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## Banking in Sub-Saharan Africa: What Went Wrong?

*Roland Daumont, Françoise Le Gall, and  
François Leroux*

## IMF Working Paper

IMF Institute

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Prepared by Roland Daumont, Françoise Le Gall, and François Leroux<sup>1</sup>

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#### Abstract

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The purpose of this paper is to study the origins of banking crises in sub-Saharan Africa, drawing upon the experience of ten countries during the period 1985–95. It examines, in particular, which factors were the most important sources of these crises. The conclusions underscore that the banking crises examined did not represent an entirely special case—a number of factors identified in the general literature, including macroeconomic shocks, were highly relevant—but note that several of their features were nonetheless specific to this part of the world. These banking crises were the very prototype of endemic crises associated with heavy government intervention in the banking system. In this regard, the paper analyzes the complex role of the government in banking in sub-Saharan Africa, the many channels through which governments intervened, and the economic and institutional environment in which the banks operated.

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Author's E-Mail Address: [rdaumont@imf.org](mailto:rdaumont@imf.org), [flegall@imf.org](mailto:flegall@imf.org), [francois.leroux@hec.ca](mailto:francois.leroux@hec.ca)

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## I. INTRODUCTION

Banking crises occurred throughout sub-Saharan Africa in the 1980s and 1990s. The banking system in many countries hobbled along or simply collapsed altogether, and financial development suffered a major setback. Furthermore, the resolution of the crises in some cases imposed very large costs on the government. Yet, the experience of sub-Saharan Africa with banking crises has drawn relatively little attention.

There is an abundant literature on banking crises, but much of the survey and empirical work covers a wide range of industrialized and developing countries, and more recently, Asian countries.<sup>2</sup> There is also a fairly substantial literature on the financial sector in Africa, for example, Mehran et al (1998), Nisanke and Aryeetey (1998), Paulson (1993), and Popiel (1994), but much of it focuses on financial intermediation and the development of monetary instruments and financial markets. Some work has been undertaken on banking crises in Africa. In particular, Brownsbridge and Harvey (1998) analyze in detail the experience of financial liberalization in eight Anglophone African countries, and in this context, look at the weaknesses in their banking sectors. In addition, Honohan (1993) briefly examines financial sector failures in Western Africa, Brownsbridge (1998) looks at the causes of financial distress in local banks in Africa, and Tenconi (1993) discusses the banking crisis of the mid-1980s in Guinea. From a microeconomic perspective, Powo Fosso (2000) investigates empirically the financial variables at the bank level that explain bank failures in the West African Economic and Monetary Union (WAEMU).

Against this backdrop, our paper provides an overview of what went wrong with banking systems in sub-Saharan Africa, or, in other words, what caused some of the many banking crises in this region. It does so with a broad brush, illustrating major themes or trends with examples drawn from ten countries (Benin, Cameroon, Côte d'Ivoire, Ghana, Guinea, Kenya, Nigeria, Senegal, Tanzania, and Uganda) during 1985–95. Several questions are of particular interest:

- Which factors behind these crises were most important?
- Were the sources of crises in sub-Saharan Africa the same as those linked to crises in other parts of the world, or were some special to Africa?

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<sup>2</sup> Surveys of a qualitative nature include Caprio and Klingebiel (1997), Evans et al (2000), Goldstein and Turner (1996), Honohan (1997), Lindgren et al (1996), and Sundararajan and Baliño (1991). Empirical studies include Demirgüç-Kunt and Detriagache (1998) and Hardy and Pazarbaşıoğlu (1998).

- What were the different channels through which the government in sub-Saharan African countries intervened in the banking system?

The sample of countries in this paper has been chosen so as to include countries that experienced some of the most serious banking crises in sub-Saharan Africa. It consists of countries with a variety of economic regimes in place prior to the banking crises—from centralized to market-oriented economies—and countries both inside and outside the CFA franc zone. The selection has also been dictated to a large extent by the availability of information, which even among the countries chosen, can be spotty and variable in quality. Country and financial sector reports prepared by the World Bank represent a key source of information on the banking sector in sub-Saharan African countries, which has been used for this paper.

The time frame of the study, the period 1985–95, has been chosen to coincide with the emergence and unfolding of banking crises in the sample countries. The dates of the crises are taken from Caprio and Klingebiel (2002) and Lindgren et al (1996), with the notion of systemic banking crisis underlying these dates. This concept can be difficult to pin down as evidenced by the varying definitions offered in different studies.<sup>3</sup> The definition of systemic banking crisis used in this paper is that given by Caprio and Klingebiel (1997) whereby nonperforming loans are at least 5–10 percent of total assets and thus likely to be sufficient to wipe out most or all of the banking system’s capital. This particular definition is well suited to this study because it captures the endemic nature of the banking crises in the ten sample countries—what Caprio and Klingebiel (1997) call a “silent form of distress” in which a significant portion of the banking system is insolvent, but still remains open. Although runs on banks or the immediate closure of banks occurred fairly infrequently, the banking system in these countries was nonetheless in crisis.

The framework for analyzing the sources of banking crises in sub-Saharan Africa classifies the factors behind the crises into three categories. The groupings seek to emphasize the differing nature of the causes of banking crisis and the various channels through which they affect banks’ soundness:

1. The *operating environment* encompasses factors linked to macroeconomic developments and policies as well as to the state of financial market development. The focus is on elements that capture important features of the African context in which the banks operated, for example, the limited diversification and susceptibility of the economies to

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<sup>3</sup> Dziobek and Pazarbaşıoğlu (1997) and Demirgüç-Kunt and Detragiache (1998), for example, each offers a set of guidelines, which, however, are generally consistent with those of Caprio and Klingebiel.

exogenous shocks, weaknesses in macroeconomic policymaking, and shortcomings in institutions.

2. *Market structure* groups characteristics of the banking sector such as bank ownership, banking concentration, and sources of bank funding. The purpose is to examine those features of the market that affect the decision making and behavior of banks.
3. *Banks' conduct* covers the extent of competitive behavior among banks, internal governance, and lending practices, notably lending to public enterprises and insider lending. These issues underscore the impact of banks' own behavior on their operations and financial performance.

We are guided in our approach by two survey articles, Goldstein and Turner (1996) and Honohan (1997), which set out in systematic fashion the causes of banking crises worldwide. The factors identified in these articles serve as a reference point for highlighting those factors relevant to the experiences of sub-Saharan Africa.

Goldstein and Turner (1996) have put together one of the most comprehensive lists of factors that, either alone or in various combinations, have contributed to banking crises around the world. First, macroeconomic volatility (e.g., volatility in growth and inflation rates or in the terms of trade, international interest rates, and real exchange rates) can cause banks to be particularly vulnerable if it alters the relationship between the values of bank assets and liabilities. Second, lending booms and surges in capital flows may prompt banks to lend excessively and unwisely during the expansion phase of the business cycle; a crisis is created when the bubble bursts. Third, when bank assets and liabilities are seriously mismatched, or where bank capital and/or loan-loss provisions are inadequate, and the economy is subject to large shocks, there is an increased risk of bank fragility. Fourth, inadequate preparation for financial liberalization can increase the danger of a banking crisis. Fifth, heavy government involvement and loose controls on connected lending can hurt bank profitability and efficiency. Sixth, weaknesses in the accounting, disclosure, and legal framework can adversely affect bank performance. Seventh, if incentives for bank owners, managers, and bank depositors are distorted, key players in the banking system may be prone to excessive risk-taking and less likely to take corrective actions at an early stage. Finally, the exchange rate regime can undermine bank soundness through its impact on vulnerability to speculative attack, a downward adjustment in the real value of bank capital, and the ability of the central bank to act as lender of last resort.

Honohan (1997) examines a subset of these factors, focusing on what characteristics banking crises display and what triggers them. He identifies three major "syndromes." Macroeconomic epidemics are features of banking crises that arise from boom and bust cycles. When times are good, banks lend excessively to projects with poor long-term prospects, and when the bubble bursts, they must contend with a weak portfolio. Microeconomic deficiencies, notably poor management practices such as connected lending, are associated with another group of bank failures. Crises of this type tend to be systemic or bunched together in time, mainly because

shortcomings in different banks are allowed to worsen under common external conditions, including weak supervision. Finally, a government that is omnipresent in banking systems is characteristic of endemic crises. In many countries where the role and functioning of the banking system is closely linked with the financing of a broad spectrum of government activities, banks operate as a quasi-fiscal mechanism. Good times can mask the problems of these banking systems, but an adverse shock can easily expose the underlying insolvency. Such shocks tend to be system-wide, causing problems to surface simultaneously in many banks. The regime shifts that trigger crises take different forms, including a change in the financial system through financial repression or liberalization, macroeconomic instability, structural economic change, political developments, and privatization.

Following this introduction, Section II presents a brief overview of banking crises in the ten study countries, focusing on the nature of the crises and manifestation of financial distress. Section III analyzes the causes of banking crises in the study countries. Section IV offers concluding remarks.

## **II. OVERVIEW OF BANKING CRISES**

Severe banking crises hit the ten study countries during the period 1985–95. As noted above, they were most often of an endemic character. This feature makes dating the crises, not an easy task to begin with, even more difficult.<sup>4</sup> Among the study countries, the first banking crises occurred in Ghana, Guinea, and Kenya in the early to mid-1980s (Table 1). A second series of banking crises shook the CFA franc zone countries in the late 1980s, and a third round affected Guinea, Kenya, Nigeria, and Uganda in the first half of the 1990s. The dates of the crises shows just how long they lasted (the crisis in Ghana spanned almost the entire decade of the 1980s) and how easily they could reoccur (as in Guinea and Kenya).

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<sup>4</sup> Frydl (1999) reviews the issues involved in dating banking crises.

Table 1. Episodes of Banking Crisis in Sub-Saharan Africa

Countries	Dates	Scope	Estimated Losses/Costs
Benin	1988–90	Collapse of all three banks; 78 percent of banking system loans nonperforming at end-1988	17 percent of GDP
Cameroon	1987–93	60–70 percent of banking system loans nonperforming in 1989	
Côte d’Ivoire	1988–91	4 large banks accounting for 90 percent of banking system loans affected; nonperforming loans at 4 largest banks reached about half of total credit outstanding	Government costs equivalent to 25 percent of GDP
Ghana	1982–89	7 of 11 audited banks insolvent; 40 percent of bank credit to nongovernment borrowers nonperforming in 1989	Restructuring costs equivalent to 6 percent of GDP
Guinea	1985	6 banks accounting for 99 percent of banking system deposits insolvent; 80 percent of banking system loans nonperforming	Repayment of deposits equivalent to 3 percent of 1986 GDP
	1993–94	3 banks accounting for 45 percent of market affected	
Kenya	1985–89	4 banks and 24 NBFIs accounting for 15 percent of financial system liabilities affected by liquidity/solvency problems	
	1993–95	Solvency problems in banks accounting for more than 30 percent of financial system assets; 66 percent of loans of one third of banks nonperforming in 1993	
Nigeria	1991–95	8 banks insolvent and 45 percent of banking system loans nonperforming at end-1992; 34 out of 115 banks accounting for 10 percent of deposits insolvent in 1994	
Senegal	1988–91	50 percent of banking system loans nonperforming in 1988	17 percent of GDP
Tanzania	1987–1990s	Main financial institutions in arrears amounting to half of their portfolio in 1987; government-owned banks, accounting for 95 percent of banking system assets, insolvent as of 1990 at least; 60–80 percent of all loans nonperforming at end-1994	Implied losses equivalent to nearly 10 percent of GDP
Uganda	1990–present	Half of banking system facing insolvency problems in 1994	

Sources: Caprio and Klingebiel (2002); Lindgren, Garcia, and Saal (1996); and World Bank (1991b).



These crises assumed systemic proportions as this term is defined by Caprio and Klingebiel (1997). In fact, nonperforming loans in the study countries far exceeded the threshold of 5–10 percent of total assets. The share of nonperforming loans in total banking system loans reached 50 percent or more in Benin, Cameroon, Côte d’Ivoire, Guinea, Senegal, Tanzania, and Uganda, while it was almost as high in Nigeria where 45 percent of bank loans outstanding were nonperforming at end-1992 and Ghana where about 40 percent of bank credit to nongovernment borrowers was nonperforming in 1989. Only in Kenya were the results somewhat better, with nonperforming assets in June 1993 estimated at less than 20 percent of total financial sector assets.<sup>5</sup> Not surprisingly, a large number of banks in the study countries had a negative net worth as illustrated by the case of distressed banks in Senegal (Table 2).

Table 2. Senegal: Summary Situation of the Banking System, 1988  
(In billions of CFA francs; end-September)

	Eight Distressed Banks	Sound Banks	Total
Loan portfolio	323	166	489
Nonperforming loans	233	6	239
Capital and reserves	36	29	65
BCEAO refinancing	167	30	197

Source: Husain and Faruqee (1994).

Financial distress was especially acute among government-owned commercial banks and development banks. Typical of this was the experience of government-owned banks in Cameroon and Côte d’Ivoire, and of state government banks in Nigeria. Specifically, in Cameroon, the commercial bank and two development banks owned by the government were technically insolvent as of 1987. In Côte d’Ivoire, the loan portfolio of the development banks was in very bad shape, with the share of nonperforming loans in outstanding loans of individual banks between 41 percent and 93 percent.<sup>6</sup> In Nigeria, 8 of the 16 banks classified as technically insolvent at end-1992 were state government banks. By 1994, about 60 percent of the total loans and advances of these banks were nonperforming. As a result, their capital and reserves were

<sup>5</sup> World Bank (1995a).

<sup>6</sup> The share of nonperforming loans stood at 57 percent at the Banque Nationale pour l’Épargne et le Crédit (BNEC) and 93 percent at the Banque Ivoirienne de Construction et de Travaux Publics (BICT) in April 1988, and at 41 percent at the Banque Ivoirienne de Développement Industriel (BIDI) and 76 percent at the Crédit de la Côte d’Ivoire (CCI) in June 1989. World Bank (1991b).

negative in an amount of N 8.4 billion (about US\$100 million) in 1994.<sup>7</sup> In contrast to this dreary picture, a few government-owned banks managed to remain solvent, notably the four major federal government banks in Nigeria and the Kenya Commercial Bank (KCB).

Local banks in Kenya and Nigeria were highly vulnerable. By 1993–94, about one-third of the local banks and nonbank financial institutions (NBFIs) in Kenya had been closed or placed under the statutory management of the Central Bank of Kenya. In Nigeria, the financial position of local banks deteriorated rapidly in 1992, and at the end of the year, eight local banks were among the 16 insolvent banks (the other eight were state government banks).

Although foreign banks were often profitable operations, outperforming their domestic counterparts, foreign equity participation in itself was no guarantee of good financial results.<sup>8</sup> In Côte d'Ivoire, three of the four largest banks were affiliates of major French banks and the fourth was an affiliate of the French BIAO-SA.<sup>9</sup> Nonetheless, the nonperforming loans of these four banks in 1990 totaled CFAF 450 billion, or about half of total credit outstanding. For individual banks, the ratio of nonperforming loans to total credit ranged from 36 percent to 76 percent.<sup>10</sup> Similarly, a few of the foreign banks in Senegal and Uganda became insolvent.

The repercussions of the crises were profound. The banking system, and with it the payments system, collapsed in some countries. As the crises came out in the open in Benin and Guinea, all the banks were simply closed. Credit to the private sector recorded particularly sharp drops in a few countries (Benin, Cameroon, Côte d'Ivoire), while financial intermediation measured by the ratio of broad money to GDP dipped to new lows in several countries (Benin, Ghana, Guinea, Senegal, Tanzania, Uganda) (Table 3). These banking crises ultimately proved to be very expensive, as in Côte d'Ivoire, where government costs of restructuring the banking system amounted to about 25 percent of GDP.

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<sup>7</sup> Brownsbridge and Harvey (1998).

<sup>8</sup> Two examples of profitable foreign banks are Barclays and Standard Chartered in Kenya, and the same two banks (in partnership with the government) in Ghana. These banks were successful in avoiding significant amounts of nonperforming loans.

<sup>9</sup> These four banks (Société Générale de Banque de Côte d'Ivoire, SGBCI; Banque Internationale pour le Commerce et l'Industrie, BICICI; Société Ivoirienne de Banque, SIB; and Banque Internationale pour l'Afrique Occidentale, BIAOCI) accounted for almost 90 percent of all loans. World Bank (1991b).

<sup>10</sup> Ibid.

Table 3. Monetary Performance: Selected Indicators, 1985–95  
(Annual change or ratios in percent)

	1985	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995
<b>Benin</b> <sup>1/</sup>											
Broad money/GDP	23.7	25.4	22.2	24.0	11.4	17.6	21.9	25.6	25.9	26.2	25.3
Broad money growth	0.6	5.5	-11.2	11.4	-52.9	62.0	31.2	25.6	5.9	40.9	16.3
Credit to private sector	24.4	-8.8	-5.9	10.4	-25.0	-1.3	-15.5	-19.5	-2.4	10.7	7.3
Ratio of loans to deposits <sup>2/</sup>	1.7	1.8	2.0	2.4	0.1	0.1	0.2	0.2	0.3	0.3	...
Real interest rate	6.1	5.7	6.6	1.8	6.6	5.9	4.9	1.8	...	...	...
<b>Cameroon</b>											
Broad money/GDP	18.5	18.9	21.7	22.3	19.9	21.1	22.1	20.8	18.9	20.5	18.0
Broad money growth	-4.3	9.3	9.7	-4.7	-14.0	1.2	4.4	-10.1	-10.3	17.7	6.1
Credit to private sector	9.0	12.3	2.9	-11.5	-1.1	0.8	-0.2	-55.2	-7.8	0.2	0.5
Ratio of loans to deposits <sup>2/</sup>	1.4	1.5	1.8	2.1	1.5	1.5	1.1	1.0	1.0	0.8	0.7
Real interest rate	3.3	3.1	4.3	5.5	5.9	6.0	8.1	5.6	11.5	-4.6	-20.3
<b>Côte d'Ivoire</b>											
Broad money/GDP	29.1	29.5	30.4	30.3	27.5	28.3	28.1	27.6	24.9	24.8	24.4
Broad money growth	20.2	4.5	-1.5	0.2	-7.4	-3.1	0.0	-1.9	-4.4	47.0	17.1
Credit to private sector	-1.9	0.6	7.1	0.0	-3.8	-3.1	-0.6	-11.2	-5.3	-4.6	18.8
Ratio of loans to deposits <sup>2/</sup>	1.8	1.8	1.9	1.8	1.8	1.9	1.8	1.6	1.5	1.1	1.1
Real interest rate	5.5	-0.8	-1.7	-1.7	5.4	7.7	5.4	3.5	...	...	...
<b>Ghana</b>											
Broad money/GDP	13.6	13.5	14.2	14.7	16.9	13.4	13.4	17.5	17.2	18.6	21.3
Broad money growth	46.2	47.9	53.3	46.3	54.7	13.3	27.2	52.2	26.4	45.7	70.1
Credit to private sector	78.4	74.0	26.8	40.2	151.0	14.3	-6.2	56.0	35.2	45.9	43.9
Ratio of loans to deposits <sup>2/</sup>	0.8	0.9	0.7	0.7	0.6	0.5	0.5	0.5	0.6	0.6	0.4
Real interest rate	5.4	-7.6	-22.2	-14.9	n.a.	n.a.	3.3	6.3	-1.3	-1.7	-30.7
<b>Guinea</b>											
Broad money/GDP	7.8	8.9	10.1	9.2	8.4	8.8	9.2	9.6	10.2	9.2	9.3
Broad money growth	12.0	100.4	48.4	18.8	15.8	27.3	34.8	23.5	22.9	-3.3	11.4
Credit to private sector	...	...	...	...	...	...	n.a.	34.4	21.9	10.9	25.6
Ratio of loans to deposits <sup>2/</sup>	...	...	...	1.1	1.1	1.2	1.0	0.9	0.8	1.0	1.1

Table 3 (concluded). Monetary Performance: Selected Indicators, 1985–95  
(Annual change or ratios in percent)

	1985	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995
<b>Kenya</b>											
Broad money/GDP	26.7	30.4	30.2	28.9	28.4	29.6	31.0	36.5	37.1	53.6	52.7
Broad money growth	6.3	32.7	11.1	8.0	12.9	20.1	19.6	39.0	28.0	73.8	14.1
Credit to private sector	15.0	16.4	6.5	16.2	16.7	11.9	22.1	30.9	5.3	27.7	50.0
Real interest rate	-0.1	1.0	-2.7	5.5	4.4	2.5	...	...	...	...	12.0
<b>Nigeria</b>											
Broad money growth	11.6	2.9	22.5	33.8	10.9	40.3	33.4	45.3	53.4	38.0	19.5
Credit to private sector	9.2	32.3	7.7	18.5	10.3	16.1	26.1	141.2	18.1	61.4	41.9
Real interest rate	3.6	3.9	2.9	-21.5	-35.8	12.4	1.9	-26.5	-33.9	-43.9	-59.3
<b>Senegal</b>											
Broad money/GDP	25.9	25.6	24.1	22.6	25.0	22.6	24.0	24.1	20.5	22.1	21.8
Broad money growth	4.5	11.2	-0.2	0.5	10.3	-4.8	5.8	3.6	-18.3	42.1	9.2
Credit to private sector	6.2	-1.3	3.0	7.0	2.4	-7.0	-3.6	5.9	1.6	-17.4	1.6
Ratio of loans to deposits <sup>2/</sup>	1.9	1.8	1.8	1.8	1.7	1.6	1.5	0.8	1.2	0.9	0.9
Real interest rate	-5.8	0.0	9.4	7.1	6.0	6.7	8.8	7.9	...	...	...
<b>Tanzania</b>											
Broad money/GDP	28.0	26.2	23.7	13.0	13.6	15.1	14.6	16.3	18.6	20.1	18.7
Broad money growth	20.6	23.6	22.1	35.8	30.6	45.4	27.0	40.5	43.8	43.7	22.1
Credit to private sector	73.6	22.1	99.2	37.1	...	29.6	32.0	-12.4	39.6	19.7	-9.8
Ratio of loans to deposits <sup>2/</sup>	0.6	0.7	1.0	1.1	0.4	0.3	0.4	0.4	0.4	0.4	0.3
Real interest rate	-31.6	-24.8	-16.7	-12.5	-14.2	...	...	...	...	...	-1.8
<b>Uganda</b>											
Broad money/GDP	9.4	10.8	10.5	6.5	6.3	6.4	7.6	8.7	8.8	10.3	10.7
Broad money growth	122.2	145.0	183.8	95.6	122.4	56.0	47.0	70.7	42.7	32.8	27.4
Credit to private sector	174.1	103.1	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	55.9	12.2	28.2
Ratio of loans to deposits <sup>2/</sup>	0.8	0.8	0.8	0.8	0.9	0.9	0.9	0.7	0.6	0.6	0.6
Real interest rate	-80.0	120.5	195.4	145.2	-98.6	-14.2	10.3	-6.4	-13.7	3.5	1.5

Sources: International Monetary Fund, African Department database, and *International Financial Statistics*.

1/ Data as of 1989 refer only to new banks.

2/ Loans to nongovernment sector/nongovernment deposits.

### **III. SOURCES OF BANKING CRISES**

#### **A. The Operating Environment**

##### **The Macroeconomic Environment**

###### *A Series of Economic Shocks*

The macroeconomic environment is shaped by the economic structure and policy framework of a country as well as by macroeconomic shocks. During the period 1985–95, the economic structure of the study countries was characterized by limited diversification, which rendered them highly vulnerable to external and internal shocks. Agriculture played a preponderant role, and exports were dependent upon a few agricultural or mineral commodities. In 1985, the share of agriculture ranged from 20 percent to 65 percent of GDP in the ten countries, while the top three export products accounted for about 40 percent of total exports in Senegal, and 60 percent or more in the other study countries. The importance of export taxes in revenues combined with rigidities in expenditures made it difficult for the public finances to adjust in a timely fashion to shocks and their consequences. For those countries belonging to the CFA franc zone, the responsiveness of the economy was further constrained by the rules of the monetary union (Box 1).

### **Box 1. The Framework for Monetary Policy in the CFA Franc Zone**

Two monetary unions are associated with the CFA franc zone. The West African Economic and Monetary Union (WAEMU) consists of 8 countries, including Benin, Côte d'Ivoire, and Senegal, and the Central African Economic and Monetary Community (CEMAC) groups 6 countries, of which Cameroon is the largest. 1/

The rules and regulations of the monetary unions in the first 15 years of their existence had profound implications for the banking sector. The unions had four essential provisions for monetary integration, of which the provision regarding the role of the French franc (and now the euro) remains valid to this day. First, the members shared the CFA franc whose convertibility into the French franc at a fixed exchange rate was supported by an overdraft facility through an operations account with the French Treasury. Second, a uniform interest rate structure applied throughout the zone. Third, uniform ceilings on bank lending margins were fixed to a common interest rate structure. Fourth, common limits were set for government borrowing from the two central banks which, except for temporary overruns, could not exceed 20 percent of the previous year's fiscal revenues.

Within this institutional framework, there was only limited room for an independent monetary policy, and therefore little scope for inflation and interest rates to be substantially different from those in France for any length of time (once allowance was made for country risk factors). As a result, credit policy was primarily assigned to maintaining an appropriate level of foreign reserves. The main policy instruments used by the central banks were (1) national and bank-by-bank credit targets; (2) a ceiling on access to central bank financing to maintain aggregate demand at a level consistent with balance of payments and domestic growth objectives; (3) a rediscount rate; (4) the interbank money market; and (5) a liquidity ratio.

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Source: Husain and Faruqee (1994).

1/ The WAEMU and the CEMAC both came into being in 1994 when two new economic unions were created to complement the existing monetary unions. The central bank for the WAEMU is the Banque Centrale des Etats de l'Afrique de l'Ouest (BCEAO), and for the CEMAC, the Banque des Etats de l'Afrique Centrale (BEAC).

A series of external shocks hit sub-Saharan Africa in the mid-1980s. The world prices of key primary export commodities such as coffee, cocoa, cotton, and oil, started upon a path of protracted decline. In addition, international interest rates rose sharply, and the U.S. dollar, retreating from its historical high of 1985, depreciated significantly against major currencies, including the French franc. In many cases, the negative effects of these shocks were compounded by internal shocks brought about by the macroeconomic policies of the authorities.

Table 4. The Macroeconomic Environment: Selected Indicators, 1985–95  
(Annual change or ratio in percent)

	1985	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995
<b>Benin</b>											
Real GDP	4.3	2.1	-1.5	3.4	-2.8	3.2	4.7	4.0	3.5	4.4	4.6
Inflation (average)	1.2	0.4	-1.3	3.4	-0.2	1.1	2.1	5.9	0.4	38.5	14..5
Overall fiscal balance/GDP <sup>1/</sup>	-4.0	-3.1	-7.7	-5.0	-0.9	-4.1	-4.0	-4.4	-0.7	-2.3	-3.2
Change in terms of trade	-9.3	-22.5	54.5	-6.1	-2.6	35.1	-16.6	-5.5	-3.2	1.1	29.0
<b>Cameroon</b>											
Real GDP	8.1	6.8	-2.2	-7.9	-1.8	-6.2	-3.8	-3.1	-3.2	-2.5	3.3
Inflation	4.2	4.3	2.8	1.7	1.6	1.5	-0.6	1.9	-3.7	12.7	25.8
Overall fiscal balance/GDP <sup>1/</sup>	-1.6	-1.2	-13.0	-5.9	-4.5	-7.6	-7.0	-6.6	-6.3	-9.1	-3.1
Change in terms of trade	28.1	-15.0	-28.8	-8.4	-13.2	-5.1	14.0	-16.1	3.2	0.9	1.5
<b>Côte d'Ivoire</b>											
Real GDP	3.6	4.7	-0.4	1.1	2.9	-1.1	0.0	-0.2	-0.2	2.0	7.1
Inflation	1.8	6.8	7.0	6.9	1.0	-0.7	1.6	4.2	2.1	26.0	14..3
Overall fiscal balance/GDP <sup>1/</sup>	2.1	-0.2	1.0	0.9	-17.9	-19.3	-13.2	-12.3	-13.1	-0.2	-3.7
Change in terms of trade	-1.4	44.8	-17.7	-1.1	-13.4	-14.7	-8.8	-8.4	24.6	12.1	15..9
<b>Ghana</b>											
Real GDP	5.4	4.8	5.0	5.6	5.1	3.4	5.3	3.9	5.0	3.3	4.0
Inflation	10.3	24.6	39.8	31.4	25.2	37.3	18.0	10.1	25.0	24.9	59.5
Overall fiscal balance/GDP <sup>1/</sup>	-3.0	-3.3	-2.4	-2.8	-2.1	-2.2	-1.3	-8.8	-9.9	-8.9	-6.4
Change in terms of trade	-10.6	5.9	-4.9	-8.9	-15.6	-7.4	1.4	-6.1	-4.8	11.8	13.7
<b>Guinea</b>											
Real GDP	5.0	3.1	3.3	6.3	4.0	4.3	5.7	3.3	5.0	4.0	4.7
Inflation	19.0	64.7	36.9	27.3	28.3	19.4	19.6	16.6	7.2	4.2	5.6
Overall fiscal balance/GDP <sup>1/</sup>	-3.0	-6.0	-4.0	-6.8	-5.0	-5.5	-4.6	-3.5	-3.7	-3.6	-2.7
Change in terms of trade	-3.9	0.0	47.9	-11.7	10.7	-8.0	20.8	-11.6	-6.4	-13.0	-12.5

Table 4 (concluded). The Macroeconomic Environment: Selected Indicators, 1985–95  
(Annual change or ratio in percent)

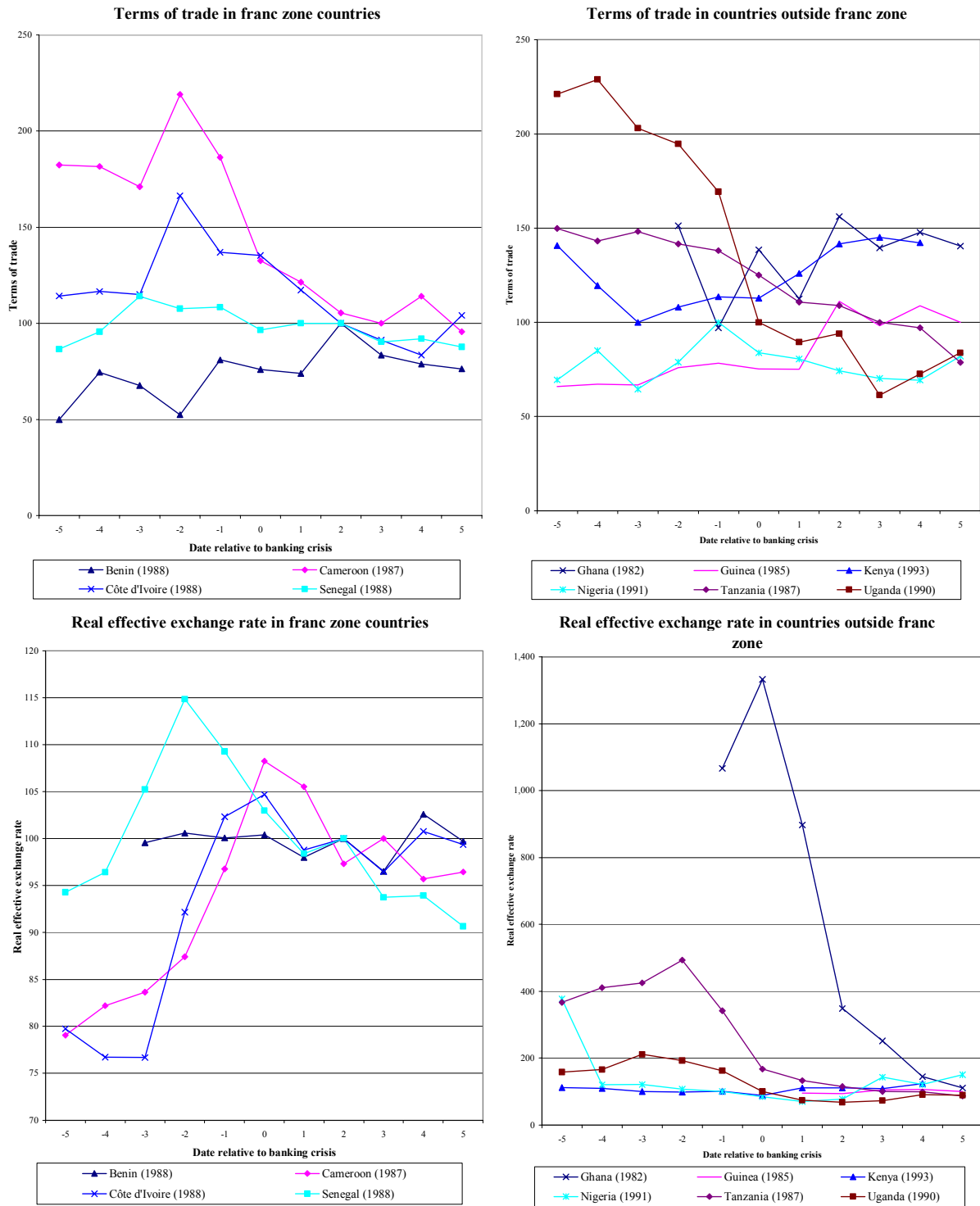
	1985	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995
<b>Kenya</b>											
Real GDP	4.4	7.0	5.9	6.1	4.7	4.0	1.5	-0.7	0.4	2.7	4.4
Inflation	11.4	10.3	13.0	4.8	7.6	11.2	14.7	33.3	46.0	28.8	1.6
Overall fiscal balance/GDP <sup>1/</sup>	-6.1	-6.0	-4.6	-4.0	-4.8	-6.8	-3.8	-6.8	-7.9	-3.6	-0.3
Change in terms of trade	-16.6	12.8	-18.3	4.6	-15.1	-16.3	8.0	5.1	-0.6	11.7	12.4
<b>Nigeria</b>											
Real GDP	10.5	-1.8	-4.0	9.4	8.5	7.5	6.0	2.6	2.2	-0.6	2.6
Inflation	5.5	5.4	10.2	34.5	50.5	7.4	13.0	44.6	57.2	57.0	72.8
Overall fiscal balance/GDP <sup>1/</sup>	-1.2	3.4	-5.2	-4.5	-2.5	3.1	0.7	1.9	-5.0	-4.8	3.5
Change in terms of trade	-18.4	-45.4	22.3	-24.0	22.2	26.8	-16.2	-3.9	-7.8	-5.5	-1.4
<b>Senegal</b>											
Real GDP	2.9	4.0	3.9	5.1	-1.4	3.9	-0.4	2.2	-2.2	2.9	5.2
Inflation	13.0	6.1	-4.1	-1.8	0.4	0.3	-1.8	-0.1	-0.6	32.0	8.1
Overall fiscal balance/GDP <sup>1/</sup>	-2.9	-1.8	-1.3	-1.6	-2.6	-0.5	1.1	-2.5	-3.1	-1.9	-0.2
Change in terms of trade	19.3	-5.6	0.6	-10.9	3.5	0.0	-9.7	1.9	-4.6	6.0	-4.7
<b>Tanzania</b>											
Real GDP	4.0	5.6	6.2	5.9	3.8	7.0	2.1	0.6	1.2	1.6	3.6
Inflation	36.1	33.3	32.4	30.0	31.2	30.4	28.0	21.9	23.6	37.1	26.5
Overall fiscal balance/GDP <sup>1/</sup>	-4.9	-4.1	-8.3	-5.7	-4.0	-3.2	-1.9	-2.2	-3.5	-3.1	-3.3
Change in terms of trade	-4.5	-2.5	-9.4	-11.4	-1.6	-8.2	-2.8	-19.0	-11.2	46.4	-0.6
<b>Uganda</b>											
Real GDP	-3.0	0.9	4.0	8.3	6.4	6.5	7.7	2.2	8.6	6.4	11.9
Inflation	100.0	143.8	215.4	166.7	130.8	45.4	20.8	42.2	30.0	6.5	6.1
Overall fiscal balance/GDP <sup>1/</sup>	-3.3	-3.1	-3.5	-3.6	-3.1	-4.1	-4.3	-6.0	-2.5	-2.7	-2.6
Change in terms of trade	63.8	3.5	-11.3	-4.1	-13.0	-41.0	-10.5	5.0	-34.6	18.0	15.5

Source: International Monetary Fund, African Department database.

1/ Including grants.



Figure 1. External Sector Indicators (1990 = 100)



Source: International Monetary Fund.

Among study countries belonging to the franc zone, the terms of trade during 1985–92 fell markedly in Cameroon (56 percent), Côte d’Ivoire (27 percent), and to a lesser extent, in Senegal (19 percent) (Table 4 and Figure 1).<sup>11</sup> At the same time, the movements of the CFA franc mirrored those of the French franc, and the real effective exchange rate of these countries appreciated considerably, cutting into external competitiveness, but moderating prices.<sup>12</sup> While the inflation rate stood in the single digits (and was negative in a few cases) in the late 1980s, in general, output decreased, or at best, increased only modestly (Figure 2).<sup>13</sup> The budget deficit was kept to modest levels in Senegal, but in Benin, and especially in Cameroon and Côte d’Ivoire, it widened dramatically. The government budget recorded a deficit equivalent to 13 percent of GDP in 1987 in Cameroon, and one averaging almost 19 percent of GDP in 1989–90 in Côte d’Ivoire (Table 4). These record deficits reflected a weakening in revenues, as elsewhere, because of the unfavorable terms of trade, but also a sharp increase in expenditures, partly because of efforts to offset the adverse impact of external shocks on the economy. The deficits were financed by a drawdown of deposits held both externally and with the domestic banking system, a buildup of domestic arrears, and an increase in foreign financing.

The deterioration in the macroeconomic environment spilled over to banks through several channels. On the asset side of balance sheets, the ability of borrowers to service their loans suffered as the decrease in incomes and demand weakened the financial position of businesses and individuals. On the liabilities side, a fall in the level of deposits in Benin (1989), Cameroon (1986–87), and Côte d’Ivoire (1989–90) hurt banks’ liquidity. This development was attributable not only to sluggish GDP growth, but also to the drawdown of government deposits for the financing of budget deficits, and to the difficult economic situation, which encouraged capital flight from countries such as Côte d’Ivoire. The accumulation of government arrears acted as an unanticipated tax on the private sector, further contributing to the slowdown in economic activity and the illiquidity of the banking system. Banks sought to offset this tightening of liquidity with an increase in recourse to refinancing by the central bank, an approach that proved to be costly since refinancing was frequently undertaken at penalty rates (“taux d’enfer”).<sup>14</sup>

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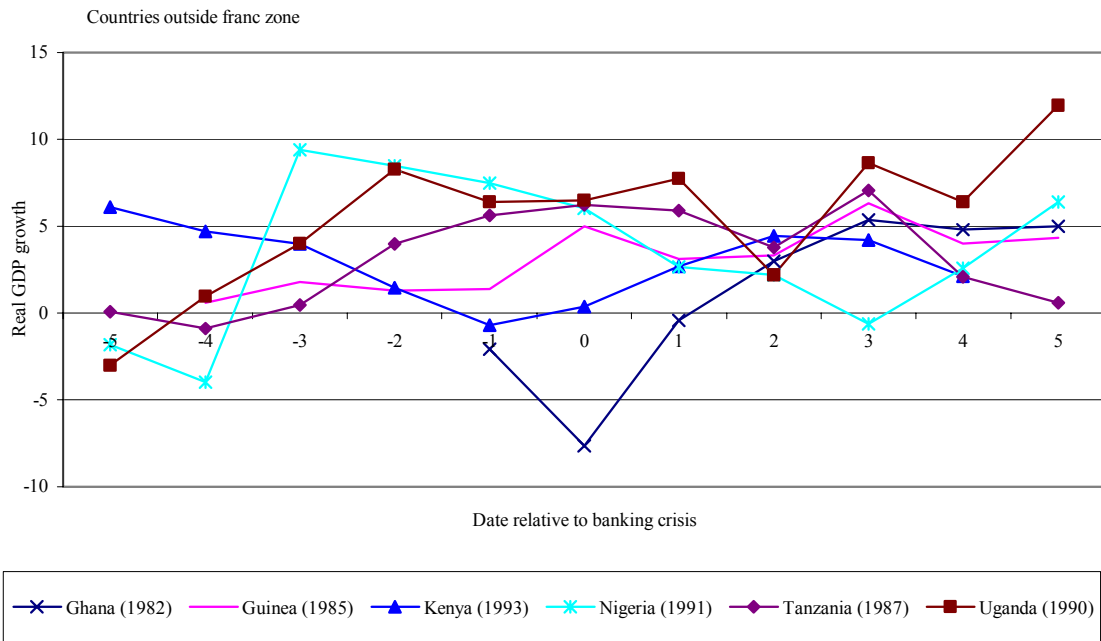
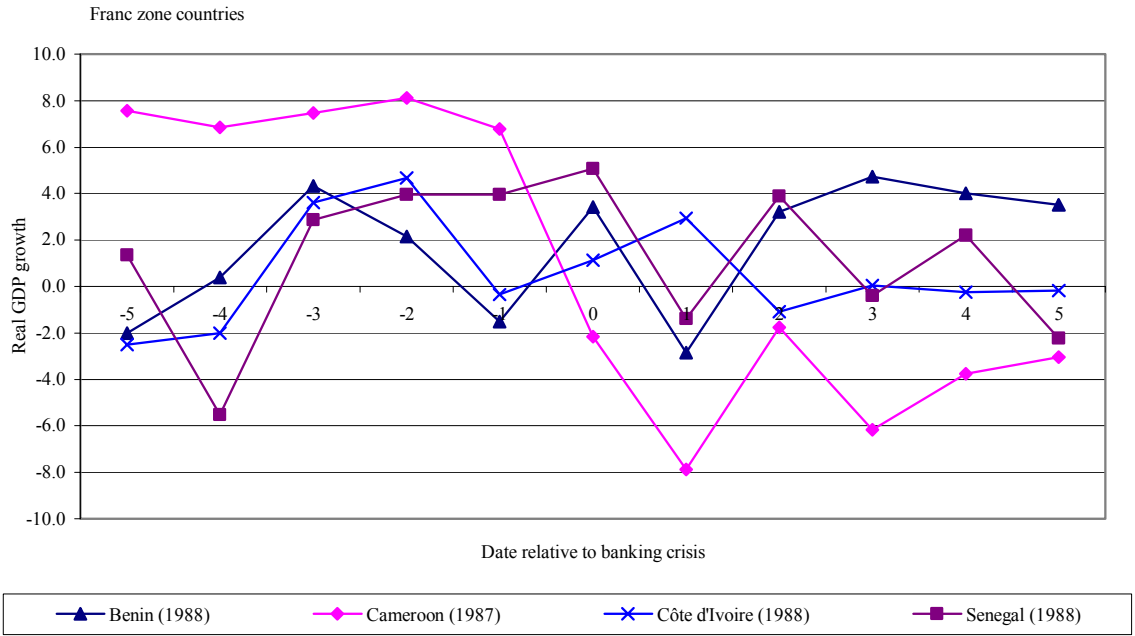
<sup>11</sup> The dates in Figures 1 and 2 are relative to the first year of banking crisis.

<sup>12</sup> For example, in a pronounced shift, Senegal’s competitiveness relative to that of countries such as Ghana and Nigeria deteriorated after 1984 in part because Ghana and Nigeria initiated economic adjustment programs in which their exchange rates were substantially devalued. Over the entire period 1981–90, Senegal’s real exchange rate indices with Ghana and Nigeria showed appreciations of 92 percent and 73 percent, respectively. World Bank (1993).

<sup>13</sup> In Senegal, economic growth accelerated in 1988 owing to the impact of favorable weather conditions on agriculture.

<sup>14</sup> The claims of the BCEAO on banks in Côte d’Ivoire rose from CFAF 392 billion at end-1985 to CFAF 524 billion at end-1990. World Bank (1997).

Figure 2. Real GDP Growth  
(In percent)



Source: International Monetary Fund.

Among study countries outside the CFA franc zone (excepting Guinea), the economic shock associated with the decline in the terms of trade was also severe. Several of these countries experienced considerable macroeconomic turbulence in the late 1980s and early 1990s. Inflation rates were high and volatile, especially in Nigeria and Uganda, reflecting difficulties in controlling the budget deficit (partly because of lower revenues attributable to the fall in international commodity prices) and rapid monetary expansion. High rates of inflation together with large devaluations, as in Uganda during the first two years of the Economic Recovery Program, eradicated much of the share capital of banks in real terms. Despite sometimes erratic progress in macroeconomic stabilization, real GDP growth held up in most of these countries during 1985–90. Several factors contributed to this outcome, including the introduction of major structural adjustment programs earlier than in most CFA franc zone countries, extensive use of exchange rate policy in Ghana, Nigeria, Tanzania, and Uganda to strengthen external competitiveness, and in Uganda, an end in 1986 to more than a decade of civil war.<sup>15</sup> Nonetheless, an economic slowdown set in during the early 1990s in Kenya, Nigeria, and Tanzania.

Overall, banks in the study countries faced a particularly difficult macroeconomic environment in the second half of the 1980s and the early 1990s—a change in circumstances which, in many cases, served as a trigger to banking crises. Their balance sheets were weakened in some countries by a slowdown in economic growth, and in others, by high and volatile inflation.<sup>16</sup> The impact of external shocks, notably a serious deterioration in the terms of trade, was felt especially hard in the countries belonging to the CFA franc zone.<sup>17</sup> Moreover, policies which allowed or accommodated government interference in the banking system, notably rigid interest rate structures, sectoral credit allocation, subsidized refinancing for selective lending, and an inefficient system of crop credit—together with inadequate risk control—contributed to the

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<sup>15</sup> See Popiel (1994). These programs were initiated in 1983 in Ghana; in 1986 in Guinea, Kenya, Nigeria, and Tanzania; and in 1987 in Uganda.

<sup>16</sup> High inflation can influence bank loan portfolios in two ways. First, it increases the volatility of business profits, thereby encouraging borrowers to take greater risks—the phenomenon of adverse selection—and raising the probability of loan default. Second, it renders loan appraisal more difficult because the viability of potential borrowers depends upon unpredictable developments in a range of prices, including the exchange rate and interest rates. See Brownsbridge (1998).

<sup>17</sup> Hoffmaister et al (1997) provide evidence showing that external shocks, notably terms of trade shocks, appear to have had a greater influence on fluctuations of output and the real exchange rate in CFA franc zone countries than in non CFA franc zone countries. The authors conclude that this result does not appear to be associated with differences in economic structure, but instead may reflect the fixed exchange rate regime of the CFA franc zone countries which did not help shield them from external shocks.

problems of banks. Distressed banks in the sample countries generally remained open for long periods of time that covered a variety of economic conditions; therefore, macroeconomic data in these countries did not always reflect the crisis in the banking system.

### **The Legal Environment in Trouble**

A legal environment that is conducive to a sound banking system must facilitate the enforcement of financial contracts as well as the recovery of loans and collateral.<sup>18</sup> If banks have no recourse against borrowers who default, borrowers will have fewer incentives to service their loans. Inadequate bankruptcy procedures can further undermine incentives to repay and hamper asset recovery. Furthermore, when banks cannot realize collateral, the value of their portfolios may be at risk. Thus, the legal framework should include sound corporate, bankruptcy, contract, and private property laws.

For the legal framework to be effective, however, there must also be an administrative structure that can enforce the laws. The judicial system needs to be impartial, honest, and knowledgeable regarding financial issues so that banks can count on fair and rapid enforcement of economic rights and obligations. Moreover, political bodies must respect legal procedures and property rights.

Prior to the outbreak of banking crises, the judicial system in the study countries clearly failed to meet the basic requirements of banks. In particular, lenders had great difficulty in bringing action against defaulting borrowers. There were several reasons for this. First, the procedures for recovering loans were lengthy and cumbersome. In Côte d'Ivoire, more than three years could go by in the late 1980s between the time procedures were initiated and the time a decision was handed down by the courts. In Uganda, defendants could easily cause delays by failing to appear in court or by contriving to mislay papers. Taking possession of assets could be frustrated by court injunctions obtained by delinquent borrowers.<sup>19</sup> Even when court orders were given in favor of creditors, further problems could arise in realizing loan securities if debtors chose to dispute the values realized at public auctions conducted by court brokers. Similarly, in Guinea, lawyers could delay the execution of judgments by filing appeals that had no real grounds. Second, high legal fees, such as a non refundable fee required to initiate legal procedures in Côte d'Ivoire (5 percent of the claim) discouraged banks from initiating court proceedings. Third, there was a serious shortage of judges in most countries; in the early 1990s, there were only about 600 judges in Cameroon and 195 in Côte d'Ivoire.<sup>20</sup>

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<sup>18</sup> See Lindgren et al (1996) for a discussion of legal infrastructure.

<sup>19</sup> In the case of the Uganda Commercial Bank, the largest bank in Uganda, some 80 percent of its nonperforming loans in the 1990s were the subject of court action.

<sup>20</sup> World Bank (1991b).

These problems resulted from critical shortcomings in the judicial system. Simply obtaining legal information could be difficult. In Guinea, judges and lawyers in the early 1990s still had difficulty accessing a compendium of existing legal texts, some of which were noticeably out of date; the bankruptcy legislation dated back to 1967.<sup>21</sup> Although land was the main collateral security underpinning medium- to long-term credits, the land cadastre in a number of countries, including Guinea and Côte d'Ivoire, was insufficiently developed. The lack of a functioning cadastral register complicated recovery efforts and impaired the effectiveness of collateral. In Guinea in particular, there was still no procedure in the first half of the 1990s for the registration of mortgages and other types of guarantee.

The rules of judicial conduct were not systematically enforced in part because many magistrates had little training in financial matters and banking techniques. Of the approximately 200 judges in Guinea in the early 1990s, only about 30 had been trained as professional magistrates.<sup>22</sup> Furthermore, as in Senegal, borrowers were sometimes protected by the judicial system because a number of judges were bad debtors themselves. In all study countries, low salaries contributed to corruption, and resources were insufficient to monitor effectively the professional behavior of members of the judiciary and to prosecute violations of judicial ethics.

In sum, deficiencies in the legal system were not the principal cause of weaknesses in banks. However, they hindered the efforts of banks to pursue defaulting borrowers, and by lowering the cost of delinquency, they discouraged compliance with contractual agreements. Thus, inadequate legal structures, together with a fragile institutional environment (see below), served to magnify the effects on banks of economic shocks.

## **An Institutional Environment with Weak Foundations**

### ***Accounting and Disclosure Standards***

Reliable estimates of the financial condition of a bank require well-designed accounting principles. Clear standards and accurate information are needed so that managers can make decisions conducive to sound banking, and supervisors can successfully resist pressures to bend prudential rules and delay corrective action.

In practice, however, accounting and disclosure standards were generally very weak among the ten study countries. Prior to the banking crises in most of these countries, there were no standard accounting principles (e.g., no required formats for balance sheets), and hence no regulatory body to put in place and enforce prudent accounting standards. Instead, accounting firms and banks were pretty much free to apply their own standards. Among the more egregious practices,

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<sup>21</sup> World Bank (1994a).

<sup>22</sup> Ibid.

banks often counted as income interest on loans that were delinquent or where repayment of loan principal was in serious doubt. For instance, a loan in Uganda could be considered “good” and income accrued for up to two years even if the loan had never been serviced.<sup>23</sup> In Senegal, as in other CFA franc zone countries, banks that continued to record accrued but unpaid interest were not penalized by the BCEAO (instead, problem banks received preferential access to central bank rediscounting). The lack of uniform accounting standards also led to inadequate loan loss provisions and reserves. Most banks made no attempt to accurately quantify the risk inherent in their asset portfolios, and to provide adequate loan loss reserves; in Uganda, for example, they were not required to do so.

Under these circumstances, it was difficult for bank supervisors to know the true financial condition of the banks. Financial reporting among banks varied significantly, making comparisons of bank performance somewhat problematic. Both bank earnings and bank capital tended to be overstated, sometimes by large amounts. For these reasons, banks could continue to operate while their problems went unchecked.

### ***Banking Regulation and Supervision***

The objective of banking regulation and supervision is to ensure that the banking system as a whole remains sound.<sup>24</sup> Banking laws and regulations seek to promote policies that allow only financially sound banks to operate; limit excessive risk-taking by owners and managers of banks; establish appropriate accounting, valuation, and reporting rules; and provide for corrective measures and restrictions on activities of weak institutions. Bank supervisors, for their part, monitor the soundness of the banking system, the adequacy of banks’ risk-management practices and financial data, and compliance with prudential regulation.

Banking regulation in the mid-1980s remained deficient in the study countries. The legacy of the pre-independence period was one contributing factor. In Tanzania, financial sector legislation that had not been updated after independence failed to give the central bank the supervisory authority needed to properly regulate the banking system. In Kenya, banking regulations did not encompass the notion of “fit and proper” in licensing standards. Most of the banks being branch offices of established foreign banks, they were assumed to operate in accordance with such principles. The Banking Act of 1970 in Ghana did not provide sufficiently clear guidelines to banks and the banking authorities on, inter alia, minimum capital requirements, risk exposure and prudential lending limits for banks, provisions for possible loan losses, and methods of interest accrual on nonperforming loans. The regulatory framework in CFA franc zone countries—of which Senegal is an important example—was similarly flawed, with major

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<sup>23</sup> World Bank (1991d), Vol. II.

<sup>24</sup> Folkerts-Landau and Lindgren (1998).

loopholes in such areas as asset quality, liquidity and maturity matching, standards for capital adequacy, and accounting rules.<sup>25</sup>

Banking supervision was beset by numerous problems, starting with poor organization. Within the WAEMU, responsibility for banking supervision was shared by the government and the BCEAO. The Banking Control Commission under the authority of the Minister of Finance was responsible for bank supervision at the national level, and the BCEAO at the regional level. Many biases in enforcing prudential requirements emerged as governments sought to intervene in banking activities in favor of public enterprises or state-supported projects. Moreover, the BCEAO operated in an uncertain legal environment, which did not specify its jurisdiction and mandate. Even when the BCEAO recommended sanctions, governments often did not comply. Similar problems existed in Uganda where the division of responsibility between the Ministry of Finance and the Bank of Uganda (BOU) created ambiguity as to which agency was really responsible for initiating certain supervisory actions.<sup>26</sup> As a result, the BOU, as the supervisor of the banking system, was not consulted in the decision made by the Uganda Commercial Bank (UCB), and approved by the Ministry of Finance, to expand the commercial bank branch network at an imprudently rapid pace. In addition, while both agencies were authorized to issue cease and desist orders, it was not clear which one should act when there was a problem.

Off-site supervision was hobbled by deficiencies in information and on-site supervision was typically sporadic. In many cases, regular reporting systems were not in place, and data were lacking. Prudential reporting was often limited to a handful of reports, and the quality of some reports was unsatisfactory. The information received sometimes comprised a large amount of data that were unreliable and untimely, or not particularly geared to the needs of bank supervisors. Furthermore, visits to bank premises were infrequent. Prior to the banking crises in the CFA franc zone, the BCEAO had not visited some banks for several years. In Ghana, the Banking Supervision Department carried out few on-site inspections of banks until 1988, relying instead on banks' internal control mechanisms and on external auditors' reports to

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<sup>25</sup> World Bank (1994c).

<sup>26</sup> The Banking Act of 1969 divided responsibility for supervising banks between the Ministry of Finance and the BOU. The Ministry was responsible for granting and revoking bank licenses, approving branch and merger applications, and issuing regulations pursuant to the Banking Act. The BOU had primary responsibility for conducting day-to-day supervisory operations and formulating major supervisory policies. Both the Ministry and the BOU had the authority to inspect banks and to issue orders requiring a bank to take corrective action or discontinue harmful practices.



analyze and assess bank performance.<sup>27</sup> Thus, as of 1987, the three largest banks had never been examined in depth. In Uganda, the UCB had not been examined on-site in 10 years as of 1991.<sup>28</sup>

Staffing constraints had serious consequences for banking supervision.<sup>29</sup> Low civil service salary levels made it difficult for banking supervision departments to attract and retain qualified examiners, and training was inadequate given the very specialized skills needed by bank supervision staff. An additional factor was at play in Kenya and Nigeria, where the proliferation of financial institutions quickly outstripped the ability of the central bank to monitor and regulate their activities.

Bank regulation and supervision in the study countries failed to signal or prevent the deterioration in banks' liquidity or solvency. Regulators and supervisors worked in an environment that lacked in transparency, independence, consistency, and enforcement, and in many cases, they were too poorly informed about the financial condition of the banks to detect financial and managerial weaknesses. Banking supervision departments had to function in a highly political and self-serving environment. Conflicts of interest between the regulator and the regulated were not uncommon, and government interference undermined the credibility of the supervisory function.

## **The Inflexibility of Monetary Policy**

### ***Controls on Interest Rates***

Nominal interest rate controls were used extensively in all the study countries and were only lifted in the late 1980s and early 1990s after banking crises had already taken hold in most of the countries.<sup>30</sup> The rationale for the controls was that credit had to be cheap so as to promote investment and support favored borrowers. The interest structure typically did not account for loan maturity or risk, and in fact, created perverse lending incentives for banks, with riskier

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<sup>27</sup> World Bank (1988).

<sup>28</sup> World Bank (1991d), Vol. II.

<sup>29</sup> A few numbers on the Bank Examination Department in Ghana give an idea of the problems. In 1988, the Department of 45 persons included about 30 examiners, of whom five were judged by the Department Head as being capable of leading examination teams. Of the 30 individuals, only one had more than 10 years experience, and only four had experience of between 5 and 10 years. World Bank (1988).

<sup>30</sup> The deregulation of interest rates took place in 1987 in both Ghana and Nigeria, in 1989 in the WAEMU countries, in 1990 in Cameroon, in 1989–91 in Kenya, in 1991–93 in Tanzania, and in 1992–94 in Uganda.

sectors such as agriculture being given a preferential rate. Furthermore, lending rates were sometimes too low to compensate for both risks and overhead associated with loans to privileged borrowers.

Practice in the West African Monetary Union prior to 1989 was a case in point. Bank lending margins were fixed zone-wide, but varied according to sector. The spread over the “taux d’escompte privilégié” (TEP) was normally limited to one percent for crop credits. Margins on loans to small and medium enterprises were fixed at a maximum of three percent. Spreads for all other borrowing were permitted to reach only 5 percent over the “taux d’escompte normal” (TEN). In addition, the same bank lending margin was applied to TEP and the TEN regardless of whether the loans were financed from deposits or rediscounts. The skewed interest rate structure prompted privileged borrowers to use cheap credits for purposes other than those intended by the authorities. In particular, marketing agencies began substituting crop credits for working capital credits. By depriving banks of the income associated with the rates for “normal” credits, such behavior served to undermine the balance sheets of banks.

### ***Reliance on Credit Controls***

Governments in a number of countries sought to influence the allocation of credit directly, with varying degrees of control. Outside the CFA franc zone, the authorities in Guinea and Tanzania followed a strict policy of directed credit. In other countries, sectoral lending requirements were on the books, but were not applied effectively. In Ghana, guidelines (in the form of maximum permitted increases in the stock of loans to each sector, with larger increases going to priority rather than nonpriority sectors) do not appear to have been rigorously enforced. In Nigeria, sectoral guidelines as of 1986 (with the priority sectors of agriculture and manufacturing targeted to receive at least 50 percent of total new credit) were for the most part ignored because the penalties to banks were not costly. Finally, in Kenya, the government used ceilings on the volume of credit to the private sector as a tool for managing aggregate demand, but tended to shy away from allocative controls, such as directed credit schemes.<sup>31</sup>

Within the CFA franc zone, credit controls were extensive. In each country, a Comité National du Crédit had the power to determine bank-by-bank credit ceilings, an arrangement which allowed the government to intervene in the decision-making process. As a result, weak banks often had higher credit ceilings as well as preferential access to rediscounting by the central bank. This was the case in Senegal where problem banks (i.e., those subject to restructuring) in 1986–87 accounted for 68 percent of credits, but 87 percent of BCEAO rediscounts.<sup>32</sup>

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<sup>31</sup> The exception was a requirement that financial institutions extend credit to agriculture in amounts equivalent to at least 17 percent of deposits. However, there were no penalties with which to enforce this requirement, and compliance was limited. Brownsbridge and Harvey (1998).

<sup>32</sup> World Bank (1989).

Furthermore, healthy banks with excess liquid deposits were constrained by the credit ceilings and, through the money market, were forced to lend their excess liquidity to weak banks. When liquidity problems surfaced, the central bank provided a considerable amount of rediscounting to distressed banks. These practices in effect permitted the balance sheets of unsound banks to deteriorate further.

Crop marketing credits—short-term advances that financed the full collection cost for agricultural products from producer through final sale—also played a key role in the banking system of the CFA franc zone. The governments frequently set producer prices (including collection, processing, and marketing costs) for most export crops at levels higher than export prices, but were unable to pay the subsidy to the banks participating in the crop credits. Under central bank regulations, the unreimbursed portion had to be carried over as a normal credit to the crop marketing agency, guaranteed by the government and counted against the country's credit ceiling.<sup>33</sup> The unreimbursed crop credits tended to accumulate, becoming a serious burden on the banking system.

### **Financial Market Development in the Early Stages**

Financial markets in the study countries have always been small. Going back to 1985, data using broad money as a rough approximation of market size indicate that the financial markets in four of the study countries measured less than \$1 billion and in another five ranged between \$1 billion and \$3 billion; only Nigeria had a larger market, totaling \$23 billion.

These markets were still at an early stage of development in the mid- to late 1980s, though the financial systems of Kenya and Nigeria were two of the most diverse and dynamic to be found in sub-Saharan Africa. Gelbard and Leite (1999) derive an overall index of financial market development for countries of sub-Saharan Africa from a set of six sub-indices representing key characteristics of markets, and on this basis, conclude that financial market development in the ten study countries was “minimal” in 1987. Among the various sub-indices, the financial products index indicates that the study countries offered a very narrow selection of financial products. Banks generally did not pay interest on demand deposits, and concentrated lending operations at the short end of the term structure. Government securities tended to be restricted to short maturities. Interbank markets were not fully developed, with transactions most often limited to interbank loans. Stock exchanges had been set up only in Kenya (1954), Nigeria (1960), and Côte d'Ivoire (1974).<sup>34</sup> Two other sub-indices, the financial liberalization index and

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<sup>33</sup> World Bank (1989). These credits did not fall under the overall credit ceiling since reimbursement was generally expected within the year.

<sup>34</sup> In addition, the number of companies listed on stock exchanges in sub-Saharan Africa has been small. As recently as 1997, the total number of company listings on the stock exchanges of Ghana (established in 1989), Kenya, and Nigeria came to 253. See Bhattacharya and Daouk (2001).

the financial openness index, indicate that the financial systems of the study countries were highly repressed in 1987 and that most were either closed or minimally open (only Kenya's system was largely open).<sup>35</sup> Finally, the monetary policy instruments index shows that the authorities had very rudimentary instruments at their disposal.

The stunted development of financial markets had a number of implications for commercial banks. In particular, the small size of these markets prevented banks from benefiting from the advantages sometimes associated with larger size, i.e., greater efficiency, risk diversification, and cost effectiveness in setting up a financial infrastructure.<sup>36</sup> The reliance of the authorities on direct instruments of monetary control, together with a difficult macroeconomic environment, discouraged financial intermediation, thereby constraining the liquidity base of the banks. Furthermore, the limited array of financial instruments made it more difficult for banks to secure alternative sources of funding. Most banks were prone to greater volatility because of the relatively high level of demand deposits in their funding, and some, notably in the CFA franc zone, were beholden to the central bank because of the importance of central bank refinancing.

## **B. Market Structure and the Government's Imprint**

### **Categories of Banks: A Question of Ownership**

In the mid-1980s, commercial banking in the study countries encompassed government-owned banks, local banks owned by private investors, and foreign-owned banks. Development banks, owned and controlled by governments, operated alongside the commercial banks. The structure of bank ownership, and in particular the role of government-owned banks, varied across countries. Government-owned banks formed the entire banking system (with some minor exceptions) in those countries that had adopted central planning, and that had accordingly nationalized the banking system (Guinea in 1960, Tanzania in 1967, and Benin in 1975). While not as dominant in more market-oriented economies, state banks nonetheless played a significant role in the countries of the franc zone, as well as in Ghana, Nigeria, and Uganda. Their influence was less pronounced in Kenya where both indigenous and foreign banks were key players.

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<sup>35</sup> The financial liberalization index measures the degree of financial repression by taking into account whether credit controls are used and whether interest rates are market determined and positive in real terms. The financial openness index combines features that reveal the degree of openness of the financial system and its integration with world capital markets.

<sup>36</sup> See Bossone et al (2001).

### ***Government-owned banks***

The establishment of state banks needs to be seen in historical context. In the decade following independence, foreign banks, which dominated African banking systems, were criticized for lending mainly on a short-term basis to finance foreign trade and provide working capital, and mainly to companies owned overseas or by the non-African resident community.<sup>37</sup> With a view to filling the perceived financing gaps, governments founded their own commercial banks, either setting up new institutions or nationalizing existing foreign banks (Box 2).

Some government-owned banks in some countries (e.g., Nigeria) proved to be viable institutions. But more often than not, these banks performed very poorly—as was the experience in quite a number of developing countries. There was typically no clear separation between government ownership and government management of these banks. As a result, managers often had little autonomy and limited incentives to conduct efficient banking operations. In addition, they were not given clear guidance on how to resolve any conflicts between the developmental and social objectives of the banks on the one hand, and the objective of making a commercial rate of return on the other.<sup>38</sup> Under these circumstances, state banks were highly vulnerable to pressures from the government and politically connected individuals to make loans to struggling public enterprises or to make improper loans. Finally, the large size of many government-owned banks, rather than serve as a counterbalance to the weight of the state, simply amplified the deterioration in the banking system.

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<sup>37</sup> Brownsbridge and Harvey (1998). For example, foreign banks in Ghana were criticized in part for modeling their lending policies on those of the United Kingdom, and hence for requiring types of security (life insurance policies, stock certificates, bills, etc.) that were not readily available in Ghana.

<sup>38</sup> Ibid.

## Box 2. Government Ownership in Banks

Governments in all study countries established their own banks. The steps that some of them took are described below.

**Benin.** The government nationalized the existing banks in 1975 in keeping with the tenants of Marxism-Leninism, which became official ideology in that year. The three banks charged with conducting banking operations followed some specialization in their lending activities. The Banque Commerciale du Bénin (BCB), the result of the nationalization and merger of three commercial banks, provided the bulk of domestic credit for commercial activities and received the preponderant share of the deposits—mainly demand deposits—of the public and private sectors. The Banque Béninoise pour le Développement (BBD) mostly financed the industrial sector, and the Caisse Nationale de Crédit Agricole (CNCA) mostly the agricultural sector.

**Cameroon.** Equity participation of the government in banks was stipulated by law. A decree of August 1985 on banking activity stated that no less than one-third of a bank's subscribed capital must come from the government. In fact, it was considerably higher than this for the sector as a whole, and one bank was wholly government-owned.

**Ghana.** All of the banks established in the two decades following independence were wholly or majority owned by the government. The Ghana Commercial Bank (GCB), set up in 1953 to improve the access of indigenous businesses and farmers to credit, became the largest bank in the country, with 36 percent of total bank deposits in the late 1980s. The government went on to found two commercial banks, several NBFIs, and nine development finance institutions during the 1960s and 1970s. It did not nationalize the two foreign-owned banks, i.e., Barclays, and Standard and Chartered Bank dating from the colonial period, but did acquire 40 percent equity stakes in them following an indigenization decree enacted in 1975.

**Kenya.** In the 1960s, the government set up two banks—the Cooperative Bank and the National Bank of Kenya (NBK). The mandate of the NBK, incorporated in 1968, was to enhance the financing of African businesses and the transfer of assets (such as farmland) to Africans. In 1970, the commercial banking operations of National and Grindlay's Bank were nationalized and renamed the Kenya Commercial Bank (KCB). The explicit objectives of the KCB were more commercial than those of the NBK, but development criteria influenced some lending policies and the decision to expand its branch network into rural areas. It was managed under contract by Grindlay's until the mid-1980s, and was generally allowed a greater degree of independence from government control than the NBK. In 1990, two more government-owned commercial banks were established. At end-1993, the KCB was one of the two largest banks in Kenya, with 22 percent of bank deposits, and the NBK was the fourth largest, with 10 percent of deposits.

**Nigeria.** Both the federal and state governments established their banks, though the importance of public ownership in banking declined as of the mid-1980s with the growth of locally-owned private sector banks. The Federal Government had major shareholdings in eight commercial and five merchant banks, nine of which were joint ventures with foreign investors, including Standard Chartered, Barclays, BNP, Bank of America, and Bank of India; it also had a minor stake in one other merchant bank. The banks in which the Federal Government had a shareholding included the four largest commercial banks and three of the five largest merchant banks in terms of assets. During the 1970s, the state governments began setting up banks in order to mobilize resources for development projects and to expand lending to indigenous businesses. By 1980, state governments held equity in 10 banks, and by 1992, this number had risen to 25. Most of the state government banks were joint ventures with local private investors, and most were quite small.

**Senegal.** The importance of public ownership of banks is seen in the composition of capital in the 14 banks operating at end-1986. The government had an equity share greater than 50 percent in five of the banks (e.g., 88 percent in the Société Nationale de Banque, 81 percent in the Banque Nationale de Développement du Sénégal, and 76 percent in the Société Nationale de Garantie et d'Assistance au Commerce).

Sources: Brownsbridge and Harvey (1998), International Monetary Fund, and World Bank.

### ***Development Banks***

Governments also set up development banks to finance priority sectors and activities, namely agriculture, industry, and housing (Box 3).<sup>39</sup> The arguments evoked in favor of this particular form of bank included the considerable financial resources needed to modernize agriculture or reduce housing shortages; the apparent unwillingness or lack of capacity of commercial banks to extend loans to priority sectors; and the ability of a specialized bank to understand a priori the requirements of a specific sector and to adapt its policies accordingly.

In practice, the development banks gave the government greater control over the banking system and the selection of priority sectors (often with little regard for a sustainable growth strategy).<sup>40</sup> Furthermore, a number of factors meant for an inherently weak financial performance among development banks. First, by their very nature, these banks could not meet prudential norms of diversification, and were thus fully exposed to shocks affecting the sector in which they operated. Second, frequent government interference in their operations circumscribed the importance of economic criteria in lending. Third, being implicated in socially and politically sensitive sectors, they could not pursue an aggressive loan recovery strategy. Finally, profitability was often considered secondary to the expansion of credits.

#### **Box 3. A Typical Array of Development Banks**

The government of Côte d'Ivoire set up five development banks in the 1950s and 1960s to finance priority sectors. These consisted of two industrial banks, the Crédit de la Côte d'Ivoire (CCI) and the Banque Ivoirienne de Développement Industriel (BIDI), which served as term lenders to industry; two housing banks, the Banque Nationale pour l'Épargne et le Crédit (BNEC) and the Banque Ivoirienne de Construction et de Travaux Publics (BICT) specializing in mortgage lending; and a rural development bank, the Banque Nationale pour le Développement Agricole (BNDA), which mobilized rural deposits, participated in the financing of agricultural projects and crops, and provided bridge loans to farmers.

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<sup>39</sup> Benin was the only study country not to have separate development banks, but its nationalized commercial banks were broadly specialized by sector.

<sup>40</sup> In some cases, clients that could have obtained financing from commercial banks chose to approach a development bank, not for its expertise, but rather for its advantages in terms of rates or commissions. Hence, for these prime clients, dealing with a development bank represented a way to obtain subsidies.

### **Local Banks**

Local or indigenous commercial banks were set up by domestic private investors, primarily in countries where the private sector was relatively well developed. Numerous nonbank financial institutions (NBFIs) were also established, notably in Kenya, where legislation initially favored NBFIs. As of the mid-1980s, local banks began to acquire a significant market presence in Kenya and Nigeria, and to a somewhat lesser extent, in Uganda (Table 5).

Table 5. Number of Local Banks and NBFIs in Selected Countries, 1980–95 1/

	Kenya		Nigeria		Uganda
	Commercial banks	NBFIs	Commercial banks	Merchant banks	Commercial banks
1980	0	8	3	1	0
1985	4	24	7	7	0
1991	7	32	...	...	4
1994	17 (25%)	35 (50%)	33 (26%)	46 (68%)	...
1995	...	...	...	...	8 (15%)

Source: Brownsbridge (1998).

1/ Shares of the deposit market are given in parentheses.

Local banks were able to enter the banking sector as entry requirements were relaxed (see below), and to expand thereafter as they found niches serving customers, such as small businesses, neglected by the government-owned and foreign banks. Investors were also keen to take advantage of profitable opportunities that had arisen from the liberalization (or partial liberalization) of financial and foreign exchange market operations. In Kenya, the introduction of Treasury bill (T-bill) auctions, together with the large domestic borrowing needs of the government, caused T-bill rates to increase sharply; banks were able to make money simply by purchasing T-bills. In Nigeria, the introduction of a foreign exchange auction in 1986 provided significant opportunities for arbitrage between the official and parallel markets. Access to the auction was restricted to commercial and merchant banks, and in order to ensure that the available foreign exchange was distributed widely among the banks, ceilings were placed on the amount that could be allocated to any one bank. The banks were able to resell the foreign exchange purchased at the auction at a substantial premium (averaging 33 percent during 1987–90) on the parallel market or in bureaux de change.<sup>41</sup> Finally, some of the banks were simply established to enable their owners to mobilize funds for their other business ventures.

<sup>41</sup> Brownsbridge and Harvey (1998).



While many local banks were able to operate on a sound basis during 1985–95, quite a number did not seek to carry out conventional banking, but rather to undertake activities that were inherently risky over the longer term. Among such banks, lack of a stable deposit base, imprudent loan policies, inappropriate conduct, and vulnerability to changes in economic policy (e.g., the foreign exchange regime) all made for a precarious position.

### ***Foreign Banks***

In general, foreign banks are considered to have a beneficial effect upon the banking soundness of a country. They have a stronger capital base than domestic banks, and in case of difficulty, can be recapitalized by the parent bank. They have easier access to external sources of liquidity, in particular through lines of credit extended to the parent bank. Foreign banks may be more conservative in their credit policies than their domestic counterparts, and may be more insulated from government pressure. These banks also have available to them better technical and operational capacities. Finally, if foreign banks provide more efficient financial intermediation and superior service, their presence may pressure domestic banks to improve.

At the same time, foreign banks can be a source of weakness. They tend to cream off the best clients and reinforce the problem of adverse selection. They may also benefit from a flight to quality in difficult times at the expense of local banks just when the latter depend most on the stability of their deposits. In addition, their commitment to a country may waiver when economic conditions deteriorate, with the head office, for example, reducing the lines of credit to a subsidiary abroad.

Foreign banks have a long history in sub-Saharan Africa, having first set up operations under colonial rule. As noted above, they dominated African banking systems at the time of independence, but then lost in importance through nationalization and the establishment of government-owned and local banks. In a few countries, however, foreign banks never stopped being major players in the sector, and in others, they were pivotal in the restructuring of the banking sector. In Kenya, two of the three largest banks accounting for 38 percent of bank deposits in 1993, were foreign-owned. In Côte d'Ivoire at the beginning of 1991, the three largest banks were subsidiaries of French banks and controlled 74 percent of banking sector assets. Of the 12 banks in operation in Senegal at end-1989, one was wholly foreign-owned and four others were majority foreign-owned (jointly with the government which maintained a share of up to 29 percent).

The foreign banks that were allowed to operate generally appear to have been better managed and to have posted better results than their domestic counterparts. Yet they failed to unambiguously strengthen banking soundness. In Kenya, the very dominance of the foreign banks prompted the government to encourage the proliferation of local banks and NBFIs. The hasty and poor preparation behind this move led to adverse selection, with the foreign banks

keeping the best borrowers to themselves and leaving the new entities with the riskiest loans. In Côte d'Ivoire, foreign banks suffered from a liquidity crisis when in the second half of the 1980s parent banks cut the lines of credit to their subsidiaries out of concern over the worsening economic climate. In Uganda, balance sheet data for 1987–89 implied that the foreign banks were well capitalized, but closer examination revealed that the bulk of the shareholders' funds consisted of revaluations of their premises. Once the revaluations were excluded from the balance sheet data, the ratio of the liquid shareholders' funds to total assets had fallen to unduly low levels. This downward trend reflected in part the foreign banks' practice of distributing the bulk of their profits (75 percent during the three-year period 1987–89) as dividends rather than reinvesting them as retained earnings.<sup>42</sup>

### **Banking Concentration**

In the mid-1980s, the banking sectors in the study countries were highly concentrated. In all cases, a maximum of four banks held one half or more of banking system loans. In the most extreme case, the government-owned National Bank of Commerce (NBC) in Tanzania, accounted for more than 80 percent of total banking sector loans.

The high degree of banking concentration in the study countries was generally associated with behavior that would undermine banking soundness.<sup>43</sup> It reflected in part efforts by some governments to establish a few large banks under their control. When some of these banks failed, their very size magnified the problems of the banking system. A highly concentrated sector was also indicative of a lack of competition even where, as in Cameroon, regulations permitted some competitive behavior. Under such circumstances, poor corporate governance and management could be expected to thrive.

### **Entry Conditions**

The purpose of entry regulations is to ensure that banks entering the system are sound and well managed.<sup>44</sup> To this end, they typically require that owners, directors, and managers be “fit and proper,” that a business plan be formulated, and that capital be sufficient to conduct operations on a profitable scale and safeguard against unanticipated events. They should also give

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<sup>42</sup> World Bank (1991d), Vol. II.

<sup>43</sup> There is, however, no one optimal level of concentration. Both a highly concentrated and a highly dispersed banking system can be efficient, as shown by the experiences of Canada and the United States, respectively.

<sup>44</sup> See Lindgren et al (1996).

supervisors the authority to reject applications or revoke licenses if the licensing conditions are not met.

During much of the period 1985–95, entry into the banking sector was closely controlled in all but two of the study countries. In the planned economies, the authorities restricted entry so as to protect a nationalized banking system. In other countries as well, few (if any) new banks were licensed once an initial group of banks had been set up in the early years of independence. For example, of the 14 banks in operation in Côte d’Ivoire in 1990, the four major banks were established in the first half of the 1960s, and the ten smaller banks in the mid-1970s at the height of the coffee and cocoa boom. In Senegal, the authorities awarded licenses to a small number of new banks, though the criteria on which they based their decisions were not always clear and well defined.<sup>45</sup>

By contrast, entry conditions in Kenya and Nigeria were considerably more lax. In an effort to reduce the predominance of foreign banks inherited from its colonial past, Kenya in the 1980s adopted a liberal approach to licensing NBFIs. Thus, while excluded from foreign currency markets, NBFIs were not subject to the same controls as banks. Until 1989, they were not required to hold reserves, and were excluded from deposit and lending ceilings. The low entry barriers resulted in a particularly rapid increase of NBFIs, some of which were established by banks seeking to circumvent banking regulations, and of commercial banks (see Table 5 above).

In Nigeria, the criteria for extending banking licenses appear to have been loosened and politicized in the second half of the 1980s.<sup>46</sup> The Federal Ministry of Finance was authorized to grant licenses, though the Presidency and Federal Executive Council were also involved in examining applications. Numerous applicants, often with no banking experience, but with ties to the military, used political influence to obtain licenses. Moreover, the minimum capital requirements were eroded by inflation during the 1980s, and by 1988, it was possible to establish a commercial bank with paid-up capital equivalent to \$300,000.<sup>47</sup> During 1987–92, approximately 27 local commercial banks were established, most wholly owned by the Nigerian private sector.

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<sup>45</sup> In Senegal, following the establishment of an initial group of banks in 1965, only six new commercial banks were licensed in the subsequent 21 years.

<sup>46</sup> Brownsbridge and Harvey (1998).

<sup>47</sup> Ibid.

Supervisory authorities in the study countries during 1985–95 appear to have fallen into two of the main traps in setting conditions for entry into the banking sector. On the one hand, the excessively restrictive regulations in most of these countries protected banks that performed poorly and that were vulnerable to adverse shocks. On the other, an overly accommodating entry policy in Kenya and Nigeria made it easier for applicants who were incompetent or whose real intentions presented a serious risk to the longer-term solvency of their banks to enter the banking profession. Thus, many of the new institutions lacked sufficient capital and the necessary professionally qualified staff to operate effectively. They quickly ran through their capital and depositors' funds by making bad loans (often to themselves or associated companies), operating on inadequate spreads, and mismatching resources. In Kenya, the rapid growth of institutions had an unintended result: rather than broaden scope and increase competition in the financial system, these weaker institutions destabilized the market, driving depositors back to the established banks.

### **Bank Financing and Shareholders**

In view of the limited development of financial markets, banks only had three main sources of financing, namely demand deposits, time deposits, and central bank refinancing. As a result, their liquidity base was not always stable. Private sector deposits fell in countries such as Cameroon and Côte d'Ivoire as GDP growth slowed or became negative. Public sector deposits, which had been built up in part to offset the weak capitalization of banks, also declined as the government's budgetary difficulties mounted.<sup>48</sup> As these sources of funding began to dry up, banks turned to the central bank for refinancing. By 1988, refinancing by the BCEAO accounted for more than one third of banks' resources in Côte d'Ivoire. Such heavy reliance on the central bank put banks in a highly vulnerable position. The decision by the BCEAO in 1988 to stop refinancing distressed banks in Senegal triggered a liquidity crisis among these banks.

The composition of funding also had important implications for some local banks, particularly in Kenya where they had access to public enterprise deposits through political connections. The availability of these deposits lessened the need to mobilize funds from the public, and partly for this reason, local banks were under little pressure from depositors to build up a reputation for sound banking.

The involvement of politicians in banks as shareholders and directors affected both private and government-owned banks. In some cases, political connections were used to facilitate the acquisition of banking licenses, and to pressure regulators not to sanction banks when violations

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<sup>48</sup> By end-1985, deposits of the government and public enterprises in Cameroon amounted to 50 percent of total deposits. World Bank (1986).

of banking laws were discovered. Banks then came under pressure to lend to politically influential individuals in return for favors performed on their behalf.<sup>49</sup>

### C. Unsound Conduct of Banks

#### General Practices in Need of Improvement

Competition among banks was very limited in the study countries, with the exception of Kenya and Nigeria. Several features of the banking sectors stood in the way of competitive behavior even when permitted by legislation (as in Cameroon), including the small number of banks and sectoral specialization among banks, the existence of sector-specific financial institutions such as development and housing banks, and government restrictions on entry. Moreover, the array of financial products available to the public was minimal; small businesses tended to be neglected by the government and foreign-owned banks in favor of large established clients; and service was usually poor, particularly in state banks.

Banks' credit policy suffered from serious weaknesses. *Credit appraisal* was generally lax as a systematic examination of the character, financial and economic track record, and prospective cash flow of borrowers often went missing. Security accepted as collateral too often was not verified for adequacy and authenticity before loans were granted, borrowers' valuations were taken at face value, and title deeds were not verified. *Credit monitoring* was hampered by inadequate loan supervision practices. Usually lacking was the capacity to identify problem loans at an early stage and take measures to protect the bank and depositor funds as soon as a loan became past due. To begin with, banks did not properly document their loans. For example, in Côte d'Ivoire, loan contracts sometimes were not signed with borrowers. In Uganda, at the UCB, securities taken for delinquent loans could not be readily traced because the bank failed to establish firm repayment schedules and to monitor borrowers' performance against them.<sup>50</sup> *Credit management information systems* were often built on a multiplicity of controls and reporting lines. In this regard, poor coordination between lending groups and the resulting absence of standardized information relating to portfolio performance meant that it was sometimes possible for one customer to get a loan from one group despite having been refused by another. Most institutions, particularly government-owned banks, lacked proper *internal control systems*. The auditing function within banks was generally weak and the board of directors often failed to exercise its supervision functions, playing instead a passive role. All of these weaknesses were taken to extremes in Guinea (Box 4).

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<sup>49</sup> Brownsbridge (1998) and World Bank (1992).

<sup>50</sup> World Bank (1995), Vol. II.

#### **Box 4. An Example of Bank Fraud and Collapse**

The conduct of banks in Guinea led to the collapse of the banking system as described in the following passage:

“The main responsibility for the failure of the banking system seems to have fallen on the management of the banks themselves, which permitted widespread irregularities, manipulations, and fraud. The lack of qualified staff, the absence of any system of internal control and of reconciliation of book entries, the excessive partitioning of operations, and the lack of communications between departments and institutions resulted in confused and disorderly accounting practices. Items were not entered in the books or were entered with considerable delays. Financial statements were not prepared or, when prepared, were often adulterated. Participation in various schemes to take advantage of the accounting chaos was widespread and seems to have involved staff members of the banking system at all levels as well as their friends and allies in the public and private sectors.

In view of the disorganization of the accounting system, the fraud did not require sophisticated manipulations. Fake or altered documents and forged entries in the books seem to have been used equally and with similar results. Depositing for immediate credit a certified check drawn on another bank was a most favored means of boosting an account balance. As a result of these various actions, the assets of the banks increasingly included claims on other banks or the central bank, which were not recognized by the alleged debtors. Those fictitious assets amounted to about GF 30 billion at the end of 1984 and included a difference of GF 12 billion in the net claims of the central bank on the specialized banks, as reported in their books, a GF 5 billion discrepancy between the reciprocal claims between specialized banks, and a gap of GF 13 billion in the interbranch account (“compte de liaison”) of the CNCIH. By the time of their closure on December 22, 1985, the fictitious assets of the state banks had jumped to about GF 40 billion—approximately 80 percent of their total assets—including GF 4.5 billion in certified checks issued after July 26, 1985 when the practice was prohibited.”

Source: Tenconi (1993).

Banking operations were characterized by high concentration of risk in portfolios, low capital and reserves, and unrecognized loan losses. Most banks made no attempt to accurately quantify the risk that existed in their asset portfolios and to provide adequate loan loss reserves. Management tended to be overly optimistic over the eventual collection or recovery of assets when determining an adequate level of reserves. The problem of evaluating asset quality often carried over to the issue of capital adequacy. Not only did banks fail to recognize loan losses and set aside adequate reserves, but their assets grew at rates far surpassing the growth in capital funds through retained earnings. As a result, the proportion of capital to assets was often insufficient to prudently support banks' operations. In some cases, such as Ghana, banking legislation itself did not mandate (until 1989) a minimum capital adequacy ratio which would have restrained the growth of banks to a controlled pace with due attention to asset quality and off-balance sheet risk.

Concentration limits were often exceeded, reflecting in part the limited diversification of the economy and pressures to lend to particular credit risks, notably public enterprises. Ugandan banks provide an example. As late as 1995, some firms were borrowing well in excess of the individual limit requiring that loans to one credit risk not exceed 25 percent of core capital; in some of the most egregious violations, loans to one credit risk still amounted to about two-thirds of core capital.<sup>51</sup>

### **Insider Lending and the Payoffs of Banking**

Insider lending was a major problem in some banks, especially local banks that had been set up in part for this purpose.<sup>52</sup> Most of the larger local bank failures in Kenya involved widespread insider lending. About 65 percent of the total loans of the four local banks liquidated in Nigeria in 1995 were insider loans, basically all irretrievable. Almost half of the loans of one of the Ugandan local banks taken over by the BOU in 1995 had been granted to its director and employees. Problems were exacerbated because many of the insider loans breached limits on large-loan exposures. These loans were extended to speculative projects unable to generate short-term returns (such as hotels and shopping centers). Hence, there was a considerable mismatch between the maturities of the banks' assets and liabilities.

The high incidence of insider lending among these banks may well have been due to the seriousness of moral hazard and adverse selection—problems that Mishkin (1996) argued can

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<sup>51</sup> World Bank (1995b), Vol. II.

<sup>52</sup> See Brownsbridge (1998) who provides a detailed analysis of connected lending in local banks in four countries of sub-Saharan Africa.

result in financial crises.<sup>53</sup> Among certain local banks in sub-Saharan Africa, several factors led to the worsening of these problems. As noted above, the involvement of politicians as shareholders and directors of some of these banks as well as a narrow ownership structure and lack of management autonomy contributed to imprudent bank practices, and increased moral hazard.

Lending at high interest rates to borrowers in high-risk segments of the credit market also undermined banking soundness. Because depositors considered them to be less safe than the major banks, many local banks had to offer higher rates on deposits. The high cost of funds made it important for local banks to generate high earnings from their assets, for example, by charging high lending rates. Consequently, local banks had great difficulty in competing with the foreign banks for the most creditworthy borrowers. Local banks were hurt by adverse selection, as many of their borrowers were unable to meet the more stringent creditworthiness requirements of the foreign banks. Credit markets were segmented, with the result that many of the local banks operated in the riskiest segment and served borrowers prepared to pay high lending rates because they could not access other sources of credit. High-risk borrowers included other banks and NBFIs, which were strapped for liquidity and willing to pay above-market interest rates for interbank deposits and loans. In Nigeria, some of the local banks were heavily exposed to finance houses that collapsed in large number in 1993 as well as to other local banks. Financial difficulties thus extended from one local bank to another because of the importance of interbank lending.

Most of the failed banks were undercapitalized, partly because the minimum capital requirements in force when they had been established were very low. Owners put few of their own resources at risk should their bank fail, which created a large asymmetry in the potential risks and payoffs of insider lending. Bank owners could invest the depositors' funds in their own high-risk projects, secure in the knowledge that they would make large profits if their projects succeeded, but would lose little of their own money if they were not profitable. Of the four commercial banks taken over by the Central Bank of Nigeria in 1995, the average paid-up share capital was N 51 million compared with an average of N 94 million for all 36 private sector

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<sup>53</sup> Moral hazard occurs when a borrower has incentives to engage in activities considered undesirable by the lender because they make it less likely that the borrower will repay the loan. Adverse selection occurs when borrowers who are most likely to produce an undesirable outcome—the bad credit risks—are those most likely to actively seek a loan and be selected for one. Mishkin argues that financial crises erupt when problems of moral hazard and adverse selection become so serious that financial markets are unable to channel funds efficiently to economic agents with the most productive investment opportunities.



banks; the paid-up share of these failed banks amounted to an average of only about 4 percent of their total loans.

### **Lending to Public Enterprises: A Push from the Government**

Many banks in the study countries came under government pressure to extend politically-based loans. In these instances, banks served as an extension of the government's economic policy toolkit. They were called upon to finance the government's development priorities and to finance public enterprises, particularly when the government was unwilling to provide budgetary subsidies to public enterprises or adopt realistic pricing policies. It was especially difficult for banks owned by the government to refuse credit to enterprises also owned by the government.

The degree of government intervention showed considerable variation. It was most evident and extensive in the planned economies (Benin, Guinea, and Tanzania) where nationalized banks provided direct credit allocations to public enterprises on the basis of their annual plans of operation. Even in countries such as Côte d'Ivoire, where banks were relatively independent from government, private banks were pressed to extend loans to public sector enterprises and other government projects. The portfolio at end-December 1988 of the NBC in Tanzania is an illustration of heavy government intervention in bank lending. Among its top 40 borrowers, 97 percent of loans consisted of loans to 34 public enterprises (including the cooperative unions), while 3 percent represented credit to 6 private enterprises. Among its top 40 borrowers in the industrial and commercial sectors, 74 percent of credit went to public enterprises and 26 percent to private enterprises; for the sake of comparison, 58 percent of total industrial sector value added was generated by public enterprises and 42 percent by private enterprises.<sup>54</sup>

In some cases, politically-based loans went to the government itself. This was the case in Nigeria where banks set up by the state governments were used to extend loans to these governments and to politically influential borrowers. A large share of these loans became nonperforming as budgetary crises emerged among state governments as of the early 1980s, constraining their ability to service their debts and recapitalize their own banks. Repeated changes of government at the state level compounded the problem as incoming governments did not consider the servicing of loans taken out by previous administrations a priority.<sup>55</sup>

In addition, there were many instances where no overt political coercion was exercised, but where banks chose to make certain loans in the hopes of gaining political favor. This was

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<sup>54</sup> World Bank (1991c).

<sup>55</sup> Brownsbridge and Harvey (1998).

probably the motivation of banks in Cameroon that extended considerable amounts of bad loans to merchants in the northern part of the country during the 1980s.<sup>56</sup>

In the final analysis, government intervention meant that banks did not base certain critical lending decisions on a proper assessment of risk and return. Often times, they ended up financing operating deficits of public enterprises with little or no prospect of repayment. This undermined morale within the banks and further reduced their capacity to operate as properly functioning commercial entities.

#### IV. CONCLUSIONS

A number of preliminary conclusions can be drawn from the experience of banking crises in the ten study countries in sub-Saharan Africa during the period 1985–95:

- Banking crises in sub-Saharan Africa did not represent an entirely special case among banking crises worldwide. Several of the factors identified in the literature as sources of banking crises (notably Goldstein and Turner (1996) reviewed in Section I) are highly relevant to sub-Saharan Africa. These are macroeconomic shocks (including exchange rate shocks); pervasive government involvement and loose controls on insider lending; weaknesses in the legal and institutional framework; inadequate capitalization and loan loss provisions, and distorted incentives that encouraged economic agents to take excessive risks.
- Several features of banking crises in sub-Saharan Africa are nonetheless more specific to this part of the world. These banking crises were the very prototype of endemic crises associated with heavy government intervention in the banking system (see Honohan (1997) discussed in Section I). In addition, the lack of a strong legal and institutional environment hurt banks in sub-Saharan Africa more than most banks elsewhere. Making conditions more difficult as well for banks was the lack of a “credit culture” that instills the view that repaying one’s loans is important. Finally, banks in sub-Saharan Africa were highly vulnerable to the limited diversification of these economies and thus to volatility in primary commodity prices.
- Some factors linked to banking crises in other regions of the world were noticeably absent in sub-Saharan Africa. Contagion did not play an important role in propagating banking crises on this continent. The bunching of crises in the second half of the 1980s

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<sup>56</sup> World Bank (1986).

and the early 1990s reflected common external shocks that hit many countries at roughly the same time as well as common deficiencies in economic policy-making and banking regulation and supervision. Furthermore, financial liberalization does not appear to have been a major factor in these banking crises as the financial systems in the period leading up to the crises for the most part remained highly repressed. More specifically, the deregulation of interest rates took place after the onset of banking crises in the study countries (with the exception of Nigeria), and in a number of cases (notably in the CFA franc zone), was part of a policy package that came in response to the crises. There is also little evidence from sub-Saharan Africa to support the view that deposit insurance schemes contributed to these banking crises. Such schemes existed in only a few of the study countries at the time of the crises.

- The role of government in the banking system and banking crises in sub-Saharan Africa was complex, and intervention by the government made itself felt through many channels. Government influenced the operating environment of banks, namely the macroeconomic setting, the legal system, and institutions, as well as the market structure of banking, in particular through its effects on ownership patterns and entry conditions. It also had a direct impact on the conduct of banks, mostly as a result of pressure to lend to public enterprises.
- The relationship in sub-Saharan Africa between the government and banks appears to have had a number of (short-sighted) benefits for both parties; in other words, it was often a two-way street. The government used banks to further its development agenda and to favor selected sectors and enterprises. By the same token, the banks used the government to intervene on their behalf, to channel credit to activities that would benefit certain individuals, and to turn a blind eye to inappropriate conduct and practices.
- The critical importance of good governance for sound banking is underscored by the experience of government-owned and foreign banks that recorded a solid performance during the periods of banking crises. These banks survived in large part because they absorbed the culture and management behavior associated with prudent commercial banking. They employed experienced and professional bankers as managers, pursued a cautious portfolio strategy, and were able to resist government pressures to extend credit according to noncommercial criteria.

In sum, the most important factors behind the banking crises in sub-Saharan Africa appear to have been government interference, poor banking supervision and regulation, and shortcomings in management. The most important triggers were economic recession and a deterioration in the terms of trade. These conclusions are consistent with those of Caprio and Klingebiel (1997).

The findings of this paper could be evaluated and extended in future research. One approach, data permitting, would be to build a framework to test empirically the relative importance of the various causes of banking crises in sub-Saharan Africa. Another approach would be to formalize the themes of this paper in a simple theory of banking crises that focuses on the role of government intervention and associated problems. Such a framework could draw upon third generation currency crises models, which were designed to understand the crisis in East Asia and which emphasize the role of government (albeit not as extensive as in sub-Saharan Africa) and institutions in the financial sector.

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