Regional Financial Integration in Sub-Saharan Africa

Montfort Mlachila

IMF Senior Resident Representative, South Africa

Keynote Presentation at the XXVII Lisbon Meeting of the
Central Banks of Portuguese-Speaking Countries

Banco de Portugal, Lisbon
9 October 2017

Introductory remarks

Governor Carlos da Silva Costa,
Governors and representatives of the Central Banks from the Portuguese-speaking countries,
Distinguished delegates,
Ladies and gentlemen.

First and foremost, I would like to thank most sincerely Governor Silva Costa for inviting me to address this august assembly. I must confess that I was a little mystified to be chosen, especially since I do not speak any Portuguese at all. It is such a great honor that I could not refuse. And of course, the allure of coming to Lisbon to sample the local cuisine and savor the great wines was irresistible.

Defining regional financial integration

I would like to start by defining what I mean by financial integration. At its most basic we can view it at three levels: international, regional, and local. At the international level, financial integration usually refers to the extent to which economies are linked to international capital markets, usually through portfolio and other capital flows, such as bonds and equities, to keep it simple.

But my focus today is on regional financial integration. It refers to a situation that prevails when financial systems within a region talk to one another, and exchange significant financial flows and data regularly as a matter of course. While we tend to reduce financial systems to banks—often due to lack of data—even in Africa the financial boundaries are ever shifting, now more than ever. It is undoubtedly true that African financial systems are bank dominated, but the role of nonbank financial institutions is increasing, especially in Southern Africa. Thus, we also should look at stock exchanges, bond markets, and less traditional players such as telecommunication companies (telcos) as an integral part of the financial system.

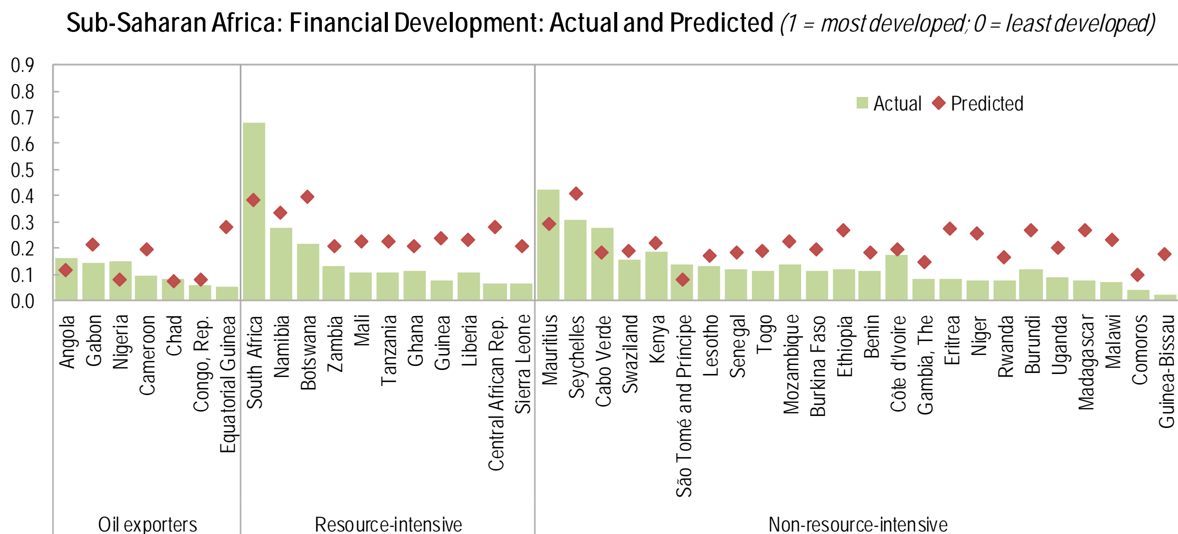
While my focus is on regional financial integration, I think that it is equally important to be aware of financial integration at the national or local level. This means bringing more people into the financial system, building bridges between the haves and have-nots, whether they are separated by geography, income, gender, or age. It's what we typically term financial inclusion, but I will not focus on this specific aspect this morning.

Why should we care?

There are many reasons why deeper financial development—the increase in deposits and loans but also their accessibility and improved financial sector efficiency—is good for sustainable and inclusive growth in sub-Saharan Africa. For one, it helps mobilize savings and direct funds into productive uses, for example by providing startup capital for the next innovative enterprises. This in turn facilitates a more efficient allocation of resources and increases overall productivity. It also supports the creation of a larger variety of products and services, improves the management of risks, makes payments easier, and helps lenders better monitor their clients. In addition, it provides instruments, such as insurance packages, and information that can help households and firms cope with negative events, ensuring more stable consumption and investment.

But how much more financial development could sub-Saharan African countries realistically achieve? A combined index of the various dimensions of financial development shows there's a substantial gap between the level of financial development at which many sub-Saharan African countries are currently operating, and their potential compared to other regions with similar structural characteristics.[1]

Figure 1.



Source: Sahay and others 2015b, and IMF staff estimations.

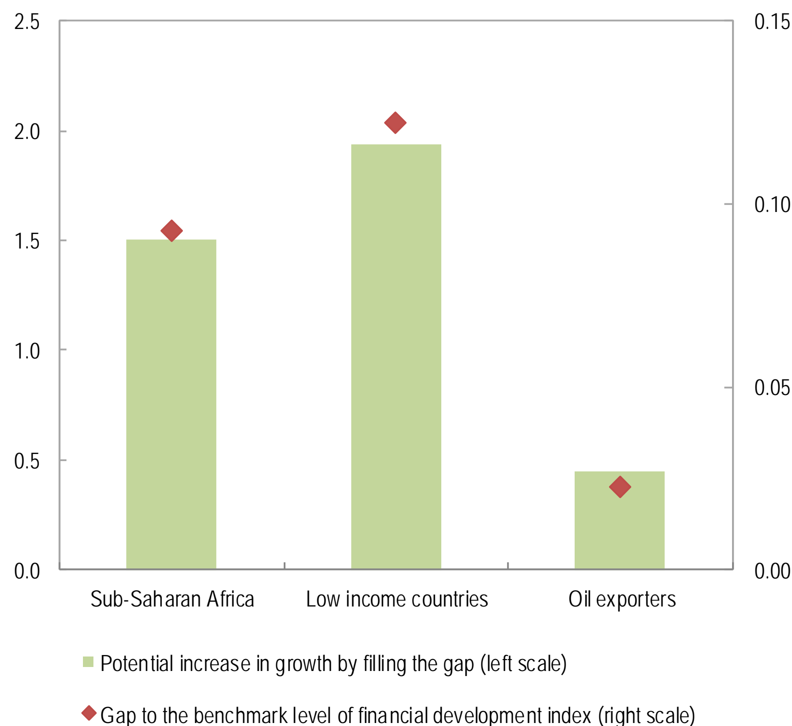
[1] The index was developed by Sahay *et al*. (2015).

Given the small size of most African economies, regional financial integration has the potential to accelerate financial sector development, and consequently growth, for several reasons. First, both banks and capital markets can benefit from economies of scale. Second, having a regional financial infrastructure expands the pool of resources available for financing. Third, a bigger market typically offers opportunities for portfolio diversification and risk-sharing.

So, the possibilities for further financial development are substantial, and the impact of filling this gap is estimated to be about 1½ percentage points additional annual growth for the median sub-Saharan African country, with variations across country groups.

Figure 2

Sub-Saharan Africa: Potential Growth Increase from Higher Financial Development



Source: IMF staff calculations.

Channels and catalysts of regional financial integration

There are two main drivers of regional financial integration in SSA. First, at the policy level, there have been deliberate initiatives to create institutions, mechanisms, and regulations that foster it. For instance, in the West African Economic and Monetary Union (WAEMU), there was a conscious effort to create a regional stock exchange, the *Bourse Régionale des Valeurs Mobilières* (BRVM) in Abidjan, Côte d'Ivoire.

Second, from the private sector perspective, the profit motive has been the driving factor. Pan-African Banks (PABs)—those banks that have chosen to expand their network beyond their home base to as many African countries as possible—have been the most notable change agent. They have been driven by many factors, including financial sector liberalization in host countries (including through privatization); the wish to support home interests in foreign markets; diversification potential; and finally, the relative saturation of their home markets. Typically, the process has been facilitated by the more advanced technological know-how of these banks. At the same time, growing SSA economies and the fact that most countries are underbanked has provided additional impetus. Finally, the withdrawal of some European and American banks—largely driven by de-risking—has offered PABs opportunities for market entry.

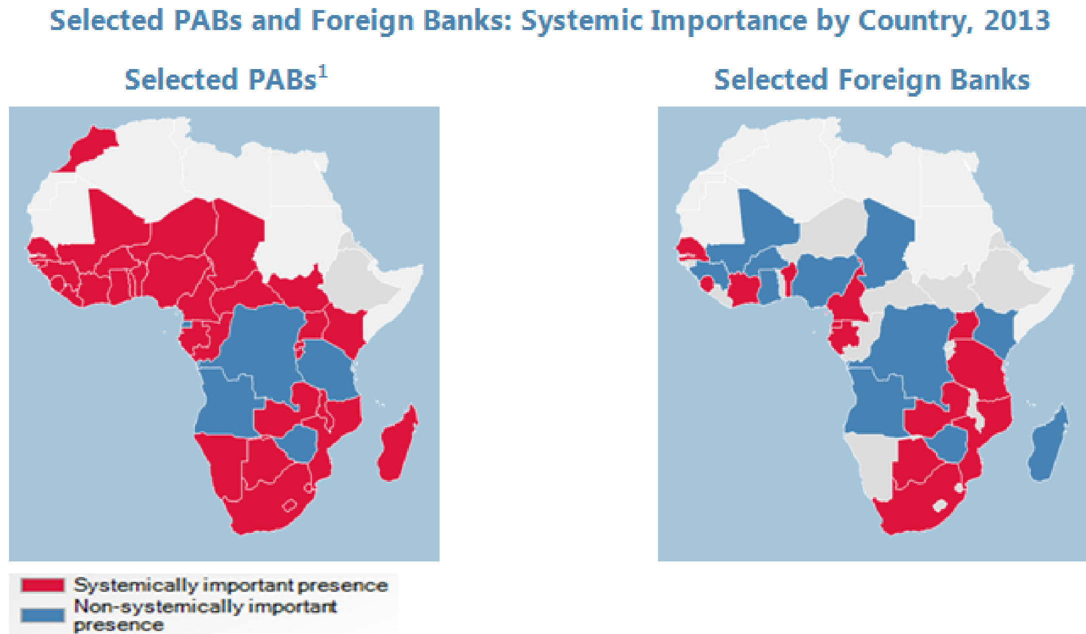
Technology, including mobile banking, has also reduced the cost of establishing banking networks and maintaining customer accounts. I will return to this point later.

Stylized facts about regional financial integration

Pan-African Banks are undoubtedly the most defining feature of regional financial integration over the past decade. They have expanded rapidly, often by way of acquiring existing local banks. The scale of their operations has become larger than that of traditional European and American Banks, as the latter reduced their operations in Africa in the aftermath of the global financial crisis in part because of the need to recapitalize their units operating in advanced economies. PABs have filled the void and created market-based financial integration.

PABs have a broad geographical reach—out of the seven PABs, all have a presence in at least 10 countries, and Ecobank has subsidiaries in more than 30 countries. In addition, in many countries, they have become systemic.

Figure 3.



Sources: Annual reports, Bankscope and IMF staff estimates.
Note: Systemically important presence includes subsidiaries and parents with a deposit share of more than ten percent of banking system deposits.
[1]The boundaries, colors, denominations, and any other information shown on the maps do not imply, on the part of the International Monetary Fund, any judgment on the legal status of any territory or any endorsement or acceptance of such boundaries.

These banks have been particularly active in syndicated loans, especially in the financing of infrastructure, and supporting local markets. Thus, some of them have gone beyond traditional banking activities to embrace operations in capital markets, insurance, pensions, money transfers, and micro-finance.

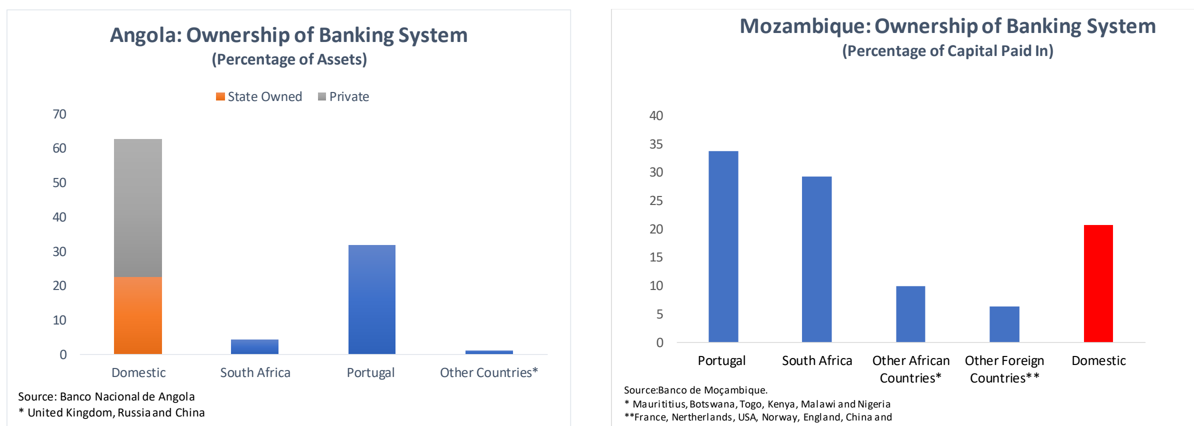
The growth of PABs has undoubtedly contributed to financial sector development. It has promoted competition for deposits and loans. The clientele has also expanded beyond large domestic and multinational entities to reach underserved segments of the market, including SMEs.

But PABs are not the only movers and shakers in regional financial integration. At a regional level, some banks have also been active. Kenyan banks have embarked on cross-border expansion, and they now have over 300 branches in East Africa. Both push and pull factors have played a role: the Kenyan banking sector has over 40 banks, while the neighboring countries have much fewer.

Since I am mainly addressing representatives of Lusophone countries, let me take a closer look at two case studies: Angola and Mozambique. They offer quite interesting and contrasting perspectives on regional financial integration, although they both have relatively similar levels of the financial development index developed at the IMF. The Angolan banking system is dominated by domestic (and some of them public) banks which hold about ⅔ of assets. It has only a small footprint by African banks, with most of the rest of the banking system owned by Portuguese banks. Interestingly, Angolan banks have expanded to other countries such as Cabo Verde, Namibia, and even to Portugal.

One of the key immediate challenges facing the Angolan baking system is the withdrawal of *direct* correspondent banking relationships in US dollars (although euro-related transactions remain). This has manifested itself by way of difficulties in accessing dollar bank notes. Some correspondent banks have preferred to withdraw from this line of business—which often has low margins—in the facing of tightening anti-money laundering and combating the financing of terrorism (AML/CFT) regulations and high-profile enforcement actions resulting in high penalties. This is an issue that is of concern for several other countries in the region and beyond.

Figure 4



The Mozambican banking system, in contrast is foreign-dominated, and by banks from a broader range of countries. While Portuguese and South African banks have the lion's share of the market, other African banks from Botswana, Kenya, Malawi, Mauritius, and Togo are also present.

The weaker economy has undoubtedly had a negative impact on the health of the Mozambican banking system. GDP growth sharply declined from 6.6 percent in 2015 to 3.8 percent in 2016. In this context, NPLs have been rising, but the capital and liquidity

positions of the main banks remain comfortable. The central bank recently raised the minimum capital requirements and introduced a minimum liquidity ratio. It also liquidated one insolvent bank and intervened another systemic bank.

Other aspects of regional financial integration are relatively underdeveloped. Except for the WAEMU and CEMAC, there are no regional stock exchanges. And excluding the Johannesburg Stock Exchange and to a lesser extent, the Lagos and Nairobi Stock Exchanges, most of them are very small and illiquid. Thus, they offer limited attraction for foreign investors from the region or elsewhere.

Uplifting stories of financial integration in Africa

But beyond these important trends, which are generally well-documented, there are other on-going changes below the surface. These may well change the financial landscape and the face of regional financial integration in SSA in the coming decade.

Apart from the success of PABs, there are several interesting success stories I would like to discuss. We all know that Africa has been a world pioneer in mobile banking, but one of my favorite stories is of a company that goes a step further. It uses innovative approaches to technology and finance. M-Kopa Solar in Kenya sells small solar panels to low-income households by allowing customers to acquire a kit by making micro-payments via their mobile phones after an initial down-payment of about $35. This allows low-income households to acquire an asset of about $200 through their micro-savings, something that they could never do under normal circumstances. At the same time, the payment record provides the company a way of assessing their creditworthiness for future credit. Thus, the company has showed that even so-called “unbankable” segments of the population can provide profitable opportunities for financial services, thereby integrating them into the financial system. Over 500,000 homes now have solar power in Kenya, and the company is expanding beyond its home base to other East African countries.

The SADC Integrated Regional Settlement System (SIRESS) is another uplifting story of regional financial integration. The aim of SIRESS is to reduce overreliance on international networks such as SWIFT and correspondent banks for regional cross-border transfers. Efficient regional payment systems can promote and support regional trade and other financial flows by increasing speed and convenience. At the same time, they can reduce risk and the cost of cross-border payments. By potentially allowing settlements in other domestic currencies, it has real potential to expand rapidly. Initial results are encouraging in terms of the rapid increase in transactions, notwithstanding some problems in terms of insufficient cost savings.

The *Agence UMOA-Titres* (AUT) has played an interesting role in developing the regional sovereign bond market in the WAEMU region. Its role is to provide assistance to member states in their financing operations on the financial market by coordinating securities issuances. It is also responsible for the conduct of auctions, oversight of market conduct, publication of market data, and investor relations. As a result, it has provided governments in the region with a wider market for their securities, and undoubtedly led to the extension of maturities as well as lowering of yields, compared to national issuances.

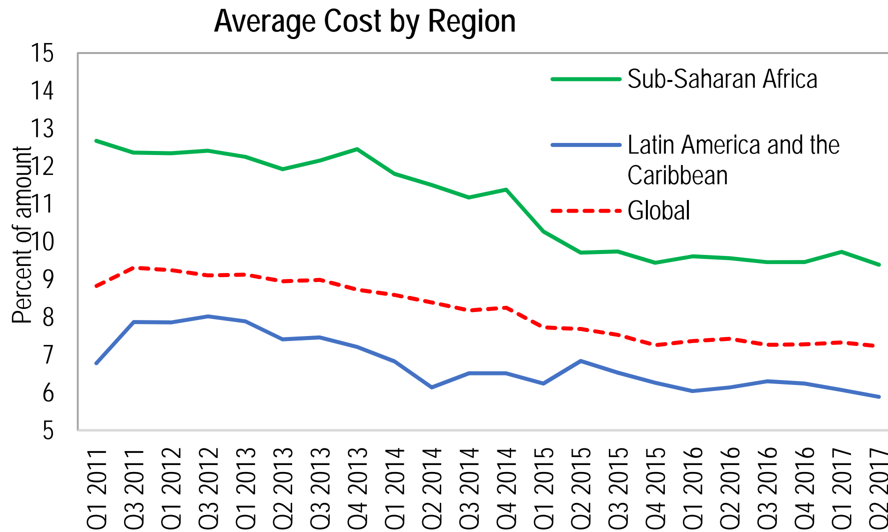
Fintech will be a game changer

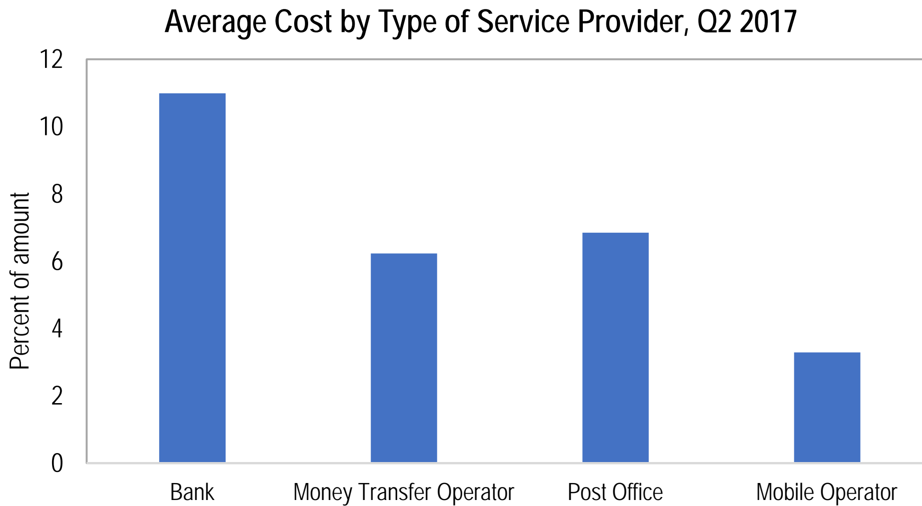
Financial technology, or fintech, is already having an impact in several areas that are relevant for financial integration. Fintech encompasses a new wave of technological innovations that leverages the explosion of big data on individuals and firms, advances in artificial intelligence, computing power, cryptography, and the reach of the internet. Recent work done at the IMF, in relation to our discussion today, shows that fintech may improve cross-border payments, including remittances, by offering better and cheaper services.[2] It may also lower the cost of compliance with AML/CFT regulations, which has been one of the driving factors in the reduction of correspondent bank relations (de-risking).

These facts highlight the potential of fintech as a game changer to make financial services more affordable and secure, with significant benefits already apparent in countries with less developed traditional financial sectors. Low-income countries, in particular, could use technology to leapfrog traditional paths to financial deepening, and fintech offers the potential to address the problems stemming from the loss of correspondent banking relationships.

[2] He *et al.* 2017.

Figure 5
The High Cost of Sending Remittances





Source: *Remittance Prices Worldwide* – Issue 22, June 2017.

One example of the advanced use of big data to promote financial integration at the local level is the Indian *Aadhaar* identification system. It uses a unique identity number issued to all Indian residents based on their biometric and demographic data. Its use has drastically reduced the cost of administration of cash transfers by allowing the transfer of money directly into people's cards, instead of forcing them to queue. By reducing the traditional heavy reliance on cash, it can bring more people into the banking system and boost financial inclusion. At the same time, the cost of know-your-customer (KYC) requirements for banks are reduced. As a result, financial inclusion has increased significantly, and more than 400 million accounts are now linked to *Aadhaar*.

Bottlenecks and roadblocks to regional financial integration

While we can all agree that regional financial integration is good, the path is often littered with bottlenecks and sometimes outright roadblocks. Financial liberalization has undoubtedly helped facilitate the entrance of foreign participants into domestic markets, but unfortunately regulatory and supervisory frameworks, especially for cross-border banking, have not kept pace. This imbalance has led to increased risks.

The relatively low penetration of mobile financial services in West Africa is likely due to different philosophical approaches to regulation. The approach in East Africa has been to be flexible in regulating telcos that are involved in the provision of financial services. The approach seems to have been "*What is not explicitly forbidden is generally allowed,"* while in West Africa the approach has typically been "*What is not explicitly allowed is forbidden*". There is some tension as to where the appropriate balance is, but regulators should always be on the alert to nip in the bud some as-yet unrecognized risks.

Avoiding what I call "own goals" is something policymakers should always be cognizant of. Policies that impede the proper functioning of markets are damaging to financial integration and development. Measures such as administrative controls of exchange rates in Nigeria and interest rate caps in Kenya are clearly unhelpful.

One might think that having more open economies in the sense of greater international (and regional) financial integration should automatically lead to higher levels of financial development. While the theory on this is well-established[3], our own empirical work in SSA shows that there is no direct and robust link between international financial integration and financial development. [4] The outcome seems to be state-contingent. We find some evidence that international integration can drive financial development in countries that have good institutions. Specifically, we find that there is a larger impact of financial integration on financial development the stronger the scores in some measures of the quality of banking regulation and supervision.

---

[3] See, for instance, Rajan and Zingales (2003).

[4] David, Mlachila, and Moheeput (2015).

What it all means for policy makers

So, what does this all mean for policymakers? Clearly financial integration at all levels is good for financial development and economic growth. That said, some modesty is in order in terms of the results. The empirical evidence shows that it takes time for financial integration to have a significant impact on financial development. Policymakers should therefore be cautious about expectations regarding immediate gains from financial integration.

They should also be aware of the risks. The flipside of financial integration is the risk of negative spillovers and spillbacks. African countries suffered less in the immediate aftermath of the global financial crisis precisely because they were not highly integrated to the global financial system. The geographical spread and systemic importance of PABs in some countries now make them a potential vector of financial spillovers.

At the same time, the rapid expansion of PABs poses new oversight challenges, which, if left unaddressed, could raise systemic risks. Greater integration has benefits, but interconnectedness means that countries are more exposed to spillovers from cross-border shocks, in case a parent bank or important subsidiaries were to be subject to financial distress. This is a thorny issue that has yet to be resolved. How can countries avoid spillovers, for instance from hallowing out of the capital base by the headquarters in support of ailing subsidiaries? Who is ultimately responsible for bailing out the mother ship (holding company) should it fail?

Given the increasing regional financial integration, it is incumbent upon policymakers to be aware of the roles that come with it. The financial sector is expanding in depth, scope, and sophistication within countries and at the regional level. Regulators should therefore avoid complacency by ensuring strong governance and compliance with regulations. Cross-border cooperation and consolidated supervision through joint inspections and supervisory colleges are needed. Also, it is essential to harmonize regulations and supervisory procedures to avoid regulatory arbitrage.

One emerging risk that policymakers have not fully integrated is that from macro-financial linkages. The weakening of SSA economies has led to the weakening of both public and private sector balance sheets. Thus, banking systems are coming under stress in several countries, including because of high public debt levels. A dramatic deterioration of the sovereign's repayment capacity can further hurt banks' balance sheets, possibly even triggering the failure of vulnerable financial institutions. In turn this may impose large fiscal costs, including in the form of bailouts, creating a negative feedback loop.

Our own empirical work finds that commodity price shocks can increase financial sector fragility by lowering capital adequacy, profitability, and liquidity.[5] In extreme cases, they can lead to outright bank failures and financial crises.

This work highlights the importance of macro-prudential policies: countries that have good macro-prudential policies, complemented by adequate fiscal buffers are better able to cope with exogenous shocks such as commodities price shocks. As financial sectors become more integrated and complex, building risk assessment capacities of supervisory agencies to prevent spillovers and spillbacks between the financial sector and the rest of the economy is vital. This could take the form of capacity building in macro-prudential tools and analyses, developing stress-testing and early-warning indicators, and establishing better data collection and dissemination systems.

Concluding remarks

Let me conclude by highlighting a few of the key points I would like you to take away this morning. First, I think no one needs to be convinced that regional financial integration is good, even though it may be accompanied by increased risks, and that it should be complemented by integration at the national level. It is good for financial development, and consequently it is good for economic growth and reduces its volatility. Notwithstanding the great strides made in financial development, it is still very low in the region, so a lot more needs to be done to enhance regional financial integration.

As mentioned, the flipside of greater financial integration is the rising risk of spillovers and spillbacks. The increasing sophistication and interconnectedness between financial markets suggest the need for regulatory frameworks to support regional financial stability. This highlights the need for cross-border information-sharing among supervisors. The time is now ripe for tackling the thorny issues of cross-border resolution frameworks that can reduce the risk of financial contagion following banking distress. As a South African proverb says, "*the best time to plant a tree is 20 years ago; the next best time is now.*"

---

[5] Kinda, Mlachila, and Ouedraogo (2016).

Selected References

Abraham, R., E.S. Bennett, S. Sen, and N.B. Shah. 2017. "Financial Inclusion", in *State of Aadhaar Report 2016-17*, IDinsight.

African Development Bank. 2014. "Harnessing Regional Financial Integration" in *Regional Integration for Inclusive Growth*. African Development Report 2014.

David, A., M. Mlachila, and A. Moheeput. 2015. "Does International Integration Matter for Financial Development in Africa?" *Applied Economics*, 47:15, pp. 1525-1549.

Finmark Trust. 2017. "Study on the Impact of SIRESS—Project Extension: Developing a business case and understanding pricing governance for commercial bank participation in SIRESS."

He, D., R. Leckow, V. Haksar, T. Mancini-Griffoli, N. Jenkinson, M. Kashima, T. Khiaonarong, C. Rochon, and H. Tourpe. 2017. "Fintech and Financial Services: Initial Considerations," IMF Staff Discussion Paper 17/05.

Kinda, T., M. Mlachila, and R. Ouedraogo. 2016. "Commodity Price Shocks and Financial Sector Fragility", IMF Working Paper 16/12.

Mecagni, M., D. Marchettini, and R. Maino. 2015. "Banking in Sub-Saharan Africa: Key Features and Challenges," in *Recent Trends in Banking in sub-Saharan Africa: from financing to investment*," European Investment Bank.

Mlachila, M., A. Jidoud, M. Newiak, B. Radzewicz-Bak, and M. Takebe. 2016. "Financial Development in Sub-Saharan Africa: Promoting Inclusive and Sustainable Growth," African Department Paper 16/5, International Monetary Fund.

Rajan, R., and L. Zingales. 2003. "The Great Reversal: The Politics of Financial Development in the Twentieth Century," *Journal of Financial Economics*, 69, pp. 5-50.

Sahay, R., M. Cihák, P. N'Diaye, A. Barajas, R. Bi, D. Ayala, Y. Gao, A. Kyobe, L.Nguyen, C. Saborowski, K.. Svirydzenka, and S.R. Yousefi. 2015 "Rethinking Financial Deepening: Stability and Growth in Emerging Markets," IMF Staff Discussion Note 15/08.

Vibe Christensen, B. 2014. "Financial Integration in Africa: implications for monetary policy and financial stability," BIS Papers No. 76. Bank of International Settlements.