Policy Brief 1

Policy Priorities for Sub-Saharan Africa's Financial Development

The ODI research series for financial development in Africa

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Key messages

Achieving universal financial access in LICs and FCAS remains critical for resilience and basic livelihoods in the informal sector

Further development of capital markets is needed, especially for infrastructure and private sector development in key sectors for inclusive growth and job creation

The region needs to tap into the global growth in green finance including through domestic market development, blended finance and specialist international investors

Development finance continue to be essential for infrastructure, industrialisation and agriculture. More capital from donors is needed

Technology is a critical enabler of further efficiency and access in financial development.

About this series

The ODI research series for financial development in Africa funded by FSD Africa

FSD Africa is a specialist development agency working to build and strengthen financial markets across sub-Saharan Africa. Its mission is to reduce poverty through a ‘market systems development’ approach addressing the structural, underlying causes of poverty by improving how financial market systems function.

As part of their work, FSD Africa’s invest in breakthrough research, analysis and intelligence-gathering projects to provide policy makers, regulators, development actors, investors and financial service providers with vital market insights and information and that contributes to long-term change.

As part of this research, FSD Africa have partnered with the ODI, the independent global development think-tank, to address policy issues in financial sector development in Africa. This includes a series of working papers by and for leading academics and an accompanying series of briefing papers focused on the policy implications of research targeted at policy makers, regulators and the broader stakeholder community.

The research program is being accompanied by joint FSD Africa and ODI dissemination events in the region and internationally to present and debate the policy implications of the research findings.

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Acronyms

AIM	Alternative Asset Market
FCAS	Fragile and conflicted-affected states
FSDA	Financial Sector Deepening Africa
GDP	Gross national product
IFI	International Financial Institution
LIC	Low-income country
MIC	Middle-income country
SME	small and medium sized enterprises
USD	United States Dollar

1 Introduction

Inclusive and sustainable economic development requires finance for the investment that underpins its fundamental processes – capital formation and productivity improvement.

Mobilising that needs domestic financial systems that deliver not only the right quantity of finance, but the right 'quality' – defined by stability, cost, tenure and sector.

Sub-Saharan Africa has seen significant and steady progress towards this goal since 2000. The scale of the financial sector has grown. Regulation has been broadly strengthened and systemic financial stability risks contained.

Most impressively, there has been a sharp uptick in financial access including in remote and rural areas where poverty is concentrated although some LICs and most FCAS need to make further progress.

Nevertheless, progress has been largely limited to the banking system with limited development of capital markets. And, while bank credit has grown, it remains too small, too expensive and too short-term.

Critically, the finance that is being delivered is poorly aligned with the needs of transformational growth. Far too much continues to go to sectors with little or no contribution to transformational growth, such as extractives, short-term working capital and households consumption.

By contrast, far too little is going to the long-term, large-scale capital investments needed for employment creation and productivity increases. The finance gap is particularly notable in the key sectors for transformation - infrastructure, agriculture and manufacturing – and overall investment remains stubbornly low.

More needs to be achieved - and more rapidly – to address these gaps in finance if economic progress and climate resilience is to be achieved.

In this briefing note, we firstly review this progress and gaps in more detail and then turn to the more critical question – what to do next to deliver the finance that is needed?

More detailed discussion and the full academic evidence is included in the working papers referenced at the end of this briefing.

2 What progress has been made and what gaps remain?

Since 2000, sub-Saharan Africa has seen significant progress in financial development. In this section, we review this progress as well as the remaining gaps.

2.1 Progress has been strongest in financial access

The major achievement in relation to financial development in the region has been the expansion of financial access for households which has increased by 19% since 2000 to 36% - a near doubling of access levels. This progress has been driven by the widespread uptake of mobile banking and the emergence of large regional banks.

However, progress in expanding financial access has been uneven. There has been less progress in access for SMEs and more needs to be done to close the gender gap.

Progress has also been uneven between countries. Kenya, Uganda, Ghana and Tanzania have achieved high levels of access. But in many LICs and FCAS and resource-dependent middle-income countries (such as Angola, Cameroon and Nigeria) access remains low and reliance on informal finance high.

2.2 Bank lending remains misaligned with transformation

Lending to the private sector as a percentage of GDP has reached a regional average of 17.7% in 2018. Whilst this shows good rates of growth, it remains below that needed for economic development.

Also critical is that bank lending is poorly aligned to the needs of economic transformation. Most bank lending goes to extractives or economic activities which support short-term household livelihoods and consumption (such as microfinance and short-term commerce and trade) but not transformational change.

By contrast, manufacturing, infrastructure, and agriculture received only 15%, 8% and 5% of total lending respectively in 2018. This is well below that needed to increase productivity and drive mass employment creation in these key sectors for transformation.

A further key problem is the high cost of credit and short tenure of bank lending. Margins has shown little or no compression over the last two decades - despite increased competition - and average 10.6% in 2018, the highest globally. This suppresses investment.

2.3 Domestic savings mobilization has made traction

Almost all countries have made progress - and some countries have made strong progress – in domestic saving mobilisation. Kenya, Mozambique and Togo have achieved levels of domestic savings that, by 2017, exceeded 40% of GDP. However, there are a notable number of countries where savings mobilisation remains below 20% and more progress is needed.

There has also been relatively little traction in mobilising savings through insurance, mutual funds and pension funds – although, again, with some notable exceptions. In Kenya, Tanzania and Uganda, for example, pension assets reached 13.2%, 8.5% and 8.2% of GDP respectively in 2017. This has been driven by the development of private institutions such as insurance companies and mutual funds for low-income households (in Kenya) or by government-mandated pension contributions for public employees (in Tanzania and Uganda).

2.4 Capital markets remain underdeveloped

Capital markets play an important complementary role for bank financing in economic development. They are particularly important for mobilising large scale and long term finance such as that needed for infrastructure and capital investments in the private sector.

To date, twenty-eight sub-Saharan African countries have national stock exchanges and the total capitalisation exceeds more than $1.1 trillion. But capitalisation remains small relative to GDP and the number of listings is low. Further, markets are dominated by public debt (and especially short-term government debt) and, the limited number of corporate issues has been concentrated in financial services and extractives. The range and tenure of securities are limited, secondary market liquidity is weak and the investor base is too small.

2.5 Financial regulation have strengthened but so have challenges

There has been steady progress in improving the regulatory and governance and banks have high levels of capital and liquidity. There has been the broad enactment of Basel I and selected aspects of Basel II and III.

Nevertheless, financial shocks have occurred. there have been failures of individual banking institutions (most commonly because of failures of governance, insider lending and corruption) and systemic problems in a few countries (For example, in Ghana in 2015 and

Nigeria in 2009 and 2015). There has also been significant growth in Eurobonds which increases risks of financial instability and debt sustainability risks with, at the times of writing, Zambia in default and others at high risk of default.

A further regulatory challenge has been the growth in regional banking. At present, there are 10 major pan-African banks based in Kenya, Nigeria, South Africa and Togo. They have contributed to the expansion of financial access and credit growth including for households and SMEs. However, they also have greater exposure to the less creditworthy SME sector – with commensurately higher non-performing loans – and create cross-border contagion risks. Regulators are developing cross-border supervisory colleges and regional regulatory harmonisation to tackle these risks.

2.6 Gaps remain in the 'financial architecture'

There are notable gaps in the 'financial architecture'. Intermediation is impeded by thin interbank markets and gaps in credit bureaus. Risk management is impeded by illiquid or absent markets for products such as foreign exchange and interest-rate derivatives. There is an absence of specialist exchanges such as commodity exchanges. Remittances and payment systems remain expensive especially for small amounts, although mobile platforms and digital currencies are rapidly transforming these services. These gaps in the financial architecture create inefficiency, impede specialist functions and can act to make the banking sector more fragile and susceptible to shocks.

3 What are the policy priorities?

In this section we make policy recommendations to address the issues discussed above.

3.1 Achieving universal financial access

In many LICs and FCAS, poverty – and extreme poverty - remains high. Addressing this through further increases in financial access for low-income households is a policy imperative. Successful approaches have included ringfenced funds for commercial banks to provide credit to targeted groups such as low-income households and micro and small businesses. This should be continued.

3.2 Further development of capital markets

Further development of capital markets is needed. Recent interventions have included donors providing technical support to regulators and acting as anchor investors and providing technical assistance to support the issuance of local currency bonds and bonds whose proceeds are committed to low-income households, SMEs and green infrastructure (most commonly energy). This are proving effective in mobilising funds for these key areas. However, their scale remains small and it is not clear if they positively effect broader market development.

Policy efforts to tackle these problems have included improving regulation and incentives such as tax breaks. International development partners have offered technical capacity building to support these efforts. However, to date, these have not been particularly effective in accelerating capital market development.

More needs to be done to bring corporate issuers to market. As noted, donors acting as anchor investors and providing technical assistance for new issuers is positive but needs to be scaled further.

Development finance channelled through private equity-style funds need to do more to exit via capital markets rather than non-listed transaction. However, valuations in the public markets and predictability of access to these markets need to be tackled to make this a reality.

Both need to be directed more into transformational sectors including infrastructure (such as clean energy, urban infrastructure and logistics) and private sector development.

For the latter, agriculture and manufacturing are of particular interest because they are currenlty underfinanced despite being critical for inclusive growth because of their role in employment creation and sustainable rural livelihoods).

It is also important to deepen the investor base. This can be supported by further regulatory reforms to grow the pension, mutual and insurance fund sector and expanding the range of products in which they can invest.

Increasing issuers and investors will need more innovation. New products are needed. Development partners could help develop listed investments tailored to the risk and fiduciary needs of institutional investors. Securitised or mutual funds could act as aggregators in sectors where finance is granular, such as in agriculture or micro-finance and micro-infrastructure.

Another approach would be for issuers to list on non-domestic markets include regional exchanges and international capital markets. This is especially relevant for smaller economies where their local investors base has limitations. It is also relevant for larger issuers for whom demand may not meet their financing needs.

To date, regionally, there has been cross-listings. This should be progressed further with a view of regional hubs for capital markets. Increasing regional cooperation through the African Union and continual strengthening of trading and currency blocs including in East, West and southern Africa may make this more politically feasible. Encouraging discussion within policy circles would assist in further thinking on this issue.

Internationally, to date, the African issuers in London and New York have been concentrated in extractives. Nevertheless, there have been some modest diversification of companies coming to market. For example, the London Alternative Investment Market (AIM), a specialised capital market for relatively small companies and funds, have seen issuances by African names in logistics, agricultural processing, financial services and airlines. More companies could be brought to these international hubs but need support to meet the transparency and governance requirements for a listing and to provide attractive investment products for institutional investors.

Key further paper in the FSD Africa-ODI series: Tyson, J. (2021) Capital Markets Development in Sub-Saharan Africa: Progress, challenges and innovations. See references for link.

3.3 Tapping into green finance

Africa is vulnerable to climate change including through expansion of arid areas and disruption to rain fed agriculture. Further, the region needs to make sure that future economic growth is climate Adapted. Mobilising green finance to address climate adaptation and to build Green infrastructure to support economic development are particularly important.

There have been initiatives in the region to develop green bond markets most commonly led by central banks. Recent initiatives include strengthening of the legal and regulatory framework through national green bond programmes in Morocco, South Africa, Nigeria and Kenya. These have introduced clear green bond guidelines and governance including independent certification and monitoring of proceeds, issuing benchmark sovereign green bonds and developing securitization vehicles.

These are important initiatives but to date there have only been 16 bond issuances across the region. These initiatives need to continue and there needs to be specific efforts to attract institutional investors from the domestic market into capital markets including green bonds as part of the initiatives discussed in 3.2 above.

A further important new trend for the region is the global growth in green finance and especially green bonds[1]. These market trends are creating a unique opportunity for developing countries to access green finance.

However, to date, there has been a low level of participation by Africa. Unfortunately, the region is a relatively unattractive option for international investors because of higher risks in relation to foreign exchange, political risk and the macroeconomy – all of which are difficult to hedge. In addition, there are insufficient ‘bankable’ green and social assets or projects suitable for bond financing and potential green investors have high governance standards for green and social goals and fiduciary and regulatory responsibilities which limit the risk of assets in which they can invest – effectively excluding them from investing in many African countries.

Further, although IFIs have mobilised significant finance for green infrastructure and the SDGs through innovative funds and blended finance there has been minimal allocation of finance from such initiatives to sub-Saharan Africa. Such specialist funds need to be expanded into include a greater focus on sub-Saharan Africa and

[1] Defined as bonds whose proceeds are to be used for financing climate change and adaptation or socially responsible goals[1] - or more formally bonds which comply with the Green Bond Principles (GBP) and standardised certification of a bond as ‘green’ - this emerging asset class has grown exponentially to more than $6 trillion in the last decade. Common uses the proceeds include the financing of green infrastructure particularly in energy, transport, buildings and agriculture as well as wider variety of uses of green bonds including, for example, financing of projects directed towards preserving the environment or biodiversity. (Tyson, 2020)

especially its' low-income countries and into particular sectors of interest for transformation and poverty alleviation (such as the employment intensive manufacturing and agriculture).

Key further paper in the FSD Africa-ODI series: Tyson, J. (2021) Capital markets and Green Finance in Sub-Saharan Africa. See references for link.

3.3 Continued support for development banking

As noted, private finance is poorly aligned to the needs of development and these problems are likely to persist because of inherent risk and commercial incentives.

This means there is a need to maintain support for public development banks. These have had a mixed history in sub-Saharan Africa including because of poor management and corruption. However, there have been recent examples of successful regional development banks. For example, the African Development Bank is being instrumental in leading investment in infrastructure, industrialisation and agriculture. These are highly compatible with the needs of economic transformation.

Given this, there is a good argument to consider greater capital financing from donors and from national governments for development banks that are well governed and can demonstrate a track record of successful investment for economic transformation.

3.4 Technology and digitalisation are crucial enablers

As noted, key issues in the current financial landscape includes gaps in financial access and high cost of finance. Fintech can act as a key enabler to tackle these issues especially in the context of sub-Saharan Africa because of the high uptake in mobile finance.

Financial service providers have seized on the opportunities offered. Examples include digital payments, credit assessment, loan allocations and insurance services. There is also ongoing innovation outside of basic financial services. Online shopping is booming in the region. Crowdfunding and crowd investing have grown at a rapid rate with 57 African funding platforms which generated over $200 million in 2018.

Supporting these innovations including providing venture capital from donors engaged in private sector development is essential.

Also important is to support regulation and governance in parallel with the expansion of digital services given their susceptibility to fraud and money-laundering. One way to do this is the use of block chain technology. However, in the region currently, there has been limited uptake of block chain technologies. This should be a focus for national governments and donors. Also important is to ensure that governance of customer remains strong including know-your-client and customer protection.

4 Concluding remarks

Over last two decades, the fundamentals within the banking sector in sub-Saharan Africa have been established and there has been significant success in financial access. However, the financial sector remains poorly aligned with the needs of economic transformation.

Policy should maintain successes in development banking and expanding financial access into LICs and FCAS. Beyond these basics, capital markets development – including regional integration and tapping international capital - are key. Further, the global trend towards green finance and Fintech are particularly significant for the region.

Finally, in order for these opportunities to be seized it is also important that there is a focus on political economy. Key is deepening of regional cooperation and harmonisation of regulations and governance frameworks.

In the region in the last two decades, there has been significant progress in deepening in such cooperation including substantial progress led by the African Union and by the various regional economic communities. These need to continue to be extended to ensure that barriers to further financial development are tackled to the benefit of all countries in the region.

References

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Further reading

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Photograph suggestions (links) or photo supplied or graphic idea	None
Alt-text/caption/credit for cover photo	N/a
Short summary text for webpage (200–400 words)	Financial development has progressed well in sub-Saharan Africa but key further goals include universal financial access in LICs and FCAS, further development of capital markets, tapping into the global growth in green finance and public finance for infrastructure, industrialisation and agriculture. Technology is going to be a critical enabler of further efficiency and access in financial development.
One sentence summary for web (<155 characters)	Financial development has progressed well in sub-Saharan Africa but key further goals include universal financial access in LICs and FCAS, further development of capital markets, green finance and public finance for infrastructure, industrialisation and agriculture remain critical goals.
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