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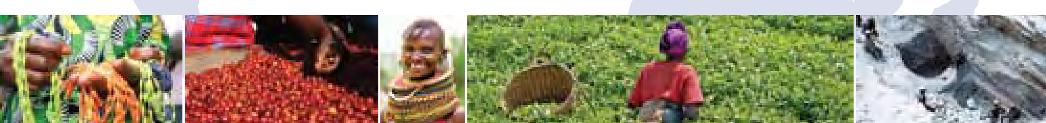
ACCESS TO CREDIT IN EAST AFRICAN COUNTRIES:

Shared Issues and Priorities for Reform



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ACCESS TO CREDIT IN EAST AFRICAN COUNTRIES:

Shared Issues and Priorities for Reform

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Cover photos (from left to right) by: Cameron McCool, Rowan Seymour, Lister-Kaye Photography, Andreas Rolfer, Hendrik de Bruyne

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INTRODUCTION

This paper summarizes the key issues identified over the course of six diagnostic exercises conducted under the auspices of USAID's Business Climate Legal and Institutional Reform (BizCLIR) project: Ethiopia (2006); Tanzania (2007); Rwanda (2008); Burundi (2008); Uganda (2008); and Kenya (2009).[1] These six countries include all five members of the East African Community (EAC), plus Ethiopia. BizCLIR teams analyzed several key diagnostics of the business environment in each of these countries, including the issue of access to credit—specifically, the legal, institutional, and social frameworks that support access to credit by individuals and businesses.

Access to finance allows well-functioning economies to effectively allocate resources to their most efficient use. Individuals need finance to fund housing, education, and healthcare to raise their standard of living and improve their productivity. Farmers need credit for infrastructure investments and the purchase of seeds, tools, and fertilizer. Manufacturers and service firms need finance to expand operations and investment in enhanced productivity. Entrepreneurs need it to fund new innovative ventures that can spur competition. Financial firms act as the mechanism to allocate resources to their most effective use.

However, when the business enabling environment does not provide for the transparent sharing of credit information, the ability to efficiently secure interest in collateral, and the ability to enforce loan contracts in case of default, financial firms are incapable of achieving the optimal resource allocation for society. All of these are serious problems across East Africa.

KEY REGIONAL ISSUES

Any discussion of these six countries must first note that two of them are very different. Kenya's financial sector is much larger and more sophisticated than any of its neighbors. The other countries of East Africa have financial sectors that are appropriate to developing countries. Kenya's banks and other financial institutions resemble those of a middle-income or, in some cases, a developed country. They are bigger,

1 Individual country reports are available through the USAID/BizCLIR website: www.bizclir.com

more efficient, more competitive, more sophisticated, have much more money, and offer a far wider range of products than their counterparts in other developing countries. Kenya's financial sector is simply in a different league.

In *Ethiopia* the government has adopted a number of unique policies, including very strict state regulation of the sector and a ban on foreign investment or participation.

That said, certain common elements exist in the financial sectors of these six countries. The following characteristics are found in most or all of them:

- High interest rates
- High levels of liquidity
- Lack of long-term capital
- Large sectoral and regional imbalances in access to credit
- Limited product lines
- Neglect of agriculture
- Competent central banks
- Few bank failures, especially in recent years
- Rapid growth, albeit from a small base
- MFIs (microfinance institutions) and SACCOs (savings and credit cooperative societies) as important elements of the financial system
- Foreign investment
- Limited competition
- Weak enforcement of judgments
- No regional integration

This last point is perhaps the most surprising. The EAC Treaty provides specifically for regional coordination of financial services.[2] East Africa has a rising level of regional trade, and has made some efforts at regional integration and standardization in several areas, e.g., tariff levels and customs practices.

2 In particular, Articles 85 and 86 of the Treaty state that "the Partner States shall… harmonise their banking Acts [and] policies on cross-border listing, foreign portfolio investors, taxation of capital market transactions, accounting, auditing and financial reporting standards… harmonise the regulatory and legislative frameworks and regulatory structures… permit the free movement of capital within the Community [and], develop, harmonise and eventually integrate their financial systems."

However, virtually no integration of the region's financial sectors has occurred. Thus far, only a Kenyan bank has invested in another bank or financial institution elsewhere in the region. There are a number of foreign investors in East Africa's banks, but they all come from Europe, West Africa, or the Middle East. Regional central banks communicate with each other, but they make no effort to coordinate their policies. Commercial banks show little interest in cross-border cooperation or joint ventures, and there is very little lending across borders. Trade in services is stunted (see the regional BizCLIR report on trade), and with the notable exception of Rwanda, EAC members have not encouraged the free movement of skilled workers across their borders. Bankers discuss the EAC, but only in terms of how it will affect their customers. As for the banks themselves, their six countries might as well be on six different continents.

The reasons for this are not clear. Banks in some smaller countries seem fearful of financial institutions from larger countries: banks in Rwanda and Burundi, for example, are worried about big Kenyan banks entering their markets and buying them out or competing with them. The lack of a regional financial center may also play a role. While East Africans look to Kenya for news and entertainment, they do their advanced banking in London, Brussels, or Dubai. A mere lack of interest may play a role Whatever the reason, the lack of regional integration is a fact.

Other common issues are discussed further below.

HIGH INTEREST RATES

Interest rates vary widely across the region, but they are everywhere high by world standards. Commercial loans in Kenya typically are between 13–15%; in Burundi, around 16%–18%; in Rwanda, they can exceed 20%. Loans from MFIs are usually more expensive (although there are occasional exceptions).

These high rates are driven by various factors. Banking sectors in East Africa, with the exception of Uganda and Ethiopia, have high rates of non-performing loans (NPLs). NPLs can be caused by many factors, from the general difficulty and uncertainty of the business environment, to political and military conflicts (as in Burundi), to loans made to bank officers, and loans made for political purposes. Whatever the reason, NPLs are a common problem and a major cause of high interest rates.

Other causes include the difficulty of foreclosure (described further below); high transaction costs due to a lack of IT and trained bank staff;

the difficulty and high cost of proper credit analysis and due diligence; the absence, across most of the region, of credit agencies; and high interest rates on central bank bonds, which compete with borrowers for bank funds.

HIGH LEVELS OF LIQUIDITY

Most East African banks are, by world standards, flush with cash. Commercial banks lend a relatively small portion of their total deposits, and a large percentage of their total deposits remain in liquid assets such as cash, inter-bank loans, central bank debt, and short-term state securities. National bonds—which are low-risk, usually tax-free, and have attractive returns—tend to soak up large amounts of bank funds. This is good for the stability and reliability of the banks, but bad for the country as a whole. The money sits in a financial instrument rather than entering the economy to stimulate growth. This liquidity is driven in part by the high reserve requirements of East African central banks, but also by reluctance of the banks to loan. For many East African banks, it is often easier and more profitable to park money safely in bonds than to provide loans.

LACK OF LONG-TERM CAPITAL

Lack of long-term capital is a widespread complaint in East Africa. Outside of Kenya, capital markets are weak or absent. Foreign investors are present but reluctant to commit large sums of capital. Governments do not have spare cash to invest in the financial system. As a result, banks are left to use their own deposits as resources. But across the region, deposits are dominated by short-term and demand deposits. This makes banks very reluctant to invest heavily in medium- or long-term loans. Across the region, lending is dominated by loans of less than two years; in some countries, the average duration of a commercial bank loan is well under a year. Outside of Kenya, loans of more than five years are very rare.

This tends to starve those sectors that require medium- and long-term capital (such as agriculture and manufacturing). Sectors that can make do with short-term loans, such as trade and construction, are at a relative advantage, and accordingly dominate borrowing.

LARGE SECTORAL AND REGIONAL IMBALANCES IN ACCESS TO CREDIT

As noted above, East African lending tends to favor certain sectors. Within those sectors, banks also tend to make loans to certain favored borrowers again and again. This is common worldwide, of course, but in East Africa it often restricts access to credit to a very small circle of "good" borrowers, such as large, well-established businesses with good political connections. Sectoral imbalances also tend to perpetuate themselves. As banks make ever more loans to one sector (e.g., construction) at the expense of another, they become more competent in assessing its creditworthiness. Other sectors, such as agriculture, starved for credit assessments and loans, remain foreign territory. Such patterns among large numbers of banks become very difficult to change.

Another common element is that credit is much easier to access in the capital city and other larger cities than in small towns and rural areas. Outside of Kenya, commercial banking in rural East Africa barely exists. The gap may be filled at times by MFIs, SOCCAs, or ROSCAs (semiformal rotating savings and credit associations). More often, it is not filled at all, and rural farmers have no access to credit beyond borrowing from local moneylenders or running an account (typically against a harvest, and at a very high rate of interest) at the village general store.

This is not entirely the fault of the banks. Rural East Africans tend to be extremely poor. They are often either landless or lack clear title to the lands they use, so they have nothing to offer as collateral. They may also be either illiterate or unsophisticated, or both, making it difficult to negotiate and affirm loans. Additionally, because of infrastructure problems—bad roads, lack of electricity—they are simply hard to reach. Establishing even small bank branches in small, poor communities can be prohibitively expensive. In some countries (Burundi, Uganda), the presence of armed rebel groups in parts of the countryside has placed geographic limits on possible expansion.

One potential solution to this problem is the development of mobile banking. Kenya in recent years has seen explosive growth of banking by mobile phones. Several million rural Kenyans now use mobile phones to transfer money, and more advanced uses are coming soon. However, only Kenya has made this leap thus far. In the rest of the region, mobile banking remains limited or nonexistent.

Finally, it should be noted that, across the region, access to credit is limited even in large cities. In Uganda, only about 40% of adults have even the most limited access to the financial sector; in Tanzania, a recent survey indicated that only 9% have access to formal financial sector services; in Burundi, the figure is probably even lower.

LIMITED PRODUCT LINES

Outside of Kenya, East African banks offer only a limited range of products. The default product remains a short-term commercial loan collateralized by land or by large, easily identified movable property (e.g., construction equipment). Secured transactions using movable collateral are much less common; charges on inventory, finance leases, and accounts receivable are less common still. Consumer finance does exist, and may thrive for a few specific products, but overall it is not well developed.

Few banks offer credit cards and—outside of Kenya—few merchants take them. Warehouse receipt financing is not well developed. Factoring is uncommon and export factoring is very rare. No secondary mortgage market exists (in some countries, a primary mortgage market barely exists), and securitization is almost unknown. Trade finance usually begins and ends with a letter of credit.

This is slowly changing: especially so in those countries with limited competition (Burundi, Ethiopia). Sometimes new instruments are first introduced by MFIs, which may be less regulated than commercial banks, and are almost always less hidebound. However, East Africa's commercial banks tend to be rather conservative. As banks come to realize that these products can make money, they gradually invest in their development. Human capital is a constraint: before a bank can offer, for example, export factoring, it needs to train a critical mass of staff to handle the new product line. This is not always easy. The lack of regional integration is probably one factor slowing development, making it more difficult for banks in Rwanda or Uganda to copy Kenya's successes.

NEGLECT OF AGRICULTURE

Neglect of agriculture is, unfortunately, a reality throughout the region. In each of the six countries discussed here, agriculture is a core industry, in some countries employing as much as 75–90% of the population and providing for nearly half of GDP. With the exception of Kenya, these countries each have export sectors dominated by agricultural products-in the cases of Ethiopia, Rwanda, and Burundi, the export sector is dominated by a single product (coffee). Yet in all six countries, the agricultural sector is consistently starved for credit.

This is not for lack of effort. Governments and donor agencies have both tried to push more money into agriculture. Their methods have ranged from tax exemptions to guarantees for agricultural loans. The only consistent element has been a failure to succeed: across the region, agriculture remains woefully short of credit.

The credit shortage is not categorical. Export crops (coffee, tea, cut flowers) can sometimes acquire credit—although when they do, it tends to go to processers and exporters before producers, and large producers before small ones. Large farms, agricultural processing businesses, and slaughterhouses can sometimes obtain loans, but small farmers are at the very end of the line. When they do acquire credit, it is on the worst possible terms.

Some of the reasons for this have already been mentioned; others are obvious. One factor that deserves mention is the problem of title: across the region, rural farmers either do not have clean titles to their lands or cannot easily produce the necessary proof of ownership. Thus they are not able to use their land as collateral. Meanwhile, many banks are not well-versed in the agricultural sector and find it quite difficult to develop and market products that are sensitive to agricultural cycles.

Another issue is the near complete absence of agricultural insurance. Farming is a risky business, and without some level of risk mitigation, banks are reluctant to lend against crops that may be damaged or wiped out by drought, flood, or pests.

COMPETENT CENTRAL BANKS

East Africa does have some advantages. Across the region, central banks tend to be competent, fair, relatively autonomous and, to some extent, insulated from political pressure. This is in large part because most East African countries suffered through periods when central banks were not well-governed, and they had an opportunity to see the results firsthand. By global standards—and given these countries' income levels and general state of development—their central banks are much better than might be expected.

To be specific, all East African central banks are able to carry out basic monitoring, regulatory, and enforcement functions. Some of them are able to carry out more advanced functions, such as anti-money-laundering efforts or capital markets regulation. Most are seen as enforcing a correct level of regulation, neither too much nor too little (Ethiopia is the notable exception here). And most are seen to be reasonably fair.

This is not to say that all is well. East African central banks are often subject to political pressure. Some can resist it, but this very much depends on the particular country and circumstances. Bank directors are often political appointees. Bank staff may be underpaid and have limited competence; if they are good, they may be subject to "revolving door" hiring by commercial banks. Some central banks have become, to some extent, captives of the banks they are supposed to be regulating.

FEW BANK FAILURES, ESPECIALLY IN RECENT YEARS

Since 2000, fewer than ten East African banks have failed. Two of those failures were in Burundi, and came near the end of the long civil war there. Across a region of six countries and more than 150 million people, this is not a bad record. This is in part because governments have stepped in to save weak banks, but mostly it is because East African banks have become more risk-averse, and central banks have gotten better at their jobs. Indeed, one point that is not widely appreciated outside the region is that most East African banks are healthy, and many of them are quite profitable, with surprisingly high returns on investment.

RAPID GROWTH, ALBEIT FROM A SMALL BASE

The last decade has seen the rapid growth of financial sectors across the region. In the case of Kenya, the growth has been explosive. However, in every country, bank deposits and loan portfolios have at least doubled since 2001. In all cases, financial sector growth has outstripped growth in GDP.

This rapid growth must be seen in context: with the exception of Kenya, it is growth from a very small base. Nevertheless, it is an impressive testament to the entrepreneurial spirit of East African businessmen and bankers. Foreign investment has played a modest part, as has donor assistance, but most of the growth has been endogenous. If there is a single most important factor, it is probably competent regulation by the region's central banks.

FOREIGN INVESTMENT

With the notable exception of Ethiopia, where foreign investment in the banking sector is not allowed, all of the countries surveyed here have significant foreign participation in their banking sectors—either partial or complete foreign ownership of local banks, branches of foreign banks, or both. Oddly, almost none of this investment is from within the region: it tends to come from Europe, West Africa, or in some cases South Africa or the Middle East. As elsewhere, such foreign investment is attracted by liquidity and high profit margins; in addition, East Africa is still regarded as a banking frontier, with tremendous potential for future growth.

With the exception of Uganda, none of these countries has a financial sector dominated by foreign investors. However, foreign investors are playing an important role in transferring knowledge, providing access to some medium- and long-term capital, and sparking innovation and competition.

COMPETITION

With the exception of Kenya, no East African country has a truly competitive banking system. Banks compete for deposits and loan customers. They watch each others' interest rates carefully and are solicitous of large clients. However, their limited market penetration and high profitability means they have no strong incentives to improve efficiency or service. In countries where few competent bank managers are available (everywhere, except Kenya) banks tend to draw trained personnel from the same small pool, with managers often moving from one bank to another. Many banks have overlapping boards. The larger banks will often cooperate with each other, especially in funding large recurring enterprises, such as the annual coffee campaigns. However, such cooperation is not always benign: banks, insurance companies, and parastatal agencies are often linked in a complex web of minority ownerships, loans and deposits, interlocking directorates, and mutual back-scratching. Thus, competition tends to be muted, or even absent. Banks have much in common and no strong motivation to make difficulties for each other. Foreign investors into the sector can sometimes upset this cozy network of shared interests, but not always.

Most East African countries have no anti-trust agencies or competition authorities. Where they do exist, they usually ignore the financial sector. Thus, there is no disincentive for collusion among banks.

MFIS AND SACCOS AS IMPORTANT ELEMENTS OF THE FINANCIAL SYSTEM

With the exception of Ethiopia, MFIs and SACCOs are important elements of the financial system across the region. In most of the countries they make more than 20% of all loans. More importantly, they provide financial services to regions, sectors and individuals that are served poorly or not at all by commercial banks.

MFI regulation varies widely across the region. International best practice is to draw a regulatory distinction among (1) commercial banks,

(2) deposit-accepting MFIs, sometimes called MDIs, and (3) MFIs that do not accept deposits. However, not all countries follow this pattern. For instance, Ethiopia regulates all MFIs like banks, whereas Burundi treats MFIs and MDIs as the same.

Government attitudes towards MFIs, and donor levels of support, also vary widely. MFIs in Rwanda have seen very high levels of donor support, while their neighbors in Burundi are being helped by only a single project. Kenya has allowed a huge and vibrant SACCO sector to grow up under a very loose regulatory scheme; Ethiopia has regulated them so strictly that, in a country of 75 million people, there are fewer than 30 MFIs. The only consistency seems to be that, when properly regulated, MFIs are remarkably tenacious: they spring up quickly, somehow find money, and begin lending in unusual market niches. The MFI sector tends to produce more failures than banks, but also more brilliant successes, and in some places MFIs have begun graduating customers up the value chain to banks.

WEAK ENFORCEMENT OF JUDGMENTS

Weak enforcement of judgments is a problem across the region, although it is much worse in some places than in others. Uganda seems to have partially escaped it, thanks to an unusually strong and well-regarded commercial court system. Ethiopia, meanwhile, has avoided many (though not all) of the problems of foreclosure by allowing self-help and private sales, a system unique in the region. However, across most of East Africa, obtaining and enforcing a judgment against a creditor remains very difficult.

OTHER ISSUES OF INTEREST

In addition to the common factors listed above, several other issues are worth discussing briefly.

SUPPLY AND DEMAND

According to most East African businesses surveyed for this study, the supply of credit remains a serious constraint. However, there are social factors that limit demand as well. Most small businesses (especially individual entrepreneurs) rely solely on their own resources and those of family and friends, and many are suspicious of formal credit. They often have a foot in the informal economy and are usually keen to minimize scrutiny from the state.

Meanwhile, East Africa's savings rate is quite low. Several factors contribute to this. Most of the country's population consists of poor farmers. They have only limited access to trustworthy depositary institutions where they can accumulate funds risk-free. Banks and MFIs do not adequately penetrate the hinterlands.

Small farmers also have reasonable concerns. While bank failures have been few, they have made a strong impression, and there have been several failures of MFIs in recent years, making depositors nervous. Additionally, East African commercial banks are focused on collecting deposits from civil servants and other elites. Customers who are illiterate and unsophisticated do not find commercial banks user-friendly.

POLITICAL AND RELATED LOANS

Corruption affects access to credit in a variety of ways. One of the most obvious is politically motivated lending. Most banks privately admit to carrying some of these, and it is acknowledged to be particularly problematic among the region's state-owned banks.

Political loans are often repaid, not in cash but through political means, e.g., a well-connected borrower may exercise influence on behalf of bankers who made a loan possible. The interlinked relationships within most East African banking sectors make this easy. For example, a bank official may be a former deputy minister or a future agency head, and may currently have an interest in a business that sells to the government or needs government licenses. In such cases, there would be little expectation of repayment. The loan would be classified as a non-performing loan (NPL) and eventually written off.

Related loans—made to officers, directors, and shareholders of the bank—are also an issue. Here again, the complex web of mutual ownership and investment between the banks, insurance companies, and parastatals makes these loans easy. Indeed, sometimes the distinction between a related loan and a loan to a long-time customer or business partner is unclear.

Political and related loans tend to raise banks' bad loan ratios. Perhaps as important, they also make it more difficult for borrowers without connections to get access to credit and reduce the capital available to real investors.

WOMEN AND CREDIT

Women have very limited access to credit. While East Africa has many female small entrepreneurs, women are underrepresented in the civil service and other forms of steady employment. Married women do not usually have property in their name and so cannot provide collateral, and in several countries they cannot mortgage property without the consent of their husbands. While a few MFIs make a deliberate attempt to reach women customers, most do not.[3]

INSURANCE

The region's formal insurance industry is worth mentioning because it is closely intertwined with the banking sector. Banks often are associated with particular insurance companies and vice versa, and considerable movement of capital occurs between the two sectors. Also, insurance (or the lack thereof) is a significant factor in banks' willingness to lend. Agricultural insurance is very rare in East Africa—indeed, it is almost unknown outside of Kenya—and this makes banks more reluctant to extend credit to farmers, growers, herdsmen, and agricultural cooperatives.[4]

Across the region, the insurance business is small, but growing quickly. It faces a number of challenges, notably a difficult institutional environment and a weak insurance culture in the economy. Regionally, the most popular products insure against various accidents, motor vehicle damage, losses in transit, and losses from fire. Many products common in developed countries—particularly credit insurance and agricultural insurance—are rare or unknown. Insurance companies, like banks, are still concentrated in particular regions and specific sectors of the economy; most East Africans have little or no access to insurance. However, this sector is growing rapidly and seems likely to provide significant financial intermediation in the next decade.

REGIONAL CREDIT INFORMATION

Much of the commerce in East Africa is conducted on a regional basis, with various producers, traders, and suppliers crossing one or more of the boundaries in the region. As a result, there is great need for creditors to have access to information on a regional basis. However, with functioning credit bureaus in just two of the six countries surveyed here, this seems a distant dream. It will be much easier to develop regional credit bureaus if this capacity is built into new systems, rather than retrofitted onto old ones. As they develop software and legal frameworks for these institutions, all the countries should keep regional integration of credit information firmly in mind. This could include, for example, development and implementation of EAC protocols and standards and/or joint ventures with trustworthy credit agencies from other countries, among other possibilities.

3 Rwanda appears to be a partial exception to this rule. According to Rwanda's Banque Centrale, nearly 30% of bank loans go either to women or to businesses wholly or partially owned by women. The reasons for this are unclear. Rwanda also has a number of MFIs that focus on loans to women.

4 Agricultural loan guarantees seem to be particularly popular among donors: there are programs in five of the six countries covered by this report. However, without the development agricultural insurance and other incentives and protections for creditors, these programs are unlikely to lead to rapid expansion of credit.

MEDIA

In mature economies the media, especially industry periodicals, can play an important role in supporting and developing financial sectors. This is not generally the case in East Africa. Outside of Kenya and Tanzania, media coverage of financial issues tends to be superficial, with little useful analysis of trends, government initiatives, or other financial issues. In some countries, reporting is further complicated by political concerns and a climate that is not friendly to investigative reporting. Most businesspeople in the region rely on Kenyan sources for regional information.

DONOR COORDINATION

There is little or no donor coordination in East Africa on issues of access to credit. Donor activities tend to be ad hoc, with little communication, never mind coordination, among them. To give a single example, in Burundi the IMF and the World Bank have been assisting the country's Central Bank, and USAID has been providing loan guarantees to particular banks, while the Dutch government has been providing technical assistance to microfinance providers. Last year, with the World Bank's assistance, the Central Bank passed new regulations on microfinance. Neither USAID nor the Dutch project were aware of this initiative, though it affected them both.

The problem may not be one of donor coordination per se. Rather, it may be that access to credit is not viewed as a distinct policy area in the same way that, for instance, maternal health is. Donors may simply not be aware of the work of other donors, or may not see it as relevant to their own work.

An interesting exception to this generalization can be found in Rwanda, where most of the major donors have joined FIRST, a multi-donor initiative to strengthen the financial sector. FIRST has had several successes, most notably the drafting, adoption, and partial implementation of a Financial Sector Deepening Plan for the entire country. Donors may want to look hard at this initiative and consider similar initiatives elsewhere in the region.

Another partial exception is the Financial Sector Deepening Trust. This is led by DFID but involves multiple donors, and it is active in Kenya, Tanzania, and Uganda. The FSD Trust could, perhaps, be used as a vehicle for donor coordination on financial issues throughout the region.

COUNTRY ISSUES

BURUNDI

Burundi is widely acknowledged to have the weakest economy in the region, with extreme poverty and recent instability placing sharp constraints on financial sector development. Not surprisingly, Burundi also has the lowest "Getting Credit" score: in this year's World Bank Doing Business report, it ranked 163rd, significantly worse than any of its neighbors.

Despite this low score, Burundi's banking and MFI sectors are surprisingly robust. Burundi has eight commercial banks, two government-owned financing institutions, and more than 25 MFIs. Although a number of banks have gone bankrupt in Burundi—the most recent just two years ago—the surviving commercial banks all appear to be stable and liquid. Loans and deposits are both growing rapidly, and the banking sector appears to be quite profitable. It is also attracting foreign investors: outside banks have purchased two Burundian banks and have taken a large minority share in a third.

That said, the sector has problems. The bad loan rate is very high: between 10% and 20% for individual banks, with an average of 15% to 16% for the banking sector as a whole. Interest rates are high as well: 16% to 20% for bank loans to large commercial clients, with higher risk loans (such as unsecured loans to individuals) charging 30% or more. Corruption is a serious concern, with political and related loans very common. No formal system of credit information exists.[5]

Perhaps the biggest problem, from a development perspective, is that Burundi's banking sector is disconnected from the rest of the economy—a common issue across the region, but particularly problematic there. Almost all loans are extended to a fairly small group of commercial borrowers. Import and export businesses are disproportionately favored while agriculture, manufacturing, and services are neglected and starved for credit.[6] The majority of bank loans are short term; more than 60% are for one year or less, and only about 5% are for more than five years.

The great majority of Burundi's population has no contact with banks or MFIs whatsoever, either as borrowers or depositors. Lending is concentrated geographically in Bujumbura; very few bank branch offices exist outside of the capital and the two largest towns. The

5 An informal system of a "black list" of bad borrowers is kept and administered by the Central Bank. The black list is simply a database of several thousand names with minimal notation: lending bank, date of loan, size of arrears.

6 *See* http://www.brb.bi/pdf/ii12.pdf.

country's large rural population is serviced only by a few MFIs and an indeterminate number of ROSCAs.

Loans for capital investment are almost unheard of.[7] Agricultural lending is almost entirely limited to the coffee and tea sectors; even there, it is limited to processors and exporters, rather than growers, and banks spend a great deal of time and energy fighting for partial or complete loan guarantees from the government and relevant parastatals. A fluctuating but large portion of the banks' loan portfolio is in treasury bonds. These pay a good rate of interest (8% to 9%, tax-free, on short-term bonds) and are quite safe. (Despite its troubled history, the government of Burundi has never defaulted on its loans.) This is good for banks, but a serious problem for the rest of the country which is desperately starved for credit.

Enforcement of loan agreements is a major problem in Burundi. The court system is slow, overcrowded, and corrupt, and judges have only a limited understanding of contracts and commercial law. Banks respond to this by over-collateralizing. Almost all large commercial loans are secured by at least 125% of their value, and mortgages of 150%, 200% or even more are not unknown. In almost all cases, the primary collateral is real property; land is by far the dominant form of security. The majority of commercial bank loans, and a large minority of MFI loans, are secured by real property mortgages. These loans tend to be over-secured, not only because of difficulties in foreclosing, but also because banks have a limited ability to assess land value. Because most landowners in Burundi do not have clear title, only a small minority of Burundi's land is available for mortgaging.

Secured transactions of movable property are rare in Burundi. Accounts receivable financing exists but is not common. One bank recently introduced finance leasing. Warehouse receipts are unknown outside of the coffee sector. Trade finance has not advanced beyond letters of credit; guaranties, export factoring, customs bonds, and other such instruments are unknown.

Burundi's *Banque Centrale* is, on paper, a typical small-country Central Bank, with responsibility for issuing currency, setting monetary policy, overseeing foreign exchange, selling treasury bonds, and regulating the banking sector. The Central Bank receives substantial technical assistance and institutional support from the World Bank and the IMF, and it appears to be competent to carry out its basic functions. It is supposed to be financially and administratively independent of the government and politically neutral. In fact, it is very much subject to influence by the government and banks ostensibly under its supervision. Thus the

7 The typical Burundian bank loan has been described as "about US$10,000 for an LOC to import a container full of cement."

banking community is generally satisfied with the Central Bank's regulatory regime. The MFIs are less so; they are pleased to be regulated, but feel that the Bank's regulations were passed hastily, without enough discussion with the sector, and are too rigid. (For example, the regulations do not distinguish between deposit and nondeposit-accepting MFIs.)

Burundi has a small, but lively and rapidly growing, MFI sector. As of late 2008, it held an estimated $30 million in loans—a figure that has roughly doubled over the last three years. The MFIs have a much wider geographic reach than the banks, and service a much wider range of customers. However, they have very limited access to capital and are not receiving support from the donor community beyond a single project funded by the Netherlands.

ETHIOPIA

In terms of ease of access to credit, the World Bank ranks Ethiopia above Rwanda and Burundi but below Uganda, Tanzania and Kenya. This might suggest that Ethiopia is average for East Africa. In fact, the opposite is true: Ethiopia's financial sector is unusual in a number of respects.

- Foreign banks are not allowed to operate in the country, nor are they allowed to purchase shares in Ethiopian banks.
- Because of concerns about the country's balance of payments, obtaining or doing business in foreign currency is very difficult.
- The financial sector is stringently regulated. Anecdotal reports suggest that Ethiopia may have the least corrupt financial sector in the region. However, it is quite difficult to perform large or unusual transactions, or to introduce new financial products.
- Ethiopian banks tend to over-collateralize their loans heavily, even by regional standards—often by 200% or more.
- Ethiopian banks like to take pledges of a business as a going concern, effectively tying up all assets of a business for any significant loan. Although this is a useful option, in well-balanced financial systems it is not used so frequently.
- Foreclosure can avoid the court system. Ethiopia is the only country in the region that allows self-help and private sale of foreclosed assets.
- Ethiopia is also the only country in this study that is not a member of the WTO.

Like Rwanda, Ethiopia does not allow private ownership of land, though individuals can take leases of up to 99 years. Much of the Ethiopian economy remains publicly owned, which has significant effects on the banking system. Telecommunications are a state monopoly, which means that mobile telephony uptake is the lowest in the region, behind even Burundi. The use of mobile telephones for banking is, therefore, years away.

Currently, nine commercial banks are under the supervision of the NBE (National Bank of Ethiopia): three state-owned banks and six private banks. The NBE also supervises 26 MFIs. Ethiopia's MFI sector is, in proportion to its population, the smallest in the region. There are two reasons for this. First, MFIs were not legal until recently. Second, the National Bank does not distinguish between banks and MFIs (even ones that do not accept deposits); all are subject to the same regulation. MFIs are thus severely constrained by conservative prudential regulations aimed at larger entities and this has hampered their growth.

The problem of overregulation is not unique to the MFIs. Current regulations have criminalized management error or poor financial performance due to economic downturn, so that losses on loans can lead to a jail term for those responsible for giving the loan. Although inappropriate lending should be regulated, such a severe approach does not comport with commercial reality. Even in the healthiest economies, companies fail on a constant basis for a variety of reasons. Many of these companies are unable to repay their loans, but such failure is not reasonably foreseeable at the time of the loans. Criminalizing lending that leads to nonperforming loans encourages bankers to take excessive collateral in order to protect themselves from jail terms. This provision, along with other strong central bank regulation, has encouraged Ethiopian banks to be the most conservative in the region, making loans only when repayment is almost certain. This has resulted in very low rates of nonperforming loans and—by regional standards—low interest rates. However, banks are very risk-averse, unnecessarily liquid, and very reluctant to introduce new procedures or new products. Despite Ethiopia's many unique characteristics, the end result is very similar to several other countries in the region: the banking system makes loans to a handful of preferred borrowers, and is largely disconnected from the rest of the economy.

Secured transactions are known in Ethiopia but are not common. Finance leases are legal—a leasing law was passed in 1998—but leases are heavily regulated and no leasing industry has emerged. For example, only "capital goods" can be leased, and the list of capital goods is determined and kept by the Ministry of Trade and Industry. Also, cars and trucks—the most popular subjects for leasing, especially when a leasing industry is young—are subject to very heavy import duties.

There are few warehouses in Ethiopia, their quality is low, and warehouse personnel are not well trained, thus warehouse receipts, like finance leases, are permitted by law but do not exist in practice.

As noted above, Ethiopia allows self-help and private sale (by auction) of foreclosed assets. This seems to be working well, though some wealthy debtors have been able to game the system by filing a court injunction to stop the process. Even if based on spurious claims, this can take several years to resolve. However, the majority of foreclosures proceed quite rapidly.

Ethiopia has no formal credit information provider, public or private. Banks share lending information with each other, and the Central Bank publishes a monthly list of those who have defaulted on bank loans.

KENYA

In many ways, access to credit represents a good news story for Kenya. The private financial sector is large and vigorous. Banks and other institutions are growing, competing, innovating, and expanding into areas previously viewed as unbankable. Foreign banks continue to enter the Kenya market. Over 5,000 MFIs and SACCOs continue to provide financial services to many Kenyans, specifically in the rural areas, and are flourishing. Non-banks are even wading into the financial waters with innovative products that are providing improved services oriented to the needs of the average Kenyan.

Most remarkable of all, Kenya's World Bank "Getting Credit" ranking is an astonishing *fifth in the entire world*—tied with the United States, and ahead of such major developed economies as Germany and Japan.

Even allowing (as the World Bank itself acknowledges) that their methodology sometimes gives some odd results, it is clear that Kenya is very different from the rest of East Africa. In almost every respect—size and number of banks, size of deposits and portfolios, level of foreign investment, intermediation—Kenya's financial sector is in a class by itself.

Kenya's financial sector is competitive and diverse, with 45 licensed banks, hundreds of MFIs and more than 5,000 SACCOs. Recent years have witnessed new entrants, consolidation, and conversion of MFIs into commercial banks. Approximately 10 years ago, many commercial banks pulled out of rural areas, as the profit margins were too low. However, fast growing institutions, such as Equity Bank, have demonstrated that with the right business model, many previously unbanked individuals could be profitable customers. Many of the large commercial banks have returned to the rural areas to compete with Equity, other smaller banks, MFIs, and SACCOs. The competition among the various types of financial institutions is healthy.

With such rapid growth, the amount of human capital adequately trained to meet the needs of banks, MFIs, SACCOs, and other financial institutions is being stretched thin. All financial institutions must develop a stronger concept of the competencies they require for various positions, and work with educational and training institutions to ensure that their curricula adequately prepare students to enter the labor force.

Kenya recently passed legislation allowing private credit reference bureaus. At least two applicants are already pursuing licensing under the new credit reference bureau legislation. Both firms have been operating in Kenya for some time.

Secured transactions are common in Kenya. There is a system of collateral registries. It has various problems: it is slow, bureaucratic, does not use modern IT, and cannot easily be searched. Lenders use it for lack of anything better, but it is overdue for an upgrade.

Trade finance is well developed. Both domestic and export factoring are widely used. The larger banks are able to handle fairly sophisticated trade finance transactions, including document collection, guaranties, and customs bonds.

Interest rates, though high by world standards, are among the lowest in the region. Kenyan borrowers face the common African problem of lack of access to long-term capital, but this has been to some extent mitigated by foreign investment and the development of local capital markets. While it is not easy to find long-term capital for commercial investment in Kenya, it is at least sometimes possible.

The Central Bank of Kenya is the primary regulatory and supervisory authority of banks and MFIs in Kenya. It is viewed favorably by most in the financial sector as competent, fair, and reasonably free from political influence. It is also seen as unusually transparent and supportive of transparency across the sector. (To give a single example, the CBK is the only bank in the region that publishes an interest rate comparison for lending and savings products for all banks.) The CBK collaborates closely with the Kenya Bankers Association and the Association of Microfinance Institutions on financial sector reform issues.

Kenya has been seeing a very rapid uptake of mobile telecom products for money transfer, and in some situations more robust mobile finance. It is, so far, the only country in the region that is conducting very large amounts of payments and money transfers by mobile phone. These are currently not formally regulated. Though payments/transfers by mobile technology are less risky and more trackable than cash transactions, the lack of a formal regulatory infrastructure is a concern. The CBK is aware of this issue and is developing regulation.

Another unique aspect of Kenya's financial sector is the Kenya School of Monetary Studies. Originally set up by the Central Bank, the school aims to build human capacity for banks, regulators, and non-bank financials in Kenya and across the continent. The School offers a variety of programs including diploma courses, professional courses, and a master's degree in banking. The institution has the potential to be the hub for building human capacity for the financial sector across the EAC and the whole of Africa.

Kenya is also unusual in that banking services are becoming available across the entire country, including rural regions that were traditionally unbanked. Often these services are provided by MFIs or SACCOs. This is an area of some concern, as SACCOs are not regulated at the same level as commercial banks; there has been at least one recent pyramid scheme involving a SACCO, and other forms of fraud are still possible. However, most Kenyan SACCOs are both honest and sound, and in the aggregate they are providing an unprecedented level of access to basic financial services. While the countryside remains severely underserved relative to the larger cities, a rural Kenyan is much more likely to use financial services than a rural Tanzanian or Ugandan.

One could argue that the success of the financial sector has occurred in spite of Kenya's business enabling environment, rather than as a result of it. While the Central Bank is viewed as honest and competent, the rest of Kenya's government is not seen in the same light. Corruption is perceived as a major problem and a significant drag on certain types of investment. The government does not always pay its bills on time, making banks reluctant to lend to government contractors. Poor infrastructure makes trade difficult and raises the cost of capital, especially in rural areas. Enforcement of contracts in Kenya is a problem. With 800,000 to 1,000,000 cases backlogged in a judicial

KENYA: MAKING SENSE OF ALL THE NUMBERS

Over the last ten years, the proliferation of rankings and indicators to measure development results and stimulate reforms has turned into a cottage industry. It can at times be difficult to make much out of any of them, as they often seem to contradict one another.

Kenya provides a perfect example. The charts on the right are only a sampling of the many indicators that are available. The World Bank's *Doing Business* Report has Kenya ranked 5th globally in the area of Getting Credit. They are tied for 1st in their legal rights index with Hong Kong, Malaysia and Singapore. In contrast, the World Economic Forum's (WEF's) Global Competitiveness Report and the World Bank's Enterprise Surveys rank Access to Finance as the 2nd most burdensome constraint to doing business.

So which acclaimed source is right? Actually, both are.

The two variables from the *Doing Business* Report that lead to such a high ranking examine the laws/regulations on the books providing legal rights to creditors and the requirements for credit information sharing. Based on their findings, Kenyan laws meet all 10 of the proxies for strong creditor rights and 4 of the 6 proxies for strong credit information. The WEF and Enterprise Surveys arrive at their conclusion by surveying a sample of firms. The firms report their most problematic constraint, and their responses indicate access to finance being among the top two in each. Part of the story is that all firms would like more finance at better terms. However, there are real problems in accessing finance in Kenya.

For example, though creditor rights are protected in the law, the courts ability to efficiently and transparently enforce the law leaves much to be desired. In fact, it was estimated that the commercial court has 800,000–1,000,000 cases in its queue. The docket for 2009 is already filled and the 2010's is yet to be opened, thus new cases cannot even be filed.

The overall message is that achievement in a particular ranking or indicator should not lead policymakers to declare victory. In fact, they should look to such rankings and indices only to gauge relative success of the business environment.

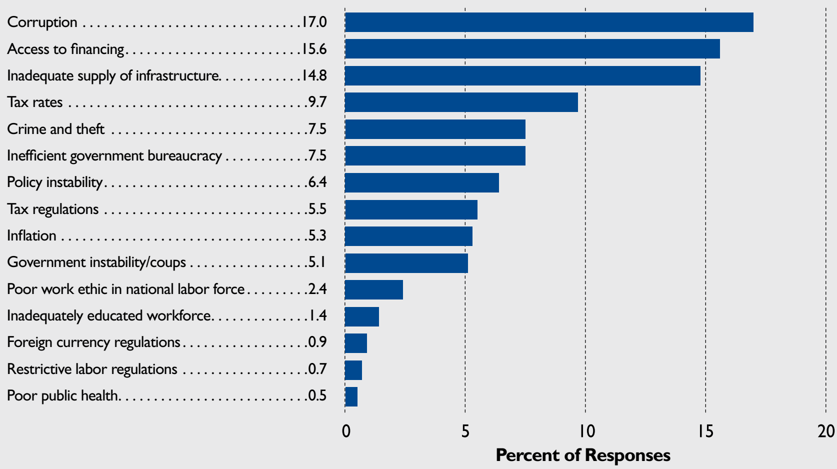
WORLD BANK'S *DOING BUSINESS* (2009)

Doing Business Indicators	Percentile Rank	Indicator Value	Income Group Average	Region Average
Getting Credit Legal Rights Index	99.4	10 of 10	4.3	4.5
Getting Credit Information Index	64.6	4 of 6	2.1	2.3
Getting Credit Private Bureau Coverage (% adults)	56.7	2.1%	3.0	39.3
Getting Credit Public Registry Coverage (% adults)	53.9	0.0%	2.7	3.6

OVERALL GETTING CREDIT RANKING: 5 OF 181

WORLD ECONOMIC FORUM'S GLOBAL COMPETITIVENESS REPORT (2009)

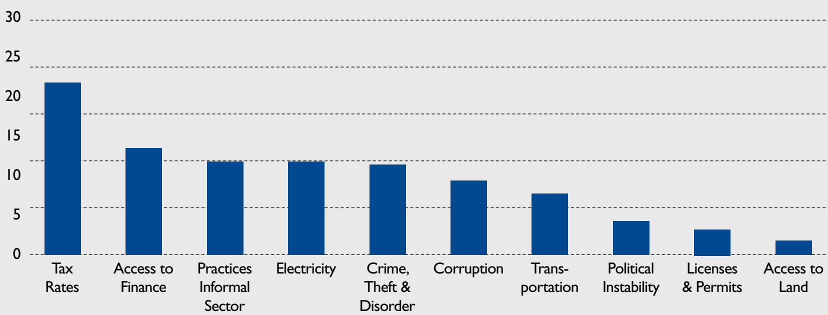
THE MOST PROBLEMATIC FACTORS FOR DOING BUSINESS



Note: From a list of 15 factors, respondents were asked to select the five most problematic for doing business in their country and to rank them between 1 (most problematic) and 5. The bars in the figure show the responses weighted according to their ranking.

WORLD BANK'S *ENTERPRISE SURVEY* (2007)

TOP 10 CONSTRAINTS TO FIRM INVESTMENT IN KENYA (2007)
% OF FIRMS IDENTIFYING PROBLEM AS THEIR GREATEST OBSTACLE



system with too few resources, few have faith that any resolution to cases will be made efficiently and transparently. Political risk is also an issue: last year's brief outbreak of political violence caused a brief but sharp curtailment of lending, and the possibility of further conflicts may be adding a risk premium.

It is also worth noting that Kenya's banks, for all their successes, have shown little interest in expanding regionally. Thus, Kenya's good practices have been slow to spread across its borders.

With respect to media, the best business reporting in East Africa comes from Kenya. The *East African* is the news source of choice for commercial information among businesses across the region. Thus, Kenya's neighbors are well aware of the advances in its financial sector, even if they are not yet able to emulate them.

RWANDA

Lending in Rwanda presents a complex picture. On the positive side, substantial reforms have lowered the costs and risks of lending. *Banque Nationale du Rwanda* (BNR—the nation's central bank) has led the banking system through impressive changes and currently is implementing a comprehensive Financial Sector Development Plan. Since 2000, nonperforming loans have dropped from roughly 60% to approximately 23%. These improvements are reflected in the changing investment climate, with a number of reputable foreign banks actively seeking investment in Rwandan banks. As of late 2007, commercial banking (other than microfinance) reached approximately 40,000 borrowers and 145,000 depositors, out of a total population of more than 9 million. In the microfinance sector, there are tens of thousands of active loans. Although readily available numbers are not complete, Banques Populaires, the country's largest MFI, reportedly has extended over 600,000 small loans. Its core set of borrowers is small enterprises owned by women.[8] Moreover, a number of foreign banks have invested in Rwanda and others are showing strong interest.

At the same time, the World Bank's *Doing Business* still ranks Rwanda as one of the worst in the world (145th out of 181 countries) for getting credit—the second lowest score in the region, after Burundi. The overall lending level is low, and financial institutions are not adequately serving rural areas and various key sectors in the economy.

Non-collection is still a major problem. The enforcement system is weak, as are standards for business records, so banks currently charge

8 *See* Anthony Faiola, Women Rise in Rwanda's Economic Revival, W. Post, May 16, 2008, at A01.

as much as 9% in risk premiums to their less qualified borrowers. High inflation (currently over 10%) drives up the cost of money, forcing up commercial interest rates, which leads to less affordable credit. Mortgages on real property—the most common type of collateral across the region—are complicated by state ownership and other issues (see below), making them less attractive to banks.

Political norms represent an additional problem. Rwanda has a legacy of government influence in lending, where loans have been made based on the political connections of the borrower, not on the borrower's underlying ability to repay. This was a major factor in the country's historically high nonperforming loan rates. To a lesser extent, it still is.

Rwanda has six commercial banks. These banks are generally liquid, but their rates and terms are considered unaffordable to many potential borrowers: interest rates on commercial loans are generally upward of 18% annually, with 200% to 400% collateralization (notwithstanding legal limits on collateralization that are significantly lower). The problem has been magnified by relatively high-interest government bonds (with rates as high as 8–10%), which compete against riskier and more costly loans to potential commercial borrowers. These rates have fallen in recent years, but ongoing problems with inflation tend to offset the gains from these improvements.

Another cost factor is operational inefficiencies. Rwanda's private commercial banks have instituted various internal training programs to improve operations, but Rwandan staff still under-perform compared to bank staff in surrounding countries. The current quality of banking expertise is low. One Rwandan banker estimated that his staff is approximately 40% less efficient than similar bank staff in Uganda and Kenya. This raises the cost of lending and also limits the possibilities for offering new financial products and services. To give a specific example, Rwanda offers only a very limited range of products in trade finance: Rwandan banks can offer letters of credit, but do not undertake guaranties, documentary collections, export factoring, or invoice discounting. There simply are not enough trained personnel to do so, even if demand is present.

Rwanda is unusual in the region in that all land is formally owned by the government: individuals hold only long-term leasehold rights. This has made banks more reluctant to extend loans backed by mortgages. In theory, banks can foreclose on leases in the same manner as fee simple ownership, but there is a perception that leases are more subject to arbitrary amendment and interference from the government. Matters are complicated further by an ongoing program of land distribution which, while politically necessary and socially desirable, adds to fears about the security of land titles. Additionally, Rwanda has a weak system of land titles and recording even by regional standards. The net result is that only a small portion of the country's land is considered suitable for issuing mortgages, and banks want to charge significant risk premiums even for suitable lands.

The mortgage market also suffers from mismatched maturities in the capital markets. Borrowers typically need long-term financing for mortgages on real property investments. For the most part, Rwandan banks take in short-term and demand deposits which must be paid regularly. If they lend funds on a long-term basis, they are unable to meet current obligations effectively. (As noted above, this is a common problem across the region.) Banque Commerciale du Rwanda recently floated a five-year bond on the stock market to increase its medium-term capital, but more work is needed. Outside investment and new financial instruments are necessary to establish long-term sources of funds to support development.

Rwanda has no private credit bureaus to date. There is a public credit bureau, managed by BNR, but it has limited coverage and utility. Only bank loans over about US$9,000 are covered, searches are difficult, and it is quite easy for an informed applicant to evade defraud the system. The IFC is currently working with the BNR on a major upgrade.

Secured lending on movable property is almost nonexistent. The legal framework to support it does not exist, although a law has been drafted and may be approved this year. There is no collateral registry. Finance leasing is legal but very rare because taxation issues make finance leases unattractive. (Rwanda's VAT system is structured so that finance leases are double-taxed.) Receivables financing is known but is rare.

Legal recourse is a serious problem in Rwanda. Once in court, a claim can take several years to process and enforce. Interestingly, the problem with enforcement is not inefficient or unreliable enforcement procedures, but inefficient and unreliable court procedures *prior* to enforcement. Lenders generally agree that once they receive a favorable judgment in a case, they can enforce the judgment within a reasonable time and upon reasonable terms. However, it can take so long to reach that point that many lenders are very reluctant to use the court system, and will do so only as a last resort.

The *Banque Nationale*, BNR, is well regarded by the banking and finance community. Stakeholders agree that (1) BNR is broadly competent to fulfill basic central banking functions, including oversight and regulation of banks and MFIs; (2) BNR, though subject to political influence, has enough autonomy and independence that its decisions are not seen as arbitrary or necessarily motivated by politics; and (3) BNR has involved the finance community in the preparation of new laws and regulations. All these factors have begun to rebuild trust between BNR and the finance community while building greater ownership of the regulatory framework.

That said, there are some weaknesses. In particular, Rwandan finance professionals express concern at the depth of capacity at BNR. There are also concerns about how BNR has dealt with insolvent institutions: the sudden and unexpected closing of eight MFIs several years ago led to a run on banks, as well as an ongoing problem of decreased deposits from Rwandans who are afraid of losing their money in a closure.

Rwanda has a lively and growing MFI sector with a high level of donor support. BNR recently promulgated regulations for a new microfinance bank (MFB), the first of its kind in Rwanda, thus distinguishing the needs of the MFB from the needs of MFIs.

Last year, in accordance with the Financial Sector Development Plan, the BNR launched the Rwanda Stock Exchange (RSE).[9] The RSE, which opened on January 31, 2008, initially offered government and private bonds and now offers equity shares as well. The RSE is open to foreign and national investors and is intended to be the platform for the next round of government privatizations. On opening day, the Banque Commerciale du Rwanda floated its first-ever bond, seeking 5 billion in Rwandan francs (approximately US $9.3 million) through a five-year, 8% note.

TANZANIA

In its most recent *Doing Business* report, the World Bank ranked Tanzania 84th out of 178 countries—above the world median, well above average for Africa, and the second best in the region after Kenya. Tanzania's rank has also improved since last year (when it was 109th) and the year before, reflecting steady progress in this area.

That said, access to credit remains one of the greatest barriers to Tanzania's economic development. While it is difficult to obtain reliable, detailed information, a recent survey of 5,000 Tanzanians indicated that only 9% have access to formal sector financial services and only 4% have a personal loan from a bank.[10] Another study estimates

9 "Rwanda Opens Stock Exchange," *Business Daily Online, available at http://www.propertykenya.com/news/520509-cobrand!;* "Rwanda: Stock Exchange Lists First Corporate Bond," *AllAfrica.com* (February 15, 2008), available at http://allafrica.com/stories/200802150037.html; "Rwanda Issues Another $9m Bond," Rwanda Investment and Export Promotion Agency (RIEPA) (February 12, 2008), *available at* http://www.rwandainvest.com/spip.php?article409.

10 Financial Sector Deepening Trust (FSDT, FinScope Survey (2006).

that 85% of micro and small businesses do not have access to credit. There is a huge unmet demand for credit.[11]

Tanzania's commercial banks are lending a relatively small portion of their total deposits, and a large percentage of their total deposits remain in liquid assets such as cash, inter-bank loans, central bank debt, and short-term state securities. By way of comparison, US banks keep roughly 6% of their total deposits in liquid assets. The figure for Tanzania's National Bank of Commerce is 46%. This problem is exacerbated in Tanzania due to the attractive terms offered on government-issued bonds and the lack of alternative investment vehicles. These bonds, with rates as high as 30%, are tax-free for a period of three years and are virtually risk-free.

In the banks' defense, lending in Tanzania is fraught with uncertainties at almost every stage. Major risks include the difficulty in identifying applicants (there is no national ID system), lack of credit information, poor systems of collateralization, and ineffective enforcement mechanisms. As everywhere in the region, land is the most common form of collateral, but mortgage lending is complicated by several forms of land tenure unique to Tanzania.

The semi-formal lending sector, including SACCOs and financial non-governmental organizations (NGOs), suffers from different but equally serious concerns. Although they are expected to play a major role in the government's poverty alleviation strategies, these entities are subject to minimal oversight by ministries, which readily acknowledge their lack of capacity, both in terms of staff and technology. Further, many of the SACCOs lack the capacity necessary to manage the basic administrative tasks needed to operate. Nonetheless, the Government promotes SACCOs as the preferred vehicle for developing savings and credit options in the villages and rural areas. Until commercial banks are ready to expand beyond the larger towns, this probably makes sense.

There are 22 commercial banks and three other chartered financial institutions operating in Tanzania. Most commercial banks operate in urban areas, where customers are easily accessible and infrastructure is more developed. Lenders at all levels express interest in new technology as a means to overcome the expensive and inconvenience of servicing the rural areas, and support the government's efforts to enact a bill that will facilitate the use of cell phones to make payments.

As a result of increased competition, some commercial banks[12] are branching into micro-lending, an area they generally ignored in the past. However,

11 DFID Country profile.

12 Entities licensed as commercial banks that provide microfinance services include the National Microfinance Bank; CRDB Bank; and Akiba Commercial Bank.

additional incentives are necessary to encourage more institutions to move down market and lend in greater volumes to smaller borrowers.

Currently, the Tanzania Banking Association operates a limited credit reference bureau for its members' use. The Bank of Tanzania is moving forward with the implementation of a broader credit reference system that promises to contain more complete information and to be widely accessible.

Secured transactions are possible in Tanzania, but are rare because of problems with the legal framework and with enforcement. Finance leasing is known and is a modest success; the current level of activity is about US$20 million per year. Trade finance is not well developed and most banks do not get involved in trade finance outside of the coffee sector.

A system of warehouse receipts is being promoted in Tanzania as a means of helping farmers better manage their cash flow and financial needs. The system is still under development, but is proving particularly successful in the coffee industry. Several commercial banks now accept agricultural commodities as collateral under a warehouse receipt arrangement.

Enforcement of judgments is a problem, although the court system is said to be reasonably fair and efficient by regional standards. Tanzania has the region's best score on Transparency International's Corruption Perception Index, and outside investors believe that Tanzania's institutions are generally the least corrupt in East Africa. With regard to the courts, local actors seem to agree. When possible, creditors prefer to seek judgments in the country's single commercial court based in Dar es Salaam, as it is believed to be both faster and more competent than noncommercial courts.

The Bank of Tanzania serves as the primary financial regulator. The officials and staff of the Bank of Tanzania are highly regarded, both by the donor agencies with whom they collaborate and the commercial banks they supervise. The staff is viewed as being well trained and professional. Unfortunately, as in many countries, the Bank of Tanzania suffers from a "revolving door" through which employees are frequently lured by higher salaries from the private sector.

UGANDA

In its most recent *Doing Business* report, the World Bank ranked Uganda 109 out of 181 countries for Getting Credit—not bad by regional standards, but with considerable room for improvement. Uganda's banking sector suffers from a number of the problems common across the region, including very high interest rates, limited access to long-term capital, a weak legal framework, and a limited ability and willingness to develop and market new financial products. As a result, lending in the Ugandan economy is low and financial institutions are not adequately serving rural areas and certain key sectors in the economy.

Credit in Uganda is very expensive, particularly for small businesses. Interest rates hover around 20% and the interest-rate spread between deposits and loans has been more than 10% in recent years. Real interest rates (actual rates less inflation) are among the highest in the region, and much higher than in Kenya and Tanzania. Some banks offer U.S. dollar-denominated loans, which have lower interest rates (both nominal and real), but must be repaid in dollars.

Despite the high interest rates, the level of non-performing loans is low: only about 4%, according to the Bank of Uganda, which would make it the lowest in the region.

Ugandan banks still primarily offer short-term loans—usually two years or less—secured by immovable collateral. The short terms are due to banks' very limited access to medium and long-term capital. The requirement of immovable collateral is due chiefly to the difficulty in enforcing unsecured debt or foreclosing on movable property.

The banking system is generally considered stable, liquid, and well-regulated, although the large exposure to foreign currency, with accompanying exchange rate risks, is an area of concern. There are 20 commercial banks, however the sector is dominated by a few large foreign investors. At the beginning of 2008, four international banks—Stanbic, Standard Chartered, Barclays, and Citi—owned 65%of total commercial bank assets. Credit is increasing, with commercial banks' lending growing by over 10% per annum between 2006 and 2008. This growth was primarily driven by increases in foreign currency loans, but locally denominated loans and deposits have also increased. The growth of the sector is reflected in the number of commercial bank branches; between 2000 and 2008 these nearly doubled, from 123 to more than 220. Many more are planned.

Nonetheless, borrowing levels are still quite low. Credit in rural areas remains limited by a lack of registered titles to land for use as collateral, as well as by poor infrastructure and agricultural support services that restrict productivity and limit access to markets. Furthermore, most businesses are single owner or family-owned and lack sufficient expertise in management and accounting to become credit worthy. A recent survey by FinScope Uganda found that only 33% of Ugandans have ever received a loan and that a majority of the country does not have access to financial services.[13]

Uganda has a large microfinance sector, with over 1,000 credit-only MFIs and SACCOs.[14] This sector has received substantial assistance from USAID and other donors and in many ways it is well developed: microfinance has made the transition from a donor-subsidized sector to commercial one, with donor grants having decreased over the last 10 years. Some microfinance institutions have become deposit-taking and thus regulated by the Bank of Uganda. MFIs increased their total assets by 24% in 2007. They also registered strong growth in deposits (50%), loans (21.7%), and return on equity (14%). Nonetheless, the microfinance industry is not yet meeting all the financing needs of micro-enterprises, and loans remain relatively expensive.

Uganda's finance regulation differentiates between simple MFIs, which do not take deposits, and microfinance deposit-taking institutions (MDIs), which do.[15] Four MDIs are currently licensed by the Bank of Uganda to take deposits and conduct lending within a two-year time frame to SMEs and poorer households. Although the law allows MDIs to collect savings from the public and use them to make loans, other activities of MDIs are significantly restricted as compared to those of a commercial bank.

MDIs, MFIs, and SACCOs hold about 20% of outstanding loans in Uganda.[16] MDIs, like commercial banks, mostly lend to urban residents and SMEs, leaving rural smallholders to rely on SACCOs and MFIs. Because women can seldom hold land titles, microfinance is especially important for them, and about 50–60% of MFI and SACCO clients are women. MDIs are mostly self-sufficient, offering loans to groups and SMEs ranging between US$5,000 and $30,000, with interest rates of about 2–4% per month (27–60% per annum). Over the past three years, the government has focused its resources on SACCOs, aiming to support one in every county with preferential wholesale loans from the Microfinance Support Centre, start-up funds, and training for the staff and board from the Rural Financial Services Programme, provided that the SACCO meets prudential management standards.[17] Salary loans are a dominant product for SACCOs and other rural institutions, although these are limited to clients who work in the formal sector.

The Bank of Uganda has undertaken some ad-hoc inspections of MFIs, mainly SACCOs, to investigate complaints from the police and public

13 FinScope Uganda, *Results of a National Survey on Access to Financial Services in Uganda* (2006).

14 AMFIU, 2008, *available at http://www.amfiu.org.ug/index.php?option=com_content&task=view&id=95&Itemid=109.*

15 David Kalyango (Bank of Uganda), *Uganda's Experience with the Regulatory and Supervisory Framework for Microfinance Institutions* (IRIS Center, University of Maryland, May 2005).

16 Ministry of Finance, Planning and Economic Development, *Report of Census of Financial Institutions in Uganda* (2006).

17 The government of Uganda has adopted a National Development Plan, the PEAP. Pursuant to this, it has developed strategies for increasing access to finance, especially for SMEs and rural households. These include a Microfinance Outreach Plan (MOP) and an associated Rural Financial Services Programme (RFSP). Implementation of the RFSP aims to develop a financial infrastructure of savings and credit cooperatives (SACCOs) that are capable of reaching the population throughout the country.

that the MFIs were illegally taking deposits from the public. But the Bank of Uganda does not currently have the resources to effectively oversee SACCOs and other non-deposit-taking MFIs.

Finance leasing is slowly but steadily developing in Uganda but is not yet close to its potential for financing SMEs. Leasing represents less than 1% of private sector capital formation and approximately 5% of total private sector credit, compared to an average of 14% in emerging markets and 31% in the United States.[18] There is only one large-scale commercial leasing company in Uganda, and its portfolio value is less than $25 million. Some Ugandan commercial banks offer leasing but the volume is low. Some MFIs also engage in some micro-leasing. A leasing law has been submitted to Parliament but has not yet been passed.

Factoring does not appear to be offered yet in Uganda. Receivables financing is known, and occasionally happens, but is rare. The larger Ugandan banks offer trade finance products, including letters of credit, guaranties, documentary collections, and invoice discounting. These appear to be geared toward larger clients and financial institutions that serve smaller borrowers and do not have sufficient trade finance products and expertise.

Secured transactions exist in Uganda, but are rare. The current legal framework does not encourage them, nor is the court system very efficient at foreclosing on movable property collateral.

Until recently, Uganda had no system of credit reference. The Bank of Uganda enacted Credit Reference Bureau Regulations in 2007, and the new Bureau opened its doors at the end of 2008. It is housed at the Bank of Uganda's offices but operated by a South African firm, CompuScan. All commercial banks are required to subscribe, giving both positive and negative credit information. The current reporting system is simple, but an upgrade to full credit scoring is expected by 2011.

Warehouse receipts are well known in Uganda, though their use is limited. In 2006, a Warehouse Receipt System Act was passed, recognizing warehouse receipts as negotiable documents. Warehouse managers licensed for specific categories of goods are responsible to depositors and their banks for the stored commodities. Lenders can register charges on the goods at the central registry of the Uganda Commodity Exchange.

As in most countries in the region, agricultural lending is underdeveloped. Banks and credit institutions generally see agriculture as

18 Juma Kisaame, *Case Study of DFCU Leasing Company—Uganda* (2003).

a high-risk area where they cannot obtain liquid, immovable assets for collateral. A major MDI had a default rate of about 10–15% on its agricultural loans, with 5% of all loans becoming non-performing. Nonetheless, the volume of agricultural loans has increased in recent years—although from a low base, with most loans short or medium-term, and with large traders and processors accessing most of the credit. Even large agricultural enterprises with donor guarantees face interest rates of 19–21%. Enterprises seeking to strengthen their value addition with longer-term investment beyond five years cannot find financing, mainly because banks are constrained by the short-term nature of their own funds. And even with donor or government guarantees, most banks avoid lending to smallholders who lack land titles or other collateral.

The Ministry of Finance attempted to encourage agricultural lending by granting tax exemptions in 2005 for interest earned on agricultural loans. However, the Revenue Authority failed to implement the exemptions, and the separate accounting required proved too cumbersome for banks. The policy did not improve either the rates or volume of agricultural loans.[19]

Uganda's central bank was established in 1996 to provide regulatory, supervisory, and advisory functions in the financial sector. It controls and regulates the money markets and manages the entire financial system. The Bank of Uganda regulates deposit-taking financial institutions, including commercial banks, credit institutions, and microfinance deposit-taking institutions. The Bank of Uganda is perceived as competent, fair, and relatively independent. The Bank regularly conducts on-site inspections and off-site surveillance, as well as monitors and evaluates regulated financial institutions' internal risk management systems and corporate governance. There does not appear to be substantial political pressure on Bank management to tolerate violations of prudential rules. As a result of reforms made in the late 1990s, banks are now well capitalized: Uganda follows Basel I capital adequacy requirements and the ratio of core capital to risk weighted assets has been well over 15% since 2003.

Uganda's courts are, by regional standards, fair and effective. There is a general respect for contracts and the rule of law in Uganda. This translates to a fairly low default rate and the ability of lenders to enforce loan agreements and security interests. The Commercial Court has a good reputation with lenders and their attorneys, and Ugandan banks (and the larger MFIs and MDIs) are willing to use the court system if necessary. The court has a Users Committee and there is regular dialogue

19 Bank of Uganda, *Plan for Modernisation of Agriculture,* Agricultural Finance Year Book (2007).

between the court and attorneys and businesses that appear often in the court. The underlying law is seen as favorable to creditors. (Perhaps even too favorable. A provision granting creditors the ability to have borrowers arrested and incarcerated for up to six months for non-payment of loans—even when no fraud is involved—has been criticized as unnecessarily harsh.)

Uganda has a Securities Exchange, but so far only Standard Chartered Bank and Stanbank have done bond offerings. There is not a legal constraint that would stop banks from listing bonds, but thin capitalization of the Uganda Securities Exchange makes it difficult to raise substantial funds for long-term capital.

RECOMMENDATIONS

REGIONAL INTEGRATION

Regional integration of East Africa's financial system does not yet exist. Regional central banks acknowledge the EAC's mandate to coordinate monetary policy, and they do communicate and exchange information with each other. But they make no effort to coordinate regulation or policies, and the various central banks do not offer each other technical assistance or training. Commercial banks show little interest in cross-border cooperation or joint ventures. There is very little lending across the region's borders. Trade in services is stunted. Although the EAC Treaty encourages the free movement of capital and labor, EAC members (with the exception of Rwanda) have not encouraged the free movement of skilled workers across their borders.

This is unfortunate, because the region's financial sectors could reap tremendous benefits from integration. Human capital is an issue. Before a bank can offer a new financial product, it needs to train a critical mass of staff to manage and market it, and this is not always easy. The lack of regional integration is probably one factor slowing development, making it more difficult for banks in Rwanda or Uganda to copy Kenya's successes.

Possible areas for donor assistance could include:

- Cross-border training programs for banks and other financial service providers
- Using the Central Bank of Kenya's academy for regional training
- Comparing and harmonizing national regulations, especially prudential regulations and regulations dealing with MFIs (see below)
- Sponsoring regional conferences for financial services professionals (i.e., accountants, credit analysts, and bank managers)
- Regional credit information (see below)

REGIONAL CREDIT INFORMATION

A great deal of commerce in East Africa is conducted on a regional basis, with producers, traders, and suppliers crossing one or more of the boundaries in the region. As a result, there is a great need for creditors to have access to information on a regional basis. It will be much easier to develop regional credit bureaus if this capacity is built into new systems, rather than retrofitted onto old ones. This is especially true given that some of the markets may still have too few transactions to sustain a private credit bureau.

Donors should encourage all the countries in the region to keep regional integration of credit information firmly in mind as they develop software and legal frameworks for these institutions. Sharing and exchange of information should be built in from the foundation. Ideally, this process should include development and implementation of EAC-wide protocols and standards.

AGRICULTURAL INSURANCE

Across the region, the agricultural sector suffers from a severe lack of access to credit. There are many reasons for this. However, one that has been largely neglected by both governments and donors is the almost complete absence of agricultural insurance. Kenya has a young program for crop insurance, but in the rest of the region it is almost unknown. Post-harvest insurance exists in some countries and for some products (e.g., for coffee during processing and export), but it benefits only wholesalers and processors, not producers.

The lack of insurance discourages banks from lending on crops, since a bad harvest, drought, flood, fire, or pests can eliminate both collateral and the debtor's ability to repay.

Donors have attempted to stimulate agricultural lending by a variety of means. Agricultural loan guarantees seem to be particularly popular among donors: there are programs in five of the six countries covered by this report. However, without the development of agricultural insurance and other incentives and protections for creditors, these programs are unlikely to lead to rapid expansions of credit. The funds spent for these guarantees might be better invested in pilot programs for crop insurance.

WAREHOUSE RECEIPTS

Although many warehouse receipts initiatives have been attempted in East Africa, few have succeeded. The reasons vary across countries. Some of the possible issues include, but are not limited to: warehouse licensing, warehouse manager training, process design, legal and regulatory infrastructure, agricultural community training, and financial sector buy-in. In Tanzania, the BizCLIR project is leading a Secured Finance Reform effort that will enable the use of all movable property as collateral and encourage banks to lend through improved creditor rights and institutional infrastructure (e.g., web-based collateral registry). In many ways, this reform is an umbrella that the issue of warehouse receipts fits under.

Warehouse receipts capabilities are imperative in the agricultural sector to mitigate the imbalance of market power that manifests itself when all farmers harvest the same crop at the same time. However, donors and governments should not continue to develop warehouse receipts projects without a thorough understanding of where past projects have fallen short. A two-step process would provide the necessary foundation on which to build successful warehouse receipts initiatives:

1. Conduct a qualitative program evaluation of all of the known USAID and other warehouse receipts programs in East Africa (potentially Sub-Saharan Africa). This should include a report with specifics on pitfalls, success factors, and individual country/commodity case studies. The final analysis should be launched at a regional event where project managers of past projects can discuss the results during a facilitated session.

2. Draft a white paper on how secured finance reform and warehouse receipt reform should work together in an optimal environment. This would outline how warehouse receipts are registered in a web-based collateral registry, as well as best practices on warehouse licensing and warehouse manager training.

Such an analysis and white paper will help make sure that future projects get it right.

NEW FINANCIAL INSTRUMENTS

Outside of Kenya, East Africa's banks offer only a very limited range of products. Portfolios are dominated by large commercial loans and mortgages. Finance leases, factoring, and invoice financing are uncommon. Securitization is almost unknown. Trade finance rarely extends beyond the letter of credit.

There is clearly a great deal of potential for new financial instruments in the region. The major impediments seem to be (1) insufficient legal and regulatory frameworks; (2) lack of technical experience and trained personnel on the part of the banks; (3) conservatism on the part of bank management, and (4) lack of information and sophistication among potential customers.

All of these are problems that could be addressed fairly easily through donor intervention. Laws and regulations can be amended using international models and best practices; training programs can be provided for banks and MFIs. The costs involved would be modest, and the payoffs in terms of expanded credit are potentially quite large.

BETTER REGULATION FOR MFIS

MFIs are not treated consistently across the region. In some countries they are regulated in the same manner as banks; in others, they are regulated separately but the regulations do not distinguish between deposit-taking and non-deposit taking MFIs, or between MFIs, SACCOs and ROSCAs. This regulatory confusion is problematic because it can inhibit the growth of the MFI sector.

The international best practice is to treat MFIs as distinct from banks, and to distinguish among the different types of MFIs. There are many international models of regulation to work from, and it should not be difficult to collect stakeholder input and make detailed recommendations to the central banks.

MOBILE BANKING

So far, only Kenya has begun to exploit the possibilities of banking by mobile phone. However, the entire region could benefit from this. Donors should work closely with central banks and telecom regulators across the region to encourage rapid adoption of appropriate regulations. The Kenyan experience is highly relevant here, and can and should be used as an example.

Mobile payments in East Africa are still in a fairly nascent state. Safaricom, in Kenya, has been in the lead with its MPESA product. Its introduction has seen a rapid uptake, especially in rural areas. Though originally intended to be used in a person-to-person situation, entrepreneurs are quickly beginning to incorporate this capability into their businesses. For example, agricultural input providers are using it instead of cash to sell seed/fertilizer to small holders, which reduces the issues of bounced checks and crime. The traders that consolidate small farmer production are also using it to transact business. Mobile payments can be a catalyst to facilitate small scale regional trade, especially for the millions of agricultural producers that are unbanked. However, the legal/institutional environment currently will not support this. First of all, the payments run through the telecom and a correspondent bank, not through a national or regional payment system. As such, a Safaricom/MPESA customer may not send to a Zain customer who does not also have an MPESA account.

This creates a noncompetitive environment and discourages new entry. Also, the central bank has limited capability to regulate mobile finance. Though they liaise with the service providers, no supervision is in place.

The optimal long term solution would be to strive for interoperability across national borders and across telecom providers. The system would be regulated through the central banks to hedge systemic risk and regulate capital levels and e-money issues. Moving towards this state would require:

1. A strawman design of what the optimal regulatory/institutional end state would look like in East Africa;

2. A gap analysis of telecom, banking, competition, and consumer protection laws and regulation across the 5 member states. This analysis would indicate what legal, regulatory or institutional changes would be required to achieve the optimal end state by country;

3. Program design, to include the strategic communication and advocacy to build consensus among the many stakeholders;

4. Implementation efforts should be based on country buy-in and national capacity.

The recommended solution should not punish Safaricom or others for innovating, but should enable the opening up of the system with enough regulation to avoid any inherent risks, thus creating a more liquid market.

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