Providing Efficient Banking Services in a Fragile Environment
Structure, Performance and Perspectives of the Banking Sector in Guinea-Bissau
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Summary

With a small and underdeveloped banking sector as well as an embryonic microfinance segment, Guinea-Bissau is barely able to harvest the growth benefits that could accrue from a more efficient and effective financial intermediation. Acknowledging that the financial sector’s vulnerabilities are very much driven by the fragile political and economic environment, there are key policy recommendations that the country ought to follow in order to improve the status quo. In this regard, more robust policies, regulations and procedures should be implemented in order to strengthen the financial sector, and promote financial deepening. But getting regulation right will not be enough. Political stability, economic formalization of firms and diversification away from the cashew sector as well as stricter enforcement of the rule of law are also needed.

Introduction

To a large extent, Guinea-Bissau’s categorization as a “Fragile state” by many donors and development partners mirrors the status of its financial sector. Although it has gone a long way since its complete collapse over the 1998/99 civil war, the financial system is still underdeveloped: in 2013, financial intermediation accounted for about 4% of GDP in 2013. (AfDB 2014), banking penetration in the country is below 1% of the population (IMF 2013) and Access to finance is cited as the second most important constraint for business operations behind political instability (80.6%) at par with electricity (75.7%) (Leo et al 2012: 13).

While similar statistics could be found in other countries, what differentiates Guinea-Bissau is the underlying fragility which characterizes the country: political volatility has been undermining institutions (since independence, the country witnessed 4 coups d’états and 17 coup attempts), which have consistently been ranked in the lower end of governance scales such as the Mo Ibrahim Index. Against this background, the economy has not undergone any transformational changes and remains agriculture-based with the primary sector accounting for 49.1% of GDP in 2013 (AfDB 2014). It is within such a weak institutional and economic set-up that the financial sector is operating.

To date, much literature on the financial sector in Africa has been dedicated to understanding either how it can best grow to support the economy (access to finance for firms), how its...
weaknesses can be managed (preventing crisis), or focusing on how microfinance can best yield impacts to populations (access to finance for populations). However, little attention has been given on how a fragile state’s formal financial setup is structured and how it performs. The case of Guinea-Bissau is intended to open a discussion on what policy approaches can be taken in the case of fragile states. With this in mind, the present paper is designed to provide an overview of the strengths and weaknesses of the Bissau-Guinean financial sector taking into account the unstable political context and the structural economic issues of the country.

The first section is dedicated to landscaping basic strengths and vulnerabilities. The second section emphasizes dependence on short-term lending. The third one investigates key prudential ratios and the fourth looks at how banks function in a political and governance-wise volatile environment before delving into its actual outreach to populations in section five. Lastly, section six focuses on the embryonic microfinance sector in an effort to understand its weaknesses and perspectives. Section seven concludes and presents key policy recommendations.2

1 Landscaping the financial sector

The financial system in Guinea-Bissau is very much limited to the banking sector. There are currently four banks operating in what can be considered a small market. As far as bank ownership is concerned, regional private foreign banks have larger stakes in the local banks than any other investor. In 2012, they held 65% of shares in the Bissau-Guinean banking system, ahead of other foreign investors (15%). Private local investors only held 6% (IMF 2013). This mostly foreign owned structure is similar to that of other WAEMU (West African Economic and Monetary Union) countries bar Côte d’Ivoire (see figure 13 in Annex). Banks are regulated and overseen by the WAEMU authorities.

Following the 1998/99 civil war, the country experienced an economic collapse, and its formal financial sector a near disappearance. In the aftermath of civil strife, private sector credit to the economy plummeted below 1% of GDP and in 2003, total balance sheets of banks in the country amounted to merely FCFA 14 billion (or EUR 21.3 million), as total lending oscillated between FCFA 2 billion (EUR 3 million) and FCFA 5 billion (EUR 7.6 million) monthly over that same year. Since then, overall credits to the economy have been on the rise reaching 13.8% of GDP in 2013, yet still far below fellow WAEMU countries (figure 1). What is more, these credits remain predominantly of a short term nature (figure 2).

Figure 1 Private sector credit to GDP in WAEMU

![Figure 1](image)

Source: World Bank; BCEAO for Guinea-Bissau; 2013 Data for all countries but Guinea-Bissau are author estimates based on the least squares method.

Figure 2 Total lending to the economy in Guinea-Bissau (FCFA mln)

![Figure 2](image)

Source: BCEAO.

Today, the banking system in Guinea-Bissau is not only narrow, but it is also characterized by low intermediation. Financial intermediation is the basic function performed by banks through the pooling of deposits to be converted into loans. On average in 2011, African banks intermediated about 74% of

2 The research is based on data from the WAEMU Central Bank (BCEAO), the Global Financial Development Database (GFDD), the World Bank’s Worldwide Governance Indicators as well as field interviews conducted in 2013 with two of the four local banks.
their deposits, while the ratio was of 109% in non-African banks (Beck et al 2011: 38). In Guinea-Bissau, although the trend has been on the increase, the ratio stood at 60% in 2013 (figure 3). The implication of this low ratio is that existing resources held by banks are not efficiently channeled to support private sector activities. What is unclear however is the extent to which it is banks which are unwilling or unable to extend credit, or whether it is the private sector which is not coming forth with adequately bankable projects.

The answer lies somewhere in between. Banks’ core activities are limited to collecting deposits, lending to medium-sized firms and supporting fiscal operations using government securities (IMF 2013 – see also Box 1). Up until 2009/2010, bank lending was predominantly of short-term nature. While it is still overwhelmingly the case, medium-term lending has been on the rise (figure 2) indicating that banks are willing to extent relatively longer-term capital than they used to. In other words, for the provision of such funding to take place, some demand exists indicating some growth potential. Yet, such capital is deployed in basic trading and retailing services and other productive investments have barely grown over the past years (for instance, the share of manufacturing in GDP has decreased from 12.7% in 2008 to 11.4% in 2013 (AfDB 2014). Over the past years, it is cashew nuts related activities which have crowded in credit as explored in the following section.

As far as internal bank capacity is concerned, some available data tends to suggest that Bissau-Guinean banks are rather inefficient when compared to their regional peers. In 2011, cost-to-income ratios of domestic banks stood at 71.3% down from 92.8% in 2010 (Global Finance Development Database – GFDD - 2012), meaning that their income was barely sufficient to cover costs. Data from the GFDD also shows that these ratios are lower only than Côte d’Ivoire’s (73.4% in 2011) in the WAEMU zone and are very much linked to the cost of doing business in the country: high electricity prices (due to extensive usage of generators), sub-optimal use of modern banking techniques, small market size preventing from economies of scale (figure 10 in section 4), and a relatively low efficiency of contractual arrangements which are cost inductive (Beck et al. 2011). Similarly, overhead costs in domestic Bissau-Guinean banks are on higher that continental average: latest available data shows that in 2011, banks’ overhead costs to total assets stood at 5.2% in sub-Saharan African versus 7.7% in Guinea-Bissau. Of the 7 countries with higher overhead costs than Guinea-Bissau on the continent, 4 are fragile states. According to Beck et al. (2011), explanations for such ratios are to be found in the small size of African banks and deficient contractual frameworks. These features are strongly present in Guinea-Bissau as developed in section 5 below.

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### Box 1 Bank lending to the government

Prior to the 2012 coup, the government had an open line of credit worth FCFA 1.5 billion with ECOBANK. Since the coup took place, the government resorted to the local banking sector on two occasions, both in 2012. First, they took on debt on behalf of state-owned water and electricity company EAGB to the tune of FCFA 6 billion for buying fuel and paying salaries. Second, the government resorted to a FCFA 7 billion loan on behalf of GuineTelecom for general expenditure. Since then, the government has stayed clear of private bank lending. Interestingly, these short term loans were used for current expenses rather than for investments. Considering the thin revenue stream of the state (budget balance at -4.7% of GDP in 2013 and -3.6% estimated for 2014), and the accumulation of internal arrears (up to FCFA 7 billion in total of which 4 billion in wages only at end 2013) (AEO 2104) worries related to risks of default or arrears are not unwarranted. However, the amounts do not present a systemic risk.

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3 Data from the GFDD on overhead costs covers 49 countries. Comoros, Eritrea, Sao Tome, Somalia and South Soudan are missing. So-called “fragile countries” with higher overhead costs than Guinea-Bissau on the continent are Congo DRC, Malawi, Sierra Leone, and Zimbabwe. Others include Zambia, Rwanda and Gambia.
2 Short term lending and the importance of cashew finance

Field interviews conducted in 2013 with two of the four local banks suggest that there is currently little room for another player in the market. This is partly due to the fact that banks tend to lend in the same segment as there is little other economic activity to support. The lending focus highlighted by local banks relates to cashew nuts. Cashew production accounts for 11.9% of the country’s GDP and roughly 87.7% of its exports (AfDB 2014). Consequently, it is a major source of economic activity and revenue both for the state and the population at large.

Interestingly, bank lending in the country is very much linked to the emergence of Guinea-Bissau as a major cashew producer. Lending is mostly used in the context of pre and post cashew harvest finance, and also includes loans to small processing plants, and trading advances to exporters. Figure 4 illustrates how the country’s cashew production evolved alongside short and medium-term credit. Over the past ten years, the two have been highly linked, with a correlation coefficients standing at 0.942 with short-term lending and 0.944 with medium-term lending. Going further, it is interesting to note that the correlation is also significantly seasonal with borrowing dropping after the cashew season ends (figure 5).

The downside of the current situation is that overreliance on such credit presents a large systemic risk. Indeed, in 2012, non-performing loans (NPLs) jumped from about 3.2% to over 21.5% on the back of a bad cashew campaign. In 2013, NPLs remained at high levels since in spite of a decent cashew campaign, prices to producers (and borrower’s incomes) were decreased from 57% to 43% of export price on account of lower international prices. Beyond cashew production and other cashew related activities (including small processing plants, and trading advances), bank loans are extended to medium-size firms, especially in trade (general import-export), construction, and services.

Figure 4 Cashew production and short term-credit

Source: BCEAO, African Cashew Alliance.

Figure 5 Credit volatility in cashew season

Source: BCEAO, Author calculations. Credit volatility is defined as the monthly change in credit provision compared to the yearly average.

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4 ECOBANK (November 1st 2013) and BDU (October 29th 2013).
5 Over the past twelve years, it is interesting to note that a lowering of prices to producers has generally been accompanied by a rise of NPLs with a correlation coefficient of -0.25. However, available data series do not allow for a more in-depth analysis of causality between the two. Similarly, over the past 12 years, NPLs and cashew production have been positively correlated with a coefficient of 0.66.
3  Prudential concerns in the Banking sector

Against this background, it is clear that one of the main risks which banks face is that of sectorial portfolio concentration which derives from the lack of economic opportunities the economy can offer given a fragile environment in which long-term investments are discouraged by volatile political cycles. Beyond this, banks in the country have stayed relatively compliant with key prudential ratios, although notable breaches call for even stronger oversight. As regards to capital adequacy ratios, three of the four banks currently operating meet the FCFA 5 billion mark set by the WAEMU.

One particularly interesting prudential measure considering the overall fragility of the country and the weakness of institutions is that of related party lending, i.e. lending to employees and members of management. According to WAEMU metrics, this ratio is to be below 20% within each bank. For Guinea-Bissau, half of the banks breach this ratio, which in the case of a bank is above 33% total lending and 25% for another bank. From all the standard prudential metrics used by central banks, related party lending can give interesting insights which illustrates the degree of financial underdevelopment. In a small country such as Guinea-Bissau with a narrow potential borrower base operating in an environment with weak institutions, related party lending could make sense to the extent that there can be reputational costs to non-compliance which can induce a degree of loyalty. In this respect, literature on the issue suggests that related-party lending reflects financial underdevelopment rather than any type of cultural propensity (Rajan and Zingales 2003). At the same time, there is no clear evidence as to whether related party lending functions as a tool which tames asymmetric information between the lender and the borrower, or whether it transfers profits to related parties. While the pre-2012 coup levels of NPLs which stood below 5% on average for the 2003-2011 period tend to suggest that the former does not necessarily stand, more detailed bank-level data and analysis are required6.

As regards to liquidity, in 2013 two banks fall short of the 75% liquidity coefficient set by the WAEMU. This is however not deemed to be an overriding concern as most banks tend to stay rather liquid given an overall lack of profitable projects and the absence of a functioning interbank market (IMF 2013). Economic theory suggests that banks can fail if they tend to accept illiquid assets and offer liquid liabilities (Diamond & Dybvig 1983) rendering them insolvent. In the case of Guinea-Bissau, the generalized lack of economic opportunities (albeit increasing, cf. section 1) means that banks tend to operate with low intermediation and on a short-term lending basis. They are thus unlikely to engage into operations leading to large maturity mismatches, thus staying fairly liquid at all times.

4  Banking operations in an small and unstable environment

Incidentally, when compared against other countries, Bissau-Guinean banks and their clients suffer greatly from the politically volatile environment and its weak governance structures. As alluded in section 2, this has an impact on bank intermediation as well as on the cost of finance. Figures 7 to 9 show correlations between interest rate spreads and governance indicators as captured by the Worldwide Governance Indicators. By and-large, these indicators capture dimensions of institutional fragility: degree of corruption, regulatory quality and political stability. On each figure, the green dot represents Guinea-Bissau, the red dots represent 4 other African fragile states for comparative purposes (Comoros, Liberia, Malawi and Sierra Leone), while the blue represent the remaining 93 countries for which data was available. The negative relationship between the control of corruption, regulatory quality and political stability on the one hand versus interest rate spreads applied by banks on the other hand is clear on all figures. As for Guinea-Bissau (and to some extent for the other fragile states on the continent), it appears that these factors are important. In essence, the figures show that state fragility attributes have a bearing on the cost and access to finance. Consequently, they do not allow for the development of a banking sector which could support the economy.

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6 The relationship between NPLs and related party lending give an indication of the latter’s effect on bank risk. One way to investigate the relationship between related party lending and bank performance would be to look at return on assets (ROA) over time. Detailed data is however not available from local banks at this stage.
The instability of the surrounding institutional environment is not the only factor explaining the cost of finance in the country. The size of the market is important to the extent that it may neither provide for enough competition, nor enough scale for banks to make normal profits without applying higher than average interests. Along the lines explored in Beck et al. (2011:52), market size can partly explain inefficiencies and cost of finance. In this regard, figure 10 presents an interesting picture: all fragile states are found in the bottom right hand corner of the graph comparing the cost of finance measure by interest spreads and the size of the baking systems using total liquid liabilities as a proxy. The implication is that interest margins tend to be higher in Guinea-Bissau rather than, for instance Morocco, Nigeria or Kenya, in part due to the size of the market, risk involved, including the unstable macroeconomic and financial environment.

5 Outreach and access to finance

As seen in the previous section, the cost of finance is one of the issues constraining financial access in the country: inefficient banks in a small market located in an unstable environment will be conservative both in the risks they take and the depth of their operations, and will charge higher premiums. In this respect, Access to finance is cited as the second most important constraint.
for business operations behind political instability (80.6%) at par with electricity (75.7%) (Leo et al 2012: 13) and banking penetration in the country is below 1% of the population (IMF 2013). There are however also other key elements which determine outreach and access to finance which pertain to the economic features of Guinea-Bissau, including the limited size of the formal sector, wages being paid outside the banking system, or simply the absence of territorial coverage by banks.

At the individual’s level, the first explanation for low outreach is the lack of “bankarisation” of the population. In the recent past, the government made an attempt to compel civil servants to hold a bank account. This endeavor was part of discussions with the IMF which fell through as the 2012 coup d’état took place. One of the largest resistances found in this respect came from the armed forces, which in the end had agreed to join the planned “unified payroll system” (ISG 2012). While attempts have been made, little progress has come about. Figure 11 below highlights the extent to which Guinea-Bissau lags behind fellow WAEMU member states with regards to the number of accounts held by individuals. At the same time, banks are also lagging behind in terms of client outreach. Figure 12 shows that banking facilities such as ATMs are rather uncommon across the country. These are in fact concentrated in the capital with only a small network across secondary cities.

As far as firms are concerned, the structure of economic activity is of importance when it comes to access to finance. Economic life is essentially informal and thus delinked from the formal financial sector. As far as formal firms are concerned, only 2.1% of small firms had a bank loan or a line of credit7.

6 Microfinance

For individuals, access to finance can be greatly improved through the microfinance sector. It however remains embryonic with many challenges lying ahead. Beginning in 1997 with its entry into the WAEMU, Guinea-Bissau has made attempts to transpose legislation and frameworks so as to encourage microfinance activities. From 2005 onwards, with UNDP’s assistance, the government launched a series of activities in that respect. Workshops were organized to diffuse microfinance practices, CGAP (Consultative Group to Assist the Poor) courses were translated and trainers trained8. Concurrently, a master plan to promote the sector was developed, but little resources were put into it. Against this background, chronic political and economic instability did not allow for sustained efforts and the sector remains small and plagued by many inefficiencies.

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8 BCEAO information to author.
7 A forthcoming study by the AIDB/UNDP is investigating amongst other things access to credit in the case of newly created enterprises through the country’s “Centre for Entreprise Formalisation”. The idea is to diagnose the issues faced by newly created firms, understand their constraints and the underlying reasons behind firm mortality rates in order to create a structure to support them based on the findings.
As of 2013, five microfinance institutions (MFIs) were effectively functioning in the country. In terms of clientele, the number of clients has increased in the past year in particular as MFIs increased outreach outside of Bissau through the opening of 5 outlets, which now tally up to 19 across the country. As far as deposits are concerned, 2012 saw a 31.2% drop amidst the economic slowdown following the April 2012 coup. In the same vein, NPLs increased from 25% to 51% of total loans, considering that the sector’s regulatory prudential ratio is a maximum of 5%, reflecting important gaps in the capacity of MFIs to conduct operations and calling for a serious reform of the sector.

Against this background, the sector faces several challenges. First, the government is yet to approve and launch the master plan to promote the sector. Second, there are no specific national budget provisions for the sector. Third, the regulatory apparatus lacks resources to perform its tasks. Promotion and supervision tasks are not clearly defined and institutions tasked with these jobs are low on budget capacity. In this respect deficiencies in the sector are linked to the state’s overall lack of resources.

Beyond physical resources, there are further constraints such as language: being a Portuguese-speaking enclave in a French-speaking economic zone, the ministerial oversight committee faces issues in applying regulation. Lastly, the rule of law remains a key constraint to the same extent it applies to conventional banking.

### Table 1 MFIs in Guinea-Bissau - % change from previous year

<table>
<thead>
<tr>
<th></th>
<th>2011</th>
<th>2012</th>
</tr>
</thead>
<tbody>
<tr>
<td>Number of Clients</td>
<td>13.6%</td>
<td>5.2%</td>
</tr>
<tr>
<td>Deposits</td>
<td>22.4%</td>
<td>-31.2%</td>
</tr>
<tr>
<td>Loans portfolio</td>
<td>-45.9%</td>
<td>-77.8%</td>
</tr>
<tr>
<td>NPLs as % of loans</td>
<td>25.0%</td>
<td>51.0%</td>
</tr>
</tbody>
</table>

7 Conclusions and recommendations

The Bissau-Guinean financial sector has come a long way since the 1998/99 civil war. It however remains very much underdeveloped and plagued by much inefficiency, which to a large extent mirrors the state of the country’s economy. With hindsight, political stability remains the key overarching condition for improving the financial sector and the economy as a whole. Strengthening political and judicial institutions in an effort to create a favorable economic environment are thus basic pre-conditions for growth.

Considering the level of financial development to date, a carefully sequenced deepening, i.e. from an increased presence of finance in the economy, could prove beneficial to the sector’s development. Indeed, economic literature suggests that financial depth is strongly linked to long-term economic growth (King & Levine 1993; Demirgüç-Kunt & Levine 2008; World Bank 2012). In this respect, a pre-condition would be the development of stronger legislation and the build-up of capacity in the national institutions overseeing and promoting finance. With it, tighter regulation and prudential oversight on banks (e.g. on related-party lending) are in order. For this to happen, the government must be actively involved in the sector.

Beyond making use of its legislative prerogatives to strengthen the structuring of the sector, the government must also deal with the fact that many issues constraining financial deepening pertain to broader economic and governance issues. Such issues will need to be tackled through coordinated public policy proposals by the newly elected government following the April/May 2014 elections. These include for instance the promotion of banking access through implementing the unified payroll system. This is all the most important as the greater use of accounts tends to be associated with higher efficiency in financial institutions (World Bank 2012:32). What is more, beyond higher access to individual banking services, this will also serve transparency purposes in public financial management. It also includes working on a credit reference system to substitute any need for related-party lending, and increase trust in lending. Finally, policies should emphasize macroeconomic and sector policies devoted to economic diversification. Diverting lending away from the cashew sector will decrease...
concentration risk. For instance, setting-up structures alongside the recently created “Center for Entreprise Formalisation” to accompany newly created firms to set-up business plans and access credit could be a small by encouraging start.

Within the current socio-economic context of the country, assistance from financial and technical partners will be necessary going forward. Both regional bodies such as the WAEMU or multilateral partners such as the AfDB or the World Bank could introduce the assistance to financial deepening in their strategic papers due for the end of 2014. More broadly, they can also help the government to engage in structural changes in the economy which can help out with respect to sector concentration ratios as discussed in this paper, in addition to helping spur the emergence of new sectors. As far as the microfinance sector is concerned, it needs a comprehensive overhaul. MFIs need to be capacitated, alongside oversight authorities. More specifically, the government should move to adopt and launch the master plan for microfinance, create separate and well-endowed entities (with the help of donors if required) for the supervision and the promotion of the sector, audit existing MFIs before engaging into their restructuring, use technical assistance to strengthen capacities within MFIs in terms of governance and human resources.
References

- African Cashew Alliance website, www.africancashewalliance.com
Annex

Figure 13 Bank Capital by Ownership in WAEMU 2010-2012 in FCFA million (source: BCEAO)