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Banking and Microfinance Markets and Management

Cwinya-Ai, Steven:

Perspectives of Financial Institutions in East Africa

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Executive Summary

The paper discusses challenges and opportunities for financial institutions in East Africa. Outreach of FIs in the region is still low. However, with the growth of the economies in the region, and with their integration through the East African Union, there are many opportunities for growth. The major risk stems from the political and regulatory frameworks, the major challenges are mastering integrated technology platforms and building highly capable human resources.

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The Series

MMU's department of banking and microfinance edits occasional papers which discuss developments of banking and microfinance markets and/or of management of financial institutions.

The department welcomes papers on current and pertinent issues of banking and microfinance, well argued and written in a practically oriented style that uses minimum technical apparatus. We appreciate reference to contemporary policy debate, technological developments and recent empirical material. Furthermore, we invite response notes – arguments in support or challenge of issues brought in any of the occasional papers – of 1.5-3 pages lengths.

The department's occasional papers and according response notes are published electronically through our website; hardcopies are available in MMU's library.

Occasional papers on banking and microfinance markets and management so far:

No. 1 Schmidt O. (ed.): Proceedings of MMU's 1st Microfinance Research Seminar, May 2012.

No. 2: Cwinya-Ai, S.: Perspectives of Financial Institutions in East Africa, November 2012.

No. 3: Kanyunyuzi,, M. / Schmidt O. (eds.): Proceedings of MMU's 1st Agric-Fin Seminar, November 2012.

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List of Acronyms and abbreviations

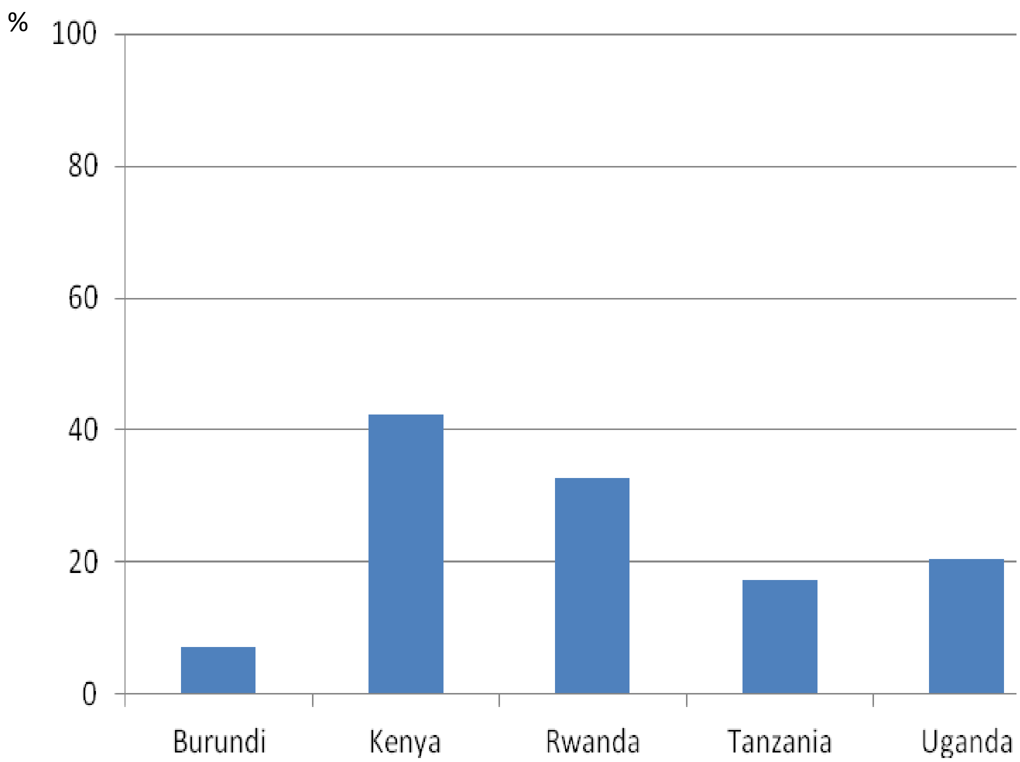
AMFIU	Association of Microfinance Institutions in Uganda
BoU	Bank of Uganda
EAC	East African Community
FDI	Foreign Direct Investment
FI	Financial Institution
GDP	Gross Domestic Product
GoU	Government of Uganda
HR	Human Resources
ICT	Information and Communication Technology
MDI	Microfinance Deposit-taking Institution

1 Introduction

East Africa's economy has developed very favourably in the last 2 decades. With increased political and macro-economic stability, income per capita has grown and poverty reduced. Radelet (2010) counts Rwanda, Tanzania and Uganda Tanzania among the most dynamic economies of East Africa. They are among 17 African countries that grew income per capita by more than 2% on annual average between 1996 and 2008. Kenya is counted as a threshold country; its income per capita grew by more than 2% in a shorter period only, between 2003 and 2008. The economist (2010) names Kenya and Rwanda among the 'emerging emerging markets'; those are the economies expected to be most dynamic in the year to come.

Accordingly, financial sectors across East Africa have grown their customer numbers and loan and savings portfolios. In 2011, about 1 out of 3 East Africans held an account in a regulated financial institution (FI) (graph 1).

Graph 1: % of population (>15 years old) with an account in a regulated FI, 2011



Source: World Bank (2012a).

To that backdrop, this article, after a brief comparison of the financial sectors of the East African countries (section 2), discusses opportunities and challenges for FIs in East Africa (sections 3 and 4). Section 5 concludes with an outlook.

2 Comparison of Financial Sectors in East Africa

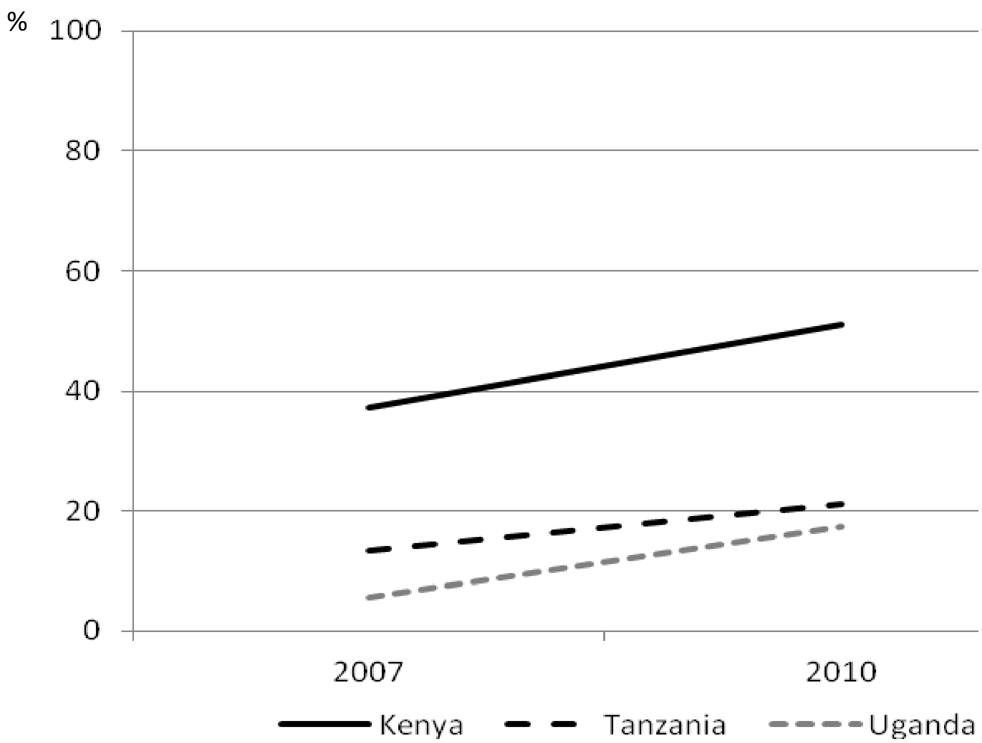
The financial sector refers to all the financial institutions, markets, instruments and regulatory framework in an economy.

In terms of domestic credit, the depth of Kenya's financial sector is more than double of the depth of Uganda's and Tanzania's financial sectors. Remarkably, Uganda has been catching up quickly with Tanzania (graph 2).

Accordingly, the number of regulated FIs is higher in Kenya than in Uganda and Tanzania:

- Burundi: 9 Commercial Banks;
- Kenya: 43 Commercial Banks, 6 MDIs;

Graph 2: Domestic Credit by regulated FIs (% of GDP), 2007 and 2010



Source: World Bank (2012b).

- Rwanda: 12 Commercial Banks;
- Uganda: 23 Commercial Banks, 4 MDIs 2 credit institutions;
- Tanzania: 29 Commercial Banks.

Out of these, 17 Banks operate across the region. These include at least 9 African banks: ABC, CBA, DTB, Eco, Equity, Fina, KCB, Stanbic, UBA.

In Uganda, the central bank (Bank of Uganda – BoU) is in charge of licensing and supervising FIs (see box 1). FIs are known by the type of license they have received. Tier 1 (commercial banks) and tier 2 (credit institutions)-FIs are licensed under the Financial Institutions Act of 2004. Tier 3 (MDIs) are licensed under the Microfinance Deposit-taking Institutions Act of 2003. Tier 4-FIs are not licensed and supervised by BoU; they include savings and credit cooperatives, money lending companies, and non-governmental organisations that offer microfinance.

Currently, Uganda has licensed 23 commercial banks, 3 credit institutions (e. g. Post Bank, Opportunity Bank) and 4 MDIs (PRIDE MF, FINCA, UFT, UWESO). Other prudentially regulated institutions include Forex Bureaus, Insurance Companies and Credit Reference Companies.

Estimates of the numbers of tier-4 institutions vary, but they are usually put at around 1,000 (e. g. AMFIU 2011).

3 Opportunities for FIs in East Africa

East Africa represents a wide market of about 140 million people. The East African Community (EAC) encourages free flows of capital, goods and labour to all areas of the region. The latter enable a fairer distribution of human capital development to reduce existing skill gaps. This becomes particularly tangible in major urban areas such as Nairobi, Mombasa, Dar-Es-Salaam and Greater Kampala. These will improve employment levels and career opportunities.

The integration into a single East African market will promote stability as local issues become less important. It will offer economies of scope and scale as regional infrastructure improves, e.g. northern corridor that runs from Mombasa to DR Congo. Customers will enjoy better and wider choices of products as companies face intensified competition. At the same time, these companies will improve their international competitiveness.

Equity and Kenya Commercial Bank are examples for East African FIs that have gained competitiveness and attracted investors beyond East Africa. They have developed new products and harnessed latest technologies to enhance their foot print and reach, examples are KCB's T24 banking platform; Agency Banking and Mobile banking.

Importantly, the economic federation will promote one stable currency for the EAC.

Box 1: Prudential and non-prudential regulation

Prudential regulation means that the companies must obtain a license before starting operating, and are closely supervised. Supervision is carried out by BoU according to the laws, including the following:

1) Licensing (requirements are laid out in detail in the law and according regulations, including minimum capital requirements);
2) Reporting (the law defines a number of reports, e. g. capital adequacy, insider lending, which have to be submitted weekly, monthly, or annually);
3) On-site-visits;
4) Approving external auditors;
5) Receiving reports directly from the external auditors;
6) Implementing instructions given by BoU based on reports and on-site-visits;
7) Assessing and (dis)approving of candidates for board of directors;
8) Removing managers;
9) If all other fails: Closing down the FI.

Non-prudential regulation means that an organization is only registered but not licensed, and its operations are not supervised. Such organisations may join voluntary arrangements, e. g. code of conduct or rating, to signal to customers that they are professional.

4 Challenges for FIs in East Africa

FIs and their investors face three categories of challenges: The macro-economic environment, the development of the market economy, and the managerial demands for expanded outreach.

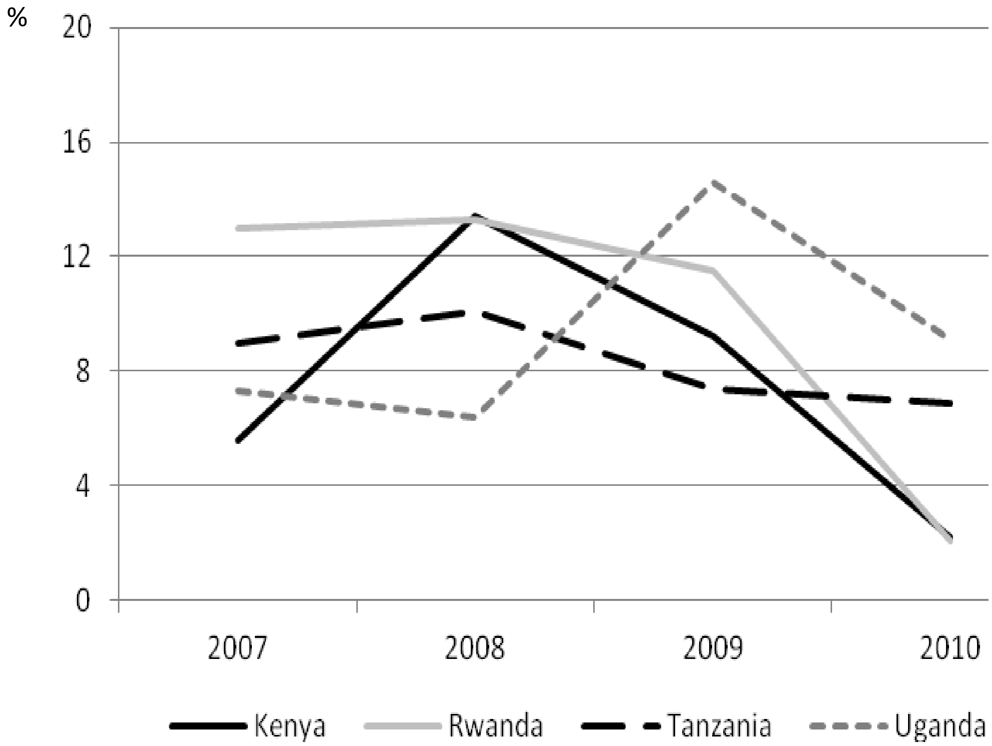
1) Macro-economic environment

The region has experienced macro-economic turbulences, in Uganda inflation (consumer prices) hit 30% in October 2011 (BoU 2011). Inflation has been volatile across the region in recent years. Food and oil prices have been major factors. Generally, the world economy has become much more volatile since the world financial crisis and subsequent depression 2008/9 (Schmidt 2011a, b). This coupled with the trade deficits place local East African currencies under pressure. East Africa is linked to the global economy through foreign direct investment (FDI), remittances by workers, tourism and donor funding. As inflation and exchange rates are two sides of the same coin, exchange rates have been very volatile, increasing the cost of cross-border business within and beyond East Africa. The region requires a strong and comprehensive regulatory environment to stabilize the macro-economic conditions.

Note that inflation in Uganda has been higher than in other East African countries since 2009 (graph 3).

Hand in hand with a strong and comprehensive regulatory environment, FIs must build prudent corporate governance as a pre-requisite for growth across the region and beyond.

Graph 3: Annual inflation rates (GDP deflator), 2007-2010



Source: World Bank (2012b).

2) Market development

FIs face changing competition especially from new players. At the same time, they have to invest to overcome underdeveloped public infrastructure and inferior technologies. The latter is expected to improve as the market for ICT services have deepened, and a new broadband cable is expected to bring rates down.

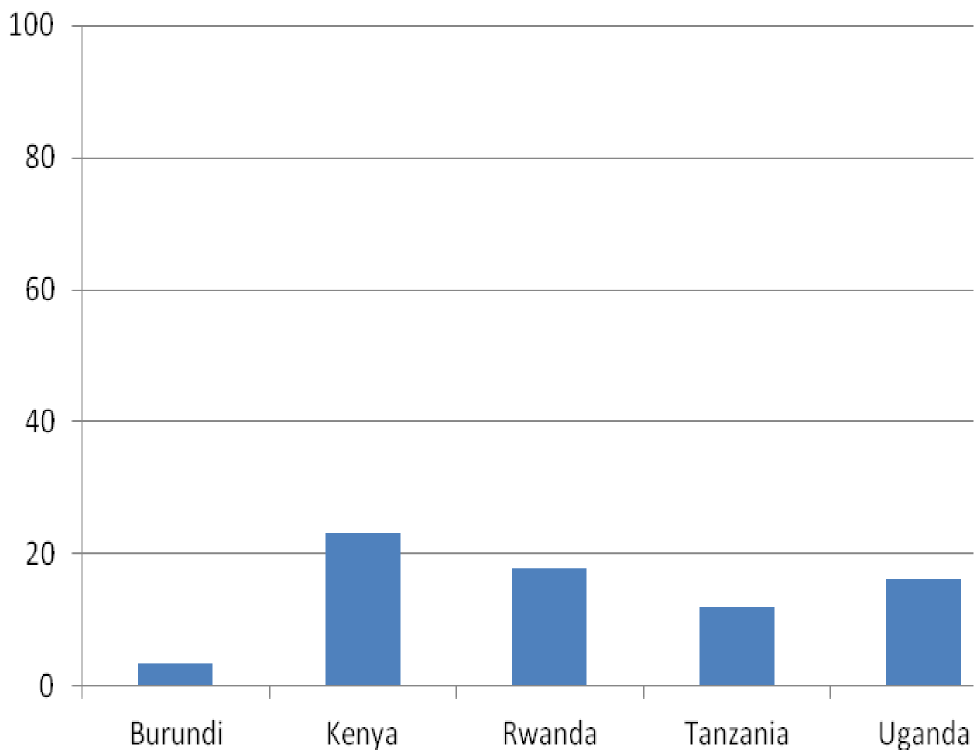
Weak capital markets hinder resource mobilization. This is closely linked to poorly developed land markets. Land reforms need to be implemented and land ownership formalized as a major vehicle of credit (collateral).

FIs also face a shortfall in human capital stocks. The costs of fraud and forgeries are high.

The monetary savings culture is rather poor (graph 5). It is noteworthy that Uganda's formal savings outreach is high relative to total account penetration (compare graphs 5 and 1).

Savings culture is closely linked to the challenges of FIs to recruit professional staff members who provide reliable services, and moreover to the high inflation which renders bank savings unattractive.

Graph 4: % of population (>15 years old) saving in a regulated FI, 2011



Source: World Bank (2012a).

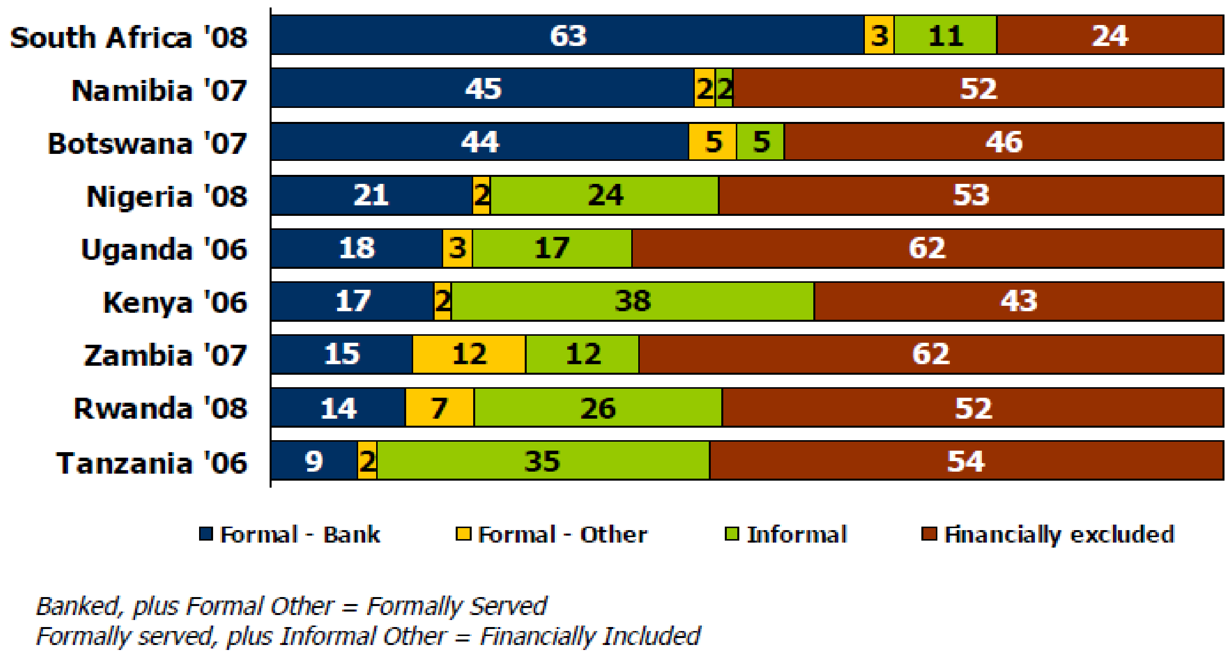
3) Outreach

FIs need to establish a wider presence across East Africa, and to penetrate the still large segment of financially excluded populations (graph 4).

To achieve more outreach, FIs are required to improve;

- Customer service – seamless service;
- Technology – A reliable, integrated core banking system;
- Product innovation and relevance;
- HR management: attract and retain the best people;
- Sensitivity to Risk management and compliance with international regulatory and governance standards.

Graph 5: Financial Inclusion in Africa



Source: FinScope, quoted by Bagazonzya (2010).

5 Outlook

The volatile and in tendency depreciated currencies could shift expenditure towards local products while boosting exports. Meanwhile, coordinated efforts by the central banks could control inflation – as has been the case through hiking the Central Bank Rate in Uganda and accordingly other East African countries – to discourage borrowing and encourage saving. Treasury bill rates were hiked to mop up liquidity from the public into the central bank. The largest risk sits with governments and their fiscal policy choices.

Overall, East Africa is a region with dynamic economies and a lot of opportunities for FIs. FI-managers will have to be professional, innovative, and passionate to harness these opportunities. If they reach out to ever more East Africans of all income strata through new products, better customer care and professional and prudent systems, they can become internationally competitive providers of financial services.

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