Making Finance
Work for Africa

FINANCING AFRICA:
THROUGH THE CRISIS AND BEYOND

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EXECUTIVE SUMMARY

Federal Ministry
for Economic Cooperation
and Development

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Cautious hope is in the air for finance in Africa. While the global crisis may have dented some of the progress made since the beginning of the 21st century, one feels the optimism and sees positive trends. A deepening of financial systems can be observed in many African countries, with more financial services, especially credit, provided to more enterprises and households. New players and new products, often enabled by new technologies, have helped broaden access to financial services, especially savings and payment products. Innovative approaches to reaching out to previously unbanked parts of the population go beyond cell phone–based M-Pesa in Kenya and basic transaction accounts, such as Mzansi accounts in South Africa. Competition and innovation dominate more and more in African financial systems, and, for every failure, there is now at least one success story. However, the benefits of deeper, broader, and cheaper finance have not yet been reaped. Finance in Africa still faces problems of scale and volatility. And the same liquidity that helps reduce volatility and fragility in the financial system is also a sign of the limited intermediation capacity on the continent. Nonetheless, as we discuss below, globalization, technology and increasing regional integration may provide new opportunities for finance in Africa.

The book intends to contribute to the efforts of African policy makers to capture opportunities and overcome the challenges faced by African financial sectors. It includes a stocktaking and forward-looking exercise that shows viable paths to financial sector deepening and broadening. It represents an effort to document existing and new trends in Africa's financial sectors, taking into account Africa's many different experiences. Broad policy messages are outlined for financial systems in Africa on the premise that one size does not fit all. The book also discusses specific segments of the financial sector, such as rural and housing finance; it does not, however, offer an exhaustive and conclusive coverage of these segments. We leave that to more specialized publications in these areas. It builds on and extends substantially the 2007 World Bank publication *Making Finance Work for Africa* by Honohan and Beck that drew attention to the opportunities and challenges of financial system development across Africa. First, it draws on a much broader array of data than the previous publication. Second, it includes North African countries in the analysis, which, along many dimensions, have seen a different path of financial sector development. Finally, it expands on the analysis of the previous publication, including a thorough discussion of the regulatory challenges of finance in Africa. Critically, the world in 2011 is different from the world in 2007. Box 1 summarizes the main differences between the two publications.

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BOX 1. WHAT'S NEW?

The environment has changed

The environment in which African financial systems operate has changed dramatically over the past four years. The number of African countries experiencing a systemic banking crisis has fallen from a peak of 15 in the mid-1990s to a sporadic outlier in the 2000s. Credit to the private sector (as a ratio of gross domestic product [GDP]) has risen by more than 20 percentage points since 1990. There has been an increasing trend toward regional integration within the continent over recent years, though this trend started well before 2007. Kenyan, Moroccan, Nigerian, and South African banks are rapidly expanding operations in the region. Over the past four years, the transformational impact of the deepening and broadening of financial system technology has become clear as well. With over 13 million clients in Kenya, M-Pesa is the world's most widely used telecommunications-led mobile money service.

Globally, too, the environment is different. We might be at the tail end of the first global financial crisis of the 21st century and the Great Recession, but the global financial system has changed for good. The center of economic and financial power has switched to the South and East, which is also reflected in the replacement of the G7 by the G20 as the major international policy coordination body.

The set of information and experiences is larger

Compared with four years ago, we have a much richer and more detailed set of data available. Specifically, we can draw on a systemic data collection effort by the African Development Bank and the Deutsche Gesellschaft für Internationale Zusammenarbeit to develop indicators on the development and structure of financial systems across Africa, as well as regulatory frameworks. Furthermore, the international community has made enormous progress in collecting data on the outreach of financial systems and the barriers to access among enterprises and households; we draw on this experience.

A critical difference with respect to the previous publication is the inclusion of the North African subregion. The inclusion of these countries—different in income level and economic and financial structure—and the comparison with other parts of Africa enrich the discussion in the book and provide additional insights into the process of financial sector deepening and broadening. The recent turmoil in this part of Africa, however, makes many conclusions on the related financial systems appear tentative.

While Africa can learn from the rest of world, the world can learn from Africa, as we will lay out in this publication. The experience with mobile phone banking, for example, shows the power of technology and the potential that payment-led inclusion strategies possess relative to credit- or savings-led inclusion strategies. We will therefore refer to experiences in other regions, but also to experiences in other African countries and how these experiences might be used across the continent.

The focus has expanded

The altered global environment also calls for a somewhat different emphasis. In light of the recent regulatory reform debate in Europe and the United States and in the context of the G20 process, we focus more prominently on the regulatory framework. We argue that the reform suggestions developed in light of the recent crisis have to be adapted with caution to the African context and, even within the African region, to the level of development of different financial systems.

Including North Africa also reemphasizes the need to focus on differences across Africa. Thus, needs and policy options vary between small and large and between low- and middle-income countries, while landlocked, resource-rich, and fragile states face yet another set of challenges.

The previous publication presented two main policy recommendations: (1) strengthen credit and property registries and streamline court procedures and (2) establish independent supervisors. This publication follows a different path by presenting three general main messages, which are then fine-tuned for each of the thematic chapters and also detailed for different country groups.

Some themes and contrasts are maintained from the previous book. The contrast between the modernist approach and the activist approach is also used in this publication to highlight the need for a careful assessment of the role of government, a role that should help create and develop markets rather than replace them. We also build and expand on the distinction between finance for all and finance for growth by highlighting the importance of finance for basic market transactions beyond fostering long-term investment activities.

Financing Africa does not belittle Africa's significant challenges, but it does provide a holistic policy framework within which to analyze the challenges and debate the most relevant policy recommendations for specific local circumstances. The remainder of this Executive Summary is structured into six sections that summarize the main findings and policy recommendations of the six book chapters.

Setting the Stage

In theory, financial institutions and markets exist to help overcome market frictions that make direct exchanges among economic agents difficult. Practitioners typically distinguish (1) payment and transaction services, (2) deposit and savings services, (3) credit services, and (4) insurance and risk management services. These services are often provided by different institutions or in different markets. Yet another, partly overlying distinction is based on different beneficiary groups and time horizons. Expanding on a distinction made in the previous book, this book distinguishes among three concepts: Finance for Markets, Finance for Growth, and Finance for All. This distinction helps us frame the discussion throughout the book.

- *Finance for Markets* relates to financial services that underlie short-term commercial market transactions, such as trade finance, remittance payments, and various forms of short-term credit facilities. This concept relates primarily to the financial system function of enabling market-based transactions within the economy and across borders. By facilitating commerce, financial systems allow the market-based exchange of goods and services beyond the immediate family and community. This concept covers transaction and payment services, including remittances from emigrant workers to their families back home. It covers deposit services for households and enterprises, as well as short-term credit facilities for enterprises of all sizes, including trade credit. These basic services are provided by almost every financial system in the world, even the most rudimentary ones, although at different degrees of efficiency.

- *Finance for Growth* relates to the finance for enterprises and governments that supports medium- and long-term activities (longer than 12 months). Finance for Growth is finance mainly for investment purposes, and it is here that financial institutions and markets fulfill their key function of the maturity transformation of short-term liquid claims—be they deposits or marketable securities—into long-term investment finance. This comprises risk management techniques and the screening and monitoring of entrepreneurs and projects. It relates to large-scale finance, including for infrastructure and agriculture, and finance for small and medium enterprises (SMEs) and to debt and equity instruments, as well as hybrid instruments, such as mezzanine debt and guarantees.

- *Finance for All* relates to the process of expanding financial services both for markets and for growth to the largest possible segment of the population, including households, small enterprises, and large firms. This concept refers to finance both for microenterprises and for small enterprises and households, whereby the distinction between households and microenterprises is often not really feasible. Finance for All overlaps the concepts of Finance for Markets and Finance for Growth, but refers to the process by which short- and long-term financial services, including payment, savings, credit, and insurance services, are pushed out to previously unserved segments of the population. It overlaps with Finance for Markets to the extent that access to basic transaction services is being extended to all segments of the population. It overlaps with Finance for Growth to the extent that more segments of the population gain access to contractual savings services, and microenterprises gain access to investment finance.

It is important to note that these three concepts do not involve a trade-off, least of all the Finance for All approach. It is more about sequencing than trading off. For instance, the existence of efficient financial services for market exchange is the basis for longer-term financial contracts. In Africa, distinguishing among these three concepts is critically important for policy design. While economies and financial systems share many commonalities, there are critical differences. Basic financial services for commercial transactions and short-term credit (Finance for Markets) characterize many low-income countries where formal financial services are limited to a small share of enterprises and households. Middle-income countries see a much larger outreach among banking systems to households and enterprises, a larger variety of financial services and products, and a diversification of financial institutions and markets. However, even among low-income countries, size matters: larger economies are able to sustain larger and more diversified financial systems.

There are also important geographical differences. North African financial systems are dominated by government-owned financial institutions to a much larger extent than are systems in Sub-Saharan Africa, where foreign-owned banks dominate the banking system, while governments dominate in other segments of the financial system, such as the pension sector and the bond market. However, there are also important differences in the challenges that countries face depending on the population density, type of legal tradition (common law or civil code countries), the presence and degree of conflict, and the blessing (or curse) of natural resources. Taking into account these large differences within the region, we use the framework above to develop three main messages resulting from our analysis, as follows:

- *Competition is the most important driver of financial innovation that will help African financial systems deepen and broaden*. Competition, in this context, is broadly defined and encompasses an array of policies and actions. On the broadest level, it implies a financial system that is open to new types of financial service providers, even if they are nonfinancial corporations. It allows the adoption of new products and technologies. We caution, however, that the focus on innovation and competition should not lead to the neglect of financial stability interests; there has been a tendency, however, to err too much on the side of stability in many African countries.

- A second and related message is that *there should be an increasing focus on financial services rather than on specific institutions*. Across all three dimensions (Finance for Markets, Finance for Growth, and Finance for All), we care primarily about the necessary financial services and, only in a second instance, about the institutions or markets that provide these services. If nonbanks are better than banks in providing certain financial services, they should be allowed to do so. In this context, it is important to emphasize that one size does not fit all; smaller and low-income countries are less able to sustain a large and diversified financial system and might have to rely more on international integration.

- Finally, there is a *need for increased attention on the users of financial services.* Turning unbanked enterprises and households into bankable and, ultimately, banked customers involves more than pushing financial institutions down-market. Achieving such change requires financial literacy, that is, knowledge about products and the capability to make good financial decisions among households and enterprises. It also implies addressing nonfinancial constraints, such as, most prominently, in the area of agriculture. It includes a stronger emphasis on equity financing for often overleveraged enterprises. It also includes the consumer protection framework, though what suits South Africa might be too costly in resources and skills for Malawi, for example.

The book's three main messages and their implications for domestic policy makers across the three themes of the book—expanding, lengthening, and safeguarding finance—are summarized in table 1 and discussed in the remainder of this summary.

Table 1. Holistic Financial Sector Development Policies

Policy	Expanding access	Lengthening contracts	Safeguarding finance
Fostering competition	1. Innovation can come from an unexpected quarter	4. Need for new providers and products	7. Mitigate risks of competition
Looking beyond institutions	2. Services matter, not who provides them	5. Look beyond traditional providers	8. Supervise according to risk, not name
Addressing demand-side constraints	3. Financial literacy	6. Business development, including skill development	9. Consumer protection

Source : Author compilation.

In arriving at these conclusions, we are especially cognizant that the characteristics of a host economy provide the backdrop before which financial institutions and markets have to operate and address the challenges of scale and risk management. African economies show several adverse circumstances—already pointed out in the previous publication—that make it more difficult to overcome the two market frictions of size and risk, as follows:

- The *small scale* of many economies does not allow financial service providers to reap scale economies. The small size of African economies is driven by the low income level across the continent, but also by the small size of countries. The demand for small transactions, be they savings, insurance, credit, or even simply payments, means that a large part of the population of African economies are not commercially viable customers. The dispersed populations in many African countries make financial service provision outside urban centers cost-ineffective. Despite the increasing trends toward urbanization, large parts of the population in Africa still live in rural areas. The small size of financial systems does not allow financial institutions to recover the fixed costs of basic systems and might undermine competition if the system does not sustain more than a small number of institutions.

- *Informality* in large parts of the economy and among economic agents increases the costs and risks for financial institutions and excludes large segments of the population from formal financial services. Many firms and households do not have the necessary formal documentation, such as enterprise registry, land title, or even formal addresses, to access financial services efficiently.

- *Volatility* increases costs and undermines risk management. On the individual level, it is related to informality and the consequent fluctuations in income streams among many microenterprises and households. This means these agents are less attractive for financial institutions. On the aggregate level, volatility refers to the dependence of many African economies on commodity exports, which makes economies vulnerable to the large price swings in commodities. Volatility on the aggregate level also refers to political and social unrest, from which Africa has suffered during the past 50 years of independence. Volatility increases the costs, but especially the risks for financial institutions and markets.

- *Governance* problems continue to plague many private and government institutions throughout the continent and undermine not only the market-based provision of financial services, but also reform attempts and government interventions aimed at fixing market failures. These governance challenges are widespread, ranging from many financial institutions, including banks, microfinance institutions (MFIs), and cooperatives, to government institutions, including development finance institutions. Governance problems have been at the root of many financial crises on the continent. They also affect directly the ability of financial institutions and markets to manage borrower-specific and systemic risks. The governance challenge and agenda contain a large number of dimensions, from political stability and accountability over the control of graft to the rule of law.

The above four characteristics of African finance call for innovative solutions to overcome the barriers of size and risk. Three phenomena—globalization, regional integration, and technology—offer such solutions, but also represent pitfalls.

- *Globalization:* Integration into international financial markets has been an important, but controversial aspect of financial sector policy throughout the world in past decades and even more so after the recent crisis. While most African countries have opened up their financial systems to foreign bank entry, capital account restrictions are still in place in many countries, although often more de jure than de facto. Capital account liberalization has long been seen as an important component of the modernist Washington-consensus agenda. Yet, the crisis experience in East Asia and other emerging markets in the 1990s led to a more cautious approach that focuses more on long-term capital inflows (foreign direct investment), rather than short-term portfolio flows, and that imposes additional safety lines on macroeconomic management. This debate has gained fresh importance during the current attempt of emerging markets to use capital flow restrictions to counter capital inflows from developed markets as a consequence of the quantitative easing policies applied in these countries.

- *Regional integration:* True, regional integration has been on the agenda of African policy makers since the time when many countries achieved political independence. And, prima facie, there is an enormous potential for Africa in overcoming scale diseconomies by coming together. Not surprisingly, there have been numerous attempts at moving closer toward such cooperation. However, the results have been limited so far. One reason for the limited integration has been political; another is overambition, as is obvious from the effort to establish a pan-African currency union; another still is weak implementation. For this reason, focusing on smaller, economically and institutionally more homogeneous subregions, such as East Africa, might be more promising than trying to integrate larger subregions containing countries at different levels of financial development and with different institutional and legal frameworks.

- *Technology:* Technology can help mitigate the scale-related and the risk-related frictions. Technology can help reduce transaction costs, especially the fixed costs component. It can help reduce operational risk as it minimizes the chances of theft and fraud. Financial services via mobile phones offer African financial systems the chance for a transformational banking model by leapfrogging conventional banking models and substantially reducing transaction costs. Moving away from the brick-and-mortar model of banking with high fixed costs toward mobile phone technology, where most of the costs are variable, can help overcome diseconomies of scale. For instance, weather insurance built on exogenous indicators can, at low cost, help overcome information asymmetries between those insured and insurance companies.

Globalization, regional integration, and technology offer new opportunities, but also challenges, which we discuss throughout the book. All three trends will also have an impact on the relative role of the private and public sectors. There will be more space for private service providers to deepen and broaden financial systems, while the public sector has to redefine its role and face new challenges in regulation and supervision. Globalization, regional integration, and technology will provide new challenges to financial sector regulators. Globalization and regional integration will require closer cooperation between home and host country regulators of crossborder banks in that home and host countries will be increasingly outside the developed world. Technology, especially in mobile financial services, will require closer cooperation between regulators in different sectors, but also a more substantive, but agile regulatory approach.

The changes in globalization and the new opportunities that technology provides also raise new challenges for governments. The crisis has reinforced the need for an open debate on the role of government. The previous publication addressed this debate by distinguishing between *modernism* and *activism:* the caricatures of two approaches to financial sector policy. While modernism focuses on creating the necessary preconditions for modern financial markets to emerge, including the necessary legal and regulatory reforms, activism aims at replacing nonexisting markets by government interventions, including government-owned financial institutions.

Many elements of the debate are reflected in this book as well. The recent crisis might trigger an increasingly activist role among governments throughout the continent, partly driven by the examples set in industrialized countries, but also by the different role of government in China, Brazil, and India, three emerging countries with rising influence and weight in Africa. This increasing trend toward an activist role of government can also be seen in the growing desire of African governments to set up new development banks. Still, the memory of activist failures is too fresh to expect a full-fledged return to government-dominated financial systems. However, the limitations of the modernist approach are also obvious.

We stress a nuanced view that recognizes the limitations of modernism, while pointing to the pitfalls of activism. Government has to play an important role in (1) expanding outreach, (2) lengthening financial contracts, and (3) safeguarding financial systems. This role goes beyond providing the rules of the game and building institutions. Government might have to play an important role in fostering competition, but also cooperation. The important message is that one size does not fit all; while learning from other countries in the region and other regions is important, a contextual framework has to be stressed. We are also still a long way from a rigorous metric that can be used to categorize and judge government interventions; there will be a lot of trial and error. It is therefore important to put in place better assessment tools for government interventions.

Landscaping Africa's Financial Systems

The book uses a large array of indicators that measure the size, efficiency, and outreach of financial sectors to compare African financial systems to the systems in other regions of the world, to focus on intraregional differences, and to benchmark countries over time. This exercise is facilitated by significant advances in measuring the access to financial services that have been achieved at the World Bank and at the Consultative Group to Assist the Poorest. We also draw on a data collection exercise undertaken for the purpose of this book on the structure of financial systems in Africa and its different segments, including the market, portfolio, and maturity structure of different financial institutions and instruments. Finally, we benefit from the increased interest of academics and analysts in African financial systems and the consequent data collection efforts.

Impact of the crisis

As the recent global financial crisis starts to fade into the distance, the debate on the impact of the crisis on Africa and its long-term implications is alive with varying degrees of relief and caution. Initial conventional wisdom at the height of the crisis was that, with the exception of large and globally more connected economies such as Kenya, Nigeria, and South Africa, the crisis would have little impact on Africa because the transmission mechanisms between the financial systems in Africa and the rest of the world were weak. African financial institutions, it has been argued, were not exposed to the risks emanating from complex instruments in international financial markets because most of the banks in Africa rely on deposits to fund loan portfolios (which they keep on their books to maturity), most of the interbank markets are small, and the markets for securitized or derivative instruments were either small or nonexistent.

Over time, however, this conventional view started to give way to concerns about the second-round effects through the real sector. The rapid decline in global trade that started in late 2008 (by up to 45 percent in real terms year on year) hit all African economies and can to a large extent explain the lower growth the region experienced in 2009. Meanwhile, the increasing role of China and India in the global economy has helped African economies, especially the commodity-based economies, recover relatively quickly. In addition, there was a significant effect through reduced capital flows, especially lower portfolio flows, but also lower foreign direct investment and aid flows. African countries experienced a dry-up in international capital flows. Africa has also suffered from the drop in remittances from Europe, though with a certain lag after the onset of the Great Recession, and part of the effect was caused by the devaluation of local currencies. Finally, there was a wealth effect in countries with stock markets that saw indexes drop substantially, though these are recovering in most cases.

The impact of the Great Recession varied with the economic structure of countries. Mauritius and South Africa, both middle-income countries and financial centers, suffered because of a reduction in crossborder bank flows and because of their dependence on export markets in Europe. Commodity exporters such as Gabon, Guinea-Bissau, and Zambia suffered from the rapid decline in commodity prices. Finally, several countries, most prominently Nigeria, suffered from domestic crises that were triggered by the exogenous shocks of the global crisis. In Morocco, the global economic crisis has indirectly affected the economy through a slowdown in the real sector (a 2 percent decrease in value added between 2008 and 2009). The main channels include, among other elements, a break in the trends in current account flows because of a decline in trade volumes in different sectors (for example, exports from the textile, electronic, and automotive industries; a decline in remittances from Moroccans residing abroad in 2009; a reduction in demand in the real estate sector, particularly for high-standing products targeting foreign investors; and a 20 percent decrease in revenues from tourism).

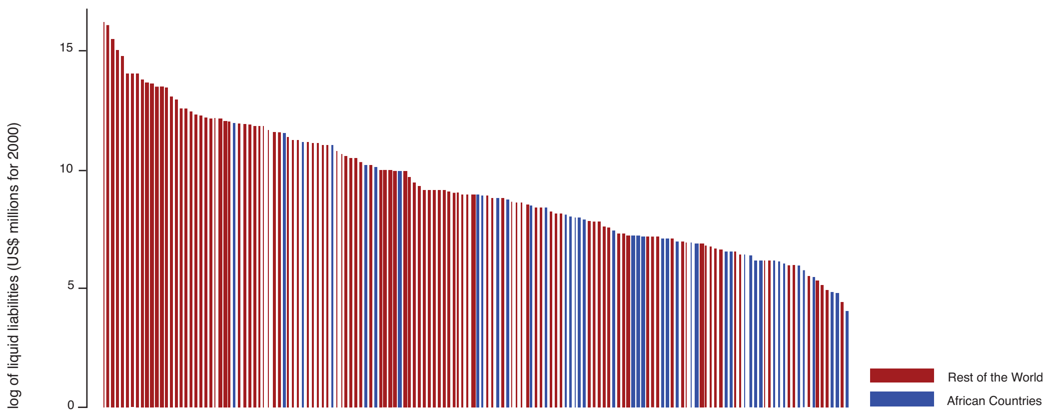
Africa in international comparison

With the benefit of hindsight, the performance of Africa's financial sector through the crisis ought not to have come as a surprise given the sector's size, lack of integration (internationally and domestically), and the nature of the structural deficiencies that remained in financial systems even as they were making progress prior to the crisis. Specifically, we refer to the following characteristics.

Size

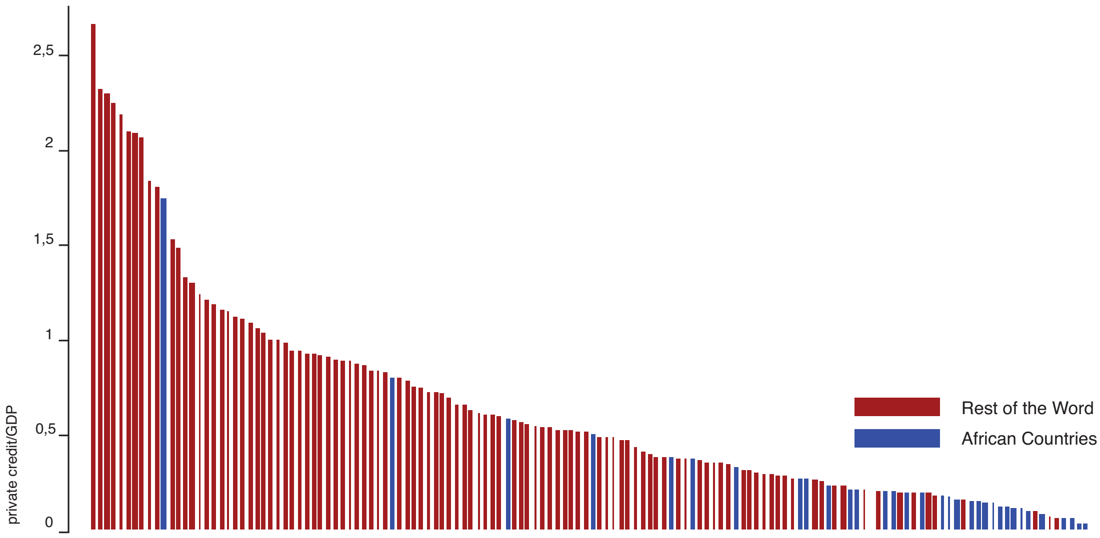
Africa's banking systems are small in both absolute and relative size (see figures 1 and 2). And they are not only small, but also show low intermediation efficiency. This suggests that the intermediation constraint is more binding than the resource constraint.

Figure 1. Absolute Size of African Banking Systems



Source : World Bank, Financial Structure and Development Database, http://go.worldbank.org/X23UD9QUX0 (May 2009 update).
Note: Sample size: 154 countries. Time period: 2009. The highest African values are for Algeria, the Arab Republic of Egypt, Morocco, and South Africa.

Figure 2. Relative Size of African Banking Systems

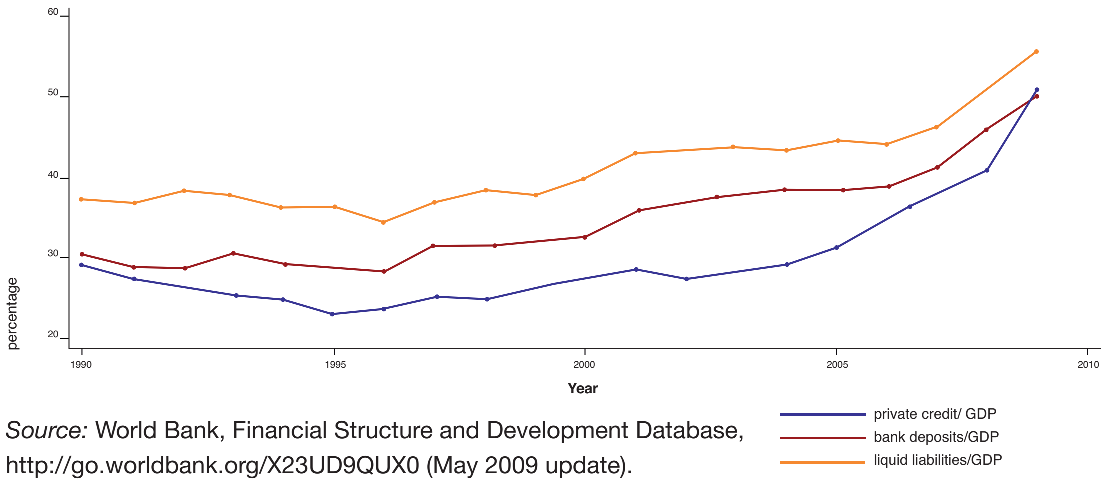


Source: World Bank, Financial Structure and Development Database, http://go.worldbank.org/X23UD9QUX0 (May 2009 update).
Note: Sample size: 154 countries. Time period: 2009. The highest African values are for Mauritius, Morocco, South Africa, and Tunisia.

Financial depth

In the years leading up to the global crisis, there were improvements across African financial systems (figure 3). There was a persistent increase in both liquid liabilities to GDP and private credit to GDP across the region that was not driven by individual countries, but occurred throughout the region. In the years leading up to the global crisis, 80 percent of all countries experienced financial deepening. There is more: Africa's banking systems also now intermediate a larger share of their deposits into loans than previously.

Figure 3. Financial Deepening across Africa



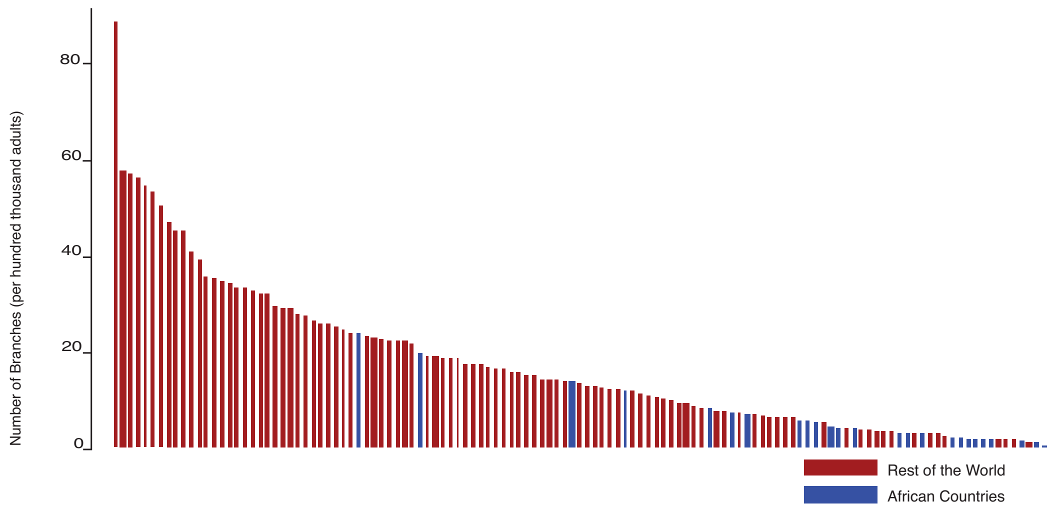
Source: World Bank, Financial Structure and Development Database, http://go.worldbank.org/X23UD9QUX0 (May 2009 update).
Note: Sample size: 25 countries. Time period: 1990–2009. The number of countries indicated represents the situation following the balancing of the data set.

Africa's financial systems are mostly bank-dominated, which is consistent with their level of economic and financial development. With a few exceptions, stock exchanges are nascent; even where they are reasonably large, they lack the necessary liquidity. In most countries, the contractual savings segment is underdeveloped; insurance companies are focused mostly on non–life insurance products; pension funds cover only a small segment of the population; and the mutual fund industry is small. Africa stands to benefit from more diversified financial systems in the interest of competition and for the benefit of users.

Breadth

African banking systems lack not only depth, but also breadth. In the absence of reliable indicators of the share of households that use bank accounts across a large number of countries, proxy indicators have been used to gauge the outreach of banking systems. Branch penetration per capita shows the limited outreach of banking systems in Africa relative to those in other regions of the world (figure 4). While Benin has less than 1 branch per 100,000 people, Bolivia has almost seven. While the Arab Republic of Egypt has four branches per 100,000 adults, Malaysia has 11. Using the penetration of automatic teller machines and point-of-sale equipment shows a similar picture. While Morocco has 9 automatic teller machines per 100,000 adults, Malaysia has 47.5.

Figure 4. Branch Penetration across Countries

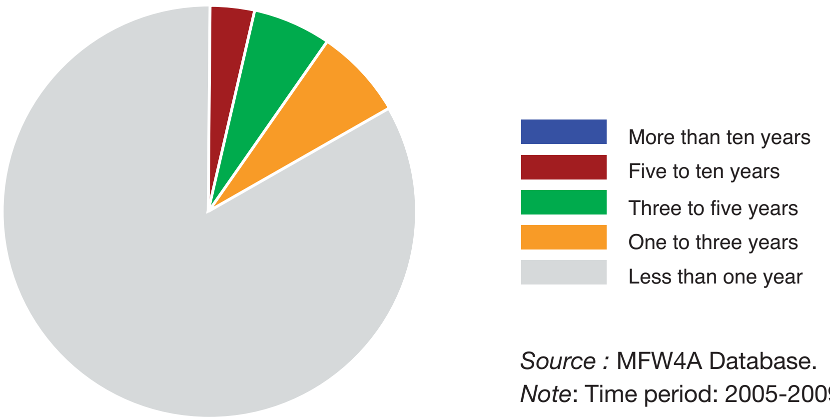


Source: Data of the Consultative Group to Assist the Poorest.
Note: Sample size: 123 countries. Time period: 2009.

Maturity

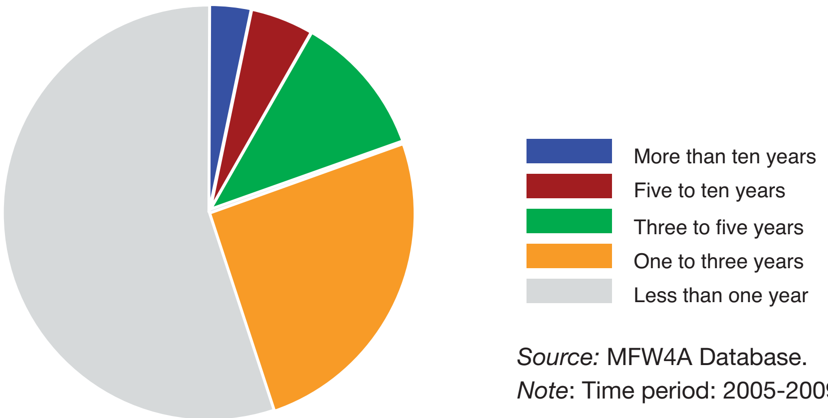
African finance is mostly short term as evidenced by the maturity structure on the asset and on the liability sides of African banks. More than 80 percent of deposits are sight deposits or have a maturity of less than one year; less than 2 percent of deposits have a maturity of more than 10 years (figures 5 and 6).

Figure 5. Maturity Structure of Deposits across Africa



Source : MFW4A Database.
Note: Time period: 2005-2009.

Figure 6. Maturity Structure of Loans across Africa



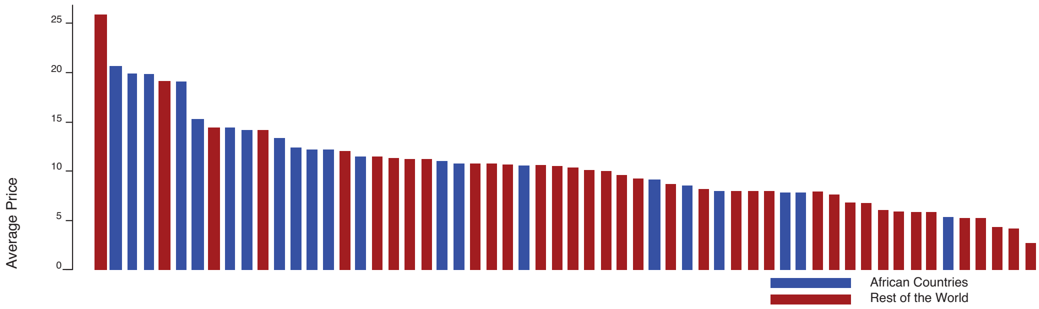
Source: MFW4A Database.
Note: Time period: 2005-2009.

Cost

African banking is expensive. African banks are characterized by high interest rate spreads and margins, driven by diseconomies of scale, risk, and lack of competition, as documented by cross-country and individual country studies. Decompositions of interest rate spreads and margins point to high overhead costs as the main driver. These high overhead costs can be explained to a large extent by the scale diseconomies suffered by African banks (discussed above). However, they also reflect the generally high costs of doing business that affect banks and that include deficient energy and road infrastructure, as well as a lack of reliable credit information and infrastructure. A second important driver of interest rate spreads and margins is the lack of competition in many African banking markets, which is also related to scale diseconomies. Africa's banking systems are mostly concentrated: few banks share the small universe of clients. Similarly, standard indicators of competition show significant market power among banks across the region. A final important driver is the risk of banking, though the role of this factor may be overstated.

The high cost of banking affects not only borrowers in terms of high lending interest rates, but also deposit customers in the form of high account fees and minimum balances. Measured relative to GDP per capita, African customers pay substantially higher amounts to maintain checking accounts relative to customers elsewhere in the world especially if one factors in the higher nonmonetary burden in terms of proof of identity, distance, and income requirements. The high costs of financial services are also reflected in the costs of sending international remittances. As figure 7 shows, corridors that include African countries have significantly higher costs.

Figure 7. Remittance Costs across Countries



Source: Remittance Prices Worldwide database; www.remittanceprices.org.
Note: Sample size: 58 countries. Time period: 2005–2009. The highest African values are for Botswana, Malawi, Mozambique, and Zambia.

Explaining financial (under)development in Africa

What are the factors explaining the low level of financial development across most African countries and the variations in financial development within Africa? A first explanation is the small size and low income levels of African economies; this is the scale argument discussed above. Macroeconomic instability, which is captured, for instance, in high inflation rates, is a second important factor explaining financial underdevelopment. A low, stable rate of inflation provides incentives for financial rather than nonfinancial forms of savings. By providing monetary certainty, it is also conducive to long-term contracting and, therefore, long-term savings and investment. The absence of monetary stability is thus directly related to the volatility undermining financial contracting. Third, on the resource and deposit side, aggregate indicators are consistent with the generally low savings rates across the continent, which, in turn, can be explained by the low, volatile incomes and the demographic structure of African populations, dominated by young people, high illiteracy rates, and low life expectancy, which, in some countries, has recently decreased because of AIDS. The low aggregate financial development indicators documented above are also consistent with the high degree of capital flight, which has been widely documented, though there are some indications of a reduction. Population density is another important driver of financial depth, especially within Africa; directly related to scale, a more dispersed population is more difficult to serve, especially in the context of Africa, which has a decayed transportation infrastructure. Finally, governance challenges loom large for African financial systems. Financial contracts depend on the certainty of the legal rights of borrowers, creditors, and outside investors and the predictability and speed of fair and impartial enforcement. For financial sector development, international comparisons have provided ample evidence of the critical role of legal system efficiency and its different elements. However, the governance agenda is broader than the contractual framework. Corruption can undermine the relationships between banks and customers, as well as between regulators and banks. Political interference can have a negative effect on the optimal allocation of resources.

In summary, despite recent progress, Africa's financial systems suffer from lack of competition and lack of diversity in providers and products, especially on the long end. There is limited outreach, and, where customers have access, the costs are high.

Expanding Financial Systems

Access to formal banking services remains severely limited across Africa. A recent Gallup survey in 18 African countries, recent household-level surveys in Eastern and Southern Africa, and financial diaries in South Africa confirm, however anecdotal evidence of the widespread use of informal financial services even by population segments with good access to formal financial services.

Recent studies find interesting predictors of formal financial service use across different households. Not surprisingly, one of the most robust predictors of formal financial service use is income: richer individuals are significantly more likely to use formal financial services. Education is another strong predictor: the use of formal financial services increases linearly with educational attainment. Geography—as measured by rural or urban residence—is not as strongly associated with the formal use of financial services if we control for other household and individual characteristics. Employment status is another important correlate of the use of formal financial services, while financial literacy, numeracy, and risk aversion are less consistently correlated with the use of formal financial services. We also find a positive correlation with the ownership of a mobile phone, suggesting that participation in the market economy is related to the higher demand for financial services. Meanwhile, women are as likely as men to use formal financial services if we control for other individual characteristics such as income, education, and formal employment. This suggests that the low bank penetration among women in southern and eastern Africa is not caused by discrimination, but, rather, by the fact that women are less likely to use formal banking services because they have lower income and lower levels of educational attainment and are less likely to hold formal jobs.

Using the concept of the access possibilities frontier, we point to different policy areas that have to be addressed in Africa to expand financial systems in Africa. Specifically, we distinguish between the current level of outreach (the banked population) of a financial system and a constrained possible maximum of outreach (the bankable population) that is determined by state variables such as the macroeconomic environment and the quality of the contractual and information frameworks, but also the size and level of economic development of an economy, which indicates the extent to which financial institutions can exploit scale economies. We argue that the frontiers might well differ across different services, especially between payment and savings services, on the one hand, where transaction costs are the major impediment to outreach, and credit services, on the other hand, where risk management imposes an additional difficulty. The challenges in expanding outreach and the corresponding policies can thus be classified according to whether they involve turning the bankable into the banked population (that is, a move toward the frontier) or turning the unbankable into the bankable population (moving the frontier outward). The difference points to the importance of both long-term institution building and more short-term policies that push financial institutions toward the frontier by fostering competition and adjusting the regulatory framework.

Landscaping the providers: how to get to the frontier

For a long time, microcredit institutions were heralded as pioneers, and they have certainly contributed to expanding outreach, though the overall microfinance penetration across the continent is still low. Similarly, cooperative institutions in Central and Western Europe (Austria, France, and Germany, among others) have often been credited with the almost universal access to financial services in these countries and the access to credit by farmers, thus helping rural areas develop. Donors have therefore tried to implement this concept in developing countries, including in Africa. Local circumstances, however, have to be taken into account. Countries with communities with roots and little migration offer themselves easily to this kind of initiative, while countries or regions with high migration flows and less tightly knit community links might be less conducive for such an approach. A similar argument can be made to explain why group lending is a less attractive lending model in Africa than elsewhere.

Banks

The dominant providers of formal financial services in Africa are still banks, although the universe of banks in Africa is increasingly diverse, ranging from subsidiaries of large multinational banks to small domestically owned niche banks. There are also several commercial banks supported by public or private donors, such as OPM in Malawi and DFCU Bank in Uganda. One contentious item on the agenda has been the role of foreign-owned banks. Foreign banks are often accused of cherry-picking the high-end wealthy customers, but their role in outreach has to be qualified: the population of foreign banks is more diverse now than it was 20 years ago. The examples of Tanzania and Uganda have shown that careful privatization can increase efficiency and stability, while avoiding a reduction in the outreach of these institutions. In Uganda, the largest government-owned bank, Uganda Commercial Bank, which was also the largest bank in the system, was successfully privatized (after an initial failure at privatization) through the Standard Bank of South Africa. Although an agreement not to close any branches was in place for only two years following the sale of Uganda Commercial Bank, Standard Bank kept all branches in place and even opened new ones. It introduced new products and increased agricultural lending. Regional banks in West Africa, especially Nigeria, and in South Africa have often brought competition and new products into domestic markets.

Though declining in importance, government-owned banks still play a role in many African countries. Government-owned commercial banks typically have a better track record in terms of outreach on the liability side of balance sheets than they do on the asset side and have proven not only to be unsustainable, but also to have a negative impact on competition in the overall banking sector. While privatization has often been considered to have a bad effect on outreach, recent experience has taught otherwise. The privatized Zambia National Commercial Bank is demonstrating how a formerly wholly state-owned financial institution can be reenergized into increasing its outreach by branching out, establishing agency arrangements with local partners (gas stations, post offices), and introducing mobile phone technology to facilitate low-cost transactions through an effort that promises to increase substantially the bank's deposit base and have a healthy demonstration effect among private banks. Where privatization is not feasible, however, the turnaround of such institutions by external management teams can also be successful if the right conditions are in place. Such a turnaround would use the franchise value of the large network and the customer base, while leveraging private expertise. The example of the National Microfinance Bank of Tanzania has been heralded as a success story. Government-owned banks that focus completely on deposit services, such as postal savings banks, have a safer record in terms of fragility than do government-owned commercial banks; however, they often suffer from poor service quality.

Financial service providers who push a system toward the frontier or even push the frontier outward often arise in unexpected places. Equity Bank in Kenya transformed itself from an underperforming building society into an innovative bank and is now the largest bank in the country in terms of clientele. It did this by offering new delivery channels such as M-Kesho, which is an advanced mobile financial product offered by M-Pesa (Safaricom, a leading mobile operator) and Equity Bank. Its customers must each have an M-PESA account (and, hence, be a Safaricom customer) and a normal Equity Bank account, which can be linked to their M-Kesho bank account, though this last is not required.

Mobile technology

Mobile banking can be an important transformational model. This is best illustrated by M-Pesa in Kenya, but there are many similar examples across the continent. Electronic banking can change the economics of retail banking. It can help push the possibilities frontier outward substantially because it reduces the fixed cost component of financial service provision and thus the diseconomies of scale in the outreach to population segments exhibiting a demand for small transactions. Pushing outreach out toward the new frontier, however, requires additional steps and the establishment of certain conditions, such as new regulatory approaches and a fresh discussion on competition.

Demand-side constraints

In addition to supply-side constraints, there are also significant demand-side constraints that have often been ignored on the household level and the enterprise level. Financial literacy has been an increasingly important topic among policy makers and donors in recent years. In this context, it is important to distinguish between financial knowledge or literacy (that is, awareness and knowledge of the existence and functioning of specific services and products) and financial capability (that is, good financial decision making and also the ability to access formal financial services through sound business plans and bankable applications). Initial studies have shown the potential for such programs, but also the need for targeted efforts.

Do financial literacy programs help? It is difficult to establish causality, but recent randomized evaluations have found evidence. The lesson seems to be that targeted literacy programs are more promising than general programs and that programs have to be adjusted according to feedback from participants. It is important to stress that these are preliminary findings. Significantly more research and analysis are needed to explore the sorts of programs required and the targeted population groups that may be appropriate. It is certainly easier to improve the basic awareness of financial concepts and financial attitudes. Measuring the long-term impact of financial literacy programs on behavior requires longer-term analysis.

There is also a general trust issue. The mistrust of financial institutions might be easier to overcome in the case of transaction services, where the intertemporal nature of financial services is reduced to a few minutes, especially in the case of mobile phone banking, than in the case of savings or credit services, where the result can only be seen after months or years.

Pushing toward the frontier and beyond: the role of governments and donors

How can the frontier—the share of the bankable population—be expanded at the household level and at the enterprise level? This brings us back to the long-term agenda of institution building. Beyond this long-term agenda, what are short-term solutions and policies that can help turn the bankable population into a banked population and thus push the financial system closer to the frontier?

Credit registries

The first publication, *Making Finance Work for Africa*, highlighted credit registries as a useful tool to broaden and deepen financial systems. While credit registries have often been praised as an important policy tool, one has to be realistic about what can be achieved. Negative information sharing will lead to the more effective screening of borrowers by lenders through access to information, which, in the first instance, may generate a reduction in access rather than an expansion. However, only through the inclusion of positive information can one achieve a buildup in the reputation capital of existing borrowers that might have an effect on competition, though this will only be felt over time rather than immediately. At the outset, this positive impact will affect the existing borrower population and will cause an expansion of the frontier to the previously unbanked population only by fostering stronger competition among the participants in the credit registry, thus forcing some of the participants down-market. Here, the type of information on which the registry can draw is critical. In general, the broader the sources the registry can draw on (nonbank financial institutions, such as leasing and factoring companies, but also utility companies, trade registries, and so on), the larger the share of enterprises that will be captured and that can potentially benefit from such a registry by proving their good borrower status. In this context, the connection to information from microfinance institutions seems crucial. While the borrowers targeted by such institutions are often different from those targeted by banks, growing microenterprises that formalize into small enterprises will, at some point, want to access bank credit as they become too large for MFIs. It is at this stage that a credit registry can help them. All these possible effects, however, should not be expected immediately, but over the medium term, that is, in three or more years.

Competition

Competition is an important area for government action. Allowing competition within the banking system and from outside the banking system will foster the necessary financial innovation to push the financial system toward the frontier and exploit the possibilities that new methodologies, products, and technologies can offer. An increased focus on competition, however, has critical repercussions on regulation and government policy in general. It entails a sophisticated approach that has to balance (1) the need for innovation, (2) the need to avoid market dominance by new players that rapidly gain market shares in new products, and (3) the need to reduce the risks of fragility.

To illustrate this, we return to the topic of mobile financial service providers. The monopolistic position of Safaricom in the cell phone market and the expectation that monopolistic rents would be available encouraged the company to launch M-Pesa[1]. The possibility of entry without regulatory restriction certainly helped, though the dominating market position is a concern relative to market development going forward; mobile payment services might also raise previously unknown risks. A dynamic approach is therefore called for, whereby the regulatory authorities—in this case, both banking and telecommunications regulators—have to follow market development closely and react flexibly.

In certain instances, authorities might have to force financial service providers to cooperate rather than compete with each other, especially in financial sector infrastructure, such as payment systems. One striking feature of African financial systems is the lack of interconnection among automatic teller machines and point-of-sale equipment networks across banks. As a public good, key payment system infrastructure such as this should meet certain public policy concerns, such as allowing fair and competitive access to retail payment infrastructure to take hold. This would also entail ensuring that different types of institutions providing payment services, be they banks or nonbank entities, have fair access, thereby supporting a level playing field in the market. In most African countries, access to payment services is limited to banks, which gives the banks a competitive advantage over other financial service providers. A more comprehensive approach would imply expanding traditional infrastructure, such as credit registries and payment systems, beyond banks.

Innovation and regulation

Fostering innovation implies a more open regulatory mindset. This might involve reversing the usual timeline of legislation-regulation-innovation among new players and products and adapting a more try-and-see or test-and-see approach, as applied by regulators in Kenya with respect to M-Pesa. Providing the necessary environment for innovation is one step; nurturing such an environment is a much more difficult undertaking. Funds for innovation and challenge funds, possibly financed and sponsored

1- The expectation of cross-selling might have been even stronger because mobile payment revenues seem to constitute a miniscule share of Safaricom's overall revenue stream.

by donors, might help. M-Pesa was partly financed by a challenge fund sponsored by the U.K. Department for International Development. The recent G20 SME Finance Challenge crowned several winners who focused on Africa.

The need to foster competition and openness toward new services and products is directly behind the second main message: the focus should be on services more than on existing institutions and markets. Focusing on expanding the provision of payment, savings, and other financial services to previously unbanked segments of the population might mean looking beyond existing institutions, products, and delivery channels, such as banks, traditional checking accounts, and brick-and-mortar branches. It might also involve a new approach to inclusion that moves away from the credit-led approach toward a savings- or transaction-led approach.

Regulation can be important in safeguarding finance and ultimately protecting the beneficiaries and users of financial services. Burdensome regulation, however, can restrict the outreach of financial institutions. Regulatory constraints can prevent microfinance from having a maximum effect. In Morocco, for example, MFIs are treated as nonprofit organizations, a rule that prevents them from diversifying their services and their sources of funding beyond their original donors. Similarly, maximum lending thresholds can limit the business of MFIs. Interest rate ceilings as established in many African countries can have an even worse impact: they effectively price microcredit providers out of the market (see the discussion in chapter 5).

Regional integration

Beyond developing national markets, African policy makers also need to look at regional solutions. Developments on the continent are such that there are tremendous incentives for creating and expanding access to finance through the rapid, but safe take-off of domestic and crossborder branchless banking, with appropriate protections for customers and the financial system. Immediate incentives include migration patterns, regional remittance flows, and trade patterns.

Rural and SME finance

The messages in the book also apply to rural finance and to the financing of SMEs. The four characteristics of African economies (described in chapter 1) that make financial service provision more challenging in Africa apply even more closely to rural areas in Africa. Rural finance in general and agricultural finance more specifically needs a variety of institutions to provide different services. In rural finance, we must also increase our focus on services and users by looking beyond institutions that provide credit, as well as looking to the needs of rural users, who require an array of financial services and whose livelihoods may not be linked to agriculture. Similarly, the financing of SMEs continues to pose significant challenges for African financial systems, but also for financial systems around the world. Recent advances in lending methodologies (transaction-based instead of relationship-based lending), as well as specific lending techniques, such as leasing and factoring, have supplied renewed impetus to SME lending also in Africa. However, many challenges remain. One important constraint on bank finance is the lack of equity in enterprises. High leverage can prevent enterprises from pursuing more debt, so that the lack of equity rather than the lack of debt is the binding constraint. Demand-side constraints should not be underestimated. Finally, it is important to stress that financing is only one of the many obstacles that African enterprises face in their operation and growth.

Lengthening Financial Contracts

Despite recent encouraging innovations among banks, contractual savings institutions, and the capital market, lengthening financial contracts remains a challenge for financial systems across Africa. In areas where progress has been made, the progress has not yet occurred at a rate sufficient to counter significantly the scale of the financing deficit on the continent. The challenge for policy makers thus consists in scaling up current initiatives that are succeeding or showing promise, tapping new long-term funding sources, especially domestic sources, and working on the well-understood constraints to long-term finance: macroeconomic instability and weak institutions.

Africa's long-term financing gap: who can fill it?

While there are various ways to demonstrate the scale of Africa's long-term financing gap, the book focuses—for illustrative purposes—only on three areas: infrastructure, housing, and firm finance.

The infrastructure finance gap

The deficit in the availability of long-term financing is most evident in the state of infrastructure across the continent. Even taking into account Africa's income level, the continent lags behind other developing regions. Electricity outages, poor roads, and the lack of water provision and sanitation networks are still common in many countries. The cost of addressing Africa's needs in physical infrastructure is estimated at US$93 billion per year, some 15 percent of Africa's GDP. About two-thirds of this amount is needed for greenfield and rehabilitation investments, and the other one-third is needed for the maintenance of existing infrastructure. The infrastructure gap varies greatly by country type, however: it is higher in landlocked and sparsely populated countries. While there are significant requirements across different sectors, more than 40 percent of the estimated spending needs are for power infrastructure. This reflects the particularly large physical deficits in this sector relative to other sectors such as transportation, telecommunications, and water. However, there remains a paucity of long-term resources available for investment in Africa's infrastructure to facilitate private investment in these key sectors.

The housing finance gap

Demand for housing, especially in urban areas, continues to rise across the continent as Africa urbanizes rapidly. Yet, across the continent, the ratio of mortgage debt outstanding to GDP remains low, averaging around 10 percent, which compares with 70 percent for the United States and 50 percent for Europe. Excluding South Africa, the ratio falls to 8 percent of GDP. Excluding the North African countries reduces the ratio of mortgage debt to GDP to only 1 percent for Sub-Saharan Africa. In those Sub-Saharan African countries where formal mortgage markets exist, such as Burkina Faso, Ghana, Nigeria, Tanzania, and Uganda, the number of loans is rarely more than a few thousand, and these loans are often limited to the wealthiest segment of the population. External financing for housing thus eludes the vast majority of the African population. The need for additional housing varies significantly across Africa, however. Cross-country differences in population growth and internal migration point to important variations in additional housing requirements over the next 40 years. Even with the current macroeconomic constraints and barriers in demand and supply, a growing, though still small segment of the African population could afford mortgage financing.

Providing firms with long-term finance

For firms, the lack of term finance is equally acute, especially for local SMEs. While large multinational firms have access to finance from outside the continent through parent companies, through domestic banks in the local market keen to keep a large corporate entity on its books, or through foreign banks that often have mandates to assist such companies outside their home countries, local firms do not have these options. Moreover, when funds are available, tenor is limited. In most countries, 95 percent of loans have a tenor of five years or less. Available data suggest that, although firms in North African countries have made progress in accessing longer financing contracts, mainly at medium-term maturities, long-term financing remains limited in the region. For instance, the share of short-term bank credit in total credit in Morocco decreased from 41.0 percent in 2007 to 38.2 percent in 2009, while medium-term credit increased from 26.0 to 31.2 percent. Similarly, medium- to long-term credit represented 54.5 percent of total bank credit in Algeria in 2008 and 55.7 percent in Tunisia in 2009. Data from bank loans across five selected countries show that long-term credit is scarce.

Optimizing the current possibilities for expanding long-term finance

More recently, there has been an increase in the entry of new institutions, instruments and products giving hope that Africa may be turning the corner on this challenge. Innovations in the use of specialized products and instruments in commercial banking are enabling banks and specialized lenders to extend the maturity of their long-term financing instruments. Also, the renewed interest in development banks recently has again highlighted the need for appropriate governance structures that shield these banks from political interference. In the following, we offer a summary discussion of both trends.

Commercial banks

Although commercial banks dominate financial systems in Africa, their participation in long-term finance remains limited because of a variety of constraints that are discussed in the book. Despite these constraints, there are exceptions: some local commercial banks find ways to overcome the challenges and provide long-term finance. For example, in Nigeria, the Lekki-Epe Express Toll Road, which reached financial close in 2008, was able to mobilize a 15-year loan from Stanbic's IBTC-Nigeria in local currency for 2 billion (US$13.4 million) at a fixed interest rate of 13.9 percent and with a moratorium on principal repayments for four years. This deal was also supported by other local banks that provided a total loan value of 9.4 billion (almost US$63 million) for a tenor of 12 years. In Senegal, the Dakar-Diamniadio Toll Road reached financial close in November 2010. The concessionaire Eiffage was able to tap into local credit from a Senegalese bank that provided approximately US$10 million, with a 13.5 year tenor and about a 10 percent fixed interest rate. This amounts to 10 percent of the total debt of the project. Similarly, the Kenyan Equity Bank has been the single largest financier in a syndicated loan to Rift Valley Railways.

Development banks and specialized lenders

State-owned financial institutions, particularly development banks, are back in the public debate. Concerned about the lack of notable progress in increasing access to long-term finance, policy makers are increasingly questioning the efficacy of development banks. African countries have had bumpy relationships with state financial institutions over the last couple of decades. In some, such as Malawi, there has been an active state-led interventionist approach to financial sector development until recently; in others, such as Mozambique and Zambia, there has been a more liberalized private sector–led model; and, in yet others, such as Ethiopia, the government continues to dominate the sector. For decades, the debate on the rationale for state intervention in the financial sector has centered on market failures, such as lack of information, which are more prominent in some sectors (see chapter 3).

For many countries, we argue, policy makers would therefore be better served by refocusing the government's primary engagement in the financial sector on policy formulation and wholesale lending activities, while leveraging the private sector to lead in the retail delivery of financial services, including long-term financial services. A holistic review and restructuring of current government institutions and programs could yield substantial economies of scale and reduce the current contamination of private sector–led efforts to increase access to financial services. Rather than establishing a new program each time a government prioritizes a particular sector, region, or activity, policy makers ought to consider focusing on using a single agency or institution to prepare and draft eligibility criteria for the new program and then tendering the actual retail implementation of the program to interested institutions. All bank and nonbank financial institutions would be eligible to bid for the tender. By leveling the retail financial sector landscape in this manner, the government would increase the involvement of the private sector in the delivery of commercially sustainable long-term financing programs in the country.

Contractual savings: pensions and insurance

To the same extent that one may observe a renewed interest in development banks, there is persistent interest in unlocking the funds held by pensions and insurance firms for long-term investment. Burdened with long-run liabilities, this segment of the financial sector has the potential to play an important role. However, as discussed in chapter 2, the contractual savings sector is even more underdeveloped in Africa than the banking system. Insurance sectors across the continent are mostly focused on non–life business lines, with the notable exception of several southern African countries, where life insurance products are popular for tax reasons, among others. Few countries on the continent have private pension funds; most rely nearly exclusively on public funds be it in the form of pay-as-you-go funds or social security funds. One important feature of African pension funds is the limited coverage across the working population, though important differences exists among countries.

For both pensions and insurance, we argue that there is a need to undertake reforms in areas such as risk diversification, solvency, consumer protection, and taxation. Capacity building among regulators and financial literacy programs for policy holders are essential. Insurers remain short on training and experience, and gaps in regulatory coverage persist. To ensure effective corporate governance, it is vital that insurance companies and pension funds have appropriate risk management processes in place. Insurance and pension regulators need to deploy risk-based supervision methodologies and thereby make use of sound oversight and supervision. In the case of the pension industry, a separate implementation body and external evaluators for the overall process should be considered.

Capital markets: a limited role

Long touted as essential to unlocking the long-term finance paradox by providing a trading platform for equities, stock exchanges have been the must-have institution of a modern national financial system. Yet, for decades, Africa's stock market capitalization has remained low; it represents, as of 2009, only 2 percent of world market capitalization. As discussed in chapter 2, markets in Africa have low levels of liquidity, with the exception of the Johannesburg Stock Exchange.

To revitalize, many stock markets in the region have undertaken regulatory and institutional reforms, such as the relaxation of restrictions on foreign investors. All African stock exchanges now allow foreign participation. Governments have also tried to use tax incentives. In Tanzania, for example, equity-issuing companies face a reduced corporate tax rate for a period of three years if at least 35 percent of the equity is issued. Efforts have been made to reduce transaction costs as well, including the taxation of capital gains. While tax incentives can increase the number of listed firms, this will not necessarily translate into enhanced liquidity in the market, as the example of Egypt shows: Egypt recently abolished some tax subsidies.

Capital markets are still constrained by outdated practices, inefficient listing procedures and trading mechanisms such as manual systems, lack of regulatory frameworks, and inefficient market information dissemination processes, though most African stock exchanges have now moved to electronic rather than manual trading systems. One option for expanding outreach is the establishment of secondary trading boards, such as exist in Botswana (introduced in 2001 as a venture capital board that is dedicated to firms looking for start-up capital), Egypt and South Africa. These exert lower demands on issuers in terms of listing fees, track records, size, reporting requirements, float, or the minimum number of shareholders trying to attract medium-sized companies and for whom regular conditions are too burdensome. While these markets have facilitated the access of firms to stock markets, their limited success suggests that they can only partly solve the problems in access to finance.

Tapping international markets

As a source of finance, global investors have an important role to play in Africa.

By investing through banks and contractual savings institutions and in capital markets in Africa, they not only provide financing for investment projects, they also have the potential to increase and improve the intermediation capacity of financial systems. We discuss three sources of long-term finance in Africa associated with international financial markets. One is private equity funds, and another is sovereign wealth funds, both African funds and non-African funds being invested in Africa. Related to these, but especially the latter, we also discuss the changing global environment, in which there is a growing role for Brazil, China, India, and emerging markets in Africa. A final opportunity is diaspora bonds, about which we are a bit more critical because the African diaspora is quite disparate, and the conditions of emigration often do not lend themselves to investment back home through formal channels.

In Africa, private equity is becoming a growing part of the financial sector, especially for long-term finance. In the boom years of 2006 to 2008, private equity funds raised in Sub-Saharan Africa amounted to approximately US$6.4 billion, while those invested reached US$7.6 billion. The private equity model in Africa seems to target mainly well-established medium-sized enterprises at the top end of the market. Notwithstanding these positive trends, the main obstacles continue to be the limited interest of financiers in investment in private equity funds targeting Africa and the excessive risk aversion of financiers toward Africa. Investors in Sub-Saharan Africa north of the Limpopo River demand some of the highest risk premiums, and risk premiums in the North African countries are only slightly lower. In addition to the perceptions of high risk, the industry suffers several specific challenges in Africa, mostly related to the institutional environment in which the industry operates, including regulatory constraints, ownership- and foreign-exchange–related barriers for foreign private equity funds, and taxation-related barriers.

Another potentially significant source of long-term funding is sovereign wealth funds (SWFs) with strategic interests in Africa, including funds in China, India, and the Middle East that have become important players in African infrastructure projects. There is a growing appetite among SWFs in Africa to support foreign mineral and raw material requirements, as seen in China's successful efforts to lock up deals in the oil and gas sector, while also providing substantial transport infrastructure funding. SWFs from the Middle East are also active in the physical and social infrastructure sectors. Nonetheless, Africa's share in foreign SWF investments remains relatively negligible. The SWF investment strategies are justified because of the weak governance and high volatility of the economies in Africa. Africa's risk is still perceived as high, which hinders the continent's attractiveness as a target for African SWF money. This takes us again to the sequencing issue: African countries would have to recompose governance structures and communicate more about the returns and risk profile of financial markets and institutions before SWF money would become available.

Pushing toward the frontier and beyond: a long-term agenda with tricky shortcuts

Lengthening financial contracts in Africa requires that policy makers address the structural bottlenecks inhibiting the issuance of longer-term contracts. To this end, there is a need for (1) increasing the diversity of domestic sources of long-term finance and (2) promoting an appropriately diverse range of long-term financial products and services. These policy reforms would aim at unlocking the substantial additional sources of long-term finance through currently existing, but underdeveloped segments of financial systems, including pensions, insurance, and capital markets. While a boom in contractual savings cannot be expected in the short term (related to demographic and income factors), a stronger role for insurance companies, pension funds, and mutual funds should be fostered. Such reforms should also aim to encourage new providers and more competition, for example, from equity funds. More urgent, however, is the need to explore alternative methods for intermediating pension recourses transparently. On a second level are market-enabling policies whereby the current environment is taken as a given and an attempt is made to maximize the absorption and intermediation of existing resources in the financial system. These policies would affect competition by encouraging the entry of new providers and removing regulatory restrictions as discussed in the case of equity funds above. However, they might also imply market-friendly activist approaches that try to crowd in private providers. Most prominently among such policies has been the use of partial credit guarantee funds as instruments for risk mitigation. As with many policy tools, the devil is in the details of the design, with a possible trade-off between financial sustainability and additionality.

Safeguarding Financial Systems

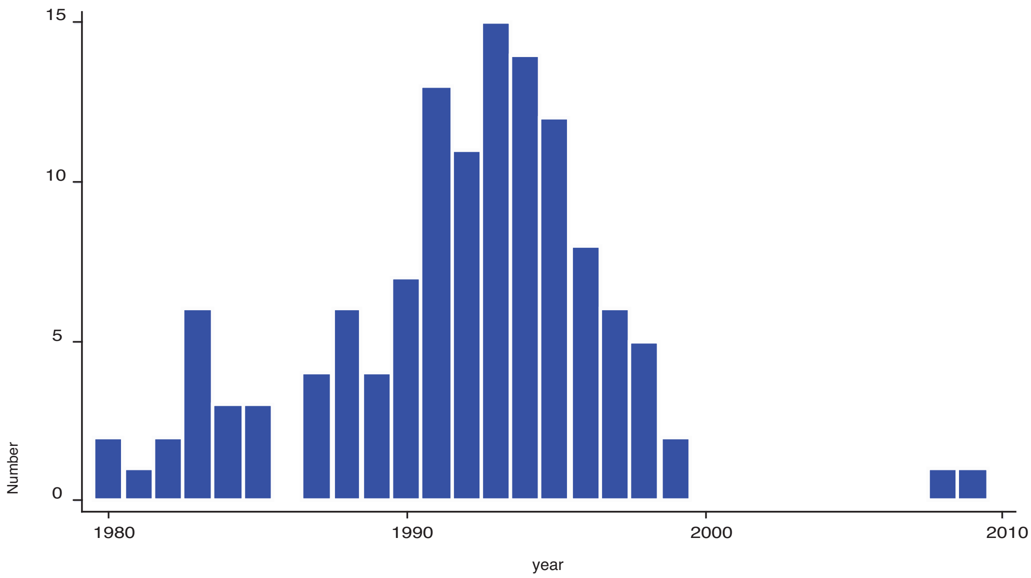
We have stressed the importance of competition in the banking system and the financial system at large. However, this also poses additional challenges for regulators and supervisors. The recent Nigerian experience of widespread and systemic fragility linked to (though not necessarily caused by) the rapid changes in market structure and in the capital structure of banks shows that regulators and supervisors have to develop the capacity to monitor such changes carefully. It also shows that increased competition has to be accompanied by improvements in governance. Similarly, the expansion of financial service provision beyond banking poses additional challenges to regulators and supervisors. This concerns not only the challenges in the supervision of insurance companies and pension funds, but also the coordination between bank and telecommunications regulators. It also 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. Finally, to the same extent that addressing demand-side constraint is important in expanding outreach toward the access possibilities frontier, demand-side constraints have to be dealt with to keep the financial system from moving beyond the frontier, as well as to avoid overindebtedness and abuse on the individual level and financial fragility on the aggregate level.

Financial stability: we have come a long way, but new challenges await

African financial systems have progressed in terms of financial stability. While, in 1995, a third of all countries in the continent were suffering from a systemic banking crisis, fragility has subsided across the continent (figure 8). Today, most African banking systems are stable and well capitalized and have a good level of liquidity. Nonetheless, there is still hidden or silent fragility in several Central and

West African countries. Among the smaller financial systems, Togo has several banks with a high level of nonperforming loans and insufficient capital-asset ratios; effectively, 50 percent of Togo's banking system is in distress as a result of governance deficiencies and political and economic turmoil over the past two decades. Similarly, the Democratic Republic of Congo suffers from undercapitalized banks, a consequence of political and economic turmoil. In Côte d'Ivoire, a large number of banks, mostly local or regional, were facing difficulties in 2008 that were generally related to the accumulation of public sector arrears, loans to risky sectors, and governance problems. The government took control of three banks and recapitalized them. Finally, in Ghana, systemic distress is concentrated in state-owned banks, and a number of small locally owned banks face liquidity problems because of their dependence on the public sector and wholesale funding.

Figure 8: Systemic Banking Crises in Africa



Source: Laeven, Luc, and Fabian Valencia, 2008, "Systemic Banking Crises: A New Database." IMF Working Paper 08/224, Washington, DC, International Monetary Fund.
Note: Time period: 1980–2009.

The overall progress has been partly due to a regulatory upgrade, although this has not been associated with a similar upgrade in supervisory capacity. Reviews and subsequent reforms of banking sector legislation have been undertaken in a number of countries in recent years. Many countries have complemented legislative reform with an overhaul of the corresponding regulations. Meanwhile, there are still deficiencies in the regulatory framework, especially in regard to risk management and the independence and resolution capacity of supervisors.

Supervisory frameworks: unfinished business

The lack of supervisory capacity seems to be at least as important as the gaps in the regulatory framework. In most African countries, supervisory resources are limited, including the availability of qualified staff and analytical tools. Many regulators are not independent of the ministry of finance or other government agencies in their decision making, and the legal framework often limits the corrective and remedial powers of supervisors to intervene in failing banks. Supervisory processes focus on compliance with regulatory standards, but are not set up to identify and manage the changing risks in the banking system. In addition, the ability to monitor risks on the institutional and systemic levels is hampered by insufficient data quality and reporting processes. These deficiencies weigh even more heavily in an increasingly globalized world.

The weakest point in the financial supervisory framework in most countries, however, continues to be the bank resolution system, that is, the capacity to intervene in a failing bank in time to prevent economic damage and contagion. The current crisis and the often bungled attempts of high-income countries to deal with their failing banks have put this issue high on the agenda. There are several dimensions to the problem. First, in many countries, there is still no appropriate bank-specific legal framework for dealing with failing banks. If such a framework is available, clear administrative guidelines for implementation are absent. Failing banks can often only be dealt with under the provisions of general bankruptcy laws. As the current crisis and the previous experience with many emerging market crises have painfully shown, the failure of a bank differs from the failure of a nonfinancial corporation along many important dimensions. For example, assets deteriorate rapidly, and depositor and creditor panic can easily lead to contagion and systemwide liquidity runs. In addition, close interlinkages among financial institutions through payment systems and interbank markets can turn the failure of all but the smallest institution easily into a systemic risk. Second, many low-income countries also lack the capacity to deal with failing banks in terms of supervisory capacity, but also financial resources. This has often led to regulatory forbearance, which has aggravated the fragility of systems.

One dimension in which quick progress could be achieved is fire drills, simulation exercises, and contingency plans. Fire drills can hone the needed capacities of supervisory staff. They can also help expose shortcomings in the current legal framework for bank insolvency and thus influence the necessary reform process in the bank resolution system. Contingency planning should encompass all relevant national authorities, including supervisors and finance ministries, as well as other relevant agencies (such as international agencies, foreign supervisory authorities, and so on). Scenarios such as takeovers by competitors inside or outside domestic banking systems should also be part of contingency plans. The introduction of deposit insurance, meanwhile, does not seem practical in this context. Apart from the traditional concerns about moral hazard, the small number of banks imposes an important constraint because the failure of a single bank, even if it is not the largest one, would exhaust the fund. If deposit insurance already exists, however, transforming it from a paybox scheme to an integral part of failure resolution, as is happening in Kenya and Uganda, might improve efficiency and crisis preparedness. It would help align incentives because deposit insurers would then have not only the incentives, but also the tools to minimize the losses of the insurance fund.

In addition to the domestic dimension of failure resolution, the crossborder dimension has become increasingly important given the international character of Africa's banking systems. Recent reforms in the international supervisory architecture have focused on the constitution of colleges of supervisors for all banks operating internationally. The representation of African supervisors in these supervisory colleges remains a weak point because of the current asymmetry between developed markets and most African markets in the size of the operations of large international banks. For example, the activities of an international banking group in Africa may make up only a small part of the group's total balance sheet, though the group may have a disproportionate systemic importance in certain African countries. This asymmetry introduces an inherent complication in the design of college arrangements: African supervisors have large interests in the supervisory college, but may be overlooked by home supervisors because of a biased view of efficiency and effectiveness. Closer to home, the emergence of regional banks headquartered in African jurisdictions requires closer cooperation among banking supervisors across the region. African home supervisors need to champion regional college agreements and bilateral memorandums of understanding to facilitate cooperation processes. Restrictions on information sharing related to the confidentiality of banking information need to be relaxed to enable regulators to pass information on to other regulators. The recent European experience, however, suggests that colleges of supervisors and memorandums of understanding are necessary, but not sufficient tools for coordination in cases of idiosyncratic or systemic fragility. In the end, memorandums of understanding are legally nonbinding documents, and, even within a college of supervisors, it is the home country supervisors who take the final decisions.

Looking beyond banks: how to regulate the nonbanking sector?

The regulation of insurance companies and pension funds has often been neglected, especially if financial sector supervision is housed in finance ministries with few staff, weak regulatory frameworks, and no supervisory powers. However, consumer protection regulations are as important as capital and governance regulations in increasing the trust in these institutions. Recently, this has started to improve because regulatory and supervisory functions have been moved either to the central bank or to dedicated nonbank regulatory agencies, such as has occurred in Botswana and Zambia.

Another reform suggestion in the recent postcrisis debate has been the extension of the regulatory is extending financial sector regulation and supervision to nonbank financial corporations such as private equity funds. This trend toward extending the regulatory perimeter is confronted not only by the lack of the necessary human and financial resources in many low-income countries, but also by the transaction costs that the expansion of regulation would have on emerging components of the financial system, such as certain over-the-counter markets or capital funds.

One of the areas experiencing the most rapid changes over the past decade or so has been the regulation of institutions that serve the bottom of the pyramid. Many African countries have, by now, introduced some kind of special regulatory framework for MFIs or are in the process of doing so. In a third of countries, however, MFIs still fall implicitly or explicitly under the banking or nonbank financial institution regulatory framework or they are left out completely.

A question with which many countries across the continent have been struggling is whether microfinance or cooperative institutions should be regulated and supervised to the same extent as banks. A global consensus has developed on extending prudential regulation and supervision only to deposit-taking institutions, while avoiding burdensome prudential regulation for nonprudential purposes. Deposit-taking microfinance institutions can certainly benefit from lower reporting requirements and lower absolute minimum capital standards; however, they may, possibly, need greater requirements for capital and liquidity ratios. There is an argument for the need for higher capital-adequacy ratios for MFIs because their loan portfolios are typically more concentrated geographically and by sector, and, for this reason, the portfolios tend to be more volatile.Rules such as limits on unsecured lending as a ratio of equity should not be imposed on MFIs because most, if not all, microlending is uncollateralized. It is important not to impose overburdensome activities or geographic restrictions on such institutions; this might undermine viability. Similarly, given the fixed costs, the regulation of MFIs is expensive for supervisory agencies. There is thus a trade-off between inclusion and the goals of stability.

Focusing on users: consumer protection

Consumer protection has gained importance throughout the world. Across the industrialized world, the aftermath of the global crisis has seen a reemphasis on protecting unsophisticated consumers of financial services from sells of products they do not need or that expose their livelihoods to extreme risk. This focus on consumer protection relates to savings and investment, as well as to credit products. It is closely related to the theme of financial literacy discussed above, but focuses more on the market-harnessing role of regulation and imposes restrictions on financial service suppliers rather than on (potential) consumers.

What are the instruments of consumer protection? In line with the motto that transparency is the best disinfectant, disclosure requirements are one of the most basic and important tools. A step above pure disclosure rules (which can be enforced by bank supervisors or even on an industry-wide basis by the banking association) are consumer protection rules that prohibit financial institutions from selling specific products to all but sophisticated clients (such as corporate clients or high-wealth individuals) or impose affordability tests on financial institutions before extending credit. Such regulation is accompanied by regulatory compliance costs on financial institutions, might prevent the broadening of the financial system, and requires additional institutional capacity among authorities. A final set of rules imposes certain minima or maxima on the costs for financial services, including usury interest rates. However, such interest rate ceilings (in the case of credit) or floors (in the case of savings products) can easily become a restrictive tool that reduces the access to services by riskier customers and customers with a need for smaller transactions and who are thus costlier for financial institutions. A third of countries in Africa still have usury ceilings in place, and a fourth imposes deposit interest rate floors. However, this high rate is driven by the West African currency union. Meanwhile, few countries set limits on fees. This obviously makes interest rate ceilings and floors less effective because fees are a popular escape route for banks facing restrictions on interest rates.

The minimal consumer protection framework should aim for (1) transparency, (2) fair treatment, and (3) recourse possibilities. It is important to note that one size does not fit all. Middle-income countries such as South Africa can afford sophisticated institutional structures. Given the rapid increase in consumer credit, there is also a stronger need for protection mechanisms in these economies. In the specific case of South Africa, this has also to be seen in the context of the consumer credit boom the country experienced in the early years of the 21st century. Small countries and low-income countries, at the other extreme, might not have the necessary resources and capacities to implement such a system and have to rely more on disclosure standards and self-regulatory initiatives. However, there is also less of a need for a sophisticated set of instruments for consumer protection in the banking system, given the poor outreach of banks in these countries. A greater emphasis might have to be placed in such countries on detecting early signs of the existence of pyramid schemes in the informal sector.

All Financial Sector Policy Is Local

The financial sector challenges described in the book are not new. Africa's informality, lack of scale, volatility, and governance problems has been discussed extensively elsewhere. Not new either is the long list of solutions that have been tried on the cntinent in one form or another. Many solutions have been discredited in one decade only to become the preferred flavor of financial sector reform in the next. Yet, the challenge represented by limited and costly finance in Africa persists. Even while solutions are being implemented in other continents today, their importation to and application in Africa are not taking place at a rate sufficient to make a substantial and sustainable impact on the availability of affordable finance.

We argue that the problem has not been in the choice of the solutions, but rather the direction and quality of the application of the solutions to Africa's local circumstances and the failure to build or scale up homegrown solutions. We also caution that, unless there are changes in the politics of financial reform in Africa, the recent opportunities offered by globalization, technology, and regional integration will be wasted as have other opportunities that once offered promise to resolve Africa's financial constraints.

While modernization represents the bedrock of any credible vision for national financial sectors whether in Africa or elsewhere, the problem has been the application of the modernist agenda according to the primary premise that modernization is equivalent to the best practice of the advanced market economies. Unless policy makers and the development partners that work with them redefine progress in financial sector development deliberately to suit local African conditions, the modernist agenda will continue to overreach in Africa. In the end, all financial sector policy is local.

The short-term election cycle of African politics is at natural odds with the long-term nature of financial sector development and reform. So is the plethora of politically convenient financial sector policies and programs that are incompatible with market-based financial sector development. Instead, the political reality calls for the design and development of second-best solutions that go beyond the preoccupation in many countries for optimal, but unachievable policies and take the governance realities into account more systematically. First, seek out incremental reform options that are feasible given the realities in political economy. Second, draw on the body of knowledge on economically optimal policies in the design of reform. Third, consider the options for strengthening institutions.

The three overarching messages of the book are closely related to the discussion on the politics of financial sector reform. One important effect of financial sector deepening and broadening is the expansion in competition and contestability throughout an economy. New players, new markets, and new products undermine the rents of incumbents not only in the financial sector, but throughout the economy. Pushing a financial system beyond banks toward new providers and products will lead to resistance from incumbent financial institutions, most prominently from banks. A critical role—here, we link to our third message—arise from the constituency for financial sector reform. Small enterprises and previously unbanked segments of the population constitute the potential beneficiaries. In the long term, it is thus critical to create a constituency for financial sector reform that comprises the beneficiaries of any broadening of financial services. Financial literacy can be important also in this context, and financial journalists can play a key role.

Making Finance Work for Africa

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