A CRITICAL REVIEW OF LITERATURE ON FORMAL AND INFORMAL FINANCE IN SENEGAL

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I. INTRODUCTION

A number of recent documents coincide in describing the Senegalese economic situation as precarious and its prospects for improvement as uncertain (Courcel, USAID, Wharton, World Bank 1989). Senegal shows the lowest GDP growth rates of all francophone countries in the continent since independence, about 2.3 percent per year for a population growth rate of almost 3 percent. As a consequence, both rural and urban per capita incomes are at present lower in real terms than in 1960.

On the one hand, an over-dependence on agriculture, primarily groundnut production for export, makes the Senegalese economy vulnerable to climate and world market fluctuations. The droughts of 1980, 1981 and 1984, and the downward trends in prices in the international edible oil markets seriously affected Senegalese export revenues and overall economic growth. On the other hand, the burden of inefficient public structures, notably the "Organisation Nationale de Coopération et d'Assistance pour le Développement" (ONCAD), and a lack of fiscal discipline contribute to the poor performance of the Senegalese economy in the first half of the current decade. Hence, after once holding a predominant position among the former French colonies in West Africa, Senegal now lags far behind Cameroon and Côte d'Ivoire in overall economic status. Current projections indicate only modest GDP per capita growth at best, and most likely a continuing fall in income if reforms are not implemented and external financing does not meet expectations.

The Senegalese formal financial system, in the midst of a liquidity and stability crisis, appears unable to perform its functions of domestic savings mobilization and funds allocation. The delinquent portfolio of the banking system approaches one-half of total loans outstanding and almost 30 percent of total assets, while illiquidity is becoming a widespread disease in the banking system. Growing concern in the Government of Senegal (GOS) and among the donor community has resulted in a banking sector reform program already being implemented with French, USAID and World Bank assistance.

Although the banking sector policy reform appears to be comprehensive and addresses the key issues of the current banking sector crisis, its effects on the overall (formal and informal) financial system have not been ascertained in the literature associated with the reform. This report attempts to provide USAID with some insights into the impact policy-induced changes in the banking system are likely to have on the overall financial system of Senegal.

The report critically reviews the literature on formal and informal finance in Senegal, emphasizing the materials dealing with the less-known informal financial sector. The next chapter reviews the status of the formal financial system, emphasizing discussion of the major constraints faced by the banking system, and particular features of formal agricultural finance. The literature on informal finance is reviewed in Chapter III, devoting special attention to the references of the mid-to-late 1980s. The final chapter outlines a number of conclusions and recommendations derived from the review.

II. FORMAL FINANCE IN SENEGAL

As a member of the West African Monetary Union (UMOA), the formal financial sector of Senegal is under the monetary authority of the "Banque Centrale des Etats de l'Afrique de l'Ouest" (BCEAO). Prior to the current reform effort, the formal sector was comprised of 15 deposit-taking banks and nine non-bank financial intermediaries (USAID 1989). In addition, there are about 15 insurance companies and a private sector pension fund (Wharton). Formal financial services are concentrated in Dakar and are estimated to reach less than 40 percent of the country's depositors and borrowers (Arthur Young).

In this chapter, we review first the status of the Senegalese banking system and the major constraints and limitations currently being addressed by the new banking policy. Secondly, we devote a special section to a discussion of the current and prospective roles of the "Caisse Nationale de Crédit Agricole du Senegal" (CNCAS) and the implications for the provision of deposit and credit services in rural areas.

A. The Banking Sector and The Banking Reform

The banking system of Senegal is relatively well developed as compared to other Sahelian and most Sub-Saharan African countries, although it is still substantially less developed than those of comparable developing countries in other continents. There is one bank branch for every 100 thousand inhabitants in Senegal, while this density ratio reaches 250 thousand in Niger and about 280 thousand in Mali (Masini 1987). Developing countries of similar or lower per capita income in Asia and Latin America, however, show bank density ratios consistently below 50 thousand inhabitants per bank branch, i.e., a banking system twice as developed in physical size as that of Senegal. Moreover, the branch network of the 15 Senegalese commercial banks is heavily concentrated in the major urban centers[1]. Of the 72 bank branches in the country in 1989, 33 are located in Dakar and 11 in Saint Louis (USAID 1989). It is interesting to note that, despite the weak performance of the Senegalese economy, the total number of branches increased by 22 percent from 59 reported by Wharton for 1985 to 72 in 1989. However, the total number of locations serviced by bank agencies decreased from 13 in 1985 (Wharton) to 10 in 1989 (USAID 1989), therefore branches were closed out of some areas altogether while more were added to already serviced areas (i.e. Dakar and Saint-Louis).

The government holds directly or indirectly about 31 percent of the total equity capital of the 15 banks, while the local private sector owns 26 percent and foreign, primarily European, equity holders account for the other 43 percent. Until recently, however, the government has been able to exercise considerable control over the banking system through its dominant position in four of the five largest banks. Indeed, the government is the majority shareholder in the two largest banks (BNDS and USB)[2], and holds a substantial position in the BIAOS and the BICIS.

The four large banks indicated above plus the SGBS in 1989 account for about 63 percent of the total number of branches, 80 percent of the total assets in the banking system,

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[1] Including the National Development Bank (BNDS). See also Zarour (1989).

[2] See list of bank acronyms in the Appendix.

and a similar share of total private deposits (USAID 1989). While the share in total assets of these same five largest banks has decreased only slightly since 1985 (84 percent reported in Wharton), their share in the total number of branches is considerably lower than the 85 percent reported for mid-1985. Indeed, the absolute total number of branches of these five banks decreased from 50 in 1985 to 45 in 1989 (USAID 1989, Wharton). A drastic contraction in the number of branches of the BIAOS, one of the so-called "problem banks", is the primary factor underlying this reduction. As will be discussed later, a contraction in the total physical size of the banking system is likely to be observed as a result of the new banking policy; what happened with the five largest banks in the last four years is an indication of this trend.

Financial Sector Regulation

The two major sources of regulatory policies in Senegal are the BCEAO and the National Credit Committee. The former establishes general regulations for all member countries of the UMOA, notably credit ceilings and interest rates, while the latter implements and translates these regulations into specific guidelines and rules for local financial institutions.

The BCEAO exercises credit control mainly through the establishment of a quantitative ceiling on ordinary credit and annual ceilings for commercial bank and government refinancing with the central bank[3]. Of these, the only ceiling that has been consistently

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[3] Ordinary credit corresponds to credit to private and parastatal enterprises and households, excluding short-term crop credit.

exceeded every year since 1980 is the limit on BCEAO rediscounting of commercial bank credit to the private and parastatal sector (USAID 1989). This systematic excess of BCEAO rediscounting over the limit of 35 percent of total (ordinary) credit indicates that (a) banks are unable to mobilize enough deposits to finance their lending operations, (b) the constraint is not enforced by the regulatory authority and (c), the regulation is ineffective.

The Wharton report indicates that BCEAO refinancing ceilings constitute only partial controls of credit expansion because they have no impact on credit financed by deposits and foreign borrowing, and they do not limit indirect government borrowing through the parastatals (classified as non-government borrowing). Moreover, certain types of credit (particularly crop credit) are exempt from the ceiling (Wharton).

The National Credit Committee translates the BCEAO country credit ceiling into bank-by-bank and month-by-month credit ceilings, even though the BCEAO abandoned this practice in 1974 (Wharton). This regulation not only introduces substantial and unnecessary transaction costs in bank portfolio management, but also leaves ample room for arbitrariness in the allocation of credit shares to individual banks.

Interest rates in the UMOA member countries are controlled by the BCEAO through setting rates on loans rediscounted by the central bank, by fixing the margins that banks can apply on rediscounted loans, and by establishing a set of minimum rates on deposits. Whether the resulting interest-rate structure in any given member country is positive or negative in real terms depends solely on the country's inflation rate since the nominal rate structure is relatively fixed. Both the USAID and the Wharton reports indicate that lending rates in general have been positive in real terms in Senegal since 1983 (1985 for agricultural credit), and that deposits have also been remunerated at rates above the official inflation rate since 1985 (1986 for savings accounts). Zarour, however, indicates that the BCEAO regulations introduce some rigidity in the interest rate structure, which not always reflect the equilibrium rates that would result in the loanable-funds market.

Selective credit controls are established by the National Credit Committee primarily through the requirement that banks obtain prior authorization for all loans which would bring a customer's total indebtedness with the banking system above 70 million FCFA. The effectiveness of this regulation is highly questionable since the additional bureaucracy involved in the procedure entails a strong incentive for avoidance by the banks supposedly being regulated. Furthermore, until recently, sanctions had not been applied on non-complying banks.

One can conclude from this brief discussion of banking regulations in Senegal that, as in many other countries, their effectiveness is open to question while the administrative burden imposed on financial institutions is substantial. Furthermore, the discretionary application of some regulations by the National Credit Committee has contributed to the crowding out of the private sector from access to credit, and has undermined the viability of those banks where the government holds a dominant position.

Sound Banks and Problem Banks

The Wharton report (1987) and more recently the USAID (PAAD) document for the Senegal Economic Policy Reform Program (1989) provide comprehensive reviews of the current problems of the Senegalese banking sector. The Zarour (1989) report also addresses the current limitations of the banking system from the point of view of the financing of small and medium-size enterprises. Major problems are a heavy burden of bad and doubtful debts, widespread and growing illiquidity, inability to mobilize domestic deposits, and serious managerial deficiencies.

According to the USAID report, bad and doubtful debt in the banking system as a whole amounted to 45 percent of loans and to 28 percent of total assets as of September 30, 1988. Three of the five largest banks, along with six other banks have been classified as "problem" banks in view of their low solvency (capital/asset) ratios. Rather paradoxically, the allocation of credit ceilings by the National Credit Committee has, until recently, favored problem banks at the expense of the six sound banks in the system (USAID 1989). At the same time, the problem banks have had greater access to the BCEAO rediscount facility compared to the sound banks. This apparent "encouragement" of problem banks highlights the negative effects that discretionary credit allocation policies are likely to have on the banking system.

The liquidity crisis of most Senegalese banks has resulted in a growing lack of public confidence due to the banks' difficulties in honoring withdrawal requests, and in the government's inability to collect tax revenues through checks drawn on illiquid banks. The deterioration of public confidence, along with poor service, the lack of a developed branch network, and double taxation of interest earnings on bank deposits explain the system's inability to mobilize domestic deposits. The leniency in the enforcement of rediscount ceilings at the BCEAO, discussed above, has discouraged banks from actively mobilizing deposits from the general public.

In summary, "in its current condition, the Senegalese banking system is less and less able to perform the traditional banking functions of mobilizing domestic savings, of providing a safe depository for precautionary and transactions balances, of facilitating everyday commercial activities, and of efficiently allocating financial resources to either traditional or non-traditional customers" (USAID 1989, p. 62). This generalized critical state of the system has induced the government and major donors to engage in a substantial banking sector reform.

The Banking Sector Reform

The general objectives of the current bank policy reforms are privatization, financial stabilization, improved financial intermediation, and viability of financial institutions. Specific goals of these policy changes are: (1) improved inspection and supervision of banks; (2) privatization, restructuring and improved management of banks; (3) accelerated recovery of bad debts; (4) mobilization of domestic savings; and, (5) improved allocation of credit and improved outreach to all sectors of the economy (USAID 1989).

While changes in the inspection and supervision procedures and practices are under study at the BCEAO level, bank restructuring in Senegal is already underway. Three of the nine "problem" banks have been restructured and recapitalized with a reduction in the share of government ownership. Five other problem banks, including the BNDS, are being merged into a new bank which will hold the consolidated performing assets of the former five. The past due portfolio of these five banks will be handled by the new accelerated recovery being implemented as part of the reform package.

The experience of one of the restructured banks, the BIAOS, and the expected changes in the new consolidated bank, provide an indication of the impact that privatization and restructuring are likely to have on the overall system. The BIAOS closed 8 of its 13 branches, reduced its staff by one half and eliminated some 15,000 small accounts, as part of a drastic cost-reduction program intended to achieve a break-even position by the end of 1989. The new bank, on the other hand, will keep 140 of the 515 employees of the original banks and expects to rely on the postal system for deposit mobilization.

The overall tone of the restructuring measures indicated above is clearly one of contraction and possibly concentration of the banking system. This is neither surprising nor undesirable. It must be borne in mind that a significant component of the overall size (in total assets or in total number of branches) of the banking system in the 1980s can be considered artificial and economically unsound. A large proportion of the non-performing assets currently overburdening the system corresponds to loans that conventional and efficient bank procedures would not have granted. The fact that loans granted through ONCAD (liquidated in 1980) still represent almost one-fifth of total loan balances in the system is a clear example of this unnatural growth of the system in the 1980s.

The foregoing discussion suggests a potential contradiction between the improved privatization/restructuring/management objective and the improved credit allocation and outreach "to all sectors" (objective 5). Privatized banks struggling for financial liability will normally try to clean up their portfolios from small, high-cost accounts, and concentrate their activities in safe, profitable sectors. The revision of credit allocation practices being reviewed for the National Credit Committee will help the banks attain these goals, but the consequences, in terms of reduced shares in total institutional credit for less attractive sectors (particularly agriculture), must be recognized and anticipated through complementary policy changes.

The likely contraction of the system, particularly if it translates into a reduction of the number of branches, will limit the access to formal financial services by the rural population and will increase the transaction costs of acquiring these services for the users. Small-scale depositors and borrowers will probably be the most affected by this contraction of the system, thus highlighting the need to help develop and strengthen alternative means of financial intermediation to service these households and enterprises. The potential role of the informal financial sector and the prospects for development of savings and credit cooperatives deserve particular attention in this respect. Our discussion of informal markets in Chapter III below helps evaluate these possibilities.

B. Formal Agricultural Finance in Senegal

1. ONCAD in the 1970s

The history of ONCAD (Office National de Cooperation et d'Assistance au Developement) and later the CNCAS (Caisse Nationale de Credit Agricole de Senegal) highlights many of the characteristic problems of agricultural credit institutions in the Sahel. In the former case a parastatal agency distributed inputs and presumed to collect loans through other field level state agencies, such as RDAs (Regional Development Agencies). ONCAD was limited to agricultural lending and did not offer any deposit services. Also its portfolio was not diversified by spreading its risks and returns among non-agricultural activities in rural areas.

By 1980 ONCAD had become financially insolvent. Tuck documents the failure of ONCAD in substantial detail (Tuck, 1987). The packaged, in-kind, loan services provided by ONCAD and the RDAs were highly centralized. Moreover, despite the large amount of inputs distributed to farmers in this program, there was no strong evidence that agricultural productivity or output increased. Following the properties of fungibility, the inputs were frequently diverted to other uses, either sold as cash, or used as collateral to borrow cash or food from local merchants. Tuck reports that horses and carts were widely used in transportation for petty trade rather than agricultural production and oxen often fattened and sold for meat rather than used for animal traction purposes. In an extreme example, seeders, acquired through this in-kind credit program, were dismantled by farmers to use as handles to chase warthogs from their fields. All these examples point to the deficiency of top-down in-kind credit programs that presume to channel credit according to some preconceived notion of need or presumed profitability rather than servicing an explicit and revealed demand by the customers themselves.

The absence of savings facilities in ONCAD meant farmer-clients had no financial mechanism for smoothing out and reducing consumption risk (i.e. accumulating savings during the harvest season and dissaving during the dry season). The lack of credit for non-farm and non-agricultural activities for rural families further limited the range of services and added to the portfolio risk of ONCAD through the exclusive concentration of lending on the riskiest rural activity, i.e. agriculture. Finally ponderous and lengthy loan processing procedures delayed deliveries of inputs. Many inputs, particularly animal traction inputs, were defective or inappropriate for many farmers further reducing the quality of these credit services.

The net result of this poor performance was an extremely high cost operation and low loan recovery (only 60 percent during the 1970-80 period). Periodic loan debt forgiveness was resorted to following drought and near-drought years. By 1980 the accumulated forgiven debts amounted to 30 billion CFA (or 100 million dollars at the 1980 exchange rate). The ONCAD program was terminated in 1980. By 1982 with accumulated interest charges, the continuing outstanding debts came to roughly 110 billion CFA or 63 percent of government revenues and 13 percent of GDP in 1982.

2. The CNCAS in the 1980s

By 1984 government authorities were determined to replace the ONCAD program with an agricultural development bank, the Caisse Nationale de Credit Agricole de Senegal (CNCAS). It is interesting to note that this institution was the most recent and the last CNCA to be established in the UMOA countries. One lesson it apparently learned from the failure of ONCAD and other CNCAs was the need to promote savings mobilization schemes (Walker, Arthur Young). In this regard the bank has achieved some success. By 1987 almost 20 percent of its total funding sources came from locally mobilized deposits (Le Breton). Preliminary evidence for 1988 suggests this relative share has likely increased as a part of an intensive savings mobilization drive (Le Breton; A. Young). Still the BCEAO, the multinational West African Central Bank, is the principal source of funding for on-lending (57 percent). None of the available studies and evaluations have analyzed the terms, conditions and transactions costs for depositors or the costs of mobilizing deposits for the institution. It is likely that the interest earnings may be less important to village level depositors than the access to institution savings services (i.e. security of deposits with quick withdrawal rights to smooth out consumption over the year). Are these deposits made by individuals, groups, or both? Do they act as an implicit collateral for future borrowing rights? Unfortunately none of the available studies on the CNCAS address these issues.

Some attempts at decentralization of the CNCAS have occurred. The bank has 17 branches, more than any other financial institution in Senegal, however its portfolio is highly concentrated. The financing of groundnut exports account for a substantial majority of its loans (80 percent in 1984-86). Most of these loans are directed towards the groundnut marketing agency, SONACOS, as crop loans used by the marketing board to purchase farmer output. More recent reports (A. Young, 1989) refer to a policy of making only group (rather than individual) loans to farmer borrowers (distinct from loans to marketing agencies). Farmers are required to organize themselves into village groups (section villageoises) or common interest groups (groupements d'interet economique) to receive loans. These groups are presumably scaled down in size from the previous large government created cooperatives. No groups are more than 100 persons. Such groups would presumably reduce the transactions costs of reaching a large number of final borrowers. There has been discussion about diversifying its portfolio into non-agricultural activity but no evidence to date to indicate it has done so.

There are a number of questions that come to mind in speculating on the potential and the problems of an institution designed like the CNCAS. First is the issue of group loans. In principle, these groups can reduce the transactions cost of lending and borrowing to a large number of village level final borrowers. However what social cohesion and sense of group loyalty exists in these groups to ensure the necessary social sanctions to induce delinquent borrowers to meet the groups repayment obligation? This is the "free rider" problem in which the structure of incentives can lead to uncooperative behavior by individuals within a group unless the potential for social sanctions within the group are sufficient to ensure cooperative behavior. Given the notoriously poor track record of previous government created cooperatives in Senegal, the question arises as to how these somewhat smaller groups (also presumably organized by some outside government authority) are any different? None of the available sources address this question and indeed appear rather naive in accepting at face value the alleged success of this new form of lending by the CNCAS. There have been a large number of group loan lending experiences in a variety of African and other LDC settings. Very few have been successful (Adams, Graham, Von Pischke, 1984). Consequently, it is incumbent on analysts of the CNCAS to recognize this issue explicitly, document the repayment performance rigorously, and, if in fact it is a success (which appears doubtful as will be seen shortly), try to explain the unusual factors that led to its success. To date no evaluation of this nature has appeared on the CNCAS.

Other questions also come to mind. What degree of decentralization and meaningful local branch autonomy in fact exists in this new organization? Decentralized decision-making in a branch level organization is not common in a Sahelian country, least of all

Senegal. Some degree of centralized control very likely still exists with all the targeted, top-down, supply-leading deficiencies common to all the CNCA experiences in the other UMOA countries. The CNCAS studies to date do not identify and carefully document the decision making dynamics of the institution. Effective decentralization is expensive in terms of the caliber of scarce personnel needed to carry out delegated decision-making with success. Le Breton refers to the fact that all people recruited by the CNCAS came from delinquency-ridden parastatal or insolvent government banking institutions in the country. This doesn't bode well for the type of loan manager needed to manage liquidity and portfolio risk in a decentralized branch operation. He also refers to the slow, drawn-out procedures to secure loans in the institution which tends to reinforce the impression of ineffective decentralization and a high cost operation (Le Breton).

The issues surrounding operational lending costs are important in evaluating the performance of a financial institution. The Arthur Young study cites a CNCAS administrator who claims the institution cannot break-even within the financial margin (roughly 5 percent) allowed by the BCEAO. Le Breton's report confirms this high cost for the CNCAS in the fiscal year 1986/87 by documenting a <u>negative</u> gross profit margin of 2.98 percent. When loan loss reserves are included to reflect unrecoverable loans, this loss rate rises to a negative 11.57 percent of the outstanding portfolio (Le Breton). Clearly the CNCAS is a high cost operation reflecting some of the debilitating features so common in a supply leading financial institution (Bourne and Graham, in Adams, Graham and Von Pischke, and the OSU Niger Report, chapter III).

This brings us to the bottom line, the state of the portfolio, and most importantly, the share of non-performing loans. Most African agricultural financial institutions are forced to lend to other parastatal institutions supplying agricultural inputs or marketing farm output. Frequently loans to these institutions are not repaid, thereby introducing a high rate of arrears into the institution's portfolio. Most CNCAS studies refer to the fact that a high proportion (around 80 percent) of its total loan portfolio is directed to the state marketing agency for groundnuts (SONACOS). Such a high degree of portfolio concentration is risky, unless it is a monopolistic agency that farmers cannot avoid. In that case loan obligations can be automatically deducted from the purchase price paid to farmers and transferred to the financial institution. Even a monopolistic marketing agency, however, can be a high-cost, money-losing operation. For example the Michigan State University marketing studies in Senegal strongly suggest that the Senegalese marketing agencies are in fact money-losers and thus candidates for privatization efforts (Morris). An important implication of these findings is that they also represent a dangerous moral hazard (i.e. an unacceptable exposure to risk) for any financial institution financing their operations.

Studies documenting the arrears of the CNCAS portfolio are limited. One study (the Arthur Young report) mentions that arrears account for only five percent of the portfolio. This is highly unlikely given the nature of the institution as described and documented above. Overdue debts associated with parastatal agencies (like SONACOS) cannot be legally included as part of the delinquent portfolio since they all carry a government guarantee. This, of course, does not make the portfolio any less delinquent or non-performing. It is merely an accounting convention followed in all CNCA operations in Sahelian countries. The net result is a dramatically misleading and understated representation of the true state of arrears for the institution.

A recent review in the Project Assistance Approval Document (PAAD) of AID on Senegal underscores the weakness of the CNCAS portfolio (USAID, 1989). This evaluation reports the fact that CNCAS losses have reached 600 million CFA or 26 percent of its capital. Of the 10.7 billion CFA in outstanding loans, 8.9 billion CFA in crop loans are unrecoverable with only a little over a billion CFA of current performing loans without arrears (probably because they have yet fallen due). This large amount of delinquent loans is associated with the large share of loans allocated to SONACOS.

This overwhelming share of the non performing loans is associated with what the PAAD review refers to as an "overhang." This is essentially an unpaid debt that grows out of an unusually high government purchase price for cash crops (especially groundnuts) deliberately set considerably higher than the world price for the commodity. When the marketing board sells the crop on the world market it suffers a loss which in turn is passed back to the source of crop finance (the CNCAS) as a delinquent loan. It is unclear from the available studies whether the crop purchase covers 100 percent of the total financing with the farmers and marketing board contributing no equity financing of their own. Similarly it is unclear how much of this financing benefits farmers through a high farm level price and how much accrues to the marketing board to cover high, uneconomic administrative costs. In the end, government pressure to force these high prices onto the system is a hidden subsidy that eventually destroys the viability of any financial institution that is unfortunate enough to be chosen to bear the cost of this policy.

Thus we come full circle with the CNCAS demonstrating all the negative operational features of a top-down, supply driven financial institution. One would have thought that the Senegalese would have learned from the ONCAD experience. Furthermore, in setting up the most recent CNCA among the six UMOA countries, one would have thought the Senegalese would have learned from the negative lessons that earlier drove the other CNCA institutions into financial insolvency in the other countries. These negative lessons were amply apparent by 1984/5 when the CNCAS was established. However, there appears to have been little if any communication among these countries or through the BCEAO authorities concerning an appropriate organizational framework or operational procedures and practices to be emphasized or avoided. Thus the CNCAS seems to be emulating many of the bad features already documented for the earlier CNCA failures. Also it is not clear the degree of risk the high default rate represents for the savers that have deposited their funds in the CNCAS during its recent savings mobilization drives. These deposits would appear to be in jeopardy, yet no documentation or discussion of this potential problem appears in the critical review of the PAAD.

The PAAD report also indicates that the CNCAS is no longer included as part of the banking reform effort in Senegal since it is no longer considered a bank. It is now labelled a cooperative within the new agricultural policy. Depositors are now presumably shareholders. This arrangement is still unclear. A more detailed explanation of this change is required before the implications of this shift can be evaluated. The issue of financial viability remains whether bank or cooperative. The degree to which the new cooperative structure can improve upon the performance of the former banking framework is open to question. A detailed documentation and analysis of the performance of the institution in both organizational forms is in order to determine its prospects for long run viability. Furthermore, regardless of institutional form, no effective rural financial intermediation can occur in the face of forced participation in deliberate subsidy transfers growing out of uneconomic pricing policies for cash crops and marketing board actions that create cumulative "overhangs" for its source of finance. <u>Agricultural price policy and marketing board reforms in Senegal must go hand in hand with financial reforms</u>.

Finally there is no evidence offered on how many producers have been reached through the CNCAS network. The penetration of this institution whether widespread or neglible could make a difference concerning the appropriate policies to consider in it reorganization.

III. INFORMAL FINANCE IN SENEGAL

Several surveys have documented informal financial activities in Senegal in the past decade. The first carried out by Laura Tuck characterizes these activities in the early 1980s, while the others document the heterogeneity of informal finance in the mid to late 1980s (Tuck, 1987; Arthur Young; McKenzie, MSI Study 1988; Dupuy et Servet; Istituto Italo-Africano, 1987; Gaye, 1988; and Vicenzo Caputo 1989). Some of these studies are based on field surveys while others are essentially case studies, designed to highlight the principal features of informal activity, the different actors or groups involved, some rough sense of their relative importance, and the typical terms and conditions for these services and repayment practices.

A. Informal Finance in the Early 1980s

Tuck estimated a lower bound threshold of 4.4 billion CFA of outstanding loans for the rural informal credit market, roughly equal to 1.5 percent of agricultural value added in 1982-3. Over 67 percent of the households surveyed (54 producer units) borrowed at least once during the year. A little over one half of the loans (54 percent) was in the form of cash. Consumption predominated over productive purposes. The average loan size was $35 dollars in equivalent CFA. Less than half of the loans carried interest charges, however, those that did were quite high (70 to 90 percent per year when rates are annualized). However the loans were small and the time period very short. Merchants provided 22 percent of the number of total loans and 42 percent of the value of loans indicating that merchant loans were larger than average in size. Thirty seven percent of the households felt they could borrow from merchants if necessary, indicating a built in credit reserve from this source beyond the 22 percent of households currently holding loans from merchants. Default does occur in these informal markets. Merchants estimate normal defaults around 20 percent (much higher in drought years). The denial of future loans is the principal form of dealing with defaulters.

On the savings side tontines predominate in urban areas for all cross sections of the population. In rural areas, on the other hand, Tuck reported that these savings societies were almost exclusively limited to women. Livestock were the other major form of savings in rural areas along with small consumer durables, cereals and seeds. Deposits in formal institutions were negligible in these settings.

B. Informal Finance in the Mid-to-Late 1980s

1. The Istituto Italo-Africano Study

The Istituto Italo-Africano Study (1987) sampled villages in two zones in Senegal (Bounkeling and Passy in the Moyenne Casamance and Saloum respectively) to document the heterogeneity of informal finance, the costs of informal intermediation, and the link between savings and loan activities in the different groups or individuals participating in informal activity.

Substantial savings occurs in these sample areas. Low transaction costs characterize the transactions. Interest earnings were not an important determinant of savings as much as deferred consumption, smoothing out consumption risk over time. The population in the villages that engaged in substantial borrowing generally save more in cash and cereal stocks (to arbitrage the price between the harvest and dry seasons) than do the populations in villages without loan activity. The former emphasized precautionary motives for savings while the latter emphasized motives of social solidarity in group saving schemes.

Formal loans directly from the CNCAS account for only 6 percent of total loan activity in these households. Moreover, all the CNCAS loans were considerably larger than any of the informal loans, suggesting that a much wealthier clientele gains access to formal credit in rural Senegal. Well over 90 percent of borrowing flowed through informal networks. Roughly 60 percent of this credit consisted of relatively small, short term loans and 65 percent were loans in-kind. However repayment of in-kind loans was frequently made in cash. Thirty percent of the loans came from merchants. These loans tended to be shorter in term and larger in size, than the average for all loans, and all loans were related to financing consumption goods. About half of these merchant loans were made in kind (largely in rice) but repaid in money. Merchants do not play an important role in financing agricultural inputs or outputs. These have traditionally been government dominated areas.

Mutual association loans were the second most common source (18 percent) of informal credit of households reporting loans, followed by loans from family members (17 percent). Both sources had loans smaller than the average. Association loans were longer and family loans shorter term than average. Interestingly over 50 percent of the association loans were in-kind (largely groundnuts and grain) while 78 percent of family loans were cash. Explicit interest rates were not charged on more than half of the loans however the authors admit the difficulty of determining implicit interest in the mix of in-kind loans with cash repayments. Of the remaining loans in which interest was charged, rates could range up to 80 percent on very short-term small loans. The rates were much lower on longer term loans.

The quality of the financial services supplied by these informal sources in the household survey was ranked quite high by a substantial majority of the borrowers. Only 16 percent of the households had any major complaints over the terms and conditions of their informal loan arrangements. Moreover, a majority stated they did not experience any quantity rationing of their credit demand and felt confident they could have asked for more if it had been necessary. This "credit reserve" feature of informal finance can play an important role in unexpected emergencies.

The link between savings and credit activity was also evident in the survey. In those households where both savings and loan activity were registered, the amount of debt was always equal to or greater than the amount saved. Finally, it was documented that merchant loans went largely for consumption purposes. Association loans on the other hand, had a relatively larger production orientation or infrastructure orientation if from a collective association. This finding led the authors to argue that village associations represent the most promising potential source of formal financial intermediation for future programs.

2. The Dupuy-Servet Review

The study by Dupuy and Servet (1987) also catalogued informal financial activity in Senegal. The authors presented case studies rather than survey results. No detailed empirical data was presented. Instead, typologies of groups and forms of savings and loan activity were described. Among them were the following:

> Village Savings Associations. These associations are made up of individuals of the same social group in a village. Very small, but frequent savings contributions are made but with no uniform amount or rigid periodicity of contributions. The contributions are directed towards collective or community ends such as schools, dispensaries and other social infrastructure. Members who migrate from the village frequent-

ly continue making contributions through remittances, thereby expanding the geographical network to other towns or even foreign countries.

Tontines: These groups are more characteristic of urban areas larger than villages and are based upon salaried workers, market merchants, and others with a regular income source. The contributions are used for individual ends, are a fixed amount and follow a uniform periodicity. Generally more exclusive in membership and smaller than village associations, tontines in Senegal are more geared toward consumption ends rather than investment projects. It is reported that they are not as dynamic as the more investment and production oriented tontines that have emerged through time in Nigeria and the Cameroons.

Merchant Monthly Finance: Many shops and merchants advance merchandise to customers who then pay at the end of the month. This form of informal finance is common among salaried workers. Sometimes a signed but undated check covering the value of the advanced goods (at times with a slight mark-up) is left with the merchant as a form of collateral to ensure repayment. Generally implicit interest is negligible in order to secure a loyal clientele.

Merchant Installment Finance: This form of finance is directed towards the sale of consumer durable goods. It includes installment payments at regular intervals over time in which implicit interest is included in the original negotiated price of the article. This is very popular in peri-urban areas for ambulatory salesmen and merchants who market these contracts in many peri-urban open market sites.

Merchant Sale-Repurchase Agreements With or Without an Intermediary: the Islamic strictures against interest are easily disguised in this framework. Here a merchant agrees to advance a good or goods to a borrower whose true market value (say 50,000 CFA) is equal to the amount the borrower needs as a loan. The borrower is then advised he should resell the merchandise to a neighboring merchant (usually a family member of the original merchant) for the stated market value. In the meantime, however, the borrower is obligated to repay the original merchant through installments that cumulatively are greater than the repurchase price (say a total of 75,000 CFA). The difference represents interest earnings for the original merchant. These arrangements can also be carried out directly with the merchant or handled through an informal intermediary who specializes in brokering these contracts among several merchants and borrowers. These have become popular forms of financing in the absence of consumer finance instruments in formal financial intermediaries in Senegal.

Dupuy and Servet argue that all of the above forms of informal savings and credit arrangements represent positive approaches to meeting the demand for financial services for the large majority of the population excluded from access to formal financial intermediaries. They state that the government should not try to interfere with or regulate these practices. Instead authorities should concentrate on removing obstacles and inducing financial innovations in the formal financial institutions themselves.

3. The Arthur Young Report

This is a case study of a limited number of informal savers, lenders, and borrowers. The visits were carried out in the Fleuve region, and in Kaolac and neighboring villages. The authors state that Senegal, though a low-income country, has had ample monetary savings in informal form flowing through urban market centers as well as rural areas. However recently, through the liquidity crunch associated with the crisis of the formal banking system, rural informal operators are affected negatively in so far as they use cash for their transactions. More commercial exchange is now carried on through barter.

From a developmental point of view, the report argues that the Village Association (caisses villageoises) are the most promising source of rural savings for future growth. Tontines in rural areas are presumably less well developed to carry out this task. Rural tontines are made up mostly of women and marketers. Farmers are much less involved. Urban-based tontines, however, appear to be more dynamic and better positioned to play a potentially more expanded role in savings mobilization within a framework of a savings and credit cooperative.

An additional suggestion of the authors highlights the prospective role of "market bankers," individuals from regional towns who visit higher level market places on their meeting dates to collect and to return deposits. These brokers could also make small loans as "bonded" representatives of a coordinating agency or intermediary, thereby reducing deposit and loan transaction costs.

Finally, the report highlights the dynamic nature of microenterprises in Senegalese towns and their growing demand for credit. Unfortunately these activities are still largely serviced through retained earnings or personal savings, rather than through credit facilities. If property rights could be more clearly defined, such clients might be able to mortgage their assets for credit services.

4. The McKenzie MSI Study

Introduction

In the present liquidity shortage experienced by Senegalese banks, formal loans to small businesses and microenterprises is practically non-existent. The low financial margins permitted by the BCEAO and high default risks associated with small business loans effectively exclude this clientele from formal finance in Senegal. McKenzie reports that formal banks assess this loan loss risk from 18 to 45 percent. The absence of meaningful collateral for small businesses (and the uncertainty of foreclosing on this collateral in the poorly defined property right milieu in the country) reinforces this rationing behavior of the banks. Moreover, the costly documentation, fees, and long delays in processing loans increase transaction costs for small business borrowers to such an extent that they choose to use private savings and retained earnings for working capital needs.

In this environment, USAID launched the Community and Enterprise Development Small Business Program (hereafter referred to as CEDP) in 1985 to strengthen the new agricultural policy in Senegal. The project is managed by the New Transcentury Foundation with Management Systems International responsible for the Small Business Program. The program is designed to support the private sector in the structural adjustment process, offering advisory services and loans to small businesses in Senegal's groundnut basin around Kaolak and Fatick.

A survey of 310 businesses in these town and villages indicated that less than 20 percent used any cash book or detailed accounting and, interestingly, three quarters answered they were too busy to bother keeping such accounts. Craft and commercial skills acquisition through the apprenticeship tradition were well developed and most businesses had plans for expansion. Less than 5 percent had access to formal loans. Most businesses surveyed were profitable with high rates of return for their limited capital base. The critical constraint mentioned by all was lack of access to credit facilities, hence the alleged need for this NGO oriented program.

CEDP Program Operation and Performance

The program was designed to be a "minimalist" program. No technical assistance or training was required to receive loans. It was felt that the participating businesses could manage their own businesses. The program was funded for five years at the end of which the investment portfolio would be handed over to a formal financial institution. At that time it is expected that the program would be able to cover all its costs out of interest earnings, thereby making it a viable option for a local bank to take over.

A network of seven field offices (store front premises) was established. Field officers received intensive field based training to engage in loan evaluation and portfolio management skills before working in the program. Results up to February 1989 appear promising with 384 loans having been granted. Only 15 loans have defaulted while 150 have been fully repaid with interest. The 15 defaulted loans represent only 4.5 percent of the total funds borrowed and repaid back. Only 30 clients out of the current portfolio of 234 loans are in arrears. Many of these are not considered serious.

The average loan size is CFA 1.2 million ($3,870) for an average term of 9 months. Working capital represents 72 percent of the loans, equipment 13 percent and the loans for both purposes 15 percent. Average asset values of the businesses increased 47 percent for the 150 clients who have fully repaid their loans and the average increase in profitability for these customers was 119 percent. Finally, employment increased in 42 percent of the enterprises. While it is difficult to attribute these inputs to loan financing alone, the access to credit no doubt was a contributing factor.

Lessons Learned and the Graduation Syndrome

McKenzie's report on the CEDP program indicates that informal businesses are viable and bankable. Informal sector borrowers do not have to be literate to succeed and it is not necessary to provide them with client oriented training and technical assistance. However, training is very important for the field staff managing the portfolio and staff rewards and bonuses for good performance may be an important contribution to prevent non-performing loans from contaminating the portfolio. This later feature stands out in stark contrast to the lack of rewards and accountability for performance that pervades formal financial institutions in Senegal.

An interesting dilemma has emerged at this stage of the program. It was unlikely that any of the informal borrowers will graduate into a formal bank's portfolio as envisioned in the program. Most banks are in bad shape financially. They are risk averse, unfamiliar with this kind of clientele, and not well established in the region. They expressed doubt as to how or whether they could incorporate the entire CEDP staff and field network into their formal organization. This was not the kind of challenge they needed at this point of financial restructuring. In this sense the reported success of the CEDP program has suffered the consequences of poor timing. The formal financial system is not sufficiently recovered to consider inheriting a novel, performing portfolio.

At the same time the CEDP program was not eager to push for graduation. The staff were concerned about transferring their successful operation into an uncertain and potentially indifferent formal institution within which they might lose their managerial flexibility. The fact that these delinquency-ridden institutions were unable to manage their previous portfolios did not inspire confidence in CEDP circles that these institutions could integrate their program successfully. Indeed it could be the kiss of death.

Interest rate issues add an additional dimension to this problem. The CEDP, in being a non-deposit institution, currently charges 22 percent on its loans, the maximum for non-deposit financial institutions. It is of interest to note that program officials feel they could charge rates as high as 40 percent and not lose any customers. If the program were transferred into a deposit taking financial institution, BCEAO regulations would require the loan rate to drop to 13.5 percent (the maximum rate for small business loans). When banks are refinanced by the Central Bank for their small business loans, they are only given a margin of 3 percentage points. Under these conditions banks would not be able to absorb the cost and risks of even a well performing small business program. Ironically, as McKenzie points out, the governments concern to protect small businesses from usurious rates means in effect they are denying them access to formal credit completely.

Given this impasse USAID has given additional funds to expand the program up to 1992. At that time some new institutional form will have to be devised to continue the program without donor support. If no formal bank integration is possible, given present interest rate constraints, some sui-generis legal status may have to be explored to allow the locally based program to continue independent operations.

IV. CONCLUSIONS AND RECOMMENDATIONS

A. Formal Finance and Related Issues

1. The banking system of Senegal is in serious disarray. Major problems are a heavy burden of bad and doubtful debts, widespread illiquidity, and inability to mobilize domestic deposits due to lack of confidence among the general public, poor services and inefficient management.

2. Largely artificial and economically unsound growth in total assets, the inherited burden of ONCAD accumulated debt, and ineffective rediscount ceilings at the BCEAO are among the causes of the current crisis. Moreover, the arbitrary allocation of credit ceilings among Senegalese banks by the National Credit Committee has encouraged problem banks at the expense of sound banks (only six out of fifteen banks in the system).

3. The privatization and restructuring efforts included in the banking sector reform program are likely to induce a contraction of the banking system, both in terms of total assets as well as in total number of branches. Banks will probably succeed in attaining financial viability only through rather severe cost-reducing measures including the closing of existing inefficient branches and drastic cuts in total personnel.

4. A reduction in the physical (branch) size of the banking system, along with the likely concentration of bank portfolios into large-scale and relatively secure customers will improve the viability of the remaining banks in the system. This process will also be facilitated by the relaxation of selective credit allocation practices. However, the consequences of this contraction and concentration will reduce access to institutional financial services by rural, small-scale customers. This outcome must be recognized and provided for.

5. The transaction costs of acquiring formal financial services are likely to increase in rural areas, and small-scale customers will likely see their access to these services limited

by the reluctance of banks to maintain small accounts in their portfolios. This trend is already evident in the initial restructuring measures of commercial banks.

6. It is necessary to compensate for the unintended cost of the banking sector reform in terms of access to formal financial services by the least economically attractive sectors of the bank clientele. Alternative suppliers of financial services must be strengthened and promoted. A more active role for the postal service as a financial savings institution with its extended network is certainly one alternative worth exploring. The promotion of financial intermediation through informal networks is another alternative.

7. Overall financial reform of the formal banking system is essential. Even though the informal sector and rural clientele have limited direct access to loans from the formal sector, banking sector reforms would clearly benefit informal sector activity. Many informal groups and individuals save or deposit their group and individual savings in formal institutions, hence these deposit services are pertinent. At the same time, the availability of liquidity intermediated through the formal system affects informal activity substantially through the downstream channels of informal finance that are derived from formal loan transactions to traders, businesses, marketing boards, etc. In short, there are substantial linkages between formal and informal finance. Reforms promoting an improved supply of financial services in the former will invariably help the latter.

8. Agricultural pricing reforms are needed to bring domestic producer prices more in line with world prices for major cash crops. Financial overhang practices should be eliminated that create burdensome debts for any financial intermediaries and long run fiscal deficits for the government.

9. Once agricultural pricing reforms are in place so that local prices reliably reflect world prices, private marketing agents and channels should be encouraged to compete with government marketing boards. In time the private merchant network should handle more of this business. More competitive markets are needed here. This should help rural financial markets as loans can be granted to more reliable marketers than the government marketing boards have proven to be in the past.

10. Additional study and review of the institutional reform of the CNCAS is in order before making any major donor commitment to the institution. What is the form and nature of the new cooperative organization that has been created in 1989 to replace the former bank organization? Why should this new institutional reform operate any more effectively than poorly performing government cooperatives of the past? What will happen to the savings mobilization functions that had been developed so assiduously in the CNCAS in recent years? Will this positive initiative disappear in this new cooperative form? To what extent is there greater decentralization and more local operational autonomy and accountability in this new cooperative venture? What are the prospects for "efficient" deposit and lending activity in this cooperative that can cover the lending costs and expected loan losses?

Can it avoid government pressure to digest financial overhangs, debilitating loan targeting practices and gain sufficient administrative autonomy to refuse loans to previous delinquent borrowers? These among other questions need to be addressed as the CNCAS is reorganized into its new cooperative organization. These questions are not addressed in the studies currently available for review.

11. AID should not make any major commitment of funds to the new CNCAS cooperative until the questions outlined above are documented and answered. Strict conditions precedent should be established on past loan recoveries and current portfolio performance before any funding support should be considered.

12. In the logical division of labor among donors, the French and the World Bank are traditionally positioned to assume the responsibility of restructuring and supporting formal financial institutions. AID is the only major donor available to support informal sector initiatives. Given the financial contraction occuring in the formal sector, it is all the more important that support be given to informal sector initiatives to help take up the slack for the system as a whole.

B. Informal Finance

13. Informal finance is surviving and picking up the slack in the current financial crisis in Senegal. This is the message of the numerous studies documenting these activities.

Caisses villogeoises appear to be the most promising group savings vehicle in the villages. Any donor attempt to build from the bottom up should look closely at these village group savings institutions. In regional towns with an urban salary base, tontines appear to be a promising base group to consider for creation of a semi-formal credit union movement. Finally NGO initiatives such as the Community Enterprise Development Project also appear to be healthy initiatives building on informal clientele. All these initiatives can contribute to the expansion of the privatization effort, increased viability of financial intermediaries and improved financial intermediation in Senegal.

14. The creation of a semi-formal form of financial institution with the caisses villageoises should address the issue of combining their current collective use of savings for community purposes with the possibility of individual member deposit and loan possibilities as well. There is no reason why a joint supply of financial services (both collective and individual) couldn't be designed into their service functions.

15. The NGO initiative in the CEDP program currently only makes loans and avoids deposit taking activity. This allows it to escape some of the more onerous interest rate controls levied on deposit taking institutions in Senegal. Ideally this program should also consider offering deposit services to their borrowers. This would add scope economies to the institution, create a liquid collateral base to use to evaluate loan applications and offer a valuable additional source of funding (in addition to the revolving fund of loan recoveries) from which to make loans after donor money dries up in 1992. Some exceptions should be

made in the current regulatory laws to allow this programs to include these services without sacrificing their current flexibility in charging higher interest rates.

16. All these potential initiatives (caisses villageoises, more urban based tontines, and NGO organized microenterprise credit efforts) will have to face three challenges for their long term future. First, as they grow and prosper with donor support, what intra and inter-regional funds transfer facility should be created to facilitate scope, scale, and spatial economies beyond the individual units themselves? Some kind of second-level inter-lending facility would have to be considered similar to the rural credit union initiative currently underway in Niger, and alrady well established in Togo. Second, after these institutions have achieved their first stage success, how can they avoid falling into the Senegalese regulatory trap of interest rate controls and related restrictions such as targeted credit? Finally, what form of prudential protection should be designed to protect the savings deposits that would form the base of these initiatives to create semi-formal institutions in the informal sector without falling into a counterproductive government regulatory trap? All these challenges point towards the need to explore new juridical forms that could service the operational requirements of a second level facility and prudential insurance without becoming subject to the debilitating features of a centralized government regulatory framework.

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Senegal: List of Commercial Banks and Financial Institutions
as of June 30, 1989

Commercial Banks

	Acronym	
1.	ASSURBANK	Assurbank *
2.	BCCI	Banque de Crédit et du Commerce International, Overseas, Limited
3.	BHS	Banque de l'Habitat du Sénégal
4.	BIAOS	Banque Internationale pour l'Afrique Occidentale-Sénégal *
5.	BICIS	Banque Internationale pour le Commerce et l'Industrie du Sénégal
6.	BNDS	Banque Nationale de Développement du Sénégal *
7.	BSK	Banque Sénégalo-Koweitienne *
8.	BST	Banque Sénégalo-Tunisienne
9.	CITIBANK	Citibank
10.	CLS	Crédit Lyonnais Sénégal, formerly USB (Union Sénégalaise de Banque)*
11.	CNCAS	Caisse Nationale du Crédit Agricole du Sénégal *
12.	MFIS	Massraf Fayçal Al Islami du Sénégal *
13.	SOFISEDIT	Société Financière Sénégalaise pour le Développement de l'Industrie et du Tourisme *
14.	SGBS	Société Générale de Banque au Sénégal
15.	SONABANQUE	Société Nationale de Banques *

Financial Institutions

1.	CCP	Caisse des Chèques Postaux
2.	CE	Caisse d'Epargne du Sénégal
3.	LOCAFRIQUE	Compagnie Ouest-Africaine de Crédit-Bail
4.		Crédit Sénégalais
5.	SOCRES	Société de Crédit et dEquipement
6.	SDE	Société Dakaroise d'Equipement
7.	SOFIA	Société Financière d'Intermédiations et d'Affacturage
8.	SOGECA	Société Génerale de Crédit Automobile
9.	SONAGA	Société Nationale de Garantie et d'Assistance au Commerce

Note: * So-called "problem banks."
Source: USAID, 1989.