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LIBERIA

SELECTED ISSUES

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LIBERIA

SELECTED ISSUES

June 23, 2016

Approved By

AFR Department

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EXPORT DIVERSIFICATION AND GROWTH IN LIBERIA[1]

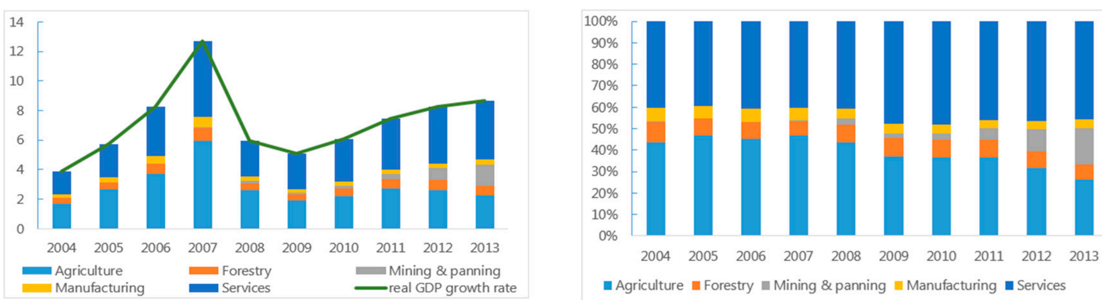
Diversification of Liberia's economy is essential to increase resilience to shocks from commodity price swings, create employment, and provide additional growth drivers. Based on findings of the recent literature on export diversification and growth this note compares Liberia to a benchmark set of countries, considers ways to diversify the Liberian economy, and discusses initiatives to promote export diversification and growth.

A. Liberia's Growth Performance and Potential Gains from Diversification

1. Liberia's GDP growth after the civil war was strong, but sharply dropped in 2014 due to the Ebola epidemic and fall in commodity prices. Throughout 2004–13, real GDP grew on average 7 percent, with significant contributions from agriculture and services (Figure 1). An increase in commodity prices was accompanied by an expansion in the mining sector (mostly iron ore), as well as diamond and timber production. Hit by a twin shock—Ebola and commodity prices—growth dropped to 0.7 percent in 2014 and 0 percent in 2015.

Figure 1. Sectoral Contribution to Growth

Percent | **Cumulative Percent**



Source: IMF staff estimates based on authorities' data.

2. Diversifying exports and reducing dependence on the mining sector could help mitigate downside risks, increase resilience to shocks from commodity price swings, and foster growth. The literature has shown a strong correlation between diversification and per capita income (e.g., Henn et. al. 2013). The causal relationship is less well understood. IMF (2014b) empirically tests this relationship. Addressing endogeneity concerns and model uncertainties, the authors find that export diversification is a determinant of economic growth in LICs. In a similar vein, diversification spurts have been associated with subsequent growth gains (IMF 2014a, 2014b).

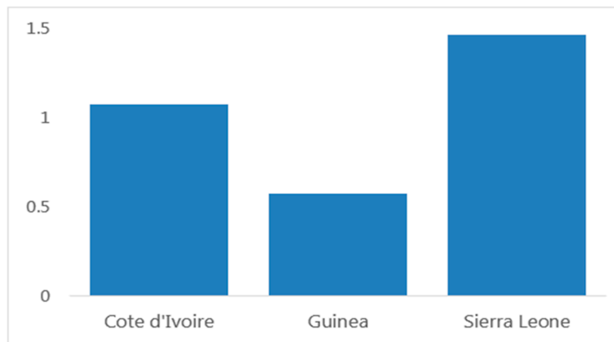
[1] Prepared by Anne Oeking.

3. **Diversification would also increase growth inclusiveness**. Employment in Liberia has been concentrated in the agricultural sector (almost half of total employment, and around three-quarters among the rural population). Around one-quarter of the employed workforce is in the wholesale and retail trade sector, more so in urban areas. Manufacturing (6.5 percent of total employment) and the capital-intensive mining sector (1.6 percent of total employment) contribute only little to employment (World Bank 2014). The very young demographic structure will bring about a rapid in increase in the labor force, particularly among youths, and providing adequate employment opportunities is a growing concern for the government. An increase in diversification away from the capital-intensive sectors to more labor-intensive sectors such as agriculture or services would enable growth that is based in different sectors and create employment opportunities in productive jobs.

4. **Estimates suggest growth gains from export diversification could be substantial**. According to IMF (2014b), a one standard deviation increase in LICs' export diversification boosts the growth rate by about 0.8 percentage points. For Liberia, this would imply that if export diversification were as high as in its neighbor countries (Côte d'Ivoire, Guinea, and Sierra Leone), annual growth could be between 0.6 and 1.5 percentage points higher (Figure 2).

Figure 2. Growth Effects From Increased Export Diversification

(Increase in annual growth rate, average 2003–20)



Sources: IMF (2014b); and staff calculations.

5. **Despite preliminary findings of a causal relationship from diversification to growth, few transmission channels have been tested empirically**. One important result is that diversification reduces output volatility by providing insurance against sector specific shocks (Papageorgiou and Spatafora 2012). This channel could also lead to increased, or less volatile, investment which would in turn foster growth. Other important considerations are productivity improvements through diversification (IMF 2014b), with productivity growth as the main driver of long-run growth and development. Quality upgrading of existing products and diversifying into new sectors can lead to sectoral productivity growth and labor reallocation, e.g. high agricultural productivity growth can free labor to be shifted to other sectors such as manufacturing. More research on the exact transmission channels and its determinants is ongoing.

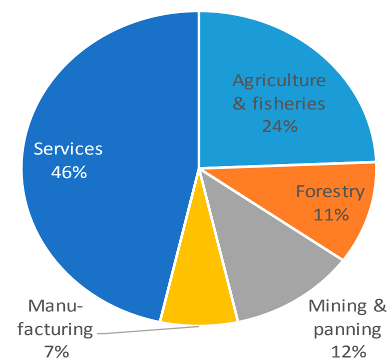
6. **In countries with small domestic markets, output and export diversification will usually be closely related**. Output diversification can be seen as a prerequisite for export diversification. Focusing not only on determinants of output but also on exports is important as exports generate foreign exchange, help finance imports, and allow exploring possible economies of scale. At the same time, exporting firms are generally more efficient than those selling only on the domestic market, and can generate positive technology spillovers to the rest of the economy (Samen 2010).

7. A combination of horizontal and vertical diversification of exports is generally a promising approach for LICs. Diversification can take place along two complementary lines: horizontally, diversifying into new sectors, and vertically, producing higher quality products within existing sectors, including higher value added products. While many LICs diversify from labor-intensive agriculture to capital-intensive manufacturing over the course of their development, there is also room to increase the quality of LICs' current exports. This involves producing higher quality levels of existing goods, i.e. building on a country's existing comparative advantage. In LICs, the agricultural sector can play an important role in quality upgrading since it is generally the least productive and has therefore scope for quality improvements and higher value-added products. Given many LIC's small size and limited possibilities to make use of economies of scale, diversifying horizontally can imply excessively high costs, making vertical diversification all the more relevant (Papageorgiou and Spatafora 2012).

B. Trends in Export Structure

8. About half of Liberia's output has been based in (non-tradable) services, one-quarter in agriculture and fisheries, and a lower share in mining, forestry, and manufacturing (Figure 3). The main agricultural goods produced have been rice, cassava, rubber, as well as cocoa and palm oil. Among these products, mainly rubber has been exported, and in smaller amounts cocoa and recently palm oil. The revived mining industry has a strong export focus and has been concentrated on iron ore, with diamonds and gold also contributing to GDP and exports.

Figure 3. Contributions to Real GDP
(2015)



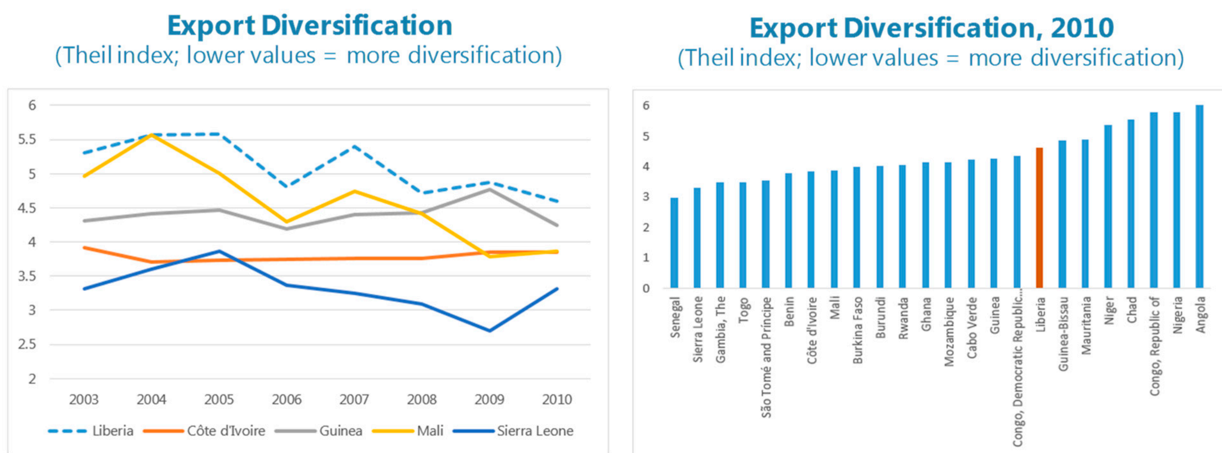
Source: IMF staff estimates based on authorities' data.

9. Liberia's exports have been very concentrated in the past, but some progress in export diversification has been made in recent years, mostly in the enclave sectors. Between 2003 and 2010, Liberia's exports concentrated on rubber (around 85 percent of its exports in 2010) and diversification increased when rubber production fell (it decreased by 25 percent in 2006 and 27 percent in 2008 implying a higher export share for other products).[2] Since 2010, new iron ore, diamond, and timber production and an increase in cocoa exports have led to further diversification increases. In particular, the mining industry greatly contributed to the increase in growth since 2010, contributing around 17 percent of growth in 2013 before the twin shock. The revival in the mining industry has been an explicit government objective in its efforts to reconstruct the country and to

[2] Data on export diversification and quality is based on the "IMF Diversification Toolkit", see IMF (2014b). The data is available from 1962-2010. Export diversification is measured by the Theil index, the sum of the *extensive margin* (a sub-index capturing the number of export products) and the *intensive margin* (a sub-index measuring the shares of export volumes across active products). A lower value on the Theil index implies higher diversification levels.

underpin growth by leveraging Liberia's rich natural resources (see GoL 2010). Yet, Liberia's overall export diversification is still low in comparison to benchmark countries (Figure 4).

Figure 4. Export Diversification



Source: IMF (2014b).

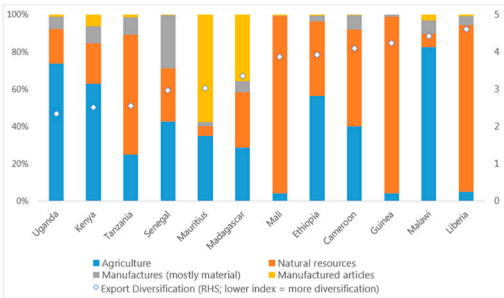
Horizontal export diversification

10. Many Sub-Saharan African countries have more diversified exports than Liberia, whether exporting mostly natural resources or agricultural products. Figure 5 shows diversification levels and breakdown of export sectors for all Sub-Saharan African countries with higher diversification levels than Liberia and upward diversification trends over the previous decade (subject to data availability). The export focus in most of these countries is on agricultural products (e.g., Uganda, Kenya or Malawi), natural resources (Tanzania or Mali) or manufactured goods classified mostly by material (e.g., cement in Senegal or aluminum in Mozambique).[3]

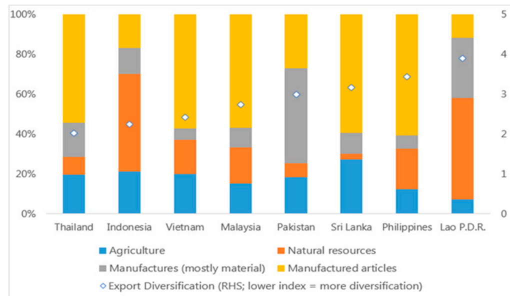
[3] The sector classifications are simplified combinations based on the UN's SITC4 classification. *Agriculture* comprises UN's categories "food and live animals", "beverages and tobacco", and "animal and vegetable oils, fats and waxes". *Natural resources* comprise "Crude materials, inedible, except fuels", "Mineral fuels, lubricants and related materials", and "Commodities and transactions not classified elsewhere in the SITC" (this category includes gold). *Manufactures (mostly material)* comprises "Chemicals and related products", and "Manufactured goods classified chiefly by material", and *manufactured articles* comprises "Machinery and transport equipment", and "Miscellaneous manufactured articles".

Figure 5. Horizontal Export Diversification

Horizontal Export Diversification
(Sub-Saharan Africa, 2010)



Horizontal Export Diversification
(Asia, 2010)



Source: UN COMTRADE, "The Atlas of Economic Complexity" Center for International Development at Harvard University.

11. Among the best performers in the benchmark group, Uganda and Mali have improved diversification, focusing on agricultural products and natural resources. Within the benchmark group, the countries with the strongest improvements in export diversification since the 1990s are Uganda, Mali and Mauritius. While Mauritius may not be the most fitting comparison because of much higher per capita income levels, Uganda and Mali are at broadly comparable income levels to Liberia. Uganda has mostly exported agricultural and fishery products (around one third of its exports nowadays is coffee, and also diversified into fish, tobacco and live plants). Mali diversified from exporting mostly raw cotton to an export combination of cotton, gold, live animals (bovines, sheep & goat), sesame seeds and other agricultural products.

12. Only few countries in the benchmark sample export manufactured goods. The biggest exceptions are middle-income Mauritius, for which more than half of exports are made up of apparel, and Madagascar for which around one third of exports consist of apparel. A much smaller export share of manufactured goods is found in Kenya, consisting of apparel, plastic packing and toys.

13. In contrast, a benchmark set of Asian countries with higher levels of per capita income have a much higher share of manufactured articles in exports. Even in countries that export a relatively large share of natural resources to total exports (such as Indonesia or Laos), at least part of exports consists of manufactured goods. Manufactured goods are concentrated either in electronics (Thailand, Malaysia, or Philippines) or apparel (Vietnam, Sri Lanka, and less so in Pakistan). When these countries were at similar income levels to Liberia today, their diversification levels resembled Liberia's diversification level, but they were already exporting some manufactured goods. In the mid-1970s, the export share of manufactured goods was around one-third in Indonesia, and between 5 and 10 percent in the Philippines and Mauritius. Laos' exports consisted of more than two thirds manufactured goods in the 1990s.

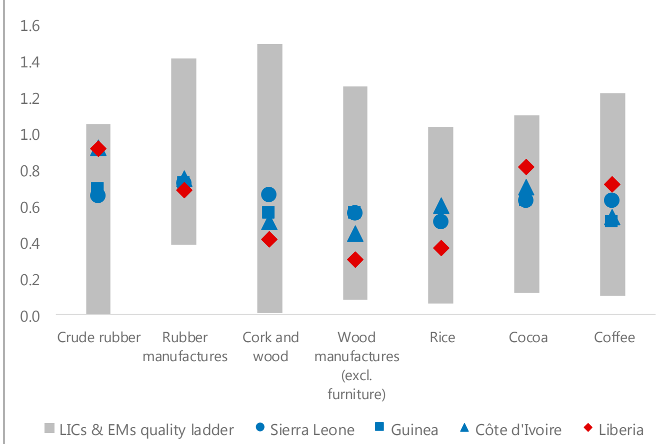
14. Moving into manufacturing for LICs appears to be difficult. Most countries with per capita income levels currently broadly similar to Liberia's do not have strong export bases in manufactured goods. One exception is Madagascar (which has exported apparel for several decades). This could either imply potential for diversification into light manufacturing at higher income levels, or it could be a sign that competition from even low-end products e.g., from China makes it increasingly difficult to enter this sector. The fact that in the past higher per capita income benchmark countries were able to export manufactured goods even at low income levels could suggest that it is harder to diversify into this sector now; however, this evidence is merely descriptive.

15. In sum, most benchmark Sub-Saharan African countries have horizontally diversified within the agricultural sector, suggesting to explore Liberia's diversification potential in this sector. Most countries with per capita income levels broadly similar to Liberia are not exporting manufactured products but rather focus on agricultural products or natural resources, suggesting horizontal entry into new products in these sectors as one possible avenue for Liberia. Diversification away from raw materials into agricultural products could be the most promising horizontal diversification strategy for Liberia at the moment.

Vertical export diversification

16. Liberia's relative position on the sectoral quality ladder indicates potential for vertical diversification, i.e., quality upgrading. Quality ladders measure the range of qualities within a particular product market. Markets with more room for quality differentiation have "longer" ladders (IMF 2014b). Figure 6 illustrates quality ladders for a (non-exhaustive) list of goods Liberia currently produces. Comparing Liberia's export quality to its neighbors Côte d'Ivoire, Guinea and Sierra Leone, which have similar climate and soil conditions, and to worldwide quality ladders for low income and emerging market economies can yield suggestions for upgrading the quality of its products:

Figure 6. Export Quality
(Average 2000–10)



Source: IMF (2014b)

- **Crude rubber** and **rubber manufactures**: Liberia's crude rubber export quality is similar or even higher than its peers' and relatively high compared to worldwide levels; such positioning implies less quality upgrading opportunities, but could suggest a horizontal move from crude rubber to rubber manufactured products for which Liberia is located on the lower range of the quality ladder. Due to Liberia's large rubber plantations, this could build on an existing comparative advantage.

- **Wood** and **wood manufactures (excluding furniture)**: In both categories, Liberia's export quality is below worldwide averages and below its neighbors' levels. As these quality ladders are very long and given Liberia's large endowment with forests (thus assuming comparative advantage in this sector), there is room for quality upgrading, in particular by producing simple manufactured wood products.

- **Rice**: Quality of rice lags behind worldwide quality levels and the quality in its neighbors. Liberia is still relatively far away from the top of the quality ladder, so this sector could benefit from much quality upgrading.

- **Cocoa** and **coffee**: in both sectors, Liberia's export quality is already relatively high compared to its neighbors and worldwide quality ladders, thus implying limited potential for vertical diversification. This, however, also suggests that increasing the absolute amount of exports in these sectors could diversify exports along the intensive margin (i.e., export shares).

17. Overall, horizontal diversification combined with quality upgrading in particular in the agricultural sector could be a promising path for Liberia. The agricultural sector accounts for a large share of output and employment (around 47 percent of total employment in 2010). Productivity improvements in this sector—e.g., by promoting the transition from subsistence farming to production for the market—could be an explicit policy target.

C. Current Government Initiatives and Policy Recommendations

18. The most binding constraints to the Liberian economy are well known and strongly impact the business environment and diversification initiatives. Liberia's technical partners, in cooperation with the Government of Liberia, have identified these constraints, such as inadequate infrastructure (in particular roads and electricity), little access to finance, weak institutional capacity and a labor force with low skill level (e.g., Government of Liberia 2013, IMF 2010b, World Bank 2012 & 2014). Many of these constraints hinder diversification, in particular, in the agricultural sector. The authorities are making progress in alleviating these constraints:

- **Property rights**: access to land and secure land tenure are essential for small farmers to move away from pure subsistence farming. While many farmers rely on land and property collateral to finance new inputs, this is challenging in the context of weak property rights and ongoing land disputes.

  - *Current government initiatives: the new Land Rights Act establishes clear systems and control measures for land acquisition in Liberia and defines land ownership rights. The Act is currently under review at the Legislature.*

- **Roads and bridges**: with currently only 10 percent of all Liberian roads paved, and many bridges in decayed condition, transportation infrastructure has been identified as one of the main constraints on the Liberian economy. The positive impact of better roads would be particularly strong on tradables in the agricultural and forestry sector.

- *Current government initiatives: the government in cooperation with several donors is working on infrastructural projects, in particular along existing economic corridors. For example, a new paved road has been completed between Bong County and Monrovia.*

- **Electricity**: insufficient and expensive electricity can lead to lower quality in the agricultural sector, e.g. due to production of rice without power rice mills, lack of investment in the tree crop sector, and lack of tractors for land cultivation which would enable more employment in areas where manual labor is productive, such as harvesting.

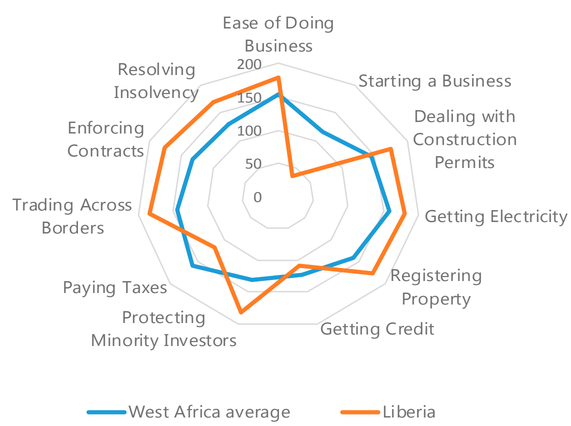
  - *Current government initiatives: several power generation and power transmission projects are currently underway (e.g., HFO projects and Mt. Coffee) and are expected to increase power supply and reduce energy costs over the course of the coming months.*

19. **In addition to addressing these constraints, the government has launched the Liberia Agricultural Transformation Agenda (LATA) to support diversification and transformation**. LATA strives to build up the agricultural sector as well as adopt a supportive industrial policy. It is based on targeted government interventions, for example to develop low-land rice cultivation, to promote the expansion of value chains and development of the private sector in particular in the agricultural sector.

20. **Improving business climate and external competitiveness could play an important role in increasing export diversification in Liberia**. As shown in Figure 7, Liberia's business climate lags behind in comparison to other West African countries, for example in contract enforcement or dealing with construction permits. In addition, Dutch disease effects due to the export of natural resources and a large amount of aid inflows undermines external competitiveness at the macroeconomic level. Focusing on reforms to improve cost competitiveness, e.g., by containing wages, or reducing other production costs (such as energy costs), reducing government market distortions (such as implicit subsidies), and increasing human capital could make the tradable sector more externally competitive (see Annex 3 in IMF 2016).

Figure 7. Doing Business Indicator

(Rank out of 189 countries)



Source: World Bank Doing Business Indicators.

21. **One additional reform measure found to boost productivity growth is the removal of tariff barriers to international trade (IMF 2014a)**. Efficiency could be increased through better access to markets and technology, cheaper imported inputs, as well as more competition with imports. Continuation of ongoing regional integration efforts with ECOWAS and the WTO membership becoming effective on July 14 will be an important step in reducing trade barriers.

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FINANCIAL INCLUSION IN LIBERIA[1]

Financial inclusion in Liberia needs to be improved, with indicators of financial inclusion, such as physical access to financial services, lower than the fragile country average and the regional average. These indicators are well far from the middle income country levels—the benchmark for the long-term Liberia Rising agenda. Improving financial inclusion could strengthen the resilience of the Liberian economy against shocks by supporting economic diversification through private sector development, and increasing credit options and risk sharing for enterprises and households. The Liberian authorities could promote financial inclusion by reforming financial sector laws and regulations and improving the business environment.

A. Introduction

1. Financial inclusion, defined as how many people and/or firms have access to, and use formal financial services, can play an important role in Liberia's economic development. Recent research, such as IMF (2015) and World Bank (2014), has already identified some positive linkages between economic and firms' growth and financial inclusion. Also, adequate financial inclusion could improve the resilience of households against life and economic events through more credit options and risk sharing. Liberia's medium-term development strategy, the Agenda for Transformation (AfT), envisages access to financial services as a key pillar to enhance private sector development, job creation, and gender equality.

2. Non-bank financial institutions (FIs) play an important role in promoting financial inclusion in Liberia. Although Liberia's financial sector is dominated by commercial banks in terms of financial assets, they are basically serving large customers in a few main towns. Non-bank FIs, such as micro finance institutions, complement commercial banks by offering financial services to the majority of individuals and micro, small, and medium-size enterprises (MSMEs).

3. The recent impact of the commodity price shock underlines the need for economic diversification. As a result of the decline in prices, exports (mostly iron ore and rubber) declined by 43 percent from 2014 to 2015, lowering GDP growth from 8.1 percent in 2014 to 0 percent in 2015. Economic diversification would add drivers of growth and contain the economy's vulnerability to commodity prices. Wider entrepreneurship and business opportunities, a necessary condition for economic diversification, also require adequate financial inclusion. But "access to financing" in Liberia is the second largest problem for doing business in Liberia.[2]

[1] Prepared by Atsushi Oshima.

[2] World Economic Forum (2015).

4. The Ebola epidemic highlighted households' vulnerability. During the epidemic, more than 40 percent of the employed population lost their jobs.[3] Although all the counties have now financial service providers, both access and usage are still limited.

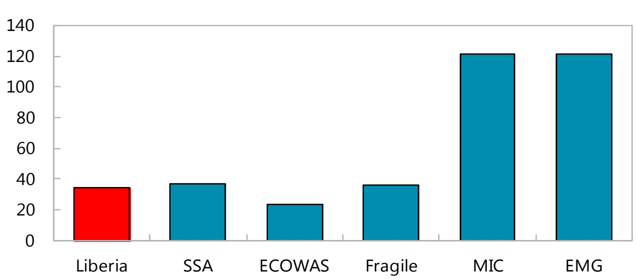
5. This paper describes the current situation and recent developments of financial inclusion in Liberia. The paper first summarizes the main features of the financial sector in Liberia, and then focus on physical access to financial services and usage of financial services as key aspects of financial inclusion. Physical access, expressed by the number of financial institutions and their branches and ATMs, indicates how easily people have physically access to financial service providers. Usage, expressed by private credit and bank deposits in percent of GDP and numbers of accounts for financial services, indicates how much people use financial services. The paper then describes the impact of the Ebola crisis and commodity price decline on the development of the financial sector. Recommendations to ensure further development of the financial sector conclude the paper.

B. The Financial Sector in Liberia

6. The financial sector is fairly diversified. The financial sector consists of nine commercial banks, one development finance company, one microfinance deposit-taking institution, 20 insurance companies, 20 microfinance institutions, nine licensed rural community financial institutions, 400 credit unions, and 1450 village savings and loans associations.[4] In this paper, non-bank FIs include all the financial institutions above other than commercial banks. Seven out of the nine commercial banks are foreign-owned. The nine rural community financial institutions have been established with strong support by the CBL to ensure access to basic financial services such as direct debit or deposit taking in rural areas in 2014 and 2015. Commercial banks dominate the sector in terms of asset size with 90 percent of total financial assets.[5]

7. Although Liberia's financial deepening is advanced compared with neighboring countries, the role of commercial banks in domestic economy is limited. In terms of financial deepening measured by M2 over GDP (Figure 1) and deposit over GDP (Figure 2), Liberia is doing better than the ECOWAS average. However, foreign concession companies, which are the main exporters of Liberia as covering

Figure 1. M2, 2014
(percent of GDP, weighted average)



Sources: International Financial Statistics; and IMF staff estimates.

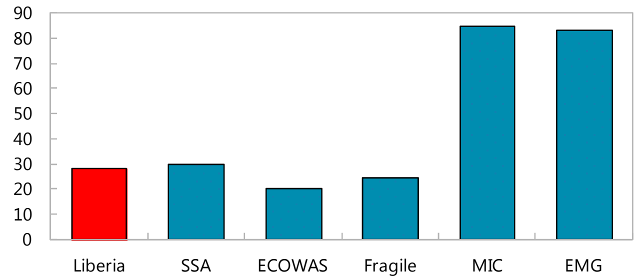
[3] World Bank (2014–2015).

[4] There is no license and/or register scheme for credit unions and village savings and loans associations. The village savings and loans associations provide short-term loans (2–3 months) for micro business or temporary personal needs. They normally consist of 25–30 members, mostly women.

[5] Central Bank of Liberia (2015).

natural resources, rely on off-shore foreign banks for their main financial transaction and use domestic banks only for payments to local employees and contractors. Commercial banks serve mainly the established businesses in Monrovia and a few main towns by providing short-term trade credit, generally in the service sector (which includes construction). On the other hand, for the majority of population, non-bank FIs are the main loan providers.

Figure 2. Deposits, 2014
(percent of GDP, weighted average)



Sources: IMF Financial Access Survey; and IMF estimates.

8. The Central Bank of Liberia (CBL) is collecting information about financial inclusion regularly, but its coverage needs to be expanded. The number of financial institutions and their branches is monitored and published annually. Furthermore, the CBL conducted a nation-wide survey regarding financial access in 2013 and published the results in 2015. The survey covered not only the supply side, but also demand side, e.g., why Liberians took loans and what types of institutions they used. In addition, in 2016, the CBL produced the Financial Sector Development Implementation Plan (FSDIP) with technical assistance of the World Bank Group and financial support of the Financial Institutions Reform and Strengthening (FIRST) Trust Fund Initiative. The FIRST collected a wide range of financial sector data and analyzed the sector. With regard to financial inclusion, the CBL collects and publishes basic information, such as the number of accounts, outstanding deposits, etc., from commercial banks. Some types of financial institutions, such as village saving and loan institutions, and some aspects of financial access, such as demographic and gender information, are however not closely and regularly monitored by the CBL. Furthermore, Liberia is not covered by the World Bank Global Findex, a survey-based database on financial inclusion covering more than 140 countries. Therefore, available data do not provide a full picture of the extent of financial inclusion in the country.

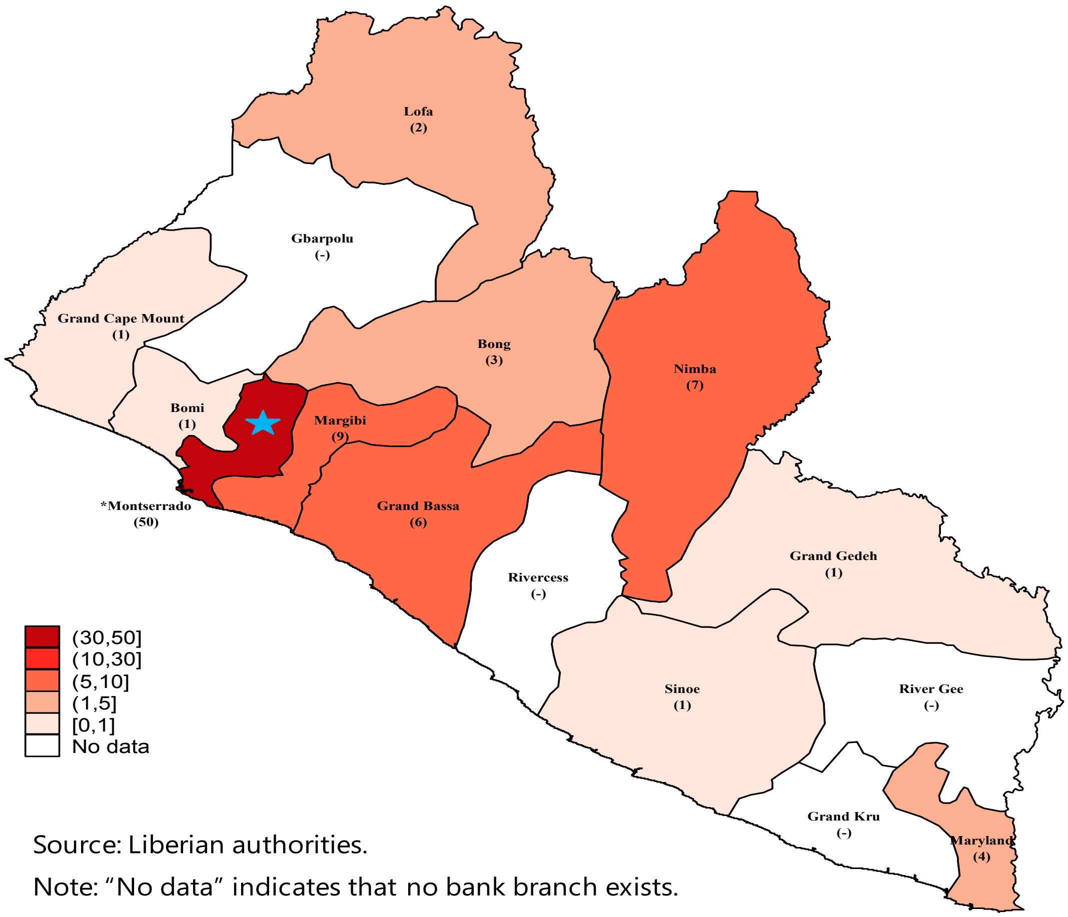
C. Physical Access to Financial Services

9. Physical access points to commercial bank services are very limited. There are only four commercial bank branches and two ATMs per 100,000 adult population and less than one branch and ATM per 1,000 km^2, with very slow growth since 2010 (Figure 3). This level of access is lower not only than the average for sub-Saharan African (SSA), but also the average for two other relevant comparator groups—fragile economies and ECOWAS—and far below the middle income country (MIC) average, Liberia's long-term goal as laid out in the Liberia Rising 2030 agenda. Furthermore, about 60 percent of commercial bank branches are concentrated in the capital region, where about one quarter of population lives (Figure 4). As a result, the physical presence of commercial banks in rural areas is extremely scarce, with four out of 15 counties not served by any commercial bank branch.

Figure 3. Physical Access to Commercial Banks

Sources: IMF Financial Access Survey; and IMF staff estimates.

Figure 4. Liberia: Distribution of Commercial Bank Branches, 2014



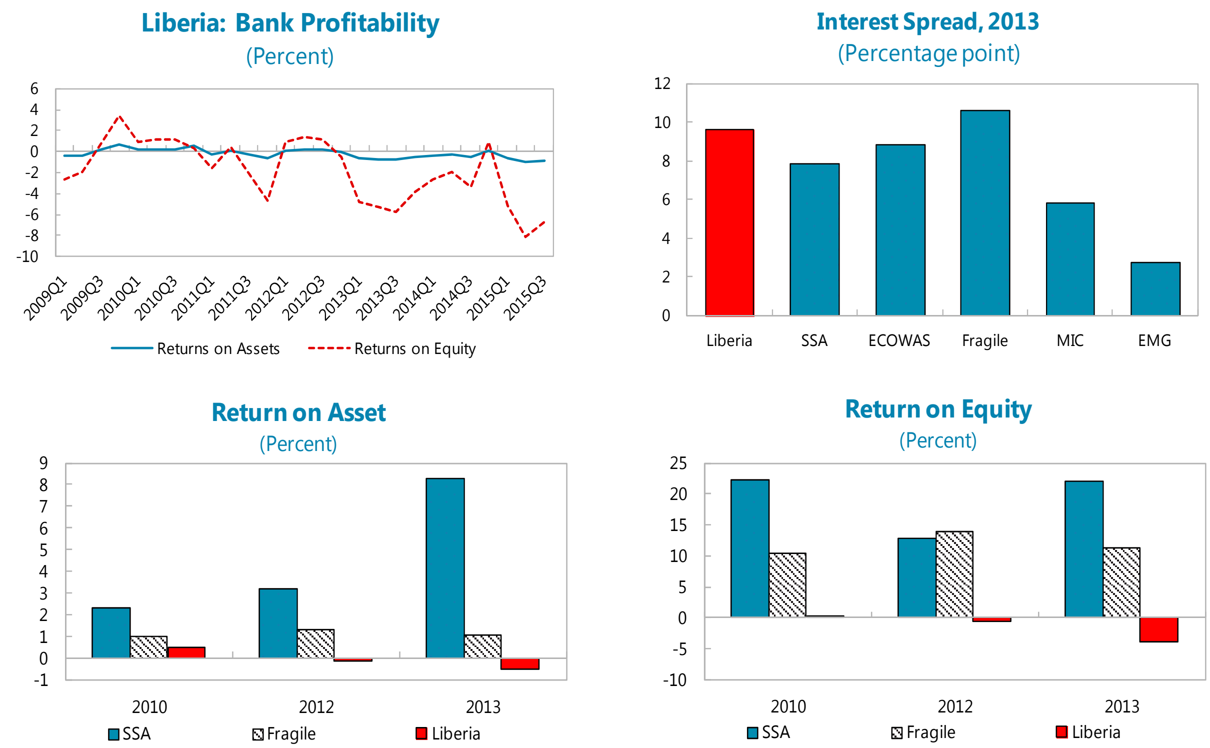
Source: Liberian authorities.

Note: "No data" indicates that no bank branch exists.

10. Non-bank FIs play an important role, especially in rural areas. The number of other non-bank FIs, such as credit union and village saving and loan associations, has rapidly grown and the number of non-bank FIs is now about 74 per 100,000 adults. Thanks to rural community financial institutions, all 15 counties now have access to at least some financial services.[6] Thus, although non-bank FIs provide only simple financial services, they provide a decisive contribution to the inclusiveness of the financial sector.

[6] Four counties did not have any financial institutions in 2012.

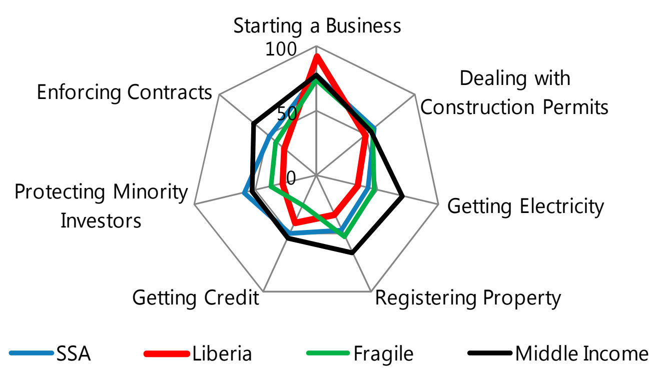
Figure 5. Banking Sector Performance



Sources: Liberian authorities; World Bank Doing Business Indicators; World Development Indicators; and IMF staff estimates.

11. Three major factors contribute to the limited physical presence of the banking sector. First, banks have been struggling with low profitability for the last several years despite relatively high interest spreads (Figure 5), due to limited lending opportunities, poor asset quality (which requires high provisioning), weak lender protection, and lack of money markets. Weak lender protection (Figure 6), in particular, stemming largely from costly judiciary process and weak contract enforcement, makes banks more risk averse and reduces business opportunities. Second, poor infrastructure (included limited and costly access to electricity) increases cost of building and maintaining branches in rural areas. Also, weak communication network in rural areas does not allow banks to maintain their business remotely. Third, the land registration scheme makes it more difficult for banks to open a new branch, since the registration process is currently time-consuming and costly.

Figure 6. Liberia: Doing Business Indicators, 2016
(Distance from Frontiers)



Sources: Doing Business Indicators, 2016, World Bank; and IMF staff estimates.

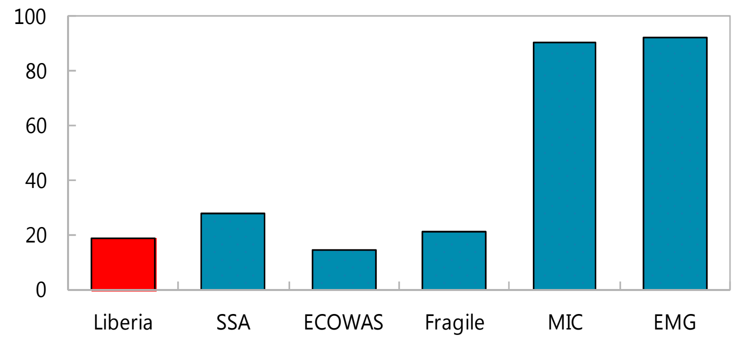
Besides, land, especially in rural areas, often does not have even clear owners, and land dispute resolution is weak.[7]

D. Usage of Financial Services

12. Use of services also has significant space for further development. Limited access to lending is often mentioned as a key obstacle to the development of the private sector. In fact, credit to the private sector, at 19 percent of GDP in 2014, is relatively high (Figure 7), but the number of commercial bank loan accounts is small (Figure 8), implying that credit is concentrated on few borrowers. With regard to deposit accounts, commercial bank deposits, at 28 percent of GDP in 2014, are fairly large compared both the fragile and ECOWAS averages (Figure 2), and relatively high usage of deposits is confirmed by the number of deposit accounts (283 per 1,000 adults for 2014), higher than the ECOWAS and fragile economy averages. In contrast, penetration of non-cash payment tools is weak. In 2011, only about 3 percent of adult population used debit cards, much lower than the fragile and ECOWAS averages.[8] And by end 2015, only four banks out of nine were issuing debit cards. Also, only a small portion of population uses electronic payment systems.[9]

Figure 7. Private Credit, 2014

(percent of GDP, weighted average)



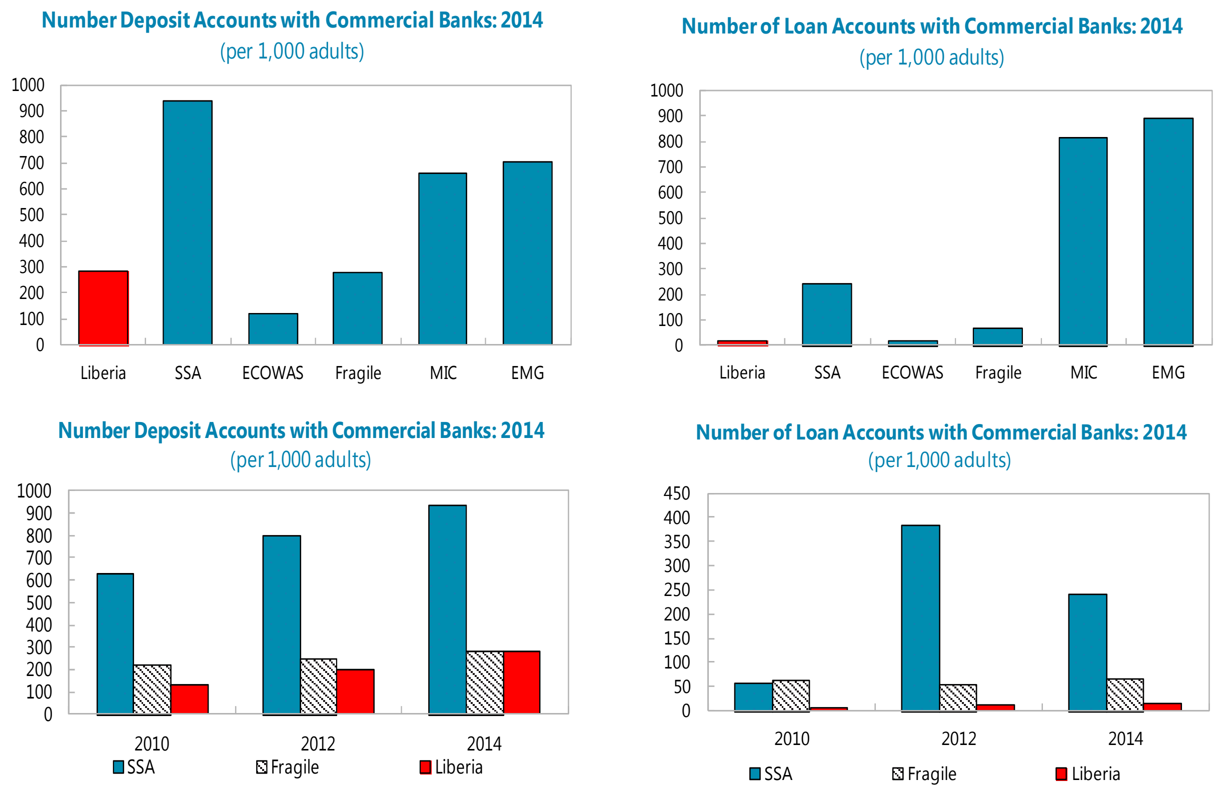
Sources: International Financial Statistics; and IMF staff estimates.

[7] A new Land Act, which reform the current practices to define and protect land ownership better, is under discussion by the National Legislature.

[8] World Bank Global Financial Development database.

[9] "Electronic payments" refers to payments made through wire transfers or payments made online for bill clearance and/or goods and service purchase.

Figure 8. Usage of Financial Services



Sources: IMF Financial Access Survey; and IMF staff estimates.

13. Non-bank FIs are important financing sources for households. Although commercial banks account for 90 percent of financial assets, about 70 percent of individuals who borrowed money in 2013 relied on non-bank FIs instead of commercial banks.[10] More broadly, non-bank FIs provide microfinance to individuals and MSMEs, as opposed to commercial banks, which generally do business with relatively large customers.

14. But services offered by non-bank FIs are costly. In particular, lending rates by the commercial banks are much cheaper than non-bank FIs. Although there is no systematic statistics, the average borrowing rate of commercial banks is around 14 percent whereas compared to upward of 25 percent for MFIs and 40 percent for credit unions.

15. The use of mobile money, a relatively new channel of financial services, services has been rising fast (Box). Liberia's mobile money services started in 2011 when the CBL issued Mobile Money Guidelines. The 2014 Mobile Money Regulation allows for the establishment of non-bank financial institutions to provide mobile money services. In 2014, mobile money deposits were estimated at US$1.7 million, while transfers were estimated at US$0.2 million. Three commercial

[10] Central Bank of Liberia (2015).

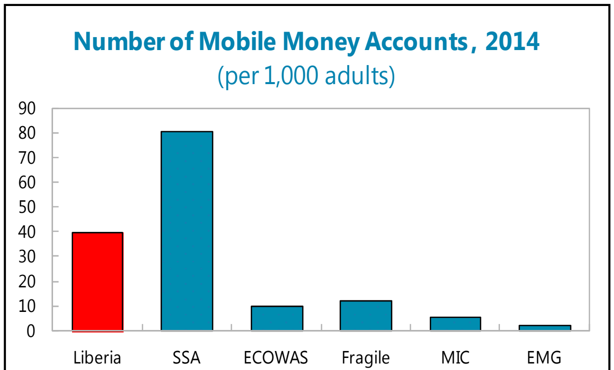
banks are providing money payment services in partnership with Lonestar Cell MTM Mobile Money Inc. Credit unions and a few foreign exchange bureaus are now also participating in the market, which could help the system to adjust for Liberia's dual currency scheme. Mobile money services cover all the 15 counties.

Box 1. Mobile Money

Technological progress created a new channel to access financial services through mobile phones, also known as mobile money or mobile banking. Use of mobile money has increased rapidly along with the strong growth of mobile telephony markets. Thanks to mobile phones, financial institutions, and sometimes even non-financial institutions, can offer financial services to clients, who do not have access to traditional channels, such as bank branches and ATMs and debit cards. Mobile money services typically include money transfers, payments, deposits, and withdrawals. Therefore, access to mobile money implies that even people living in rural areas where population density is too low to bank build branches for banks can benefit from basic financial services.

Sub-Saharan Africa (SSA), especially, East Africa, is among the regions, which are most benefiting from mobile money. Due to several reasons, including limited road network, insufficient power generation, weak business environment, and poor financial literacy, traditional channels of financial services in SSA countries are highly limited compared with other regions. The rapid spread of mobile phone coverage is helping to improve financial inclusion. One example is the remarkable success of M-PESA in Kenya. M-PESA is a mobile money system launched in Kenya in 2007, which has contributed to the expansion of active mobile money account from 1.3 million in 2007 to 25 million in 2014.

In Liberia, mobile money penetration is advanced compared with neighboring countries, but it is still lower than the SSA average. To achieve further expansion, Liberia needs to tackle two specific issues in addition to the infrastructure and regulatory issues that are shared with other developing countries. First, mobile money must be adjusted to the dual currency system. A large portion of financial assets are denominated in U.S. dollars whereas people use Liberian dollars for their small-size transactions. Therefore, for financial inclusion, involving poor and/or people living in rural communities, easy conversion between U.S. dollars and Liberian dollars within the system would be essential. Second, a quick customer identification system should be introduced to mitigate AML/CFT risks, which might be deepened by mobile money.



Source: IMF Financial Access Survey.

16. **Several factors hold lending back**. For lenders, virtually no creditworthiness information is available as there is no comprehensive database of credit history of borrowers. (Table 1) The CBL established a credit bureau and have been upgrading the credit reference system. Lack of a national identification system is another factor of limited credit reference. However, the current system has not yet been fully modernized, resulting in slow updates of information. Judicial contract enforcement and corporate transparency are weak, resulting in poor protection of lenders. On the supply side, high NPL rate combined with Liberia's weak insolvency scheme weighs on the balance sheet of banks, making lending more difficult and non-inclusive. These factors make catering to smaller, less publicly known operators, such as households and MSMEs, riskier. Constraints on

collateral, which suppress its role as security for lending, negatively affect banks' propensity to lend. Land ownership rights are not well defined under the current law (see the previous section), and there is very limited secondary market for land and real estate, partly because non-citizens (notably the Lebanese and Indian minorities which are very active in business) cannot own real estate. Lack of a well-organized collateral registry scheme had also hindered loan contracts. Until the launch of an online movable collateral registry supported by the IFC in June 2014, Liberians could hardly borrow money using their assets other than buildings of recent construction as collateral. Corporate transparency is very poor and recovery rate at the time of bankruptcy is very low.[11] In addition, financial literacy is generally low, and individual and SMEs have limited capacity to prepare good business plans and convincing investment opportunities.

Table 1. Details of Gettig Credit

	Distance from Frontiers	Strength of legal rights index (0-12)	credit information index (0-8)	Credit registry coverage (% of adults)	Credit bureau coverage (% of adults)
SSA	56.9	5.3	4.7	2.0	18.8
Liberia	43.8	8.0	0.0	1.8	0.0
Fragile	35.8	4.4	0.7	4.5	1.9
Middle Income	59.8	4.5	6.1	52.8	21.6

Sources: Doing Business Indicators, 2016, World Bank; and IMF staff estimates.

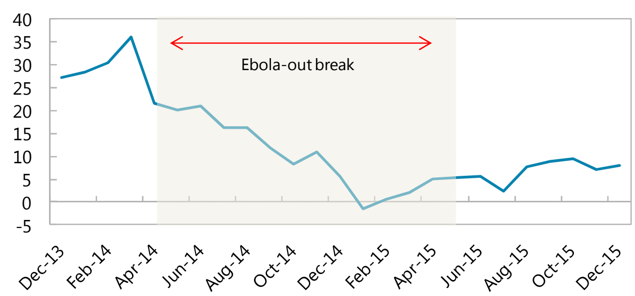
17. The authorities have supported several initiatives to improve financial inclusion, especially by promoting lending to SMEs. The CBL launched the Small-Medium Enterprises Credit Stimulus Initiative in 2010, providing low-interest financing to Liberian-owned small and medium size enterprises. The Ministry of Finance and Development Planning (MFDP) set up the Private Sector Development Project in July 2014, based on Government Enhancement Fund account in the Liberia Bank of Development and Investment. The project has provided loans of US$2.1 million in total to 41 businesses as of May 23, 2016. Also, the African Development Bank is providing technical assistance to Access Bank for MSME support. USAID has established a loan guarantee program through ECO Bank and International Bank. The CBL is planning to introduce deposit guarantee scheme, which may promote access to deposits. In June 2016, the Ministry of Education launched the pilot project of wage payments through the mobile money system. This could boost the growth of the mobile money market. In addition, the 2014 Payment System Act modernized the supervision and regulation framework of the national payment system in Liberia. The CBL has been upgrading its payment system infrastructure and has fully implemented the National Electronic Payments Switch in 2015, which allows bank customers to access ATMs, POS, Visa, and Master Card services.

[11] World Bank (2015).

E. Impact of Recent Crises on Financial Inclusion

18. The Ebola epidemic has adversely affected financial inclusion. Due to limited data, it is difficult to directly measure the impact of the epidemic on financial inclusion. However, the number of microfinance institutions (MFIs) decreased from 23 to 20 in the course of 2015, reflecting the epidemic's disruption of MSME's activities and household incomes. In addition, in early stage of the Ebola epidemic (March through September 2014), the uncertainty on economic prospects triggered extensive bank deposit withdrawals with demand deposits falling by 12 percent. Also, the economic slowdown and the impact on borrowers' assets and activities increased non-performing loans (NPLs) during the epidemic from 14.5 percent of total loans in March 2014 to 19.2 percent in June 2015. As a result of these developments, private credit growth rates fell rapidly in 2014, even going negative in January 2015 and recovering only marginally in the following months (Figure 9).

Figure 9. Liberia Private Credit
(Annual Percent Change)



Source: Central Bank of Liberia.

19. The decline in commodity prices also hit the financial sector. Although the natural resource sector is relatively segmented from the domestic economy, the contraction of rubber and iron ore exports, in particular, reduced business for local contractors and led to layoffs of local workers, resulting in a decrease in the usage of financial services.

F. Policy Recommendations

20. The factors holding back financial inclusion described above point to potential areas of intervention by the government and the CBL, in coordination with donors.

The main measures to improve *access to financial services* are:

- Enhancing investor protection by reforming corporate transparency regulation and insolvency scheme to protect lenders' rights;
- Establishing the interbank market for short-term liquidity, foreign exchange, and T-bill and T-bond to promote a more efficient asset management;
- Improving infrastructure, especially in the areas of electricity, communication network, and road, which could would reduce costs of expanding the bank branch network in rural areas; and
- Approving and implementing the new Land Right Act, which would improve land ownership rights, establish a land management framework for the acquisition, use, and transfer, and protection of land rights, and ensure equality of land rights.

The main measures to deepen *usage of financial services* are:

- Expanding credit registration coverage and establishing nation-wide credit information database as well as improving investor protection, judiciary process, and contract enforcement;
- Further promoting the new collateral registry, which could increase opportunities to use bank lending for SMEs and households;
- Introducing a deposit guarantee scheme to make opening bank accounts more attractive;
- Introducing a national identification system to strengthen credit registration and mitigate the AML/CFT risks through mobile money; and
- Over the longer run, increasing financial literacy for the population.

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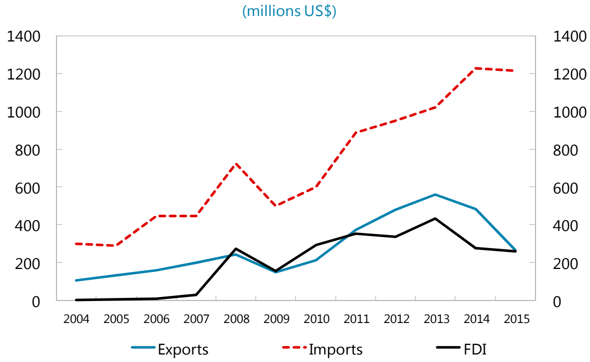
THE IMPACT OF WITHDRAWAL OF CORRESPONDENT BANKING RELATIONSHIPS ON LIBERIA[1]

A. Introduction

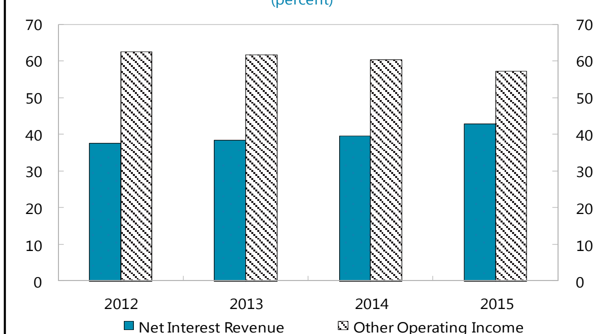
1. **Correspondent banking relationships (CBRs) have served Liberia's banking system well**. Thanks to its rapid economic growth averaging 7 percent over the past decade, Liberia has emerged as an attractive destination for trade and investment especially in the mining sector. The end of a civil war created unprecedented opportunities for imports and exports (Figure 1). Yet to take full advantage of these opportunities, importers and exporters rely on local banks being connected to a global trade finance network. CBRs have facilitated access to hard-to-reach markets for corporates and banks through tapping of extensive payments infrastructure. CBRs have also helped mitigate risks for companies that are uncertain of their Liberian counterparty's creditworthiness through payment risk instruments such as letters of credit. With limited lending opportunities, fees and commissions from CBRs have contributed to banks' growing non-interest revenue (60 percent of operating income) (Figure 2).

Figure 1. Liberia: Exports, Imports, and FDI
(millions US$)



Source: IMF Staff estimates.

Figure 2. Liberia: Banks Operating Income
(percent)



Source: Bankscope.

2. **But the recent loss of CBRs with global banks could unravel these gains and potentially hurt economic activity**. Most foreign banks are severing their CBRs with Liberian banks citing overall profitability, reputational risk, reduced risk appetite, enhanced implementation of domestic regulations (e.g., US office of Foreign Asset Control (OFAC) and Foreign Account Tax Compliance (FATCA)), global regulatory standards (including Anti-Money Laundering and Countering the Financing of Terrorism (AML/CFT), and increased compliance costs and economic trade sections (IMF 2016a). While the evidence of the macroeconomic impact is yet to be quantified, loss of CBRs is affecting financial intermediation, trade finance and remittances, with potential consequences for financial exclusion.

[1] Prepared by Rodgers Chawani.

3. This paper looks at the recent loss of CBRs in Liberia and its impact on the banking system. First, the paper aims at assessing the extent of loss of CBRs for commercial banks in Liberia. Second, the paper seeks to understand how the loss of CBRs is affecting the banks' activity and the Liberian economy. Identifying the impact could help in shaping policy priorities to facilitate new networks and alleviate any perceptions of risk.

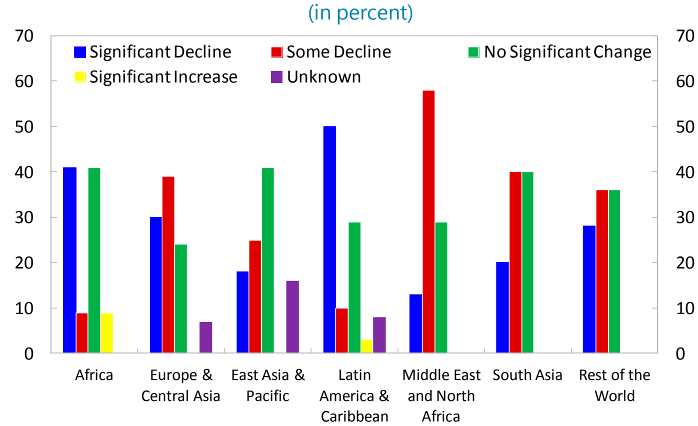
4. The findings of the paper are based on surveys conducted from February through May 2016. A Central Bank of Liberia (CBL) questionnaire to all nine commercial banks provided evidence on the loss of CBRs. The responses to the questionnaire were matched with the CBL database on correspondent networks, and with an electronic survey conducted by IMF staff targeting five of the nine commercial banks. In addition, the Financial Intelligence Unit (FIU) also requested information from all commercial banks on loss of CBRs that confirmed that the problem was systemic and needed urgent attention.

5. The paper is structured as follows. Section B presents recent trends on the loss of CBRs by banks in Liberia by using survey responses and information provided by CBL, FIU, and commercial banks. Section C considers the impact of the loss of CBRs on Liberia while section D provides context to the AML/CFT environment. Section D concludes by highlighting policy recommendations.

B. Recent Trends in Correspondent Banking Relationships

6. Withdrawal of CBRs is a problem globally. Loss of CBRs by global banks relates to a set of reactive actions adopted by banks at their own initiative and within a broader business strategy, to reduce the cost and risk exposure by withdrawing from, or reducing engagement with, categories of customers, business lines, markets, and jurisdictions—ultimately avoiding or mitigating risk. World Bank surveys (World Bank 2015c) indicated that smaller jurisdictions in the Caribbean, Africa, Europe and Central Asia were most affected by reduced transactions by U.S. and U.K. banks (Figure 3). An IMF survey with the Union of Arab Bank (IMF/UAB, 2015) revealed that de-risking had affected mainly countries under economic, and trade sanctions. A 2015 survey conducted by the Association of Banking Supervisors of the Americas (ASBA, 2015) indicated that the Caribbean was the region most affected in the Western Hemisphere and the International Chamber of Commerce Global Survey of Trade Finance (ICC, 2015) confirmed declining transactions due to onerous AML/CFT requirements.

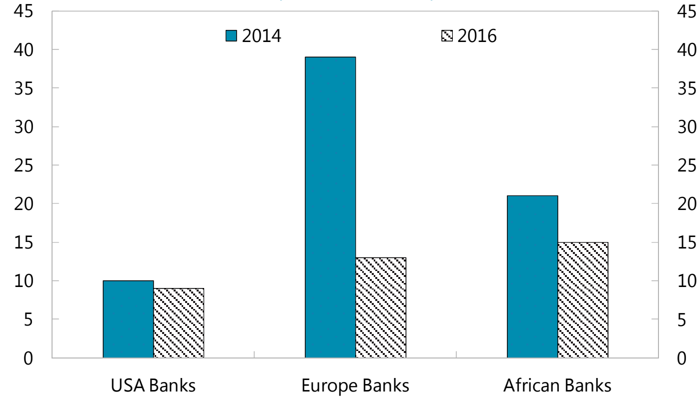
Figure 3. Global Trends in Correspondent Banking Relationships
(in percent)



Source: World Bank.

7. **Liberia has experienced a reduction in CBRs**. Since 2013, active U.S., African and Europe banks' CBRs have declined (Figure 4). Withdrawal of CBRs is broad based. All commercial banks have lost at least one CBR since 2013. Ten global banks have terminated about 48 percent of CBRs (36 out of 75), with the most hit banks losing 78 percent of CBRs compared to the banking system average of 46 percent. All banks indicated that they are down to only one global correspondent bank. The loss of CBRs is not unique to commercial banks as the CBL also had its CBR terminated in March 2014.

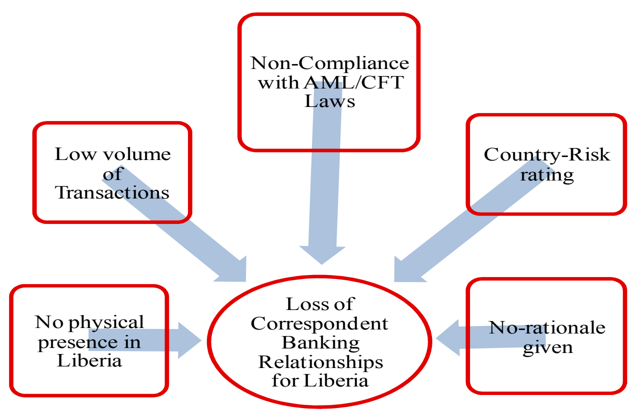
Figure 4. Liberia: Active Correspondent Banking Relationships
(Number of CBRs)



Source: CBL; and commercial banks.

8. **Global banks' reasons for terminating CBRs in Liberia are wide-ranging** (Figure 5). Most of the banks cited the country's risk rating and deficiencies in compliance with AML/CFT Laws as key influences into their decisions. Compliance with regulatory requirements in the areas of AML/CFT, customer due diligence, transactions monitoring, recording keeping, and suspicious transaction reporting, have been associated with increasing costs for most global banks. Against a backdrop of waning profitability since the global crisis and imposition of massive fines for AML/CFT deficiencies, concerns about potential litigation and significant penalties are rising. Some global banks motivated the termination of the CBR with general arguments related to the inability to meet a client's banking service needs and/or the misalignment of client's business profile with their banking model. Other global banks indicated that the withdrawal of CBR was due to low volume of transactions with the Liberian counterparts, making CBRs, a low margin business, even less attractive. One global bank also pointed to the lack of physical presence in Liberia as a reason for pulling out of CBR services. However, in several cases, no rationale was provided by global banks. The FIU noted that lingering perceptions of Liberia as a tax haven and a jurisdiction offering opaque corporate vehicles could have also contributed to the withdrawal of CBRs.

Figure 5. Liberia: Drivers of Loss of CBRs for Commercial Banks



Source: Liberian commercial banks.

C. Impact of Withdrawal of CBRs on Liberia

Economic Impact

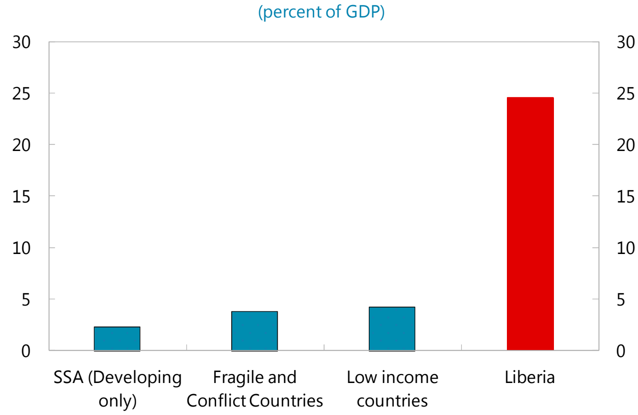
9. **Loss of CBRs is presenting a tangible threat to trade financing for Liberia**. About 78 percent of survey respondents (seven out of the nine commercial banks) reported disruptions in trade financing due to shedding of CBRs. Where lines were not severed, most global banks introduced enhanced disclosure requirements including invoices for all payments for suppliers. Trade financing constitutes about $^1/_3$ of interbank transactions for commercial banks in Liberia and CBRs have served as important conduits for cross-border payments in different jurisdictions. With heavily regulated global banks unable to issue or confirm letters of credit due to KYC or AMCL/CFT concerns, Liberian banks have noted that exports and imports were being impacted by delays or termination of service.

10. **Withdrawal of CBRs is undermining a banking system already struggling with weak profitability and rising NPLs**. About 78 percent of survey respondents (seven out of nine banks) reported a loss of customers due to decreasing range of products and services they can offer, in particular foreign-currency denominated capital or current account transactions or wire transfers. As banks find traditional payment options foreclosed, most banks are resorting to nested relationships with peers or parents abroad. Most of the alternative arrangements are invariably more expensive as the new intermediaries are charging a premium for providing service. Clearing and settlement services are also encountering high costs amd prolonged procedures. One major bank indicated that it takes about US$150 to clear a single check to the USA. As transactions are declining, banks are losing significant revenue-generating businesses. The CBL estimates the annual loss of banks' revenue due to lower fees and commissions at US$4 million (equivalent to 11 percent of total non-interest income). With interest revenue already affected by a weaker economic environment, a decline in non-interest revenue is undermining banks' profitability and their willingness to lend.

Social Impact

11. **Withdrawal of CBRs contributed to financial exclusion by disrupting the flow of remittances and aid**. Since the end of the civil war, Liberia's dependency on remittances has grown rapidly. At 24 percent of GDP, it is very high compared to regional peers and fragile countries (Dilip Ratha et al 2016) (Figure 6). With about half of the survey respondents confirming that the flow of remittances had been impacted by loss of CBRs, lower remittances could result in a reduction in consumption spending especially by vulnerable rural

Figure 6. Remittances
(percent of GDP)



Source: World Bank.

households. With active money service operators such as moneygram being affected by the unavailability of reliable counterparties, loss of CBRs is undermining role of such operators in serving as an intermediary between banks and financially excluded poor in remote areas, impacting financial inclusion efforts. Further, a major western bank severed its euro CBR with the CBL in March 2014 resulting into challenges for donors in the deployment of effective and timely humanitarian assistance, especially for fighting Ebola.

Impact on Regulation

12. The search for alternative banking relationships is reducing the CBL's supervisory and monitoring capacity. Most commercial banks reported that efforts to secure a new correspondent relationship were largely impossible following closure of CBRs. In turn, some commercial banks opted for nested banking relationships with either domestic peers or principals abroad. But, clearing through nested relationships is limiting both the traction and transparency for the CBL to effectively regulate downstream correspondents in the nested relationships. In the absence of robust memorandum of understanding for cross-boarder supervision, nested accounts add a layer of additional hurdles and complexity for regulation.

D. The AML/CFT Environment in Liberia

13. Loss of CBRs is taking place in context of a weak AML/CFT regime. The Inter-Government Group against Money Laundering and Combating Financing of Terrorism in West Africa (GIABA) mutual evaluation of Liberia's AML/CFT system in November 2010 observed that Liberia did not have comprehensive AML/CFT Laws and regulations and lacked a functional FIU. Liberia was placed on the expedited regular follow-up process requiring annual submissions of follow-up reports detailing progress in addressing the deficiencies. The Financial Action Task Force (FATF) has not yet included Liberia on the list of jurisdictions with strategic AML/CFT deficiencies due to the small size of its banking sector assets (less than the US$5 billion threshold), but has included the country in the list of jurisdictions meeting referral criteria for enhanced monitoring. Because of strategic deficiencies in the AML/CFT framework, Liberia's membership of the Egmont Group, a 151-member country informal network for promoting work of FIUs through information exchange, training, and capacity building, has been delayed.

14. Tax transparency issues may also contribute to the withdrawal of CBRs. Liberia is yet to sign the 2010 U.S. Treasury Foreign Account Tax Compliance ACT (FACTA), which targets tax non-compliance by U.S. taxpayers with foreign accounts and is listed as a tax haven by several EU members. The country is also lagging peers with respect to the Organisation for Economic Cooperation and Development's Global Forum on Transparency and Exchange of Information for Tax Purposes. The challenges in meeting international requirements stem from Liberia's policy to attract non-resident corporations subject to very few disclosure requirements, leveraging the use of the U.S. dollar as legal tender and a completely open capital account. Such a business model based on secrecy and favorable tax regimes, which is becoming less viable under international pressure towards increasing exchange of tax information, may weigh on the global banks' decision to severe business relations with Liberia.

15. Despite important measures introduced by the authorities, important deficiencies remain. In response to GIABA and other international bodies' remarks, the authorities have enacted seven laws and drafted regulation, developed a national AML/CFT strategy in 2012 and established the FIU in 2013. Yet a recent assessment by GIABA underlines that important weaknesses in AML/CFT Laws remain. The outstanding deficiencies relate to:

- *Gaps in terrorist financing laws*: The AML/CFT Act does not fully address the requirement that the offense of terrorist financing will apply irrespective of whether the terrorist act occurred and regardless of whether the funds provided were used to commit the terrorist act or whether the person alleged to have committed the offense is in the same country in which the act is committed or of the terrorist organization.

- *Criminalization of limited categories of offences:* The AML/CFT laws need to be changed to criminalize outstanding predicate offences relating to illicit trafficking in stolen and other goods, illicit arms trafficking, and counterfeiting and piracy of products.

- *Inadequate powers to confiscate property or proceeds of crime:* Law enforcement agencies (LEAs) lack powers to identify and trace property that is subject to confiscation or proceeds of crime.

- *Procedures to freeze the funds or assets of designated persons and entities:* Liberia has no targeted financial sanctions in place to comply with international obligations under the United Nations Security Council resolutions 1267 and 1373 relating to freezing of funds or assets of designated persons.

16. While instituted, the FIU is yet to fully functional. The staff complement has just reached 70 percent of the planned number (21 out of 30). Like most government agencies, the budget appropriation of FIU was drastically cut in the FY2017 draft budget, undermining its operational efficiency. Capacity building needs are increasing although the FIU is benefiting from technical assistance provided by the World Bank and US Treasury. Most financial institutions are yet to come to terms with the role of the FIU.

E. Policy Recommendations

17. In light of its wide-ranging implications, the threat posed by loss of CBRs calls for urgent action. While global banks' concerns over lower profitability, high regulatory scrutiny, hefty fines, and reputational damage may have grounds,,the preemptive termination of CBRs to manage risk is resulting into a negative externality to Liberia's financial stability, ability to receive aid and humanitarian assistance, and economic growth. Now, given Liberian banks' heavy reliance on one correspondent global bank, taking immediate action is imperative. A comprehensive response involving policymakers, regulators, banks, and other stakeholders is needed to address the loss of CBRs.

18. Addressing deficiencies in the AML/CFT framework would strengthen the case for containing the loss of CBRs and even reinstating some CBRs. Current efforts, while contributing to improve the AML/CFT environment, have not eliminated perceptions of Liberia being a safe haven for tax evasion and money laundering, and, possibly, terrorist financing. Additional policy actions are urgently needed on: (i) addressing gaps in laws on terrorist financing; (ii) strengthening legislative action to criminalize the outstanding predicate offences and intensifying efforts to facilitate money laundering convictions; (iii) incorporating into the AML/CFT legal framework powers to allow LEAs to identify and trace property that is subject to confiscation or suspected to be the proceeds of crime; and (iv) putting in place urgently effective procedures to freeze the funds or asset of designated persons and entities in accordance to UN Resolutions 1267 and 1373 resolutions.

Box 1. The Role of the IMF

The IMF remains engaged on the issue of withdrawal of CBRs. Efforts have focused on monitoring the impact of withdrawal of CBRs, fostering a shared understanding of the complexity of this phenomenon, and helping to develop possible policy responses. These issues have been highlighted in a recent Staff Discussion Note. In particular, the IMF has recently:

- Facilitated dialogue by collaborating with the Financial Stability Board, World Bank, the G20, the FATF, the Arab Monetary Fund, the Union of Arab Banks, the CPMI, and the Caribbean Task Force, among others to analyze the scale, drivers, and impact of the withdrawal of CBRs through surveys and regional roundtables.
- Fostered data gathering efforts by accumulating quantitative and qualitative evidence on instances of CBR withdrawal and the magnitude of the impact through Article IV consultations and the FSAP, where relevant. Follow up analytical work on identifying the drivers and impact of CBR withdrawal has been agreed with the MENA and SSA regions to be carried out closely with the Arab Monetary Fund and Association of African Central Banks, respectively.
- Assessed effectiveness of supervisory and regulatory frameworks mainly through FSAPs that identify shortcomings in the banking supervision and AML/CFT areas and make recommendations in the areas for the strengthening of these frameworks.
- Provided technical assistance for member countries to strengthen regulatory and supervisory frameworks, including with respect to AML/CFT. Building on FSAP and Surveillance findings the technical assistance has been helpful to address customer due diligence issues and improve the effectiveness of AML supervision.

Source: IMF 2016.

19. Strengthening banking supervision and the regulatory environment should help the CBL tackle the loss of CBRs. The CBL must assume a leadership role and develop policies and procedures that facilitate routine information gathering and sharing, to assist in identifying trends and implications of loss of CBRs. The CBL must continue to develop strong supervisory policies and regulations, and promote a legislative framework aligned with international standards. Within the context of the recently adopted risk-based supervision, the CBL must ensure that banks are compliant with Know-Your-Customer (KYC) requirements to be able to independently determine customers' risk level and take appropriate mitigating actions. The CBL could act as an intermediary between local and global banks and establish clear grounds of withdrawal of CBRs in order to clarify to banks the evolving regulatory expectations. Further, the CBL must strengthen relationships with potential "conduit countries" through signing of memorandum of understanding to foster information sharing.

20. Ensuring that the FIU is fully functional and has sufficient operational independence is essential for improving the AML/CFT framework. These objectives would be achieved by government timely providing the FIU with the full budget appropriation, ensuring adequate FIU staffing, outsourcing capacity building for staff, and requesting technical assistance in drafting of laws and regulations. Improved coordination with the Ministry of Justice, the legislature, and the CBL would facilitate an expedited processing of ammendments to the AML/CFT legal framework to make it more robust. The authorities must also improve public awareness of the FIU and its activities to instill a culture of compliance that facilitates the monitoring of emerging risks and supervision.

21. Deliberate corrective efforts by commercial banks would contribute to mitigating perceptions of risk. Working with the bankers' association, banks must review KYC policies and procedures to better identify, mitigate, and manage risk. Given the threat of low profitability, investing additional resources in compliance units through adequate staffing and requisite technology should mitigate risk management and prop-up non-interest income. Equally important is conducting comprehensive due diligence during client on-boarding to minimize compliance burdens.

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