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Adeline Pelletier

► **To cite this version:**

Adeline Pelletier. SMS Financing by banks in East Africa: Taking stock of regional developments. 2014. halshs-01205271

HAL Id: halshs-01205271

<https://shs.hal.science/halshs-01205271>

Submitted on 25 Sep 2015

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MAMBO!

TRAVAUX DE RECHERCHE SUR L'AFRIQUE DE L'EST

2014 VOL.XII N°2

SMS FINANCING BY BANKS IN EAST AFRICA: TAKING STOCK OF REGIONAL DEVELOPMENTS

Adeline Pelletier

The banking sector in East Africa has evolved considerably over the last 10-15 years with the regional expansion of African banks, coupled with financial innovations and regulatory changes. As a result, the banking landscape is marked by the co-existence of several types of banks: global banks from developed countries, emerging banks (mainly from Asian countries), foreign regional African banks and domestic African banks. Given the difficulty of access to credit experienced by SMEs, in a context of low transparency and information on borrowers, the expansion of regional African banks could have an important impact on the financial and economic development of the region. Indeed, if these regional banks are better able to evaluate SME credit risk than global banks, they might offer more loans to SMEs, thus fostering a sector which is the backbone of East African economies. In a constrained institutional setting, with a large unbanked population and little information available on borrowers, how do foreign and domestic banks screen and monitor borrowers? To what extent do regional African banks' lending practices and perception of the business environment differ from that of domestic African banks and of global banks? What is the impact of the regional expansion of African banks on SME financing?

Introduction

Kenya is the dominant banking centre in East Africa with 43 commercial banks. Over the last five years, some local banks (Kenya Commercial Bank, Equity bank) have grown larger than global multinationals such as Barclays or Standard Chartered¹, which were previously number 1 or 2 in terms of total assets. These large domestic banks have expansion strategies in East Africa, and more widely in the sub-continent having subsidiaries in Uganda and Tanzania, emulating the regional expansion of Nigerian banks such as United Bank for Africa. With new models based on technology platforms with mobile phones and agency banking, they are expanding fast and generating high profits.

Goal and survey data

During a fieldwork conducted from October to December 2013, I gathered data on 49 different banks through bank interview (72% of responses) and online questionnaire (28% of responses). 26 banks were located in Kenya and 18 in Tanzania. In addition, I collected data from Uganda (3 banks) and Zambia (2 banks) by calling to obtain the email of the person in charge of the credit department

1. In 2012, the total assets of Standard Chartered in Kenya amounted to 195B KSHS, against 91B KSHS in 2007. For Barclays these numbers were 185B KSHS in 2012 against 158B KSHS in 2007. Kenya Commercial Bank recorded 304B KSHS of total assets in 2012 against 120B KSHS in 2007 while for Equity Bank these numbers were 216B KSHS in 2012 against 53B KSHS in 2007. Source: Banking Survey 2013, Kenya Bankers Association.

and emailing the questionnaire. The respondents were mainly Head or Manager of credit (retail, SMEs or corporates) (40% of the respondents), followed by Head of credit risk or credit administration (27%) and Branch Manager or Relationship Officer (14%). The other respondents were CEO, CFO or general managers.

Out of the 49 banks in the sample, 28 banks are domestic, 9 are foreign affiliates of regional African banks, 7 are foreign affiliates of global multinational banks (MNBs) and 5 are foreign affiliates of emerging MNBs. Emerging MNBs tend to be the oldest banks to operate in East Africa (incorporated in 1965 on average), essentially Asian banks from India or Pakistan, followed by global MNBs (1985), and domestic banks (1992). The foreign affiliates of the regional African MNBs are the last entrants (2004), as expansion of regional African MNBs is a relatively recent phenomenon. In terms of size, as measured by the number of employees, domestic banks are the largest (1086 employees on average), followed by global MNBs (906 employees), emerging MNBs (211 employees) and regional African MNBs (183 employees).

Financing the SME segment: a relationship-based activity

The large majority of the surveyed banks explained that the sectorial allocation of their loan portfolio was driven by market conditions and demand. However, large banks (foreign and domestic) are still very conservative in

terms of the sector they finance. The three main industrial sectors to which banks lend are manufacturing, trade and construction and real estate. Many respondents pointed out that there is currently a boom in construction and real estate in the Kenyan market. However, if the focus on real estate is very strong for local banks, it is not the case for global banks because of their headquarters' reluctance in having a large exposure to real estate, given recent negative experience at home. Agriculture, despite being one of the largest sectors in East African economies, is relatively under-financed. Indeed, only 20% of the banks mentioned agriculture as one of the main sector in their loan portfolio and only 18% of the banks had special loan products targeted to this sector.

In terms of banks' portfolio composition, loans to large corporates represent on average 46% of total loans, followed by loans to SMEs (31%), loans to the retail sector (18%), to microfinance (4%) and others (cooperatives, etc.) (1%). However, the composition of the portfolio varies depending on the country of origin of the bank. Indeed, domestic banks tend to finance more the retail segment than other types of banks, while foreign banks are more heavily exposed to corporates (over 50%, against 38% for domestic banks). In fact, some foreign banks, such as Citi, only finance corporate and institutional clients. This is in line with the academic literature (Detragiache, Tressel, & Gupta, 2008; Gormley, 2007) that has underlined the existence of market segmentation in developing countries, with foreign banks mainly financing the top firms. However, the results also indicate that regional African MNBs and emerging MNBs have around a third of their portfolio allocated to SMEs, a proportion similar to that in domestic banks' portfolio, while for global MNBs, SMEs only represent 22% of their portfolio. In other words, the portfolio of regional African MNBs is more similar to that of domestic banks and more exposed to the SME segment. Rather than giving banks a predetermined size classification of firms, the survey directly asked banks their definition of SMEs. While most of the banks define SMEs according to the transaction amount or the turnover, the definition varies importantly between banks. For instance, the transaction amount for SME loans varies from 3,000 USD to 1M USD depending on the client and the bank. Some of the banks that were focusing on SMEs from the start (such as Equity Bank) have now some clients who have graduated from SMEs to corporates. Some of these corporates are then turning to more established, bigger banks such as Barclays or Citi, to service their expanding funding needs.

Banks generally hold a positive view on the SME segment, 71% of them considered that it offered good financing opportunities. However, banks face important constraints in expanding their portfolio of SME loans. The major ones are the lack of collateral (33% of responses), the lack of information (30%) – and, in the case of Tanzania, the lack of national identity document – and finally the lack of management capacity, or reputation of the SME (21%). Despite

these perceived obstacles, some respondents mentioned that their bank was disengaging from the corporate segment to reallocate their loan portfolio towards the SME segment which offers higher returns than corporates, due to high competition at the top.

Generally speaking, financing SMEs requires good monitoring and information systems, which depends on the operational capacity of the bank and can be costly to implement for smaller banks – contributing to increase overhead costs. Equity Bank, the largest bank by customer number in Kenya, is an interesting model in that respect. It started as a building society in 1984, then a microfinance institution and eventually transformed into a commercial bank. One of the particularities of Equity Bank is its Universal Banking Software which automatizes most of the decisions and helps relationship managers' tasks with respect to lending. Coupled with a very developed performance-based mode of remuneration, the system enables efficient screening and monitoring of retail and SME clients.

Given the restriction on loan concentration (25% of core capital to one lender), smaller domestic banks are not able to provide large loans, whereas big players can borrow offshore, which reinforces market segmentation. Indeed, 41% of the banks explained that the size of their capital base and limits on single borrower were major constraints to grow their corporate loans portfolio. A way for banks to overcome the capital constraint is to syndicate loans with other banks. However 41% of the banks interviewed said that they rarely or never participate in syndication. The large syndications in USD tend to be done offshore or by the big local players. To give an example, in 2012 the largest syndicated loan was for the Kenyan Government (600M USD), and it was arranged by Citi (lead arranger), StanChart and Standard Bank. Regional African MNBs tend to overcome their capital constraints by offering syndicated loans with affiliates of the same banking group located in neighboring East African countries, or in the large African economies (Nigeria, Ghana).

Access to cheap deposits is a challenge for domestic and regional African banks

All banks are heavily reliant on deposits (more than 80% of their funding). They also participate in the interbank market but to a lesser extent. While the large majority of the banks find access to the interbank market to be easy (83% of the banks consider that access to the interbank market is easy, somewhat easy or very easy), only 60% of the respondents consider that it is easy to gather customer deposits. However, this number hides significant differences between banks. Respondents of global MNBs perceived access to deposit to be easier than respondents of domestic and regional African banks. Indeed, a bit less than 50% of domestic and regional African banks surveyed considered that it was easy to access deposit whereas this number was close to 85% for global MNBs. The global brand of the latter helps them garner customers' trust and

attract customer deposits. Most of the respondents which perceive access to customer deposit to be difficult cited competition issues, followed by high interest rates to pay on deposit.

A centralized organization for credit management

How do banks manage credit risk in countries with low information and a weak judiciary system? One of the first element is that they tend to operate a very centralized organization of credit functions. Indeed, only the gathering of information and identification of clients and monitoring is devolved to branches. Very rarely do branches have the mandate to approve loans, which avoids leniency in lending approval. More than 80% of the banks surveyed have centralized all the loan appraisal functions at the headquarters, as well as the recovery functions. Appraisal decisions (assuming all the required documents are provided in time by the borrowers) are very quick, generally less than a week for SMEs and between 24-72 hours for personal loans. One bank manager of a regional African MNB actually mentioned that they were competing more aggressively on appraisal time than on interest rates. However, the actual disbursement of the loan can take much longer, on average 2-3 months from the approval decision as the loan as the banks need to secure title deeds from the land registry and it is a very lengthy and administrative process, not exempt from corruption. Another bank manager at an Indian bank mentioned that SMEs often proceed by “word of mouth”, with banks gaining reputation based on the swiftness of their appraisal and services. Loan approval can be slightly slower for foreign banks as they may need to get approval from their regional or global headquarters. Indeed, more than 75% of the global MNBs take a week or more to approve corporate loans, while this figure is 55% for regional African MNBs and 50% for domestic banks.

Rejection rates of loans applications are higher for SMEs (23% on average), than for corporates (18%) and personal loans (13%). Lower rejection on personal loans is due to the fact that banks essentially finance salaried employees. Banks generally sign Memorandum of Understandings with large corporates or public administration (Civil Service, Teachers’ Union) to provide loan facilities to their employees. Once an employee is offered a loan facility, the payment is directly deducted from his salary, which represents a low-risk and low-administration cost business for the banks. Rejection rates for SMEs are much higher for global MNBs (45%), regional African MNBs (30%) and emerging MNBs (27%) than for domestic banks (18%). This may be due to different risk appetites and also to different abilities to screen borrowers and manage risks in this particular segment. The main reason for rejection of SME loans is lack of satisfactory financials (88% of responses) and lack of good collateral (50%).

Assessing borrowers’ “character” in a low information environment

Since the Credit Reference Bureau (CRBs) regulations came into force on 1 February 2009, two CRBs have been established in Kenya: Credit Reference Bureau Africa Limited (2010), and Metropool Credit Reference Bureau Limited (2011). CRBs were often lauded by banks, but they sometimes faced challenges related to wrong information in database, or incomplete information. Some respondents also mentioned problems with reporting, and general understanding of the system at initiation. A CRB manager mentioned that it was actually quite difficult at the onset to gain trust and cooperation of banks. CRBs are now trying to collect positive information on borrowers, using, for instance, utility bills, but accuracy and availability of good data, in a digital format, is a real challenge. In Tanzania, the two CRBs have only been licensed recently and most of the banks are not using their services as yet.

Screening and loan appraisal are a mix of analysis of banks’ statements to identify a customer’s “character” (through analyzing how a customer manages his money) coupled with indicators such as age of the business or of the owners, and regular on-site visits. For SMEs, “character” of the customer was the most important factors in loan appraisal for 78% of the banks interviewed. In this market segment, relationship lending is often the norm, with intense follow-up, weekly communication via phone, and regular on-site visits. Banks tend to require collateral for SME term loans, but they rely more on information from bank account statements to make a judgment, partly because collaterals are extremely difficult to recover in case of default. To ensure repayment they often link with suppliers of the SMEs they finance. Concerning financing of large assets, such as the purchase of important machine from abroad, banks will sometimes pay directly the supplier of the machine. Credit scoring are being developed for SMEs and they might be even more prevalent when positive information sharing from CRBs is established. Credit scores are more often attributed to personal loans (58% of the respondents indicated that their bank use credit scores for personal loans) than to SME loans (52%) and large corporates (52%). Interestingly, emerging MNBs and regional African MNBs tend to make more use of credit scores than global MNBs. This may reflect the fact that the latter are less exposed to the retail and SME sectors, and more to large corporates, for which appraisal decisions are less easily reduced to a score and is more often based on good judgment.

27% of the banks interviewed offer uncollateralized loans to SMEs. It is mostly the case for domestic banks and regional African MNBs while none of the global MNBs interviewed offered uncollateralized SME loans. Banks offering these types of loans assess the ability to repay by examining bank statements. Some of them also explained that they use non-traditional collateral (land with no title deed), or obtain information from informal network (suppliers or customers of the SMEs, neighbors).

Mobile banking is also another operational innovation that has transformed the banking landscape. Banks are now working in partnerships with telecoms, and very few of the banks interviewed perceive mobile banking as a direct threat to their business while a large majority of them considered that it brings innovation and new services. 57% of the banks surveyed offer mobile banking service. This number is the highest for regional African MNBs (78%) while it is the lowest for emerging MNBs (40%). Once again, this is probably due to their loan portfolio profile, as mobile banking is predominantly offered to retail and SME customers, while this type of service is less used so far by large corporates.

A competitive environment with a slow judiciary but a friendly regulator

Competition and access to deposit were the two top challenges most often cited by banks. 80% of the banks interviewed perceived competition in the deposit segment to be strong or intense. Competition in the SME segment is also relatively stiff, with 66% of the banks evaluating the competition as strong or intense. For the corporate segment this number is over three quarter of the banks interviewed. For microfinance however, the majority of the banks (60%) considered that the competition was only moderate or light, which is related to the lower number of banks participating in this segment.

The regulator is generally perceived as being friendly to banks. 69% of the banks considered that the banking regulations were not or were only a minor obstacle to their business operations. In Kenya, the regulator is perceived as being accommodating and open to discussion with banks. Employment laws are not perceived as a problem, while the Court system generally is. Indeed, 68% of the banks interviewed considered that the court system is an important or extreme obstacle for their activities. Procedures in Court are generally very long, and it is only used as a last resort, which explains why collateral may not be the main element banks are considering when appraising a loan. In terms of skills, most of the respondents indicated that there is a large pool of skilled people, especially in Kenya, but retention of talent can be a challenge, as there is a strong competition for talents, especially in key sectors such as risk management. In total, a third of the banks interviewed considered that the difficulty to hire managers with the right skills was an important or extreme obstacle to their business, while 23% considered that it was a moderate obstacle. Global MNBs also rely heavily on local skills as most of their top management team is local. To a certain extent this local profile of global MNBs' top management is due to the fact that banks have to demonstrate to the Central Bank that they could not find the appropriate skills in the market, which, as a result, tends to favor local staff. Top managers interviewed also felt that there were

enough qualified local senior bankers to fulfill their need. In addition, expatriates package are expensive for banks. As a consequence, there is a general trend among global MNBs to reduce the number of expatriates and rely on local workforce as much as possible.

Conclusion

The preliminary results of this research has shown that foreign affiliates of regional African banks had lending practices that were more similar to that of the large domestic banks than of foreign affiliates of global MNBs. This is related to the fact that they have a greater part of their portfolio allocated to SMEs than global MNBs. They are also more inclined to take risk than global MNBs, willing to offer, under certain conditions, uncollateralized loans. As a consequence of a more significant exposure to the SME sector, they have also invested more heavily in information and monitoring systems and have developed credit scoring systems. In that respect, the expansion of regional African banks is good news for the SME sector. However, funding and lending constraints related to the smaller size of their capital base, the difficulty to access cheap deposit as well as the difficulty to rely on collateral when judiciary systems are weak are real challenges for these newcomers.

Adeline Pelletier is a PhD student in Economics at the London School of Economics (LSE) in London, UK.

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MAMBO! is edited by Marie-Aude Fouéré and Salimata Sow.