimenting with participation in infrastructure projects through direct equity, although this is still uncommon. Being an equity partner allows MDBs to participate in the early stages of project preparation and attract funding from other sources to cover project development costs incurred by developers prior to financial closing. Quasi equity instruments like subordinated loans are more common. The risk of foreign exchange rate volatility can be addressed through currency hedging, government exchange rate guarantees and devaluation liquidity schemes, among others. However, much greater attention needs to be paid to affordability of these instruments in the African context. The AfDB, for example, has contributed to the development of the innovative Currency Exchange Fund (TCX) which hedges the currency and interest-rate mismatch that is created in cross-border investments between international investors and local market participants, including in sub-Saharan Africa.²⁵

To address capital market bottlenecks, the AfDB has increasingly become more involved in issuing bonds in local currencies, technical support for bond issues, providing guarantees, and participating in currency swap markets. MDBs have also traditionally supported financial markets development through policy-based lending.

MDBs can also provide investment services to institutional investors, who are attracted to infrastructure investments' long-horizon and steady returns, but often lack sufficient local

²³ Preferred creditor status protects the AfDB's properties and assets from requisition, confiscation, expropriation or any other form of taking or foreclosure by executive or legislative action.

²⁴ Brixiova et al. (2011)

²⁵ Brixiova et al. (2011).

knowledge and information of on pipeline transactions. The AfDB provides such investment services to the Japan International Cooperation Agency, and opportunities exist to extend these services to a range of similar investors.

MDBs play a critical role assisting countries to access special envelopes of financing, such as climate finance. For example, the donor-funded Clean Technology Fund will leverage at least five times their value in clean energy solutions, including energy efficiency, renewable energy, and sustainable transport investments. Africa's perspective must be taken into account when decisions on disbursements of global funds for climate change adaptation and mitigation are made. To help facilitate access to these funds, the AfDB is setting up the Africa Green Fund to receive and manage resources to address climate change on the continent.

MDBs, as investors in infrastructure development, can also play a role in improving maintenance particularly in low-income, low-capacity environments. This could be achieved by, among other things, establishing a sound maintenance framework as a prerequisite to major capital investments. They can also play a countercyclical role to support maintenance activities during periods of economic recession. During the recent economic downturn, for instance, MDBs including the AfDB and the World Bank targeted the preservation of strategic assets by providing soft loans or grant facilities for maintenance.

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The EIB in Sub-Saharan Africa

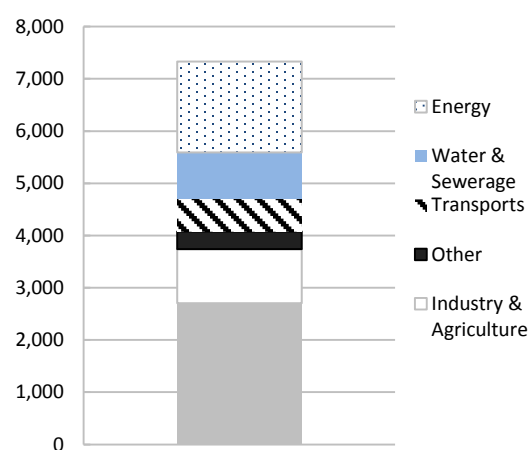
OSKAR NELVIN

The EIB is the European Union's bank. As the world's largest multilateral borrower and lender, the EIB provides finance and expertise for sound and sustainable investment projects in the EU and more than 130 other countries. The Bank is owned by the 27 Member States and the projects it supports contribute to furthering EU policy objectives. Outside the EU, the EIB supports projects that contribute to economic development in countries that have agreements with the EU or its Member States. In 2012, it provided loans totalling over EUR 700m in Sub-Saharan Africa.

Celebrating 50 years of operations in sub-Saharan Africa

Since the beginning of its activities on the African continent in 1963, the Bank has supported over 1000 development projects in 49 countries with over EUR 14bn of funding. The EIB backs projects that deliver sustainable economic, social and environmental benefits. The main focus lies in the fostering of private sector led initiatives with the aim of supporting sustainable private sector led growth and job creation. Support for the development of stronger and more professional financial institutions lies at the heart of that effort. In addition, the Bank backs public infrastructure projects, such as water and sanitation, roads and power plants, which are critical for competitiveness and development. Since 2003, the Bank's activities in sub-Saharan Africa are governed by the so-called Cotonou agreement, which is the main framework for the EU's relations with the partner countries in the African, Pacific and Caribbean (ACP) regions. The main goal is to support poverty reduction, sustainable development, climate action and the progressive integration of the region into the world economy.¹

Figure 1: EIB funding in Sub-Saharan Africa by Sector in mEUR, 2003-2012



Source: EIB/ECON

¹ The Africa, Caribbean and Pacific (ACP)-EU Partnership Agreement (above the Cotonou Agreement) does not cover activities in the Republic of South Africa (RSA). Activities in RSA are instead governed by the EU-South Africa Trade, Cooperation and Development Agreement. EIB has been active in RSA since 1994. Priorities for RSA are similar to those for the ACP countries.

The EIB adds value for partners and clients

The Bank builds on more than 50 years of experience in project finances. Active in the EU and beyond, the EIB actively contributes to knowledge transfer and thereby to improved project design. The Bank offers a wide range of financial products at favourable interest rates. In addition, the EIB offers technical assistance to support project preparation and implementation, especially in countries outside the EU.

Over the last 10 years, the EIB has provided over EUR 7bn of financing in over 30 sub-Saharan African countries, making the Bank one of the biggest multilateral lenders in the region. This effort would not have been possible without close cooperation with leading private and public sector business partners, including domestic and regional banks.

A range of flexible risk bearing instruments

Alongside its standard senior loan product, the EIB invests in credit guarantees, equity, junior loans and subordinated loans.² Currently, the Bank is for example in the process of launching an ACP-wide credit guarantee facility, which aims at improving access to local currency loans for small and medium-sized enterprises (SMEs).³ EIB also backs regional private equity funds – including funds investing in microfinance and local mid-cap enterprises - and it can provide subordinated bank capital to banks in the region. Funding in local currency is also available in a variety of African currencies. Technical assistance is another important product area for the Bank in the region.

Investing in the African financial sector

EIB invests in financial sector development and actively supports access to finance for private companies and households in sub-Saharan Africa. Poor access to financial services and credit is a severe bottleneck to growth in many African countries. The situation is especially troublesome for SMEs and micro enterprises. Eight of the 20 lowest ranked countries in terms of access to credit are located in sub-Saharan Africa, according to the latest Global Competitiveness report from the World Economic Forum. Domestic credit to the private sector amounts to only around 20% of GDP in sub-Saharan Africa⁴ compared to close to 50% in South Asia and Latin America.

The EIB supports financial sector development and access to finance both through intermediated credit lines targeted to specific sectors and through direct financial sector projects. Local intermediaries are used to provide funding to clients that are too small to benefit from direct lending. Most such credit lines are designed to reach SMEs, but the Bank has also used intermediaries in the region to reach smaller scale projects within sectors such as infrastructure, climate mitigation and social housing. Direct financial sector projects are

² In South Africa the Bank's product offering is limited to senior loans.

³ This is a joint project with the International Finance Cooperation and UK's Department for International Development. The guarantee facility will initially be rolled out in 13 sub-Saharan African countries.

⁴ Based on World Bank data from 2011. Excludes South Africa. In South Africa, private credit/GDP amounts to around 70% of GDP.

operations that are directly linked to extending the availability and quality of financial services in the region. Such projects include, for example, financing of branch network extensions or investments in new technology (see box on project focus). They also include technical assistance within specialised areas such as micro finance. Funding can be provided through equity and sub-ordinated debt, as well as through senior loans. Over the last 10 years, EIB credit lines and funding for regional or domestic banks in Sub-Saharan Africa amounted to more than EUR 2.7bn.

Focus on financial sector projects

Promoting financial services in a post-conflict country. Teaming up with Access Microfinance Holding of Germany, as well as the International Finance Cooperation and The African Development Bank, the EIB established Access Bank Liberia (ABL) in Monrovia in 2009. In a country where less than 1% of the population has a bank account, Access Bank Liberia concentrates on providing financial services to the country's informal business sector. A broad clientele of low income retail shop owners, street vendors, craftsmen and farmers have already benefitted from ABL's services. Currently the Bank serves 50,000 clients with a staff of 270. Loans range from USD 200 to USD 7,000, with an average repayment period of six to nine months. Since the launch of operations, ABL has provided local business with over 20,000 loans totalling USD 22.5m and opened over 60,000 bank accounts with deposits amounting to USD 6.5m.

Supporting access to finance and regional integration in financial services. In 2007, the EIB provided EUR 50m of financing to Togo based ECOBANK Transnational, the parent company of the largest independent regional banking group in Africa. The loan from the EIB was used to part-finance the growth of ECOBANK's retail operations - including investments in cost saving technology - and contributed to extending the availability of credit and financial services in the 20 African countries where ECOBANK was active at the time. By supporting a pan-African banking group, EIB also contributed to fostering regional financial integration. Further, by working with ECOBANK's large and international branch network, the project allowed the EIB to reach private sector projects in countries that would otherwise have been difficult to access directly because of small size or weak regulatory frameworks. A similar operation, targeting SMEs, was signed in 2012 with Nigeria based regional bank United Bank for Africa. The purpose of the EUR 75m operation was partly to leverage on the strength of the Nigerian banking sector to access clients in weaker countries in the region.

Using the domestic financial sector to provide housing for low-income households. In 2007, the EIB initiated a EUR 150m programme to fund affordable and social housing projects throughout South Africa. The funding was made available through three of the country's largest commercial banks (Standard Bank, Absa and Nedbank) and two public institutions (the Development Bank of Southern Africa and the National Housing Finance Corporation). With more than half of the world's population now living in urban areas, cities embody some of society's most pressing challenges - in particular in terms of meeting demand for housing at an affordable cost. In South Africa the problem is further complicated by the shadow of the years of apartheid, when different racial groups were geographically separated and enjoyed very different housing conditions and standards. The improvement of housing conditions for the low-income population forms a key part of the South African government's plan for social and economic integration. The EIB financing of affordable and social housing in South Africa has so far funded about 42,000 housing units. Following the success of the project, the EIB is now planning a second programme, which is expected to be put in place in 2013.

Financing infrastructure in Africa

The Bank is also a major provider of infrastructure finance in the region and it provides direct funding for larger African corporates. Eight out of the 20 lowest rated countries in the world in terms of quality of infrastructure are located in sub-Saharan Africa according to the latest Global Competitiveness report – poor roads and insufficient or unreliable electricity supply constitute significant bottlenecks to growth in large parts of the continent. Since 2003, the Bank has committed over EUR 3.5bn to funding infrastructure projects in sub-Saharan Africa. The energy sector accounts for the largest share of this effort (close to 50%) – reflecting the poor state of electricity generation and distribution in many African countries. A special emphasis has been put on renewable energy sources, both as a means to reduce dependence on expensive imported fossil fuels and to contribute to the mitigation of climate change. The bank commits significant funds every year in direct lending to African corporates. In this way the Bank finances larger scale projects in a wide range of sectors, spanning from manufacturing to agriculture.



The European Investment Bank (EIB) is the European Union's financing institution

Under its external mandates, the EIB helps to implement the financial pillar of the EU's foreign policy. It is active mainly in the pre-accession countries of South-East Europe, as well as in the neighbouring countries to the South and East. The Bank also operates in the African, Caribbean and Pacific countries and Asia and Latin America. Its financing activities are aimed at supporting local private sector development, improving social and economic infrastructure and climate change mitigation and adaptation.

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