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prevailing state of managing financial risks for market structures. It addresses the institutional constraints facing financial systems for market transformation and development.

The paper is structured as follows. Section 2 presents the risk characteristics of African financial markets and a summary of the main features of performance in their formal and informal segments. Section 3 analyses the institutional arrangements of each market segment in handling credit risks. Section 4 presents our estimates of the transaction costs associated with the prevailing methods of risk management. Section 5 summarizes and concludes with an evaluation of the implications of these arrangements for the financial market landscape in SSA.

## **2 Risk characteristics of African financial markets and institutional performance**

Lenders are generally exposed to two types of risk in their dealings with borrowers: systemic and idiosyncratic. The high systemic risk originates from unpredictable variations in income as a result of exogenous factors. The high idiosyncratic risk stems from the costly acquisition and asymmetric distribution of information, which can lead to the pervasive problem of moral hazard and adverse selection. Both types of risk are high in SSA countries. Systemic risks are high, as the economies are continuously exposed to large aggregate externally- and policy-generated shocks as well as to high political instability and civil strife (Collier 1996; Adam and O'Connell 1999). Consequently, economic transactions are conducted in highly uncertain and risky environments, which engender eminently more volatile returns to investment and highly variable income streams than in other parts of the world.

The high-risk environment and the frequent incidence of large income shocks heighten demand for mechanisms and institutions for risk management, even if only for sheer survival. Indeed, in many low-income agriculture-based economies, where possibilities of risk management through upward diversification of economic activities have not been exploited, a variety of institutional arrangements such as sharecropping or labour-migration have often served as risk-coping and risk-sharing as well as insurance mechanisms (Mordoch 1995; Bardhan and Udry 1999). However, where aggregate systemic risk is high, effective insurance against large income fluctuations is difficult to achieve through community-based risk-pooling mechanisms (Dercon 2004; Townsend 1995; Conning and Udry 2005). Many recent empirical studies reveal only limited risk-sharing even in small village communities.<sup>7</sup> When insurance markets are missing and insurance possibilities are limited, an act of intertemporal trade to effect resource transfers over time such as saving and credit becomes vitally important for consumption-smoothing (Besley 1995a, 1995b). Credit transaction is seen as an insurance substitute in such circumstances, when market opportunities for risk-sharing are limited (Besley 1995b).<sup>8</sup> Seasonal variability of agricultural production and income

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<sup>7</sup> See Conning and Udry (2005) for the results of empirical tests of the efficient risk-sharing and full insurance hypotheses.

<sup>8</sup> As Besley (1995b) notes, while the distinction between credit and insurance is often blurred, a pure credit arrangement rather than a contract with contingencies is unlikely to be optimal in many risky environments.















































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