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## Financial sector policies for enterprise development in Africa

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### Abstract

This paper explores the key issues relating to financial sector policies for enterprise development, with special implications for Africa. The role of the formal financial sector – ranging from microfinance institutions, banks, the capital market, and regulatory agencies – is discussed with respect to enterprise development at all levels, including start-ups, small and medium firms, and large corporates. Specific policy choices for African countries are highlighted, including exploiting the current communications and information technology (CIT) revolution.

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### 1. Introduction

If there was full information about the creditworthiness of enterprises, banks would probably not exist. All finance would be ‘direct finance’, in the sense that lenders would finance enterprises directly without the need for banks (Diamond, 1991). Similarly, there would probably be no need to use money for transactions, since borrowing and financing would involve transfers of assets between wealth portfolios. Moreover, the vision of a world without banks (and money) may be contemplated in the context of the on-going communications and information technology (CIT) revolution. Electronic funds transfer is already replacing cheques and giro-based transactions. It is anticipated that electronic or digital wallets will replace physical wallets and purses containing bank notes and coins. Indeed, the process is well advanced in Kenya, where the M-Pesa system facilitates transfer of money using mobile phones, and elsewhere in Africa (Napier, 2011).

However, in most African countries rural enterprises are small, such that rural credit is problematic, given the challenge of delivering financial services to dispersed farming communities in remote areas. Small urban enterprises also suffer from ‘financial exclusion’ or credit rationing problems. Unlicensed money lenders exploit the opportunity to fill the gap and charge high interest rates.

To deal with the rural ‘financial exclusion’ problem, special initiatives such as mobile banking units and microfinance institutions (MFIs) have been invoked (Napier, 2011). The most famous example is the Grameen Bank set up by Yunus (2007). MFIs, along with other mutual financial institutions (e.g. Credit Unions and Community Development Finance Institutions, or CDFIs), have used state-backed loan guarantee schemes to resolve rural as well as urban ‘financial exclusion’ problems (Mayo et al., 1998). The schemes provide government subsidised loan guarantees to reduce banks’ exposure to credit risk, thereby encouraging greater bank lending to SMEs. It should be noted that loan guarantees can be targeted, with different levels of risk cover and subsidy, on different sectors of the economy in pursuit of industrial policy (e.g. encouraging lending to start-up and ‘growth’ enterprises in high-technology sectors) and social policy (e.g. lending to businesses led by women or particular ethnic groups and lending in deprived urban areas).

This paper explores financial sector policies for enterprise development, with reference to Africa. In what follows, the paper is structured into three sections. Section 2 discusses the role of the formal financial sector in enterprise development. The policy

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implications for Africa are highlighted in Section 3, while the concluding remarks are presented in Section 4.

## 2. The role of the formal financial sector in enterprise development<sup>1</sup>

According to corporate finance theory, enterprises finance their investment and growth using a combination of internal finance (retained earnings) and external finance (new equity issues, and bank loans or funds raised by issuing debt instruments including bonds).<sup>1</sup> Hence, the capital structure of most enterprises includes retained earnings (internal finance), debt and equity (Brealey and Myers, 2002). As enterprises develop, external finance is eventually required to foster faster growth. Internal finance, however, normally remains the major source of funding for on-going investment in all firms. Much less commonly, because of fear of loss of control; small private enterprises also accept investment from venture capitalists. This typically takes the form of equity investment by individuals ('business angels') or through a private equity fund, which pools the personal wealth of investors. In general, however, as explained in Mullineux et al. (2011), enterprises tend to have a 'pecking order' of financing choices; they prefer using internal finance before they resort to external finance and prefer debt finance to equity finance.

The overall goal should be to establish a financial system that allocates capital efficiently on a dynamic basis. To achieve this, effective bankruptcy laws are required (Kowalski et al., 2005) and the use of capital allocated by the financial sector should be continuously and efficiently monitored. An appropriate balance between the rights of creditors and debtors must be struck, so that entrepreneurship is not stifled and banks remain willing to lend.

Also, the financial sector plays a key role in corporate governance. As the allocator of debt and equity finance, the financial sector is a key stakeholder in enterprise development. It also has fiduciary duties to other stakeholders, namely those that have saved and invested their personal wealth in financial institutions. The infrastructure required for the efficient operation of a financial sector includes an effective corporate governance system, including financial regulation, to ensure that financial institutions manage their risk exposures and discharge their fiduciary duties appropriately. As the financial sector develops, the importance of institutional investors (pension and mutual funds and insurance companies) tends to increase relative to that of banks (Mullineux, 2011).

In most African economies, banks remain the major source of external capital for both large businesses as well as small enterprises, and indeed for the private sector and the economy as a whole. Debt finance thus tends to dominate equity finance, and bank debt (loan) finance dominates bond finance because it takes time to develop capital markets. Hence, it is important to ensure that the banking sector operates efficiently. The potential for

banking sector instability and its damaging effects have been illustrated by an ever expanding catalogue of financial crises, including the Global Financial Crisis (Reinhart and Rogoff, 2011). Hence, banks should monitor borrowing firms to ensure that the firms use capital efficiently and banking firms should themselves be monitored to ensure that they use their capital and the deposits they collect, and thus other peoples' monetary and savings balances, efficiently, non-fraudulently, and without taking excessive risks (Murinde and Mullineux, 1999). There is accumulating evidence that banking instability and subsequent recapitalisation of banks are expensive in terms of charges on state budgets and lost growth (Reinhart and Rogoff, 2011). Furthermore, fluctuations in growth and inflation have an impact on the balance sheets of firms and the asset quality of banks. Bank supervisors must take this into account (Murinde et al., 2011).

Also discouraging MSME lending, especially to smaller enterprises, is the 'fixed cost problem' (Mayo et al., 1998) that results from the fact that the costs of making a loan rise less than proportionately to the size of the loan and so, to control costs, bankers prefer to make a smaller number of larger loans, than a larger number of smaller loans. Smaller enterprises also commonly find it difficult to provide 'collateral', or security, against loans in order to gain cheaper borrowing rates. Those with little or no wealth essentially face 'financial exclusion' from banks and must consider instead the prohibitive borrowing rates charged by 'informal lenders'.

Where credit market imperfections exist, credit rationing faced by MSMEs is commonly addressed using government sponsored loan guarantee schemes, sometimes with supporting business skills training programmes. Financial inclusion, or access to finance, is addressed through the promotion of Community Development Financial Institutions ([www.cdfa.org.uk](http://www.cdfa.org.uk)); which provide microfinance in urban areas in the US and the UK (Mayo et al., 1998). Loan guarantee schemes are used to resolve the risk exposure problem faced by banks. Government backed funds. Schemes vary in the extent of the guarantee and the degree of state subsidy and which types of business (classified by size or nature area of business) qualify. Subsidised insurance premiums are commonly paid by firms in the form of a supplement to the interest rate charged by the lending banks, which normally manage the loans. The accumulated premiums rarely cover the disbursements from the fund resulting from defaults on loans, and hence government funding is required. By reducing banks' risk exposure, it is hoped that banks will be induced to lend more than they otherwise would to MSMEs and rely less on 'collateral' and other loan securities.

Schemes such as the UK's 'Small Firms Loan Guarantee Scheme' (SFLG) were introduced on an experimental basis with the objective of encouraging banks to engage in and learn the business of lending to small firms on the basis of projected cash flows; rather than providing overdrafts and relying on collateral to secure loans (Cowling, 2010). The amount of bank lending to SMEs under the SFLG Scheme was sensitive to the extent of the guarantee, and the take-up by SMEs, not surprisingly, seemed to be related to the size of the risk premiums charged and hence the degree of subsidy (Mullineux, 1994; Cowling, 2010). Failure rates amongst SMEs, especially

<sup>1</sup> We ignore informal financial sector 'money lenders' and the 'shadow' banking sector' (Pozsar and Singh, 2011).

start-ups, were relatively high (Cowling, 2010). This is in part due to the inexperience and lack of training of the managers and the difficulty of accessing good advice. Loan guarantee schemes are thus frequently linked to the provision of pre and post finance training and business development advice, as in the case of the Small Business Administration in the US.

An alternative to the US and UK models is the German system, which revolves around the government development banks (KfW) and regional guarantee banks. These are in turn supported by Chambers of Commerce (Mullineux, 1994; Mullineux and Terberger, 2006). The KfW provides implicitly subsidised medium to long-term loans to SMEs and helps underwrite loan guarantees extended by the guarantee banks. The implicitly subsidy results from the financing of the KfW by government backed, and thus, relatively cheap, bond issuance. The guarantees are also partially covered by state (Länder) governments. The German Chambers of Commerce provide expertise to help screen the loan applications. The originating banks are expected to screen the loans prior to applying for the guarantee and to manage the loans where guarantees are agreed. The process of screening the loans encourages the development by banks of expertise in MSME lending, and helps to facilitate the spread of best practice in screening loan applications by providing direct or indirect feedback from experts to banks on their screening processes. Thereby, the tendency for banks to rely too heavily on collateral to secure or underwrite loans is reduced.

Mutual and cooperative banks have emerged in many countries as vehicles for means of providing finance and education on money management. Cooperative banks have been formed to serve agricultural communities in many countries and have been prevalent in France (Crédit Agricole) and Japan (Norinchukin), for example. 'Raiffeisen banks' emerged in a number of European countries to service the needs of urban craftsmen. Like their credit union cousins (Mishkin, 2012, Chapter 12), which service the financial needs of households rather than enterprise, these mutually owned banks tend to operate through the pooling of savings for lending to members. In this way, information problems are reduced and peer pressure can help assure prompt and full repayment of borrowed funds. The original Raiffeisen banks were essentially urban cooperative banks, or business credit unions. The general principles of mutuality have also been applied to insurance and to the housing sector, through UK building societies and US Saving and Loan Associations, for instance. The co-operative banking sector is particularly strong in Germany (Mullineux and Terberger, 2006). Internet based group lending schemes amongst households, such as Zopa, and to firms, such as Thin Cats, have also emerged in the UK recently (Davis, 2012).

An important component of the formal financial sector with respect to enterprise development is venture capital. Venture capitalism involves the provision of equity capital for the start-up and development of enterprises (Smith and Smith, 2000; Lerner et al., 2009). The capital is normally raised from investors in the form of a fund, which is used to make private equity investments in business 'start up' and early stage growth businesses.

There is also growth in private equity investment in SMEs by rich individuals, or 'business angels' (Smith and Smith, 2000; Lerner et al., 2009; Davis, 2012). The private equity investors essentially provide capital to supplement that invested by the initial entrepreneurs and normally require, in return, influence over the way the businesses is run. Taking on private capital from outside is thus a big step for MSMEs because it entails dilution of their control over their enterprises.

It is important to ensure that the tax system is conducive to the provision of private risk capital, both by insiders ('entrepreneurs') and outsiders. It is also important that firms and private investors wishing to re-invest profits, rather than take them out of their businesses, are given a fiscal incentive to do so. This may justify setting a capital gains tax at a lower rate than on profits tax.

To encourage the participation of business angels, access to information on potential clients is also important. A government business support agency, possibly the state development bank, could help construct a database to be accessed via the Internet, for example. There may also be an important role for business support agencies in fostering the supply of private equity or venture capital. Development banks could adopt a market development role here, perhaps through co-financing or through a dedicated fund. This is a role which the European Investment Bank ([www.eib.org](http://www.eib.org)) has recently been assigned. As the venture capital market becomes established, development banks would be expected to withdraw after spinning off, or winding down, active funds.

The central bank should encourage banks to share information on credit risks in order to reduce the level of bad lending in the banking system. Increasingly, venture capital funds and business angels in more developed economies are looking abroad for opportunities. The funds are likely to become a growing source of foreign investment if the tax incentives and legal infrastructure are conducive and could play a key role in enterprise restructuring programmes. There is a tendency for older and larger venture capital funds (VCFs), to withdraw from start-up and early-stage investments and to concentrate on investing in growth enterprises and 'high-tech' sectors. Meanwhile, the focus of Private Equity Funds (PEFs) is increasingly on financing management 'buy-outs' and 'buy-ins' (Lerner et al., 2009). Whilst PEFs perform a useful role in the corporate restructuring process and the financing of enterprises, a gap in small enterprise equity finance can emerge. For this reason a sympathetic tax regime should be retained to encourage 'business angels' and new entry into the venture capital business, including 'crowd funding', and a government sponsored development bank that might maintain an interest in providing start-up capital, alongside loan guarantees perhaps, in the medium term.

Just as MSMEs are likely to graduate from being financed by friends and family and CDFIs, to bank financing; successful 'growth MSMEs' will outgrow business angel and venture fund financing. The investors in the VCFs and PEFs will want to liquidate their investments, take their profit, and re-invest in the next batch of growth and high-tech SMEs after a few years. At this stage, it is common for the private SMEs to become fully public shareholder owned companies. This can

be achieved through ‘stock exchange floatation’s’ (‘initial public offerings’, or IPOs) and ‘trade sales’ to larger companies. IPOs involve the sale of shares to the general public so that the private capital providers can redeem their investments and take profits. They can then reinvest some of the capital by purchasing shares in the public company. Hence, private equity funding is active in countries with well-developed capital markets that can provide the private funders with an ‘exit route’ in the medium term.

Another important component of the formal financial sector with respect to enterprise development is the development of money and capital markets. It should be emphasised that it takes a considerable amount of time to develop well-functioning capital markets. A sound regulatory and supervisory framework needs to be in place and buyers and sellers in the market will not have full confidence or trust in it until it is tried and tested. As confidence gradually grows, then more and more buyers (investors) and sellers (issuers) of primary securities will come to the market and its liquidity and stability will increase as a secondary market develops and holders of portfolios of shares trade some of their shares. This cannot be achieved by decree. Foreign portfolio investment can help deepen markets if a country’s the ‘Capital Account’ has been liberalised, but capital can flow out as quickly as it flows in, causing large swings in stock prices. Further, money will not flow in if there is a fear that it cannot be taken out again. Transparency, sound regulation and vigilant supervision are important means of encouraging foreign investors to take the additional risks, including exchange rate risks and political and country risks, of investing overseas. It is not just financial risks and economic stability that matters, capital inflows and outflows are as much, if not more, affected by the level of political stability (Dickinson and Mullineux, 2001).

Indeed, there are some lessons which the emerging stock markets can learn from the experience of the more developed markets, such as the London Stock Exchange, in terms of their potential for financing enterprises as well as the impact of government intervention in the market (see Green et al., 2000). The attractiveness of the shares will of course depend on how well the state owned enterprises have been financially and organisationally restructured prior to privatisation. This is as true of banks as non-financial firms and, as mentioned above, it is important that plans are in place to deal with any outstanding bad debt problems, or, preferably, that such problem have already been resolved. The growth of the life insurance sector and the creation of funded pension schemes will help to ‘deepen’ the capital markets by creating a relatively stable demand for equities and government and commercial bonds to satisfy the long-term portfolio needs of such institutions. Price index-linked government bonds can provide protection against inflation and help discipline issuing governments.

The costs of complying with stock exchange registration requirements may, however, discourage initial public offerings (IPOs) by ‘growth MSMEs’. For this reason, some industrialised countries have developed special stock markets, such as AIM (the Alternative Investment Market) in London and NASDAQ in New York. These are designed to attract IPOs by ‘growth

MSMEs’, which may later hope to graduate to the main stock exchange. Generally, such exchanges have a lighter regulatory regime, with reduced reporting requirements that are less costly to comply with. Such specially designed stock markets increasingly provide the exit route for private investors. As the capital markets develop towards the stage reached in the US in the 1990s, and by the countries participating in the Economic and Monetary Union in Europe in the 2000s, ‘junk bond’ markets may develop. Junk bonds are issued by companies judged by Credit Rating Agencies to be below the ‘investment grade’ credit risks associated with low risk borrowers; the bonds have relatively higher and uncertain credit risks and offer higher rates of return for investors in compensation.

In the more advanced stages of financial sector development, markets in financial derivatives (swaps, options, etc.) may emerge and domestic banks may offer customised ‘over the counter’ derivatives (Fabozzi et al., 2010, Part IX). Financial derivatives facilitate the hedging of risks, as well as speculation. They are useful tools for asset and liability risk management by banks (Casu et al., 2006, Part 3) and other enterprises, but it is by no means clear that countries should rush to develop their own domestic derivative markets, given that they are accessible through international financial centres operating with economies of scale, and are highly risky. To further facilitate asset and liability management by banks, the ‘securitisation’ of loans developed increasingly rapidly in the US and UK during the 1990s, with mortgage-backed securities (MBS) becoming particularly prevalent (Fabozzi et al., 2010, Part VIII). Securitisation involves issuing bonds backed by receivables (interest and principal payments) from a package of loans that have already been originated. Further packaging of MBS into derivatives, namely Collateralised Debt Obligations (CDOs), along with the mispricing of the risks, was at the heart of the ‘subprime crisis’ that generated the 2008–2009 GFC (Shiller, 2008). Securitisation consequently fell from favour in the wake of GFC, but it is likely to revive when confidence returns.

However, a word of caution is in order. Financial sector liberalisation has been undertaken in order to remove ‘financial repression’ and hence enhance the role of banks and financial institution in enterprise development. However, even in the most advanced and liberalised financial sectors, including the US and UK, there remain well documented impediments to the flow of credit to micro, small and medium sized enterprises (MSMEs) (Mayo et al., 1998). Also, gaps have been identified in the supply of equity finance to MSMEs (see Bank of England, [www.bankofengland.org.uk](http://www.bankofengland.org.uk), OECD, 2006/2007; UN, 2009). The major market imperfection is ‘asymmetric information’, the implications of which are discussed clearly and succinctly in (Mishkin, 2012, Chapter 8). Asymmetric information can explain the very existence of banks, and why they need to be regulated. It also explains why MSMEs face rationing in the supply of credit, or ‘credit rationing’, as a result of the ‘adverse selection’ problem. It is costly to collect and process the information necessary to select the least risky borrowers, or to ‘screen’ them, and it also costly to ‘monitor’ their use of the borrowed funds. One response is to ration the supply of credit to MSMEs (Stiglitz and Weiss, 1981).

### 3. Formal financial sector policies for SME development in Africa

In many African countries, money transfer systems (MTS), based on mobile phone networks, are well advanced and widely trusted (e.g. M-Pesa in Kenya). With higher grade smart phones and networks, a cashless and largely wireless and contactless, payment system, akin to the prepayment system piloted at the London 2012 Olympics, could be developed. As information on credit worthiness is collected, prepayment based systems could be replaced by transfers between bank accounts, if the banks joined forces with the telephone companies ('telecos'), and based on credit from banks.

The mobile phone based payments technology could 'leap frog' the plastic card magnetic stripe, and more expensive, 'chip and pin' technologies which are currently used for pre-payment cards, debit cards, charge cards and credit cards, as well as the use of paper (bank notes and cheques) and coins, which would increasingly become redundant. A digital mobile phone and computer based payments system would be significantly cheaper than plastic card and paper based systems and would encourage commerce by reducing transactions costs. Information is the key to developing an efficient financial system based on 'e-money' and 'e-commerce'. Most important is information on credit worthiness. The financial system as a whole will function much more effectively if all relevant credit information is shared, subject to adequate data protection procedures to assure confidentiality. National central banks, with the support national development banks, with the African Development Bank advising on best practices, would oversee the development of databases on credit scores.

Financial systems in Africa tend to be dominated by big banks, with capital (bond and equity) markets at a much earlier stage of development. Insurance products are available, but again the insurance markets are not highly developed, especially as regards re-insurance, and private and company pension's provision is patchy. To facilitate the development of insurance markets, sharing of information on insurance risks should also be encouraged.

Capital markets are used by larger firms to raise debt and equity through bond and share issuance. The development of capital markets takes time as it is based on accumulation, through public reporting, of information on companies over time and the establishment of trust. The supporting structure of financial institutions includes market making, providing advisory services and underwriting, broking and fund management. These services earn fees, which can be substantial. Fees are also paid to accountants, auditors, lawyers and other providers of professional services. Also are the costs of regulation and supervision to ensure that insider dealing, based on privileged information, and fraud, do not result in financial instruments being traded at manipulated prices.

Microfinance is less well developed in African countries than in many other emerging markets (Napier, 2011) and rural banking provision is also patchy. Experiments with rural-cooperative based banking have often been less successful than elsewhere. Mobile bank branches have been used with some success in

South Africa, though the aforementioned mobile phone based technology could make it redundant if information on credit worthiness can be collected and shared.

For the banking system to function efficiently, a well functioning wholesale interbank market is essential to enable banks with surplus funds can lend them to banks that have greater lending opportunities. Retail savings banks tend to generate surplus funds, whilst more commercial lending oriented banks tend to have insufficient retail deposits to fund their potentially profitable lending opportunities. The national central banks naturally foster the development of interbank money markets based on bills issued by the central bank ('bank bills') or the government ('Treasury bills'), because they are necessary for liquidity and interest rate control and the stability of the payments system based on interbank transfers. As the GFC has demonstrated, however, wholesale interbank markets can seize up when banks cease to trust each other because they are unable to assess 'counterparty risks' Information on the credit worthiness of banks, and telecos, companies, is thus required to underpin the system. This requires information from credit rating agencies related to their asset quality, and from prudential supervisors, probably most credibly and appropriately the national central banks, who assure their capital and liquidity adequacy. Once the information sharing requirements are fulfilled, African countries have another opportunity to leapfrog older and more costly technology.

Given that many African countries are well advanced in developing and using the information based money transfer technology that underpins these network based lending and investment systems, there is great potential to use them to provide financial services to households and MSMEs. In many countries, Internet banking has been used successfully to provide payments services and collect savings deposits too. These low transaction cost network-based financial products, services and markets must be operated by trusted suppliers, which need not necessarily be the traditional banks. A key role of the financial services suppliers is to collect the necessary information on the credit standing of the investors and borrowers and any additional information required for the successful 'match making' of lenders and borrowers, and to post accurate and timely information on financial instrument prices to facilitate fair trading. Access to a credit standing database and diligent data protection and appropriate freedom of access to non-confidential information is required.

The network-based systems will need to be regulated and supervised to assure fair pricing and the protection of depositors and other savers. There must be careful regulatory screening to avoid the emergence of Internet based fraudulent 'pyramid' and 'Ponzi' savings and investment schemes, in particular. The non-deposit taking operators might however expect to be allowed to operate with less expensive, 'light touch', regulation. State intervention will then only be required to fill the financial gaps to deal, for example, with the subsidised provision of essential financial services, including insurance, to the 'un-bankable' poor, and to stimulate infrastructural investment to provide 'public goods', which the private sector cannot be expected to finance in full.

There is thus a great opportunity for countries in SSA to take advantage of recent electronic digital SSA banking and wider

financial systems have embedded within them old fashioned foreign banks from former colonial days and newer arrivals, such as Citibank from the US. A number of these banks and other potential entrants have creaking information technology (IT) systems in which their problems have been aggravated by mergers with banks using different IT systems, making integration difficult. Standard Chartered and HSBC, and indeed Citibank and the major South African banks, such as Standard Bank, FirstRand Bank and the Absa Group, may be different because they have experience of managing dispersed international operations.<sup>2</sup> African countries have an opportunity to largely bypass costly cheque clearing systems and cash machine (automated teller machine, or ATM) networks based on paper technologies, and also plastic card based technologies, and to promote cashless, mobile phone network and Internet based, digital money transmission systems. These facilities can be extended to savings mobilisation, lending and credit and equity financing, gaining a cost advantage over the traditional banking institutions.

If African countries are to be successful in this brave new cashless and digital finance world, the MTS must be regulated as a utility to assure, as far as possible; universal access, absence of monopolistic power, data protection and freedom of information, and the reliability of the underpinning IT infrastructure; and generally that customers are treated fairly by the providers of MTS and other financial products or services, to ensure trust. The providers seem likely to include telecoms in conjunction with banks and other financial institutions; including market makers, brokers, fund managers, and insurers. Those wanting to compete in the digital financial arena will have to invest in reliable and up to date IT equipment and governments will have to make sure the networks are regulated and supervised. There will also be a need for well-trained IT operating staff alongside staff well trained in banking and financial services, lawyers and auditors. Well trained and competitively remunerated supervisors will also be required.

To enable banks to mobilise deposits and underpin banking stability, funded deposit insurance schemes with risk related premiums are recommended (Diamond and Dybvig, 1983). The premiums charged to banks need to be related to the riskiness of the banking assets in which they are invested, so that banks that invest deposits in more risky assets, pay more for their insurance. Effectively, risk taking is taxed, as long as the premiums are paid up front into a fund; which can be used to finance the ‘resolution’ of failing banks and thus to protect the taxpayer. Flat rate, non-risk related, premiums based schemes encourage banks to game the system by taking more risks than they are paying to have insured, at the expense of others. Such banks have an incentive to pay higher interest than competitors to attract depositors, creating an adverse selection problem. Unfunded schemes, which are generally preferred by big banks who claim they will never

draw on the scheme because they are ‘too big (to be allowed) to fail’ (TBTF), are unlikely to work since, when the ‘hat’ is passed round, the ‘good’ banks are likely to complain that they cannot afford to contribute and that the system it is unfair. TBTF, or strategically important, banks should either be broken up, so they are no longer TBTF, or forced to pay for their implicit insurance by taxpayers; by contributing to the deposit insurance fund, and also through holding supplementary capital, as proposed by the Basle Committee on Banking Supervision and the Financial Stability Board.

To stimulate traditional bank lending to MSMEs, loan guarantee schemes are widely used in developing country and recommended for Africa. The existing provision of loan guarantees in Africa is generally through national development banks and, is patchy. Policy leadership often comes from multinational institutions, such as the World Bank and the ADB. In developed countries success with loan guarantee scheme is mixed. Germany, through KfW, its development bank, and the US, through the Small Business Administration, provides examples of good practice, but the UK experience has been mixed. Cowling (2010) evaluated the long running Small Firms Loan Guarantee Scheme (SFLGS), which has been succeeded by a rapid succession of new initiatives since the onset of the credit crunch in 2008. There has been insufficient time for these to become embedded and seriously evaluated.<sup>3</sup>

#### 4. Concluding remarks

In conclusion, African countries have a wide range of financial sector policies to engender and sustain enterprise development. We highlight the key options below.

Government intervention, in the form of regulation and supervision of the wider financial sector and in the provision of funded and risk related deposit insurance and loan guarantees and other MSME business support services, is necessary to counteract market failures caused by information asymmetry and fixed-cost problems in African countries. However, market-led ‘financial reforms’, with the pace financial innovation regulated, but making full use of the latest mobile phone network and Internet technologies, are the key to the evolution of the financial sector and enterprise development. The private sector should be brought into partnership with the government to assure widespread access to finance and markets should be conditioned by ‘incentive compatible’ solutions, including risk-related capital adequacy requirements and deposit insurance premiums.

Central banks, especially where they have a regulatory and supervisory role, can guide financial sector development whilst

<sup>3</sup> Lessons from the UK (Cowling, 2010; Mullineux, 1994) are that banks generally find the scheme cumbersome and do not want to bother with the paperwork and SMEs are put off by having to pay a high premium for insured loans. The higher the guarantee to the banks offered by the scheme, the more the banks use it, the lower the premium and thus the greater government subsidy, the more SMEs want to use it. The government of Japan has varied its multiple loan guarantee schemes to stimulate bank lending to SMEs since the collapse of the Japanese ‘bubble economy’ (Bayoumi and Collins, 2000) in 1990, and again in response to the GFC. Its experience is reviewed by Nishada (2010).

<sup>2</sup> In 2012, IT based payments system failures in the UK at RBS (NatWest Bank and Ulster Bank) and Nationwide, a large nationally networked building society, demonstrated the costly operational and reputational risks banks face through mismanagement of IT based money transmission systems (MTS). However, there were also significant ‘outages’ due to IT system failures, at the UK telecom operators O2 and at Orange, and at ‘BlackBerry’ in the UK in 2012.

attempting to control inflation and maintain financial stability. National and multilateral development banks can help fill financing gaps resulting from market failures until they can be plugged through financial sector development. The development banks can also help with the financing of infrastructural development, but should progressively withdraw as the financing gaps are closed and as bond and equity markets develop.

Banks should continue to play a leading role in promoting the growth of enterprises, especially the MSMEs, and bond and equity markets will become increasingly important for larger firms in emerging market economies. However, the important role played by mobile phone networks in Africa's payments systems, such as M-Pesa in Kenya, suggests that there is likely to be a strong symbiosis between banks and telcos built around network-based phone and computing technologies (Napier, 2011). Davis (2012) provides a review of what is already being achieved in the UK by Internet based technologies in circumventing banks in business lending and equity finances. Information on credit worthiness and digital technology, rather than cheques and paper money, and plastic cards hitherto dominated by traditional banks, underpin these financial innovations. If the banks in Africa want to grow, they should consider joining forces with telcos and adapt their mode of doing business.

Pending the development of domestic capital markets, or access to international capital markets, development banking will remain important for funding long-term investment and infrastructural projects. Developing country governments will also continue to use development banks to tap into international capital flows by offering co-financing prior to the development of fully fledged capital markets. The national development bank, or some other agency, should also develop loan guarantee schemes and provide training and other services to managers in the MSME sector. In other words, development banks should focus on addressing market failures. As the market failure in the provision of long-term capital to larger enterprises declines in importance, because access to capital market financing increases, the development and commercial banks should increasingly focus on meeting the needs of MSMEs, for it is MSMEs that will be the engine for future development. It seems likely that the banks will increasingly operate in partnership with telcos, which already have a strong and growing foothold in payments systems in Africa.

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