AFRICAN DEVELOPMENT BANK **AFRICAN DEVELOPMENT FUND**

BANK GROUP FINANCIAL SECTOR POLICY

Operations Policies and Review Department (POPR)

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ACRONYMS AND ABBREVIATIONS

ADB	African Development Bank
ADF	African Development Fund
AMINA	African Development Fund Micro-finance Initiative for Africa
APRM	African Peer Review Mechanism
BCEAO	Banque Centrale des Etats de l'Afrique de l'Ouest
BEAC	Banque Centrale des Etats de l'Afrique Centrale
BWIs	Bretton Woods Institutions (the IMF & the World Bank)
CADI	African Development Institute
CAR	Central African Republic
CFA	Communaute Francophone Africaine
CSP	Country Strategy Paper
DFIs	Development Finance Institutions
ECA	Economic Commission for Africa
ESW	Economic and Sector Work
FI	Financial Intermediary
FSAL	Financial Sector Adjustment Loan
FSAP	Financial Sector Assessment Program
FSAP*	Financial Sector Adjustment Program
FSAR	Financial Sector Assessment Report
FSDS	Financial Sector Development Strategy
GDP	Gross Domestic Product
IFIs	International Financial Institutions
IMF	International Monetary Fund
LOC	Line of Credit
M2	Currency in circulation + demand deposits + savings deposits
MEFMI	Macroeconomic and Financial Management Institute
MSME	Micro, Small and Medium Enterprises
MFI	Microfinance Institution
NEPAD	New Partnership for Africa's Development
NBFI	Non-Bank Financial Institution
NGO	Non-Government Organization
ODA	Official Development Assistance
OECD	Organization for Economic Cooperation and Development
OED	Operations evaluation Department of the World Bank
OPIC	Overseas Private Investment Corporation
PBL	Policy-Based Lending
PFI	Private financial Institution
PFP	Policy Framework Paper
PRSP	Poverty Reduction Strategy paper
SADC	South African Development Community
SAL	Structural Adjustment Loan
SAP	Structural Adjustment Program
SECAL	Sectoral Adjustment Loan
SME	Small and Medium Enterprises
UA	Units of Account (= SDR, Special Drawing Right)

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EXECUTIVE SUMMARY

Overall Approach

The financial sector, as defined in this report, comprises *financial policies* (monetary, financing of the public sector, provision of financial services), *financial infrastructure* (legal and regulatory framework, audit systems, accounting and financial procedures, payments systems), and financial *institutions* (banks, non-bank financial institutions, money and capital markets). The financial sector policy that is proposed in this report for the Bank Group to adopt covers these three aspects. The overarching Vision of the Bank Group highlights development and poverty reduction in Africa as its 'primordial challenge'. Financial sector has a direct role in the promotion of development and reduction of poverty. As such, the Bank has to be increasingly involved in supporting financial sector development on the continent.

The proposals made in this report are based on **two premises**: *one*, that economic growth is the main driving force behind poverty reduction, and, *two*, that a dynamic and progressively deepening financial system accessible to all is an essential prerequisite for ensuring economic growth. The recommendations ensuing from these premises are governed by **three principles:** collaboration, comparative advantage, and value-added. The collaboration principle recognizes that the formulation and implementation of policies is primarily the responsibility of member countries themselves, and that the Bank is only one among many donor countries and institutions pursuing their own strategies to assist African countries in the latter's efforts to develop the financial sector. As such the Bank must design its policies in consultation with member countries, and collaborate with other donor countries, institutions, especially the World Bank and the IMF, and regional organizations. In designing its strategy, the Bank would wish to avoid any significant overlap, or conflict, between its initiatives and those of other international institutions to strengthen financial systems in Africa. The comparative advantage principle dictates that the Bank uses its special relations with the African countries, and its knowledge and expertise in specific areas to identify the niches for its operations. The value-added principle enjoins that the Bank should evaluate the specific impact of its operations, as well as its long-term sustainability, and ensure cost effectiveness. Bank's interventions should also leverage the assistance offered by others. Thus it may intervene in those areas which it considers necessary in the context of its Vision but where other institutions may not be operating, or operating insufficiently.

Financial System, and Development and Poverty Reduction

Theoretical and empirical research has shown a positive relationship between sound financial system and economic development, and between economic development and poverty reduction. The contribution of the financial system comes in various ways, such as mobilization of savings, enhancing efficiency of investments, reducing costs of intermediation between savers and investors, maintaining macroeconomic stability, and improving the access of the poor to financial services.

Since the mid-1980s, African countries have been implementing financial sector reforms, generally conceived within the framework of structural adjustment programs supported by the IMF/World Bank and the Bank Group, to restore macroeconomic stability and the health and soundness of their financial systems. However, these reforms, while helpful in breaking the logjam of financial sector repression in African countries,

have been inadequate in deepening the financial systems and putting them on a sustainable path of development, or in fulfilling the sector's potential role in growth and poverty alleviation.

Financial sector development differs across African countries, and as such the priorities of reform measures would also differ across countries, according to the level of development of the financial system. However, the stage of development of the financial sector, and its soundness, also encompass various macroeconomic and microprudential indicators such as GDP growth, inflation, fiscal balance, external debt, capital adequacy, management, earnings liquidity, and sensitivity to market risks. Superimposing these criteria on the traditional criteria of financial sector development gives a better picture of the status of the financial system. It also helps in designing country-specific policies, especially the relative weight that the countries should assign to macroeconomic policies, on the one hand, and to financial sector reform and development, on the other.

Strategy for the Financial Sector Development in Africa

The unfinished agenda for the financial sector reforms in Africa consists of filling three gaps: the *financial intermediation gap* as represented by the fragility of the financial system, *the development gap* as reflected in the shortage of long-term finance for investment, and *the poverty reduction gap* as denoted by the vast unmet demands for financial services by the MSMEs, and economically active poor and the disadvantaged, especially the women. A comprehensive strategy covering measures in the three areas of financial policies, financial infrastructure, and financial institutions, is suggested in the report to fulfill this large agenda and help its implementation. Each country will, of course, adapt the strategy to its own peculiar circumstances, as per some of the criteria mentioned in the previous paragraph, and elucidating broad sub-group specific policies to develop the financial systems.

The Bank Group's Future Role and Strategy

For the Bank Group, financial market development is an indispensable element of its strategy to pursue the twin goals of promoting economic development and alleviating poverty in Africa. With the growing realization of the important role the financial sector can play, other multilateral institutions like the World Bank and the IMF, have recently adopted more comprehensive strategies for their operations in the financial sector of their member countries, and are directing a greater share of resources towards financial sector issues. The Bank Group cannot be an exception to this trend. Currently, the Bank has in use all the necessary operational instruments, and basic staff that has acquired valuable experience and expertise in the course of joint participation with the World Bank and the IMF missions to negotiate SALs and SECALs, to effectively address financial sector issues in Africa. The Bank will further refocus these instruments, and build upon its staff experience consonant with the requirements of the proposed strategy.

It should be expected that the Bretton Woods Institutions would be appropriately covering the macroeconomic and other aspects relevant to risk avoidance and risk management in the financial sector, and generally the financial policy component of the sector's development. The Bank Group would, in turn, focus on addressing the other gaps in financial sector development in Africa, namely the development and poverty-reduction aspects, and within those areas on improving relevant financial governance and infrastructure, building capacity of financial institutions, supporting financial integration

and redressing gender biases in enterprise financing. To that extent, the Bank will also collaborate with the BWIs and other institutions in building capacity towards improving financial sector soundness. The main areas of the Bank's strategy in the financial sector development, therefore, include the following:

- Supporting establishment of healthy and sound financial systems;
- Improving the depth and development orientation of the financial system; and
- Promoting the poverty reduction orientation of the financial system by improving access of the poor and women to finance.

Implementation of the Bank's Strategy

The Bank will implement the above strategy by:

- Encouraging member country ownership of its financial sector strategy that will help to guide Bank Group intervention in the sector;
- Assisting countries, where necessary, in the preparation of their financial sector development strategy by carrying out Economic and Sector Work (ESW), followed by the Bank participating in the World Bank/IMF-initiated Financial Sector Assessment Program (FSAPs). In countries where the BWIs may not have immediate plans for conducting FSAPs, the Bank may benefit from the findings of the African Peer Review Mechanism. These studies and surveys should provide inputs into the Bank's own CSPs that will include elements of the Bank's strategy for financial sector development in the RMC;
- Encourage dialogue between the public authorities and the private stakeholders (including MFIs, NGOs) in the formulation of national financial sector strategies. In this regard, the Bank could assist country authorities to prepare for and convene a national workshop/seminars to discuss such strategies;
- Taking a leadership role in developing a framework for fostering implementation of (internationally accepted) banking and financial standards (including on combating money laundering) in RMCs, and helping to design a peer review mechanism under the NEPAD and supporting its implementation;
- Strengthening strategic partnership with the BWIs and other institutions supporting financial sector development in RMCs;
- Formulating specific work program, including appropriate combination of instruments at the Bank Group's disposal to provide an overview of the financial system issues and policy responses;
- Staffing the (newly established) financial sector policy and operations units in the Bank by individuals with appropriate qualifications and expertise, supplemented where necessary by recruiting long-term specialist consultants, in the Bank's chosen priority areas. The units will collaborate with each other in all aspects of financial sector work.
- Drawing up Action Plans to implement the Financial Sector Policy.

CHAPTER 1

INTRODUCTION

1.1 Background

1.1.1 Since it began its activities, the Bank has engaged in various operations in Africa that have had direct or indirect impact on financial sector developments. However, these operations lacked a coherent strategy, thereby reducing their beneficial impact. These operations are unlikely to meet the full challenge of development and poverty reduction implied in the Bank Group Vision, unless the intervention instruments are sharpened, and the operations are conducted in the context of a comprehensive strategy by member countries addressing crucial aspects of the sector's development.

1.1.2 Until now the Bank has been content to extend its support for some specific aspects of policy reforms in the context of Bretton Woods Institutions-supported adjustment programs[1]. To the extent that many of these programs have enabled African countries to improve their macroeconomic situation and the financial sector, the Bank can take credit for having helped in the promotion of financial sector reforms in Africa[2]. In the process, Bank staff has also gathered some experience and knowledge concerning the formulation and implementation of financial sector policies that should enable the Bank to take a more active role in assisting member countries in their efforts to develop their financial systems.

1.1.3 Furthermore, the widespread incidence and high costs of banking problems beyond national borders, following the East Asian crisis, has prompted the international community to focus on promoting the soundness and stability of banking systems, with the main focus being on preventing and managing the risk of failures of the financial systems, rather than on their developmental and poverty-reduction potential[3]. The Bank Group, with its Vision focused on growth and poverty reduction in Africa, will broaden these national and international efforts to include these latter aspects as an integral part of financial sector development strategies.

1.1.4 However, to play its proper role, the Bank needs to develop clearly its own strategy for assisting in the financial sector development in Africa, adapting its operations to the needs of client countries. The Bank has already issued several new policies delineating its approaches to development assistance and lending operations in the other areas of focus in its Vision. The present policy paper, designed to elucidate the Bank's strategy in the financial sector, is a continuation of that process.

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[1] The only exception is the issuance by the Private Sector Unit of the Bank of a policy document entitled Policies for Lines of Credit, Agency Lines and Guarantees to Private Sector Financial Institutions, Board document, August, 1998.

[2] It is worth noting that the IMF/World Bank supported SALs until late 1980s also did not generally contain specific financial sector reform measures but concentrated more on 'controlling' monetary expansion through credit ceilings. It was not until these institutions encouraged the introduction of market-based measures (liberalization, privatization, etc.) that the issues of financial sector development came to the fore and were addressed explicitly and independently of the stabilization issues.

[3] Thus, at the Lyon Summit in June 1996, the G-7 called for " the adoption of strong prudential standards in emerging market economies". Similarly, the Ministers of Finance of the G-7 countries called upon the IMF and the World Bank to encourage and assist emerging market economies in strengthening their financial systems and prudential standards. In response, international financial institutions, regional development banks, and official groupings are according high priority to these issues in their work program. The Basle Committee's "Core Principles for Effective Banking Supervision" have been internationally accepted as the focal point. The IMF and the World Bank have been active in assessing member countries' financial systems and developing broad principles and characteristics of stable and sound banking system.

1.2 Objectives

The main objective of the paper is to lay out the areas in the financial sector where the Bank Group sees as making the most contribution. The report provides broad elements that need to be addressed by the relevant authorities in RMCs, though recognizing that individual countries must adapt them to their own specific circumstances. It is also realized that the sector's development would need a variety of actions and support, not only by the country authorities but also the multilateral and regional development organizations, and private and civil society stakeholders in the country. The Bank's objective would be to promote those actions in a collaborative manner within the framework of the country's overall strategy.

1.3 Organization of the report

The rest of the report is organized as follows:

1.3.1 Chapter 2 describes the role of the financial sector in promoting development and poverty reduction. It then focuses on the financial reform policies adopted by the African countries since the mid-1980s. The outcome of these reforms is seen as mixed, lessons are drawn from the experiences that are then taken into account in formulating a broad overall strategy for future actions. The report identifies the above-mentioned three gaps in the financial sector that the authorities must address. The argument is made that this would require a comprehensive strategy that includes actions in the areas of financial policies, financial infrastructure, and financial institutions. In the African context special attention needs to be paid to extending the reach of the financial system to the micro, small and medium enterprises (MSMEs), the women, and other poor entrepreneurs.

1.3.2 Chapter 3 describes the Bank's past operations in the financial sector in Africa, and the various instruments adopted. Some broad lessons are drawn from those interventions, which are then taken into account in elucidating the proposed role and strategy of the Bank for the development of the financial sector in Africa.

1.3.3 Chapter 4 elucidates the specific components of the overall strategy on which the Bank Group may concentrate, based on the three principles of collaboration, comparative advantage, and value added. The areas recommended concern mainly the financial infrastructure and financial institutions that would contribute the most to sustainable development and poverty reduction, including improving women inclusiveness in the system.

1.3.4 Chapter 5 then suggests the way forward for the Bank Group, especially the implications of the proposals in this report for designing the available instruments and strengthening the institutional and operational organization.

CHAPTER 2

FINANCIAL SECTOR DEVELOPMENT AND STRATEGY IN AFRICA

2.1 Role of the Financial System

The financial system is defined in this report to comprise three components: *financial policies* (monetary, financing of the public sector, external sector, and provision of financial services), *financial infrastructure* (legal and regulatory framework, audit systems, accounting and financial disclosures, payments systems), and *financial institutions* (banks, non-bank financial institutions, money and capital markets). The financial system plays a critical role in economic growth, and poverty reduction. Theoretical and empirical research has shown a positive correlation between sound financial system and economic development[4]. The financial sector's contribution to development and poverty reduction comes through various channels. *First,* the financial sector provides the facilities and instruments for mobilizing savings and allocating them for consumption and investment purposes. *Second*, a well-developed financial system enhances the effectiveness of macroeconomic policies to promote price stability, which is conducive to development and high economic performance[5]. *Third,* the financial sector is the main channel through which countries enter the mainstream of globalization and reap benefits via increased trade, capital flows, and access to technological know-how. *Fourth,* as provider of financial services that are used as inputs in other productive sectors, the financial sector helps to economize on the cost of transactions and enables economic agents to pool, price, and exchange risks, thereby increasing the efficiency of use of resources, and the rate of growth. *Fifth,* the financial sector has the ability to contribute directly to poverty reduction through intermediaries , such as MFIs and the informal financial sector, that provide savings and credit facilities to the micro, small- and medium-scale enterprises (MSMEs), the poor, and the disadvantaged in the rural sector.

2.2 Evolution and Implementation of Financial Sector Reform Policies in Africa

2.2.1 In the period from Independence to about the late 1980s, many African countries, in common with other developing countries, regarded the financial sector as a conduit for financing government deficits, and as an instrument for directing credit to 'priority' sectors of the economy, often at controlled and subsidized interest rates. At the same time, financial institutions were created in the public sector, and some private financial institutions (banks) were nationalized to enable governments to 'promote development'. These institutions were encouraged to lend to public enterprises regardless of their profitability. Overall, the financial systems in Africa developed all the hallmarks of financial repression, including widespread government dominance in ownership, management and procedures of financial institutions, corruption, directed credits, negative real interest rates, and poor investment decisions. Additionally, many African countries suffered from deficient financial infrastructure including weak supervisory and regulatory framework, absence of clearly defined and enforceable property and contractual rights, and lack of human technical capacity. As a result, the financial sector failed to become a dynamic instrument of development. Reflecting this failure, savings and investment failed to grow appreciably, growth rates tended to decline and became negative in per capita terms, the incidence of poverty increased, inflation soared, exchange rates became overvalued, and serious

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[4] Cf. Lindgern Carl-Johan, Gillian Garcia, and Matthew I. Saal: *Bank Soundness and Macroeconomic Policy, IMF, 1996.*

[5] " A banking system that is in distress can distort allocative efficiency and macroeconomic policy implementation, even though it can continue to function as long as it remains liquid. In addition to complicating monetary management, banking system unsoundness can also impose high costs in the form of fiscal obligations and other macroeconomic distortions". Lindgern, Carl-Johan: *op. cit.* P.57

price distortions crept into the economic system. Moreover, a large number of countries experienced banking crisis that forced their governments to come to their rescue at enormous fiscal costs.

2.2.2 Most governments' perception of the role of the financial sector in development began to change in the light of this experience. This change in perception was further strengthened by a number of other factors, including the relative decline in ODA flows, the failure of African countries to attract an adequate share of the substantial increase in international private capital flows into developing countries, reemergence of the private sector as the dynamic player in development, increased globalization of trade and financial markets, and the growing realization within the donor and academic community of the importance of sound banking and financial systems. Accordingly, and at the urging of multilateral financial institutions and the donor community, African countries gradually adopted market-oriented policies and initiated reforms of their financial systems to ensure efficient implementation of those policies.

2.3 Implementation of Financial Sector Reforms in Africa

2.3.1 The scope of financial reforms has been increasingly broadened to cover the above-mentioned three aspects of the system i.e. financial policies, financial institutions, and financial infrastructure. However, relative emphasis on these aspects has varied across countries and over time. As greater experience was gained with the reforms in Africa and other developing countries, and their results evaluated, the programs became progressively more comprehensive. Broadly, three 'generations' of reform may be distinguished: the first generation emphasized financial policies, the second generation addressed, along with financial policies, financial institutions and instruments, and the third generation dealt with all the three aspects. A common element underlying all the programs has been the adoption of market-based approach that includes financial liberalization.

2.3.2 The reforms were largely conceived within the framework of structural adjustment programs supported by the IMF and the World Bank[6]. Initially, the emphasis of the reforms was on restoring macroeconomic stability, principally by reducing fiscal deficits and their financing by the banking system, by prescribing ceilings on the expansion of total credit, some rise in interest rates, and exchange rate depreciation. These reforms were gradually expanded to include granting central banks more autonomy in the conduct of monetary policy; liberalizing interest rates, and gradually eliminating administrative allocation of credits. Other elements of the reforms implemented in the more recent past have comprised the introduction of indirect monetary policy instruments, restructuring and recapitalization of weak and insolvent banks, and improving infrastructures, including bank supervision and accounting and auditing practices[7].

2.3.3 The introduction of the above reforms has proceeded differently in different countries and has produced varying results. The outcomes of the reform measures have been mixed, influenced as they were by, *inter-alia,* the initial severity of macroeconomic imbalances, the sequencing of the reform measures, the speed of implementation, and the degree of political commitment, as well as the clarity on the direction of the reforms (see Boxes 2.1 and 2.2). In some countries, these issues were addressed at least partially and financial systems development was sustained. In other countries where financial sector reforms were delayed or disrupted due either to the lack of complementary reforms in the real sector or wrong sequencing, or the failure to put in place effective prudential, legal, and regulatory frameworks, reforms experienced repeated difficulties.

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[6] As a result the financial sector reform programs in Africa differed from those in the East Asian countries in that the latter were more 'home-grown' and therefore commanded domestic political support, while the former were generally devised and proposed by the staffs of the IFIs and lacked national ownership.

[7] Hassanali Mehran, et. al. *Financial Sector Development in Sub-Saharan African Countries,* IMF, Washington DC, 1998.

The costs of restructuring of banks in the latter type of countries have been very high, and some restructured banks have fallen back into losses[8].

Box 2.1 Ghana's Financial Sector Reforms

Following severe deterioration of the macroeconomic situation and the financial sector, the Government undertook an economic recovery program beginning in 1983. The program initially focused on macroeconomic issues. Subsequently far-reaching reforms in the financial sector, beginning with the restructuring of the banks and the banking sector, were introduced.

During the first phase of the Financial Sector Adjustment Program in 1988-90, the authorities created the Non-Performing Assets Recovery Trust as part of the efforts to reestablish the soundness of the banking system, and established money and capital market institutions. The follow-up second phase of the Program continued with the bank restructuring, reduced public sector shareholdings in selected banks, and allowed increased competition in the financial sector. Financial restructuring measures included recapitalization, balance sheet clean-pup involving bond issuance against non-performing loans, conversion into equity, and/or swaps of certain foreign obligations to the government or the Bank of Ghana as well as cash injections. In addition, corporate banking culture was enhanced by the introduction of short-term turnaround plans, performance monitoring, and rolling corporate plans. Subsequently, the Government continued with its divestiture program as part of its policy of liberalizing the financial sector.

Box 2.2 Cote d'Ivoire: Financial Sector Adjustment Program (FSAP*), 1991

The 1991 FSAP followed the adoption of new monetary policy by the BCEAO, and the creation of the Regional Banking Commission. It included some measures to improve the macro policy environment, strengthen regulatory framework, restructure financial institutions, and develop the capital market.

The FSAP* recognized the improvement of the legal aspects of the financial sector as an important element of the reform package. This included: i) a law establishing a procedure for the recovery of certain debts of financial institutions taken over by the State, ii) a law on bank secrecy, iii) a law on simplified procedures for the recovery of civil and commercial debt, iv) modification of the civil, commercial, and administrative procedural code with the view to rendering justice more accessible, less expensive, and more speedy, and v) a new arbitration law to facilitate arbitration between willing litigants.

Under the FSAP* four major banks were recapitalized, and other banks restructured to include downsizing of the staff. The restructuring of insurance companies' balance sheets was initiated, and 13 insurance companies were liquidated. The Stock exchange was also restructured with the establishment of the Stock Exchange Board and the introduction of a weekly alternating quotation system.

These reforms were, however, undercut by the continuing problems connected with non-performing crop credit in the coffee and cocoa sectors. These problems were addressed later, following the devaluation of the CFA franc, as part of the Government's efforts to strengthen the financial system. Thus, coffee and cocoa marketing was liberalized in 1998-1999, the indicative price and the administrative setting of cost schedule (*bareme)* were eliminated, and the CAISTAB (the Stabilization Fund) was restructured and its mission redefined and restricted to non-pricing functions.

2.3.4 On the positive side, financial repression has been perceptibly reduced, and African countries have made substantial progress in the area of monetary policy operations, and in liberalizing the external sector. Prudential lending and capital adequacy guidelines have been introduced, banks re-capitalized and restructured, non-bank financial institutions and stock markets established in many countries, and some progress made in strengthening banking supervision and adopting prudential regulations.

2.3.5 However, in most African countries, financial intermediation does not appear to have advanced. The degree of financial intermediation, as represented by the variety in instruments and

[8] In the CAR, for example, one bank was restructured thrice. In Mauritania, five state-owned banks were recapitalized at a cost of 15 per cent of GDP, or the equivalent of 50 to 60 percent of their loan portfolios.

ratio of M2 (currency plus demand and savings deposits) to GDP, and of credit to the private sector (Cp) to GDP, remains low in most countries, and in fact has registered a decline in several countries. Prevailing economic policies in many African countries still remain expansionary, and have limited the domain and influence of regulatory systems. Moreover, the enforcement of these regulations has been greatly compromised by the lack of adequate human technical capacity within the enforcing authorities (usually central banks), and payments systems remain weak. A lack of human and technical capacities has also hindered improvement in the internal governance (i.e. decision making, information flows, and incentive systems) of private financial institutions. Consequently, banks in many countries still have serious liquidity and solvency problems and the banking system remains fragile, while bank failures and financial sector crises occurred in some countries during the 1990s, with costly and negative impacts on fiscal resources and social programs. While privatization of banks, and liberalization of interest and credit supply have made some progress, the state remains an important shareholder in banks, and exercises significant control on banking operations that continue to be carried on less than fully commercial basis. Despite the establishment of a number of non-bank financial institutions, the financial system is oligopolistic in nature, and provides limited services to limited sectors of the economy. The financial service needs of the poor, such as savings mobilization, credit and money transfer, especially in the rural areas, remain largely unmet.

2.3.6 The financial sector reforms have not also resulted in substantial increase in savings, especially long-term and financialized savings, to support economic development. Following restructuring and consolidation, bank portfolio concentration has been away from long-term finance into short-term and public sector finance. Although a number of African countries deepened their financial markets by establishing stock markets during the 1990s, these markets remain generally small in size, with very few listed companies and low market capitalization. They are also characterized by high transaction costs, low liquidity, inadequate market regulations, and lack of adequate transparency (see Box 2.3). More importantly, financial sector reforms in Africa have not resulted in any increase in savings[9], or in domestically financed investment.[10]

[9] Strictly speaking, financial sector reforms impact directly on financial savings. However, if the financial reforms are carried out in the context of improved macro environment, and generally result in increased interest rates, total savings ratio should normally be expected to rise.

[10] Average rate of gross domestic savings in Africa declined from 27.1 percent of GDP during 1975-84, to 22.2 percent during 1985-89, to 17.6 percent during 1996-98 and 17.4 percent during 1996-2000.

Box 2.3 The WAEMU Regional Financial Market

In December 1993, the Council of Ministers of WAEMU mandated the BCEAO to establish a regional financial market. Accordingly, a regional securities exchange (Bourse Regionale des Valeurs mobilieres, BRVM) was established as a private company in Abidjan and began operations in September 1998. A Regional Securities Commission (CREPMF) was established in 1997 and entrusted with the supervision and control of the market. The regional financial market comprises two components: the bond market and the securities market. The latter has the following characteristics:

- A centralized market governed by buy-and-sell orders, in which security prices are determined through a comparison of buy-and-sell orders received before quotation;
- Three trading sessions per week;
- A spot market settlement processing;
- Guaranteed transactions assured by the creation of Investor Protection Fund
- Safekeeping and centralization of securities by the central depository and clearing house and the circulation of such securities in electronic form only.

At end-1999, 37 companies were trading on the BRVM, with total capitalization of US$1.5 billion. Presently 15 brokerage firms are licensed by the CREPMF to operate. Two indices are use to track the overall movement of share prices, the BRMV Composite Index, and the BRMV-10 Index. The volatility of the market has been low; at end-1999 the BRMV Composite Index was some 22 percent below its peak of October 19, 1998.

In the bond market, the primary market has been very active, with issuances amounting to about CFAF 150 billion in 1999. The transactions in the secondary market have been limited as most papers are subscribed by insurance companies that pursue long-term strategies.

Source: IMF: West African Economic and Monetary Union, May 23, 2000

2.3.7 The reforms have also failed to address directly the problem of fragmented markets in Africa, or to improve significantly the access of the economically active poor, the women, micro-entrepreneurs and small enterprises to credit and other financial services facilities. Liberalization should normally be expected to lead to a greater access to formal finance, lower spreads between borrowing and lending rates, increased financial flows between various segments of the financial system, and gradual reduction in the role of informal finance by a 'graduation' into the formal system[11]. However, these expectations have not been fulfilled in the case of African countries. The informal financial sector has responded positively to increasing demand for its services and shown some signs of innovation in the adjustment period[12]when the banks were being consolidated. However, most informal financial institutions/agents generally have a limited capital base and little access to borrowed funds. Their operations are generally limited to specific localities and communities, are short-term in nature, and consumption-oriented. Their linkages with the formal sector also remain weak, and the financial flows between the formal and informal markets continue to be negligible. Even among informal financial institutions, there are few or no direct linkages. The vast needs of micro and small enterprises remain unmet, as they rarely draw on informal lenders who tend to be either expensive or too small and unreliable as a source of finance[13]

2.3.8 A general evaluation by the Operations Evaluation Department (OED) of the World Bank in 1997 found that only about 43 percent of the financial sector adjustment programs supported by the World Bank in Africa had satisfactory outcome in terms of that institution's performance criteria indicators[14]. The OED report noted that the programs mostly had perfunctory approach to competition within the banking system, and neglected competition between the banks and non-bank financial institutions. The programs were also characterized as having paid inadequate

[11] In Asia the growth of formal financial markets has either tended to supplant the informal markets (e.g. in Korea) or forged links between informal and formal markets (e.g. in Indonesia).

[12] Aryeetey.A, Hettinge.H, Nissanke.M, and Steel.W: *Financial Market Fragmentation and Reforms in Sub-Saharan Africa, World Bank, 1997.*

[13] Aryeetey and others have referred to this credit gap as the 'missing middle' in the enterprise development in Africa.

[14] World Bank Operations Evaluation Department, *Financial Sector Reform,* Washington D.C. 1998

attention to payments systems, accounting and auditing standards, collateral laws and regulations, and training in accounting and banking that are critical to the sustainability of the reforms. The implementation of the programs was also judged by the OED as lacking national ownership[15], which adversely affected their implementation. Financial sector reform involves the sector's disengagement from its past legacy of controls, and radical change in institutions, governance and mindsets of political authorities, the civil service, and the management of financial intermediaries. It involves actions on a wide variety of political, economic, and social fronts that tend to upset various vested interests and groups, which are averse to change. For the process to be sustainable and successful, therefore, the reform strategy should involve broad-based participation of the major stakeholders to ensure that the reforms are home grown, indigenously conceived and formulated, and retain national consensus and a sense of ownership[16] among them. Promoting such a national ownership should be the first and foremost priority of the strategy to reform the financial sector. This evaluation would appear to be still broadly valid in the African context.

2.3.9 The experience with the financial sector reforms so far has identified some prerequisites and produced a few lessons that may be summarized as follows:

- A well functioning financial system is an on-going process and its development requires a long-term view and commitment by country authorities and their development partners;
- Stable and sound macroeconomy, including price stability and sustainable domestic and external debt situation, is important for establishing an environment conducive to investment. Financial sector reforms must, therefore, be preceded by a comprehensive assessment of the fragility of the financial system and measures to address any weaknesses in this regard;
- Country ownership of the program is an essential precondition for the successful implementation of the reforms and must be explicitly promoted. Financial sector reforms will not be effective unless all constituent bodies, i.e. governments, central banks, other local stake-holders, and international development partners are brought on board and buy into the reforms;
- To be successful, the introduction of the reform measures and instruments should be properly designed and sequenced, and appropriately implemented and monitored, while some kind of safety net, designed to protect the overall system and promote consumer confidence, should be established. A clear statement on the direction of reforms should be made to win support from the financial and business community;
- Financial sector reform is not sustainable unless it is comprehensive and penetrates down to the institutional level[17], and only if technical assistance components are a part of the reform package[18];
- Good governance, including the rule of law, ability to enforce contracts, good public sector management, and the fight against corruption, is essential for promoting efficient financial systems. Therefore, strengthening the legal and regulatory framework should come alongside with financial sector reforms, while the adoption of financial and banking standards should enhance transparency in financial policymaking and regulation and help foster stability of the system;
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[15] The OED report defined ownership as "joint identification of program goals, consensus within the government leadership, up front actions to demonstrate conviction, and broad outreach regarding reform goals within the body politic" (p.19).

[16] A crucial aspect of the Mexican financial reforms in 1989-90 was the authorities' efforts to retain national consensus on them by explicit introduction of social projects aimed at ameliorating poverty.

[17] " Institutional development is critical to financial reform because without high quality technical capabilities and general institutional efficiency, resource mobilization and efficient allocation remain weak" (World Bank, OED: *op. cit.*

[18] To ensure sustainability of institutions undergoing reform, attention needs to be paid to the payments system, accounting and auditing standards, collateral laws and regulations, education programs in accounting and banking, increased professionalism in banking, on-site training of staff, and improvement in the quality of banks' portfolio.

- Emphasis must be put on introducing competition and appropriate infrastructure; especially effective prudential regulations;
- In the current situation of imperfect information systems and uncertainty, informal financial institutions can be made to serve efficiently a larger section of the population who have little access to formal financial intermediaries. In the medium-term, while awaiting the deepening and widening of the formal financial system, expanding the role of informal financial system and improving its integration with the formal system may be an efficient route to reducing financial dualism and mobilizing and channeling financial savings. But this would require that governments adopt a pro-active policy for their promotion.

2.4 Strategy for the financial sector in Africa

2.4.1 The survey of the financial sector reforms in Africa also suggests that the unfinished agenda for the development of that sector is large. The future strategy needs to address three inter-related 'gaps' or inadequacies of past reforms (see section 2.3 above). *First,* there is the 'financial intermediation' gap, emanating from the fact that the financial systems in many African countries are still narrow and shallow, as well as fragile and vulnerable, and enabling environment is not quite stable. In the absence of corrective measures, this could lead to financial disintermediation. *Second,* there is the 'development' gap in that the system lacks the institutions and instruments necessary to promote an increase in savings, especially mobilized financial savings, and meet the needs for long-term investment finance. *Third*, there is the 'poverty reduction' gap in that the needs for financial services by MSMEs, the poor, and the disadvantaged, especially in the rural sectors, remain largely unmet. In addition, the results from previous financial sector programs have been compromised by inadequate implementation of program policies, signifying an 'implementation' gap, principally due to a lack of adequate human and technical capacity and political will at the national level. A comprehensive strategy needs to be designed to fill all these gaps. The New Partnership for Africa's Development (NEPAD), recently adopted by African countries, provides the necessary impetus for the implementation of such a strategy.

2.4.2 For most African countries, therefore, the strategy will generally include elements from the following broad strategic framework:

Measures to prevent financial disintermediation

A: <u>Financial Policies:</u>

- Restoring and maintaining macroeconomic stability,
- Proper synchronization and consistency between financial sector reform policies and the reform of the real sector,
- Careful sequencing of financial liberalization policies (see Box 2.4)

B: <u>Financial infrastructure:</u>

- Strengthening the legal, regulatory and prudential systems, including property rights;
- Developing monitoring systems that provide early warning of potential banking problems;

C: <u>Financial Institutions:</u>

- Reducing state ownership and control in financial sector, particularly in the banking system;
- Restructuring, and recapitalizing weak banks and other NBFIs;
- Promoting competition, while exercising caution in licensing new entries

Measures to promote development:

A: Financial Policies:

- Liberalizing interest rates, and foreign exchange market;
- Revising legal asset ratios for contractual savings systems (e.g. insurance companies) to avoid excessive concentration of government securities in their portfolios;
- External current account liberalization to be followed by carefully measured liberalization of capital account;

B: Financial infrastructure:

- Improving regulatory controls and prudential guidelines for contractual savings systems in the interests of policy holders and subscribers;
- Developing appropriate securities markets and financial institutions regulations to safeguard their viability;
- Increasing the potential number of credit worthy borrowers to avail of the increased credit and investment facilities;
- Promoting sub-regional harmonization of banking and property right laws and prudential criteria, establishing sub-regional supervisory mechanisms, and allowing cross-border banking;

C: Financial institutions:

- Reforming and strengthening (capacity building) of contractual savings systems to reorient their activities towards long-term private sector investments;
- Reforming public pension and social security funds management on commercial principles;
- Developing money and capital markets;
- In appropriate cases promoting sub-regional money and capital markets;

Measures to facilitate access of the poor to credit:

A: Financial policies:

- Allowing institutions to provide credit and other financial services to MSMEs at market-determined interest rate and prices;
- Providing financial incentives to commercial banks to move into rural areas, and link with semi-formal financial institutions for both deposit mobilization and credit facilities;
- Encouraging micro-finance institutions to mobilize deposits as the long-term sustaining source for their credit operations;

B: Financial infrastructure:

- Improving the legal and judicial framework, and property rights laws;
- Introducing simple supervisory and regulatory laws and procedures for deposit-mobilizing micro-finance institutions;

C: Financial institutions:

- Extending the reach of the financial systems to the MSMEs, and the disadvantaged in the rural sectors;
- Introducing instruments and interventions that may encourage gender-awareness approach to the provision of financial services;
- Consolidating and expanding micro finance by concentrating on few financial institutions that are successfully active in that area;
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- Establishing special non-bank financial institutions that are particularly relevant to the needs of MSMEs and facilitating their operations with the provision of guarantee facilities;
- Prioritizing technical assistance needs and factoring in appropriate technical assistance from multilateral and bilateral sources.

Box 2.4 Timing and Sequencing of Financial Sector Reforms

The timing and sequencing of reforms that take into account the institutional imperatives in the reforming country have a better chance to succeed. Four components of the reforms are particularly important as issues in sequencing, i.e. *interest rate deregulation, directed credit, competition, and capital account convertibility.*

If the macroeconomic environment is unstable, and supervisory and prudential controls are deficient, interest rates should be liberalized gradually *pari passu* with the improvement in those areas. Problems in the real sector must also be alleviated before interest rates are freed. Furthermore, the elimination of controls on interest rates should be synchronized with the cyclical phase of the economy.

Policy with regards to the deregulation of directed credit must avoid causing abrupt portfolio shifts, and the consequent price bubbles, by the financial sector. These controls should be phased out in stages and synchronized with the strengthening of the institutions involved, prudential controls, and the building of human and management capacity within the banking system.

Open entry for banks, though desirable over the longer-term, can create severe problems of banks' unsoundness, especially where bank supervision machinery is weak and the accounting systems/standards inadequate. Competition should be introduced only after the incentive system for the financial institutions is improved to ensure their soundness.

Capital account convertibility enables a country to integrate into global capital markets, and thus is an integral part of financial reforms. It would seem prudent to hold this aspect till the tail end of financial reforms. However, a distinction must be made between controls on outflows and controls on inflows of capital. For the controls on outflows to succeed they need to be quite extensive. After a period, they are likely to become distorting and less effective. Thus, as the financial system develops, controls on outflows should be reduced gradually at a time when the exchange rate is not under pressure. Controls on capital inflows, if market based (e.g. a tax on capital inflows to compensate for the anticipated exchange rate movements and the differential between the domestic and foreign interest rates) could be helpful for a country seeking to avoid the difficulties that may be encountered by domestic policy as a result of capital inflows (cf. Stanley Fischer; *Exchange Rate Regimes: Is the Bipolar View Correct?*).

2.4.3 The priority among the above measures, and their sequencing would differ among countries (or between different groups of countries in similar circumstances). A key consideration, in this regard, would be the level of financial system development, which traditionally is measured by financial ratios such as the ratio of M2 to GDP and of credit to the private sector to GDP as well as the range of financial instruments and institutions. On the basis of such indicators, African financial systems may be divided into three groups, namely:

- Least developed – poorly functioning financial systems that are dominated by commercial banks and a narrow range of financial instruments (mostly cash, bank deposits and short-term loans).
- Moderately developed – system dominated by commercial banks but also having a limited number of specialized institutions that provide insurance, housing finance, and short-tern finance facilities.
- Highly developed – with fairly diverse range of financial intermediaries and functioning, but not very liquid, capital markets[19]

2.4.4 The stage of the development of the financial sector, however, encompasses more elements than the ratio of financial assets, and the number of financial markets. A financial

[19] South Africa, which would be included in this group, is in a class of its own having a financial system comparable to that in industrialized countries.

system may be ‘developed’ in terms of the financial ratios, but if the system is not sound, or if it operates in an unsustainable macro-environment, it is highly unlikely to develop, and may in fact retrogress. Therefore, in judging the strength and potential for the development of a financial system, attention also needs to be paid to what has been called 'initial conditions' in which the financial systems operate. The IMF, in collaboration with other international organizations, is working to develop macroeconomic and microprudential indicators to assess the soundness of a financial system in the ongoing process of strengthening its surveillance activities[20]. The microprudential indicators are summarized as **C**apital adequacy, **A**sset quality, **M**anagement soundness, **E**arnings, **L**iquidity, and **S**ensitivity to market risks (**CAMELS** for short). Macroeconomic indicators on the other hand include *inter-alia,* economic growth, balance of payments, inflation, and interest and exchange rates. Based on these indicators, African countries may be further classified as highly unstable, unstable, marginally stable, and stable.

Table 1: Financial Systems: Financial Depth and Macro-Prudential Indicators Matrix

Macroeconomic↓ Financial depth→	**Least developed**	**Moderately developed**	**Highly developed**
Highly unstable	(Group I)*	(Group II)	(Group III)
Unstable	(Group IV)*	(Group V)	(Group VI)
Marginally stable	(Group VII)	(Group VIII)	(Group IX)
Stable	(Group X)	(Group XI)	(Group XII)

* Many of these countries are currently experiencing political conflicts that would have worsened their macroeconomic indicators.

2.4.5 Generally, countries with highly developed financial systems would have relatively better macroeconomic indicators. However, the juxtaposition of the degree of financial depth and macroeconomic indicators is randomly distributed for countries with the least developed and moderately developed financial systems. Even among the countries with the “highly developed” financial systems, the soundness of macroeconomic indicators differs among different countries. Thus, one general type of financial development strategy based solely on the degree of financial depth would not be appropriate and must be further tailored to the macroeconomic (and microprudential) situation in each country. Table 1 (above) shows what classification of countries the juxtaposition of the level of financial systems development on the financial system soundness may give.

2.4.6 Although, there will be many common elements, individual country financial sector strategies will, therefore, differ as to the relative emphasis placed on improving macroeconomic (and prudential) situation, and on financial deepening. Thus, countries characterized by serious (unstable) macroeconomic imbalances, would place greater emphasis on improving the macroeconomic situation, while also taking steps to enhance financial intermediation along sequential stages. In their case, a particular attention may need to be paid on strengthening the legal, supervisory and regulatory framework, as well as the monitoring systems, to ensure that the weak macroeconomic conditions do not lead to a weakening of the financial system. On the other hand, countries having stable macroeconomic environment but relatively less developed financial

[20] Owen Evans, et. al.: *Macroprudential Indicators of Financial System Soundness* Occasional Paper 192, IMF, Washington D.C. 2000

system, would appropriately put priority on establishing suitable infrastructure and institutions to enhance the poverty reduction and development potential of their financial systems. They should address the need to extend the reach of the formal financial system to low-income groups, especially those operating in the informal financial sector and women, facilitate the creation and expansion of small and medium-size enterprises, develop credit information infrastructure for micro-enterprises, and support micro-enterprises with new sources of funds, especially through domestic deposit mobilization.

2.4.7 For countries with relatively developed and relatively stable financial systems, bond markets in domestic currencies could provide efficient ways of mobilizing long-term finance by tapping new sources of finance and diversifying the financial sector away from traditional reliance on bank lending and donor flows. The bond markets in these countries have an immediate potential to grow provided that certain preconditions are established. These include maintenance of stable macroeconomic environment, supportive regulatory environment, a clearly articulated government debt management strategy, liquid and stable money markets, presence of large institutional investors (helped by the reform of the contractual savings and pension systems), appropriate investment and analytical tools, establishment of credit agencies and rigorous credit analysis, and adequate market infrastructure, transparency and efficient information flows. Privatization and the establishment of a variety of institutions such as finance companies, leasing companies, venture capital companies, and unit investment trusts, are also potential means of developing emerging capital markets. These countries should also aim at a greater integration of their financial systems with the global markets and should further refine their prudential provisions to conform to the internationally agreed standards. They must be particularly vigilant with regards to short-term capital inflows, and enforce strict accounting and disclosure regulations for the financial institutions.

CHAPTER 3

OVERVIEW OF BANK GROUP'S FINANCIAL SECTOR OPERATIONS

3.1 Introduction

3.1.1 The Bank Group's approach to financial sector development has evolved over the years. Until the mid-1980s, a major part of its programs focused on direct project loans and on LOCs. Though the attached conditionality tacitly centered on issues related to the viability of the DFIs, the lending operations suffered from double limitations in so far as their impact on the financial sector development was concerned. First, they tended to concentrate on only the institutional aspect of the financial systems to the neglect of other enabling conditions. Second, even within the institutional area, the focus was on the borrowing intermediary institution and not on the overall development or efficiency of the financial institutions. Also, the dirigist regimes in most of the member countries did not allow for a congenial policy environment that could ensure competitive and distortion-free economies, and adversely affected the financial sector. Thus, not only did a viable and vibrant financial system fail to emerge but also the DFIs, so much relied on to provide the impetus to enterprises, languished.

3.1.2 In the 1980s, there was a growing awareness of the close, two-way, relationship between financial system development and economic growth. The overall financial systems in Africa, and not just the intermediary institutions, needed to be reinforced and developed to support development of the real sector. These developments led the Bank, like similarly situated other multilateral institutions, to take a different track in its operations after the mid-1980s by bringing issues concerning the reform of the financial sector to the forefront. If the financial sector is to be promoted and its efficiency bolstered up, the entire economic structure needs to be reviewed with a view to removing distortions, and creating enabling environment for private sector development. The Bank, therefore, ushered in policy-based lending in synergy with that of the Bretton Woods institutions. Financial sector issues were broadly addressed both in the context of SALs and SECALs. However, as the size of the Bank's operations in the financial sector was rather small, the impact has also been small. Moreover, these operations in many ways overlapped with those of the World Bank and the IMF so that it is difficult to isolate the impact of the Bank's operations.

3.1.3 The Bank developed a broader perspective about its role in the financial sector development in 1996, when it articulated its policy in regard to the private sector. For one thing, by bringing private financial institutions in the fold of its operations, the Bank directly focused its attention on the private sector part of the financial sector. For another, the Bank Group introduced new and varied intervention instruments, such as guarantees, equity and quasi-equity investment, and agency lines, which have the capability of fostering the development of the financial sector. In 1998, the Bank further broadened its financial sector perspective when it created the AMINA Unit to support the development of microfinance in Africa. However, so far these interventions appear to have been employed in isolation, without taking into account their mutual and reinforcing relationship and without a comprehensive framework for the sector's development. Terms and conditions for individual operations tend to be decided on a case-by-case basis, as projects are selected on the basis of their individual viability, and their impact on the financial sector development rarely directly factored into the preparation or monitoring of the project. The following is a brief overview of the Bank Group's financial sector intervention instruments.

3.2 Intervention Instruments

The Bank Group has used essentially four instruments for disbursing its loans and grants i.e. *Specific Investments, Policy Based Lending (PBL), Technical Assistance Grants, and Debt Alleviation/Relief.* Specific investments took the form of either public and private sector project loans, Lines of Credit (LOC), equity investments, or guarantees. The PBL, on the other hand, took the form of either structural adjustment loans (SALs), or sectoral adjustment loans (SECAL). Specific investments accounted for 80.7 percent, and PBL for only 16.3 percent, of the total amount of Bank Group's loan and grant approvals during 1967-2001. More than half (57 percent) of the PBL was in the form of SECALs, and the balance (43 percent) under SALs. The relatively low share of PBL reflects the fact that the Bank resorted to that instrument only in the late 1980s when African countries began adopting structural adjustment reforms to correct the serious economic and financial problems facing them. During the period 1996-2001, PBL's share increased to 24 percent of total Bank approvals. Except for the PBL lending, interventions of the Bank did not have direct impact on the development of the financial sector as a whole; indeed those interventions did not explicitly include financial sector development as an objective. Nevertheless, some intervention (especially LOCs, equity investments, creation of some financial institutions and assistance to the private sector channeled through private financial institutions) did have an indirect impact on individual components of the financial sector that were the recipients of Bank assistance, and are also reviewed below.

3.3 Lines of credit (LOCs)

3.3.1 The Bank Group's LOC operations, which totaled UA 3.84 billion during 1967-2001, are carried out through three windows: the "ADB" window, the 'ADF' window, and the private sector development window [21]. Initially the LOC operations were all carried through the ADB window. While subsequently the ADF window was added, and charged with supporting the development of social goals of member countries, since the mid-1990s the Bank has placed top priority on private sector development through the ADB LOCs. The emphasis was on support to small and medium enterprises (SMEs), both directly and indirectly through the private financial institutions (PFIs). The Bank established the third window in the early 1990s to facilitate further support to private sector development in the context of economic and financial sector reforms. The rules and regulations governing the operations of the three LOC windows vary, reflecting their objectives. The most commercially oriented operations are those from the private sector window, while the softest interventions are those through the ADF window; the terms and conditions governing the operations of the Bank window are in-between those of the other two windows. The most important of the three windows is the ADB window, which approved approximately UA3.52 billion or 91.6 percent of total LOC approvals through 2001; approvals from the ADF window amounted to barely UA305.63 million. Presently, the amounts approved through the private sector development window are small, totaling only UA 268.62 million through 2001.

3.3.2 The impact of the past LOC operations has been mixed. At the institutional level, LOCs provided liquidity (access to foreign exchange resources and credit funds) and contributed to institutional development and capacity building. The long-term tenure of the LOCs also, importantly, allowed the borrowing institutions to extend the maturity of their lending operations. LOCs also allowed the Bank to indirectly and efficiently reach a larger number of enterprises than would otherwise be possible, particularly the SMEs. The Bank's LOC due diligence process and loan conditionalities also helped somewhat to improve the borrowing institution's corporate governance, particularly for the private financial institutions for which the Bank is more vigilant in ensuring their financial soundness and competitive functioning than it has been in the case of

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[21]There is a fourth window: the Nigerian Trust Fund (NTF), an arm of the Bank Groupbut the size of funds provided through this window is relatively negligible.

DFIs. However, a larger part of LOC operations appears to have had a narrow focus on only the beneficiary institution, with few direct inclusions of the broader financial sector elements (or policy conditions). More generally, a review of the post-1986 LOC operations suggests that the LOC operations did not always include the reform of the financial intermediary involved, and if the reform measures were included they were narrowly defined and limited to the concern of the lending operation, with little ripple effect on the rest of the financial system. Thus the current LOC policies have yielded a limited pay-off in terms of the development of the financial sector at the policy level.

3.4 Guarantees

The Bank introduced guarantees as an instrument in 1998, and as at end of 2001, guarantees amounting to UA 259.43 million had been extended to 2 enterprises. The significance of this instrument is that it facilitates the access of the enterprise to local or foreign currency funding on attractive terms and maturities not otherwise available. However, to the Bank, guarantees carry risks similar to those for the loans to the enterprise. As such, the projects for which guarantees are issued by the Bank, are appraised, processed and supervised in the same fashion as project loans, and are subject to exposure limits[22]. Since the primary objective of the instrument is private sector development, the main beneficiaries are private enterprises, local or foreign, including financial institutions. Government-owned financial institutions may, however, also benefit from the facility if the operation could be of considerable advantage to private enterprises. Nevertheless, from the point of view of the financial sector development, guarantee operations of the Bank can have catalytic impact as commercial paper of short and medium term, guaranteed by the Bank, could contribute significantly to the development of money and capital markets.

3.5 Equity participation

3.5.1 Equity participation is another tool at the disposal of the Bank for promoting both private sector and financial sector development through cooperation with the DFIs and other private institutions. Under its statutes, the Bank can hold equity in any public or private enterprise but without assuming any managerial functions, though it can oversee the operations of the enterprise whose equity it holds. As at end of 2001, the Bank had active equity investment portfolio totaling UA 26.553 million in eleven public sector institutions and UA 34.347 million in eight private sector enterprises. These interventions take a variety of forms- ordinary shares or preferred stock with or without participating features. In most instances, equity instruments are denominated in local currency and consequently entail foreign exchange risks for the Bank. In African countries, business firms are often small partnerships, relying on the funds of the owners. Through equity participation, the Bank is able to undertake an important function of bringing in other investors with capital, managerial skills and technical know-how, thereby contributing to the emergence of capital market in the member countries. A recent review of the Bank's investee institutions indicate that the performance of these institutions is affected by the economic environment in which they operate, the quality of management, and the commitment of the shareholders. While the overriding objective of the Bank's equity participation is not financial return, in recent years the Bank no longer takes up equity in enterprises that cannot distribute dividends.

3.5.2 The Bank is also empowered to make quasi-equity investment in various forms, ranging from subordinated loans, with or without conversion rights, and income notes to redeemable preference shares. Such quasi-equity holding normally ranks junior to loans in the event of liquidation. Their main characteristic is that they combine some features of loans with those of equity. They do not generally involve an exchange risk for the Bank and are retired under agreed

[22] African Development Bank: Policies for Lines of Credit, Agency Lines and Guarantees to Private Sector Financial Institutions, Board document, August, 1998.

schedules, making them more suitable instruments in countries without a well-developed capital market in which a ready sale of equity is difficult.

3.5.3 At the regional level, the Bank has also been instrumental in creating a number of regional financial institutions such as Africa Re and the Africa Export Import Bank through equity participation. The Bank still maintains equity shares in these and other subregional financial institutions (EADB, PTA Bank, BOAD etc). These institutions help to fill in some gaps in financial services.

3.6 Policy-Based Lending (PBL)

3.6.1 Policy-based lending by the Bank Group has a more recent origin compared with its other intervention instruments. It was introduced in mid-1980s in response to the serious economic crises that the member African countries experienced in the aftermath of the 1980s oil price hike. The underlying rationale of this instrument is to foster, over a period of time, an incentive environment conducive to savings and investment, and efficient use of resources. The accent of PBL is on supporting member countries in their efforts to implement comprehensive reform programs aimed at eliminating or reducing macro-economic distortions in the economies, promoting growth and alleviating poverty.

3.6.2 A total of 15 countries in Africa have benefited from the PBL facility. The PBL operates at two-levels: at the macroeconomic level the PBL provides funds under structural adjustment loans (SALs), and at the sectoral level the PBL supports reforms in specific sectors, such as the financial sector, through its sectoral adjustment loans (SECALs). This dichotomy, however, is more apparent than real, in as much as appropriate sectoral reforms will succeed only in a sound and stable macroeconomic environment, which in turn could be threatened by weak and unviable real and financial sectors. Thus while the focus of policies under SAL and SECAL may be different, both need to ensure a minimum of financial and sectoral stability and growth. The important components of the programs supported by the Bank Group through its PBL are trade reforms, exchange rate adjustments, elimination of price distortions, as well as reforms affecting public finance, public sector management, monetary policy, freedom of entry and competition, and strengthened bank supervision and regulation.

3.6.3 The Bank Group has granted only five financial sector adjustment loans (FSALs), some of which had explicit financial sector objectives, i.e. “to make the banking system competitive, diversified, sound and profitable with a view to better mobilization of domestic savings, selective and appropriate allocation of resources in order to support the investment efforts of the public sector.” FSALs also included policies in the non-financial sector that were deemed necessary for the realization of the objectives in the financial sector[23]. Some of the programs resulted in the creation of money and capital markets, reduction in the state ownership of selected banks, cleaning-up balance sheets of banks, improved profitability and portfolio quality, and increased competition. Others included the establishment of legal procedures for the recovery of debt, imposition on the banks of binding obligation of professional secrecy, strengthening of prudential controls on banks, and improvement of banking services.

3.6.4 In theory both the PBL and LOC operations should be paying attention to institutional development and macroeconomic environment. In the past, however, when serious macroeconomic imbalances were widely prevalent, PBL proved to be an effective complement to

[23] FSAPs tend to be designed and implemented in the same manner as SALs, and some of the conditionalities, particularly bearing on the financial and fiscal sectors, are virtually the same. Both types of PBL recognize the linkages between the financial sector and the real sector. Thus while the banks’ may be restructured and recapitalized with the infusion of new funds, their performance and efficiency are unlikely to improve perceptibly unless there are credit worthy borrowers, and existing loss making public enterprises are reformed and made profitable, or privatized.

the LOC in encouraging financial sector reforms. While the LOCs tended to focus narrowly on institutional development, and within that on the development (viability) of only the borrower institution rather than of the entire financial sector, the PBL, by combining measures to improve macroeconomic environment and reform the financial system, promoted a more sustainable development of both the real and the financial sectors. Within the PBL, the limited experience with FSALs does not permit a definitive judgment on the relative efficacy of SALs versus SECALs. However, since ideally the policy matrices for both types of programs need to converge, the preference for one or the other type of lending may depend on the circumstances of the country concerned. In countries where substantial macroeconomic distortions exist, SALs may be a more useful instrument for the Bank's operations. On the other hand, if macroeconomic environment is sustainable and supportive of financial sector development, FSALs may be more appropriate.

3.6.5 Implementation of the PBL has made heavy demands on the institutional capacity and expertise of the Bank. Essential for PBLs is a continuous policy dialogue with the member countries, which is possible only when an in-depth analysis of the individual country situations is undertaken, and policy alternatives commensurate with the underlying economic conditions are explored. The Bank has, therefore, tended to take a pragmatic approach in the implementation of PBLs. It has recognized that the lead role in the design of adjustment policies should be that of the World Bank and the IMF. However, it has ensured that it become an active partner in preparing background studies and policy framework papers and get involved, along with the IMF and the World Bank, in policy dialogue with member countries. While this pragmatic approach would still be useful, it should be possible for the Bank to design certain kinds of PBLs in future, such as those related to improving financial and corporate governance.

3.7 Micro-finance

3.7.1 The Bank's intervention in the micro-finance sector is guided by three objectives: income generation, empowerment of women, and improving the living standards of the poor. Its target beneficiaries are the economically active poor, especially women who work and operate businesses that are in the informal sector. The informal sector constitutes at least 80% of the workforce and the number of enterprise activities in most African countries. Currently the Bank has supported 48 projects with micro-finance components in 21 African countries. So far, the Bank has not financed any standalone micro-finance projects. All the projects are implemented through MFIs (micro-finance institutions), and/or the NGOs, which, in turn, provide loans to groups of enterprises or to individuals, as appropriate. The Bank's financial contribution to micro-lending has so far totaled $132 million in the form of credit funds, and $65 million for capacity building.

3.7.2 Following the conclusions of the Consultative Meeting related to the Seventh Replenishment of the ADF, AMINA was established in 1997 as the latest addition to the Bank Group's intervention instruments to help alleviate poverty in its member countries. AMINA's activities consisted of capacity building, policy dialogue, donor coordination, information collection and dissemination in a few selected countries, and mainstreaming micro-finance best practices within the Bank. The experience gained was to help AMINA devise appropriate modes for its operations to promote micro-finance in Africa. However, the implementation of the planned activities was hampered by the temporary nature of the program, as well as staff and management limitations. A Mid-Term Review of AMINA, in 2000, as well as a position paper on the Bank Group's Role in Microfinance drew lessons from the program's experience and made recommendations on improving the microfinance interventions of the Bank Group. These recommendations included the need to (i) build upon the institutional and human resource capacity building activities of AMINA by replicating them in other RMCs; (ii) further increase awareness of operations staff of the key notions of microfinance; (iii) actively incorporate

microfinance best practice standards in Bank Group operations, where appropriate; (iv) transform AMINA to ensure that its structure and organizational placement allows for regular staffing, easy accessibility to/by the operations complex, and the least conflict with Bank Group processes and procedures. In order to implement the recommendations and enhance the effectiveness of Bank Group's role in microfinance, a decision was taken to mainstream microfinance into Bank operations. This includes the placement of microfinance specialists into operational departments and units primarily to assist in project cycle activities for those projects containing credit access and microfinance components as well as the conversion of AMINA into the permanent Central Microfinance Unit with a mandate to help improve the quality at entry and sustainability of the Bank's microfinance projects and programs.

3.8 Agency-lines

An agency line is a line of credit to private financial institutions (PFIs) to increase the volume of funding which can be provided to SMEs with minimal increase in the project processing work for the Bank, and without increasing the credit risk of the PFIs. It is similar to a line of credit, with the exception that the credit risk is borne by the Bank. A unique feature of this instrument is the fact that, in addition to the LOC to PFIs, the Bank can concurrently extend a loan in the same amount (as the amount on-lent by the PFI) directly to the sub-borrower. The PFIs, acting as agents of the Bank, are required to evaluate the sub-borrowers and the projects, a service for which they are paid fees—normally 1 percent of the amount of the Bank's part of the loan. However, the Bank has not yet used this lending instrument.

3.9 Non-lending Operations

3.9.1 Technical Assistance

Lack of financial resources in the African countries is one predominant constraint on their development; the other equally important constraint is the paucity of appropriate technical skills in both the private and public sectors. Particularly severe is the gap in knowledge about land registration, capital and money markets, asset/liability management skills, legal institutions, which all constitute the preconditions for the private sector growth. The Bank has, therefore, attempted to be a source of advice and information to the member countries. These advisory services fall into three distinct categories: special advisory services on project structuring and financial packaging, financial advisory services for privatization projects or to private enterprises, and policy advice on private sector development, foreign investment, capital market development and other related subjects. All technical assistance, which has amounted to US$681 million over the period 1967-2001, is in the form of grants. The advisory work associated with technical assistance has been largely centered on institution building, tied to the projects. As much as 95 percent of the technical assistance grants are used to manage project cycle. The remaining 5 percent have been focused on building up knowledge in member countries.

3.9.2 Economic and sector work (ESW)

ESW is one of the most effective instruments the multilateral institutions employ to enhance the efficiency of the use of their resources. The Bank Group is no exception and makes use of ESW to obtain analytically based information about the development conditions, constraints, and prospects in member countries. ESW process enables the Bank to formulate appropriate macroeconomic and structural intervention strategies in member countries and to improve policy dialogue with them. In the past the Bank had not devoted sufficient staff time and resources to this work. However, in line with the defined Vision of the Bank to focus on

selectivity-based country-specific development needs of its member countries, the Bank has more recently prepared guidelines[24] for its staff to be increasingly involved in ESW.

3.10 Bank Portfolio Performance

The Bank portfolio performance classified by lending instruments shows that structural adjustment loans carried the highest potential risk in 1999 but the lowest in 1998[25]. The risk involved in LOC was at 34 percent of the commitments in 1999, as against 40 percent in 1998, suggesting that the size of the risk did not vary much between two years. On the other hand, commitment at risk in respect of sector adjustment loans was 55 percent in 1998 but declined to 4 percent in the succeeding years. All in all, no clear pattern emerges and a conclusion may be drawn that the portfolio risks do not vary according to the lending instrument chosen. However, as the number of loans included under some categories in the APPRs is small, these results should be interpreted with caution.

3.11 Lessons

The above review points to a few lessons for the future operations of the Bank Group as they relate to the financial sector development. These may be summarized as below:

- Financial sector development involves myriad aspects, and narrow focus on developing one or other financial institution without reform measures in other relevant areas will not yield the expected pay-off;

- Prevalence of large macroeconomic distortions hampers, if not negates, the implementation of reform measures in the financial sector;

- The Bank has followed a pragmatic policy in developing its instruments of intervention, depending on the perceived needs of its member countries. Thus the establishment of AMINA and its transition to mainstreaming microfinance within the Bank, and the private sector window were in response to the needs in the rural and SME sector, and the lack of long-term finance for the private sector. Generally, the Bank has at its disposal the necessary instruments to be proactive in assisting member countries in their quest for financial sector development. However, the Bank has yet to develop a comprehensive strategy for the sector so that these instruments could be used in a mutually supportive role;

- From the point of view of the impact on the financial sector development, LOC has been a less efficacious instrument than PBL, especially as the former has focused narrowly on the development of only the intermediary institutions rather than on the bulk of the main financial institutions;

- Despite the above, LOCs have great potential for fostering financial development, provided they are properly organized and administered, especially after macroeconomic stability has been achieved;

- Within the PBL, the choice between SAL and SECAL as the principal instrument to promote financial sector development depends on the circumstances of the country. In conditions of serious macroeconomic distortions, SAL may be a preferred instrument,

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[24] ADB Group: *Guidelines for Economic and Sector Work-* OM 320, April 2000.

[25] African development Bank: Annual portfolio Performance Review (APPR), 1998, 1999

while in conditions of relative macroeconomic stability, SECAL may be more effective;

- The Bank's private sector development window offers an effective channel for forging institutional improvements in PFIs. However, care must be taken to avoid the operation's adverse effects in terms of credit segmentation;

- From the point of view of the Bank's portfolio, including risk management, there appears to be no stable relationship between the instrument of intervention and the risk factor. Thus the choice between the various instruments of intervention to help develop the financial sector should be based mostly on their impact on the sector; and

- Finally, the proposed ESW should become the principal vehicle for the Bank to develop its country strategies, and the ESW processes should be introduced forthwith.

These lessons have been taken into account in formulating in the next chapter the Bank's future role and strategy in promoting financial sector development in member countries.

CHAPTER 4

THE BANK GROUP'S FUTURE ROLE AND STRATEGY

4.1 Link with Bank Vision

The Bank Group's Vision highlights poverty reduction in Africa as the 'primordial challenge' for the Bank. To that effect, the Bank is adopting a development strategy, which should effectively promote accelerated, sustainable growth with equity and poverty reduction as its central goal. The Vision statement further clarifies the Bank's focus at the country level on three broad themes (agriculture and rural development, human resource development, and private sector development), one general theme of governance and two cross-cutting themes on environment and gender. At the regional level, the Vision focuses on regional economic integration. Financial sector policies and development have relevance for almost all these focus areas of the Bank Group. Economic growth is the engine for poverty reduction. But, as discussed in Chapter 2, the soundness and dynamism of the financial sector importantly affect growth. Financial sector integration is also a good starting point for fostering regional and sub-regional economic integration. Furthermore, as the African experience shows, rural development and rural poverty, as well as gender issues cannot be satisfactorily addressed in the absence of appropriate financial intermediaries and instruments, which do not automatically emerge as the economy grows. The Bank has interest in encouraging the financial sector to engage in micro-finance developed on the standards of best practices, and to improve its efficiency and linkages with the informal finance system. The Bank's concerns about human resource development and improved governance must also extend to those in the financial sector, as without them the financial sector will remain weak and risk-prone. Thus, through its interventions in the financial sector the Bank Group could simultaneously address a wide spectrum of its agenda as articulated in the Vision statement.

4.2 Premises and Principles

4.2.1 The strategy for the Bank Group is based on **two premises** derived from the discussions in Chapter 2: *one,* that economic growth is the main engine that drives the poverty reduction train and that poverty reduction, in turn, assures the longer-term sustainability of growth and growth-oriented policies; *two,* that a stable, sound, dynamic, and progressively deepening, financial system is an essential pre-requisite for ensuring economic growth. The recommendations following from those premises are governed by **three principles**: collaboration, comparative advantage, and value-added. The *collaboration principle* recognizes that the formulation and implementation of the financial sector policies is the responsibility primarily of the member countries themselves, including local financial institutions. The Bank Group's interventions must, therefore be designed in consultation and collaboration with its member countries, and the relevant financial institutions. Furthermore, the Bank is only one among many donor organizations and institutions (including NGOs and African regional organizations such as ECA, SADC, and MEFMI) that are actively pursuing their own strategies to assist African countries in their efforts to promote financial sector development. In implementing this strategy, the Bank will collaborate with these institutions and organizations. It will also ensure that there is no significant overlap or conflict between its initiatives and those of other international and regional institutions to strengthen the financial sectors in Africa. Moreover, given its limited resources, the Bank cannot play a sole leadership role in this area and must foster strategic partnership with others, especially the IMF and the World Bank who have the mandate, the resources, and technical capacities to assume that role. However, the Bank's special partnership relations with the BWIs enables it to share special concerns with them and collaborate to refine approaches in support of financial sector development. The PRSPs, for example, provide an appropriate mechanism to pursue such collaboration with the BWIs. As elucidated later in this report, the Bank could,

however, take a lead role in establishing a mechanism at the regional and sub-regional levels to help monitor implementation of financial sector reforms in a collaborative context.

4.2.2 The significance of the *comparative advantage principle* is that, although the Bank's experience and interventions in the financial sector have so far been limited compared to the BWIs, it should be able to identify for itself specific niches where it can build capacity to achieve or reinforce a comparative advantage over other institutions on account of its special relations with African countries, and in areas where it has gathered unique knowledge, experience and expertise. The Bank should also be able to build on its advantage as an African institution that enjoys special insights into the aspirations and concerns of African policymakers, and especially in the context of NEPAD. As an African institution, the Bank could also build itself to engage in continuous policy dialogue with African countries, even on difficult and sensitive national and regional issues. It could also build on its knowledge of socio-economic conditions and political parameters in African countries to promote the design of relevant and acceptable country strategies and their 'ownership' by national authorities. Furthermore, the Bank is able to appreciate and analyze Africa's customary socio-legal traditions and practices that may have implications for the design of the formal legal/judicial financial infrastructure. Even so, as indicated earlier, the Bank is a relatively new player in the financial sector and it would need time to assume an effective leadership role based on its comparative advantage. Therefore, the Bank will interpret the comparative advantage principle in a dynamic manner, envisaging that its areas of comparative advantage would evolve as the institution develops its technical and financial capacities, and as opportunities arise in particular areas of focus in its Vision, such as governance (including financial standards and judicial reforms), micro-finance, capital market development and regional financial integration. The *value-added principle* suggests that the Bank should evaluate the specific impact of its operations, as well as their long-term sustainability, and ensure 'best value for its money'. Furthermore, as a multi-sector institution with its focus on poverty reduction, the Bank should take a broad view of development and help to apply financial sector policies within a broader context of poverty reduction. It may, therefore, intervene in those areas which it considers necessary in the context of its own Vision but where other institutions may not be involved or involved insufficiently. For example, the Bank has accumulated some experience and is building expertise in areas such as regional integration, human resource development, capacity building, private sector development, governance and transparency, gender-awareness, and micro finance, where its involvement could have *added value.*

4.3 The Bank Group's Role and Strategy

4.3.1 The Bank considers financial sector development as an indispensable element of its strategy to pursue the twin goals of promoting economic development and poverty reduction in Africa. In this regard, as explained in Chapter 2, the unfinished agenda for financial sector reforms in Africa that should inform the Bank Group strategy consists of addressing three gaps, namely: the financial intermediation gap, as represented by the fragility of the financial system; the development gap, as reflected in the shortage of long-term finance for investment; and the poverty reduction gap, as denoted by the unmet demands for financial services by the MSMEs and the economically active poor and the disadvantaged, including the women. Therefore, the Bank Group will focus its actions in the following three broad areas to help the development of the financial sectors in its member countries:

- Supporting establishment of healthy and sound financial systems;
- Improving the depth and development orientation of the financial system; and
- Helping to improve the access of the poor and women to finance.

4.3.2 As already indicated, the framework for assistance in these areas will be the Bank Group Vision, with its focus on poverty reduction and particular attention to, inter alia, agriculture and

private sector development (especially for MEMSEs), governance (including the legal, regulatory and prudential systems), gender, and regional (financial) integration. Even so, the Bank's human and financial resources are limited and have to be spread over a variety of sectors and activities to fulfill its overall mission. Hence, the Bank must choose its priority areas for intervention in the financial sector, taking into account the three principles stated above (that is collaboration, especially with the BWIs, African regional organizations, and othet donor agencies; comparative advantage; and value added).

A. Supporting establishment of healthy and sound financial systems

4.3.3 The establishment of a healthy and sound financial system is vital for the overall development of the financial system. Not only does it instill confidence in the private sector to save and invest in the country, it also enhances the authorities' ability to implement macroeconomic and other financial sector policies. In addition, it improves the availability of financial services on market basis and diminishes the risk of costly financial crises, with their impact on development and poverty reduction. Financial sector soundness requires the establishment of certain key elements. First, as a prerequisite, it requires the establishment of macroeconomic stability and policy consistency to create an enabling environment for investment and to facilitate macroeconomic management. A sustainable debt situation and efficient debt management are also characteristics of macroeconomic stability and prerequisites for sound financial systems. Second, financial sector soundness requires the improvement in financial governance, including the establishment of appropriate legal and regulatory environments as well as absence of distortions arising from political pressures, financial crimes and lack of transparency in financial management. Recent efforts in this regard are being facilitated by the adoption and implementation of banking and financial standards and anti-money laundering policies. Third, it also requires the establishment of a competitive environment to facilitate the development of institutions and instruments that cater for a wide range of market participants. Nevertheless, liberalization carries with it the risk of increasing vulnerability to financial crisis. Therefore, the fourth element for financial sector soundness requires the improvement in financial sustainability, and there are several areas to tackle in this regard, including strengthening corporate governance and capacity of financial institutions, streamlining the licensing of banks, strengthening banking laws, and developing good monitoring systems.

4.3.4 However, overall, the Bank understands that the establishment of a healthy and sound financial system is an important aspect of financial sector development, and that the Bretton Woods institutions are presently adequately addressing this area, with particular emphasis on financial policy and on supporting sound macroeconomic management and encouraging risk prevention and risk management. Therefore, the Bank as a regional development institution will mainly play a supportive and complementary role in this area. Consequently, Bank Group support in this area will cover only selected areas (capacity building for policy management, financial infrastructure and governance, and corporate governance and institutional capacity) and be delivered in a targeted manner as explained below:

Building institutional capacity for macroeconomic management

4.3.5 As explained in chapter 2 above, several African countries, with the support of the Bretton Woods Institutions, have made progress in improving their macroeconomic stability and reducing financial repression. This has helped, to some extent, to deal with the problems of unsustainable fiscal deficits, loss-making public enterprises, high inflation, and inadequate exchange and trade systems that plagued most African countries in the 1980s. In addition, since the mid-1990s, the financial reform efforts have paid attention to issues of sequencing of the reform measures and their synchronization with macroeconomic stabilization and real sector reform measures.

Nevertheless, a major drawback in earlier reforms in Africa, and which the Bank Group can help to address, has been in the inadequacy of attention paid to human capacity in different institutions (e.g. the Ministry of Finance and the central bank) and weak institutional arrangements (the lack of proper coordination in the actions of different parties). The Bank through its participation in the PRSP process will encourage and provide technical support to African countries to address these weaknesses. The Bank will also provide technical assistance to countries that have experienced severe internal conflicts, in rehabilitating and rebuilding institutions that have collapsed during the conflict, and in redressing macroeconomic stability in the post-conflict phase.

Supporting the improvement of financial governance and regulation

4.3.6 African countries must also provide the financial markets with a transparent information environment that will assure investors and others that progress is being made to improve the financial sector's soundness. This will require improvement in the disclosure of macroeconomic information and adherence to standards and guidelines on good governance and transparency in fiscal and monetary policies. In addition, African countries must focus on legal and regulatory frameworks that are now also considered as important for improving financial system soundness[26]. Three aspects of the framework are: a regulatory and institutional structure that supervises the financial system, creditor rights and insolvency laws, and an impartial and expeditious judicial system to enforce those laws. Institutional reforms are needed to bring African financial regulatory and supervisory systems to international standards[27].

4.3.7 The Bank Group will use its role in the New Partnership for Africa's Development (NEPAD), as the lead institution on banking and financial standards, to foster the improvement of financial governance in African countries. The competitive advantage of the Bank is that it can engage in policy dialogue with governments and play this role with continuity and commitment[28]. The Bank, as a regional institution, can assure a broader vision and perspective of these standards and collaborate with the Bretton Woods institutions and other standard-setting bodies to ensure that the implementation of these standards are properly adapted to the situation of African countries. Not surprising, the Bank's role in the NEPAD will mainly be advisory. In this regard, the Bank has proposed a framework for the implementation of standards under the NEPAD and helped to identify indicators for measuring constraints in the African Peer Review Mechanism (APRM) by which NEPAD will seek to assess and encourage progress in each country's effort. While the field assessments will be coordinated by the NEPAD Secretariat, the lead institutions and other relevant regional bodies (such as the Economic Commission for Africa and the Association of African Central Banks) are expected to provide advice and technical assistance to the process. In addition, the Bank will provide background materials to assist the process[29]. Beyond assessments, however, the Bank will offer support in implementing action plans to redress weaknesses identified. An important factor in the implementation of the action plans should be the cost and the personnel required to formulate the required legislations and to build

[26] Good financial governance is also a prerequisite to the successful anti-money laundering effort and the promotion of good corporate governance (see sections below).

[27] Various public and private international bodies are developing international financial standards I their respective areas of expertise. These include the International Accounting Standards Committee, the International Organization of Supreme Audit Institutions, the international Corporate Governance Network, the International Organization of Securities Commission, the Basle Committee of Banking Supervision, the International Federation of Accountants, the International Association of Insurance Supervisors, and the Organization of Economic Cooperation and Development.

[28] The G8 Ministers of Finance, at their meeting in Rome in June 2001, also called on the Bretton Woods Institutions and the Regional Development Banks to help foster implementation of standards and codes, including on anti-money laundering.

[29] The Bank has participated once in the FSAP, in collaboration with the BWIs. However, except for such ad hoc situations where the Bank's expertise may be requested to fill a specific gap, its participation in the FSAPs and other assessments is not expected to be on systematic basis.

the necessary legal structures, accountability mechanisms and regulatory regimes. These costs can be substantial and the required personnel have to be well experienced in the intricacies of financial legislations and regulations, both well beyond the means of many African countries. Therefore, in addition to its advisory role, the Bank Group, will, as part of its operations, collaborate with the BWIs to provide training as well as assistance in the mobilization of financial resources to build the capacity of the necessary institutions. The Bank will also take into consideration concerns about implementing standards in the formulation of its country strategies and in the design of its projects/programs in the financial sector.

Building capacity to address the problem of money laundering

4.3.8 Money laundering and terrorist financing affect the soundness of the financial system in a number of ways. In particular, they divert financial resources from development activities and may involve sharp changes in financial flows that can also affect the stability of the financial system. Therefore, NEPAD has determined to pay special attention to money laundering in African countries and the Bank has been requested by the NEPAD Heads of State Implementation Committee to play a lead role also in this effort in RMCs[30]. As with fostering banking and financial standards, developing mechanisms to address money laundering would also involve providing training and mobilizing resources to establish the necessary legal structures, accountability mechanisms and regulatory regimes. Again, while the Bank will provide advice and necessary information to facilitate assessments under the NEPAD, its main focus will consist of collaborating with the BWIs to provide technical assistance and mobilize resources to draw up and implement action plans, including building the required skills and establishing the necessary institutions. The Bank will also reflect concerns on money laundering in the formulation of country strategies and the design of financial sector programs in RMCs.

Strengthening corporate (internal) governance and capacity of banks

4.3.9 Generally, in efforts to improve the soundness of the financial system, the key institutions to pay attention to in African countries would include the central banks, commercial and development banks and, in some countries, the securities markets and insurance institutions as well. While the BWIs have been assisting African countries to address the weaknesses of these institutions, it has not been possible to give adequate attention to banks (including the development banks)[31]. Yet, these institutions are at the heart of the financial systems in Africa and their continued weakness in certain areas poses great risks to the stability of the systems. In particular, many of these institutions suffer from weaknesses of their corporate (internal) governance systems, reflecting, among others, the lack of appropriate information and its flow within these institutions, the shortage of management skills, and the inadequacy of incentives provided to management and staff[32]. In addition, many countries suffer from weak supervisory systems, including off-site monitoring, that are unable to help in adopting international standards on corporate governance[33]. In the case of some development banks, the problem is compounded by government interference in their management and operations and the fact that they are not

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[30] The G8 has also requested the multilateral development banks (including the ADB) to collaborate in assisting their client countries to implement anti-money laundering actions.

[31] While the Bretton Woods Institutions are assisting central banks to improve internal governance, there is no systematic source of assistance to commercial banks and the DFIs.

[32] Corporate governance provides for accountability of corporations and directors. In particular, it requires transparent relationship between management and stakeholders. It also requires firms to be sensitive to good business ethics, including regard to human rights and environmental sustainability, while aiming to achieve their economic objectives.

[33] The new Basel Capital Accord regards the supervisory review process as a critical complement to the minimum capital requirements. It expects supervisors to ensure that each bank has sound internal processes in place to assess the adequacy of its capital, based on a thorough evaluation of its risks. The Accord stresses the importance of bank's management developing an internal capital assessment process and setting appropriate targets for capital.

systematically subject to regulation. Hence, as an integral part of the strategy to develop the financial sector, the Bank will support African governments to factor in capacity building and information technology in strengthening internal governance of financial institutions and in building supervisory capacity. The Bank will place great emphasis on this aspect, and provide training facilities at the national/sub-regional levels. Concerning development banks, additionally, the Bank will encourage the rationalization of government involvement in their management and operations, and where necessary, support their restructuring or privatization, provided that privatization would be accompanied by appropriate measures (such as promotion of competition and improvement in the legal and regulatory framework) to avoid any negative effects[34].

B. Improving the depth and development orientation of the financial system

4.3.10 Attaining high rates of growth and poverty reduction require mobilization and efficient allocation of higher amounts of medium and long term (MLT) finance. Promotion of longer-term finance requires action on various fronts, including: enhancing the confidence and choice of savers, strengthening the capacity of financial intermediaries, banks and nonbank, to mobilize and allocate term resources, promoting capital markets, especially in the context of regional integration, and reforming contractual savings systems (insurance companies, pension funds, and social security funds) so that the long-term funds mobilized could be channeled to support investments. The confidence of savers will generally move with the broader range of instruments and the lowering of risks that improved financial sector development and soundness will help to bring. In the case of the reform of contractual savings, while it would be useful for several African countries, it could also be time and resource intensive and would require very specialized skills that other donors are already helping to provide[35]. Therefore, the Bank will focus on building the capacity of financial institutions to mobilize and allocate MLT, on strengthening the DFIs, and supporting regional capital market development.

Building the capacity of financial intermediaries (FIs) to mobilize and allocate MLT

4.3.11 The Bank aims at enhancing the role of non-bank financial instruments and institutions, including leasing, hire purchase, credit guarantee and asset management companies and bond markets in providing finance to the private sector. However, there are special problems related to the intermediation of MLT compared to the shorter term finance that prevail in the continent, and for a number of reasons. In particular, MLT finance is subject to higher risks of repayment, reflecting longer maturities and the fact that MLT credit is vulnerable to economic fluctuations and shocks as it only allows for slow diversification of risk. The gains from MLT finance also tends to be lower because of the higher administrative costs of the analysis, monitoring and appraisal of documents involved and especially also as the market fixes interest rates of the MLT credits more rigidly than for short term credit. Besides, MLT credit requires a specific organization and culture, given the demands of long relationships with clients. Heavy administrative structures are needed for feasibility analysis and loan recovery.

4.3.12 Improving the capacity of FIs to intermediate in MLT, therefore, involves the strengthening of financial infrastructures to mitigate the risks in MLT finance, including refinancing mechanisms to help the refinancing of MLT, guarantee mechanisms and political risk insurance to cover aspects of the risks, rating systems to facilitate screening of borrowing firms,

[34] While some form of government intervention may be warranted, especially due to externalities and information asymmetries, such interventions can raise issues of governance and financial market distortions. Therefore, they should be limited, transparent, closely monitored and evaluated to ascertain that they do not compromise good corporate governance or create excessive distortions.

[35] Reforming contractual savings may require addressing simultaneously, the policy and regulatory environments and the funding as well as revising the prudential guidelines and prescribed asset ratios and improving their management.

and deposit insurance to encourage MLT savings. The introduction of these facilities would involve the collective effort of governments, the FIs themselves and donors (including multilateral development banks). In this regard, the Bank will, through policy dialogue, encourage governments to set up or to facilitate the private sector (of the FIs themselves to collaborate) to set up the mechanisms. It would also help to disseminate best practices and innovations through workshops and conferences, and would collaborate with other donors to provide appropriate funding and capacity building towards institutional strengthening. The Bank will also provide guarantees to viable institutions to help them mobilize long term funds in international capital markets.

Strengthening development finance institutions

4.3.13 Development finance institutions (DFIs) are special financial institutions involved not only in MLT but also in providing advisory services to their clients. Therefore, they tended to operate differently from other banks. Unlike banks that take deposits (and create money), most DFIs tended to borrow their funds, thus making them dependent on government and external sources for funds and reducing pressures for them to operate efficiently. DFIs also tended to focus on project lending, tying the recovery of their loans to the viability of the projects, whereas banks grant loans on the basis of the ability of the borrower to repay. Typically, DFIs also made their own decisions concerning accounting and funding rules. Unlike banks, DFIs also generally lacked access to refinancing facilities. While many DFIs have adopted practices similar to banks, other problems remain for the state-owned DFIs. A study undertaken by the Bank on development finance institutions (DFIs) in African countries found that most state-owned DFIs have not proved successful for various reasons, including political interferences in their management and operations, difficulties in coping with external shocks and financial liberalization as well as the absence of appropriate framework for their regulation, and many of them have been closed down, while others have been restructured as autonomous commercial institutions[36]. However, the challenge of supplying medium and long-term finance, especially for SMEs and in the transitional economies, underlines the case for supporting some DFIs.

4.3.14 The study undertaken by the Bank suggested that support to DFIs should be contingent upon the existence of conditions for their success. These conditions include ensuring government commitment to good and transparent management; suitably designed operating standards, especially for accounting and provisioning for risks; good negotiation with clients and proper supervision. The Bank will, therefore, encourage and support the relevant bodies (such as the Association of African Central Banks and the Association of African Development Finance Institutions) to collaborate in developing the appropriate accounting and supervisory mechanisms for the development banks. The Bank, through its LOC operations and technical assistance, will also continue to seek revitalization of DFIs and encourage them to raise resources domestically through a variety of offerings such as deposit facilities, negotiable certificates of deposit, and floating rate notes. In extending support, the Bank would distinguish between three categories of DFIs: those that are insolvent, those that are solvent but need to build their capacity to remain viable and perform efficiently, and those that already have good operating standards and are performing well in favorable macroeconomic environments. There is usually no easy way to fix an insolvent bank, and the process is bound to be long, arduous and politically contentious[37]. The Bank would, therefore, focus on addressing the needs of the latter two categories of DFIs. It would offer technical assistance to the second category of DFIs to improve their performance and prospects of sustainability while the third category of DFIs would have access to LOCs and,

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[36] See ADB: Study on Strengthening Development Finance Institutions, December, 2001.

[37] Dealing with insolvent banks may involve either liquidation or recapitalization and restructuring. The second option would entail provision of additional capital, financial restructuring, and isolation and treatment of bad assets, in addition to institutional strengthening and capacity building in risk management.

where necessary, technical assistance as other well-performing banks[38]. In the past, the Bank has subscribed to equity in some DFIs. This form of assistance will be very limited and, even so, the Bank will ensure that exit mechanisms are included in the agreements.

Supporting subregional financial integration

4.3.15 The relatively small size of most African countries precludes the development of broad and diversified financial systems within national boundaries, thereby constraining the system's ability to mobilize domestic and foreign savings for development. At the same time, the limited availability of domestic human capacity compromises the authorities' ability to enforce prudential and other regulations that safeguard the soundness of the financial system. To overcome these constrains, neighboring countries in the sub-regions should explore the possibility of harmonizing banking and property rights laws and prudential criteria, establishing sub-regional supervisory mechanisms, allowing cross border banking, developing sub-regional money and capital markets, and harmonizing their monetary policies over time. The African experience would also suggest that certain essential preconditions must be satisfied for the stock markets to become vibrant and efficient channels for intermediating long-term and cross-border funds. These include: macroeconomic stability, sound and well functioning banking system, appropriate security laws, regulations, corporate governance requirements, and trading practices, functioning money markets and bond markets, regulatory infrastructure, and institutions (pension funds, insurance companies, etc.) that can make securities markets function, provide primary issue demand and secondary market liquidity. In its policy dialogues with RMCs, the Bank would emphasize that governments, especially in small countries, should approach cautiously capital market development, and ensure that these conditions are satisfied along with the establishment of stock markets.

4.3.16 The Bank will encourage the pursuit of sub-regional cooperation and integration in the overall context of its Policy on Economic Cooperation and Regional Integration[39]. The strategies include the promotion of open regionalism, private sector participation, progressive integration using bottom-up and variable geometry approaches, rationalizing regional integration activities, promoting collaborative work with other institutions, and promoting regional cooperation on cross cutting themes. In the area of financial integration, the Bank will **act** on two fronts: (i) promoting similar banking laws and approaches to accounting practices and prudential supervision, joint staff training facilities, and sharing supervision experience and personnel. In this regard, the Bank will cooperate with sub-regional capacity building institutions, such as MEFMI in Eastern and Southern Africa, which provide appropriate training programs to financial officials from the sub-region. It will also support network of financial associations through training, and establishment of appropriate websites; and (ii) supporting the development of integrated sub-regional financial systems, including harmonization of domestic and cross-border payments, clearance and settlement mechanisms as well as region-wide banking regulations and supervision.

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[38] Details on the guidelines on financing DFIs will be included in the revised Bank Group Guidelines on LOCs.
[39] cf. Economic Cooperation and Regional Integration Policy, ADB/BD/WP/2000/13 dated 3 February, 2000.

Box 4.1: Role of the African Development Bank in Developing the Financial Sector – Emerging areas of focus

The performance of African countries in the past few years on economic reforms as well as their aspirations (such as expressed in NEPAD) to improve financial sector soundness and integration have thrown into focus certain areas that the Bank will need to pay more attention to than before. These include capital market development, financial standards, financial integration and micro-finance operations.

Fostering Implementation of Financial Standards and anti-money laundering measures.

The Bank will foster the implementation of financial standards, especially in the context of NEPAD, to enhance transparency in policymaking and corporate management and, thereby, improve the soundness and stability of financial markets and advance regional and global financial integration. It will also encourage and support the implementation of anti-money laundering measures to combat financial crime that divert resources from development. International standards have only recently been developed, and there is limited awareness of them, while some standards have still not gained general acceptance. The African Development Bank will encourage the use of international standards by raising awareness about them and explaining their role. In addition, the Bank will mobilize resources to provide technical assistance and build capacity of RMCs to implement standards and anti-money laundering measures, provide advice in the conduct of assessments and extend support to institutional reforms necessary to enhance the effectiveness of the financial sector. The Bank will collaborate and exchange information with other donors and regional organizations that are also supporting the RMCs in these areas.

Financial Integration

The Bank's strategy to improve macroeconomic stability, strengthen the legal, regulatory and prudential systems as well as support the liberalization of financial markets and adoption of financial standards will help to strengthen domestic financial markets and advance financial integration in African countries. The Bank's present limited participation in the domestic bond markets in African countries could be broadened to help develop those markets. Simultaneously, the Bank would use its advisory services to assist countries to establish a supportive regulatory and fiscal practices framework. With the development of the bond market, the Bank could also provide technical assistance to member countries to improve public debt management. Additionally, the Bank will directly collaborate with regional and subregional integration entities to support the development of integrated financial systems. It will also support networks of financial associations through training, and provide technical assistance towards the development and implementation of agenda for cooperation.

Micro-finance operations:

The Bank will further strengthen and mainstream micro-finance in all its operations to improve the access of poor and small productive enterprises engaged in small-scale production, micro commerce, and service activities. To that effect it will explore innovative means to channel credit and other facilities to productive persons, groups, and enterprises at non-subsidized interest rates. It will assist countries to improve their sectoral policies and regulatory frameworks in which micro financial institutions may flourish profitably, to build institutional capacity including training, for example, in book-keeping, project appraisal, and risk management procedures), in those institutions, and foster their linkages with the formal financial system. It will concentrate on institutions that are in the business of lending for productive purposes, and regarded sustainable over the longer period, and when such institutions receive funding support, the Bank will make the operation subject to commercial discipline. The Central Microfinance Unit (OCMU former AMINA) is a potentially effective instrument for advancing the Bank's poverty-reduction strategy and to further financial intermediation. OCMU has been reorganized and made an autonomous unit. The recent organizational changes will enable the Bank to work flexibly with a country to develop its microfinance including through awareness raising, policy dialogue and training; diagnostic work (ESW); program design and program support (through lending and non-lending instruments).

C. Promotion of poverty reduction-orientation of the financial system

4.3.17 Africa abounds in micro, small and medium entrepreneurs (MSMEs) and self-employed traders and producers. The bulk of these enterprises and entrepreneurs, majority of whom are found in the rural and informal sector, have little or no access to financial services from the formal financial system, and rely mainly on money-lenders and group-based savings and credit societies (ROSCAS) to meet their credit needs. The SMEs appear to fall between two stools: they are considered too small for lending by the commercial banks, and too large for lending by the informal/semi-formal financial organizations and institutions. Traditionally, commercial banks in Africa have had short-term horizon and they have shied away from long-term lending. This practice has been further accentuated by the banks' risk-aversion that leads them to invest in the safer government securities. Yet, experience shows that low income entrepreneurs and producers, when given access to responsive financial facilities can service their debts at market rates, repay their loans, and use the proceeds to improve their incomes and assets[40]. Extending financial services to them will increase their assets, their living standards, and their participation in civil activities. Within the MSME sector, women micro-enterprises tend to be at a greater disadvantage in obtaining credit and other financial services: women are still a smaller percentage of borrowers from the financial institutions, reflecting the gender-related higher transaction costs in financial markets while financial sector reform policies are likely to have gender-differentiated impact. The Bank will support implementation of policies to redress such gender-biases.

Improving access of women and MSMEs to formal finance

4.3.18 The strategy to extend the reach of the formal financial system to MSMEs and women should target both the formal financial system (commercial banks in particular), MSMEs, and micro finance institutions. The promotion of that strategy should encompass actions by governments, external donors, the banks, the micro finance institutions, and MSMEs themselves (Box 4.2), and the Bank will work flexibly with RMCs to design and implement the appropriate strategy, including providing advice in developing the policy and regulatory framework, capacity building at the level of the institutions, and appropriate technical support in the introduction of innovative approaches and instruments as follows:

- Governments must institute measures that encourage the institutions, instruments, relationships and financing modalities that ensure the provision of responsive financial services to MSMEs, and foster greater competition in the formal financial system by actively supporting the establishment of different types of non-bank financial intermediaries in the MSME and rural sector to create additional facilities for the MSMEs. Establishment of independent credit rating agencies, specializing in SMEs, and credit insurance agencies, could help encourage financial institutions to extend credit to MSMEs, and other low-income entrepreneurs. The Bank will, therefore, assist governments to review the existing legislation with a view to removing any perceived obstacles, and making the necessary legal and regulatory revisions to establish a favorable regulatory and incentive framework for micro finance institutions, facilitate the provision of banking services, and encourage the entry and growth of a range of private financial institutions in the micro finance sector.

- The Bank through its microfinance operations, as well as other donors, would also support retail financial institutions, through training of their staff and dissemination of best practices to equip them to introduce sound commercial practices for managing costs and risks as well as develop proposals for bank financing.

[40] Women's World Banking: *The Missing Links: Financial Systems that Work for the Majority,* April 1995.

- Some recent experience, especially in Latin American countries, has demonstrated that, given appropriate regulatory framework and the right incentives, including competition, commercial banks may be willing to move into the area of SME financing by aggressively seeking market opportunities in the MSME sector, establishing links with micro finance institutions, and making appropriate changes in their management and organizational structures. Recent innovations in technology and in banking practices such as being pioneered in South Africa and Asia (with the introduction of simplified ATMs, biometric recognition, mainly fingerprinting, and mobile branches) are also helping to extend banking into the rural areas. The Bank will provide, although in very exceptional cases (such as when the commercial bank is benefiting from LOCs to support SMEs), technical support for the appropriate operational changes and the introduction of appropriate financial instruments to reach MSMEs, and encourage other external donors to do the same[41].

Promoting sustainable microfinance institutions

4.3.19 The micro finance institutions (also like DFIs) should also move towards being self-sustaining and performance-oriented organizations, a process that will depend greatly on their ability to tap local resources and becoming less dependent on external sources of finance. While being subjected to appropriate prudential laws to protect depositors, these institutions, like the banks, should be encouraged to bring savings facilities and payments mechanisms nearer to low income and rural areas to mobilize financial resources locally as the primary source of their loan funds. They should be encouraged to link up with the formal banking system by building deposit/credit relationships, as well as through acting as on-lenders of funds provided by the banks. Provision of credit is often a strong motivation for savings, and the lending institutions should be encouraged to take advantage of that motivation. The Bank can provide assistance to these institutions, especially through training, to improve their financial management, including developing systems of analysis and monitoring of credits. In addition, the Bank will encourage these MSMEs and other informal sector entrepreneurs to organize themselves into being credit-worthy borrowers (Box 4.1).

Box 4.2 Improving Micro-finance: New Paradigms, Productive Roles, and Actions

Actors	Paradigms, Roles, and Actions
Governments	Encourage autonomous, catalytic, second –tier institutions that can mobilize funds for capitalization, and institutional development for those retail-level intermediaries that meet performance and reach standards; Liberalize interest rates; Create regulations that encourage a range of intermediaries; Create incentives for the intermediaries with the commitment and capacity to provide financial services to target groups.
Donors	Support the development of national financial systems that work for the poor; Build appropriate financial instruments and vehicles that respond to large number of small intermediaries at different stages of development; Support retail institutions that meet agreed standards of performance and client reach, directly and through second-tier and network arrangements.
Banks	Seek market opportunities; Make changes in organization, systems and products to reduce costs and risks of lending to large and growing client group; Establish bank-NGO-client credit lines.

[41] See ADB: Guidelines on Rural Finance, 2002.

NGOs, Specialized Financial Institutions	Build reach and role of financial inte build self-sustaining, self-determined to local needs; Make changes in organization and sy Performance and reach standards; Use practitioner networks to build mu Standards, lateral learning, and effici
Low-income, Women and Men	Gain access to information on availal services and use them to build incom making; Build and join organizations that are Income entrepreneurs' economic acc Organize into sector and area groups economic power; Establish relationships with solid fina

Source: Women's World Banking: The Missing Links: financial Systems That Work For The Majority

4.3.20 In addition to providing advice, capacity building and technical assistance, the Bank Group will extend financial support, as appropriate, with the objective of developing sustainable institutions that can borrow on commercial basis and to provide catalytic funding to ease credit constraints to MSMEs and women. Such support will be given not only to MFIs, DFIs and banks but also, through the private sector window, to leasing, factoring, discounting and warehousing firms. The main feature of Bank support will be unsubsidized finance and the subjection of the operations of the beneficiary institutions to commercial discipline.

CHAPTER V: IMPLEMENTATION OF THE BANK'S STRATEGY - THE WAY FORWARD

5.1 Introduction

The proposed strategy, as outlined above, is much larger in scope than previous programs. Consequently, the Bank Group recognizes as very central to its implementation the building of strategic partnerships with other donors and regional institutions that also support financial sector development in RMCs. Moreover, financial sector development is one of the most dynamic components and characteristics of the ongoing integration of world economies, and for which purpose methods and ideas have to be constantly sharpened. The establishment of appropriate networks and partnerships would facilitate the useful exchange of ideas and methods. Another consequence of the relatively wide scope of the proposed strategy is that its implementation would require a deeper understanding of the socio-political, legal, and economic circumstances of the country, and their mutual interactions, as well as strong political commitment to the reforms such as would only be obtained if there was national ownership of the programs. The strategy also touches on almost all areas of the Bank's Vision and, therefore, raises the need for greater integration of Bank design activies and the involvement of different Bank departments/units. Therefore, the Bank will take the following complementary actions to facilitate the successful implementation of its financial sector policy.

5.2 Strengthening Strategic Partnerships

5.2.1 In recent years, the ADB has strengthened its partnership with the Bretton Woods institutions and other regional organizations that support financial sector development in RMCs. In the context of the MOU with the World Bank, signed in 1999, and a non-formalized agreement with the IMF, the Bank is strengthening its collaboration with the Bretton Woods institutions through coordination of work and missions, exchange of information, training, institutional building and the preparation of the PRSPs. In addition, the Bank Group and these institutions routinely interact through the MDB Working Group on Financial Sector Reform.

5.2.2 The Bank will also continue to strengthen its collaboration with other donors to the benefit of improving implementation of its financial sector policy. In the area of microfinance, the Bank has been an active member of the CGAP, where donor collaboration has been very useful in the development of best practices, the undertaking of diagnostic studies and the organization of training. Collaboration in the area of ESW, a necessary activity in financial sector reforms, can also provide economies in the utilization of staff time and other resources.

5.2.3 The Bank's role under NEPAD regarding banking and finance is another area for which strategic partnerships have to be strengthened. A number of relevant banking and financial standards have already been developed by special institutions and the Bank does not have to develop new ones but only help foster their implementation. In this context, the Bank has received particular support from the IMF in the design of the framework for implementing the standards and for the methodology for the assessment under the African Peer Review Mechanism. The Bank will broaden the collaboration to other standard setting bodies. Particularly in this context, the Bank will also seek to improve collaboration with African regional organizations such as the UN Economic Commision for Africa, the Regional Economic Communities (RECs), and the Association of African Central Banks in undertaking the assessments and formulating action plans to address weaknesses identified.

5.3 Promoting Country Ownership

5.3.1 Promoting national ownership of financial sector reforms would only be possible if national authorities themselves formulated and monitored the reforms, and placed them within a comprehensive framework that pays due attention to these factors. The Bank will encourage and assist the authorities to incorporate the framework of their financial sector development strategies in their Country Strategy Paper. It will emphasize that a significant reduction in poverty in Africa cannot be achieved without creating a healthy and vibrant, and gender-aware, financial system, and that such a system would not automatically emerge but would require a pro-active stance on the part of the national authorities.

5.3.2 While in theory the authorities in isolation could formulate the reform strategy, its implementation involves other actors and stakeholders whose commitment to the strategy is necessary for its successful implementation. Private banks and other non-bank financial institutions and markets, have to adopt their procedures and practices to the new strategy. Loss-making state enterprises, politically motivated and subsidized investments, bureaucrats who benefit from exercising monetary controls and discretion, have to be won over to the reform strategy. And, finally, there are the potential users of financial services, especially the poor and the women, who must also benefit from the strategy. All these parties have a direct stake in the strategy, and their early participation in its formulation would secure their commitment to its implementation. The strategy must, therefore, be prepared in consultation with them. The Bank will, therefore, encourage dialogue between the public authorities and the stakeholders. To facilitate such a process, the Bank could, among others, assist the authorities in the convening of a workshop/seminar of the principal private and public stakeholders in the financial sector to seek their input into the formulation of the strategies. The Bank will also expand its policy dialogue with RMCs beyond governments to include a network of national and regional private financial sector associations and support them in the areas of policy research, coordination, and consensus-building.

5.4 Improving the Preparatory Process and Quality at Entry

5.4.1 The Bank will undertake the necessary complimentary actions to ensure successful implementation of its financial sector policy. As already explained, the Bank will encourage formulation of country financial sector strategies by the national authorities While the Bank's efforts will be undertaken on an individual country basis, in the case of CFAF countries having a common central bank (BCEAO, and BEAC) and well-integrated systems, or other neighboring countries with similar level of development, size, and needs of the sector, the Bank's operations could be more effective on a sub-regional basis.

5.4.2 The Bank will also ensure that it's own understanding and analysis of the financial sector's needs will precede its assistance in the preparation of country's comprehensive strategy. This will be assured through the Bank staff carrying out economic and sectoral work (ESW) in collaboration with the financial authorities of the country concerned. The draft guidelines require that the country departments undertake two major reviews as part of ESW material, viz. a *Country Economic Review*, and a set of *Sectoral reviews.* The sectoral review would identify the more pressing development and poverty-reduction issues, especially as they relate to institution building and financial infrastructure development, that a subsequent survey mission to the country should address.

5.4.3 The Bank will seek to align its financial sector assessments with the Financial Sector Assessment Programs (FSAPs) that the IMF and World Bank undertake to identify the strengths, vulnerabilities and the risks in the financial sector of member countries and to help design appropriate policy response. In the case of those African countries where the World Bank and the

IMF are planning to launch FSAP[42], the Bank will collaborate with the two institutions in their preparation by participating in those missions, based on the specific expertise the Bank staff could provide[43]. In other member countries, where the BWIs are not in a position to launch an FSAP[44], but where the Bank expects to be active, the Bank will encourage assessments under the NEPAD APRM. The Bank will seek collaboration from the World Bank and the IMF in these assessments. The Bank will explore with the World Bank and the IMF how these cooperative arrangements could be formalized through a separate Memorandum of Understanding (MOU) on collaboration or through appropriate amendments to the existing ones.

5.5 Refocusing the Instruments of Intervention

5.5.1 The Bank has followed a pragmatic policy in developing its instruments and mechanism of intervention, depending on the perceived needs of its member countries. However, to be effective the Bank will need to devise some new mechanisms and sharpen its existing instruments. In the following sections some suggestions are made, based on the needs of the proposed policy and the overview in Chapter 3.

5.5.2 Policy dialogue and monitoring of reforms implementation

The Bank should be able to assist African countries to implement their financial sector strategies on a consistent and sustainable basis. Such a role for the Bank is also envisaged in the New Partnership for Africa's Development (by the Heads of State and Government that have assigned the Bank to take leadership role in fostering implementation of internationally accepted banking and financial standards and anti-money laundering measures). Accordingly, the Bank will remain in continuous policy dialogue with its member countries in the context of its PBL and other financial and non-financial operations, and by increasing its field presence. The Bank, in consultation with the RMCs, has identified the appropriate banking and financial standards to implement and the methodology for monitoring and peer review in this regard. The Bank will continue to provide advice and technical support towards the effective implementation of the peer review.

5.5.3 Policy-based lending (PBL)

By combining measures to improve macroeconomic environment and structural reforms, the PBL is a more suitable instrument than Lines of Credit (LOCs) to implement country financial sector strategies. The PBL operates at two-levels: at the macroeconomic level the PBL provides funds under structural adjustment loans (SALs), and at the sectoral level the PBL supports reforms in specific sectors, such as the financial sector, through its sectoral adjustment loans (FSALs). As explained in Chapter 3, the preference for one or other type of lending would depend on the circumstances of the country though both types of programs must ensure a minimum of macroeconomic and financial sector stability. However, PBL support must be based on a thorough understanding of the financial sector's operations and its development needs, which could be generated through ESW or assessments such as the FSAP and the NEPAD APRM process. Particularly in loans responding to crises, for which resource transfer becomes a major focus, the Bank will ensure a realistic appraisal of the risk. There should be continuous close collaboration with the member countries and the BWIs in determining the specific policy reform needs of respective countries. In addition, since the strengthening of financial infrastructure and

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[42] The FSAPs are the sole responsibility of the World Bank and the IMF, which, given the large resource requirements of the programs, recruit external experts from other international institutions and central banks on a needs basis.

[43] The Bank participated, for example, in the FSAP mission to Senegal.

[44] This may be particularly in the case of countries with small financial systems.

institutional reform could be a lengthy process, the Bank will maintain close dialogue with the client country. The formulation of PBLs by the Bank on its own could, therefore, make heavy demand on staff time. Consequently, even though the Bank has at its disposal the basic staff experienced in PBL operations concerning the financial sector, it will continue to take a pragmatic approach by following the lead of the Bretton Woods Institutions in the design of adjustment policies and collaborating with them to prepare the necessary background studies and policy framework papers. However, in the area of financial governance, where the Bank will also benefit from assessments under the APRM, the Bank will prepare itself to design PBLs on its own.

Table 5.1: The menu of Bank group instruments in the financial sector

Instrument	Health and soundness			Depth and development orientation			Poverty reduction	
	Macro-economic management	*Financial Governance (including anti-money laundering)*	*Internal (corporate) Governance & capacity building*	*Building capacity of FIs to intermediate MLT*	*Revitalizing/ Strengthening DFIs*	*Financial integration*	*Women and MSME access to formal finance*	*Promoting sustainable MFIs*
	In collaboration with BWIs	*In collaboration with BWIs, African regional organizations. and/or other donors*		*Possible collaboration with other donors*				
Nonlending Instruments								
Policy dialogue& Advisory sevice	√	√	√	√	√	√	√	√
Assessments and ESW	√	√				√	√	√
TA	√	√	√	√	√	√	√	√
Financial Instruments					**Available only to financially sustainable DFIs**			
PBLs &FSALs	√	√				√		
LOCs				√	√			√
Other (including equity,guarantees & Agency LOCs)				√	√			
Knowledge generation & Dissemination								
Training	√	√	√	√	√	√	√	√
Seminars & conferences	√	√	√	√	√	√	√	√
Research & Publications	√	√	√	√	√	√	√	√

5.5.4 Lines of credit (LOCs)[45]

- Unlike PBL operations, LOCs are narrowly focused on specific elements of reform, and serve specified objectives in the development of a specified sector. The Bank will seek to direct LOCs to two inter-related objectives, i.e. to address market failures (such as limited longer maturity lending and limited SME's access to credit), and to strengthen the capacity of the participating financial institutions to lend more to SMEs. Thus, in the financial sector, the Bank will seek to make LOCs directly instrumental in improving competition, promoting internal governance of financial institutions, and helping the integration of the developed financial system countries with the global markets[46]. Currently, the use of LOCs is limited because of the problems with DFIs. Therefore, the Bank will direct LOCs to institutions which have in place good and transparent management, suitably designed operating standards, especially for accounting and provisioning for risks, good negotiation with clients and proper

[45] The Bank is developing guidelines on LOCs that will provide details on the use of this instrument. An ongoing Bank study on DFIs will also have relevance.
[46] For example, the Bank may provide complementary loans to financial institutions in Category C countries in conjunction with their efforts to borrow in the international markets when they have acquired a satisfactory rating from international rating agencies.

supervision. However, for LOC objectives to be achieved in full, the internal management of LOC operations must be refined. Therefore, the Bank will develop new operational guidelines for the LOC instrument to clarify, among others, issues of design, conditionalities, subsidies, and internal controls.

5.5.5 Other lending instruments

The Bank shall continue to use **equity participation, guarantees and agency lines of credit** both for institutional strengthening and development of the financial sector. However, the effectiveness of these instruments would be enhanced by ensuring that the economic environment in which the institutions operate is conducive or being reformed to support enterprise efficiency, that the quality of management is satisfactory, and that there is high commitment of the shareholders.

5.5.6 Technical assistance

The Bank will continue to be a source of advice and information to member countries. The advisory work associated with technical assistance has been largely centered on institution building, tied to the projects. In the context of the proposed strategy, the Bank may also provide self-standing advisory support and assistance for training programs, including programs to improve internal governance in private financial institutions[47]. Technical assistance will also be extended to address the needs identified by the APRM and to enhance the implementation of banking and financial standards. The Bank also regards a strong information technological base as a veritable instrument for enhancing the Bank Group's service delivery capacity to member countries, as well as enhancing operational, monitoring and evaluation efficiencies. Currently the Bank Group has installed an ERP software, and has a website which is being populated with crucial economic and financial statistics to enhance information sharing. To enable African countries make full use of these facilities, the Bank will consider funding projects to develop IT capacity in member countries, and support the strengthening of their IT policies.

5.5.7 Training

Helping to build capacity in RMCs through training is an integral part of the Bank's agenda of sustainable development and poverty reduction, and is the focus of the African Development Institute. The Bank will expand and use its training programs as an instrument for creating awareness of new knowledge, tools and approaches in financial sector policy design and implementation as well as assisting RMCs to handle and manage new institutions and instruments with the increasing depth of their financial markets. The Bank will also use regional workshops to facilitate exchange of experiences among policymakers and market participants and to create synergies between staff and client learning.

5.5.8 Monitoring, and evaluation

The usefulness of the Bank's Financial Sector Policy will depend upon the use made of it by the Bank staff in the preparation of country projects, and by the Bank management and Board in the evaluation of project proposals. The Bank will, therefore, strengthen its capacity for monitoring and evaluating financial sector development. The evaluation of the Bank's intervention will be based on the extent to which the Bank succeeds in providing support for the development of appropriate institutions and instruments in the financial sector to advance

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[47] The IMF has given considerable attention and assistance to improving the internal governance of central banks. A similar centralized mechanism to help improve the internal governance of commercial banks and DFIs does not exist. The Bank will encourage the assessment of these needs in the context of its ESW and the APRM, and provide training facilities in accounting and information systems, as well as information technology equipment.

financial intermediation, and improve the sector's development and poverty-reduction contribution. Lessons from the evaluation will be synthesized to guide future lending.

5.6 Organizational and Resource implications

The development of the Bank Group Financial Sector Policy coincides with the implementation of a new structure. Under the new organizational structure, there are various departments/units that have been established to facilitate policy and diagnostic work in the financial sector and, therefore, the additional resource implications of the Financial Sector Policy is expected to be minimal. The new departments and units have clear roles and responsibilities but they are expected to collaborate with each other in the entire preparatory and implementation process.[48] In addition, continuous coordination of the Bank's financial sector activities and the assurance of their quality will be assumed by the Operations Policies and Review Department. The Bank will take advantage of its increasing field presence to enhance financial sector interventions and, especially, to strengthen its ability to incorporate local knowledge, insight and institutional context in its financial sector interventions in RMCs. The Bank will provide adequate staffing to the relevant policy and operational units progressively as the need arises and build in-house expertise, especially in such new areas as financial governance and microfinance (Box 4.1).

5.7 Guidelines and Action Plan

5.7.1 Effective operationalization of the Bank Group Financial Sector Policy requires the development or revision of key guidelines and implementation of other actions, including:

- implementation of new Country Strategy papers that will include examination of financial sector issues;
- strengthening Bank Group capacity for Economic and Sector Work;
- developing guidelines on lines of credit (including to the DFIs); guidelines for policy-based loans on governance; guidelines for policy-based loans on regional integration activities; guidelines for Economic and Sector Work; and a business plan for microfinance activities;
- establishing a NEPAD/regional integration unit; and
- establishing collaboration arrangements with the relevant NGOs (such as the Association of African Central Banks) and donors (e.g. the FIRST Initiative) in addition to strengthening cooperation with the Bretton Woods Institutions and other African regional organizations.

These activities will be initiated concurrently with the development of the Bank Group Financial Sector Policy, or soon after its approval.

5.7.2 In addition, the Operations Complex Departments, in collaboration with the Operations Policies and Review Department, will develop Action Plans for enhanced support to financial sector development in RMCs. The Action Plans will be developed taking into account the diversity in financial sector development on the continent, and distinguishing among the needs of countries at different levels of financial sector development and reforms. The Bank Group's expected role under the NEPAD will also be considered. Given that the Action Plans are

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[48] These units include the (Financial) Governance Division in the Operations Policies and Review Department, the Private Sector Department, and the Financial Sector Division and the Central Microfinance Unit in the Operations Complexes. The Country Operations Departments are also central to financial sector operations.

implementation tools, they would be revised and updated every two to three years to reflect the changing needs of the Bank's clients, and also to guide the Lending Program of the Bank. The Operations Policy and Review Department will monitor the implementation of the Action Plans, in collaboration with the Country Operations Departments.

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