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Financial Liberalization, Bank Restructuring and the Implications for Non-Bank Intermediaries in the Financial Markets of Africa: Lessons from The Gambia

Abstract: Research on structural adjustment, liberalization and privatization in sub-Saharan Africa has not focused on the consequences of these policy initiatives on the financial sector. This paper documents and discusses the consequences of these reforms on the financial sector in The Gambia. Marked changes in the market structure and portfolio composition of the bank sector severely ration loan activity, particularly in rural areas. This creates a vacuum in which non-bank intermediaries currently operate with varying degrees of moral hazard and principal agent problems. The institutional design for non-bank intermediaries necessary to ensure a viable sustained supply of financial services for a rural clientele in Africa is discussed.

INTRODUCTION

Structural adjustment programmes and the liberalization of markets have traced a checkered path through recent African history. Documentation and analysis of the consequences of financial market liberalization, however, have been less evident in the literature on structural adjustment, which invariably focuses on fiscal and trade balances. At the same time, sub-Saharan African countries have become a laboratory for innovative approaches to reach a marginal clientéle with financial services. Although rarely analysed, there is a logical interrelationship between these two distinct macro and micro oriented developments in recent African financial history. This paper highlights the key consequences of structural adjustment on the financial sector and the implications for financial reforms and the emergence of client-owned non-bank financial intermediaries in the rural financial markets of The Gambia, as representative of the experience of many sub-Saharan African countries.

The Gambia serves as a revealing example of the impact of liberalization on institutional change in the financial sector. The country's experience illustrates how the private sector market demand has responded to the challenge of financial reform and draws out lessons for one increasingly travelled path of financial reform within structural adjustment efforts in Africa.

THE GAMBIA: FROM SUPPLY LEADING FINANCE TO PRIVATIZED FINANCIAL MARKETS

The principal macroeconomic parameters for The Gambia are presented in Table 1. Rising rates of inflation, negative real interest rates, growing budget deficits, and a low growth profile emerged by the mid-1980s. This state of affairs led the government to initiate the Economic Recovery Programme later reinforced by structural adjustment loans from the

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IMF and the World Bank (McPherson and Radelet, 1991). Increasingly rigorous stabilization policies have substantially reduced the rate of inflation from 1988 to the present. The thrust of liberalization in these programmes decisively reshaped the financial sector, which consists of a large public sector development bank and the branches of three international banks. Credit ceilings on the volume of credit were phased out as more traditional methods were established to control the money supply (i.e., open market operations in government securities). Interest rate ceilings were also removed and subsidized interest rates were eliminated, with positive real rates of interest emerging from 1988 onwards. In short, all the distortions and subsidies of the selective credit policies so characteristic of the former supply leading financial development strategy were removed.

Table 1 *Selected Macro-financial Indicators of Growth in The Gambia*

	Financial sector indicators				Real growth of bank credit (1981=100)	
Year	GDP growth rate	GDP deflator (%)	Real loan rate: agric. loans	Loan deposit ratio (private banks)	Agricultural credit	Total credit
1984	–4.5	17.2	–0.4	-	84	89
1985	3.1	8.6	–5.2	-	82	87
1986	2.5	42.9	–10.1	0.45	66	68
1987	2.8	29.9	–16.2	0.35	40	48
1988	1.7	6.4	6.4	0.25	44	47
1989	4.1	13.2	9.2	0.31	32	47
1990	5.6	14.6	9.8	0.31	19	40
1991	2.1	9.9	18.8	0.33	20	40

Source: Central Bank of The Gambia, various bulletins, reported in Graham, *et al.*, 1993.

Finally, a complete privatization of the supply of financial services emerged in July 1992 as the once dominant public sector Gambia Commercial and Development Bank (GCDB) sold its deposit base and a small part of its remaining non-delinquent portfolio to an international bank (Meridien). Instead of privatizing the GCDB itself, a small portion of its performing loans and an ample supply of treasury bills balanced out all its deposit liabilities and were transferred to this private international bank that agreed to enter the banking sector under these conditions. In effect, this buyout represented an implicit deposit insurance bailout vehicle for the government as it found an international bank to assume the deposit liabilities of a failing public sector bank it would otherwise have had to assume itself. Therefore, by late 1992, the banking sector consisted of the branches of four private international banks. The earlier experiment of creating a semi-specialized development bank came to an end as deregulation successfully privatized the country's entire supply of financial services.

Nevertheless, this path of liberalization created important consequences. Columns 5 and 6 of Table 1 highlight the substantial decline in total bank credit and, in particular, agricultural credit that accompanied this process of stabilization, liberalization and privatization. The ratio of agricultural credit to agricultural GDP declined from a range of

30 to 40 percent in the early to mid-1980s to 7 to 8 percent in the early 1990s as a result of the strong urban bias growing out of this financial market reform.

Two features of this decline merit comment. First, much of the decline in the outstanding credit balances, particularly for agriculture, is a reflection of the growing defaults in the GCDB that were finally written off as losses with the closure of this public sector bank in 1992. The decline in the credit balances for the performing loan portfolios of the private sector banks, though evident, was much less severe. Secondly, with the sharp decline in the supply of agricultural credit it is clear that groundnut producers and other rural clientéle have been substantially rationed out of the urban-biased portfolios of the remaining formal sector private banks. Given the high risk and high incidence of defaults in the agricultural portfolio, this is not surprising. Nevertheless, it is important to note that urban-based formal bank networks are not a viable institutional design for removing the dangers of moral hazard in the supply of rural credit in Africa. Other institutional innovations are required to service this missing market niche on a viable self-sustaining basis.

Table 2 *Asset Composition and Rates of Return on Loans and Non-loan Assets in the Gambian Private Banking Sector for Selected Years, 1986–91*

Year	1986	1987	1988	1989	1990	1991
	(1)	(2)	(3)	(4)	(5)	(6)
	A	Relative share of assets				
1. Cash	3.1	3.4	3.4	2.3	2.1	4.5
2. Government securities	25.2	31.4	45.9	45.5	50.4	42.8
3. Loans and advances	26.3	24.9	18.6	21.3	23.9	26.6
4. Other assets	45.4	40.7	32.1	30.9	23.7	26.1
5. Total assets	100.0	100.0	100.0	100.0	100.0	100.0
	B	Rates of return on loans and nonloan assets				
1. Return on loan assets			–3.9	10.3	7.9	-
2. Return on non-loan assets			14.4	14.2	15.2	-
3. Return on total assets			11.2	13.3	13.3	-

Source: Graham *et al.* (1993).

At the same time, an additional portfolio shift can be seen in the loan/deposit ratio for private banks, which declined from 45 percent in the mid-1980s to 31–33 percent by the early 1990s (Table 1, column 4). The low and declining loan/deposit ratio for private banks raises questions about the asset structure of the banking system. On the one hand, a sharp decline in loan activity has been recorded from the early 1980s. Clearly, some asset other than loans has risen in relative importance in the asset portfolio of the banking industry from 1986 to the present to absorb the excess liquidity in the banking system. The evidence in Table 2 is clear. Short term treasury bills (i.e., government securities) rose rapidly in the portfolios of the three commercial banks that eventually comprised the entire banking industry by the end of 1992. Whereas in 1986 treasury bills comprised only 25 percent of total assets, by 1990 they had increased to 50 percent of the asset portfolios of the private sector banks. This is far higher than the ratios typically recorded for government and corporate securities held by banks in developed countries (i.e., 20–25 percent).

From 1988 onwards the relative weight of treasury bills in total assets grew to roughly twice that of loans. In the final analysis, this risk-free return of T-bills clearly outweighed the risk-adjusted returns in the loan market. Table 2, panel B underlines this risk feature by comparing the rates of return to loan and non-loan activity for private commercial banks in the banking industry of The Gambia from 1988 to 1990. First, the risks of lending are apparent through both the negative returns recorded in 1988 and the greater variance in returns compared to non-loan activity (primarily returns from T-bills and foreign exchange transactions). The returns on non-loan activity are substantially higher and more stable through time, and unusually high by international standards. Rates of return on assets of only one to two percent are already considered high in the banking industry in developed economies. The high rates in The Gambia grow out of the wide gross intermediation margins of 15 to 16 points registered by banks in the country, which are three to four times higher than those characteristic of banks in more developed financial markets and clearly reflect the higher risks of lending and the lack of competition in the banking industry in The Gambia.

The challenge now facing the Gambian authorities is to expand and broaden financial intermediation beyond the mere transfer of the public deposits into securities to cover the government's budget deficits. More attention must be given to the encouragement of institutional innovations to increase the supply of financial services to the admittedly riskier rural clientéle that have been largely rationed out of bank portfolios through this path of deregulation and privatization. The degree to which NGOs can satisfactorily fill this vacuum and supply viable, self-sustaining financial services to their low-income constituencies is the challenge facing many African countries.

NONBANK FINANCIAL INTERMEDIATION: THE NGO OPTION

NGO services grow most rapidly in a liberalized economy and in a democratic policy environment. The relatively more liberal and open society in The Gambia has stimulated a response from several NGOs to create an alternative supply of financial services for their marginal constituencies. Their diverse operational philosophies, however, have resulted in heterogenous financial technologies that send mixed market signals and create market segmentation. Indeed, the entry of NGOs in the rural financial markets of The Gambia to overcome the lack of government services and the limited reach of formal financial services has led to a number of cases of market failure (Graham *et al.*, 1993). This raises the question of whether NGOs can develop into viable semi-formal financial institutions. An examination of the NGO experiences in The Gambia can shed some light on the role of NGOs as financial intermediaries and indicate possible policy implications for the financial sector in newly liberalized economies in Africa.

Principal-agent problems are allegedly low for NGOs compared to formal lenders such as banks due to information advantages gained from their operations at the grassroots level. However, problems inherent to rural financial markets remain in terms of developing incentive compatible contracts, contract enforcement and effective monitoring of agents. Lack of regulatory guidelines for NGOs in The Gambia, combined with lack of legal support to enforce contracts, offers weak incentives for the development of sustainable financial programmes by NGOs. The majority of these programmes are frequently designed as an opportunistic response to donor signals, with little emphasis on programme viability and sustainability. The problems can, however, be minimized through appropriate organizational design. The operational characteristics of four different NGO programmes that currently provide financial services in rural Gambia are reviewed. The evidence on their performance offers insights into the organizational features conducive to a sustainable supply of financial services.

NGOs became active participants in Gambian financial markets in the 1980s as a result of economic liberalization and the concomitant decline in formal financial services. Currently, 14 national and international NGOs provide financial services which supply nearly 20 percent of total agricultural loans (Graham *et al.*, 1993). The operational strategies of these several NGOs range from the classic supply leading model to more unsubsidized institutions. Table 3 summarizes the operational strategies and performance indicators of four representative designs which can be arranged in a continuum based on their level of subsidization.

At one extreme, in column one of Table 3, Action Aid, The Gambia (AATG), represents a typical supply leading model that is supported by external funds and offers subsidized loans to a targeted clientele. At the other extreme, in column four, the Village Savings and Credit Associations (VISACAs) offer untargeted loans at market rates using locally mobilized resources and attractive deposit services. The middle section of the continuum is composed of The Gambia Women's Financing Association (GWFA) that offers only unsubsidized loans using external funds and no deposit services, and the Association of Farmers, Educators and Teachers (AFET) that mobilizes local savings, to a large extent to provide unsubsidized loans that are linked to savings held by the beneficiaries.

In general, the evidence in Table 3 suggests that the sustainability of a programme depends largely on its ability to: generate internal funds through deposit mobilization by offering attractive interest rates to fund loans; cover operational costs without external subsidization; mitigate risks due to covariance in incomes through geographic and portfolio diversification; reduce agency problems through an increased stake of the depositor-savers and the local loan approval committee; develop appropriate collateral substitutes in the absence of tangible collateral held by the population, and recover loans. If performance indicators such as loan recovery rate, marginal clients served and services offered are a reflection of the efficiency of a programme followed by an NGO, the VISACA stands out as the best model to attain sustainability.

In summary, the emphasis on locally mobilized resources to supply loans and the use of local personnel to screen applicants have helped the VISACAs to reduce loan monitoring and contract enforcement costs. Furthermore, their attractive savings programmes that are flexible, remunerative and accessible with minimal transaction costs, provide incentives for savings mobilization and induce an incentive-compatible environment for contract enforcement on borrowers, as local saver-depositors closely monitor the use of their funds by borrowers. In addition, their use of both tangible collateral and effective collateral substitutes to supply loans to asset-poor members and enforce contracts contributes towards their success in loan repayment. The VISACA model is clearly a Pareto improvement over the other NGO models in The Gambia. As indicated in line 7, its agency problem of moral hazard is low in comparison to those of the

Table 3 *Operational Characteristics of Selected NGO Designs in Providing Financial Services and their Performance Indicators: The Case of The Gambia*

Items	NGOs			
	Action Aid The Gambia (AATG)	Gambian Women Financial Association (GWFA)	Association Farmers, Educators, Trainers (AFETs)	Village Savings and Credit Association (VISACAs)
	(1)	(2)	(3)	(4)
1. Status	International	National	National	Hybrid
2. Sponsors	UK[1]	WID of WB[1]	DANIDA[1], US embassy	CIDR/KFW[1]
3. Organizational design features				
a. Operational philosophy	Encourage income generating activities	Production loans	Improve access to financial services through village banks	Provide unsubsidized financial services
b. Source of funds for financial services	External	External	Local savings; some external	All local savings
c. Financial services offered	Credit, compulsory savings	Credit	Credit and savings	Credit and savings
d. Target clientele	Women and farmers	Women	Microbus, women and youth	Untargeted
e. Mode of reaching clientele	Mostly kafo groups	Individuals	Mostly kafo groups	Mostly individuals

Table 3 *Operational Characteristics of Selected NGO Designs in Providing Financial Services and their Performance Indicators: The Case of The Gambia* (continued)

Items	NGOs			
	Action Aid The Gambia (AATG)	Gambian Women Financial Association (GWFA)	Association Farmers, Educators, Trainers (AFETs)	Village Savings and Credit Association (VISACAs)
	(1)	(2)	(3)	(4)
4. Terms and conditions and instruments used				
a. Loan int. rate (%/yr)	12	24–25	24	40–60
b. Savings int. rate (%/yr)	0	-	15–18	20–40
c. Collateral	Group liability	Co-signers	Guarantors and savings	Animals, tools and jewelry
5. Subsidy component				
a. External technical assistance	High	Moderate	High	Moderate
b. Operational costs	High	High	Moderate	None
6. Performance Indicators (as of 1991)				
a. No. of loans issued	246 individuals; 53 groups	66 individuals	1343 individuals	1266 individuals
b. Ave. short term loan size ($)	25	580	28	37
c. Repayment rate (%)	42	75	72	95
d. Percent of women clients	63	100	82	52
7. Agency Problem	Severe	Moderate	Moderate	Low

Source: Graham *et al.*, 1993, chapters 1, 2 and 5.

Notes: UK: United Kingdom, WID of WB: Women in Development Division of the World Bank, DANIDA: Danish International Development Aid, CIDR/KFW: Centre International de Développement et de Recherce/Kreditanstalt fur Wiederaufbau.

other NGO designs. However, it is still susceptible to systemic failure due to its design as a village unit rather than as a broad network that could mitigate covariant income through geographic diversification. Furthermore, there are some limitations to locally available resources that can be mobilized in VISACAs. Hence, the VISACAs' loan portfolio is constrained by the economic activities of the region in which they operate. Nevertheless, in the end the model underlines the positive impact of local savings on the portfolio performance of the village banks.

CONCLUSIONS

Several conclusions may drawn from this study. First, it is clear that stabilization and deregulation was a necessary condition for The Gambia eventually to work itself out of growing economic stagnation from the late 1980s onwards. Secondly, it is also clear that deregulation of markets and a need to clean up the balance sheets of an insolvent development bank led to a decline in the real levels of outstanding credit from the levels established during the period of supply leading finance in the early to mid-1980s. This was, however, to be expected, given the high level of non-performing loans inflating the credit data for the earlier era. Thirdly, it is clear that there was a sectoral incidence in the reallocation of the portfolio of formal financial markets as agricultural lending declined relative to non-agricultural lending. In the meantime, riskier but potentially remunerative low-income clientele, particularly rural clientéle, were screened out of formal financial sector portfolios. In short, formal sector banking institutions have the resources, but not the information nor the contract enforcement mechanisms to service this clientéle.

Finally, it would appear that non-bank financial institutions can play a positive role in servicing the demand for financial services from this low-income rural clientéle. In The Gambia, several NGO initiatives are under way to fill the vacuum left by the downscaling and elimination of government subsidized credit delivery vehicles in rural areas. While local NGOs presumably have a comparative advantage over formal banks in the quality of local borrower information, they do not necessarily have the means to deal with effective monitoring and contract enforcement at this level. The evidence to date strongly suggests that local deposit-savings mobilization is essential to ensure a proper organizational incentive for effective monitoring and contract enforcement. Deposit services in village banks or savings and credit associations generate valuable services of safekeeping, liquidity reserves and returns on savings. Liquidity reserves are particularly important for rural clientele to manage risk and smooth consumption. Subsidization is legitimate in these cases for initial start-up costs and technical assistance support over a period of time. However, unsubsidized market rates should prevail for deposits and loans; otherwise, subsidized loan rates will come at the expense of a lower return for net savers in these institutions, weakening the base for local deposit mobilization.

In conclusion, it is necessary to document more fully the numerous NGO (non-bank) experiments currently operating in Africa. Some recent scholarship on the multiple roles and functions of informal contracts and the way in which they substitute for missing markets has enriched the literature (Udry, 1990; Eswaran and Kotwal, 1989), but it is more sparse on the recent experience of semi-formal financial intermediaries and the degree to which they can resolve the information and contract enforcement problems necessary to expand the frontier of finance in rural Africa and open the possibility for linking formal and informal financial markets.

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DISCUSSION OPENING — Herbert I. Behrmann *(University of Natal, Republic of South Africa)*

This paper has been interesting to me in highlighting a particularly successful NGO form of credit Association, VISACA. It is reminiscent of the Raiffeisen system of cooperative credit that was developed in Germany in the nineteenth century. It is notable that the types of variable cost inputs that are financed with moveable collateral as security are those that realize high marginal returns but inputs that are not likely to be financed by banks because of the high risks. Simple, and not excessively punitive, rules are needed to administer such a form of credit.

A system of informal savings associations has developed on a large scale in South Africa called 'Stokvels' and there is apparently literature available on the functioning of this system.