Chapter 3

FINANCIAL SECTOR REFORM AND DEVELOPMENT IN SIERRA LEONE

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3.1 Introduction

Financial instruments, firms, and markets influence saving rates, investment decisions, technological innovations, and long-run economic growth rates. From a functional perspective, financial systems perform five basic functions which have been highlighted in the finance and growth literature (see, for example, Levine 1997). Namely, they

1. facilitate the trading, hedging, diversifying, and pooling of risk,
2. allocate financial resources among competing users,
3. monitor managers and exert corporate control,
4. mobilize savings in all the geographical areas they serve,
5. facilitate the exchange of goods and services.

The performance of these functions then affects economic growth by increasing the incentives for capital accumulation and technological innovation. In their day-to-day activities the firms and individuals in financial systems can be observed advising clients, structuring and arranging deals, providing finance to borrowers and equity issuers, and managing funds and investments of individuals and so-called institutional clients.

The available evidence indicates that countries with larger banks and more active stock markets grow faster over subsequent decades even after controlling for many other factors underlying economic growth. Industries and firms that rely heavily on external financing grow disproportionately faster in countries

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with well-developed banks and securities markets than in countries with poorly developed financial systems (see Levine 1997; Demirgüç-Kunt and Levine 2008). There is some element of reverse causation as well. In other words, economic activity and technological innovation affect the structure and quality of financial systems. Financial development will also be affected by innovations in telecommunications and computing, and by legal and political institutions of countries (see Levine 1997; Demirgüç-Kunt and Levine 2008).

The most developed financial systems are generally international in their scope, so-called *international financial centres*. At its most dense a financial centre will actually be a form of cluster containing a substantial number of fair-sized financial services firms, major international accounting firms, as well as legal services and telecommunications and computer engineering firms (including consultancies). The financial services firms in such a centre will be highly diversified with some of them engaged in activities covering the whole spectrum of activities in major areas like banking, securities, foreign exchange trading, insurance, derivatives, fund management, and various specialized professional financial services. Such a financial centre will often be an exporter of financial services as well, in addition to responding to local demand for such services (see Johnson 2009a).

As with so many institutional and organizational developments, financial systems emerge and develop via a mixture of spontaneous order and central direction or official policies. Many writers have raised the question of what the structural factors that make for a reputable world-class financial centre are, apart from simply being a developed financial system. One publication (Securities Industry Association 2007) lists the factors as follows:

- open and fair financial markets;
- free flow of capital and a convertible currency;
- skilled workforce/flexible labour laws;
- prevalent use of a globally familiar language;
- fair, transparent, efficient legal and regulatory regime;
- sound and fair tax regime;
- implementation of international standards and best practices;
- low cost of doing business;
- high-quality, reliable and appropriate physical infrastructure;
- stable political and economic environment.

This implies that countries that want to foster the emergence of highly developed world class financial systems must find ways to create environments which have these characteristics.

In this paper, we outline a strategy for financial sector reform and development, starting from a very rudimentary financial system as that currently existing in Sierra Leone, which builds on the stock of international knowledge and experience. We focus, especially, on getting the fundamentals right, the need for a well formulated and appropriate regulatory strategy, and key policy areas in the first steps in the financial market development process.

3.2 Social Efficiency

An overarching goal of financial sector reform and development is to create an environment that would permit the emergence and sustainability of a socially efficient financial sector, in both a static and dynamic sense. Static efficiency means that, given the institutional framework, the tastes and preferences of the individuals in the society, as well as the distribution of wealth, the resources employed in the financial sector cannot be reallocated in such a way as to improve someone's welfare without making someone else worse off; in other words, there is intra-sectoral efficiency in resource allocation. Static efficiency also implies intersectoral efficiency. That is, given the same underlying structural factors (institutions, tastes and preferences, and wealth distribution) the resources employed in the financial sector should not be more productive elsewhere in the economy nor should there be resources that are employed in other sectors that are more productive in the financial sector.

Dynamic efficiency means first of all that institutional changes affecting the financial system are made when the changes yield greater benefits than they cost (in the sense of opportunity cost). Institutional changes involve changes in the rights and obligations which control/regulate economic relations among persons, namely,

(i) property rights,

(ii) norms, rules and conventions of behaviour,

(iii) types of contracts.

Dynamic efficiency not only implies institutional changes, in a formal sense, being made when they are beneficial to make, but also that the degree of enforcement of institutional arrangements will be increased up to the point where the marginal cost of additional enforcement becomes equal to the marginal benefit.

Institutional changes are not the only modifications that are required from time to time. Starting from some equilibrium, the returns to resources allocated among sectors can change over time because of changes in the environment including changes in relative prices. Dynamic efficiency requires that resources be mobile among sectors and thus are able to respond to changes in opportunities. Indeed, dynamic efficiency requires equality in risk-weighted rates of return to investment in firms and activities within the financial sector and among sectors of the economy.

In assessing whether or not a financial system is efficient or facilitates efficiency, one can use certain direct and indirect indicators. One can group these indicators into those that relate to

(i) the institutional environment,

(ii) market structure and size,

(iii) the nature, level and evolution of transaction costs.

3.2.1 Institutional Environment

The institutional environment is the most important of these factors because institutions both enable and constrain crucial actions. Hence they are major determinants of the incentive structure. The institutional structure specifies the conventions and codes of conduct, the freedom to contract, and the property rights structure (ownership rights, rights of transfer, appropriability of earnings from one's assets, the internalization of costs and benefits from one's activities). This is one reason why the legal and the regulatory framework are extremely important. So also are clubs and associations (e.g. forex clubs, bankers' associations, accounting associations, etc.). Hence either by law, by negotiated agreement, or 'tradition', institutional arrangements evolve or are designed to enhance the efficiency of the financial system by facilitating certain transactions, reducing transaction costs, and integrating otherwise segmented markets. Such institutional arrangements specify, for example:

(i) rules, codes of conduct including fiduciary obligations, and procedures in interactions;

(ii) uniform guidelines in formulating different types of contracts;

(iii) uniform standards and measurements for commodities and services;

(iv) assessment and evaluation standards (credit ratings, etc.);

(v) common technical language in communications, common value dates for money, exchange, and securities transactions, and uniform computer codes and languages for financial transactions;

(vi) chart of accounts for use by banks.

These factors, in turn, promote well-functioning and orderly competition, exchange, intermediation, and arbitrage.

3.2.2 Market Size and Structure

The social efficiency of financial markets tends to be enhanced

(i) the more competitive markets are,

(ii) the higher the level of expertise of market participants,

(iii) the more internalized costs and benefits are so that market participants capture a high fraction of the flow of wealth (net of externalities) created by their actions,

(iv) the more quickly market participants respond to price signals using efficiently all the information at their disposal.

Market size and structure affect each of these characteristics of the market (competitiveness, participants' expertise, internalization of costs and benefits, and response elasticities). There are also often economies of scale which accrue as the unit size of financial transactions increases or as the absolute size of a total market increases.

In investigating the contribution of market size and structure to the social efficiency of the financial system, one would tend to look at a number of indicators. These would include

(i) barriers to entry (hence openness of the market),

(ii) the degree of segmentation of the market for a particular asset (e.g. government securities, foreign exchange) across regions or across groups of firms of the same country,

(iii) the number of firms in a particular market,

(iv) the stock of financial assets held relative to GDP,

(v) the variety of financial instruments in the market,

(vi) the diversity of participants (brokers, dealers, market makers) and the degree of specialization by functions and by assets,

(vii) the extent to which a market is privatized or at least the degree to which organizations are profit-seeking and have autonomy and accountability in decision-making.

3.2.3 Transaction Costs

Transaction costs in financial markets show up as buying and selling spreads, commissions and brokerage fees, various kinds of service charges, insurance costs, and risk premiums. These represent the costs of making computations and of record-keeping (e.g. labour time used in paperwork and accounting), acquiring and processing information, assessing risks (including the credit standing of counterparties in transactions), measures taken to deal with residual risks (including insurance), enforcing contracts and agreements (e.g. monitoring and policing agents and counterparties), and policing property rights in general. They also reflect basic marketing and other costs involved in the business of intermediation – the essence of much normal activity in private financial markets.

Transaction costs reflect genuine opportunity costs of resources used in transacting and such costs can be reduced by institutional reforms or modifications of market structure. In other words, the level of transaction costs in relation to the total value of the commodity being transacted partly reflects the state of development of financial markets and of the supporting infrastructure in the economy at large (communications facilities, computer facilities, adequately trained personnel, etc.).

3.3 Developing the Financial Sector in Sierra Leone

Sierra Leone is at a very low level of financial development. A country of about 6 million people, with a per capita income of around US$315, Sierra Leone currently has 13 commercial banks, 9 community banks, 9 insurance companies, 3 housing finance companies which are non-deposit taking, 2 savings and loans, the Finance and Trust Corporation, 2 discount houses, some 42 foreign exchange bureaus, and 6 microfinance institutions, also non-deposit taking. Total bank assets at end-2010 were equivalent to US$582 million. The Bank of Sierra Leone further lists the National Social Security and Insurance Trust and the Sierra Leone State Lottery as non-bank financial institutions. A stock market was launched on 18 July 2009.

Sierra Leone has a fairly liberalized financial system. Interest rates and exchange rates are market-determined, there are no selective credit controls, and despite the fact that the largest commercial bank is state-owned, the banking system is not government-dominated in its activities. But there are cash and liquidity requirements, which banks have to follow, constraining somewhat the structure of banks' asset portfolios.

3.3.1 The Challenges

Banks in Sierra Leone are small (assets averaging about US$45 million); efficiency is low (non-interest expense averaging about 10.1% of total assets, and interest rate spreads some 10.8 percentage points); there is high concentration in the banking sector, despite recent improvement (the three largest banks hold about 54% of total assets); and the skill and experience level of bankers are deemed low on average. The new stock exchange will take some time to get a significant number of listings.

Soundness of the financial system is in some question, although it is not in any danger of crisis. The capital–asset ratio of the banks, for example, is good (about 17%), but non-performing loans are a problem – tending to hover around 16% in recent years.

The state of banking supervision is still rudimentary. Certainly one does not see any attempt to explicitly organize the approach to assessing the soundness of a financial firm and its management around risks and risk management, which in turn would stress the importance of clear understanding of financial risks and optimal assignment of the responsibility for managing the risks, namely liquidity, credit, interest rate, market, foreign exchange, operational, sovereign, legal, and fraud risks. All in all, the regulatory strategy is in need of a focused, coherent, modern approach.

The payment system is very rudimentary, with no interoperable ATM system, no widespread credit card use in domestic payment transactions, no significant use of checks or internet banking, and of course no electronic large value payment system. There is also no credit rating agency.[1] Although there is no generally available empirical evidence on the matter, it is also very doubtful that the commercial banks have the data and the sophistication to have developed internal processes that go beyond so-called traditional approaches in credit risk management, in general, and for most of them so-called 'expert systems' among these traditional systems.[2] Furthermore, the normal financial markets (short-term credit, medium and long-term credit, foreign exchange, etc.) are very rudimentary and not well functioning.

There is a lot of work to be done on what we shall call 'the fundamentals' in Sierra Leone. We shall mean here, in particular, the innovation system, human capital, financial capability of the populace, infrastructure and public

[1] The 2011 *Credit Reference Act* provides a framework for the establishment of credit reference bureaus. Until such bureaus come into existence, the Bank of Sierra Leone is authorized by the Act to create a credit reference division at the Bank to perform the functions of a credit reference bureau.

[2] Saunders (1999) classifies the traditional approaches into *expert systems*, *rating systems*, and *credit scoring systems*. In the first, *expert systems*, the credit decision is made by the local lending officer who typically makes recommendations to some loan committee. The officer in making a recommendation takes into account the so-called five Cs, namely, character, capacity, capital, collateral, and cyclical or economic conditions (see Saunders 1999, pp. 7–9). This approach is criticized for not ensuring consistency and objectivity across clients, offices and types of borrower. *Rating systems* could vary enormously. Banks' internal rating systems differ in sophistication, depending on the data available (quantity and quality), the training and skills of the staff of the firm, and other resources (computers, libraries, and research budgets) devoted to the effort (see, for example, Stephen and Fischer 2002). Their models seek to foster consistency, transparency, and objectivity in credit ratings. The effort involves building databases, benchmarking, constant review, and backtesting. The models use financial and market data, sector-specific information (data and variables), and qualitative information. In decision-making on rating grades, they estimate probability of default and loss given default (and hence expected loss from a loan to a counterparty), as well as migration potential, which is the probability that the credit rating of the counterparty will change to some other rating grade (AAA, Aa, A, Baa, Ba, B, Caa–C, for example) from one period to another. The objective of *credit scoring systems* is to identify important variables affecting the probability of default and weighting them into a score. Thus, the credit scoring system can be used as an element in the rating system. Another way to look at it is that one can fit a model for default probability as a function of several variables and then use the coefficients as weights in determining credit scores. A simple well-known example of a scoring model (the Z-score model) is that of Altman (1968) for commercial loans, where Z is a function of the ratio of working capital to total assets, the ratio of retained earnings to total assets, the ratio of earnings before interest and taxes to total assets, the ratio of market value of equity to book value of total liabilities, and the ratio of sales to total assets.

services, various factors affecting microeconomic incentives to enterprises (openness, taxation, administrative barriers, legal environment), and general governance (macroeconomic policies, socio-political governance, compliance with international standards and codes).

Moreover, in Sierra Leone, all the financial markets are rudimentary in their development and operations. This reflects especially the weak fundamentals. In addition, the financial sector associations, including the bankers’ association, are not well functioning.

3.3.2 The Authorities’ Financial Sector Development Plan

The financial sector development plan (FSDP) of Sierra Leone emphasizes eight major areas:

(i) building commercial banking sector capacity;

(ii) increasing access to finance;

(iii) improving mobilization and investment of long-term funds;

(iv) strengthening banking supervision and regulation;

(v) improving the macroeconomic environment, *inter alia* to bolster financial system stability;

(vi) modernizing the payment system;

(vii) strengthening short-term financial markets and monetary policy;

(viii) strengthening the central bank infrastructure.

The action plan of the FSDP does not include any form of sequencing of policies. Such an approach would be useful, based on forward-looking effective demand calculations, budget constraints, and other elements of implementation capacity. The role of the actors responsible for the implementation – the government, the central bank, private financial firms, other supporting firms, and the nonfinancial sector users of financial services – would also be specified in such a plan. The Sierra Leone FSDP is, otherwise, a reasonably comprehensive plan. It is a development plan, starting from a very low base of financial development.

We proceed now to present a coherent analytical approach to guide policy actions for the development of the financial sector in Sierra Leone. This could assist any attempt by the authorities to refine the FSDP and to construct an action plan for its resolute implementation.

3.4 Getting the Fundamentals Right: Capacity Building

As in so many other activities, reputation is important in the financial services business. Credibility of promises and a belief that the authorities are serious and committed to building a world class financial sector will flow from good reputation. Capacity to do the job well, as revealed by competence and integrity of the firms and service providers that operate in the financial sector, enhances reputation. As is recognized in the FSDP, a strategy must therefore be put in place to build capacity of the people and organizations in the financial system to perform their tasks well. We would argue that the relevant capacity building will be facilitated by the quality of the national innovation system, the human capital of the financial system, the financial capability of potential demanders of the financial services, the supporting infrastructure, and the steps taken to improve effectiveness and efficiency of cooperation among the firms concerned.

3.4.1 Innovation System

Innovation is important in the financial services industry and it is a continuous process, which of course poses great challenges for regulators. In trying to develop the financial system, the Sierra Leonean authorities will be advised to examine closely their innovation system to ensure that it supports their plans.

The concept of a national innovation system is useful in ordering one's thinking in this regard (see, for example, Nelson 1993; several papers in Oyelaran-Oyeyinka and McCormick 2007). A national innovation system is the set of institutions, organizations, and mechanisms supporting technical innovation in a country. Here, one would be interested in the processes by which firms in the financial system master, use and supply products that are new to them.

The innovation system will comprise the whole set of institutions and organizations whose interactions determine the innovative performance of the markets and firms in the financial system. Innovation will involve copying and catching up with products and practices of others; appropriate adaptation of existing products to the specific clients and/or environment of the system; investment in new equipment; organizational reforms; learning new skills, including technical and analytical knowledge (mathematics and statistics, finance, economics, etc.); and adopting new approaches in marketing and cooperation with financial centres around the world. An objective of a policy on the national innovation system is, in short, to enable domestic firms to develop sufficient technological, organizational, and scientific sophistication and adaptability to function effectively when compared with some other financial systems in the global environment.

Strengthening the national innovation system and making it supportive of the financial services sector would involve looking at the quality of secondary schools; programmes at universities, research centres and institutes; technical and vocational training in the country; and training and research programmes within firms in the financial sector. Apart from training and research facilities, there are other important factors which will influence the innovation system and which the authorities must influence. Among these, habits and practices of major actors in the financial system are important. Firms must be motivated to inculcate habits and practices which encourage innovation. In that regard, the incentive structures within the financial firms matter.

The competitive environment is also important. National policy fostering open markets and safeguarding their integrity will be good for innovation. Appropriate incentives will also encourage innovation and survival of only strong firms which tend to be more innovative. Labour-management relations matter, *inter alia*, because they can influence employees' attitudes and commitments towards technical change and innovation. Moreover, availability of finance to support innovation (especially acquisition of equipment and training) is extremely important. Government policies can influence all of these elements that affect innovation, as can cooperative arrangements among firms and organizations in the system.

3.4.2 Human Capital

The quality of the human capital in the financial system will be crucial to financial development. The technical capability, innovative ability and integrity of the human beings operating in the system and overseeing its markets and organizations are important dimensions of this quality. Indeed, many of the policies being implemented to boost the development of the financial system will be designed with an eye to attracting high-quality personnel. The indispensability of high-quality people to achieving a high degree of competitiveness has forced all financial centres seeking to compete at the international stage, for example, to be open in their recruitment policies, acquiring people from wherever they can be found. Sierra Leone can, no doubt, benefit from adopting such an attitude.

Given sound government policy, including support for education and training of Sierra Leoneans in top universities around the world, within a relatively short period of time Sierra Leoneans will have no problem having a substantial share of the top positions in the leading financial firms in the country, without sacrificing quality. Thus, given the benefit of rapid financial development the country should be open to firms – especially banks, insurance companies, rating organizations, and accounting firms – from all over the world. International firms and conglomerates thrive on their diversity and their ability to rotate their employees worldwide. The authorities in Sierra Leone should not only welcome such international firms to the country but should also refrain from restricting their flexibility in personnel management. Similarly, fund managers, advisors and consultants of foreign origin should be encouraged to open offices in Sierra Leone if they so wish. A high-quality labour pool should enrich the country, with appropriate efficiency gains.

Two areas with thorny issues that all financial sectors around the world have had to address are labour policies and personal income taxation. In the case of labour polices, the main issue is the degree of freedom and flexibility that the top management will have with respect to hiring and firing, overtime pay, minimum wage, leave, treatment of unions, and hiring of foreigners at all levels of the firm. A cautious approach would be to take a survey of what countries with leading financial centres are doing at the moment and adopt a mix of policies, in light of normal practices in those leading centres, which are sufficiently flexible and also would be fair to the workers in Sierra Leone. If necessary, legal changes should be made in the Sierra Leone institutional environment.

The same can be said for personal income taxes. First and foremost, a country like Sierra Leone should negotiate double taxation treaties with at least those countries where the risk of double taxation exists. As to the level of taxation when relevant, the advice again would be to do a survey of the leading financial centres and get a good idea of their personal taxation, both of nationals and of foreign nationals who are residents in the country. Then an attempt should be made to modify domestic taxation laws to become competitive.

3.4.3 Financial Capability of the Populace

Other things being equal, it seems reasonable to expect that persons with enormous financial capability, namely, 'the knowledge, skills and motivation to manage their finances' (HM Treasury 2007, p. 3), will tend to use financial systems more than persons with low capability. Indeed those with high financial capability will have greater ability to reap returns from their savings and will be willing to explore alternative ways of investing their assets and managing financial risks. Having a large proportion of the population with a high level of financial capability should motivate more business for a national financial system than otherwise. This will help build a solid demand base that is useful for sustaining a national financial system and hence giving its financial services personnel good practice. In addition, the population of young persons from which future financial services experts could emerge would become greater.

The United Kingdom has introduced a useful initiative, elements of which I believe are worth copying in Sierra Leone. The idea is to put together a coherent programme to enhance the financial capability of the population. The overall strategy will include supply-side policies to improve general access to financial services markets as well as to good but affordable financial advice. The expected outcome of the strategy is 'better informed, educated and more confident citizens, able to take responsibility for their financial affairs and play a more active role in the market for financial services' (HM Treasury 2007, p. 7). One obvious indication of the relevance of this approach for Sierra Leone is that when one looks at Sierra Leone, planning for retirement and old age has always been a challenge, abated only by the willingness and ability of the younger generation to voluntarily care for their old citizens. The introduction of the National Social Security and Insurance Trust (NASSIT) will go some way towards remedying this problem. But NASSIT, by its nature, covers mostly the formal sector, which still remains smaller than the informal sector of the economy. One can argue, of course, that the relationship between participation and/or the form of participation in the financial system on the one hand and financial capability on the other is worth empirical investigation. This is an exercise that the policymakers can attempt in due course.

Taking a cue from the British approach, key elements in an action plan for Sierra Leone would be: appropriate education (mathematics, finance, etc.); improved avenues for information and advice; availability of opportunities to practice and develop appropriate skills; and outreach programmes. The Bank of Sierra Leone could lead the effort, in partnership with the government, the financial services industry and civil society organizations of interest. Other countries have programmes that achieve some of the same objectives as the UK one and apply some of the same tactics, most notably introduction to personal finance education in schools. Businesses and voluntary associations and organizations offer free programmes to young people and economically disadvantaged persons in other countries as well. Moreover, it is possible to obtain much of the training and the advice in the open market. The idea in the Sierra Leone case, as is the intention in the UK one, would be to have a high degree of planning and overall coherence and to offer much of the programme without significant monetary outlays from the beneficiaries. Indeed, in Sierra Leone, formal finance education, advice and outreach programmes are not widely available from schools, charitable organizations, or the financial services industry. Hence, a publicly organized financial capability programme would seem to be of much social value.

As in other programmes, with this sort of planning, it is always useful to organize some sort of a survey so as to fully understand the nature and dimensions of the problem to be tackled and the seriousness of the different aspects of the problem. Hence, it would be useful for the Sierra Leonean authorities if they want to mimic this effort to organize such a benchmark survey.

3.4.4 Infrastructure and Public Services

The physical and technological infrastructure in place will be important elements of the capacity available to perform financial services tasks, including the ability to innovate. This infrastructure will comprise

1. transport and communications networks,
2. basic utilities such as electricity, water, sanitation, and postal system,
3. financial system related infrastructure (trading facilities, clearing and settlement systems for money and securities, other electronic linkages among participants).

Some of the infrastructure decisions and investments will, of course, be left to the financial services markets and firms themselves. As regards public sector organization, the central government and the local governments will have clear functions specified in law regarding the provision of infrastructure and other public services. It would seem that the effectiveness and efficiency of the public sector organization could be enhanced if some explicit coordination is arranged within the public sector to focus on the requirements of the financial system. In the Sierra Leone situation, this could be one of the tasks of the Financial Sector Steering Committee which has been proposed to oversee the implementation of the FSDP.

3.5 Getting the Fundamentals Right: Microeconomic Incentives

The policy environment will affect the economic returns to the people and firms that operate in the financial sector. If these returns are low, people and firms that can earn higher returns elsewhere will leave, until an appropriate stock is left, such that the marginal returns to those who stay equals the returns they would earn elsewhere. To make matters worse, if the policy environment is unfavourable, even the highly productive human capital developed within Sierra Leone could actually flow out of the country. In short, the incentives to attract and retain high-quality people and firms in the financial sector are extremely important.

Some of the incentive issues have already been addressed when discussing human capital. We can mention here that the quality of life also matters in attracting talent. Hence, making the country attractive to live in will be a positive incentive to enterprises. Later, we will briefly discuss governance issues, which also can affect the structure and hence the behaviour of enterprises vis-à-vis the financial sector. We now briefly discuss issues of openness, taxation, administrative obstacles, and the legal environment.

3.5.1 Openness

The financial sector will benefit from the presence of strong firms – by definition, firms that can survive in open competitive markets and can build the capability to export their services. In order to attract such firms and keep them, an overarching requirement is the maintenance of an economic environment (markets, institutions, immigration laws, information flows, ideology, and access to the authorities) that is open.

An open environment will exhibit several obvious characteristics. First, there will be fair and open access rights to all to locate in and/or do business with the Sierra Leone financial sector, irrespective of national ownership of a firm. Hence, firms with 100% foreign ownership will be welcomed. Especially in the early stages of financial development, such firms have the potential, when properly screened using objective standards, of bringing badly needed expertise and business connections to the local financial sector. Second, 'firewalls' limiting the types of business to be engaged in by the same firm/organization will not be too restrictive, that is, not out of line with the leading financial centres of the world.[3] Third, innovation will be encouraged, that is without regulatory and other obstacles that are more stringent than those found in the leading financial centres, taking due account of the capability of a financial firm. Fourth, institutionalized procedures will exist through which policymakers and regulatory and supervisory authorities consult and elicit the opinions of financial services providers before implementing new or revised rules, taxes and other costly obligations on the financial sector markets, firms and people. The authorities must also demonstrate that they seriously consider the views and analyses of the financial sector organizations before finalizing their decisions. Fifth, there must be a high degree of freedom and flexibility allowed firms in their day-to-day operations, again taking due account of the capabilities of the financial firms. Hence, such firms must be allowed capital mobility,[4] currency convertibility in an open exchange market and, as stated before, implementation of human resource management policies that enable them to accumulate the human capital they find optimal.

3.5.2 Taxation

The various kinds of taxation to be considered include corporate taxation; taxation of wages, salaries, interest, and dividends; taxation on capital gains; and taxation of specific transactions. Then, of course, there can be all kinds of taxes in the form of fees which are not labelled as 'taxes'. Rather, they may be called registration fees, stamp duties, transfer fees (such as when shares are transferred).

[3] In its argument urging the Japanese authorities to remove certain firewall restrictions, the International Business Association (IBA) Japan (2007, p. 15) argued as follows:

> IBA financial conglomerate members currently encounter the following problems due to the firewall restrictions in Japan; (1) inefficiencies due to the overlapping of human resources, organizational structures, and systems; (2) constraints on effective and efficient business management practices, including the formulation and implementation of business strategies and risk management at the group level; and (3) constraints on providing comprehensive financial services that would maximize customer convenience.

Note that a financial conglomerate could, for example, conduct banking, securities as well as other financial services business.

[4] Capital mobility has a positive impact on financial market development: among other things, it improves the menu of investment outlets available to suppliers of funds while users of funds have access to cheaper and more sophisticated financing, and so it expands the opportunities for portfolio diversification. At the same time, capital mobility complicates risk management for individual financial firms, makes macroeconomic management more challenging, and fosters financial integration, which increases the risk of cross-border contagion (see Sundararajan *et al.* 2002). In order to address the complications, two fundamental policy responses have been found useful. First, the macroeconomic policy framework (most notably monetary and exchange policies) must be appropriately designed and tailored to meet the circumstances. Second, a strong prudential framework should be developed to help ensure a sound financial sector with a high standard of risk management (see Sundararajan *et al.* 2002).

Governments in their tax policies are usually concerned with revenue, fairness, income distribution, protection, and efficiency. In the context of a financial sector, it is useful for the Sierra Leone authorities to see the problem as one in which they are trying to promote production (of financial services), enable the financial sector to attract and keep talent, and to attract foreign direct investment to the financial sector. Hence, the taxation of the financial services must not do damage to the competitiveness of the financial sector in all these dimensions. It should be particularly obvious that the bargaining power (that is, the special non-pecuniary attractions and indirect pecuniary benefits) of operating in the Sierra Leone financial sector is not likely to be great for some decades to come. So there will be no 'rents' to be partially captured. This means that the solution to the tax problem is straightforward. The taxes mentioned above cannot, in their total burden on the firms and the highly talented employees, be higher than appropriate competitor financial sectors in the international financial world. In fact, it would seem that the general burden of the different taxes should be at least as favourable (that is, as light) as the most favourable of the top 50 financial centres in the world.

Similarly, if special incentives are granted to investors of any kind, there is no reason why investors in financial services should not be extended similar benefits, as appropriate.[5] A general advice would be to look carefully at what others are doing and be as competitive as possible with respect to the types and levels of taxation. Double taxation treaties, for instance, as mentioned before, should be signed where useful. Many countries have also been directly addressing certain specific taxes that are relevant in this area. One could benefit from what those countries are doing and at worst match the most favourable ones, in order to be competitive.

In its attempt to examine the tax code to remove elements that would be discouraging to the development of a sound financial sector, Sierra Leone may use the opportunity to reform the whole tax system. A compelling reason may be that some taxes may not be easy to remove or lower for the financial system without doing so for the whole economy. A way around this may be to make the financial sector an enclave which will allow it to enjoy special tax privileges not enjoyed by firms, organizations and individuals outside the enclave. But we would not recommend this approach in Sierra Leone.

3.5.3 Administrative Barriers

Although on the face of it the administrative barriers to doing business in Sierra Leone are not as great for the financial sector as for many other sectors in the economy, there should be some effort made to reduce whatever administrative barriers exist to smooth operations in the financial sector, especially for foreign firms and individuals. In brief, the barrage of licenses, approvals, permits, and other requirements should not unduly raise the costs of setting up and doing

[5] A similar point has been made by Sanyal (2007) in the context of Mumbai.

business in the financial sector. For example, any lingering recurring problems with utility companies, the tax and port authorities, and the immigration office could be greatly alleviated. Of course, improvements should benefit all the firms and organizations in the financial sector, not only those with foreign ownership.

3.5.4 Legal Environment

The law, the courts, and the police all need to be reviewed in light of the requirements to make the financial sector in Sierra Leone grow, be efficient and competitive. It would be advisable to do a formal review of the legal system in light of the experience of the top international financial centres in the world to ensure that the legal framework is adequate. Even casual observation reveals that the regular courts in Sierra Leone in their operations are way below the normal level of efficiency required to support the financial system rather than be an obstacle to the system's development. The evidence on this score must be clear, since the courts have been handling cases in which the financial services sector has been involved. Indeed, since the hard evidence indicates that the court system is not up to the task, especially in terms of speed and decisiveness, Sierra Leone commissioned a Fast Track Commercial Court in December 2010 to expedite commercial cases. This process needs to continue, in addition to instituting reforms of the regular courts and the legal system as a whole.

For instance, the FSDP suggests setting up 'an effective court system', *inter alia* to strengthen debt collection. There would seem to be a need for a special court system to handle most if not all financial sector matters, including disputes and contracts among the financial firms themselves, basically to speed up the legal processes involved. Hopefully, the Financial Sector Steering Committee will address this broad issue.

The ability to use land and other real estate as collateral is a major problem for financial sector development in Sierra Leone. The FSDP also raises this as an area worth addressing. Inadequate land titling and registration and the traditional land tenure system (see chapter 6 of this volume) all impose constraints on use of real estate as collateral. A further aspect that is ignored in general is the absence of an orderly and well-functioning real estate market, even in that part of the country where there is fee simple ownership of land. This greatly reduces the liquidity of real estate and hence its utility as collateral in the credit market.

3.6 Getting the Fundamentals Right: General Governance

The overarching policy environment of a country greatly affects the rating of its financial system among peers and among regulatory authorities in other countries of the world. Hence, given the abundance of alternatives, strong financial firms or highly talented people may not find it good for their reputation to operate or work, respectively, in a country that is considered poorly governed, or even to having close business relations with financial firms located in that country. In addition, the governance of a country has immediate wealth effects on the owners and employees of firms and organizations that are located in that country. Of particular importance are three components of the national governance environment, namely, macroeconomic policies, socio-political governance, and the degree of compliance with relevant international standards and codes.

3.6.1 Macroeconomic Policies

Macroeconomic policies are important for obvious reasons. The financial system's participants will expect these policies to affect the real rate of return on their efforts; the expected real value of their investments in the system, over time; and the ability to transfer their assets and earnings in the system from the domestic economy to another country. Thus a financial system benefits from low inflation, stable exchange rates, capital mobility, and convertibility of the domestic currency or at least an absence of exchange controls.

The manner in which the central bank uses its instruments to achieve its objectives of low inflation and financial system stability will affect competitiveness and efficiency of the system. Among the instruments are reserve and liquidity requirements; these should not be used in ways that seriously tax banks or reduce their flexibility in using their reserves. Central bank fees and other regulations for use of payment systems facilities it controls should also be no more onerous than those in leading financial centres. As we argued earlier, capital mobility will also pose challenges. A country cannot really be a big player in the financial system business if it has stringent capital controls – inwards and outwards. At the same time, capital mobility complicates risk management for individual financial firms and could make macroeconomic management more demanding. Assuming that other governance aspects (to be discussed below) are consistently well taken care of, the basic strategy to address these complications and challenges is twofold. First is to put in a place a macroeconomic policy framework that ensures low inflation and exchange rate stability. The second is to ensure that the financial system is sound, most importantly by establishing a prudential framework appropriately designed and tailored to meet the challenge. Important elements in the quality of such a prudential system will be that

1. there should be clear understanding of risks by those who are the bearers of the risks,

2. the responsibility for managing risks in financial transactions should be clearly assigned,

3. there should be appropriate incentives to those responsible for managing risks to do so in a socially efficient way (see Johnson 2002b).

No matter how sound the underlying macroeconomic policy and prudential frameworks, it is doubtful that the probability of a financial crisis can be reduced to zero. Hence, as part of the public policy framework, the authorities will be well advised to have measures in place to address crises when they do arise. Since the size of the financial system relative to GDP is bound to increase with its development, financial crises can become particularly disruptive. Hence, having a policy response fairly well thought out in advance is important. Liquidity support (typically from the central bank) and fiscal support from the government are the overarching elements of such a strategy, coordinated with emergency measures by the regulatory and supervisory authorities.[6]

3.6.2 Socio-political Governance

One of the problems that policymakers in Sierra Leone have to address is the need to effectively pay a premium to attract strong firms and highly talented people, because of uncertainties related to political instability and governance in the country. Investors worry about corruption, government efficiency, maintenance of rule of law, and sustainability of policies. Strategies must therefore be developed to build credibility for political stability, low level of corruption and other elements of good governance.

When assessing countries on corruption and socio-political governance on the whole, many analysts will resort to surveys and indices purported to measure, for instance, *risk of expropriation*, *general governance indicators*, and *constraints on the executive*.[7] Analysts will also look at the global corruption reports of *Transparency International*. It would seem sensible for the authorities in Sierra Leone to treat such surveys, indices and reports with the same seriousness as they would a credit rating report. In other words, the Sierra Leone authorities should try and understand what go into these reports and what they can do to improve their ratings. This will help them design an appropriate plan.

Another part of the response strategy is, of course, to design a plan to improve general governance – with clear objectives and instruments – make it transparent, and then implement it resolutely. In designing the plan, the

[6] See Välilä (2002) for a discussion of the basic analytical issues involved in considering fiscal support.

[7] *Risk of expropriation* comprises survey indicators of institutional quality from the *International Country Risk Guide*. The data include subjective assessments of risk for international investors along such dimensions as law and order, bureaucratic quality, political corruption, risk of expropriation by the government, risk of government contract repudiation, and overall maintenance of the rule of law. The *governance indicators* of the World Bank currently comprise six dimensions: voice and accountability; political stability and absence of violence; government effectiveness; regulatory quality; rule of law; and control of corruption. The *constraints on the executive* measures come from Polity IV data set (*Polity IV Project*). The aim is to measure directly the limits of executive power. Constraints on the executive refer to the extent of institutionalized constraints on the decision-making powers of chief executives. The concern is with the checks and balances between and among the various parties in the decision-making process.

authorities should remember that they will need to worry about sustainability during implementation. For this reason, especially, particular attention should be paid to the deliberative process in putting the programme together and the legal and organizational framework involved (see, for example, the discussion in Johnson (2007, pp. 155–161)).

3.6.3 Compliance with Appropriate International Standards and Codes

One of the costs of globalization is that countries are affected, through trade and financial flows, by what other countries are doing. Hence, developments that adversely affect financial sector stability and efficiency in one country can easily spill over into other countries. In addition, countries are genuinely interested in adopting practices that have improved risk management, efficiency and governance in other countries.[8] For these reasons, countries have been cooperating in various venues and organizational settings to agree on standards and codes in a number of areas, which would be institutionalized in countries worldwide, thereby reducing the cost of enhanced cooperation in financial services, among other economic activities.

The standards and codes are broad norms legitimated by the international community of market economies. They have evolved from experience and widely accepted theory; arrived at by agreement (via open discussion); and are expected to be implemented by national authorities, without a central world authority, because such implementation is in the self-interest of the countries. The self-interest of countries emanates from two basic forces: the quest for domestic financial stability and development, and the desire to participate in the increasingly global and integrated system of trade and financial markets.[9]

In trying to develop its financial system, Sierra Leone, then, must clearly demonstrate that it is resolutely implementing relevant norms – the standards and codes. Otherwise, as stated above, the rating of the country's financial firms, among peers and by regulators in other countries, will tend to suffer. In that case, the financial firms in the country will not be able to participate in important financial cooperative arrangements with other financial firms abroad and the country will not be attractive to some major international financial firms and centres. Important standards and codes that would need to be implemented to achieve credibility are listed in Table 3.1.

It will first and foremost be useful to develop domestic expertise to implement the full compliance processes, starting with self-assessments of the state of compliance. Even with such expertise, a developing country like Sierra Leone will still find that, for credibility, it will have to arrange peer review by experts

[8] In Ghana, for example, Asembri (1996) was proud of the high standards for listing and trading that the young Stock Exchange of Ghana had set as confirmed by a visiting team from the Commonwealth Secretariat in October 1992.

[9] See Johnson (2002a), who makes these points in the case of the compliance with the *Core Principles for Systemically Important Payment Systems*.

TABLE 3.1. International standards and codes: useful for financial services supervision and the enabling environment.

Banking Supervision	Basel Committee's *Core Principles for Effective Banking Supervision*
Banking Supervision	Basel Committee on Banking Supervision, *Principles for Sound Liquidity Risk Management and Supervision* (September 2008)
Financial Stability Forum	*FSF Principles for Sound Compensation Practices* (April 2009)
Securities	International Organization of Securities Commissions' (IOSCO) *Objectives and Principles for Securities Regulation*
Insurance	International Association of Insurance Supervisors' (IAIS) *Insurance Supervisory Principles*
Payment Systems	Committee on Payments and Settlement Systems (CPSS) *Core Principles for Systemically Important Payment Systems*
CPSS–IOSCO	Joint Task Force's *Recommendations for Securities Settlement Systems*
Anti-Money Laundering and Combating the Financing of Terrorism	Financial Action Task Force's (FATF's) *40+8 Recommendations*
Corporate Governance	OECD's *Principles of Corporate Governance* and Basel Committee on Banking Supervision's *Enhancing Corporate Governance for Banking Organisations*
Accounting	International Accounting Standards Board's *International Accounting Standards (IAS)*, and *International Financial Reporting Standards (IFRS)*
Auditing	International Federation of Accountants' *International Standards on Auditing*

from the leading financial centre countries of the world and/or from appropriate international organizations – in essence, to validate the country's own self-assessment and implementation of compliance.

Table 3.1. Continued.

Data Transparency	The International Monetary Fund's (IMF's) *Special Data Dissemination Standard/General Data Dissemination System* (SDDS/GDDS)
Fiscal Transparency	IMF *Code of Good Practices on Fiscal Transparency*
Monetary and Financial Policy Transparency	IMF *Code of Good Practices on Transparency in Monetary and Financial Policies*

3.7 Regulatory Strategy

Sierra Leone, like other African countries, needs a high-quality regulatory environment, not only to avoid financial crises but also for financial development. There are at least three major consequences for financial sector development. First, a high-quality regulatory environment will have a positive effect on cooperation among the firms in the financial sector since all the firms will trust each other more than if the regulatory standards were suspect. Second, financial firms outside the country will look favourably on building relationships with the financial firms and markets in the country. Third, authorities in other countries will be less prone to imposing tight regulatory standards on dealings of their local financial firms and markets with financial firms and markets in Sierra Leone (see Johnson 2009b).

The regulatory strategy in a high-quality regulatory environment must achieve two overriding objectives. First, it must ensure clear understanding by regulators and financial firms of risks faced by the financial firms and how those risks could be managed. Second, the regulatory strategy must be clear about the role of regulation versus the market in ensuring that the financial risks are efficiently managed and controlled. We should note that, in this discussion, oversight agencies are part of the regulatory authorities.

3.7.1 Financial Risks and Their Management

Not too long ago, banking supervisors would talk about ‘CAMEL’. That acronym stands for capital adequacy, asset quality, management capability, earnings level and quality, and liquidity. There is nothing wrong with assessing a financial firm using those headings to organize one's approach. But nowadays there is increasing feeling that explicitly organizing one's approach to assessing the soundness of a financial firm and its management around risks and risk management is extremely important. The CAMEL is taken care of in this approach while bringing risks and their management more sharply into focus. In fact, it is interesting to note that supervisory authorities in a number of countries, while still using the CAMEL approach, had transformed the CAMEL into CAMELS or CAMELOT. But then they were not unanimous about what the S, O, and T stood for. Sometimes the S (in CAMELS) was for 'systems and control', but typically it was for 'sensitivity to market risk'. Similarly, the O and T in CAMELOT were sometimes for quality of 'operations' and 'treasury management'; otherwise they were for 'operating environment' and 'transparency'.

Returning to risk management, the regulatory agency or agencies of the country must ensure that the human and non-human capacity is there – within the regulatory community and the financial firms – to understand and manage the financial risks in the markets in which the financial firms in the country operate. An important component of the human capacity is knowledge of the analytics of risk management. Complementary resources include computers, data, libraries, and research budgets. Firms will have their internal processes. The regulatory agencies must set standards, sometimes in great detail, and must also oversee internal processes of firms to make sure that they are appropriate and sound.

Many different types of risks are identified in the literature. The most important ones are liquidity, credit, interest rate, market, foreign exchange, operational, technological, sovereign, legal, and fraud (see, for example, Penza and Basal 2001; Saunders and Cornett 2008).

3.7.2 Regulation versus the Market

Since financial firms have an incentive to survive, it would seem that market discipline should do a satisfactory job in forcing internal processes of banks to develop and maintain sound models and processes to address risks. Indeed, financial firms should take primary responsibility for their risk management.

While accepting this perspective, a traditional response has been threefold. First is that market discipline can be effective if there is full and accurate information disclosure and transparency. Given that precondition, the more sophisticated the pool of those who could monitor the management of financial firms – such as owners, depositors, customers, and rating agencies – the more effective one would expect the forces of market discipline to be.

Second, even with substantial market discipline, from a micro point of view the actions of financial firms could have certain adverse effects on third parties for which it is very difficult to structure property rights and enforcement sufficiently to ensure complete internalization of costs and benefits. Indeed, this is one motivation for the great concern with consumer protection as an element of regulation.

Third, from a macro point of view, the argument is that the soundness of the financial system is essential for systemic stability and economic growth. Hence regulators must also have important responsibilities for risk management within financial firms.

One sore point about regulation, though, is the issue of *standardization*. Indeed, dissatisfaction with some of the regulatory initiatives has been an additional motivating force for financial firms to develop techniques and approaches that would be superior (from the perspective of firms' risk-return profiles) to the regulatory standardized approaches (see, for example, Crouhy *et al.* 1998). The intention is to convince the authorities to permit the firms to implement their own internal processes, with only oversight by the authorities. Perhaps no other regulatory move was more energizing to the financial firms than the Bank for International Settlements (BIS) accord on risk-weighted capital requirements. The 'one size fits all' policy, as the firms saw it, was damaging to their optimal portfolio management and hence profits. Banks, for example, believe that the credit risk associated with a portfolio would be affected by the degree of portfolio diversification and the credit quality of the counterparties. Thus, for them, it is difficult to come up with capital requirements without detailed analysis of a bank's particular situation. There is, therefore, continuous debate on when and how to use internal models as opposed to some standardized approach; on when the market is a more socially optimal regulator of governance behaviour than public authorities; and on how one goes about deciding an optimal regulatory regime and strategy.

An *optimal regulatory regime and strategy*, among other things, will balance regulatory rules, supervisory review, and market discipline. Llewellyn (2002), for instance, argues that several problems emerge with a highly prescriptive approach to *regulation*. For example, the risks under consideration may be too complex for simple rules; prescriptive rules may prove inflexible and not sufficiently responsive to market conditions; and the rules may have perverse effects in that they are regarded as actual rather than minimum standards. He stresses that a central issue is the extent to which regulation differentiates between different banks according to their risk characteristics and their risk analysis, management, and control systems. An important theme in this framework is that regulation can never be an alternative to market discipline. On the contrary, regulation needs to reinforce, not replace, market discipline within the regime.

How one determines, in practice, the balance between regulation, on the one hand, and market discipline, on the other, is bound to remain of major concern among experts. Sometimes the determination in practice gets influenced by balance of power of those with interests in the outcome of the game. Calomiris (2006), for example, discusses the influence of three constraints to the regulatory stance of the US Federal Reserve (Fed) during the Greenspan era: opposition by politicians, opposition by big banks, and effect on the erosion of Fed regulatory power. In this general context, it is interesting that in the final decades of the twentieth century, at the same time that the public authorities around the world were emphasizing an important role for market discipline in eliciting good governance in financial firms, those same authorities – as well as the international organizations in their standard-setting activities – were refining regulatory rules, standards, and codes. In the end, the one thing on which the experts seemed to agree was that the relative weights should indeed vary from one country to another and perhaps among types and sizes of financial firms as well, depending on the particular circumstances. Some of the determining factors, for a country, would be the available expertise within financial firms and within regulatory agencies, the nature of the risks faced by the financial firms, and the relative sophistication and efficiency of the pool of others who could monitor the management of financial firms.

Despite the publicity accorded the recent *communiqué of the G-20* meeting in London (G-20 (April 2009)), and numerous high-level discussions among policymakers in the major countries since then, our suspicion is that the nature of this market versus regulation debate will change little. Indeed, the basic principles guiding regulatory frameworks for some time now are likely to remain the same. The vigilance in the application of those principles might intensify and, perhaps, certain markets and organizations which have been spared close supervision will now be subjected to scrutiny. For example, the G-20 members in the communiqué agree ‘to extend regulatory oversight and registration to Credit Rating Agencies to ensure they meet the international code of good practice, particularly to prevent unacceptable conflicts of interest’. Certain systemically important hedge funds may also be subjected to regulation and oversight. Moreover, capital requirements of financial organizations will most likely be re-examined and perhaps tightened, which means raising minimum capital in absolute terms or, at least, in relation to (risk-weighted) assets.

The financial firms that are considered too big to fail might, for example, be required to hold more capital in relation to risk-weighted assets than they have had to before, after adjusting for their individual circumstances. But we do not believe that banks considered too big to fail will be broken up or prevented from engaging in certain market activities they were allowed to before the recent financial crisis, as some well-known persons have suggested. But at least these banks will most likely end up losing some of the trust, which they enjoyed in the past, notably in the quality of risk assessments of their activities and in setting appropriate capital requirements. Their risk management practices in particular will be more tightly overseen.

3.7.3 Corporate Governance

If one starts with the realization that the financial organizations under consideration will be operating in a developing country like Sierra Leone and that failures in a financial system have systemic economic effects, it is difficult to be concerned with only shareholder interests when looking at corporate governance of financial firms and markets in general. Indeed, even extending the concern to workers and other participants in the financial system is not enough.

These days, most experts in the field of corporate governance start from the view that a corporation is ‘a complex web or “nexus” of contractual relationships among the various claimants to the cash flow of the enterprise’ (Macey and O’Hara 2003). In the context of a developing country, the fiduciary duties of managers and directors of financial services firms should be broader than maximizing the value of the firm for shareholders. Loyalty of the organization's officers to shareholders should not have external harmful effects on the larger community for which those shareholders do not pay. The beneficiaries of directors' fiduciary duties (in particular, of care and loyalty) in the case of banks and other financial organizations should extend beyond shareholders.[10]

The requirement of fiduciary duties of senior officers of financial services firms, organizations and markets should then hold the officers liable not so much for mistakes of judgement or wrong decisions but rather for actions and inactions that manifest fraud, illegality, gross negligence, and conflicts of interests or wrong decisions not made in good faith. It is not only shareholders that should take action to enforce the fiduciary rules but also the supervisory authorities. In that regard, the internal supervision of financial services firms, the information reporting systems of the firms, and the decision-making processes, research facilities and standards of the organizations, will all be matters of supervision/oversight by the authorities.

A clear approach is thus necessary to ensure that, in exercising their fiduciary duties to shareholders, the financial services firms and markets in the financial system do not act in ways that threaten the stability of the economy or reduce confidence in the financial system as a whole. In fact such an approach is implicit in the best supervisory regimes around the world. Such regimes contain rules, procedures and processes designed to ensure the soundness of financial firms, including their ability to withstand shocks of reasonable probabilities. The fiduciary duties to shareholders are conditional on meeting these supervisory standards.

3.7.4 The Compensation System and Risk-Taking

If the incentives in regulatory agencies are sufficient to make the personnel in those agencies perform their work well in making sure that risk assessments and capital provisions in the systemically important financial firms are optimal, there will be no need for additional micro-supervision such as implementing pay limitations for executives of the financial firms. Still, it is easy to endorse an increased focus on the relationship between compensation systems and risk taking within financial firms. It is very tempting to say that this is not a big issue in an African country like Sierra Leone, partly because compensation packages are not as explicitly structured in ways that encourage high risk deals for quick profit, and partly because the kinds of bubbles that provide an environment for such deals tend to be really rare and not as bloated in the African economies as compared with more developed economies. Yet it

[10] Macey and O'Hara (2003) also take a view that is along this line when discussing the corporate governance of banks. They call for 'bank directors to expand the scope of their fiduciary duties beyond shareholders to include creditors'. Hence they 'call on bank directors to take solvency risk explicitly and systematically into account when making decisions, or else face personal liability for failure to do so'.

would be surprising to see, occasionally, bank personnel systematically permit dangerously high concentration of exposure to a few sectors, as was the case for the recent banking problems in Nigeria (see Sanusi 2009), without some initial motivation to exploit what was perceived as possibilities for quick and/or certain substantial profit in the hope of being rewarded with salary hikes and other compensations (bonuses, promotion, etc.).

The Financial Stability Forum (re-established as the Financial Stability Board in April 2009), in April 2010, issued nine *principles for sound compensation practices* designed to ensure effective governance of compensation, effective alignment of compensation with prudent risk taking, and effective supervisory oversight and engagement by stakeholders (FSF 2009). The three principles dealing with effective governance are especially important. Principle 1 states that 'the firm's board of directors must actively oversee the compensation system's design and operation.' The idea is that the compensation system 'should not be primarily controlled by the chief executive officer and management team. Relevant board members and employees must have independence and expertise in risk management and compensation'. Principle 2 states that 'the firm's board of directors must monitor and review the compensation system to ensure the system operates as intended.' Principle 3 states that 'staff engaged in financial and risk control must be independent, have appropriate authority, and be compensated in a manner that is independent of the business areas they oversee and commensurate with their key role in the firm.'

3.7.5 Early Warning Signals

Public policy towards crisis prevention and resolution has included concerted efforts to improve early warning signals and the promptness of response to crises. Policy in the area of warning signals has at least two interrelated aspects. One is developing the ability to recognize and comprehend signals from financial firms that they are experiencing serious problems, especially liquidity and credit problems. The second involves putting in place a forward-looking risk-based supervision framework that could alert the authorities to problems arising with respect to both individual firms and a financial subsector or market.

A *risk-focused bank supervision framework that is forward-looking* can be an important component of an early warning system (see, for example, Baldwin 2002). Risk-focused supervision requires the supervisor to make qualitative assessments and develop a thorough understanding of a bank's risk profile and risk management capabilities. Forward-looking and proactive, risk-focused supervision also requires flexibility in supervisory programme design. The approach, in brief, involves identifying different categories of banks and then developing supervisory programmes tailored to the specific needs of each category. Statutory supervisory requirements must be sufficiently flexible to accommodate such an approach.

3.7.6 Organizational Structure: Unified or Not?

It is obvious that, from an organizational perspective, a regulatory/supervisory agency must have clear objectives, autonomy, and expertise to do its job, as well as be accountable to government, parliament, financial sector/industry, and the populace at large. Autonomy includes budgetary and instrument autonomy. Instrument autonomy includes authority and power to enforce its rules and to sanction for non-compliance, as well as immunity from prosecution of its officials for official actions taken in the line of duty.

Most experts believe that a supervisory/regulatory agency outside the central bank or the government must be funded by levy on the regulated firms and markets, rather than by government. South Africa, for instance, has a Financial Services Board (FSB) that supervises non-bank financial services; the FSB is financed by the financial services industry itself, with no contribution from government. The FSA in the United Kingdom also does not receive any funding from government; it charges fees (which it classifies as *periodic*, *application*, and *special project* fees) to firms they regulate and to other bodies (such as 'recognized investment exchanges', according to the FSA). Having said that, there is nothing, in principle, to prevent a country from deciding to wholly or partially finance an independent supervisory agency from general government revenue if, in light of the rudimentary state of the financial sector, levies from that sector are insufficient to maintain a supervisory agency of a sufficiently high standard.

Whatever the case, Sierra Leone is likely to continue to have the Bank of Sierra Leone as the bank supervision authority for the foreseeable future. There is nothing wrong with that, especially since the bank appears committed to continue its efforts at strengthening its capacity to perform the relevant tasks. Still, for reasons stated in the next three paragraphs, Sierra Leone may need to re-examine this question sometime in the not-too-distant future as the financial system develops.

An important issue is whether there should be a unified supervisory agency as in Australia, Canada, Denmark, Iceland, Japan, Norway, Korea, Singapore, Sweden, and the United Kingdom, for example, or instead one should adopt various models of splintered agency arrangements as in the majority of countries (see, for example, Abrams and Taylor (2000) for a discussion). A disaggregated approach to supervision could work well, even for a country trying to develop its financial system from a low base. In addition, the country, for historical reasons, may feel comfortable with a non-unified approach. Moreover, the financing of a unified agency outside the central bank may prove difficult for the country.

In the case of Sierra Leone, it would seem reasonable that, despite its history, a single, unified agency would have several advantages which are important for an accelerated development of its financial system. First, there would be efficiency gains – economies of scale in regulatory activity – in the form of savings on administration, infrastructure, data collection and management;[11] absence of a need for modalities to share information and establish cooperative committees and the like with other agencies; efficient use of highly trained and experienced experts in short supply coupled with the ability to pay them well and hence to retain them in the public sector; ability to finance continuous training of staff in-house or externally; and externalities in knowledge and information sharing among staff of varied expertise in close proximity to each other (clustering effect). Second, it makes sense to encourage financial conglomerates[12] and, for these, unified supervision is advantageous; overall risk-assessment for the whole enterprise is important, because problems in one area will spill over to other areas. Third, products across subsectors are becoming more and more similar and hence directly competitive; regulatory neutrality can be better attained with unified supervision. Fourth, there will be little or no risk of financial services falling between the cracks due to lack of clarity of supervision authority in a dynamic financial services environment, foreign regulators will have to deal with only one supervisory agency, and the accountability problem is simplified as everyone will know the agency that is responsible for the supervision of the financial services industry and hence for any lapse or mistake. Finally, the gains from clustering and accessing global value chains will be better appreciated, and hence facilitated, by a single unified regulator.

There are, of course, certain risks and challenges that will confront a unified agency. But the experience of those agencies, particularly in the case of the UK Financial Services Authority which deals with a global financial centre, demonstrates that the challenges can be comfortably met. First of all, there will be a challenge to balance the multiple objectives of a unified supervisory agency. But surely, these objectives would all revolve around risk management, efficiency, consumer protection, and corporate governance issues. Second, possible diseconomies may arise. One frequently mentioned is that politicians and policymakers may be tempted to assign the unified agency functions that are outside its core domain. Another is that the unified agency may become somewhat inefficient due to its monopoly status. But clearly the direct solutions to these problems are not difficult to find. Third, it may be challenging to create a single agency culture, since the mindset of supervisors of different types of specialized financial firms and markets often appear to differ. Still, countries with unified agencies in place have been well aware of this problem and have found solutions for it.

[11] Michael Foot, for example, notes that before the FSA in the United Kingdom, there were eight different 'principal' regulators. They 'all had support services for Information Services and Human Resources that were seriously suboptimal in size. It proved also much easier and more effective for the FSA to represent UK interests in Brussels and at the huge range of international regulatory meetings than it had been for the individual regulators'.

[12] Fear of conflict of interest, insider trading and domination and abuse are, of course, risks that should be addressed in this regard. Conglomerates are also more complex to supervise than financial firms operating in only one subsector, because the risks, consumer protection, creditor protection, and corporate governance issues differ in significant details across subsectors.

3.7.7 The Role of the Central Bank under a Unified Structure

Even where there is unified supervision of financial services, by an agency separate from the central bank, the central bank must ensure that it has up-to-date prudential information on the banks. The central bank needs the prudential information on the banks in connection with its conduct of monetary policy, its foreign exchange rate policy and management, and its lender-of-last-resort function and other elements of its role in the payment system. In each of these areas of activity, banks will be the primary, and sometimes the only, set of financial services firms with which the central bank will be directly dealing. The central bank will need to have adequate information on the state of banks and the authority to request information (including via regular reporting) from individual banks.

Apart from direct contacts with banks, in the unified structure the central bank should in any event maintain close contact with the financial services supervisor. That way, the central bank can obtain additional insight from the financial services supervisor on the state of particular banks, as necessary. Indeed, as in Ireland, the financial sector supervisor can reside within the central bank while being independent (see O'Sullivan and Kennedy 2008).

3.8 First Steps in the Financial Market Development Process: Key Policy Areas

A developed financial system will have certain architectural and organizational structures that are well functioning. Indeed, it is these structures and their functioning that make a financial system developed, as opposed to being underdeveloped or rudimentary. This means that, from a policy point of view, financial market development can be seen as finding a socially optimal way to put such structures in place and have them well functioning. The important questions include: where should the focus be over the next decade or so in a country like Sierra Leone with a highly underdeveloped financial system and what are the appropriate roles of the public sector and the private sector? In addition, what should be the nature of cooperation between the private and the public sectors? In this context, selective intervention policies should be carefully thought through: financial markets should generally be given freedom and space to evolve and expand. Clearly, in the early stages of a major effort in financial market development, attention needs to be paid to certain important elements and aspects of the money market, the payment system, and capital markets.

3.8.1 Money Market Development

An active money market benefits monetary policy, the government as well as portfolio managers, banks, and securities markets. Hence, serious attention needs to be paid to its evolution from a very early stage of implementing a financial system development plan.

As regards *monetary policy*, problems and shocks relevant to monetary policy formulation are revealed more quickly the more developed are money markets, as they show up in market variables such as interest rates; the monetary transmission process is also smoother, and with shorter lags, the more integrated and efficient are money markets. An active, liquid, integrated and efficient national money market facilitates open market and other central bank operations to influence interest rates, base money, bank free reserves or any other targets of monetary policy.

Government instruments to finance deficits will also see increased demand and hence lower interest rates, other things being equal, the more developed are money markets. Moreover, with well-developed money markets, low risk instruments become available to portfolio managers and banks, and hence diversification and intermediation are made easier, with ultimate benefit to saving and investment as the gains are passed on to savers and investors.

For money market development, the building blocks and enabling environment are well known. To facilitate the evolution of well-functioning and active markets in financial products, the authorities need to take resolute steps to ensure certain desirable qualities of the environment. These relate to the legal framework, the clearing and settlement systems, the efficiency of the banking system, and macroeconomic stability, which are discussed elsewhere in this paper, as well as credit rating systems.

Ideally, well-functioning and efficient credit rating organizations would be desirable. But these are not likely to emerge in Sierra Leone for some time to come. Banks should therefore be encouraged to further develop their own internal credit rating systems. These, no doubt, will vary in sophistication from one bank to another, as mentioned earlier. The Bank of Sierra Leone should improve its database to help provide some of the information that the banks would need.

Ultimately, the financial system would benefit from specialized credit rating organizations. The authorities could promote the emergence of such organizations, including helping to identify sources of technical assistance. The authorities should also ensure that the credit rating organizations maintain an appropriate balance between confidentiality and accessibility to lenders and investors of the raw data and information collected and the credit ratings themselves.

The money market in Sierra Leone will evolve along several different lines depending on the preferences of the participants. The products of a developed well-functioning money market could be standardized (typically by maturities) or non-standardized. Non-standardized products have irregular maturities and in some countries irregular settlement procedures as well. They can also have specific securities as collaterals, e.g. repos with liquidity provided against specific bonds. The organization of the market differs in detail among countries, even with well-functioning money markets. The relative importance of market makers (who take positions, quote two-way interest rates) and of brokers (who do not take up positions and charge commissions for their services) also differ widely from place to place. Generally in well-functioning markets trading via brokers is small (around 10–20%); the rest is done on a bilateral basis. The nature of the trading also differs (role of electronic screens, bilateral direct contacts via telephones, use of correspondent accounts with major banks, etc.). Foreign exchange swaps tend to be quoted in terms of an exchange-rate premium/deduction, and not directly as an interest rate. The premium, of course, will tend to reflect interest rate parity calculations. In general, there are deposit and short-term funds, bond repos, securities with short remaining maturities, private sector money market assets, and swaps.

Deposits are the cornerstone of the interbank market. This is normally a market for unsecured overnight funds. The associated credit risks could be enormous. A secondary market in prime assets (an asset-based market), in contrast, facilitates interbank transactions across the maturity spectrum and avoids the credit risk problem, whether by outright sales of paper, collateralized deposits, or repurchase agreements.

As part of its role in the market, the central bank may help determine the standards that banks need to satisfy to be allowed to participate; it may help in developing an electronic trading system to use; and it could insist on specifying the maturities and the limits (e.g. in relation to deposits or capital) to prevent excessive borrowing or short-term borrowing becoming long-term.

The interbank market itself can be important for monetary operations and policy. The interbank rates can serve as benchmarks for fixing interest rates for other financial products and could be the major operating targets of monetary policy.

Private sector money market assets, such as bankers' acceptances (BAs),[13] certificates of deposits (CDs),[14] or commercial paper[15] could be useful in the development of the money market. But they could differ greatly in credit risks and the authorities may have little or no control over their supply. Discounting them can be a challenge for the central bank. For BAs, there are typically two names at least, the endorsing bank and the accepting bank; hence the credit risk is typically lower. The CD is a 'one name' paper, the name of the issuer, as is the commercial paper.

The Bank of Sierra Leone, as the central bank, can have substantial leverage over the money market, because it could decide standards to participate in any open market operations, to come to its discount window, and to settle in its books. The central bank can take several direct steps to assist in the development of the money market. Perhaps the most important role the central bank could play is the provision of settlement services for the banks. That way, they do not have to use correspondent banking arrangements and will

[13] Banker's acceptance is a bill of exchange or time draft drawn on and accepted by a bank. The bill of exchange itself is a two-name paper, the drawer and the drawee.

[14] A negotiable claim issued by a bank in return for a term deposit.

[15] An unsecured note issued by companies for borrowing (typically on a short-term basis).

settle using balances with zero credit risk and achieve settlement finality with payment, once their accounts have been credited and debited in the books of the central bank.

The central bank can be also important in information, practices and architecture. In other words it can encourage certain practices and procedures, and its persuasive powers are enhanced by the fact that it could intermediate and foster cooperation among market participants, at the early stages of market development. The central bank could encourage the emergence of market makers and market maker agreements, for instance by having special financing facilities for market makers and requiring signing of market-maker agreement(s) in the various products for access to the financing facilities. The central bank could also encourage up-to-date computerization. Moreover, the central bank could collect, collate, and disseminate information (mainly aggregated and with short time lag of a week to a month) to market participants on things like positions, transactions volume, financing, bids and offers. The central bank should also see that the market participants set standards on matters like delivery and payment, no doubt with the purpose of early achievement – that is, as soon as possible – of delivery versus payment on the books of the central bank.

Important issues arise with respect to *discount window policy* and *reserve requirement policy*. There is a delicate balance to be struck with respect to access of banks to borrowing from the central bank at the discount window. The central bank cannot encourage use of its discount window as a first resort; the banks should be encouraged to go to the market. The central bank could even help by having a 'discount window' that is effectively selling one bank's excess to another bank with a demand for reserves, e.g. for settlement purposes in the books of the central bank. In other words, the central bank could be operating an interbank market for, say, overnight funds. At the moment, in Sierra Leone, the discount houses do not appear to be doing a satisfactory job in this area, and the level of activity in the interbank market is low.

To encourage banks to continue to first look to the interbank market, as that market develops, the Bank of Sierra Leone could lend at only penalty rates, sometimes even backed by securities (so-called Lombard facility). The central bank could, alternatively, lend at non-penalty rates with rules of access that discourage overuse. With minimum reserve requirements, allowing the averaging of reserve holdings would facilitate active reserve management by banks, increasing their liquidity.

The central bank could influence the composition of the products in the money market, e.g. via the instruments selected for open market operations or discounting. For instance, if over time there comes to be only limited stocks of government treasury bills for public debt purposes, a decision would need to be made regarding whether the central bank would issue its own bills, whether the government would agree to have a special issue of bills to be employed for monetary policy purposes only, or whether the central bank would agree to using short-term private debt instruments (including interbank products) in its monetary operations. In the case of private debt instruments, the central bank selects among the market papers available, taking into account especially credit risk, and this has an unavoidable impact on the product structure of the interbank market.

All things considered, Sierra Leone already has substantial ability, which with some appropriate technical assistance, could enable it to rapidly develop its money markets, particularly by aiding in the evolution of bonds, bankers' acceptances, commercial paper, and bond repos. Banks could issue certificates of deposits (CDs), and large non-financial firms could issue commercial paper and bankers' acceptances (BAs). These instruments could soon begin to be regularly traded in financial markets. The Bank of Sierra Leone should set capital requirements for accepting banks in the case of BAs. The right to issue CDs and accept bills of exchange/time draft could be restricted to sound banks – banks declared safe and well run – by the banking supervision department of the BSL. Given the limited trust for banks by potential depositors, the credit risk fears of some market participants, and the expected initial absence of a sizeable and active market for CDs, banks may, for some time, be able to attract participation only in CDs of short duration – say three, six, and nine months. After some experience with those maturities, additional and longer maturities could be successfully issued.

Banks could also be permitted to sell bonds. Bonds would normally be of longer duration than CDs – say, three to five years to start. In the current Sierra Leone environment, banks may need to take measures to increase the attractiveness of the bonds. Until an active secondary market for them emerges, the issuing banks could stand ready to repurchase the bonds on demand, with discount rates closely tied to some indicator rate. The discount factor would differ with the term to maturity of a bond. A disadvantage of the policy of commitment to repurchase the bond is that banks may lose the assurance of the medium-to-long-term nature of the loan involved in a bond issue; they may, therefore, feel constrained from using the funds to make medium-to-long-term loans. While this is understandable, the enhanced liquidity of the bond due to the policy may encourage the development of a secondary market in the bonds, so that the issuing banks in fact are never called upon to repurchase the bonds before maturity.

In addition to standing ready to repurchase outright their own bonds, banks could also be willing to arrange repo agreements involving their own or other banks' bonds. In this way, a bond repo market involving commercial bank bonds could emerge.

3.8.2 Payment System Development

Sierra Leone has a very rudimentary payment system. Desirable for efficient and well-functioning financial markets would be at least one large value payment system that satisfies the ten core principles for systemically important payment systems (see CPSS 2001). The Bank of Sierra Leone would no doubt own and manage this system. Settlement among domestic banks for all financial market transactions would also take place in the books of BSL. The BSL must unavoidably address a number of organizational issues as it strives to lead the modernization process and develop the payment system. Typically, countries find it useful to set up a National Payments Council (NPC), comprising at least the central bank and a number of commercial banks, and probably also other financial organizations that actively participate in the payment system. Within such a coordination body, ideas can be openly discussed, information on demand for payment services obtained, and a consensus reached on important public policy issues related to institutions (including the legal framework), competition policy, and the role of the central bank, as well as technological and other choices for major (especially large-value) systems (e.g. types of payment instruments, queuing mechanisms, availability and pricing of intraday liquidity, overnight credit, availability of information to participants, and time of settlement finality) and risk control measures such as use of collateral and backup and contingency plans (see Johnson *et al.* 1998). Support from the NPC can indeed greatly enhance cooperation, at the implementation stage of major initiatives, thereby lowering implementation cost. It is hoped that the National Payments Council/Committee proposed in the FSDP of Sierra Leone will be sufficiently well designed and well functioning to achieve the desirable objectives of such a coordinating body.

A major challenge the authorities will face is deciding how the payment system should evolve with the demand (basically user requirements) of the financial system, given limited resources on the one hand and the desire to foster economic growth and development on the other (see, for example, Johnson *et al.* 1998; CPSS 2006). This is made more complicated by the fact that, despite the slow pace of realizing the objective, a monetary union is proposed among The Gambia, Ghana, Guinea, Liberia, Nigeria and Sierra Leone, which will ultimately form a monetary union with the Banque des Etats de L'Afrique de L'Ouest (BCEAO) countries, in order to achieve monetary union of the countries of the Economic Community of West African States (ECOWAS). This means that Sierra Leone, in its payment system development policies, will face pressures to develop its desired real time gross settlement (RTGS) system in order to facilitate cross-country transfers within such a union, an RTGS system that will, no doubt, be more sophisticated than what would be optimal for purely domestic payments purposes for some time to come. The likely fruition of the monetary union being uncertain in its timing will leave the Sierra Leone authorities with major uncertainties in their decision-making process. Nevertheless, the challenge must be met and with careful analysis the country should be able to avoid unnecessary waste of funds.

A well-developed depository system for securities should complement the development of the clearing and settlement system. Moving quickly to dematerialized securities and making sure that the speed of settlement of stock transactions meets international standards would also help the development of the capital market (discussed below).

3.8.3 Capital Market Development

From the perspective of financial market development and benefiting from the growth effect of such development, Sierra Leone should not in principle be anxious to push stock market development at this stage, rather than simply pressing on with development of the banking system. Overall, financial structure per se does not seem to matter a lot for economic growth as compared to financial development pure and simple (see, for example, Demirgüç-Kunt and Levine 2001). Still, introducing a stock market as an important element in the development of the market-based segment of the financial system can contribute not only to accelerating financial development but also to raising the efficiency with which the banking system operates in the performance of its intermediation function. In addition, the banks will be able to raise equity in the stock market and the stock market will benefit from the screening capabilities and securitization activities of the banks. Hence, there could be an effective co-evolution of two important branches of the financial system (see, for example, the model of Song and Thakor 2010). All of this should have a positive effect on economic growth.

A stock market was inaugurated in Sierra Leone in 2009 and a Securities and Exchange Commission (SEC) is expected to be established in the near future. Before it comes into being, the Bank of Sierra Leone will perform the SEC functions. Apart from trying to get the stock market functioning in a regular way and putting in place the rules (particularly relating to capital adequacy of brokers and ensuring disclosure and investor protection) and the machinery to make the SEC perform its functions effectively, the Sierra Leone authorities want to take some initial steps to develop and deepen the capital market. According to the plan, these steps should include creating a long-term debt market depending initially on government debt instruments, and introducing law and regulations to facilitate collective investment schemes 'to allow the formation of investment companies and unit trusts'. The authorities, as reflected in the FSDP, also see the two discount houses as potentially 'the dominant players' in the capital market in the foreseeable future.

Unfortunately, stock market capitalization and liquidity[16] in Sierra Leone are unlikely to be significant for the foreseeable future. Many obstacles lie in the way. Development of the stock market will be challenging for the Sierra Leone authorities and the financial sector participants themselves, given the small size of the Sierra Leonean economy. Such development will require policies

[16] Two measures of liquidity found useful are the *value traded ratio*, that is, the total value of shares traded on a country's stock exchanges divided by GDP, and the *turnover ratio*, that is, the total value of shares traded on a country's stock exchanges divided by stock market capitalization (the value of listed shares on the country's exchanges). The turnover ratio measures trading relative to the size of the market. Levine (1997), in addition, notes that trading costs and the degree of uncertainty associated with trading and settling transactions are also important in assessing liquidity. He further explains that the objective of the liquidity indicators is 'to measure the degree to which agents can cheaply, quickly, and confidently trade ownership claims of a large percentage of the economy's productive technologies'.

and investment, particularly for automation of trading and setting up a central depository system. The Sierra Leone stock exchange should nevertheless benefit from attempts within ECOWAS countries to promote regional integration of such exchanges, as evidenced by the example of the Bourse Regional Des Valeurs Mobilière (BRVM), a regional exchange involving eight French-speaking West African countries of the West African Economic and Monetary Union (see, for example, Yartey and Adjasi 2009).[17]

To ensure that the stock market contributes effectively to financial development and economic growth of Sierra Leone, the authorities will need to take steps to ensure substantial growth in listing on the market, including the organizational and institutional changes mentioned above to promote development of the market. Otherwise, as the evidence shows, the stock market will help large firms raise capital but the direct contribution of the stock market to economic growth will be very small and probably even insignificant; in addition, the stock market will remain underdeveloped (see Yartey and Adjasi 2009).[18] Indeed, despite the strong case for co-evolution, one would suspect that, particularly at this early stage of stock market development, the banking system evolution is likely to be of greater help to development of the stock market than the reverse.

As regards relying on the government bond market to be the backbone of development of the capital market in general, a problem is that it can encourage undesirable government budget deficits not financed by foreign grants. Government bonds also typically are a more expensive source of finance than treasury bills. Rather than pushing public debt to form the backbone of the development process of the capital market, the authorities should work on the enabling environment to stimulate private equities and private debt (bonds and long-term bank loans and deposits) to play this role.

This does not mean, of course, that government bond issuance should be discouraged, only that it should not be expanded aggressively as a means to help develop the capital market. The government can, for instance, develop a modest programme of issuing bonds via regular auctions, which can serve purposes of market development as well as assisting in monetary policy of the central bank. The government can also lead the way in issuing different types of bonds, e.g. indexed bonds, floating rate bonds, retail bonds (for small investors), which the private sector can mimic, thereby promoting the development of the market.

Still, in general, as potential major investors in long-term debt instruments – such as the National Social Security and Insurance Trust (NASSIT) – increase

[17] The eight countries are: Benin, Burkina Faso, Côte d'Ivoire, Guinea-Bissau, Mali, Niger, Senegal and Togo.

[18] The evidence is that the contribution of the stock market to economic growth becomes significant after some threshold of the ratio of value of shares traded to GDP is crossed. In other words, stock market liquidity matters greatly for the contribution of stock markets to economic growth in general.

their demand for bonds and long-term bank deposits, ways should be found to enable private sector firms as well as public enterprises to build the appropriate capacity (such as proper accounting and good governance) to enter such a market, in addition, of course, to the normal equity market (the stock exchange). A 'corporate bond market' can thereby emerge. Venture capital could be a great source of funds in such a market. Of course, venture capital firms could also emerge to acquire equity in well-run public commercial firms, if such firms exist.

Credit ratings matter greatly for the development of capital markets. Banks and ordinary savers are not likely to hold the equity or liabilities of commercial firms without some concrete knowledge of the risks they face and the appropriateness of the pricing of those risks. This, understandably, leads to an anxiety to create credit rating organizations. But such bodies even if planned can take some time to emerge and become effective in performing their role in the financial system. Hence, Sierra Leone's banks and other financial firms need to depend heavily on their own internal rating systems more heavily than in fully developed financial systems. Since, in any event, such internal rating systems will always have value, no matter how developed the financial system, it makes sense to stress, as part of the first steps in financial market development, capacity building of financial firms, particularly banks, to accelerate development of their own internal credit rating systems and processes.

This also means that, as part of the first step in capital market development, serious technical assistance would be useful to potential entrepreneurs, to modernize their operations, particularly those firms and enterprises in tourism, agriculture and exports in general. Such firms could then provide the incentives for venture capitalists to enter the budding Sierra Leone capital market and for banks to increase seriously their portfolio of long-term loans. The modernized enterprises would also be able to issue equity and bonds for which there would be effective demand from savers and regular investors. Various aid agencies and non-governmental organizations could assist commercial enterprises in Sierra Leone in their undertaking to modernize. Seeking such assistance makes sense because, if there is a sound economic policy environment in Sierra Leone (see Johnson 2004) and hence good prospect for sustainable growth in the 7–10% range for a couple of decades, modern companies will undoubtedly be the drivers of this growth process. They will become important channels via which foreign investors come to Sierra Leone, to invest outside of the minerals sector, including investing in the county's bond and equity markets, and financing enterprises in tourism as well as in agriculture and industry, particularly export-orientated enterprises.

The development of the secondary bond market may also need early attention in the financial development programme implementation. Promotion of some kind of bond market association, as found useful in some countries (e.g. Republic of South Africa), is a logical way to begin. This may evolve into a bond exchange, as in South Africa (see Mboweni 2006); or some other arrangement may be equally satisfactory in the Sierra Leone context.

3.9 The Longstanding Access to Finance Questions

Since independence, policymakers in Sierra Leone, as in most other sub-Saharan African countries, have worried about access to credit for low-income and rural persons (individuals and enterprises); for certain types of activities, especially agriculture; and for medium- and long-term investments, as opposed to short-term particularly self-liquidating demands of commerce. In economic terms, the view is that the way the credit markets work in these low-income countries has resulted in a deviation of private and social profitability in the allocation of credit; adverse effects on small-scale entrepreneurship; and overall suboptimal financial intermediation that has deterred saving mobilization for development. As stated in the Sierra Leone Financial Sector Development Plan (FSDP), 'increasing access to finance for the 73% of the population who live in rural areas, the 70% who live in poverty, and the 50% of the economy that is represented by agriculture, are at the heart of the FSDP.'

If the available funds for lending are suboptimally allocated, it seemed logical to many policymakers, for a long time, that part of the solution or remedy should lie in selective credit controls. Unfortunately, such controls were seen to have serious adverse welfare and economic growth effects and considered rather indirect attempts to solve the underlying problems (see Johnson 1974, 1975). Johnson (1974) argued that to address the underlying problems the direct solutions involved an explicit tax-cum-subsidy or the creation of financial firms with actual or potential comparative advantage in assessing the creditworthiness of, and in administering and servicing loans to, what we can call here the 'neglected borrowers'. This second approach has gained much currency because high administrative cost and the fear of high default rates, in light of adverse selection and/or moral hazard, are seen as important reasons why certain borrowers are neglected by the regular financial firms. Credit rating agencies certainly do not exist in Sierra Leone to help banks in the client screening process, for instance, and internal rating systems of the banks are not designed – in light of profitability considerations – to help solve the screening and monitoring problems related to lending to micro-borrowers, for example.

The informal financial sector in Sierra Leone is regarded as also not functioning well, having been adversely affected by the decade long socio-political instability (1991–2001). Hence, apart from whatever innovations the regular commercial banks are able to make to adapt and improve their ability to increase credit to the neglected individuals and enterprises, the FSDP is placing its hopes on microfinance institutions (MFIs) and on community banks which also accept deposits unlike the MFIs.

3.9.1 Community Banks

It is not clear why the Sierra Leone authorities want to actively promote community banking in a small underdeveloped country like Sierra Leone with an underdeveloped commercial banking system, as opposed to simply focusing on encouraging greater commercial bank branching and increasing the ability of those banks to lend to certain 'neglected' groups. In big countries like the United States, the idea of community banks is to give greater attention to the demand ('needs') of local communities – individuals and businesses. Community banks are expected to channel deposits, obtained mainly from the local community, into loans in the communities involved. The bank officers are also supposedly highly accessible to the community depositors and borrowers and are immersed in the local affairs of their communities. In making decisions on loans, for example, personal characteristics of the borrowers are likely to be taken into account, including family history. One advantage often cited for such banks is that they understand the needs and constraints of small businesses, being small businesses themselves.

But community banks in a country like the United States are big relative to some of the commercial banks in a country like Sierra Leone. Moreover, the commercial banks in Sierra Leone are likely to behave like community banks in extending loans and in their relationships with their communities. It is little wonder that even in the FSDP there is the thought that it may be a good idea to encourage commercial banks (among others) to acquire major shareholding in the community banks. In this author's view, in the Sierra Leone context, promoting branch banking by the commercial banks is a more direct way to achieve whatever benefits are seen to ensue from promoting so-called community banks.

3.9.2 Microcredit Organizations

The place of microcredit firms and organizations in a country like Sierra Leone is still open to discussion. The issues are how they should be financed and operated and what the measurement of their 'success' should be. The promise is, of course, that by increasing access to credit for neglected groups and activities, microcredit organizations can substantially alleviate poverty, promote entrepreneurship among the low-income population, facilitate improved intertemporal consumption patterns among the very poor and hence welfare of those borrowers and, in some cases, will augment the saving rates of the poor communities. An important general recommendation that can be made is for the authorities to arrange for a comprehensive study of the way forward in microcredit design, organization, monitoring and supervision, building on the recent Sierra Leone experience as well as the worldwide experience with microcredit. The result of the study should not only be used to guide government intervention but also to inform financial firms, civil society and aid organizations that are supportive of special initiatives in microcredit.

For instance, the enormous research that has been going on in the microcredit area has provided evidence that group lending, which has seemed like the preferable way to lend to the poor, to enable group enforcement of obligations, may not be as essential as once thought. Collateral-free individual liability lending has worked under several schemes. Also, experience has revealed ways to address problems with group lending – most notably strategic default leaving others to bear the repayment obligation – where such lending continues to be found essential. The structuring of incentives – e.g. gradual increase in lending ceilings, threats to cut off credit for repayment failures, varying interest charged with repayment record – have been experimented with in several locations around the developing world (see, for example, Karlan and Morduch (2010) for a review and some references). Diversity in the structuring of repayment schedules has also been experimented with, demonstrating that flexibility is feasible in this area and that a one-size-fits-all approach is not necessarily optimal even within the same organization and country. Ways to improve screening of potential borrowers and perform risk analysis with the data set available from the information obtainable are important areas of work to which public policy can also provide some input and incentives.

At the same time that all of this is going on, there is also a case for addressing the general question of the role of microcredit in poverty alleviation. No doubt an important issue in these investigations would be if it is possible to ensure viability of microcredit programmes without subsidies and financial aid. On the face of it, this possibility seems realistic with appropriate design and management, especially given the high return to capital found among microcredit enterprises in several contexts around the world and the high interest rates the very poor are willing and able to pay for consumption and emergency loans obtained from traditional lenders, even in Sierra Leone. Related to this is the question of whether finance is the main constraint on entrepreneurship among the poor.

The fundamental question is whether there are better ways for public policymakers to use public funds (including money obtained from aid) to help the poor – for instance, via general education and technical and vocational education and training, or provision of certain health services – than subsidization of microfinance activities. Studies can be easily designed and conducted to help answer these questions. The ideal would be to get a better sense of how much additional credit should be aimed at the very poor as opposed to being allocated to someone else – a sort of marginal decision-making regarding the optimal allocation of any given amount of credit in the economy – since, for example, poor people do vary widely in their ability to benefit from additional credit via microcredit programmes (for discussions of some of the issues involved, see Armendáriz de Aghion and Morduch (2005), Banerjee and Duflo (2010), Khandker (1998) and Yunus (1999)).

3.9.3 Long-Term Finance for Small and Medium Non-micro Enterprises

The measures to improve the enabling environment for financial firms, by getting the fundamentals right, as well as to develop the capital markets, discussed earlier, would all help to increase the access to long-term investment funds, including bank long-term loans. As mentioned in the FSDP, there is also a need to look at specific problem areas that many have highlighted, namely, the system of land rights, several collateral issues, as well as transparency in pricing and in the procedures of the banks. Beyond that, in order to improve policymaking in this general area of long-term investment funds for the medium- and small-scale enterprises in the private sector in Sierra Leone, there is great need for serious research and analysis in order to clarify several major issues. These would include the following topics:

- the available evidence that finance is a significant constraint on local entrepreneurship among small and medium enterprises (SMEs) in Sierra Leone;
- the nature and potential sources of funds available to Sierra Leone enterprises;
- the type of actions that local entrepreneurs can, and should, take to gain increased access to potential funds, given their capacity to use the funds;
- the ways local entrepreneurs can enhance their capacity to use available funds profitably.

Answers to such questions would help in designing appropriate public policy (especially via the government, the central bank, and the legal system) not only to further improve the enabling environment so as to attract suppliers of funds to lend to the long-term investors but also to enhance the capacity of the Sierra Leone entrepreneurs to attract and use the funds.

3.9.4 Saving Facilities for the Lowest Income Individuals and Groups

Although discussions of access to finance for the so-called underserved in most African countries, including Sierra Leone, have emphasized credit, it is useful to keep in mind that the supply of instruments, mechanisms and products for financial saving as well as the supply of insurance services are also elements of access to finance that are important to financial development and to economic growth in general, which it can be argued are not optimally available in most African countries and certainly not in Sierra Leone. Here, again, the low-income and rural populations are the most underserved.

Policymakers in Sierra Leone know that low-income individuals, despite their low incomes, are capable of saving and do save. In Sierra Leone they save via cash held in their homes, including in foreign exchange, especially US dollars; deposits made with trusted, typically more well-to-do, relatives and friends; investments in non-financial assets like cattle, land, residential buildings and jewellery; and miscellaneous business assets, which they use in commerce as well as in other businesses they operate, such as tailoring or taxi service. When these are the only saving outlets, the savers can typically benefit from greater flexibility, liquidity and diversity in their savings portfolios. More importantly, and related, financial intermediation in the system as a whole is most likely suboptimal. Indeed, from a national point of view this also means that national investment may not be as efficient as it can possibly be. The return to national savings may not be as high as is feasible and the saving rate may not be as high as it possibly can.

Hence, countries like Sierra Leone want to design and effectively market financial sector products that can attract savings of the poor into the financial system (see, for example, CGAP 2010; WSBI 2004, 2008). In the formal sector, an effective tool recently introduced in Sierra Leone is the National Social Security and Insurance Trust (NASSIT). It seems surprising that no serious initiative has been put in place to enable and attract the informal sector to participate in this system. It seems highly desirable and possible to get informal sector employees to participate in NASSIT on a voluntary basis. Hence, NASSIT should be encouraged by the authorities to look into ways to make this a reality.

A successful initiative of years past was the Post Office Savings Bank (POSB). The objective stated in the FSDP of separating the POSB from the Post Office and rejuvenating it, including increasing its access in the rural areas, is an excellent one. But the management of the POSB would have to improve drastically for it to fully attain its potential effect on financial saving, especially among the poor. As with the Tanzania Postal Bank (see WSBI 2004, 2008), the POSB of Sierra Leone can also profitably enter the microcredit business, with the saving and credit components complementing each other. In this light, some minimal saving requirement could be a qualification for obtaining a loan, whether individually or as a member of a microcredit group. In order to boost the ability of the POSB to garner savings, following concerted efforts to improve the POSB management and putting in place an appropriate supervisory framework for it, the Bank of Sierra Leone can examine the possibility of increasing the safety of the saving deposits by providing some kind of guarantee to the depositors.

With literacy rates increasing and general educational levels rising among the poor, it should become easier even for commercial banks to design and build up flexible saving accounts in the population as a whole. These accounts could earn interest, and hence superior to traditional passbook accounts, while not as inflexible as term deposits. Such accounts, as with certain saving accounts already in existence, could allow withdrawals after minimal notice. In order to market such accounts, apart from finding ways to spread the information, innovations like using deposit collectors, mimicking what informal saving arrangements do, can be efficient, especially in the larger towns. In Sierra Leone, following tradition, to attract the savers from smaller towns and villages, the deposit collectors can arrange periodic meetings with depositors (say once a month) in public places such as community centres. The challenge would be to find inexpensive ways for savers to withdraw funds to meet urgent unexpected needs; indeed, accessibility to savings accounts at all times is an important incentive contributing to success in saving drives directed at low-income individuals and groups. The availability and increasing use of cell phones could play a part in such drives in the foreseeable future. For instance, a saver could call a deposit collector who would agree to meet the saver who wants to withdraw money before the next regular meeting of depositors.

The government and banks, but not other private firms, in the nearer future could also be allowed to issue bearer (coupon) bonds. The bonds maintain anonymity with respect to the holder to whom interest and principal will be paid upon tendering a bond certificate; hence they do run the risk of loss due to theft, misplacement or destruction. But unlike cash they earn an interest. In the early stages, an innovative bank could offer safe deposit facilities especially for low-income persons residing in certain neighbourhoods.

The government could also, or instead, consider issuing a small savers security to be purchased on tap. The security could be of various maturities, cashable before maturity but not transferable, and hence avoiding the risk of forgery which can be quite substantial for a bearer instrument. The interest rate on this security should at least match that of regular government securities of similar or close maturities.

3.9.5 Insurance

The FSDP has some sensible plans for strengthening the insurance industry (Republic of Sierra Leone 2009, pp. 40–47). The plans include amending the current Insurance Act (2000), *inter alia*, incorporating microinsurance and crop insurance, and creating the conditions for its speedy implementation, including by putting in place the necessary institutional and organizational framework. The supervisory authority (the Sierra Leone Insurance Commission – SLICOM) will be strengthened. To meet the challenge, the Sierra Leone authorities propose to work closely with the Sierra Leone Insurance Association (SLIA), which they will try to make more effective as an organization through various devices to enhance its capacity to support the industry as a whole, as well as with the individual firms/companies themselves. Ways will also be found to make the industry better serve the public including via requiring companies to maintain a complaints register and formalizing an insurer redress mechanism that works in the public interest. Finally, the FSDP indicates that the authorities will encourage the insurance companies to come up with more socially optimal ways to use their investment resources, diversifying away from the current tendency to concentrate in the real estate area.

All these are steps in the right direction. But no doubt more needs to be done. We would add that the FSDP should, in addition, put some plans into effect to increase the demand for insurance, particularly for health, housing, and life. There is clear suboptimal insurance in these areas. Hence, the SLIA should be encouraged, perhaps in cooperation with the Bank of Sierra Leone, the Ministry of Finance and Development, and SLICOM, to study ways in which the insurance market could be expanded in Sierra Leone, including the appropriate insurance product designs for various types of potential clients/demanders.

Insurance facilities and products for the lowest income individuals and groups, which are no doubt very hard to design and manage and for which the effective demand, prima facie, is especially low, should be given special attention in such a study. Poor households in poor countries like Sierra Leone do face a variety of risks from shocks, which can have serious adverse long-term consequences for their well-being. There are traditional devices which the poor use to address these risks. In farming, for example, multi-crop farming is one. Generally, mutual and communal assistance arrangements, especially to deal with adversities like illnesses, bereavement, and crop failures are also forms of insurance. Still, there is a potential effective demand from the formal insurance market, which should not be neglected *ex ante*.

3.10 Keeping Track of Progress and Programme Evaluation

We have indicated above that an action plan would be an essential element of the reform and development plan. No doubt, this would be a rolling plan. Now, in conclusion, we highlight the important issues of tracking progress in implementation and of programme evaluation. In order to ensure that the relevant authorities and the financial sector keep track of the progress being made in the reform and development processes and to enable continuous programme evaluation as well valuable research projects, we would highly recommend that systematic data collection and storage begin as early as possible. In particular, we would recommend data on:

1. evidence of actual implementation of official programme initiatives;
2. the detailed evolution of important aspects of the financial system;
3. panel data on important outcomes, that is, effects on 'final' financial system variables of policy interest.

The goal of the reform and development, in a sense, is to effect changes in 'final' financial system variables such as:

1. credit (aggregate and to various sectors, subsectors and categories of borrowers);
2. real interest rates on loans;
3. spreads between lending and borrowing rates;
4. saving rates;
5. aggregate value of insurance premiums per capita or relative to GDP;
6. the total value of shares traded on the country's stock exchange divided by GDP;
7. the total value of shares traded on the country's stock exchange divided by the value of listed shares on the country's exchange.

The data collected would allow policymakers to test, for example, whether credit to a particular group increased between two or more dates because of human capital improvements in the banks, particular innovations in the banks, increased financial capability of the populace (as measured by some index), or because of some specified changes in the taxation system, the legal system, or the regulatory system?[19] The individual bank data should be collected and used for such estimation.

It is also important to keep track of the evolution of aspects of the financial system, because in a sense, these are the intermediate targets of the programme; they are the evidence of the success of implementation of the programme. Continuing with the above example, these 'intermediate' target variables are the independent variables used in explaining the 'final' system variables (the final outcomes) of the reform process. The more the intermediate target variables change over time, the more meaningful the econometric evaluation can be. Of course, the hope is that the changes will be in the direction that reflects success in financial system reform and development.

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[19] For an introduction to the econometric evaluation of programmes, see Imbens and Wooldridge (2009).

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