

Senegal

Financial Depth and Macrostability



Patrick Imam and Christina Kolerus

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Introduction

This enhanced review of Senegal's financial sector is one of several pilot reviews called for by the Executive Board in May 2012. The purpose of the reviews is to go beyond the traditional surveillance focus on banking system soundness and solvency by analyzing in more depth the interplay between financial development, macroeconomic and financial stability, and effectiveness of macroeconomic policies in low-income countries. Senegal is a member of the West African Economic and Monetary Union; a number of key macroeconomic and financial policies are designed and implemented at the union level. This study focuses on Senegal-specific issues. Another pilot study, to be prepared in the context of the next annual consultation on regional policies in early 2013, will focus on union-wide issues.

The financial system in Senegal, like in many other low-income countries, is dominated by the banking sector, with commercial banks representing about 90 percent of the financial system. A large number of microfinance institutions supply limited financial services targeting lower-income households. They help raise overall access to the financial system to about 20 percent of the population. Insurance companies account for most of the remainder of the domestic financial system. The regional securities and equity market is a marginal source of funding, except for the government. The interbank market remains underdeveloped.

The banking system appears to be relatively robust, with lending concentration and asset quality being the main risks. Financial soundness indicators suggest that banks are on average adequately capitalized, profitable, and liquid. Microprudential regulation of banks needs to be enhanced and supervision strengthened further. The authorities are encouraged to develop a holistic view of the financial system and systemic risk.

Financial depth has increased in recent years and is broadly in line with the country's structural characteristics. However, a comparison with selected countries suggests substantial scope for further deepening, which would facilitate the conduct of fiscal policy, make it easier for agents to deal with volatility, and foster investment and growth.

There is broad agreement that the main obstacles to further financial development include large informational asymmetries, a poor business and judicial environment, an inadequate tax regime, regulatory and supervision issues, and inadequate skills. The authorities have a strategy to address a number of these issues, whose implementation they intend to accelerate. The regional authorities are working on the development of the interbank market and the strengthening of the public debt market, which they see as priorities.

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Senegal's Financial System: Structure, Performance, and Risks

Overview of the Structure of the Financial System

The financial system in Senegal is dominated by the banking sector. It is composed of 19 commercial banks concentrated in the three largest cities. Banks make up about 90 percent of the financial system (Table 1). The five largest banks account for 66 percent of assets and collect 79 percent of deposits. A large number of microfinance institutions (MFIs; 234 establishments) supply limited financial services targeting lower-income households. Although they cover both urban and rural regions, about half of the sector's activity is concentrated in greater Dakar. Insurance companies (25) account for most of the remainder of the domestic financial system. The regional securities and equity market is a marginal source of funding, except for the government.¹

The banking sector is dominated by subsidiaries of French, Nigerian, Moroccan, and pan-African banks (regional banking groups that are originally African). Nonresidents also have stakes in banks majority-owned by residents. The government has minority stakes (ranging from about 10 to 25 percent of equity) in a number of banks. One bank provides Islamic banking services. Only about 7 percent of the population holds a bank account, though this may be overstated as some individuals may hold multiple accounts. Bank deposits amount to about 40 percent of GDP. The interbank market is underdeveloped, with only a limited amount of liquidity traded among banks. There is no explicit deposit insurance scheme. More detailed analysis on the banking system is available in the subsequent section, "The Banking Sector."

MFIs represent a small but rising share of the Senegalese financial sector. MFIs focus on basic services such as savings accounts and microcredit.

¹ In addition, there is a public pension fund ("social security fund"). Employees of the formal sector (but not civil servants) contribute to it. Given Senegal's very young population, the fund is well capitalized. It manages assets of CFAF 175 billion (2.6 percent of GDP) and invests predominantly in long-term deposits in banks and in real estate.

Table 1. Senegal: Financial System Structure, end-2011

	Total Assets			Deposits		Credits	
	Amount (bn of CFAF)	(% of total)	(% of GDP)	Amount (bn of CFAF)	(% of GDP)	Amount (bn of CFAF)	(% of GDP)
Private Deposit Taking Financial Institutions							
Banks	3,365	88%	53	2,401	38	2,022	32
<i>Of which:</i> Foreign-owned banks	1,904	50%	30	1,598	25	1,384	22
Microfinance Institutions	278	7%	4	181	3	214	3
Non-Deposit Taking Financial Institutions							
Insurance ¹	161	4%	3				
Life	62	2%	1				
Nonlife	99	3%	2				
Securities firms	N/A						
Dealers	N/A						
Others	N/A						
Public Financial Institutions	N/A						
Total financial system (excluding BCEAO)	3,804	100%					

Sources: Association of Insurers, BCEAO, DRS, IMF.

Note: BCEAO = Central Bank of West African States.

¹End 2010.

More people have accounts at MFIs than at banks, which helps raise overall access to the financial system to about 20 percent of the population. MFIs' loans amount to about 10 percent of bank credit. Most MFIs are operated as mutuals or by nongovernmental organizations, and have a social mandate—for example, to lend to farmers in remote regions. The 18 largest MFIs (with assets or deposits above CFAF 2 billion) make up 90 percent of the MFI sector. More detailed analysis on MFIs is available in the section entitled “Microfinance.”

The insurance industry, although still in its infancy, is growing. Nonlife insurance development has been fostered by the growth of credit markets, with banks requesting their clients to take insurance on assets (e.g, houses) purchased through loans, and the development of the formal sector. Life insurance expanded by 20 percent in 2011. Insurance companies are required to hold a minimum of cash deposits (11 percent of their assets) for liquidity purposes. Their assets are invested in term deposits with commercial banks (47 percent); securities, in particular government paper, and equity (18 percent); and real estate (12 percent). Large foreign insurance companies are present, though mostly in the form of domestic partnerships.

The regional capital markets remain a marginal source of funding except for the government.² The regional stock exchange based in Abidjan (known as BRVM, its French acronym) has only one listed Senegalese company, Sonatel. Sonatel, a telecom company with subsidiaries in three other countries in West Africa, is the largest Senegalese company and has the highest capitalization at BRVM. Only very few private and public companies have issued debt in the regional market, unlike West African Economic and Monetary Union (WAEMU) sovereigns, which have significantly increased their recourse to regional financing. Sovereign debt can be issued either at BRVM or through the central bank on the regional money market. This latter segment has been the most active in recent years. Senegal has been able to tap the regional market for increasingly large amounts, with gross issuance likely to exceed CFAF 500 billion (about 7 percent of GDP) in 2012, but at short maturities (average maturity was 1.2 years at end-2011). The regional government debt market is increasingly integrated, with more than half of the debt issued by the Senegalese government bought by WAEMU investors outside Senegal. In addition, Senegal issued a 5-year eurobond (\$200 million) in 2009 and a 10-year eurobond (\$500 million) in 2011, which were partly used to retire the 2009 issue. No company has yet issued securities in international security markets.

The Banking Sector³

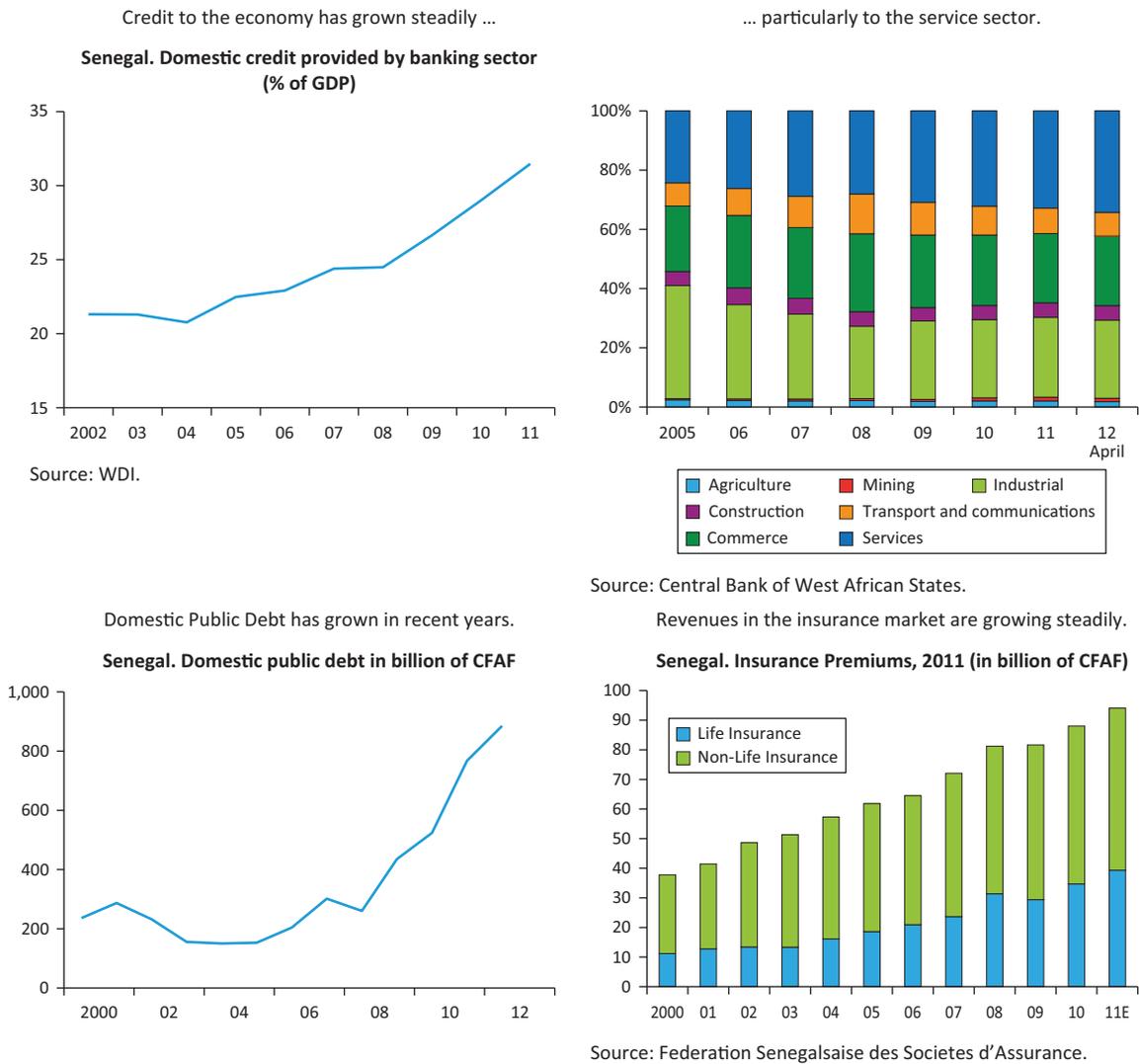
The banking sector has expanded significantly in recent years. In 2011, bank credit to the economy increased by 19 percent (to 29 percent of GDP), the number of bank branches by 11 percent, and the number of bank accounts by 44 percent.⁴ Preliminary numbers for 2012 suggest a similar pace of development, taking overall bank credit to the economy at more than 30 percent of GDP. Credit to the service sector has been particularly buoyant, whereas credit to households, especially longer-term credit, has also increased (Figure 1). Most banks' core business consists in collecting deposits, lending to bigger firms including subsidiaries of multinationals, and holding and dealing in government securities. The entry of three new banks (mostly regional African banking groups), combined with growing competition from MFIs, has recently pushed existing banks to diversify away from their

² There is a growing consensus in the literature that the degree of bank-based versus market-based system does not matter much for economic growth. It is less important what the particular institutional arrangements that provide financial services to the economy are; what matters is the overall financial development.

³ All data on individual banks were obtained from the Central Bank of West African States. The labeling of banks 1–19 differs across graphs, and therefore a particular number does not necessarily correspond to the same bank.

⁴ The large increase in the number of bank accounts reflects to a large extent the recent obligation for civil servants to have a bank account to receive their salary by bank transfer, and a similar decision for the payment of monthly grants to university students.

Figure 1. Senegal: Evolution of the Bank and Nonbank Sectors



high-end clients by offering basic, cheaper services to the middle class, including students and young professionals.

The banking system appears to be relatively robust, with concentration of lending and credit quality being the main risks. Both the authorities and Fund staff have conducted stress tests in recent months (with the authorities doing this on a quarterly basis). The stress tests calibrated various large but plausible shocks (applied to individual banks) in line with the economic structure of Senegal. The system was shocked for (i) sectoral risk, including default by the largest individual exposure and a shock to the three largest borrowing industrial sectors; (ii) overall credit risk comprising a downgrade

of nonperforming loans (NPLs) by one category and an increase in total NPLs by 50 percent; and (iii) credit risk related to default of a public entity, or default on credit to the government and to public enterprises. The stress tests found that liquidity risks and interest rate risks could be withstood, given that banks are highly liquid and the maturity mismatch between assets and liabilities is rather small. Only the concentration of lending was found to be a major source of vulnerability, as loans are concentrated in a few sectors and companies, and exposure to the public sector is large.

The findings of the stress tests are corroborated by the usual financial soundness indicators (FSIs). With the usual caveat in mind—FSIs are backward-looking and procyclical in nature, provide only averages that may hide important variations, and assume that the data are accurate—Box 1 and Table 2 provide an overview of the soundness of the Senegalese banking system. Based on these indicators, Senegalese banks appear on average well capitalized, profitable, and liquid, with asset quality being the main concern. Also the international financial crisis and the ongoing crisis in Europe did not seem to have large repercussions for Senegalese banks, even though indirect effects may have been significant.⁵

Microfinance

After a period of consolidation spearheaded by the authorities, the microfinance sector has continued its rapid expansion. A regulatory reform initiated in 2008–09 led to a reorganization of supervisory responsibilities, with the larger institutions holding assets and/or deposits of more than CFAF 2 billion now supervised by the banking commission, whereas smaller institutions are supervised by the Ministry of Finance. Following the reform, 118 entities were closed down, though credit (and deposits) continued to rise, from CFAF 81 billion in 2005 to CFAF 219 billion in July 2012 (about 3 percent of GDP). Consolidation has led to the emergence of 18 larger entities that together represent 90 percent of the market, with one institution alone making up 60 percent of the market. Credit is mostly allocated to microbusinesses in trade, services such as catering, agriculture, and transportation. Larger MFIs cooperate with various commercial institutions in transferring money and increasingly use banks to finance operations as they do not have access to BCEAO refinancing.

⁵ The direct impact has been limited because banks (including subsidiaries of foreign banks) are locally funded. An indirect effect has reportedly been felt through (i) lower remittances; (ii) some local clients, who export and were paid with delays from overseas, requested extensions of credit lines by local banks; (iii) corresponding banks in Europe imposed tougher restrictions on Senegalese banks, and tightened credit lines; (iv) subsidiaries of international banking groups were requested by their headquarters to tighten their rules on risk taking. Note that African banking groups appear to have taken the opportunity to expand in the region, counterbalancing some of the negative effect.

Table 2. Senegal: Financial Soundness Indicators

	2003 Dec.	2004 Dec.	2005 Dec.	2006 Dec.	2007 Dec.	2008 Dec.	2009 Dec.	2010 Dec.	2011 Dec.	2012 June ¹
(in percent, unless otherwise indicated)										
Capital adequacy										
Capital to risk-weighted assets	11.7	11.5	10.8	12.9	13.5	13.8	16.3	18.0	16.0	16.9
Regulatory capital to risk-weighted assets	12.1	11.9	11.1	13.1	13.6	13.9	16.5	18.2	15.9	16.5
Capital to total assets	7.8	7.7	7.6	8.3	8.3	9.1	9.3	10.0	9.8	12.0
Asset composition and quality										
Total loans to total assets	59.6	57.1	64.0	63.8	58.8	62.8	59.5	57.5	60.6	73.7
Concentration: loans to five largest borrowers to capital	141.0	131.4	179.9	103.7	88.5	100.9	71.7	70.6	69.8	58.1
Sectoral distribution of loans										
Industrial	41.1	33.6	35.5	28.9	25.1	19.5	27.5	26.4	22.2	21.5
Retail and wholesale trade	19.9	19.3	17.0	18.9	14.4	18.5	24.5	23.8	19.2	19.1
Services, transportation and communication	17.2	27.4	28.0	30.0	29.6	31.1	34.1	41.9	34.0	34.4
Gross NPLs to total loans ²	13.3	12.6	11.9	16.8	18.6	17.4	18.7	20.2	16.2	17.5
<i>Of which: Without ICS</i>	...	...	...	...	12.7	14.2	15.8	15.8	13.2	15.7
Provisions to NPLs ²	75.3	75.7	75.4	52.0	53.8	51.5	53.1	54.9	54.0	55.4
<i>Of which: Without ICS</i>	...	...	...	...	74.6	65.7	64.7	65.3	68.3	62.8
NPLs net of provisions to total loans ²	3.3	3.4	3.2	8.8	8.6	9.3	9.7	9.1	8.1	7.8
<i>Of which: Without ICS</i>	...	...	...	...	3.6	5.4	6.2	6.1	4.6	5.9
NPLs net of provisions to capital ²	27.8	25.1	27.2	67.9	60.7	63.9	62.3	52.3	50.4	43.4
<i>Of which: Without ICS</i>	...	...	...	...	23.8	35.3	38.4	41.5	35.7	43.3
Earnings and profitability										
Average cost of borrowed funds	1.8	2.0	2.0	2.2	2.3	2.8	3.4	2.2	2.0	
Average interest rate on loans ³	8.7	11.7	11.8	11.3	11.6	13.9	15.4	8.1	8.4	
Average interest margin ⁴	6.7	9.7	9.8	9.2	9.3	11.1	12.0	5.9	6.4	
After-tax return on average assets	1.8	1.8	1.6	1.6	1.6	1.4	1.3	1.6	2.2	
After-tax return on average equity	22.1	17.6	15.8	14.6	15.3	13.0	16.0	15.4	22.6	
Noninterest expenses/net banking income	48.9	48.7	47.9	49.4	50.7	51.3	60.3	56.7	56.0	
Salaries and wages/net banking income	21.8	21.5	21.2	21.7	22.2	21.1	23.0	24.8	23.8	
Liquidity										
Liquid assets to total assets	66.5	66.4	...	...	...	...	74.9		74.9	
Liquid assets to total deposits	81.0	82.0	...	...	...	...
Total deposits to total liabilities	82.0	79.6	78.3	75.8	73.6	70.3	74.9	76.0	62.8	81.0

Source: Central Bank of West African States.

Note: ICS = Industries Chimiques du Sénégal; NPL = nonperforming loan.

¹ Provisional data.

² NPL changes in 2006 due to ICS. In 2008, ICS was recapitalized and the government guarantee for its bank loans was lifted. However, the loans in question remain classified as non-performing for the time being, although without the need to provision.

³ Break in the series in 2010 due to a methodological change.

⁴ Excluding the tax on banking operations.

Box 1. Banking System Soundness

Capitalization: Financial soundness indicators show that the banking sector is overall at an adequate level of capitalization. Although the capital adequacy ratio decreased to 16 percent at end-2011, it is still largely above the regulatory minimum of 8 percent, and increased further through June 2012.¹ Part of the explanation for this high level is large holdings of sovereign paper, which carries zero risk-weighting. As illustrated during the euro area crisis, this treatment of sovereign risk may be problematic. The recent crises in the West African Economic and Monetary Union (Côte d'Ivoire and Mali) also suggest that this risk cannot be considered nil; an increase in the risk-weighting of sovereign papers would reduce capital adequacy ratios significantly. Only one bank is currently undercapitalized, but because of small size and limited interconnectedness, it does not raise a systemic risk, and it is being restructured.

Asset Quality: At first glance, the quality of assets appears to be a cause for some concern, and may require further investigation and analysis. The ratio of gross nonperforming loans (NPLs)² to total loans was 16.2 percent at end-2011, and increased further in early 2012. However, there are factors qualifying the risk from such high NPL numbers. The latter reflect to a large extent the portfolios of three banks with NPLs in excess of 20 percent, whereas most other banks have NPLs below 5 percent. In addition, the relatively high level of provisioning for NPLs mitigates risks. A reason for high NPLs reported during discussions with bankers is that NPLs tend to be kept on banks' books longer than is typically the case in other countries, in part because of the long time needed to exercise guarantees through the judicial system. Nonetheless, legacy NPLs do not explain completely the situation, as new NPLs are still relatively high, hinting at limited risk-management capabilities, particularly for some of the smaller banks. In addition, a relatively high concentration risk (see the following) suggests that the quality of assets can deteriorate rapidly if only a few debtors get into trouble.

Profitability: The profitability of the banking sector is high. The return on assets was 1.8 percent as of mid-2012 for the sector, with the return on equity being above 17 percent. The profitability of banks is boosted by the fact that they have access to ample and cheap deposits from households with which they can purchase government paper. The net interest margin on these nominally risk-free operations is substantial.

Liquidity: Liquidity risks are low for the banking sector as a whole, though three smaller banks do not meet the minimum liquidity requirements. Structural factors explaining high liquidity include the limited number of bankable projects, but also regulatory rules that require banks to finance medium- and long-term assets to a large extent with

¹ One could admittedly question whether the 8 percent ratio is adequate given the environment of Senegal, but this is beyond the scope of this paper.

² The accounting convention followed by the banking system for NPLs and provisioning is not in line with best international practices. For instance, a claim becomes nonperforming after six (not three) months of missed payments.

Box 1. (concluded)

medium- and long-term resources; as the latter are scarce, banks tend to keep their funds in liquid assets. In addition, subsidiaries of international banking groups are constrained by intragroup regulations and treat debt issued by West African Economic and Monetary Union sovereigns as risky, and as a result limit their exposure to these sovereigns. This restricts the investment universe of banks further, and constrains the amounts of lending activities of these subsidiary banks, thereby keeping liquidity levels higher than they would be otherwise. Finally, the lack of a developed interbank market tends to increase the accumulation of liquidity by the banking system, as liquidity is not significantly traded.

The larger MFIs are increasingly competing with banks. In 2012, the asset holdings of the largest MFI make it as big as the seventh largest bank. Four MFIs have been transformed into corporations (“sociétés anonymes”) and are capitalized, often with the support of donors; one MFI has even set up its own bank. Larger MFIs enjoy certain advantages that may improve their competitive position relative to commercial banks:

- Most MFIs are structured as cooperatives, benefitting from tax exemptions that were originally justified by their social mandate and not-for-profit motive.
- The cap on interest charged for loans is 27 percent for MFIs but 18 percent for banks.
- MFIs often benefit from public and/or donor support via (i) direct or indirect funds that constitute cheap financing, (ii) guarantees, and (iii) training of staff.

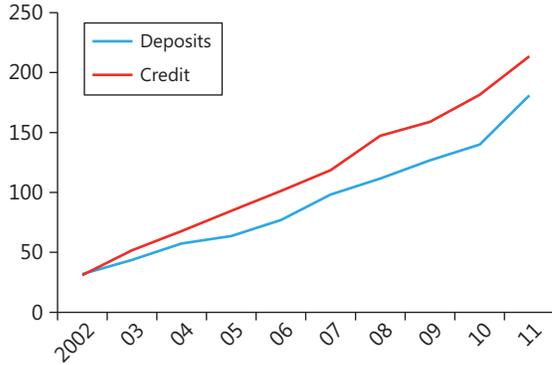
Although the MFI sector is profitable overall, the situation varies greatly depending on the size of the institutions. In 2011, the 18 larger entities generated cumulative profits of CFAF 4.5 billion whereas the other institutions had cumulative losses of about CFAF 0.5 billion. One reason for smaller MFIs’ poor profitability might be that the rapid expansion of the sector has shrunk the pool of “lower-risk” clients and forced MFIs to grant credits to “higher-risk” borrowers, while entering new areas or offering new products in which they may lack expertise. Also, smaller networks tend to be in rather remote areas with a high share of credit to agriculture, which is highly volatile and prone to shocks.

FSIs for the larger MFIs suggest a relatively sound situation. As of June 2012, only one prudential norm, the cap on operations other than savings and credit (money transfer, for instance), has not been met (Figure 3).

Figure 2. The Microfinance Sector

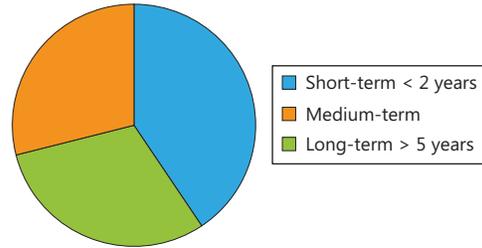
Despite consolidation in the sector, credit and deposits in MFIs have grown at a rapid pace...

Credit and Deposits at MFIs (billions of CFAF)



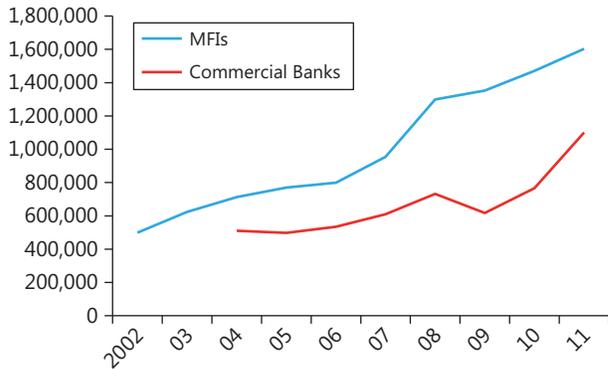
... but short-term loans remain the largest part of allocated micro credit.

Credit Maturity, 2011

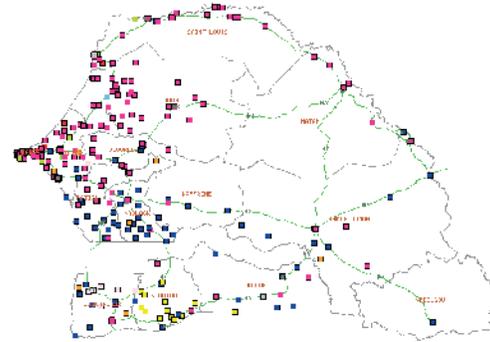


There are more accounts at MFIs than banks.

Number of Accounts



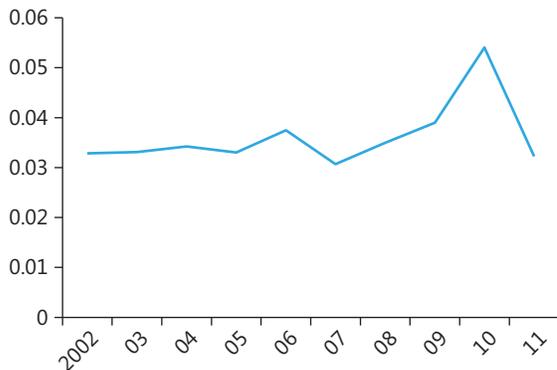
MFIs' operations are less concentrated on Dakar than banks' operations.



Note: Squares represent one or more branches of MFIs; color indicates network.

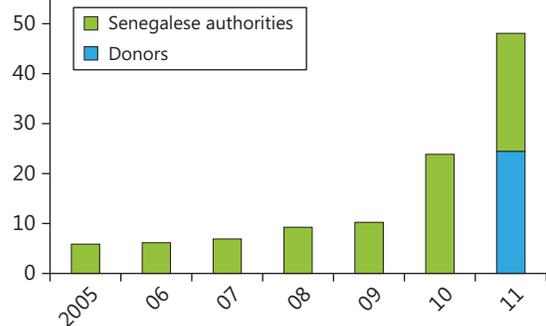
After a spike, NPLs are back to relatively low levels.

NPLs/total loans



Public funding for the microfinance sector has increased significantly in recent years.

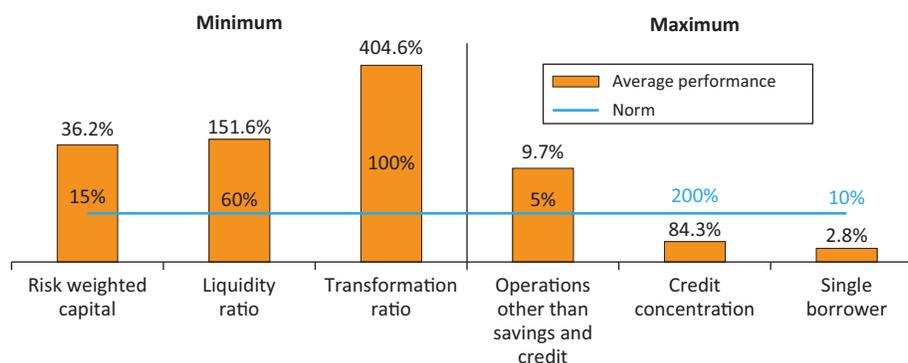
Public funds to the microfinance sector (billions of CFAF)



Source: Central Bank of West African States, Ministry of Finance, staff calculations.

Note: MFI = microfinance institution; NPL = nonperforming loan.

Figure 3. Selected Prudential Norms for Microfinance



Source: Central Bank of West African States.

However, the sector misses indicative profitability benchmarks.⁶ Further, the mutual structure may also raise collective action problems—particularly for institutions with a large number of members—potentially raising governance and accountability issues. Governance problems were indeed experienced by the largest MFI in recent years but were addressed forcefully by the authorities.

Systemic Risk in Senegal

Systemic risk is defined as any threat of disruption to financial services that is caused by an impairment of all or parts of the financial system and that has the potential to have serious negative consequences for the real economy. It is a form of negative externality that occurs when a bank failure, market seizure, or breakdown of the infrastructure can have serious adverse implications for market participants. Systemic risk can be decomposed into time-series and cross-sectional risk. In the *time-series dimension*, the buildup of risk over time interacts with the macroeconomic cycle. Financial institutions and borrowers may take on excessive amounts of leverage in the upswing of an economic cycle only to become overly risk-averse in a downswing. This amplifies the boom and bust cycle in the supply of credit and liquidity—and by extension in asset prices—which can be damaging to the real economy. In the *cross-sectional dimension*, the growing size and complexity of the financial system are raising interconnectedness and common exposures that may increase contagion when problems arise. As a result, the failure of one institution—particularly, one of significant size or with strong interconnections—can threaten the system as a whole.

⁶ Performance vis-à-vis profitability benchmarks is as follows: return on equity (5 percent vs. a target of 15 percent); return on assets (2 percent vs. a target of 3 percent); profit margin (13 percent vs. a target of 20 percent); and cost income ratio (81 percent vs. a target ranging between 40 and 60 percent).

At this juncture, systemic risk is likely to be limited in Senegal, as no sector seems highly leveraged (Box 2). Banks in Senegal finance mostly prime borrowers with short-term credit such as trade finance, implying that risks to the financial system, apart from exogenous shocks, are likely to be low.

Time-series systemic risk has been low. The correlation between credit growth and GDP growth has been very limited so far (at about 0.1). This reflects low financial depth—which means that even a large increase in credit to the economy remains relatively small relative to GDP—and leverage that does not fluctuate much over the business cycle. In addition, Senegal has not been subject to large capital in- and outflows that often constitute the source of time-series volatility in emerging markets (Figure 4).

Most common forms of cross-sectional systemic risk are not a major concern at the moment, although some developments need to be closely monitored. Interconnection among banks is limited (see Figure 4). This reflects, in particular, the underdevelopment of the money market. Risks arising from common exposure seem limited too, although there is high lending concentration in

Box 2. Leverage in Senegal

Leverage levels in Senegal are low to moderate. The mirror image of a relatively low credit-to-GDP ratio is low leverage levels in the economy. Government debt, although on a rising trend, remains manageable; corporate, banking, and household leverage levels are low to nonexistent.

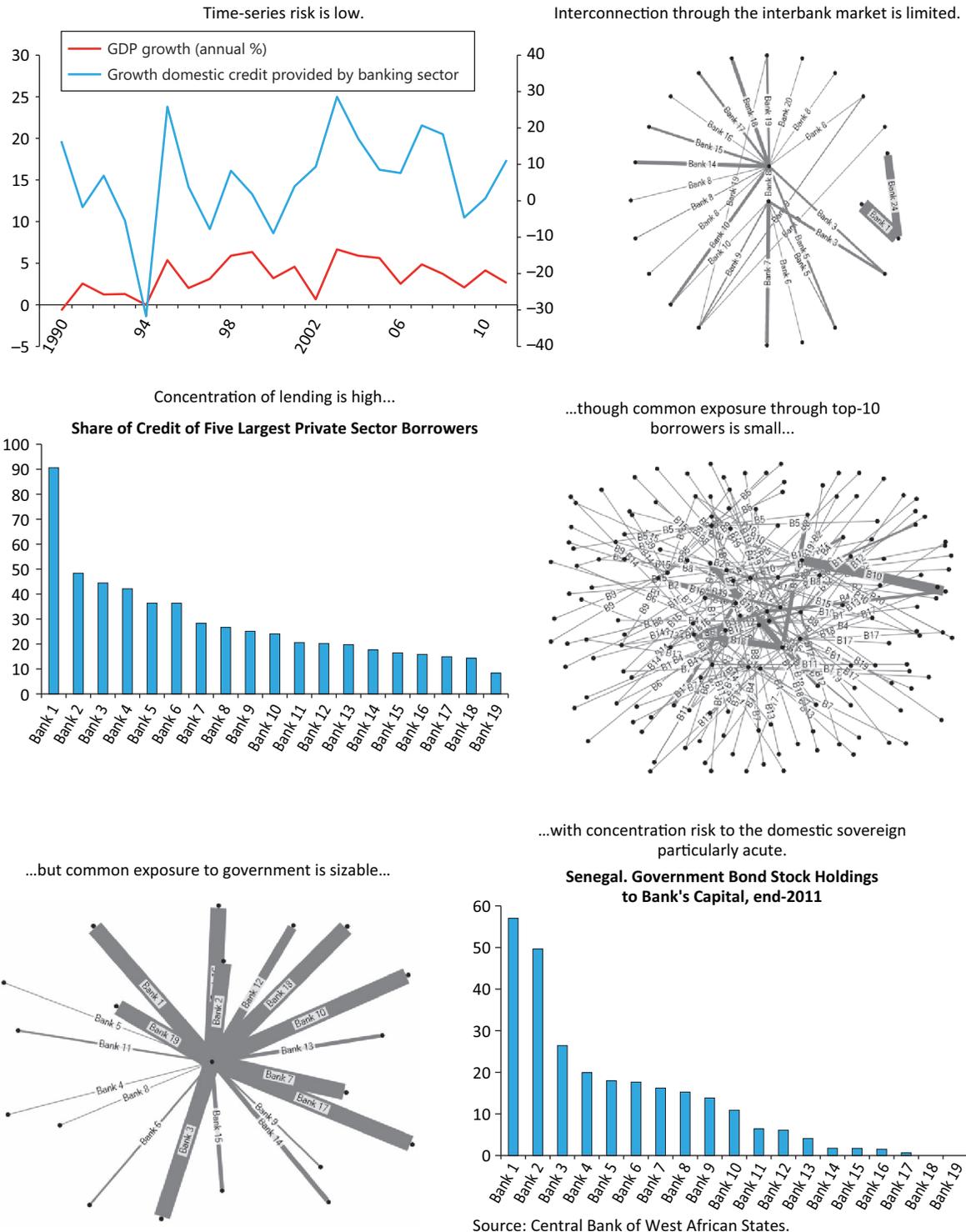
A. The **government** has in recent years accessed the international capital market, but it borrows abroad largely from donors on concessional terms. Domestically, borrowing takes place largely through the regional bond market. Domestic debt has increased rapidly in recent years, but remains at manageable levels (about 10 percent of GDP).

B. **Banks** finance themselves largely out of deposits, with limited debt issuance, keeping leverage in check. In addition, banks generally are highly liquid.

C. As bank lending takes place against guarantees rather than future cash flows, only **households** with significant assets are in a position to borrow, but even they tend to have low gearing ratios. Most other households are credit-constrained, and hence unable to leverage up, at least in the formal market. In rural areas, there may be pockets of households that are overleveraged from having borrowed from microfinance institutions, though no data is available on that.

D. The **corporate sector**, similar to the household sector, is dual in nature. One part is composed of a few large companies with strong balance sheets that largely borrow short-term to finance working capital, but have low leverage levels; the other part is the small and medium-sized enterprise sector that is largely credit-constrained and hence “unable to leverage.”

Figure 4. Senegal: Time-Series and Cross-Sectional Risk¹



Sources: Central Bank of West African States, IMF staff estimates, World Bank.

¹ For interconnection charts, both the number of connections and the size of the line matter for the interpretation. More connection to an individual entity means higher interconnection risk, and a thicker line means higher exposure.

most banks.⁷ This is because the top borrowers tend to differ across banks. The main exception is the government, as many banks hold government debt. With the planned development of the interbank and government debt market, bank interconnectedness could increase quickly and will need to be monitored.

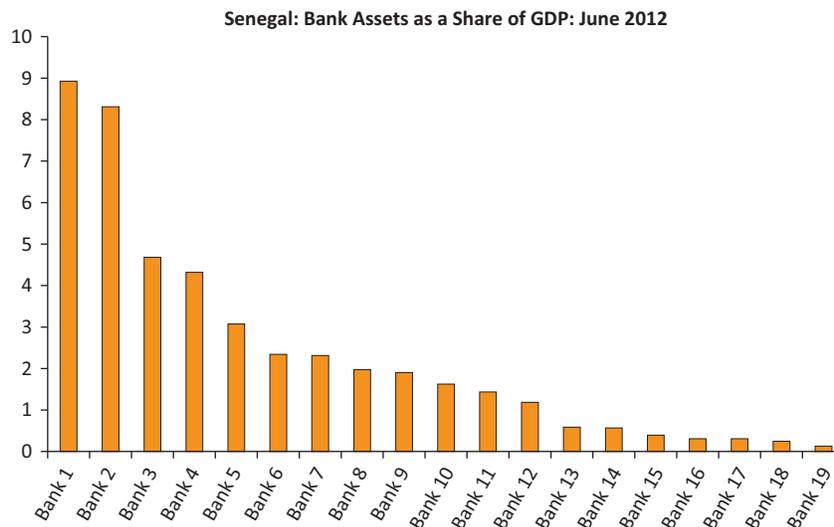
Interconnection between banks and the rest of the financial system is significant and needs to be monitored too. Insurance companies use bank deposits as an investment vehicle, rather than simply for liquidity purposes. Insurance companies also buy regional bank bonds and have equity participation in some of the banks. In addition, MFIs also place their money in banks, with one MFI even owning a bank. Lack of detailed data did not allow further analysis of the importance of these linkages, but such a risk mapping warrants further investigation by the authorities.

None of the Senegalese banks fits the definition of being too big to fail, suggesting that this form of cross-sectional systemic risk is contained.⁸ A systemically important financial institution is an institution whose eventual demise would create havoc for the rest of the financial system because of its size, interconnectedness, complexity, international linkages, and/or the lack of available substitutes for the service it provides. Société Générale and BNP Paribas, which have subsidiaries in Senegal, have been designed as systemically important financial institutions by the Financial Stability Board. This is not the case of the parents of other foreign-owned subsidiaries, or any domestically owned bank (Figure 5).

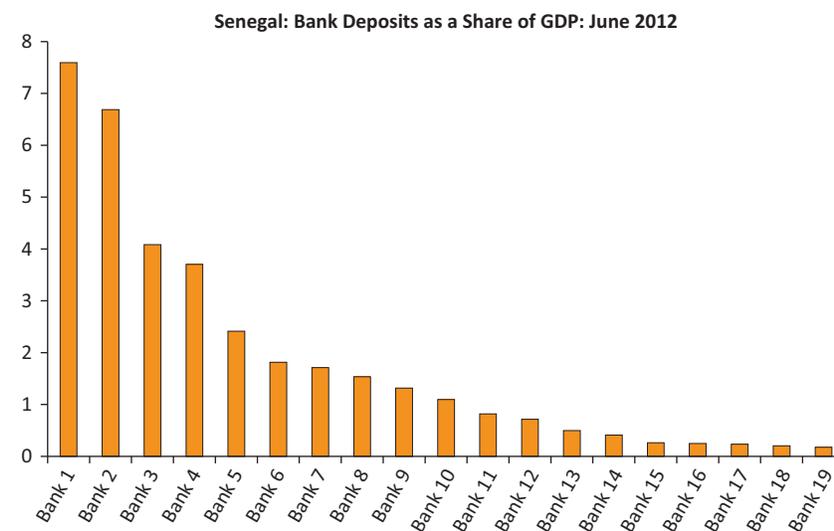
⁷ Related party lending rules, although less stringent than in other jurisdictions, do not seem to be a major factor behind the high lending concentration.

⁸ The focus on too-big-to-fail banks does not mean that the failure of a smaller bank is not an important issue; such a failure needs to be handled well to avoid raising concerns about the health of the remaining banks.

Figure 5. Senegal: Bank Assets and Bank Deposits



Source: Central Bank of West African States.



Source: Central Bank of West African States.

Benchmarking Senegal's Financial Sector: What do International Comparisons Tell Us?

Methodology of the Benchmarking Exercise

The benchmarking exercise allows an assessment of Senegal's financial sector performance with respect to depth, breadth, access, and efficiency.⁹ For each key financial sector indicator, a structural benchmark is estimated based on the country's economic and structural characteristics.¹⁰ The difference between the observed value and the benchmark then needs to be interpreted. A negative difference suggests scope for policy action, whereas a positive difference could reflect successful reforms. The analysis was carried out using data from 1995 onward, where available, and the tool developed by the World Bank for this purpose.

Comparisons are also made with a few selected countries, namely Côte d'Ivoire, Kenya, and Morocco. Côte d'Ivoire was chosen because it is a member of the West African Economic and Monetary Union (WAEMU) and it shares a number of characteristics with Senegal. Kenya is an example of a sub-Saharan African economy with a rapidly developing financial sector. Finally, Morocco is a country that many Senegalese observers view as a potential model for financial development, and it is used as an emerging market comparator.

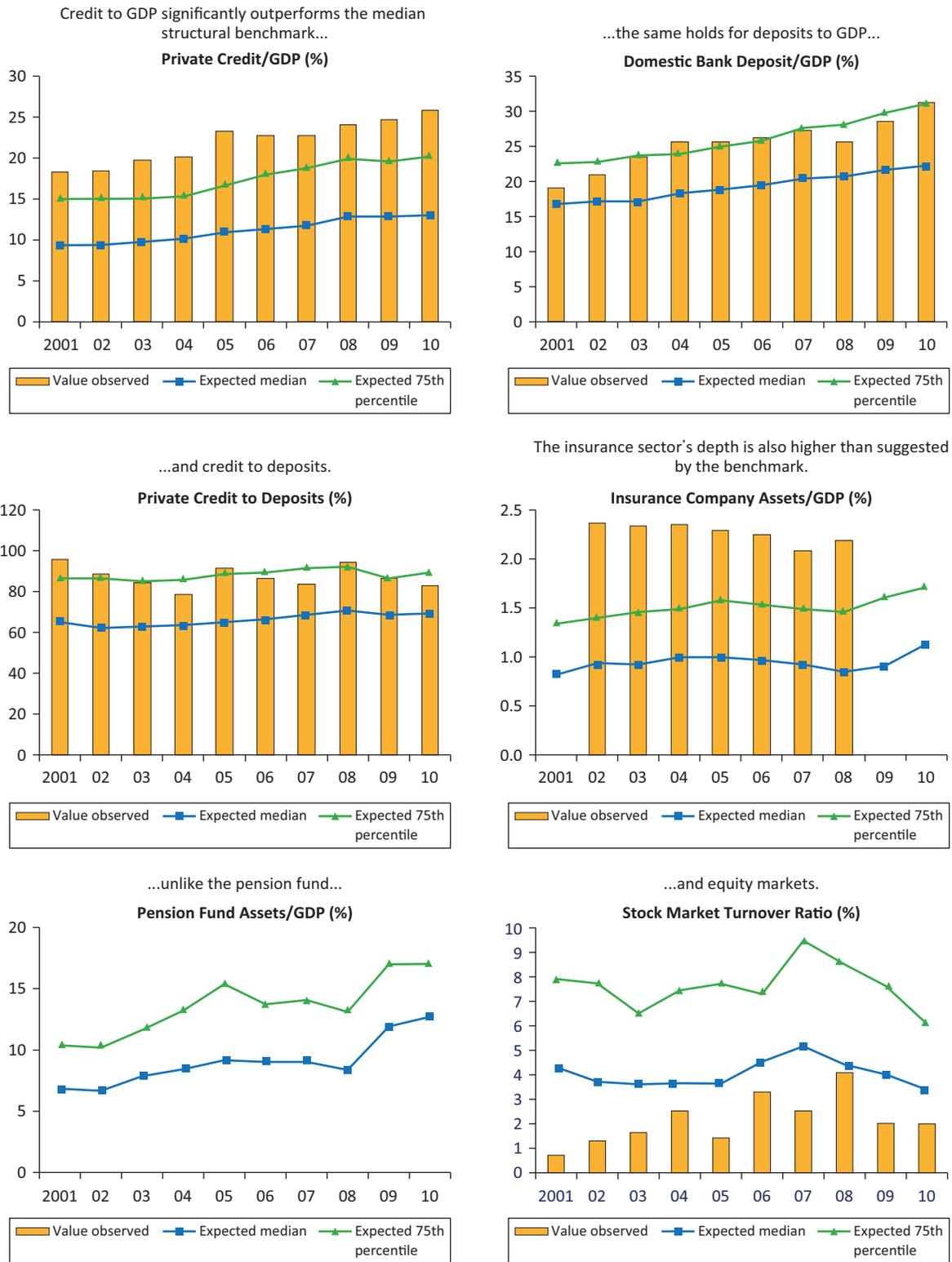
A Financial Performance Broadly in Line with Structural Characteristics

Depth. Senegal outperforms the benchmarks for banking and insurance, but underperforms for debt and equity markets (Figure 6).

⁹ This exercise considers only the banking market, debt and equity markets, and some nonbank financial institutions. Due to limitations in the dataset, microfinance could not be benchmarked.

¹⁰ The structural benchmarks are calculated based on Al-Hussainy et al. (2010) and FinStats from the World Bank. For a large set of countries, each financial indicator was regressed on a set of structural characteristics, such as GDP per capita and its square, population size and density, the age dependency ratio, country-specific dummies, and year fixed effects. These regressions are expected to be updated regularly.

Figure 6. Selected Indicators on Financial Sector Depth in Senegal



Source: FinStats Database.

- Senegal's banking sector has deepened significantly in recent years with the ratios of credit and deposits to GDP now significantly above their benchmarks. Bank intermediation, measured by the credit to deposit ratio, is in line with the structural benchmark.
- Although low in absolute terms, the ratios of insurance sector assets and insurance premiums to GDP are significantly above their benchmarks.
- Debt markets are deepening, but they remain below potential, particularly as a source of private sector financing.
- Taking into account its regional nature and the limited recourse to it by the private sector, the equity market looks underdeveloped, at least from a Senegalese perspective.

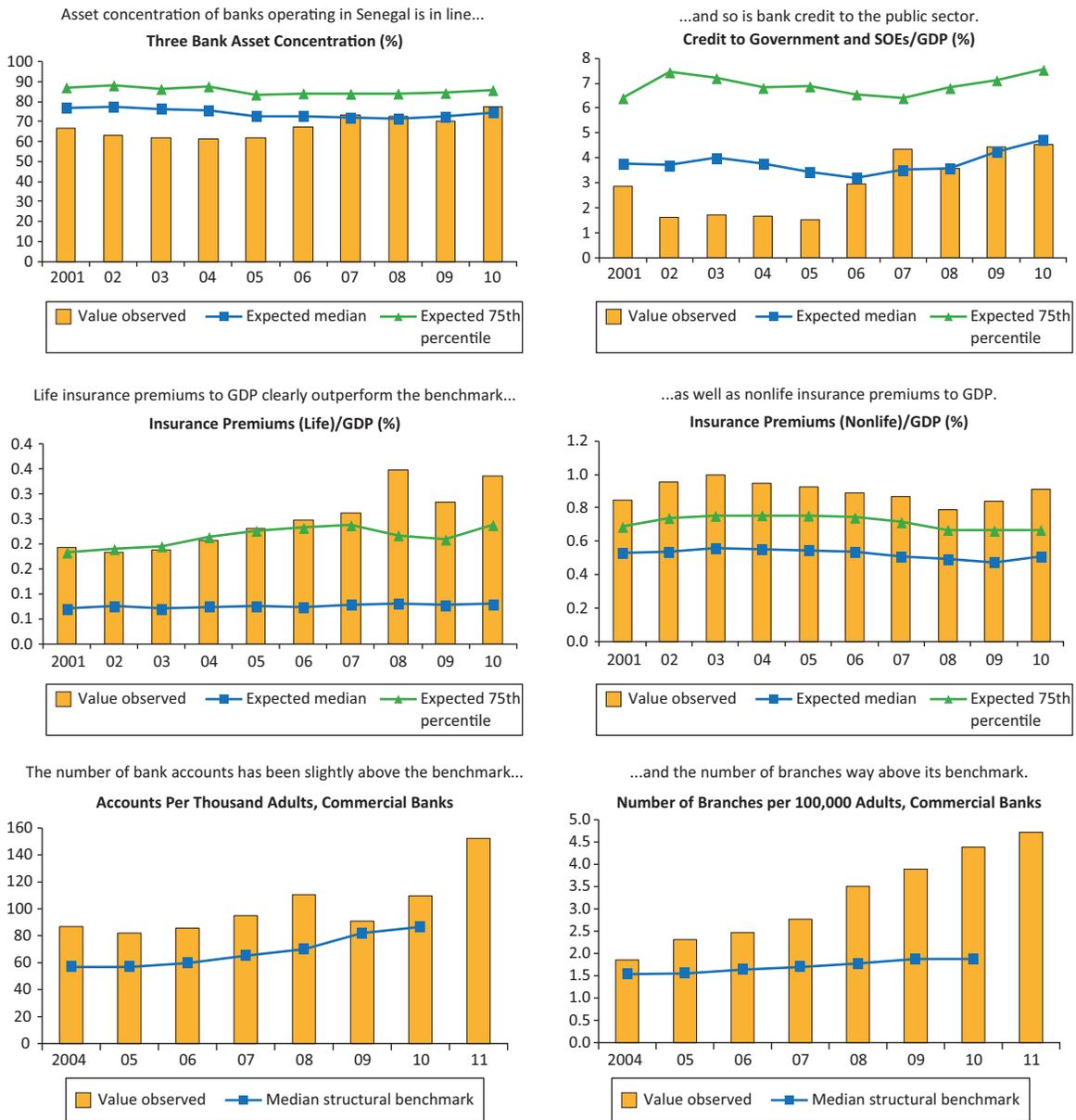
Breadth. The picture is more mixed with regard to the range of products, markets, and providers (Figure 7).

- The level of competition in the banking system—proxied by the asset concentration of the three largest banks or the interest rate margin—is close to the benchmark. More recent data (for 2011 and 2012) suggest that competition may have increased.
- The ratio of credit to the public sector to GDP is in line with its benchmark. This ratio has increased in recent years, likely reflecting the development of the government debt market.
- The insurance sector outperforms the benchmark, in particular in life insurance.
- There is underperformance in the area of long-term financing, including from the regional stock market, where only one Senegalese company is listed against a predicted value of 30 companies.

Access. Access to banks is mostly in line with the benchmarks. In particular, the number of bank branches relative to the population significantly outperforms the benchmark, and the gap has increased.

Efficiency and profitability. These are both broadly in line with structural characteristics for the banking sector. One exception is nonperforming loans, which are significantly higher (and provisioning lower) than their benchmark.

Figure 7. Selected Indicators on Breadth and Access in Senegal



Sources: FinStats Database, Ministry of Finance.

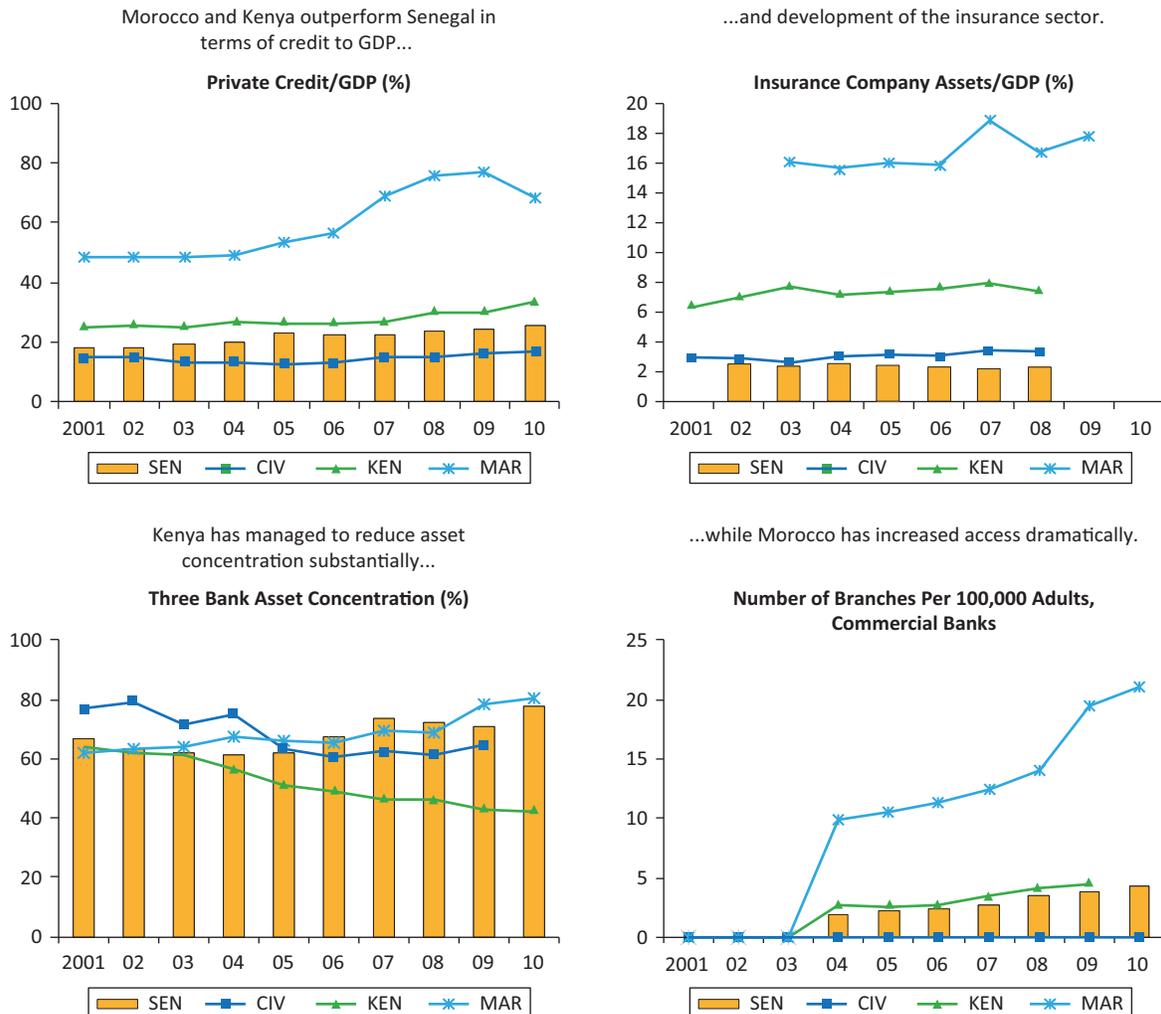
But with Still Substantial Scope for Deepening

Although statistical benchmarking shows that Senegal is not lagging in terms of financial sector development, direct comparison to selected peer countries suggests substantial scope for further deepening. Even for indicators for which Senegal outperforms the benchmarks, there is still some distance to

peer countries. Policy action may be warranted to catch up with them, in particular Kenya, which has overtaken Senegal on various indicators over the past five years, despite having started at similar levels (Figure 8).

- Depth.** Kenya's deposits and credit to GDP ratios are about 10 percentage points higher than Senegal's (SEN), whereas Morocco's are more than twice as high. Even though Senegal's insurance market performs very well compared to the structural benchmarks, the share of insurers' assets to GDP in Côte d'Ivoire (CIV), Kenya (KEN), and Morocco (MAR) is significantly larger. Stock market capitalization to GDP has picked up markedly in Kenya since 2002.

Figure 8. Comparing Senegal to Selected Peer Countries



Sources: Central Bank of West African States, FinStats Database, IMF staff calculations.

- **Breadth.** Kenya has been able to reduce bank asset concentration since 2003, starting from the same level as Senegal then. Life insurance premiums have increased much faster in both Kenya and Côte d'Ivoire than in Senegal throughout the past decade. Also, there is a big difference in the development of the equity market, with 50 listed companies in Kenya and more than 70 in Morocco, but only 1 in Senegal.
- **Access.** Although broadly in line with other peers including Kenya, access is significantly lower than in Morocco for firms as well as for households. However, the indicators may not reflect the impact of mobile banking on access. Mobile banking has developed very quickly in Kenya, but not in Senegal.

Gains from Further Financial Deepening¹¹

Impact on the Private Sector: Dealing with Volatility and Financing Growth

Shallow financial markets make it more difficult for firms and households to access financial services, leading to the following:

- **Higher volatility:** One of the key functions of banks—to enable agents, including households, to smooth consumption over time—is not performed by an underdeveloped banking system. Shocks have to be fully absorbed by a household’s existing assets, and should they be insufficient, adjustment has to be instantaneous, leading in extreme cases to destitution or worse. Shallow banking systems tend to create procyclical financing conditions, providing the private sector with credit in good times, but cutting it back in bad times, accentuating volatility. Financial sector development can help alleviate these liquidity constraints, thereby ultimately reducing volatility.
- **Lower growth:** Financial development affects economic growth by facilitating the mobilization of savings to finance investment and by contributing to a better allocation of resources. Rioja and Valev (2004b) find that finance boosts growth in rich countries primarily by raising productivity growth, whereas finance encourages growth in poorer countries primarily by increasing capital accumulation. Furthermore, Rioja and Valev (2004a) find that the impact may be nonlinear: countries with very low levels of financial development experience little growth acceleration from a marginal increase in financial development, whereas the effect is larger for rich countries and particularly large for middle-income countries.

¹¹ The Article IV consultation with Senegal focused only on the fiscal implications of a shallow financial system, as monetary policy is set at the regional level. The consequences on the latter was analyzed during the regional consultation held in early 2013.

Impact on the Public Sector: Removing Constraints on Fiscal Policy

The constraints on fiscal policy stemming from a shallow financial system are multiple, though not always visible:

- **Liquidity (and interest rate) risk:** With a large part of domestic debt issued at relatively short maturities, liquidity risks faced by the government are significant. Should regional liquidity dry up, the government would be in a difficult position to roll over its debt, and may have to finance itself through undesirable means such as arrears, turning a fiscal issue into a financial stability risk (if arrears to banks) or a risk to private sector development (if arrears to suppliers). This situation was experienced to some extent by Senegal in early 2012. Difficulties in raising financing ahead of the presidential election led to significant payment delays to suppliers. Short maturities also expose sovereigns to significant interest rate risks.
- **Fiscal cost:** A deeper financial market, by creating more liquidity and allowing for economies of scale in debt issuance (reducing average cost of issuance by utilizing the same infrastructure), may reduce the marginal cost of borrowing to the sovereign. These costs tend to be high presently in Senegal, particularly for longer maturities. For instance, the yield at issuance for bonds with maturities of three to five years was in the 7–9 percent range in the first half of 2012, whereas average inflation was around 2 percent.
- **Scope for countercyclical policy:** Senegal's economy is susceptible to shocks. This puts a premium on fiscal flexibility, particularly because monetary policy is set at the regional level and therefore cannot address the impact of asymmetric shocks. A deeper financial system would give the government more scope to run countercyclical policies in the event of a shock, potentially reducing the need for large fiscal adjustment, which would particularly affect the part of the population that lives close to the subsistence level and has itself limited access to credit. It would also help keep up the pace of execution of investment projects, which if delayed would generally result in higher fiscal costs (beyond lost output in the medium term).
- **Diversified investor base.** An investor base that is homogenous and narrow, by carrying similar risk preference and time horizons, is a concern. It creates a market that may be easily disrupted. In the case of Senegal, the liquidity of the debt market is highly dependent on the liquidity situation of banks, which are the main investors.

- **Financing public investment.** A shallow financial system limits the ability of the government to finance long-term investment with large economic and/or social rates of return. This is particularly pertinent for Senegal, given the need for timely infrastructure investments in energy and transportation.

Further Deepening with Stability: Obstacles and Recommendations

The development of the financial system should be pursued forcefully in a way that preserves financial stability. Financial systems play a crucial role in facilitating growth and helping reduce vulnerability and poverty. From this perspective, there is no doubt that further financial development is highly desirable in a low-income country like Senegal. However, financial systems can also be a source of volatility and crisis, particularly when they become large and/or highly interconnected. There is large body of evidence that financial crises are usually preceded by rapid growth in financial aggregates. As discussed earlier, Senegal's financial system remains relatively small and interconnectedness is limited, and therefore these risks are presently lower than in more developed countries. Although this suggests that further development should be the priority in Senegal when designing a strategy for the financial sector, the implications for financial stability should also be analyzed and addressed.

Obstacles to Further Financial Development

There is a broad agreement between the authorities and the Fund on the main obstacles to further financial development.¹² Many of these obstacles, which have been well identified in the past few years, are commonly found in low-income countries. They include the following:

- **Informational asymmetries.** Lack of information on borrowers, due to the limited size of the formal sector, the limited availability of audited

¹² These issues were discussed in the Senegal Financial Sector Assessment Program (2004) and the West African Economic and Monetary Union Financial Sector Assessment Program (2008), and many analyses and recommendations made at the time remain valid.

Table 3. Summary of Recommendations on Financial Sector Development and Stability

Recommendations	Responsible authorities
Development	
Accelerate implementation of the action plan that followed the National Consultation on Access to Credit, particularly with regard to: <ul style="list-style-type: none"> • Increasing the availability of information on borrowers. This could cover banks and larger microfinance institutions. • Facilitating the use of guarantees. • Reducing cost of using the legal system, including by increasing resources. 	National
Develop the interbank market	Regional/National
Develop the government debt market by broadening the range of investors and fostering the development of a secondary market	Regional/National
Level the playing field between banks and larger microfinance institutions—for instance, by facilitating the transformation of the latter into banks	National/Regional
Review financial activity taxation, after the new tax code has been implemented and revenue concerns have decreased	National
Development and stability	
Review bank regulations to facilitate further deepening while preserving stability; priority should be to address the regulatory ratios that are systematically breached by most banks; ultimately, bring regulations to international standards	Regional/National
Stability	
Strengthen bank supervision	Regional
Have a unit in the Ministry of Finance that has a holistic view of the financial system and systemic risks in Senegal	National
Enhance further the national/regional coordination to ensure high responsiveness of the prudential framework to new needs	National/Regional
Review and strengthen the financial crisis prevention and resolution framework to ensure that it remains adequate to address new risks (e.g., development of cross-country banking)	Regional/National

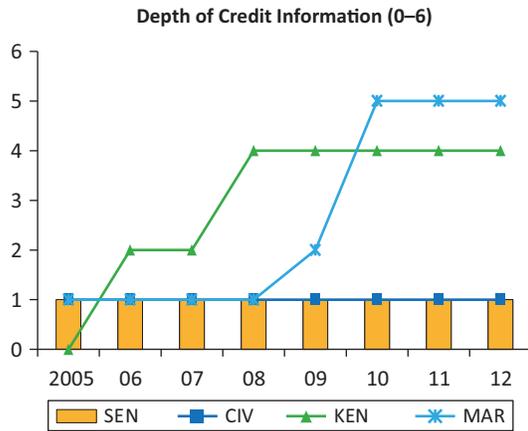
Source: IMF staff.

company statements, and the absence of credit bureaus (and limited use of existing databases at the central bank), increases adverse selection and moral hazard issues, and ultimately leads to credit rationing (Figure 9). This problem also affects the larger microfinance institutions (MFIs), which tend to lend to some of the banks' customers too. Information asymmetries are also an issue for the development of the interbank market.

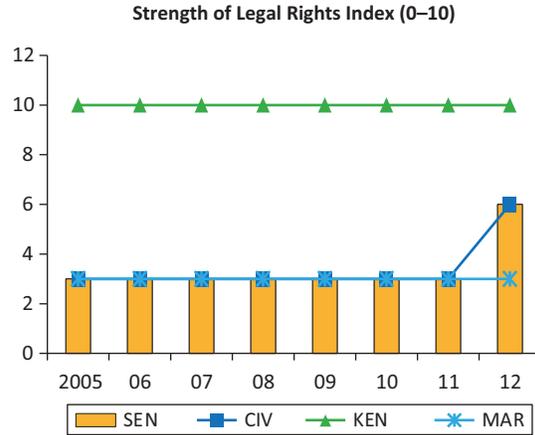
- **Business and judicial environment.** A key issue is the absence of formalized property rights in large parts of the country, which increases the difficulty of using land as collateral in lending. Moreover, the judicial process tends to be costly and slow, with some recent judgments viewed

Figure 9. Senegal's Performance in Selected Doing Business Indicators

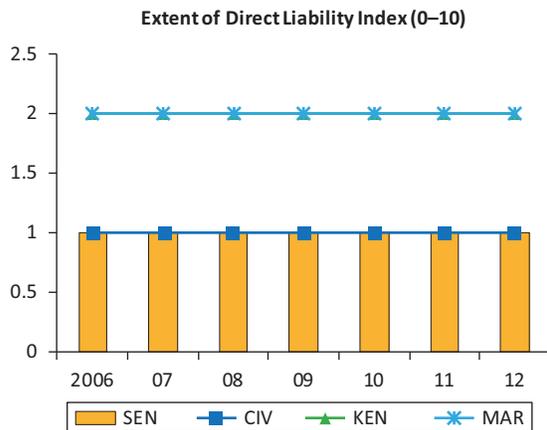
Senegal's score on the credit information index is stagnating at low levels while Kenya and Morocco have reformed successfully.



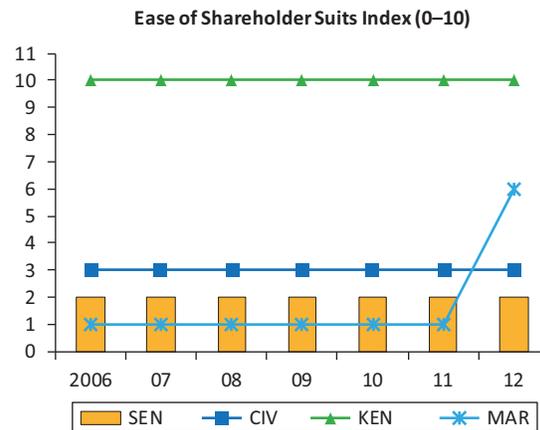
After reforms in 2012, the legal environment improved somewhat...



...but remains low in particular with respect to disputes on collateral...



...and shareholder issues.



Source: World Bank, Doing Business Report 2012.

by lenders as motivated by social considerations rather than legal merit. This inability to recoup losses at a reasonable cost, through collateral initially pledged, discourages lending further, particular to new segments.

- **Tax regime.** Taxes and fees on banking and stock exchange operations are relatively high. This raises the cost of financial services and reduces demand for them.
- **Regulatory and supervision issues.** Some regulatory ratios, such as the transformation ratio, are perceived as excessively constraining and

curbing the development of medium- and long-term credit. This ratio, as well as a few others (see the following), is not observed by a number of banks. This situation can affect the credibility of the banking system regulatory and supervisory framework and exacerbates the informational problems mentioned earlier. Another issue is whether the prudential framework is sufficiently responsive to new needs that are likely to emerge first at the national level, but will eventually need to be regulated at the regional level. When a country is at the forefront of financial sector reform, which seems the case of Senegal on certain issues (e.g., credit bureaus, Islamic banking), the need to develop or amend regulations at the regional level may slow the reform process. It should be recognized, however, that by pushing for reforms to develop their national financial sectors, countries closer to the reform frontier create positive spillovers for the entire region.

- **Skills.** The quality of human capital is critical for banks and MFIs, as it provides the necessary risk-management expertise and the ability to design and sell the products that customers need. The lack of appropriate skills may explain why in recent years some MFIs that moved from dealing with microenterprises to dealing with small to medium-sized enterprises (SMEs) saw their profitability decrease. Banks may face similar challenges moving from larger enterprises to SMEs. The lack of financial culture is also often blamed for the very limited recourse to the stock exchange.

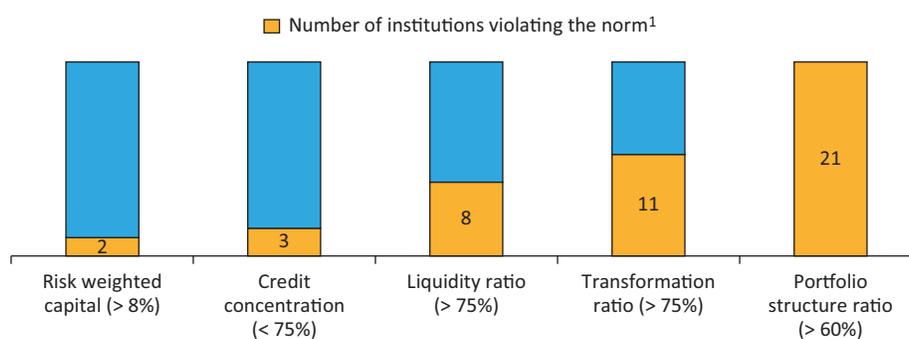
The authorities have a strategy to address a number of these issues whose implementation needs to be accelerated. The national consultation on credit took place in 2010. It identified clearly the main obstacles and led to an action plan with specific measures to improve access to credit for both households and firms, particularly SMEs. These measures are grouped in 11 different categories, including facilitating the use of guarantees, SME debt and equity financing and general support to SMEs, availability of information, cost of credit, financial intermediation, and the judicial environment. Progress was made in some areas, such as registering land titles and information provision (although the introduction of credit bureaus, for instance, was delayed to allow for a regional approach to the issue). Although measures on the mobilization of resources are generally behind schedule, the study to determine the share of stable resources among bank deposits has been completed by the Senegalese banking association. This study is a prerequisite for the regional regulator to the reconsideration of the transformation ratio, which banks view as an impediment to the availability of longer-term credit. Actions to improve the efficiency of the judicial process, such as the training of judges in economic affairs, are generally behind schedule, and so are measures aiming at streamlining and improving public support in favor of SMEs. Staff is of the

view that this action plan remains largely relevant and that its implementation should be accelerated. A number of obstacles, however, will need to be addressed at the regional level. As mentioned earlier, prudential regulation is a regional responsibility and so is the development of regional financial markets. As detailed in the latest report on West African Economic and Monetary Union (WAEMU) policies, the regional authorities are working on the development of the interbank market and the strengthening of the public debt market, which they see as priorities. They also intend to review certain prudential rules. These issues were discussed in more detail during the WAEMU regional consultation in early 2013.

Enhancing Financial Stability

Microprudential regulation of banks could be enhanced and supervision strengthened. As discussed in the 2012 report on regional policies, some prudential ratios and rules are not in line with international best practices. Banks’ compliance with prudential rules will also need to improve (Figure 10). For instance, the transformation ratio is met by only 11 Senegalese banks, whereas no bank meets the portfolio structure ratio, which requires that at least 60 percent of a bank’s credit portfolio be composed of rated assets. In these specific cases, low compliance may reflect the perception by banks that certain rules are inadequate. Low compliance, however, also suggests a need to strengthen bank supervision and the enforcement of corrective measures.¹³ New challenges, such as the need to monitor the rapid development of banking groups in Senegal and more generally the region, also call for

Figure 10. Selected Prudential Norms for Banks and Nonbank Financial Institutions



Source: Central Bank of West African States.

¹ Twenty-one institutions, of which nineteen banks and two nonbank financial institutions.

¹³ The portfolio structure ratio, which requires that at least 60 percent of a bank’s credit portfolio be composed of rated assets, is problematic in an environment where few rated entities exist with the requisite characteristics.

strengthened supervision. These issues were discussed during the last WAEMU regional consultation held in early 2013.

With the financial system growing and getting more interconnected, systemic risk issues will be more likely to arise in the future and will need to be mitigated. Financial regulation in the WAEMU region, like in many countries or regions abroad, is mostly based on the microprudential paradigm that assumes that by making each financial institution safe, the system as a whole is safer. A macroprudential approach to regulation instead considers the systemic implications of the collective behavior of financial institutions—for example, what would happen in the WAEMU if suddenly all banks decided to stop buying sovereign debt? The recently established Financial Stability Council, which comprises all the key regulators at the regional level, monitors the emergence and limit the consequences of systemic risk. Its activity and effectiveness will be discussed in the context of the next regional mission.

With the increasing interconnectedness and breadth of its financial system, Senegal may need to develop a more holistic view of the system and of systemic risk at the national level. At present, it seems that no single entity within Senegal has a detailed view of the whole financial system, the interconnection of its various components, and where the potential pockets of systemic risk may lie. Such a function should be developed in Senegal, preferably under the purview of the Ministry of Finance, and in close collaboration with the other regulators and supervisors, particularly the Central Bank of West African States. The institution responsible for this function would also be well placed to reflect on the scope for national macroprudential regulation to address country-specific systemic risk.¹⁴ Such a reflection should obviously be conducted in concerted fashion with the regional authorities and regulators.

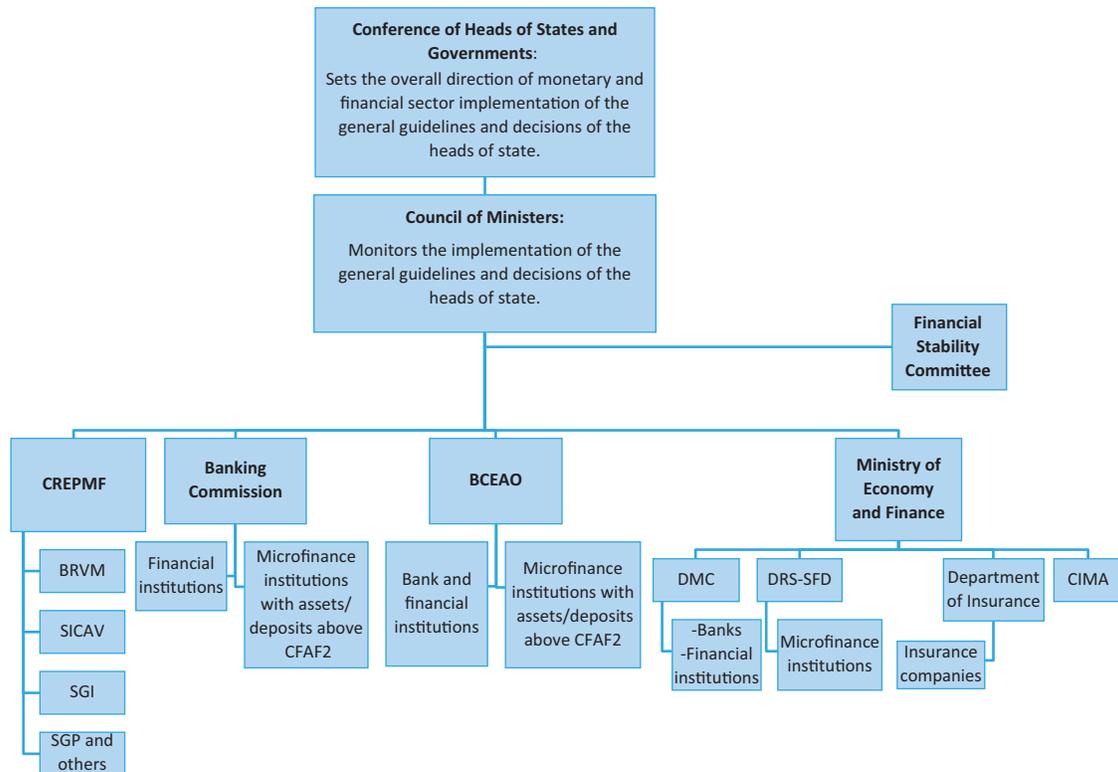
Another area for further work is the financial crisis prevention and resolution framework. The fact that technically insolvent banks have been allowed to continue operations in some WAEMU countries may reflect weaknesses in the bank resolution framework (Box 3). As shown by the euro-area experience,

¹⁴ This approach has been followed in the euro area. The European Systemic Risk Board (ESRB) was established in December 2010, charged with providing macroprudential oversight of the EU and the financial system as a whole. In addition, in January 2011, the Committee of European Banking Supervisors, the Committee of European Insurance and Occupational Pensions Supervisors, and the Committee of European Securities Regulators were replaced by European Supervisory Authorities to create a new European System of Financial Supervision. The ESRB was tasked with monitoring, identifying, and predicting potential systemic risks and issuing recommendations. At the same time, the ESRB collaborates with European Supervisory Authorities, providing them with the necessary macroprudential input to assist them in carrying out their supervisory functions. One of the ESRB's first decisions was to recommend the establishment of an efficient macroprudential policy framework in each EU member state. The recommendation was for each member state to designate an authority in national legislation to conduct macroprudential policy. Cooperation between the national macroprudential authorities and the ESRB would be warranted, particularly to enable the timely identification and subsequent discussion of relevant cross-border issues.

Box 3. Bank Supervision and Resolution in Senegal: Division of Labor between the National and the Regional Authorities

The architecture of the supervisory system is based on a clear division of labor between the national and regional level (Figure 11). Banks and other large deposit-taking institutions (including microfinance institutions) are supervised at the regional level by the Central Bank of West African States (BCEAO) and the West African Economic and Monetary Union Banking Commission. Smaller microfinance operators are supervised at the national level by the Ministry of Finance. Capital market activity is supervised regionally under the supervision of the Regional Council for Public Savings and Financial Markets (CREPMF, as per its French acronym). The Ministry of Finance, in conjunction with the supraregional insurance sector regulator CIMA (“Conférence Inter-africaine des Marchés d’ Assurances”), supervises insurance companies. The 2010 central bank reform created the Financial Stability Council, charged with macro-prudential supervision and guaranteeing the stability of the overall financial system at the regional level.

Figure 11. Organigram of the Supervisory System in Senegal



Source: Ministry of Finance.

Box 3. (continued)

The resolution framework similarly depends on a sharing of responsibilities between national and regional bodies. The national directorate of the BCEAO—which is regularly collecting data on various financial indicators and carries out off-site supervision—is typically the first body to detect difficulties at a financial institution. It flags potential operational and stability concerns to the banking commission, with the concerned national authority kept informed. The banking commission is responsible for on-site supervision. When concerns arise, joint inspections comprising members of both the banking commission and the BCEAO national directorate intensify the supervision of the institution. Evidence from on-site and off-site inspections guides the banking commission’s decision on possible prompt corrective actions or possible sanctions. In case of solvency concerns, the banking commission can recommend the closing of an institution. The banking commission informs the Ministry of Finance, which is the body that has to formally rescind the banking license. The Minister of Finance, however, has the possibility of appealing to the council of ministers, where a simple majority could overrule the banking commission’s decision.

having a good framework in place will be increasingly important with the deepening of the financial system and further regional integration. Developing the financial crisis prevention system is also an important task. Work is ongoing in this area—for instance, on the creation of a regional financial stability fund and the establishment of a deposit insurance scheme. These are areas that will require close cooperation between the national and the regional authorities.

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