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African Development Finance Institutions: Unlocking the Potential

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AFRICAN DEVELOPMENT BANK GROUP

African Development Finance Institutions: Unlocking the Potential

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Office of the Chief Economist

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Abstract

African development finance institutions (DFIs) can play an important role in addressing market failures in credit markets. However, in spite of their importance, very little is known about them. This paper contributes to fill this gap by assessing the compliance of African DFIs with international best practices in corporate governance and risk management based on the results of the peer review process of the "Prudential Standards, Guidelines and Rating System for African Development Banks and Finance Institutions". This paper finds that African DFIs are compliant with a number of best practices yet there is scope for improvement. This paper concludes that policymakers might consider addressing existing gaps should they wish improving the performance and effectiveness of African DFIs.

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1. Introduction

The recent financial crisis has triggered new debates on the role of the state in the economy, particularly in the financial sector, contributing to renewed interest among policymakers in the role of development finance institutions (DFIs).[2] In many economies, DFIs played an important counter-cyclical role by expanding their activities to prevent a sharp credit crunch in light of deleveraging and increased risk aversion by private agents. A current challenge is how to ensure that DFIs are effectively used as counter-cyclical policy instruments, while simultaneously guaranteeing that they play an active role in promoting financial access as well.[3]

This is especially relevant for Africa, where pervasive market failures in the provision of infrastructure finance, agriculture finance, housing finance and small and medium enterprise (SME) finance provide a strong rationale for an active developmental role played by DFIs. There are more than 140 DFIs in Africa, encompassing a wide array of institutions such as government-owned banks, development banks, insurance companies, guarantee funds etc. Their common denominator is represented by a policy mandate to foster economic development in the jurisdictions in which they operate. African DFIs can make an important contribution to lengthen maturities in the financial sector and mobilize resources for underserved segments of the economy. From this perspective, they can play a useful complementary role to that played by international financial institutions, such as the African Development Bank (AfDB), and commercial banks.

Despite their importance, very little is known about African DFIs. Recent research either takes a cross-country perspective (see De Luna-Martinez and Vicente, 2012) or focuses on case studies (see Rudolph, 2009). To the best of our knowledge there is no specific assessment of the

[2] See, for example, World Bank (2012).
[3] For a discussion on the trade-off between the short-term countercyclical role of DFIs and their longer-term developmental role see Gutierrez et al (2011).

African DFI landscape. In particular, very little is known about the corporate governance arrangements and risk management systems of African DFIs. This is important because existing studies suggest that weaknesses in corporate governance and risk management structures are the key determinants of the historically poor performance of DFIs.[4]

This paper contributes to the growing literature on the role of DFIs in economic and social development. In particular, this paper analyzes the results of the peer review process of the "Prudential Standards, Guidelines and Rating System for African Development Banks and Finance Institutions" (PSGRS) with the aim to assess compliance with international best practices in corporate governance and risk management, and identify areas for improvement to guide policymakers on key reform priorities.

This paper finds that African DFIs' compliance with best practices in corporate governance needs improvement in a number of areas. In particular, there is a need to (i) enhance the regulatory and supervisory structure to separate ownership from control; (ii) strengthen the framework where the mandate, the objectives, the strategy and the targets of DFIs are defined; and (iii) improve the process of selection and appointment of the board of directors and reinforce its role. This paper also finds that African DFIs need to improve compliance with international principles of risk management in several dimensions. In particular, African DFIs need to (i) develop a more systematic ex-ante assessment of the development impact of their operations; (ii) establish a proper Environmental and Social Management System to identify and manage environmental and social risks and impacts associated with their financing activities; (iii) strengthen the overall credit administration and monitoring process, including the workout function; and (iv) improve their liquidity management frameworks.

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[4] See, for example, Dinc (2005), Caprio et al (2004) and La Porta et al (2002) on the link between corporate governance and performance of DFIs, and Yaron (2004) and Titelman (2003) on risk management and performance.

The remainder of this paper is organized as follows. After this introduction, the next section briefly presents some methodological notes and the sample used for the analysis. Section 3 discusses the findings of the PSGRS peer reviews with regard to corporate governance, in the context of relevant best practices. Section 4 presents the main risk management practices of African DFIs and benchmarks them against international standards. Section 5 presents some performance indicators of African DFIs. Section 6 concludes.

2. Methodology and sample

DFIs form a heterogeneous group of institutions, with structural variations in terms of ownership structure (public, private or mixed), mandate (universal, sectoral or export-import) and business model (first-tier or second-tier financial institution). Generally employed definitions focus on DFIs' core activity to provide long-term financing to projects to foster development.[5] For the purpose of this paper, we define a DFI as *an institution which is majority owned by the government and that has an explicit legal mandate to foster economic and social development in a country, sector or target market, mainly by providing investment finance*. This definition is aligned with the profile of the ordinary members of the Association of African Development Finance Institutions (AADFI).

This paper is based on the results of the self-assessment performed by the ordinary members of AADFI in 2009 and 2011.[6] The self-assessments were part of the peer review process envisaged by the "Prudential Standards, Guidelines and Rating System for African Development Banks and Finance Institutions".[7] The PSGRS was adopted in 2008 by AADFI in collaboration with the AfDB after consultations with various stakeholders. Its main objective is to assess compliance with a set

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[5] See, for example, Panizza et al (2004).
[6] AADFI (2009a; 2011).
[7] AADFI (2009b).

of internationally accepted corporate governance and operational standards and measure financial performance to provide stakeholders, including shareholders, regulators and donors, with useful benchmarks to assist in their respective involvements. The PSGRS is based on a survey containing 100 questions grouped into three specific areas: governance standards, financial prudential standards and operational standards. Compliance is assessed for each category and sub-category based on three criteria: full compliance, partial compliance and no compliance. A weighted score is ultimately produced to rank institutions.

In this paper we take a slightly different perspective. The aim of this paper is to identify the main challenges that African DFIs face with the objective to strengthen their institutional setup, insulating them from undue political interference, and to turn them into profitable and financially sustainable institutions with modern corporate governance arrangements and solid risk management frameworks. Accordingly, instead of ranking the institutions based on their scores, we discuss the main components of the survey in the context of the relevant empirical evidence and best international practices.

African DFIs which undertook the 2011 PSGRS peer review include 30 institutions, of which 21 had participated to the 2009 exercise as well. For the latter, we only consider responses provided in 2011. We exclude from the analysis the sub-regional DFIs in order to concentrate on national DFIs. This is because due to their multilateral status sub-regional DFIs display institutional and operational features whose implications go beyond the purpose of this paper. We are therefore left with a total of 33 national DFIs and 1,452 responses, which served as the basis for this study.[8] Overall, 17 countries are represented, with the sampled institutions accounting for 60 percent of

[8] Of the original 100 questions, we focus only on 44 questions which are relevant for the purpose of this paper. See Annex for the full list of questions used in this paper.

AADFI ordinary members and 40 percent of the African government-owned financial system by total assets.

Three important caveats are in order. First, the data come directly from responses provided by senior managers of DFIs which participated in the surveys. There was no auditing of the data. However, DFIs' senior managers had an opportunity to validate their institutions' data. Second, some of the responses were provided in 2009 and therefore may not be truly representative of DFIs' current status. Yet, the survey's analytical categories focus on structural features which are difficult to address in the short term. In any event, any change is not likely to materially affect our findings. Finally, the sampled DFIs vary in terms of ownership, mandate, governance and business strategy. Therefore, no single set of standards can be fully relevant and appropriate for all DFIs. Nonetheless, the questions included in the PSGRS were designed to accommodate this wide variation.

3. Corporate governance[9]

Good corporate governance is as important for state-owned institutions as for private sector institutions and can contribute to improve their performance. Given their public policy role, it is all the more important that DFIs have a proper framework in place to ensure that they carry out their mandate and meet their objectives effectively.

According to the OECD (2004), corporate governance refers to "a set of relationships between a company's management, its board, its shareholders and other stakeholders. Corporate governance also provides the structure through which the objectives of the company are set, and the means of attaining those objectives and monitoring performance are determined. Good corporate governance should provide proper incentives for the board and management to pursue objectives

[9] This section discusses the findings of the PSGRS peer reviews in the context of the OECD guidelines on state-owned enterprises. See OECD (2005).

that are in the interests of the company and its shareholders and should facilitate effective monitoring".

Evidence suggests that most of the poor performance of DFIs is explained by shortcomings in corporate governance structures, which are instrumental to political interference and poor managerial skills (Dinc, 2005; Caprio et al, 2004; La Porta et al, 2002). Yet putting in place a proper governance system in place for DFIs is not an easy task. This is because the exercise of direction and control is complicated by the multitude of institutions usually involved in the ownership of a DFI. Moreover, given the leverage involved in their operations, DFIs have the potential to create contingent fiscal liabilities for the government. Finally, DFIs have to balance a trade-off between the two potentially conflicting objectives of fulfilling their policy mandate and being financially sustainable (Scott, 2007). For all these reasons, introducing and enforcing a sound corporate governance system requires a significant investment in resources and, most importantly, continued commitment by the shareholders.

The PSGRS addresses various dimensions of the corporate governance framework of African DFIs. First is the broad state ownership policy. The way in which the state organizes and manages its relationship with the DFI constitutes the basis for overall corporate governance. In this respect, the legal and regulatory framework for the DFI's operations should ensure a level-playing field with commercial financial institutions in order to avoid market distortions. In particular, the legal form under which the DFI operates should ensure adequate protection of creditor rights and not provide exemption from the application of general laws and regulation. It should also allow sufficient flexibility to adjust the DFI's capital structure based on the needs and the objectives of the DFI. Compliance with these requirements can be achieved by incorporating the DFI under the Companies Act or the Banking Act. The results obtained from the peer review exercises related to the PSGRS point to overall compliance with this principle, with 91 percent of African DFIs either incorporated under the Companies Act or the Banking Act, or subject to their requirements.

Another accepted standard of state ownership policy is a clear separation of responsibility within the government between exercising ownership on the one hand and exercising regulation and supervision on the other hand. This is especially important for DFIs which collect deposits from the public. In this context, African DFIs show some deficiencies. Only 55 percent of them is regulated and supervised by the central bank or other financial sector regulatory body, with the remainder subject either to the Ministry of Finance (21 percent) or to other government entity (24 percent).

As an active shareholder, the government has an interest that the DFI fulfills its policy mandate in a financially sustainable manner and according to an explicit set of operational objectives and financial performance targets. Failure to do so can lead to political interference, excessive management autonomy and/or difficulties in measuring and evaluating the performance of the board and ultimately of the DFI. To achieve this in practice, the government and the DFI should enter into a written performance agreement documenting the mandate, the objectives, the strategy and the financial and non-financial targets. The findings of the peer reviews of the PSGRS show that only half of African DFIs have an explicit performance agreement with the government outlining the areas mentioned above, and only 30 percent have a performance-based incentive system for their management. Moreover, 45 percent of African DFIs require government approval of at least one area of operations.

A final key ownership task is to appoint the board of directors. An appropriately constituted, qualified and empowered board of directors is an essential pillar of good corporate governance. The government should have in place a well-established and transparent board nomination process, which ensures that the board of directors has the relevant capacity to perform its role. From this perspective, only 58 percent of African DFIs have board of directors where a vast majority of its members meet eligibility criteria in terms of professional and technical background. A related issue with respect to board composition is whether government officials should be appointed on the board of a DFI and whether the chairperson should have executive responsibilities. As the controlling owner, the government is in a unique position to nominate and elect the board without the consent of other shareholders, if any. However, in this process and to minimize potential conflicts of interest it should avoid appointing an excessive number of public servants, even when they meet the necessary skills and experience requirements. African DFIs seem to be far from this ideal situation. Only in 55 percent of the DFIs government officials represent less than one third of the board of directors, while in 33 percent of the respondents government appointees constitute the majority of the directors. The question as to whether the chairperson of the board should be prohibited from having executive responsibilities is one confronted in the private sector as well, and there seems to be a consensus for a separation of roles. From this perspective, African DFIs largely follow best practices, with only 9 percent of the respondents declaring to be not compliant.

A second dimension of the corporate governance framework of a DFI is the role and functioning of the board of directors. In principle the board should carry out its functions of strategic guidance and management monitoring within the performance agreement between the government and the DFI. One key function of the board is to appoint and dismiss the chief executive officer (CEO). Without this authority it is difficult for the board to exercise its oversight function and hold the CEO and executive management accountable. In Africa, the shareholder representative or the government retain the power to appoint and remove the CEO in 58 percent of the DFIs in our sample, while in the remaining 42 percent there is some sort of cooperative arrangement between the shareholder representative and the board or a board committee. To exercise effectively its monitoring function, the board should also have a decisive influence over the compensation of the CEO and executive management. In principle, executive management compensation should be market-based and related to performance. Yet according to the PSGRS peer reviews only 30 percent of African DFIs have executive management remuneration linked to performance.

A final dimension of corporate governance of DFIs is the information, reporting and disclosure regime. Effective governance is based on information sharing internally within the DFI and externally with the government and the public in general. This includes management information systems, management reporting to the board of directors, board reporting to the shareholder representative, shareholder representative reporting to the government and public reporting via published accounts. Ensuring adequate reporting requires investment in accounting and information systems as well as in policies and procedures. From this perspective, African DFIs show mixed compliance. While 82 percent of the institutions participating to the PSGRS peer reviews report that they prepare an annual budget ahead of any fiscal year to guide their operations, only 9 percent have in place a detailed cost accounting system to measure profits and losses associated with specific programs or products, and only 24 percent have an ability to report separately on funds managed on behalf of the government.

Equally important is the need to develop efficient internal audit procedures and establish an internal audit function that is monitored by and reports directly to the board of directors or board committee. The latter is important to increase both the independence and the authority of the internal audit function. In some cases, due to the lack of scale or capacity, the internal audit function is outsourced to an external auditor which is granted the same powers. In this respect, the totality of African DFIs report having in place an internal audit unit reporting to the board or audit committee.

Finally, it is important that DFIs are subject to an annual independent external audit based on internationally agreed accounting standards. While DFIs are typically inspected on a regular basis by the government to monitor the use of public funds and budget resources, an external audit typically focuses on the operations of the DFIs as a whole and therefore contributes to reinforce trust in the information provided by management to the board as well as in the internal procedures and systems. In this context, 94 percent of African DFIs state that their accounts are audited annually by an external auditor, with 85 percent reporting according to international accounting standards.

4. Risk management[10]

The ability of DFIs to identify, measure, monitor and control the risks they face as well as to determine that they hold adequate capital against those risks is a critical component of the overall corporate governance framework and ultimately an essential determinant of performance. Credit risk is the main risk faced by DFIs. In addition to shortcomings in corporate governance, lax credit standards and poor portfolio risk management have been recurrent causes of failure for DFIs around the world (see Yaron, 2004 and Titelman, 2003). It is therefore essential that DFIs have in place an appropriate credit risk environment, operate under a sound credit granting process, maintain adequate credit administration and ensure controls over credit risk. While specific credit risk management practices may differ depending on the specific nature of the DFI, a comprehensive credit risk management framework is expected to cover the areas mentioned above. These

[10] This section discusses risk management practices in the context of international standards set by the Basel Committee on Banking Supervision. See BCBS (1991; 1999; 2000a; 2000b; 2006; 2008).

principles should also be applied in conjunction with sound practices related to the assessment of asset quality, the adequacy of provisions and reserves, and the disclosure of credit risk.

The PSGRS includes a number of questions aimed at assessing compliance with international best practices in credit risk management. First is the loan approval process. Establishing sound, well-defined credit-granting criteria is essential to approving credit in a safe and sound manner. The criteria should set out who is eligible for credit and for how much, what types of credits are available and the terms and conditions. DFIs should receive sufficient information to enable a comprehensive assessment of the risk profile of the borrower. Consideration should be given to the integrity and reputation of the client. Eighty-five percent of the African DFIs which participated to the PSGRS peer reviews claim that before granting a loan they require satisfactory credit references, including information on banking relationships, often by accessing credit bureaus available to commercial financial institutions, where these are in place.

In assessing whether and in what from granting a credit, DFIs should also consider the risks against the expected return, factoring in price and non-price terms. They can use transaction structure, collateral and guarantees to help mitigate risks though transactions should be ultimately entered based on the intrinsic strength of the borrower’s repayment capacity. However, given their policy mandate to contribute to socio-economic development, DFIs should also include key development impact measures in their lending criteria and have in place a proper system to identify environmental and social risks associated with their financing activities. From this perspective, African DFIs exhibit mixed behaviors. On the one hand, they seem to be financially prudent when granting a loan, with 76 percent of them requiring that the borrower contributes at least 25 percent of the total project cost with equity and provide collateral in the form of cash and physical assets to cover at least 35 percent of the loan value. On the other hand, African DFIs have not clearly defined development criteria incorporated in their investment processes, with only 21 percent calculating systematically key performance indicators such as the economic rate of return of a project, the expected employment generated and the cost per job created. Finally, 52 percent of African DFIs have written policies and procedures with respect to the environmental impact of projects largely in line with international or national guidelines.

An important principle of credit risk management is the establishment of exposure limits on single counterparties or groups of connected counterparties. Diversification of risk is a key precept in banking. Risk concentration can take a variety of forms, and can affect the asset side as well as the liability side of a DFI. Systematic sources of concentration risk include sectoral specialization and statutory reliance on government budget allocations to fund operations. Idiosyncratic concentration risk stem from excessive credit exposure to single borrowers. Experience suggests that credit concentrations can result in substantive losses and it is therefore essential that DFIs have an appropriate framework for measuring and controlling concentration risk. While systematic risk cannot be diversified, name concentration risk can be mitigated by setting appropriate limits. Typically, single exposure limits are expressed in terms of an institution’s capital, with 25 percent as a desirable target for the upper limit. Seventy-six percent of African DFIs are compliant with this criterion.

In order to maintain a sound credit portfolio, DFIs should have a clearly-established process in place for approving new loans as well as for amending, renewing and refinancing existing exposures. Approvals should be made according to written guidelines and granted by the appropriate level of management. African DFIs have in place sound formal procedures for extending credits to their clients. Ninety-one percent of the entities participating to the PSGRS peer review exercises claim that all loans are granted on the basis of an appraisal report approved by a credit committee whose membership includes staff from at least four organizational units.

Credit proposals should be subject to careful analysis by qualified credit analysts with relevant expertise. DFIs should encourage sectoral expertise among credit analysts and ensure that they are involved in the information flow related to the performance of the loan. In this regard, 42 percent of African DFIs are fully compliant with this best practice, with the remainder to a large extent partially compliant.

A second important dimension of credit risk management discussed in the PSGRS is the overall credit administration and monitoring process. This is a critical element in maintaining the safety and soundness of a DFI. Once a credit is granted, the DFI should develop and implement comprehensive procedures and information systems to monitor timely the evolution of individual credits and single obligors across the loan portfolio. African DFIs show mixed compliance with this principle. While 58 percent of DFIs prepare detailed supervision reports at least on a quarterly basis, 27 percent only report twice a year, with the remainder 15 percent monitoring projects on an annual basis.

An effective monitoring system should highlight criteria for classifying and reporting problem loans as well as possible corrective action. One reason for establishing a systematic credit review process is to promptly identify deterioration in asset quality. DFIs' credit policies should clearly set out how the institutions will manage problem credits and assign responsibility accordingly. Seventy-three percent of African DFIs report having written procedures for remedial action, typically undertaken when a credit is 30 days overdue. When a credit-related problem arises, it is also important to segregate the workout function from the unit where the loan originated. This is because additional resources, expertise and business focus are expected to improve collection results. From this angle, African DFIs show some deficiencies. Only 48 percent claim to have adequately staffed workout units which deal with problem credits based on written procedures and report regularly on the status of the exposure. Forty-two percent of African DFIs only have written policies but no specific workout unit, while the remaining 9 percent has no systematic remedial management process.

Finally, DFIs should also have sound loan valuation policies and practices regardless of the accounting framework applied, and provide timely information to the public. Effective credit risk assessment and loan accounting practices should be performed systematically and in accordance with established policies and procedures. This involves classifying loans on the basis of a credit grading system and a sound loan loss methodology. In this regard, African DFIs seem to be largely compliant with international best practices: 85 percent of the institutions participating to the PSGRS peer reviews report that they classify and provision loans in accordance to the Basel Committee standards. It is also essential that DFIs disclose comprehensive information on their loan portfolio, including information on impaired assets and past due assets. Assessed against this best practice, African DFIs show a high level of compliance, with 73 percent providing detailed information in the notes to the audited financial accounts.

The second most important risk faced by DFIs is liquidity risk. The importance of this risk dimension depends upon the funding model employed by the institution. DFIs can fund their operations by taking deposits from the public, borrowing from capital markets, using their own equity and receiving budget allocations from the government, or a combination of them. In general, the presence of an implicit or explicit government guarantee should minimize liquidity risk for a DFI. However, at times of stress the option of refinancing cannot be taken at face value. It is therefore essential that the DFI has an effective liquidity risk management framework to ensure that it is able to meet cash flow obligations as they come due. As with credit risk management, the formality and sophistication of the process employed to manage liquidity can differ from DFI to DFI. However, reliable management information systems, analysis of the net funding requirements, diversification of funding sources and contingency planning are crucial elements of strong liquidity management.

Each DFI should have a liquidity management structure in place to execute effectively the institution's liquidity strategy, policies and procedures. DFIs should assign ultimate responsibility for setting liquidity policies and reviewing liquidity decisions to a specific and well identified group within the institution. This typically takes the form of an Asset/Liability Committee comprised of senior management, the treasury function and/or a risk management department. African DFIs show a very low level of compliance with this principle, with only 39 percent having a liquidity policy implemented and overseen by an Asset/Liability Committee, which meets at least monthly. The remaining 61 percent does not have a proper structure to manage liquidity risk, possibly reflecting their particular funding model, which might be entirely reliant on government budgetary resources. As a matter of fact, when asked whether they have a dependable source of funding in place, the same proportion of African DFIs (61 percent) responded positively.

DFI's management should also set limits to ensure adequate liquidity or alternatively comply with limits set by financial regulators. Limits are typically set either in terms of cumulative cash flow mismatches over particular periods or in terms of minimum liquid assets as a share of total assets. Fifty five percent of African DFIs report that they are in compliance with the minimum liquidity requirements imposed by the regulator, while 39 percent claim that in the absence of limits is able to cover 1.1 times their short-term liabilities with liquid assets.

An important component of the liquidity management framework is a management information system designed to provide the board of directors and senior management with timely information on the liquidity position of the DFI. This should provide the basis for measuring and monitoring liquidity risk over a series of specified time periods. A maturity ladder is typically used to compare cash inflows and outflows to determine net funding requirements. From this perspective as well, African DFIs seem to be largely not compliant with best practices in liquidity management, with only 42 percent reporting that they prepare a gap analysis at least on a quarterly basis and have a plan for dealing with any negative gap within the next year.

A final element of a DFI's liquidity management structure is a measurement, monitoring and control system for its liquidity position in foreign currency as well as a set of limits in terms of acceptable mismatch. When dealing in foreign currencies, a DFI is exposed to the risk that a sudden change in foreign exchange rates or market liquidity, or both, could sharply widen the liquidity mismatches being run. This can result in an increase in the foreign currency funding gap and/or a rise in impairment in foreign currency assets, especially when borrowers are unhedged. As with other areas of risk management, the particular issues to be addressed, and the resulting framework, will depend on the nature of the DFIs' business, with export-import DFIs clearly more exposed. Foreign currency assets represent less than 40 percent of total assets in the almost totality of the DFIs in our sample (97 percent), with 73 percent of them reporting that they have a FX policy and a net open FX position within 20 percent of their equity base, in line with limits typically set by the financial regulator. An additional 88 percent of African DFIs report that they do not lend FX loans to unhedged borrowers.

5. Financial performance

How do the overall corporate governance framework and risk management systems of African DFIs translate in terms of financial performance? As discussed in the previous sections, a common criticism against DFIs is that shortcomings in corporate governance and weaknesses in risk management are major causes of poor financial performance. The PSGRS collects some generic information on profitability, asset quality and capital adequacy of African DFIs, which can be useful to perform a preliminary assessment of the sector's financial soundness.

Although DFIs are not profit maximizers, their profit generation capacity is arguably a key determinant of their long-term success or failure. On the one hand, earning power can substantially increase DFIs' capitalization, thus enhancing their risk-bearing capacity as DFIs do not distribute dividends or pay tax. On the other hand, losses can lead not only to a rapid depletion of equity, ultimately borne by the taxpayers, but can also erode confidence in the DFI. From this perspective, African DFIs which participated to the PSGRS peer review exercises in 2009 and 2011 show relatively poor profitability measures. While net interest margin is above 4 percent of total assets in 70 percent of the institutions, only 30 percent have noninterest income accounting for more than 5 percent of their assets, and two-thirds of African DFIs report operating expenses in excess of 4 percent of total assets. All this translates in relatively poor bottom line profitability, with 24 percent of the institutions reporting return on assets (ROAs) in the negative territory and 15 percent posting positive ROAs though below 1 percent.

As with commercial banks, the quality of the assets is a major determinant of DFIs' profitability. A healthy and performing portfolio generates interest income and does not require specific provisions. Good asset quality is in turn the result of sound risk management systems and processes. In this respect, the findings of the PSGRS peer reviews confirm the shortcomings identified in the previous section. Measured in terms of percentage of loans classified as nonperforming, African DFIs exhibit on average problematic asset quality, with 52 percent of the institutions reporting a nonperforming loan (NPL) ratio in excess of 15 percent, which compares unfavorably with levels observed in the banking systems of many African countries. It is true that given their policy mandate DFIs tend to have a higher risk appetite than commercial financial institutions, which in turn is expected to translate in higher than average NPL ratios. However, such a high level of impaired loans may signal important weaknesses in the DFIs' risk culture and measuring and monitoring tools.

Finally, the PSGRS surveys the capital adequacy of African DFIs. Capital is the ultimate line of defence against credit losses. Therefore, capital has the ultimate role to protect taxpayers' money. It also determines the capacity of the institution to leverage external sources of financing and define the DFIs' risk tolerance level. As discussed above, most African DFIs are not regulated and supervised by the central bank or the financial regulator, and as such are not required to comply with minimum prudential capital requirements. Nonetheless, many institutions have developed internal guidelines, which include among others statutory limits on the maximum leverage defined in terms of Basel capital standards. In this respect, African DFIs post relatively high levels of capitalization, when compared with the private sector, with 88 percent reporting a ratio of equity to long-term debt in excess of 25 percent.

6. Conclusions

The recent financial crisis has generated renewed interest in DFIs. In the African context, government-owned DFIs can play a useful complementary role to fill existing gaps in the provision of long-term finance, especially in infrastructure, housing, agriculture and the SME segment. African DFIs have historically played an important developmental role, taking higher-than-average risks to perform their mandates and reducing credit pro-cyclicality. However, the track record of African DFIs is mixed, and their developmental contribution has frequently come with a cost in terms of relatively low efficiency and effectiveness.

A growing body of empirical evidence indicates that once DFIs are provided with strong governance structures and the right incentives they can play an effective role in expanding financial access, ultimately contributing to economic and social development. This usually involves clear and focused mandates, robust corporate governance standards with independent boards, proper performance assessment criteria, appropriate lending and risk management technologies, the requirement to be financially sustainable, and the ability to recruit and retain qualified staff. It is therefore important to assess compliance with those best practices.

This paper reviews African DFIs' existing practices in corporate governance and risk management with the objective to identify key areas for improvement so that policymakers can be better informed should they consider strengthening government-owned financial institutions to address present and future needs in their respective jurisdictions. In particular, this paper analyzes the results for 2009 and 2011 of the peer review process within the PSGRS, focusing on national DFIs.

This paper finds that African DFIs comply with many international best practices. However, there is scope for improvement. In particular, in terms of corporate governance framework, this paper finds that:

- 45 percent of African DFIs are not regulated and supervised by the central bank or other financial sector regulatory body;

- 50 percent of African DFIs have no written performance agreement with the government documenting the mandate, the objectives, the strategy and the financial and non-financial targets;
- 70 percent of African DFIs have no performance-based incentive system for their management;
- 45 percent of African DFIs require government approval of at least one area of operations;
- 42 percent of African DFIs have no well-established and transparent board nomination process, which ensures that the board of directors has the relevant capacity to perform its role;
- 33 percent of African DFIs have a board of directors where government appointees constitute the majority of the directors;

In terms of risk management systems, this paper finds that:

- 79 percent of African DFIs have no clearly defined development criteria incorporated in their investment processes;
- 48 percent of African DFIs have no Environmental and Social Management System to identify and manage environmental and social risks and impact associated with their operations;
- 42 percent of African DFIs do not prepare detailed supervision reports on their credit exposures at least on a quarterly basis;
- 52 percent of African DFIs do not have adequately staffed workout units to deal with problem credits based on written procedures and timely reporting;

- 61 percent of African DFIs do not have a liquidity policy implemented and overseen by an Asset/Liability Committee, which meets at least monthly;
- 58 percent of African DFIs do not prepare a gap analysis to monitor their funding needs at least on a quarterly basis and do not have a plan for dealing with any negative gap within the next year.

All this translates in a financial profile characterized by some weaknesses. In particular:

- 24 percent of African DFIs are not profitable, with negative ROAs;
- 52 percent of African DFIs have NPLs in excess of 15 percent of their loan books.

In the face of the huge developmental needs of the continent, there are strong reasons for African policymakers to continue strengthening and modernizing their DFIs, giving them the tools to better fulfill their policy mandates. This paper represents a first step towards improving knowledge about African DFIs so as to provide evidence on the key areas to target. More research is, however, warranted. For example, it would be useful to review African DFIs' mandates to assess the continued relevance of their strategic focus, their terms of engagement with commercial financial institutions and the sustainability of their efficiency objectives. It would also be valuable to perform a comprehensive assessment of the development effectiveness of African DFIs to measure public policy performance in this area. Finally, it would be worth considering a review of the PSGRS to streamline its focus and simplify its structure with a view to elevate it to a semi-regulatory tool.

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ANNEX

Excerpt of the "Prudential Standards, Guidelines and Rating System for African Development Banks and Finance Institutions" used in this paper.

1) *Are there clear eligibility criteria Directors must and do meet to ensure that they have the professional and technical background to enhance commercial Governance?*

   Full: If all members of the Board of Directors, with the exception of up to 2 Government officials who may be on a Board for ex-officio reasons, and a maximum of one Director chosen because he has a completely different background (such as a college professor) meet written eligibility criteria that ensure they have strong relevant professional and/or technical backgrounds.

   Partial: If a majority of Directors meet these eligibility criteria, the DFI should be rated as in partial compliance.

   Non: All other cases.

2) *How many members of the Board of Directors are at present Government Officials?*

   Full: If DFI has 2 or less Directors who are Government officials and they do not constitute 35% or more of the total number of Directors and do not include the Chairman.

   Partial: If DFI has more than 2 but less than a majority of Directors who are Government officials and the Chairman is not a Government official.

   Non: If a majority of a DFI's Directors are government officials.

3) *What decisions require direct Government approval?*

   Full: If DFI requires no government approvals beyond those a 100% privately owned DFI would require except for changes in its Act.

   Partial: If DFI requires government approvals in no more than two areas, e.g., annual budget and procurement.

   Non: All other cases.

4) *Is the DFI under its own Act, Companies Act and/or Banking Act?*

   Full: If DFI is under the Company or Banking Act but is not under its own Act.

   Partial: If DFI is under its own Act but is also fully subject to the requirements of either the Companies Act or Banking Act.

   Non: All other cases.

5) *Is the DFI externally supervised or overseen by any entity other than a Government Ministry?*

Full: If DFI is regulated and supervised by a central bank or financial institutions supervisory board or it if is a regional institution. (A corporate supervisory entity like a securities exchange is not a substitute for a financial institutions supervisory board in this question).

Partial: If DFI is supervised by a Ministry of Finance, but no other ministry.

Non: If DFI is supervised in all or in part by a line ministry other than a Ministry of Finance.

6) *How is the CEO chosen? Are there clear criteria that a CEO must and does meet that ensure the commercial skills necessary to run a financial institution effectively?*

Full: If a CEO is chosen by the shareholders or a Board of Directors representing shareholders and the selection is based primarily on a strong relevant professional and technical background.

Partial: If a CEO has a strong relevant technical or professional background but is chosen by Government or by a Government official.

Non: All other cases.

7) *Who has the power to fire the CEO? Have any CEOs been fired in the past 5 years? If so, for what reason?*

Full: If a Board of Directors, a committee of such a Board, or a Shareholders' Meeting are the only entity with the power to fire the CEO.

Partial: If only the Board can fire a CEO but it has been pressured into firing a CEO during the past 5 years for political reasons or by Government.

Non: All other cases.

8) *Do the Chairman or Directors who are not full time members of the management have any executive responsibilities?*

Full: If some key management representatives are on the Board, but they do not constitute a majority and the Chairman does not have executive responsibility.

Partial: If management representatives constitute a majority of the Board of Directors but the Chairman does not have executive responsibility or if the Law does not allow for a nonexecutive Chairman.

Non: All other cases.

9) *How many key executives and managers have performance based contracts with your DFI?*

Full: If the CEO and at least one other manager have a performance based contract, i.e., remuneration is based on the DFI's profit and/or other performance indicators.

Partial: If the CEO, but no other managers, has a performance based contract or if remuneration of key managers is based on performance against targets.

Non: All other cases.

10) *Do individual managers have specific profit and performance targets and are pay increases and promotions tied to performance against these targets?*

Full: If individual managers have specific profit and performance targets and pay increases are tied to performance against these targets.

Partial: If individual departments and/or profit centers have performance targets and their manager and key staff salary reviews are to a significant extent dependent on them.

Non: All other cases.

11) *Are accounts kept in accord with international accounting standards allowed by national or central bank account requirements and in compliance with those requirements?*

Full: If accounts are kept fully in accord with international accounting standards to the extent feasible while in compliance with national and/or central bank accounting requirements and the audited accounts are not qualified.

Partial: If accounts deviate from international accounting standards in only one area (but not loan classification and provisioning), are largely consistent with domestic accounting standards, and the audited accounts are not qualified.

Non: All other cases.

12) *Are loans classified and provisioned for in accord with international and Basel (or local central bank) standards?*

Full: If loans are classified and provisioned in full accord with international and local central bank standards.

Partial: If loans are classified and provisioned reasonably rigorously, but not in full accord with international and local central bank standards.

Non: All other cases.

13) *Do audited accounts disclose the amount of gross loans, the percentage of gross loans that are nonperforming and uncollected interest separately? What are the policies for capitalizing interest?*

Full: If the percentage of nonperforming loans and amount of uncollected interest on loans that are not overdrafts is separately disclosed in notes to the accounts, and interest, except during grace periods where stipulated by the loan agreement, is not capitalized except in cases of formal rescheduling.

Partial: If NPLs are disclosed in the accounts and uncollected interest is not capitalized except in cases of formal scheduling, but is not separately disclosed in the accounts.

Non: All other cases.

14) *Are accounts audited by an international accounting firm or one of the best private domestic firms, e.g., one qualified to audit commercial banks?*

Full: If accounts are audited by an international firm or one of the very best private domestic firms whether or not they are audited by a government auditor. (In some countries, the central bank provides a listing of audit firms it considers qualified to audit commercial banks).

Partial: If accounts are audited by both a private domestic firm and a government auditor.

Non: All other cases.

15) *Does the institution have an internal audit department or a qualified external audit company that reports directly to the Board of Directors? If not, does it have an internal audit department or qualified external audit company? Does it have formal procedures for encouraging "whistle blowing" by staff when they see something wrong?*

Full: If the DFI has an internal audit department or an external audit firm other than its own external auditors performing that function reporting directly to the Board and formal procedures for encouraging "whistle blowing" with copies of written reports submitted to the Board, also provided to the CEO for comment.

Partial: If DFI has an internal auditing department or qualified external audit firm performing that function that reports to the CEO.

Non: All other cases.

16) *Is there an annual budget prepared in adequate detail before the new fiscal year begins?*

Full: If DFI has an annual budget prepared in adequate detail before the new fiscal year begins, does not require Government approval, and reviews and, if necessary, revises the budget at least once during the year.

Partial: If DFI has an annual budget which was not approved before the beginning of the fiscal year or which needs Government approval.

Non: All other cases.

17) *Does DFI have a cost accounting system which it uses to identify profit or loss of various programs and products, including those that are done primarily with socio-economic objectives in mind?*

Full: If the DFI uses cost accounting to identify profit or loss of all major programs and products.

Partial: If it does not have a cost accounting system, but does detailed analyses from time to time to ascertain the profit or loss on programs and products.

Non: All other cases.

18) *Does DFI use cost accounting to measure losses on non-commercially viable programs or policies which Government forces or pressures DFI into implementing?*

Full: If the DFI uses cost accounting to measure losses on non-commercially viable programs or policies forced on it or pressured by Government, or if it has no such situations.

Partial: If it does periodic analysis to measure losses for most of these situations.

Non: All other cases.

19) *Does DFI have a clear written performance agreement with its owner, clearly defining its mandate, what its primary financial and socio-economic objectives are, mandating that management make financial sustainability its most important goal, and specifying the obligations of the owner with respect to financing commercially unviable programs or products that the DFI is expected to undertake to meet its socio-economic development objectives?*

Full: If a written performance agreement between the primary government owners and a DFI is transparently in place that meets the above conditions.

Partial: If a written performance agreement is in place that meets some but not all of the above conditions or if the DFI is a regional or privately owned institution.

Non: All other cases.

20) *Does DFI have a clear written strategy as to how it intends to implement its mandate, preferably as presented in a performance based agreement with the owner? Does it revise this strategy from time to time when situations dictate?*

Full: If there is a written overall strategy for implementing the mandate as presented in a performance based agreement with the owner which is revised when needed.

Partial: If there is a written overall strategy which is revised from time to time but which is not based on any written agreement with the owners.

Non: All other cases.

21) *What is the long term debt (liabilities with an original maturity of over two years) to equity (i.e., net worth) ratio? Is it below 4 to 1? Is it below 8 to 1?*

Full: If DFI has a long term debt to equity ratio of less than 4 times.

Partial: If DFI has a debt to equity ratio of more than 4 but less than 8 times.

Non: All other cases.

22) *How much are annual administrative expenses (defined as all overhead expense including staff cost) as a percentage of average total assets and are they adequate?*

Full: If annual administrative expenses are less than 4% of average assets.

Partial: If annual administrative expenses are more than 4% of average assets but less than 6%.

Non: All other cases.

23) *How much is annual profit after tax as a percentage of assets? Is it over 1% and reasonably sustainable? Is there a profit?*

Full: If DFI has a minimum annual profit after tax of more than 1% of assets which is reasonably sustainable and it makes loan provisions and unpaid interest not taken into income in accord with international standards.

Partial: If a DFI has a minimum profit of more than zero but less than 1% of assets and makes loan provisions and suspends interest in accord with international standards.

Non: All other cases.

24) *How much is profit as a percentage of the increase in risk weighted assets over the past year, i.e., is profit high enough to preserve adequacy and, thus, sustainability?*

Full: If DFI has a profit equal to or exceeding 15% of the increase in risk weighted assets during the year.

Partial: If there is a profit of more than zero but less than this amount.

Non: All other cases.

25) *What is annual noninterest income from operations as a percentage of assets? Is it over 5%, thus implying significant diversification of revenue sources?*

Full: If annual noninterest income from operations (excluding write backs of previous bad debt provisions) exceeds 5% of average assets.

Partial: If noninterest income is more than 2% but less than 5%.

Non: All other cases.

26) *What is the interest margin and does it suggest earnings from lending are adequate?*

Full: If interest margin (defined to be the difference between total financial costs as a % of total assets and total interest and dividend income) is more than 4% of average assets.

Partial: If the interest margin is more than 2% but less than 4%.

Non: All other cases.

27) *What percentage of loans is classified as nonperforming?*

Full: If nonperforming loans (defined as loans more than 90 days over due) are less than 15% of the gross loan portfolio.

Partial: If NPLs are more than 15% but less than 25% of portfolio.

Non: All other cases.

28) *Does the DFI have an Asset Liability (ALM) Committee that meets at least monthly and does it have a policy of minimizing risk on management of liquid assets?*

Full: If there is an ALM Committee that meets at least monthly and there is a policy of minimizing risk on management of liquid assets.

Partial: If one of these two elements is in place.

Non: All other cases.

29) *What is DFI policy with respect to maximum single financial exposure risk to one credit risk (gross value before provisions) as a percentage of the DFI's net worthl and does DFI comply with this policy? What is the actual maximum single financial exposure risk as a percentage of capital?*

Full: If the DFI has, and is in compliance with, a maximum single financial exposure limit that does not exceed 25% of the DFI's net worth. A single financial risk should be defined as gross exposure before provisions and to include all entities that are related through same ownership, subsidiary or affiliate relationships.

Partial: If the DFI has, and is in compliance with, a maximum financial exposure limit that does not exceed 40% of its net worth, but does exceed 25%.

Non: All other cases.

30) *What percentage of total assets is denominated in foreign exchange? Is it more than 40%?*

Full: If 40% or less of total assets is denominated in foreign exchange.

Partial: If less than 60% but more than 40% of assets are foreign exchange denominated.

Non: All other cases.

31) *What is the net foreign exchange-denominated asset or liability position as a percentage of total net worth? Does this comply with central bank or the DFI's financial regulatory authority requirement?*

Full: If net foreign exchange-denominated assets are within central bank requirement limits for commercial banks, or less than 20% of net worth. Net foreign exchange-denominated assets are defined as foreign exchange assets, net of provisions, minus foreign exchange-denominated liabilities.

Partial: If net foreign exchange-denominated assets are less than 30% of net worth assets, but more than 20%.

Non: All other cases.

32) *Is the DFI in compliance with any relevant central bank or the DFI's financial institution authority liquidity requirement for itself?*

Full: If DFI is now compliant with central bank or its own financial institution authority liquidity requirements and has not been noncompliant by as much as 30 days over the past year. It should not be considered desirable to comply with central bank liquidity requirements for banks which DFI is not subject to.

Partial: If there are no relevant liquidity requirements, and the DFI has a current ratio of at least 1.1, the DFI should be given a partially compliant rating.

Non: All other cases.

33) *Does the DFI prepare a gap analysis at least quarterly that compares the tenor of assets and liabilities in at least 6 time buckets which vary from as low as 30 days to as long as 5 years and does it have a definite plan for dealing with any negative gaps over the next year?*

Full: If DFI prepares this gap analysis at least quarterly and has a definite plan for dealing with any significant excesses of liabilities over assets within all time buckets up to one year.

Partial: If it prepares a gap analysis at least annually and has a plan for dealing with significant negative mismatches, if any, within the next year.

Non: All other cases.

34) *Is there a dependable source of future long term foreign and local funding resources? What is the source (s) and in what currency are they denominated?*

Full: If it has an identified dependable funding source of both future long term foreign and local currency resources.

Partial: If it has an identified dependable funding source of either long-term foreign or local currency resources.

Non: All other cases.

35) *What are the foreign exchange risk policies and how does the DFI shield itself from this risk on its balance sheet?*

Full: If DFI has, and is in compliance with, foreign exchange risk policies which sharply limit the foreign exchange risk it can take (e.g., not more than 5% in net foreign assets) and avoiding net foreign exchange liabilities.

Partial: If it has these policies in place but does not fully comply and its uncovered foreign exchange asset or liability position (net) exceeds 5% but is less than 10% of assets.

Non: All other cases.

36) *What are the policies for lending in foreign exchange? How much lending to non-exporters is financed with foreign exchange-denominated resources?*

Full: If DFI never lends foreign exchange denominated resources to borrowers who cannot fully hedge that risk through their own businesses and does not lend foreign-exchange denominated funds to borrowers without passing on the foreign exchange risk or unless the foreign exchange risk is insured.

Partial: If DFI never lends funds for which it is taking foreign exchange risk to borrowers without passing on that risk but does lend in foreign exchange to some borrowers who cannot hedge that risk.

Non: All other cases.

37) *Are appraisal officers organized based on sectoral expertise? Do they have responsibility for supervising the projects they appraise and regular feedback is provided on loan portfolio performance by appraisal work unit and/or rotate all project officers between the appraisal and supervision work units ?*

Full: If its appraisal officers are organized by sector, have supervision responsibility for the loans they appraise, and receive regular feedback on the collection performance on this portfolio.

Partial: If two of the above three elements are in place.

Non: All other cases.

38) *What is the approval process? Is an appraisal report required for all term loans? Does DFI have a loan or credit committee and, if so, what is its composition and how much is it authorized to approve? Are any term loans allowed to be approved below the credit committee level?*

Full: If DFI has a system in which all term loans must have an appraisal report and must be approved by a credit committee whose membership is drawn from at least three departments of the institution in addition to the unit responsible for the appraisal. (Unusually small loans may be excluded from this requirement).

Partial: If all term loans (other than those of extremely small size) must have an appraisal report and be approved by either a credit committee or the Board of Directors.

Non: All other cases.

39) *What are minimum equity requirements imposed on project sponsors? How much can be in the form of land or buildings and how much must be in liquid resources?*

Full: If it requires minimum equity investment of 30% of project cost of which at least 10% of project cost must be in the form of liquid resources or 40% of project cost without liquid resource requirements.

Partial: If minimum required investment is at least 25% of project cost of which at least 5% must be in the form of liquid resources, or at least 30% without a limitation on how much of the equity can be in the form of land and buildings.

Non: All other cases.

40) *Does the DFI require and analyze credit references for borrowers? Is a satisfactory credit reference a requirement? Is it a participant in any credit bureau available to commercial banks?*

Full: If it is a participant in any credit bureau available to commercial banks and requires relatively full credit references, including all information on banking relationships, from all borrowers and ensures these references are satisfactory before granting a loan.

Partial: If there is a credit bureau available to commercial banks that it is not a participant in, but it requires relatively full credit references, including all information on banking relationships, from all borrowers and ensures these references are satisfactory before granting a loan.

Non: All other cases.

41) *What are the environmental impact analysis requirements for projects and what are policies with respect to environmental impact? Does DFI adhere largely to internationally recognized guidelines relating to environmental impact?*

Full: If it has written policies with respect to environmental impact of projects which are largely in line with internationally recognized or nationally required guidelines (and which specifically require environmental impact studies for environmentally sensitive projects) and to which it adheres.

Partial: N/A

Non: All other cases.

42) *On appraisals, what are the primary economic impact measures? Is an ERR (economic internal rate of return), employment created, and cost per job measured? Is resource leveraging monitored by comparing DFI financing size with total project cost? Are there other specific economic development related targets?*

Full: If DFI ascertains the ERR (with sensitivity analysis), employment created, cost per job created, and amount of investment resources for the project borrowed from sources other than the DFI.

Partial: If it ascertains at least an ERR and one of these elements as well as one additional economic impact measure of its choice.

Non: All other cases.

43) *Are detailed supervision (monitoring) reports prepared for each project? How often are projects supervised and supervision reports updated?*

Full: If DFI prepares a detailed supervision report at least quarterly for all projects under implementation or in their grace period, and all projects in their first year of operation.

Partial: If it prepares reports for all of these projects at least semi-annually.

Non: All other cases.

44) *Does the DFI have an adequately staffed workout unit for problem projects? What are the procedures for resolving problem loans and for reporting on status of resolving problem loans?*

Full: If DFI has an adequately staffed workout unit for problem projects and detailed written policies and procedures for resolving such projects, largely adheres to its policies and procedures, and reports regularly on the status of problem loans.

Partial: If it has detailed written procedures for identifying and dealing with problem projects which it applies in most cases.

Non: All other cases.

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