How can development finance institutions help to build an effective African banking sector?

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Limited, fragmented, inefficient and characterised by strong regional disparities, Sub-Saharan Africa’s banking sectors lack the capability to meet the private sector’s financing needs. Development finance institutions (DFIs), which already have a high level of involvement, can facilitate consolidation processes, support the emergence of pan-African champions and widen access to long-term funding.

Africa’s banking sector has seen strong growth for a number of years now – yet it remains small, fragmented and insufficiently competitive, only partially capable of meeting the private sector’s financing needs. By helping to facilitate the emergence of sufficiently large banking groups and by organising syndication markets, Development Finance Institutions (DFIs) can help to boost the sector’s financing capacity and improve its performance. Similarly, even though African banks have an overall funding surplus, they nonetheless struggle to secure the long-term funds that would enable them to finance investments over adequate time periods. Here again, DFIs can help to organise the market so that long-term financing possibilities that exist locally are leveraged more effectively.

A small, fragmented and under-performing financial sector

Sub-Saharan Africa has the world’s least-developed financial sector. Total African bank assets, excluding South Africa, amount to less than USD 300 billion – around one tenth the balance sheet size of China’s leading bank. Even taking GDP disparities into account, Africa’s finance sector remains abnormally under-developed, with a penetration rate of around 30 to 40 %, less than half the average for other developing markets. Access to banking services for local populations remains very limited, with fewer than five bank branches for every 100,000 inhabitants – the lowest rate in the world (see maps 1, 2 and 3).

Map 1: Number of commercial bank branches per 100,000 adults and depositors with commercial banks per 1,000 adults – World

Source: Authors calculations, based on the Financial Access Survey database

Map 2: Banking sector total assets, private-sector credit and bank deposits (%GDP) – Africa

Source: Authors calculations, based on the Africa Development Indicators database and Beck and Ed Al-Hussainy (2009)

Map 3: Bank deposits (%GDP) – World

Source: Authors calculations, based on Beck and Ed Al-Hussainy (2009)
Africa's banking sector is highly fragmented, too: the leading banking group in Sub-Saharan Africa has a total balance sheet of USD 17 billion – one third the size of the leading bank in Cyprus – and only fifteen or so banking groups have total assets in excess of USD 5 billion. Africa hosts more than 500 banks in all – which means a large number of very small banks that lack efficiency, because they cannot generate returns to scale, and lack innovation (box 1). These banks are incapable, therefore, of generating healthy and productive competition; they confine themselves to low-risk, high-return niche markets such as public debt, foreign exchange and money transfer - in consequence having virtually no impact on private sector financing. Total private sector credit is no higher than 20% of GDP in Africa² - the lowest rate in the world.

West Africa: a fragmented, under-performing banking sector

In Ghana, despite having a large number of banks (27), with total assets of less than €10 billion, the banking sector is relatively uncompetitive (average lending rate over 25%, net interest margin above 8%, ROA of 2.4%), relatively inefficient (cost to income ratio of 60%, non-performing loans rates between 15 and 20%) and highly profitable (ROE of 18%, pre-tax profit margin of 31%; PwC, 2012). The under-performing banking sector in the WAEMU (West African Economic and Monetary Union) zone offers another illustrative example. With a statutory minimum capital requirement of just FCFA 5 billion (€7.6 million), the region has around one hundred banks - yet private-sector credit stands at no more than 15% of GDP. A large number of these banks are virtually insolvent, destined to disappear or be taken over, surviving merely because the regulatory authorities lack the drive to restructure the sector.

Africa is also the continent where the dominant banks enjoy the highest level of market power: Beck and Honohan (2007) show that, across a representative sample of African countries, the three top banks hold a market share of 73%, as compared with 60% in the rest of the world. Yet even though these leading banks hold dominant positions locally, they remain small in global terms and are therefore limited by prudential constraints when it comes to financing major operations. In the absence of an efficient syndication market, a significant proportion of the financing needs of African economies - especially in the infrastructure, agribusiness, construction and civil engineering, telecommunications, energy, oil and gas and mining industries - is covered by external financial systems (funding agencies, international banks, supplier credits, etc.), while at the same time a significant proportion of the continent’s own bank funds are invested outside Africa (map 4). This paradoxical situation - particularly acute in the countries with the least developed banking sectors (Central and West Africa) - in large part reflects the fragmentation of the local banking systems and their inability to coordinate and mobilise their resources for major projects.

Map 4: Net foreign assets and offshore bank deposits/domestic bank deposits - Africa

Source: Authors calculations, based on the Africa Development Indicators data database and Beck and Ed Al-Hussainy (2009)

Radical restructuring needed

A banking sector of this kind is inefficient and needs restructuring, in order to boost competition levels while at the same time facilitating the emergence of banks large enough to meet the needs of the whole local private sector. To date few countries have undertaken a restructuring of their banking sector, however; and those that have completed this process remain the exception. Nigeria is one of these exceptions and today its restructuring is beginning to bear fruit: several banks have reached a size where they are generating genuine returns to scale and can finance major transactions in the local private sector. Nigeria’s banking sector includes six of the seven largest banks in Sub-Saharan Africa: it has become competitive, capable of offering substantial volumes and competitive financing terms. Numerous countries have announced similar consolidation measures,
following Nigeria’s example (the WAEMU and EMCCA zones, Ghana, Kenya, etc.) – but are dragging their feet with respect to implementation. The banking sectors of Central Africa and to a lesser extent West Africa are still mainly in an early development phase (box 2). Several countries in Southern and East Africa have successfully developed regional banks (banks such as I&M, Equity Bank or BancABC – without taking South Africa’s banks into account).

<table>
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<th>The three development phases of Africa’s banking sector</th>
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<td>The first development phase typically sees two or three major banks operating in a quasi-monopolistic position. They concentrate on high-return, low-risk activities, providing very little finance to the private sector. Alongside them are a few small banks operating in niche markets. The banking business is focused on taking in short-term funds from depositors in order to provide finance to risk-free counterparties or to invest the funds in the financial systems of developed markets. The countries in this development phase are mainly in Central Africa.</td>
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<td>In the second phase, four to five dominant banks are beginning to generate scale benefits. A number of private universal banks appear on the scene but competition remains limited. A syndication market is not developing and external financial systems continue to play an important role. Banking activity consists of financing the state, major corporations and individuals who can provide appropriate guarantees. Kenya, Ghana, Côte d’Ivoire and Senegal are examples of countries in a phase two stage.</td>
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<td>In phase three, the banking sector has undergone a wave of consolidation and the small, inefficient banks have disappeared. A healthy level of competition is developing. The sector has sufficient capacity to finance the majority of local transactions and a syndication market is beginning to develop. The banking sector’s penetration rates within the economy are rapidly increasing and a phase of expansion into neighbouring markets is getting under way. At present only two countries, South Africa and Nigeria, can be regarded as having genuinely reached phase three.</td>
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This lack of depth in Africa’s financial systems is quite clearly holding back the development of the local economy, and of the private sector in particular. More than 60% of companies surveyed in Sub-Saharan Africa regard the cost of finance as an impediment to growth and nearly half see access to finance as a factor limiting their development. These rates are the highest in the world, far surpassing the levels observed in other developing markets (17% and 15% respectively; Honohan and Beck, 2007; Demirgüç-Kunt et al., 2008).

Fostering pan-African champions

In order to effectively leverage the opportunities the continent offers, the banking sector needs to foster the emergence of a few pan-African “champions” capable of carrying capital-intensive transactions on their balance sheets. Development finance institutions (DFIs) can help here, with targeted initiatives designed to support banking groups that are well positioned to play this role. Apart from existing groups (Ecobank, BOA, UBA) – which have already received substantial support from DFIs – two kinds of players are likely to prove good candidates. Some regional banking groups which have already attained critical mass – such as Orabank or BGFI Bank in Central and West Africa, I&M, Equity Bank or Kenya Commercial Bank in East Africa, and BancABC in Southern Africa – have a good knowledge of the markets in which they operate but limited resources. They could benefit from capital injections by DFIs – like those by FMO in Afriland First Bank, Proparco in I&M and Orabank, or IFC in Equity Bank.

Africa’s leading financial centres might also produce these pan-African champions. With the exception of Central Africa, each of these regions has at least one country that leads the way in terms of financial sector development: Nigeria and Morocco for West Africa, South Africa for
Southern Africa and, to a lesser extent, Kenya for East Africa (map 5).

Map 5: Total banking assets of African countries

Source: Author calculations, based on the Africa Development Indicators database

These four countries could act as the engines driving regional development. Even though South Africa and Morocco are not, strictly speaking, part of Sub-Saharan Africa, this geographic region is their natural expansion area. Pan-African expansion by banks based in these countries is a recent phenomenon: Moroccan banks are expanding in francophone West Africa, Nigerian and South-African banks in anglophone Africa. Yet this expansion remains cautious; the largest banks in these countries are still very focused on their domestic markets. DFIs have a role to play here in encouraging and supporting these banks as they move beyond their national borders. Proparco and FMO supported the regional expansion of BMCE, for example, by facilitating its alignment with BOA Group, while the International Finance Corporation (IFC) invested in BCP Maroc to finance the acquisition of Banque Atlantique group in West Africa. Similarly, DFIs are supporting the development of the banking networks of Nigerian and South African banks that have already ventured abroad (UBA, GT Bank, Zenith Bank, Access Bank, Standard Bank, etc.). Nonetheless the expansion of these banking networks remains highly dependent on the proximity of the markets concerned – proximity in historic, cultural (especially the business culture), institutional and regulatory terms. While Nigerian banks are establishing dominant positions in anglophone countries (Ghana, Sierra Leone, Gambia, etc.), they are much more cautious in the WAEMU zone where the Moroccan banks – virtually absent in anglophone markets – are preeminent. DFIs could therefore reinforce their cooperation with these banks by helping them to penetrate markets which are less natural and accessible for them.

**Long-term funding – a key need that remains unmet**

To date the support provided by DFIs has primarily involved relatively traditional financing based on long-term debt or equity, in order to provide banking groups with the long-term resources they lacked. Now, however, other more innovative forms of support might be envisaged. Groups such as Ecobank could undoubtedly secure funding on good terms from the financial markets – yet they lack the necessary profile with investors outside Africa. DFIs could help to integrate Africa’s banks in the international finance systems – by guaranteeing their first bond issues, for example. DFIs could also help local banks to use the resources available within their domestic markets more effectively. Insurance companies and other social security funds, for example, have substantial long-term funding reserves at their disposal but – due to their lack of knowledge of the banking sector – may be reluctant to invest them with banks over the long term. By guaranteeing loans from these organisations to local banks, for example, DFIs would be helping to channel these long-term funds into the banking sector in order to boost financing of the productive sector. Similarly, most African banking sectors have excess short-term resources which, although very stable, cannot be used to finance long-term investment due to the statutory liquidity requirements applied to banks. In order to facilitate a more productive use of these resources, DFIs could provide banks with refinancing in the event of a liquidity crisis, enabling them to convert a larger proportion of their short-term resources into long-term funds. Finally, and again with a view to helping banks extend the maturity of the funds at their disposal, DFIs could consider stimulating the interbank market by encouraging banks to refinance each other over the long term, or encouraging more bond issues in local securities markets.

**Developing synergies between the various markets**

Consolidating banks’ resources is not the only way to increase their response capabilities, however. A more effective use of their resources could also enable them to overcome the constraints imposed by their limited size. Developing the syndication market could prove especially fruitful in this respect. Even though syndication is beginning to develop within national markets, “transnational”
syndication remains very rare: only bank groups with operations in several countries (Ecobank, BOA Group, Standard Chartered, Standard Bank, etc.) are able to initiate these syndications. DFIs certainly have a role to play in organising this market and encouraging increased bank cooperation. They could, for example, offer intermediation services to local banks, in order to help develop their coordination capabilities. This avenue remains under-explored by DFIs to date: their syndication initiatives are generally confined to projects in which they are themselves involved – projects which are therefore funded in hard currency. Yet this would aid the stimulation of local currency finance markets – markets over which DFIs have very little leverage. From a more general point of view, it might be possible to improve cross-border cooperation by encouraging banks operating in different markets to develop synergies. Partnerships like the one between Nedbank (based in Southern Africa) and Ecobank (present across the rest of Sub-Saharan Africa)³ remain the exception. Most Ghanaian banks, for example, have no partner banks in the WAEMU region, even though Ghana is located at the heart of this area, which limits the scope of the transactions they can undertake with clients active in this region. DFIs could facilitate regional trade by guaranteeing African banks vis-à-vis their banking counterparts in neighbouring countries (as they do for international trade transactions between Europe and Africa). Generally speaking, DFIs’ cross-sectoral involvement makes them ideally placed for connecting banks capable of developing synergies, thereby stimulating regional banking integration and the dissemination of expertise between different markets. This kind of support would help banks get to know their neighbouring markets and gradually look beyond their own national borders - helping to strengthen the overall capability of Africa’s banking systems.

Footnotes:

¹ Excluding South Africa.
² By comparison, this ratio is higher than 100% in high-income countries.
³ The two banks have complementary networks, providing mutual support for transactions outside their areas of coverage: http://www.ecobanknedbankalliance.com/.


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