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FINANCIAL SECTOR REFORMS IN AFRICA: REALITIES AND PROBLEMS

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I. INTRODUCTION

1. Financial sector reforms have become an integral part of economic reforms and the adjustment process in Africa. Market-oriented reforms, the globalization of capital markets, and the difficulties of mobilizing external finance have all combined to make it imperative that African countries improve and modernize the process of financial intermediation in their economies. Many of the structural adjustment programmes undertaken by African countries in recent years, and supported by the World Bank, the International Monetary Funds and other donors, contain an element of restructuring of the financial sector. While, financial structures remain generally weak across Africa, some countries have made good progress towards financial sector reform. It is thus important to take stock of the situation and provide a forum for member states to share their experiences in the formulation, design sequencing and implementation of financial sector reforms.

II. THE STATE OF THE AFRICAN FINANCIAL SECTOR IN THE 1990s

2. Financial systems in Africa are characterized by the low level of financial intermediation which takes place in the formal sector, the distressed nature of financial institutions, the high risk profile of financial asset portfolios due to the concentration of numerous countries' economies in only a few commodities and industrial sectors and the vulnerability of financial asset portfolios to price and supply shocks. In addition, very few formal financial institutions have shown the capacity of willingness to provide financial services to the small-scale entrepreneur and the rural operators. Formal financial institutions in Africa (especially banks) generally focus on support of trade-related activities.

3. Furthermore, the range of financial institutions and instruments is narrow. Public ownership of financial institutions is pervasive. Institutions are plagued by a large proportion of non-performing loans in their portfolios. Management lacks the relevant management skills. Financial market depth and breadth is still very limited. Few African financial systems are tapping the large pool of financial resources available in international capital markets to support the region's development process.

4. Banking is concentrated mainly in urban centres. Informal financial institutions play an important role in the mobilization and allocation of financial resources in the rural areas in most countries. Institutions in the formal sector which specialize in providing rural financial have rarely been able to achieve self-sustainability.

5. Many African countries have, in recent years, embarked on financial sector reforms in the context of the overall reforms of their economies. These reforms have focused on improving the

legal, regulatory, supervisory and judiciary environment, reducing financial repression, restoring bank soundness, rehabilitating financial infrastructure and have included programmes designed to downsize publicly-owned banks, privatizing them where possible and encouraging new entrants. There are challenges in every country in formulating, designing, sequencing and implementing such reforms.

III. LINKAGES BETWEEN THE FINANCIAL SECTOR AND THE REAL ECONOMY

6. Linkages go both way from the financial to the real sector and from the real to the financial sector. The financial sector's contribution to growth lies in the central role it plays in mobilizing savings and allocating these resources efficiently to the most productive uses and investments in the real sectors.

7. On the other hand, restructuring of the financial sector is often a mirror reflection of reforms in the real sector, including trade and parastatal reform. Restoration of banks' financial health requires decisions about what to do with non-performing loans. The solidity of bank's portfolio depends on the health of its borrowers. In many countries, failed public enterprises bring down the banking system. Furthermore, efficient cleaning of banks balance sheets often entails substantial reorganization of claims over the corporate sector and can prove costly to government and the public. Accordingly while financial reforms are necessary in many African countries, their design and implementation has to take due cognizance of the links with the real sector, of their implications on borrower net worth and, ultimately, their effects on the portfolios of banks and the general institutional health of the financial system. The success of financial sector reforms calls for a pragmatic approach which takes into consideration not only the current state of the financial sector, but also of the real sector. Moving too fast to improve balance sheets of financial institutions and recapitalizing banks in an environment where the main borrowers (the Government and public enterprises) are financially distressed and the institutional capacity is weak could engender serious systematic risks to a country's financial system[1] and the vice versa.

IV. FINANCIAL SECTOR REFORMS IN AFRICA: EXPERIENCES OF SELECTED COUNTRIES

8. Financial sector reforms have multiple intermediate objectives with the ultimate aim of achieving an efficient allocation of financial resources and supporting sustainable economic growth. They contribute to increase competition in the financial sector by opening up entry into and exit from the sector. They broaden the range of financial instruments available to both savers and investors. They facilitate financial transactions (payments, saving, financing) through rehabilitated and expanded financial infrastructure. They improve the mechanism for determining

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[1]World Bank: Adjustment in Africa: Reform, results, and the road ahead, opcit.

interest rates in order for them to reflect the opportunity cost of financial resources. They ameliorate the allocation of foreign exchange and the determination of the exchange rates in order for it to reflect the opportunity cost of a unit of foreign exchange. Overall, they improve the process of financial intermediation and mobilization and allocation of financial resources.

Major challenges in design and implementation of financial sector reforms

Creating an enabling macroeconomics environment required to sustain financial sector reforms (and which will in turn reinforce macroeconomic stabilization)

Enhancing competition among market participants to support market-determined prices for interest rates, exchange rates and financial instruments

Successful restructuring and privatization of state-owned banks

Developing efficient interbank markets necessary for market-determined interest rates

Developing efficiently functioning foreign exchange markets needed for allocation of the scarce foreign exchange and for market determined exchange rate

Modernize telecommunications to support payment system

Moving from direct to indirect monetary policy instruments and away from administratively determined allocation of credit

Reducing Government dependency on inflationary financing and finding alternative sources of government finance to replace inflationary financing

Providing the rural economy and micro enterprises access to financial services including payment services and deposit taking

Formulating, designing and implementing the institutional, legislative and regulatory framework needed for efficiently functioning financial markets.

9. Kenya is a typical example of an African country that has, in recent years, embarked on a comprehensive reform of its financial sector in order to enhance the sector's contribution to the country's overall development process. Unlike many other African countries, Kenya has a significant diversified financial market structure, successful enterprises in the agricultural, industrial, service and export sectors, and a technically competent staff in the Central Bank.

10. Nevertheless, prior to the implementation of comprehensive financial sector reforms, the financial sector was tightly controlled and fragmented. Differences in regulations governing banking and non-bank financial intermediaries created loopholes in the regulatory and supervisory mechanisms leading to an excessive proliferation of banks and NBFIs (some 80 in total). The

Central Bank of Kenya lacked autonomy. Coupled with weak supervisory capacities, the Bank's ability to exercise its surveillance role and enforce banking regulations was impaired. Differentiated interest rate structures between banks and non-banks produced fragmented credit markets. Inappropriate Government policies contributed to the poor performance of the financial sector and an accumulation of non-performing loans.

11. Against this background, the Government embarked, in the mid-1980s, on financial sector reforms designed to promote a more efficient and market-oriented financial system. The focus of the reforms was on relaxing controls on interest rates, developing and initiating the use of indirect monetary policy instruments, strengthening the framework for the supervision of financial institutions, restructuring troubled financial institutions and promoting development finance institutions and capital markets[2].

12. The reforms were reinforced in early 1990s with further significant changes in the legal and regulatory framework and enhanced with programmes of financial restructuring. Changes in the legal and regulatory framework included amendments to the Central Bank of Kenya Act, the Banking Act, the Capital Markets Authority Act and directives for non-banks to convert into banks. Reform of the Central Bank Act, coupled with internal capacity building at the Central Bank of Kenya strengthened supervisory capacity of the Bank to enforce laws regarding reporting and auditing requirements and contract. Reform of the CBK and of the regulations of the clearing house helped to reduce, if not eliminate, automatic access of commercial banks to overdraft facilities at the central bank. Legislation reforms also ensured the emergence of level playing field for all banks by limiting the powers of the Government to grant individual banks exemption from specific provisions of the banking act. A large number of insolvent banks and non-banks financial institutions were closed. Simultaneously, the Government embarked on a programme to reduce its equity participation in commercial banks. More recently, the Government has taken active steps to develop money markets and reform pension funds.

13. On the opposite side of the continent, Côte d'Ivoire is another country that benefited from substantial restructuring of its financial sector. It started int he late 80s and early 90s with a complete overall of the regulatory and supervisory environment for a commercial bank. This was done at the regional UEMOA level which regroups seven West African countries which share a common currency, central bank and regulatory agency. This was accompanied by liberalization of monetary policy including the removal of credit and a refinancing ceilings and moving towards market determined interest rates. Some efforts were also directed at improving the support provided by the judiciary system to the recovery of loans and the enforcement of contracts. These included modernization of laws such as the accelerated recovery procedure, the training of magistrates and the restructuring of the clerk of the courts office. Dealing with the environment also meant the settlement of public sector debt and arrears. The settlement was global, equitable (treating equally creditors within the same category), irreversible and took into account the severe budgetary constraints of the time. In the specific case of the debt of the banks, 10 per cent was

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[2]For further details, see: United Nations Economic Commission for Africa (UNECA): Kenya's financial sector: Institutional structure, Evolution and resource mobilizlation, document E/ECA/TRADE/96/7, September 1996

paid in cash, the remainder was securitized over 15 years at a 3 per cent of interest. Ninety percent of the amount securitized was immediately refinanced at the central bank at a special rate of 3 per cent. Also, the Government instituted a policy of withdrawal from the management and capital of financial institutions. By decree, the maximum rate of government and public enterprises participation in the capital of financial institutions was set at 20 per cent.

14. Commercial banks were the object of a profound financial and operational restructuring. This involved the absorption of past losses by existing shareholders at the prorata of their participation in the capital and the recapitalization of the banks by private shareholders (old and new). It also involved reduction in staff, closure of branches internal reorganization with a strengthening of credit analysis and monitoring, the creation of a loan recovery agency and the establishment of internal control mechanisms. Unviable banking institutions, namely five development banks, were closed with some losses of deposit (small depositors were reimbursed). The insurance sector was similarly restructured with some companies recapitalized and others liquidated.

15. The Abidjan Stock Exchange was downsized, its internal structures reformed and trading procedures modernized. Subsequently, work proceeded at the regional level to establish a bond and equity market for the seven UEMOA countries. The system of financial rural cooperatives "CREPs" was also restructured.

16. All this took place before the devaluation of the CFA francs in January 1994. When the change in parity occurred, the Ivorian financial system was ready to fully support the supply response from the private sector. In return, the devaluation gave the needed boost to financial institutions, and in particular commercial banks, to hasten their return on the road to growth.

17. The problems and approaches in Cameroon were similar to those in Côte d'Ivoire: a distressed banking and insurance sector, an inadequate regulatory, supervisory and legal framework and unstable macroeconomic situation. At first, the regulatory and supervisory environment for the banking sector was improved with the two treaties creating the banking commission and harmonizing banking regulations across the six members countries in 1990 and 1991. The sub-regional banking supervisory agency (COBAC) became operational in 1992 and later issued new prudential regulations. A first attempt at bank restructuring in 1990-92 was unsuccessful because of the absence of an adequate macro framework, lack of support from the judiciary system and its lack of comprehensiveness. The second wave of financial sector reforms took place in 1996, two years after the devaluation of the CFA franc. It included judiciary reform, settlement of government debt, withdrawal of government from the management and the ownership of financial institutions, and improved loan recovery procedures with penalties imposed on delinquent borrowers (interdiction to secure new bank loans and to participate in procurement bids and in privatization bids). This was followed by financial and operational restructuring of commercial banks and insurance companies. The next step will involve the development of capital markets, particularly at the sub regional level, the restructuring of the social security system and the development of macro finance institutions.

18. In 1988, Ghana's financial sector was technical insolvent, saddled as it was by huge amounts of non-performing loans. Particularly affected with the five state-owned commercial banks and the three development banks which together dominated the market.

19. In order to set the ground for successful restructuring of distress banks, the financial sector reform programme first concentrated on (a) improving the regulatory framework which included the establishment of prudential standards pertaining to legal lending limits, capital adequacy ratio, uniform standards for accounting and prudential reporting; and (b) strengthening bank supervision (completion of annual external audits and improvement of the supervisory capacity and efficiency of the Bank of Ghana).

20. After promulgation in August 1989 of the Amendment to the Banking law, it was decided to move ahead with restructuring of the eight state-owned financial institutions, as a first step towards their eventual privatization which is now complete. It was agreed that managerial and organizational restructuring was to precede or, at a minimum, be carried out concurrently with financial restructuring, ensuring that all institutions were put into the hands of independent professional management before they were recapitalized. Pending the outcome of the process, the Government adopted conservatory measures such as curtailing new lending, reducing operating costs and concentrating management efforts on loan recovery.

21. After changing the top management and reconstituting banks' boards of directors, non-performing loans to the public sector were removed from banks' portfolio while non-performing loans to the private sector were redeemed through offsets and insurance to the banks of Government bonds. The newly created Non-Performing Assets Recovery Trust (NPART) was given five years to realize assets transferred to it, and a special judiciary tribunal was appointed and given the necessary powers to speed up recoveries.

22. In Algeria, a significant reform of the financial sector was launched in the early 90's with the introduction of a new banking law which includes prudential regulation in line with international standards and increased supervision capabilities by the central bank. Institutional development plans were prepared for each of the state-owned banks in 1993 in conjunction with a massive government repurchase of non-performing loans to state enterprises amounting to 40 per cent of the banking sector's assets. Banks were recapitalized in 1995 and minimum capital requirements are being raised to meet internal norms. In spite of these reforms, the financial viability of the financial sector which is almost entirely state-owned remains largely dependent on the overall credit quality if state enterprises which represent more than 75 per cent of the commercial banks loan portfolio.

23. A significant shift from centrally directed credit allocation to indirect instruments of monetary control has been implemented through the introduction of public auctions of central bank credits and a reform of Government debt instruments leading to the development of an active market in short-term government securities. In parallel, ceilings on banks lending and deposit rates were removed, allowing interest rates to move closer to the rate of inflation after a long period of strongly negative real rates. There is still no market for long term savings and financing instruments and net investments in financial assets by the insurance sector and contractual savings institutions are negligible. A law for the creation of a stock exchange has been adopted and a

regulatory authority for the securities market is being developed as part of the necessary framework for the introduction of a potentially substantial mass privatization programme.

24. Financial sector reform in Morocco started in the mid-eighties. The key measures of this first wave of reforms included liberalizing bank deposit rates, eliminating mandatory bank lending to selected sectors, and strengthening bank prudential regulation and supervision. Also, the central banks abolished ceilings on banks credit and revised its refinancing facilities. Further reform in the conduct of monetary policy is being implemented through the introduction of competitive repurchase agreements and open market operations and the removal of all ceilings on lending rate, leading to a more efficient pricing of bank credit and liquidity. In general, commercial banks in Morocco are financially sound but have a relatively strong risk aversion with about half of their assets in government securities. As opposed to Algeria, public enterprises account for a relatively small portion of total domestic credit to the economy. Following the recent privatization of financial institution, including in 1995 the privatization of the second largest commercial bank, the private sector share of the banking sector's assets is now close to sixty percent. The central component of the on-going banking sector reform consists of removing the mandatory bank asset allocation in low-yielding government securities and completing the privatization of the largest commercial bank and other state-owned banking institutions while further strengthening bank supervision.

25. Contractual savings institutions play a growing, albeit still limited, role in the financial sector of Morocco. The basic institutional and legal framework for the regulation of the securities market was put in place recently while privatization through public offerings since 1992 has re-vitalized a long established but dormant stock exchange by raising market capitalization from 5 to about 15 per cent of GDP. The supervisory and regulatory capacity of the stock exchange and the Securities commission is being reinforced so as to properly monitor the emergence of the mutual fund industry and the growing number of market intermediaries.

V. STRENGTHENING THE AFRICAN FINANCIAL SECTOR: AGENDA FOR REFORMS

26. As can be seen from the previous examples, financial sector reform is a complex process which tends to extend over a number of years and its successful implementation depends on a number of key institutional and economic conditions being in place. Foremost among these are basic legal structures, a supportive judiciary apparatus, acceptable accounting regulations and practices, effective banking regulation and supervision, functioning payment systems and a macroeconomic climate featuring low inflation and exchange rate stability. Furthermore, proper sequencing of the reform process is essential for its success.

27. The experiences of some countries would appear to suggest that a more gradual approach to financial sector liberalization can be, but is not necessarily, preferable to a dramatic one. Such an approach allows the financial system to adjust to a more rigorous environment and minimizes output losses arising from firms becoming bankrupt as they try to swim in the new and more competitive environment.

28. However, recommendation of a phased approach to financial sector liberalization should not be equated with "non-action" in the implementation of such reforms. Rather, the approach requires a careful and comprehensive appraisal of all the conditions necessary for a viable financial sector to be salivated from the pervasive failures which characterize the African financial system. In order to minimize the negative impacts of financial sector reforms on the real sector, a case can be made for a cautious approach as regards the design, sequencing and implementation of such programmes.

29. In devising financial reforms in some African countries, there appears to have been perhaps too much emphasis on quick fixes and overestimation of the benefits of restructuring bank balance sheets and recapitalization. The time it takes to improve the financial infrastructure has been underestimated in an environment where the major borrowers are often from the public sector and the institutional capacity is weak. Nonetheless, despite the difficulties, African countries need to preserve with financial sector reforms if they are to be effectively integrated in the global economy and establish viable financial sectors that are capable of underpinning the development of their economies. The decision as to whether a country should adopt a phased or a more dramatic approach to financial sector liberalization will depend to a certain extent on the macroeconomic conditions prevailing in the country as well as the current state of health of the financial sector. The World Bank's Operations Evaluation Department (OED) also counsels careful planning, sequencing and implementation of financial sector reforms within a broader overall economic reform programme. It has argued that while certain components of the reform programme (institutional and competition reforms, for instance) could begin early in the adjustment process, widespread financial liberalization "should wait for macroeconomic stabilization and liberalization in the real economy"[3].

30. The danger with some of the financial reform programmes implemented in African countries is that "failures of financial markets" have tended to be equated to "Government involvement and intervention" in such markets. This can lead to limit the role of government in the financial sector; to supervisory activities and the conduct of monetary policy. However, the developmental role of Government should also be recognized.

31. The agenda for strengthening the African financial sector invariably has to include: adoption and implementation of policies designed to achieve macroeconomic stability; formulation, design and implementation of comprehensive policies and measures for financial sector reforms; and sequencing of the implementation of the reforms. These three elements are essential for the success of such reforms. Macroeconomic and microeconomic policies that are essential for the success of financial sector reforms include:

1. Restoration of macroeconomic stability within which financial sector restructuring can proceed:

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[3]World Bank: "Adjustment lending: lessons of experience" operations evaluation department (OED), lessons and practices, No. 2, September 1993

- strengthening public finance;

- reducing inflation.

2. Development of a strong and dynamic private sector that can provide a strong client base for the financial sector:

   - creating and maintaining a conducive regulatory, legal and judicial environment for the development of the private sector;

   - allowing the private sector to play a more dynamic role in the economy.

3. Improving the performance of state-owned enterprises, including privatization where necessary:

32. The major elements of a comprehensive financial sector reform programme have to:

- include policies and measures designed to improve the efficiency and competitiveness of the financial sector and the intermediation process;

- improve the legal, regulatory and supervisory framework of the financial system;

- implement policies and measures to improve the institutional and human capacity of the financial sector;

- modernize managerial and technical skills of personnel in the sector;

- expand the structure of the sector and its financial instruments;

- improve payment systems;

- downsize the role of Government in the financial sector;

- strengthen the role of the Central Bank and/or financial supervisory authorities;

- promote the efficiency and development of money, banking and capital markets;

- encourage technological modernization of the sector;

- liberalize and move towards market-determined exchanges rates and interest rates;

- restructure financially and operationally financial institutions;

- provide for the legal, regulatory and fiscal framework for the development of capital markets.

33. These are some of the major elements of a comprehensive financial sector reform programme and which should constitute a framework agenda for such reforms in Africa. The infrastructure and the institutional framework of the financial sector need to be strengthened for it to effectively play the role of mobilizing resources for development and financial intermediation. To be effective, reforms call for careful design, sequencing and implementation. This suggests that financial reforms need to be deliberately sequenced with regard to other reforms and realistic time-frames adopted.