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NEPAD-OECD AFRICA INVESTMENT INITIATIVE

DEEPENING AFRICAN FINANCIAL MARKETS FOR GROWTH AND INVESTMENT

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List of Acronyms

AfDB	African Development Bank
BRVM	Bourse Regionale des Valeurs Mobilieres
OECD	Organisation for Economic Cooperation and Development
FDI	Foreign Direct Investment
IMF	International Monetary Fund
SME	Small and Medium Size Enterprise
MFI	Microfinance institutions
NGO	Non-governmental organisation
ODA	Official Development Assistance
SMEEIS	Small and Medium Enterprises Equity Investment Scheme
UNECA	United Nations Economic Commission for Africa

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A. EXECUTIVE SUMMARY

While well regulated financial systems are essential for macro-economic stability, as demonstrated by the international Crisis, vibrant financial markets also play a critical role in channelling resources into productive investment and fostering growth. The purpose of this paper is to provide an overview of the state of financial markets in Africa, identify the main impediments to their development and give further recommendations for African governments and the international community on how to reconcile the need for increased flexibility with the necessary safeguard measures.

What are the main obstacles to efficient financial markets in many African countries?

- ***An inadequate regulatory framework*** which makes for a highly concentrated banking sector, very low intermediation rates, and inefficient collateral registry systems that further impede businesses and individuals' access to credit.

- ***A banking sector that fails to exercise its role of intermediation*** due to very high interest rate spreads which make credit expensive. Moreover, deposits are poorly remunerated.

- ***Underdeveloped capital markets*** that remain narrow and illiquid, thereby limiting access to long-term financing and hindering countries' capacities for local debt financing.

- ***A lack of innovative financial instruments,*** notably those geared towards Small and Medium Enterprises, which constitute a majority of the businesses on the continent but remain too often confined to the informal sector due to inadequate financial services.

What policies can be implemented to establish well functioning and inclusive financial markets?

- ***Address regulatory bottlenecks*** by putting in place and enforcing laws aimed at fostering confidence in investors and banks through the creation of credit bureaus that oversee repayment records.

- ***Reorganise the banking system*** through opening the sector to competition, reviewing prudential ratios and putting in place innovative savings and borrowing instruments adapted to local needs.

- ***Develop capital markets*** and particularly bond markets for long-term financing needs by setting up adequate guarantee schemes against currency and other types of risks.

- ***Bridge the gap between the informal and formal financial sectors*** by formalising microfinance institutions to help them scale up activities while developing financial products geared towards Small and Medium Enterprises (SMEs). Innovative financial tools that use technology such as mobile banking can also help leapfrog traditional finance services and reach a larger population.

B. DEEPENING AFRICAN FINANCIAL MARKETS FOR GROWTH AND INVESTMENT

I. Introduction

1. When the financial crisis hit Africa in 2008, the Continent was on the rise. It had registered a growth rate of over 5% between 2003 and 2007, systematically outstripping the world average. This growth, stimulated by an important set of reforms, was also both the consequence and the driver of historically high levels of inflows and domestic resources.

2. Financial flows to Africa have recorded unprecedented levels of growth over the past few years. Thanks to the surge of commodity prices, African exports have almost doubled between 2000 and 2006, from USD 159 billion to USD 290 billion. Meanwhile, ODA to the continent has tripled, reaching an all time high of USD 43.4 billion in 2006. Capital flows including Foreign Direct Investment (FDI), portfolio equity and loans have registered a fivefold increase over the period and exceeded USD 60 billion. And while FDI has reached a historical peak at USD 36 billion, portfolio equity has grown from virtually nothing in 2003 to USD 13.5 billion in 2006. Bank debt and bond flows have also increased substantially, to reach USD10 and USD 3 billion respectively. Finally, estimates put 2006 remittances to Africa at USD 22 billion.

3. On the eve of the crisis, there were also more domestic resources available for African governments and private entrepreneurs than ever before. Total government revenue as a share of GDP increased from an average of 21% to over 26% between 2001 and 2006 for Sub-Saharan Africa as a whole – reaching a total of USD 185 billion, which represents nearly six times the volume of ODA to the sub-continent. In addition, between 2002 and 2007, the capitalisation of African stock markets increased from USD 250 billion to more than a trillion.

One of the most pressing issues for Africa is to channel existing resources into the appropriate sectors to stimulate productivity, create employment, provide people and enterprises with basic utilities, and contribute to efficient natural resource management.

4. Notwithstanding these positive developments, African growth had not yet proven to be sustainable and fully inclusive, even before the crisis. While GDP growth and macro-economic stabilisation have reassured and encouraged private investors, they still largely depend on commodity prices, leaving the continent extremely vulnerable to a downturn. This has been illustrated by the Crisis, whose main transmission channel in the continent was the collapse of export revenues following the decline of the world demand for mineral and fossil resources. Therefore, one of the most pressing issues for Africa is to channel existing resources into productive investment so that they can stimulate productivity, create employment, provide individuals and enterprises with basic utilities, and contribute to efficient natural resource management.

5. Financial markets can play a critical role in this respect. The savings-investment-growth link remains central to the question of financial sector development and the ability of financial institutions to fully play their intermediary role. Putting in place well-functioning infrastructure in the banking sector and capital markets is crucial for catalysing domestic and foreign resources for growth and investment.

6. Given this context, this paper focuses on how developing financial markets can serve to make the most of African resources to elevate the potential growth rate of the continent. The paper first identifies the main impediments to financial deepening on the continent before proposing policy recommendations to further develop financial markets.

II. Critical bottlenecks to the development of African financial markets

7. Financial systems represent a cornerstone of economic development. To ensure that resources are efficiently mobilised and allocated among different actors, financial systems must be adequately regulated and also expanded to offer a wide range of instruments and services.

Weak regulatory frameworks

8. Some prerequisites for a well-functioning financial system are: macroeconomic stability diversified financial products, effective enforcement of laws and regulations as well as functioning registration systems for assets. Transparency and availability of information are also key to reducing screening costs and preventing adverse selection.

9. The institutional framework remains central to the smooth functioning of financial systems in the sense that well-established property rights, together with an efficient judicial system, foster investors' confidence while lowering screening and monitoring costs. In most African countries, institutional capacity tends to be lacking when it comes to property rights, cadastral systems and contract enforcement.

The number one reason for loan refusal is insufficient collateral.

10. According to the World Bank[1], the number one reason why individuals do not apply for or are denied loans is insufficient collateral, which is the result of both an inefficient registration system for moveable assets and the lack of adequate documentation for ownership claims. In fact, collateral requirements in Africa are extremely high in comparison with other regions. According to the *Africa Competitiveness Report 2009*[2], it is the second highest in the world at 137% of the value of the loan.

11. On the supply side, banks tend to favour large enterprises and government assets to minimise risk. By the same token, because of the lack of information on creditors and the perceived default risk, there is a fragmentation of the financial system with a large part of the population lacking access to formal financial institutions.

There appears to be a clear correlation between increased financial intermediation and the quality of the legal and regulatory framework.

12. Despite the size of the informal sector in most African economies, formal financial institutions tend to operate only on a fraction of the market and often do not take into account the informal sector. This is attributable to the fact that since those firms are not registered, it becomes that much more difficult for contracts to be enforced and thus more costly for banks in terms of monitoring and screening costs.

13. Strengthening judicial systems and the enforcement of regulations are thus central to deepening financial systems. Protecting creditors' and borrowers' rights, enforcing contracts and putting in place transparent information sharing mechanisms are also prerequisites for financial deepening.

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1 Making Finance Work for Africa, 2006

2 *The Africa Competitiveness Report 2009*. Publication. World Economic Forum, World Bank, African Development Bank. Web. <http://www.afdb.org/fileadmin/uploads/afdb/Documents/Publications/Africa%20Competitiveness%20Report%202009.pdf>.

14. According to the IMF, financial intermediation has progressed in countries with solid legal institutions while it has remained low for the others despite substantial liberalisation reforms.[3]

Figure 1: Bank credit to the private sector to GDP ratio (percent)

	1983-87	1993-97	2000-04	1990-99	2000-04
All SSA countries	15.6	13.2	15.1	13.7	15.1
Twelve top performers	13.7	21.6	29.8	21.1	29.8
Three countries with recent improvement	10.0	8.9	13.5	10.0	13.5
Remaining SSA countries	17.2	9.7	8.7	10.7	8.7

Source: McDonald, Calvin and Liliana Schumacher

15. Therefore, there appears to be a clear correlation between increased financial intermediation and the quality of the legal and regulatory framework.

Lack of access to the banking sector

16. A typical characteristic of most African countries' banking sectors is the high concentration ratio with a large share of assets held by the top 3 largest banks[4], which leads to excess liquidity and risk aversion. At an aggregate level, the World Bank estimates that the average market share of the three largest banks is about 73 percent[5] in Africa. Such an oligopolistic banking sector has negative consequences, among which are high interest rate spreads which crowd out credit to the private sector by making loans too costly. In this context, banks tend to favour government assets, thus resulting in low intermediation rates and a smaller share of credit allocated to the private sector.

The World Bank estimates that the average market share of the three largest banks is about 73 percent in Africa.

Figure 2: Average interest rate spread and interest rate differential in African countries[6]

Period	Deposit rate (%)	Lending rate (%)	Spread (%)	Differential with USA (%)
1980-84	8.3	13.5	5.2	-19.3
1985-89	10.7	16.1	5.4	-26.5
1990-94	15.4	23.3	7.9	-8.9
1995-99	12.8	23.4	10.6	-0.9
2000-03	10.6	22.4	11.8	4.9

3 McDonald, Calvin, and Liliana Schumacher. Financial Deepening in Sub-Saharan Africa: Empirical Evidence on the role of Creditor Rights Protection and Information Sharing. Working paper no. 203. Washington: International Monetary Fund, 2007

4 According to the 2006 Economic Report on Africa, in many African countries, "three leading banks account for over 70% of deposits, loans and assets, and the market share of the top four banks is as high as 75% in a few countries"

5 Making Finance Work for Africa

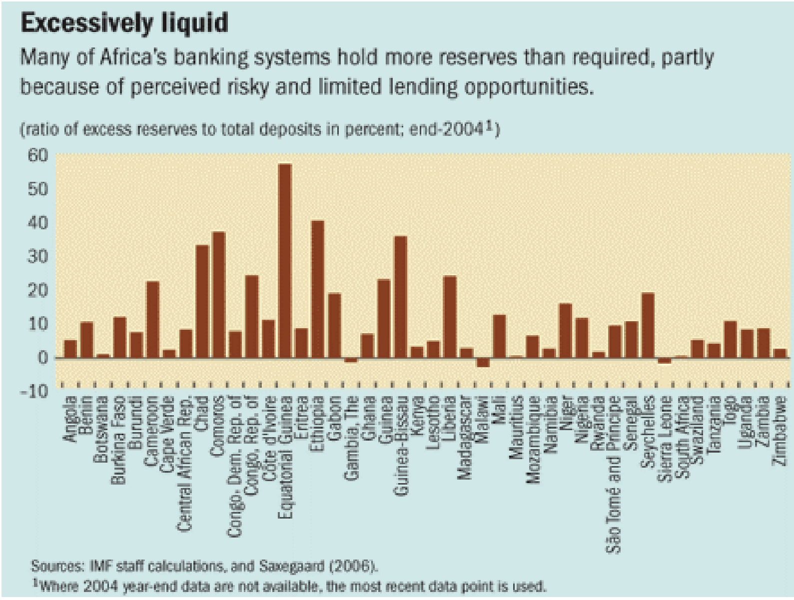
6 United Nations Economic Commission for Africa. Economic Report on Africa 2006.

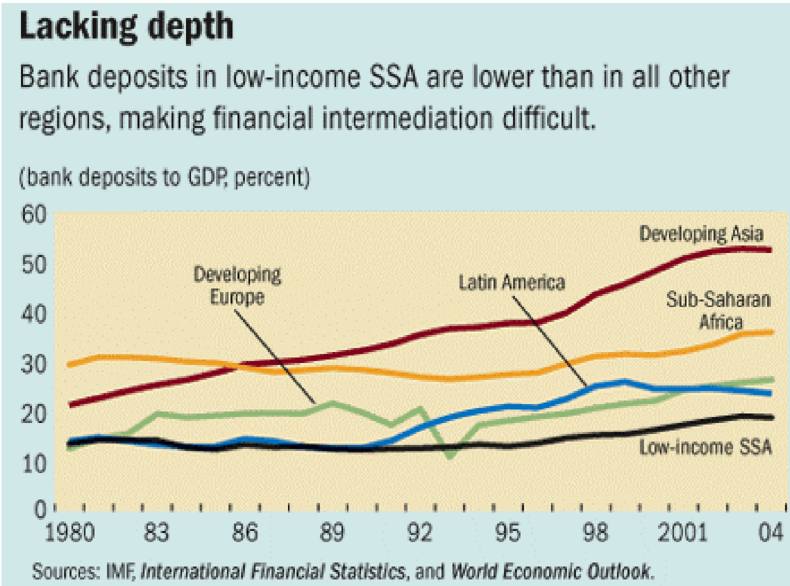
17. These interest rate spreads reflect the high cost of credit in Africa. This originates from a number of factors among which is the limited market size. In effect, African economies are caught in a vicious circle where low incomes and difficulties accessing credit hinder growth, thereby lowering household savings which, in turn, depresses investment and domestic resource mobilisation.

18. The lack of financial depth in Africa is exemplified by the highly liquid and yet narrow banking sectors which are "smaller than a mid-sized bank in continental Europe" with less than USD 1 billion in assets (see figure 3).[7]

The lack of financial depth in Africa is exemplified by the highly liquid and yet narrow banking sectors.

Figure 3: Banking Systems are Liquid but Lack Depth[8]





7 Africa Competitiveness Report 2009

8 Gulde, Anne-Marie, and Catherine Patillo. "Adding Depth." Finance and Development 43 (June 2006).

Foreign banks' subsidiaries in Africa are more profitable than their counterparts in other regions.

19. There is, however, some noteworthy progress, namely increased financial coverage in many SSA countries and high profitability of banks. Indeed, according to the *Africa Competitiveness Report 2009*, foreign banks' subsidiaries in Africa are more profitable than their counterparts in other regions (although higher profitability might be caused by a majority of risk-free government assets), while the concentration ratios are dropping – indicating increased competition in the sector.

Figure 4: Bank Profit Comparisons, 2000–04

	Return on assets (%)	Return on equity (%)
Africa	2.1	20.1
Foreign banks in Africa	2.8	26.7
Subsample of foreign banks in Africa	4.7	43.2
Rest of world	0.6	8.5
Foreign banks in rest of world	0.9	8.6
Subsample of foreign banks in rest of world	0.7	9.7

Source: *Making Finance Work for Africa*
http://siteresources.worldbank.org/AFRICAEXT/Resources/Africa_Finance_report.pdf

20. Nevertheless, there is still a lack of strong financial institutions that can provide long-term financing to support the African economy.

Narrow and Illiquid Capital Markets

21. In conjuction with the banking sector, capital markets are a central component of efficient financial markets. However, they remain largely underdeveloped in Africa and therefore further discourage investors. In this regard, the development of efficient capital markets is essential if governments want to increase investment opportunities for both domestic and foreign investors.

Characteristics

22. African capital markets are traditionally narrow and illiquid. This can be explained by a combination of factors that hamper their development such as : low income levels, ineffective collateral registration systems, weak judicial institutions (particularly in terms of contract enforcement and commercial regulations), exposure to external shocks and, most importantly, a scarcity of human capital and financial infrastructure. In addition, the dearth of domestic investment opportunities prevents the development of dynamic stock exchanges that stem from local demand rather than external influence.[9] The small number of portfolio options (property, deposits, equities, bonds etc.) also hinders the growth of capital markets. These, in turn, are affected by non-transparent monetary policy, the lack of secondary markets in the local banking

[9] The UNECA 2006 report cites the example of the Mozambiquan stock exchange where the only company listed is the national brewery. The listing was done in order to facilitate the privatisation of the brewery. As the UNECA report asserts : "To the extent that the establishment of stock exchanges was driven by outside influences — rather than emerging from a realistic need felt in the market, whether by investors or by issuers — it is perhaps unsurprising that many have so far struggled to reach an effective scale and activity level".

sector, and capital account regimes.[10]

Progress in Strengthening Capital Markets

23. Although they remain remain relatively small and illiquid, African capital markets have developed steadily over the years with some 20 stock exchanges and a regional entity (Bourse Regionale des Valeurs Mobilieres, BRVM) covering the countries of the West African Economic and Monetary Union (WAEMU).[11] South Africa, as an African economic powerhouse, is an exception in the sense that its financial markets are substantially more developped with, for example, highly liquid nominal government bonds.

Regional Integration

Capital markets in Africa tend to be small and fragmented.

24. Despite recent progress in market capitalisation, value traded, and companies listed, capital markets in Africa tend to be small and fragmented. While it is true that they remain profitable – with an average equity return of 34 per cent according to UNECA,[12]national capital markets cannot be effectively sustained in the long-term given the small size of a majority of African economies. Regional integration could contribute to more efficient capital markets; yet, limited intra-regional trade, underdeveloped financial infratructure and lack of regulatory capacities remain major constraints.[13] In order to compensate for these shortcomings, regional integration can be useful, particularly in terms of economies of scale, to:

- Increase market size;
- Integrate information systems to reduce monitoring and screening costs and mitigate risk;
- Pool resources for high-cost, long-term investments (e.g. in infrastructure);
- Reduce regulatory burdens by harmonising financial laws and processes;
- Reduce exposure to external shocks; and
- Attract international capital flows.

25. There are a few examples of regional financial integration on the continent which build on existing Regional Economic Communities, the most noteworthy being the BRVM.

Shortage of Innovative Financial Instruments

26. Given the specific nature of African economies, formal financial institutions need to adapt their products to local demands (particularly those designed for poor populations). The emergence of microfinance as a tool for financing the informal economy coincides with the growing understanding between NGOs, development experts and policymakers that a large fraction of the population in low-income countries has no

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10 Blommestein, Hans, and Greg Horman. "Government Debt Management and Bond Markets in Africa." *OECD* (2007). Web.

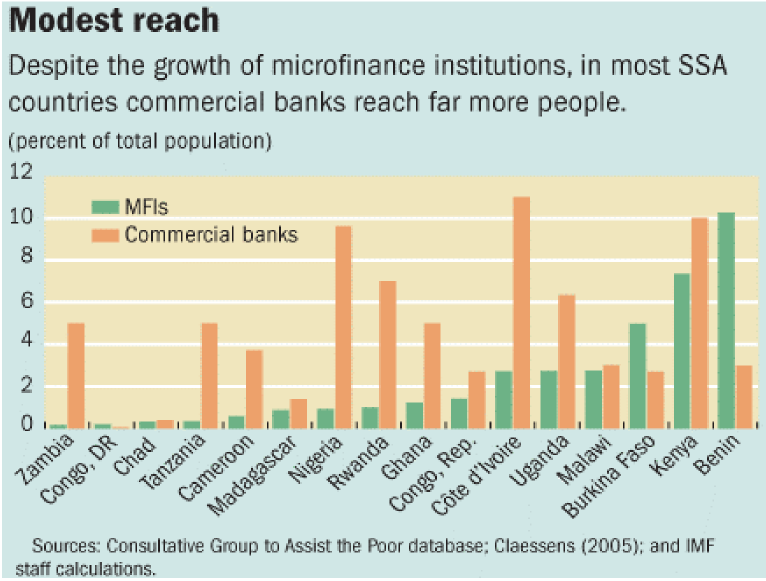
11 United Nations Economic Commission for Africa. Economic Report on Africa 2006.

12 United Nations Economic Commission for Africa. Economic Report on Africa 2006.

13 Regional Financial Integration: Its Potential Contribution to Financial Sector Growth and Development in Sub-Saharan Africa. Rep. Washington: International Monetary Fund, 2008.

access to financial services. Microfinance, which at first seemed to be a panacea, has demonstrated its limitations in scaling-up operations and satisfying the growing client needs. Indeed today, fewer people have an account with a Micro Finance Institution (MFI) than with a commercial bank, as illustrated in Figure 5 below.

Figure 5: The limitations of microfinance[14]



27. However, formal credit remains inaccessible to most households because many Africans hold their assets (such as livestock, commodity stocks or property) without proof of ownership (title deeds). As a result, they struggle to provide collateral to financial institutions.

Effective cadastre systems, land title transfers and credit registries are critical to the functioning of financial inter-mediaries, particularly for Small and Medium Enterprises (SMEs).

III. Proposed Solutions

Institutional and Regulatory Framework

28. A well-functioning financial system requires strong institutions and a sound legal framework. Consumer and property rights protection, contract enforcement laws and corporate governance are key elements for increasing the depth of financial markets and creating an enabling business environment.

Registration systems for assets

29. One of the major impediments to credit and other types of borrowing in Africa is the lack of collateral, not because of insufficient assets but rather due to inefficient registration systems. Effective cadastre systems and land title transfers as well as credit registries are critical to the functioning of financial intermediaries, particularly when it comes to Small and Medium Enterprises (SMEs). A well-organised registration system for moveable and immoveable assets or property requires a strong legal framework to

14 Christensen, Jakob, Anne-Marie Gulde, and Catherine Patillo. "Bankable Assets." Finance and Development 43 (December 2006). International Monetary Fund. 1 July 2009 <http://www.imf.org/external/pubs/ft/fandd/2006/12/christen.htm>.

increase transparency and facilitate the obtention of information on those assets. This is particularly true for the cadastre system. African governments should strive to increase the comprehensiveness of their cadastre systems which should include information on the ownership, location, dimensions and value of a given parcel of land. In addition, they should make this information as widely accessible as possible in order to increase firms' access to bank finance and decrease the cost of monitoring for banks, thereby lowering the cost of credit.

It takes African firms on average half the value of the claim to go through the courts while in some extreme cases it exceeds it.

Credit guarantees for specific borrowers

30. Small and Medium Enterprises constitute the bulk of economic operators in Africa. However, they are also the most deprived of finance. Thus, governments should look for ways to further expand their access to credit. One way of doing this would be for governments, development banks or business associations to provide partial loan guarantees to commercial banks that lend to SMEs. This approach would be particularly useful in sectors such as agriculture, for which credit is difficult to access due to lack of collateral and important climate risk.

Law enforcement and regulatory capacities

31. According to the *Africa Competitiveness Report 2009*, despite recent progress, Africa still lags behind other regions in the quality of the regulatory environment and the cost of doing business. Against this background, governments should focus on facilitating the creation of credit bureaus in charge of providing repayment records and other information to financial institutions.

African bankers should seek not only to provide SMEs with appropriate savings and borrowing instruments but also increase their staff's ability to cater to the different markets.

32. In terms of consumer rights and private property protection, the legal framework is also of great importance. According to the *Doing Business Report 2008*, taking a claim to the courts costs African firms on average half the value of the claim. and in some extreme cases, it even exceeds the value of the claim itself. According to Christensen et. al, to enforce a commercial contract, creditors in SSA must "go through 35 steps, wait 15 months and pay 43 percent of country per capita income" .[15] In the same way, the cost of liquidation procedures for failing businesses represents a large share of company assets. Therefore, African governments should aim to reduce the legal and regulatory hurdles that hamper the conduct of business while also striving to enforce procedures that facilitate it. They can protect creditor rights and private property by:

- Creating simple and transparent property registration systems;
- Strengthening contract enforcement mechanisms;
- Facilitating bankruptcy procedures; and
- Establishing commercial courts.

33. These measures would greatly improve the business environment as well as add to the depth of African financial markets.

[15] Christensen, Jakob, Anne-Marie Gulde, and Catherine Patillo. "Bankable Assets." Finance and Development 43 (December 2006). International Monetary Fund. 1 July 2009 <http://www.imf.org/external/pubs/ft/fandd/2006/12/christen.htm>.

Banking System Reforms

34. Access to external resources will never suffice to meet financing needs. As the recent Crisis has demonstrated, external shocks can have serious consequences on financial flows to the continent. Therefore, mobilising domestic resources is critical to sustaining growth and investment. Banks, as the primary channels of financial intermediation, can play a key role in this regard. The African banking sector thus needs to be reformed to effectively accommodate the demand for credit from both the public and the private sector, so that savings and resources can be channelled towards productive investment.

Credit bureaus and rating agencies would help reduce risk, thereby lowering interest rates and facilitating businesses' access to credit.

35. Banks in Sub-Saharan Africa have gone through a first set of reforms under the Financial Sectors Adjustment Programs (FSAPs)but there are still a number of additional reforms needed. These include the following:

1. African bankers should seek not only to provide SMEs with appropriate savings and borrowing instruments, but also to increase their staff's ability to cater to the different markets. As the market currently stands, the high liquidity of African banks reflects a failure to provide credit to the private sector. According to the World Bank, this is due to the lack of bankable projects, which can be attributed to the low financial literacy and managerial capacities of SMEs.

2. In order to reduce the risk of a systemic banking crisis, it is essential to regulate the banks' choices in terms of assets and also put in place regulatory measures regarding their capitalisation (Basel Accord).

3. Putting in place appropriate deposit insurance mechanisms could also help to foster the stability of financial institutions and develop clients' confidence in banks.

4. The availability of information on creditors and their projects is key. Putting in place credit bureaus and rating agencies responsible for providing banks with information on their clients would help reduce risk, thereby lowering interest rates and facilitating businesses' access to credit.

Capital Markets Development

36. Well-functioning capital markets play a great role in resource mobilisation and remain particularly important to countries long-term financing needs. African capital markets, however, tend to be narrow and illiquid. This limits the ability of countries to attract and efficiently direct domestic and foreign investments.

37. There are several ways of addressing the main restrictions on capital markets development:

The development of maturity instruments remains crucial and local actors should be encouraged to invest in domestic bond markets.

1. The narrowness of African capital markets could be overcome by increasing the number of actors through regionalisation. Pooling resources and investors at the regional level will also help to build economies of scale in terms of financial infrastructure and regulatory capacities while providing both domestic and foreign investors with a diversified set of investment opportunities.

2. The insufficient sophistication of financial instruments could be addressed through creating second-tier markets and increasing portfolio options.

3. Given the lack of investor confidence in local capital markets, guarantee schemes against

currency risks should be developed, building on regional regulations and legal frameworks to enforce contracts.

4. Information scarcity – which contributes to poor ratings on international markets despite high returns – could be resolved by enforcing regulations and creating credit bureaus and rating agencies.

5. The shallowness of local capital markets can be partly overcome by providing firms with incentives to list their shares on local stock exchanges.

Bond markets

38. In light of the impact of the financial crisis on private flows to Africa, the development of sustainable bond markets is necessary to bridge the financing gap. According to the African Development Bank's Financial Markets Initiative, Africa will need USD 20 billion in infrastructure investment per year which can only be sustainably financed through long-term bonds.[16]

39. Consequently, the development of local bond markets is essential in order to match local financing revenues with debt service. The expansion of local-currency bonds should decrease the cost of local-currency debt which remains expensive due to high domestic interest rates. Also, such markets are needed for enhanced financial stability, and better integration in the global financial landscape.[17]

40. The development of maturity instruments thus remains crucial and local actors such as social security or pension funds, as well as insurance companies, should be encouraged to invest in domestic bond markets. To facilitate the activities of such private investors, governments need to disengage from statutory funds and put in place adequate legislation to encourage the emergence of private insurance and pension funds. Given the importance of local debt financing, several international firms have come up with innovative tools to build the capacity of local markets.

Guarantee schemes

41. Given the predominance of SMEs in Africa and the limited loans available to them from banks, it is essential to create systems to help enterprises overcome these constraints. Access to finance is critical to the development of SMEs and thus to developing countries' economic growth. It is therefore useful to put in place effective, reliable and practical guarantee schemes aimed at lowering banks' operating costs and the cost of credit, thereby encouraging financial institutions to lend to SMEs.

Credit risk guarantees are also particularly useful for countries' long-term financing needs.

42. Credit risk guarantees are also particularly useful for countries' long-term financing needs (for investment in infrastructure for example) specifically when issuing local-currency debt. Most importantly, through domestic debt issuance, countries use and recycle their own savings towards their investment needs rather than increase their external debt.

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16 Mapping of Current Ongoing Initiatives related to Bond market Development in Africa. African Development Bank. 22 June 2009 http://www.afdb.org/en/news-events/article/donor-workshop-on-african-bond-market-4443/ .

17 Blommestein, Hans, and Greg Horman. "Government Debt Management and Bond Markets in Africa." *OECD* (2007). Web.

43. In addition, the World Bank has pointed out the importance of equity markets specialised in exchanges between SMEs in order to provide capital for high-risk firms as well as increase investment opportunities for domestic investors. Although these markets mostly cater to high-tech or innovative firms in the developed world (the NASDAQ in the US is the most well-known), adapting the model to African markets could be useful given that SMEs represent a large proportion of the firms operating on the continent and may benefit from SME exchanges.

Innovative Approaches to Finance and Domestic Resource Mobilisation

Generalise access to informal banking services

44. Given the importance of financial services in the economy and the reality that SMEs are not only less likely to access credit but to pay more for it – in terms of interest rates for example – it is essential for policy makers to create financial products geared towards SMEs.

According to the *Africa Competitiveness Report 2009*, this can be done by providing:

1. Guarantees to commercial banks that lend to SMEs;

2. Excess collateral guarantees in order to share the burden with the SMEs that usually have to post higher collateral than larger firms; and

3. Financial (and managerial) literacy training, particularly for micro-enterprises that would otherwise not have the ability to present a viable business plan to secure a loan.

The Nigerian Small and Medium Enterprises Equity Investment Scheme (SMEEIS) requires all banks to also provide financial and managerial training.

45. In Nigeria, for example, the Small and Medium Enterprises Equity Investment Scheme (SMEEIS)[18] initiated by the Bankers Committee requires all banks to not only invest 10% of their profits after tax in eligible SMEs in the form of equity or loans in single digit interest rates, but also provide financial and managerial training. The government is responsible for providing an enabling environment by cutting SMEs' taxes to 10% and offering a 5 year tax holiday to participating SMEs.

46. In those SSA countries where such schemes do not exist, SMEs tend to turn to informal finance to access funds. Although Microfinance Institutions (MFIs) fill the financial gap created by the formal institutions' tendency to focus on large enterprises, they nonetheless face difficulties scaling-up and thus meeting the growing needs of SMEs for larger loans and diversified financial products. MFIs are also heavily donor dependent and are often run as non-profits by NGOs which greatly reduces their access to commercial financing for supporting their activities and broadening their product range.

47. It is therefore necessary for MFIs to be integrated in the formal financial system in order to scale-up their activities while retaining their comparative advantage in their relatively lower interest rates. Several MFIs have sucessfully made the transition to formal financial institutions and now have access to local capital and debt markets to

18 Africa Competitiveness Report 2009 and <http://www.cenbank.org/OUT/PUBLICATIONS/GUIDELINES/DFD/2005/SMALL%20AND%20MEDIUM%20ENTERPRISES%20EQUITY%20INVESTMENT%20SCHEME.PDF>

finance their activities.[19]

48. One notable initiative is the recent establishment of a company[20] that seeks to reduce the currency risk faced by microfinance institutions by providing them with hedging instruments as well as risk management and mitigation tools. The goal is to offset currency risks faced by MFIs (which often have to borrow in dollars or euros and lend in local currencies) through promotion of local currency loans, thus reducing MFIs' costs.

Other examples of innovative tools

In Kenya, Equity Bank has specialized in providing small loans at low interest rates along with free savings accounts to rural populations and farmers.

49. Against the rising demand for financial services expressed by low-income populations, there has been a rapid development of financial products designed to satisfy the needs of 'unbanked' populations in Africa. In Kenya for example, Equity Bank has specialised in providing small loans at low interest rates along with free savings accounts to rural populations and farmers who represent 75% of the working population. They now have over 3 million customers and are the third largest bank in the country.[21]

50. In South Africa, the country's largest banks have agreed, under the Financial Sector Charter, to create a special bank account for poor households called the *Msanzi* account. This initiative has had tremendous success, with over 3.3 million account holders in the first 18 months.[22] Customers can also use any of the participating banks' ATMs at no additional charge.

Mobile phone providers have successfully leap-frogged the formal banking sector by providing low-income, unbanked or underbanked populations with cheap and secure financial services.

51. In addition, access to finance can be made easy and affordable through using cell phones and doorstep banking. Mobile banking has revolutionised the way Africans use financial services with the rapid spread of mobile payment and transfer services throughout the continent. In an effort to lower transaction costs often associated with traditionnal banking services, mobile phone providers have successfully leap-frogged the formal banking sector by providing low-income, unbanked or under-banked populations with cheap and secure financial services. By doing so, they remove one of the major obstacles to accessing finance, namely velocity – smoothly transferring money from sender to receiver – which is often impeded by distance and cost. A case in point is South Africa's 'virtual bank' *Wizzit*[23] which has no physical branches but uses established banks as a network to make secure financial transactions from any operator and bank. Providing its customers with a debit card they can use at any ATM to withdraw cash, *Wizzit* also offers them the possibility to use their mobile phones to make payments and transfers, and buy prepaid airtime.

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IV. Conclusion

52. Innovation and a wide spread of public and private activities and partnerships can contribute significantly to the development of African financial markets. However, access to finance is still a challenge for most Africans. Overcoming this bottleneck is critical if Africa is to increase its investment rate and its growth potential, as financial intermediation is the key to channelling resources into productive activities. Making African financial markets work for investment and development will require significant efforts aimed at strengthening their legal and regulatory infrastructure, and lifting the quality and scale of their operations. Major possible reform areas include improving property rights' regimes, diversifying the supply of financial products and services in the banking sector and regionalizing financial markets through legal harmonisation and cross-listing at regional level. This will require intense cooperation among African governments and their partners from OECD countries and emerging economies as well as innovative solutions that have proven to be successful in Africa, alongside sound macroeconomic policy management.

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