Policy brief
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Management practices and banking

The case of Ethiopia

In brief

- This study investigates whether management practices allow Ethiopian bank branches to improve their credit provision.
- Researchers surveyed over 1,900 branches affiliated with 16 Ethiopian banks to score management practices across various dimensions and collect information on day-to-day operations.
- Ethiopian bank branches that adopt stronger management practices issue loans with larger amounts, longer maturities, smaller collateral, and lower default rates.
- There exists a positive relationship between management practices and the ability to serve more extensive geographic areas.
- Private ownership and branch competition are associated with the adoption of better management practices.

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Research overview

The economic literature provides a large body of evidence highlighting how the availability of credit is essential for firms in any productive sector. This is necessary to jump-start new enterprises, stimulate firm-level investment, and boost firms' employment. Unfortunately, there is limited knowledge on the mechanisms that determine the credit flows from the banks towards the productive sector. Moreover, the need to understand this phenomenon is particularly pressing for low-income countries, where local financing constraints are significantly tighter and firms are disproportionately reliant on banking services.

This study investigates a novel dimension through which Ethiopian banks position themselves in local credit markets: the management practices of their local branches. Apart from traditional ways of expanding and strengthening their customer network (e.g., branch network expansion, provision of broader services portfolio), branches also invest in the adoption of management practices that allow them to reach out the most productive entrepreneurs and innovative projects. Such a dimension of financial development is particularly important in contexts like Ethiopia, where banking activities are constrained by a lack of infrastructure, poor labour market conditions, and other institutional frictions. Thanks to effective performance monitoring techniques, structured reward schemes and lean organisational structures, financial institutions are nonetheless able to build a stronger local presence by employing a dynamic organisational structure, providing performance-based rewards, and strengthening their local presence.

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Ethiopia represents an ideal environment to test such dimensions of financial development. In fact, these banks invest significantly in their existing network of branches, as alternative improvements are either too expensive or impractical. Issues like underdeveloped electrification and the high search costs of qualified personnel force banks to reinforce existing local units and to invest in retaining their labour force. An effective and relatively cheap way to accomplish this is the adoption of a managerial framework that fosters efficiency and promotes cohesion among employees.

Data

In order to measure the impact of good management practices on branches' activities, the study relies both on novel survey data and on pre-existing datasets on economic and financial variables. A survey, which was carried out in collaboration with the World Bank, was designed to score management practices across various dimensions and to collect information on day-to-day operations at the branch level. A total of 1,911 branches affiliated with 16 Ethiopian banks were surveyed, corresponding to approximately 60% of all the branches active in the country in 2017.

Policy motivation for research

This piece of research investigates whether management practices allow Ethiopian bank branches to improve their credit provision. This question is particularly relevant in developing countries where the banking sector is a key provider of firm credit. Given the important role that financial institutions play in these contexts, it is essential to understand how management quality at the branch level influences the provision of finance to productive sectors. At the same time, it also relevant to assess which factors promote the adoption of better management practices. To do so, this study specifically investigates how management frameworks influence certain loan characteristics, in particular their number, their average size, their relative interest rate, the associated required collateral and their maturity. In order to offer a complete picture, this analysis also addresses the potential factors promoting the adoption of superior practices at the branch level. The study focuses in particular on the influence of the degree of competition, the type of bank ownership (i.e., private or public) and the level of local economic activity on the recorded level of management practice development. Figure 1 summarises the structure of this investigative effort.

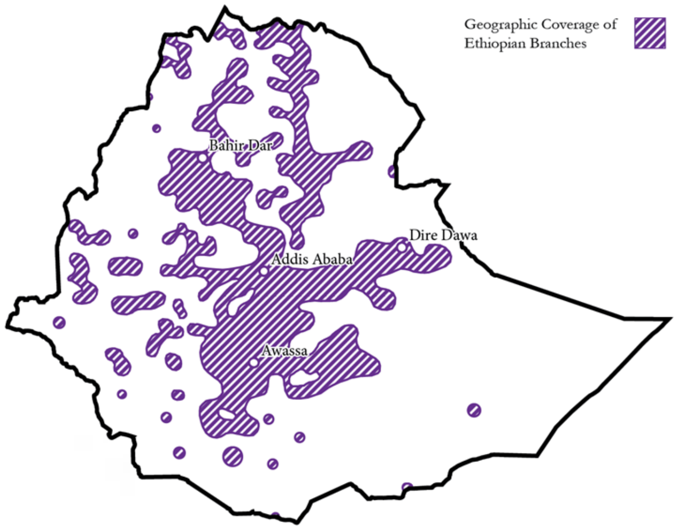
Figure 1. Structure of the study

Results

Effects of management practice quality

This study finds that branches adopting better management practices tend to serve larger geographic areas and provide more credit, although they do not issue a larger number of loans compared to branches operating with inferior management practices. We provide graphic evidence of this fact through the map below, which shows the city average of the geographic coverage by local bank branches. This figure provides a key message: bank branches are able to bypass the impossibility of opening new bank branches (given by infrastructure or labour markets) and extend the financial inclusion of a wider part of the local economy by investing in their management practices. Combining the findings that banks with good management practices provide larger average loans, but not a bigger number of loans, may imply that more efficient branches are generally constrained on their overall credit allocation capacity.

As a consequence, they utilise their superior managerial frameworks to accurately screen firms applying for credit, issuing larger loans to selected ones. Moreover, the attentive selection of credit recipients allows these branches to experience lower default rates and issue loans with longer maturities and lower requirements on collateral payments.



Finally, the analysis does not produce evidence on a possible correlation between good management practices and lending rates. This result is not surprising as higher rates generally lead the best entrepreneurs to obtain credit from other competitors or outside the banking sector. Figure 2 summarises these findings.

Table 2: Effects of good management practices

Good management practices		
	+	Larger average loan size
		No impact on number of issued loans
	+	Longer average loan maturity
	–	Lower average collateral required
		No impact on average lending rate
	–	Lower average default rate
	+	Higher average operational distance

Drivers of management practice quality

The second part of this study focuses on the characteristics of the local economy that may promote the adoption of good management practices. An important finding is that the level of competition within cities, measured as the number of competing branches, is positively correlated with the adoption of superior management practices. Another interesting finding is that the type of bank ownership has a considerable impact on the management frameworks adopted at the branch level. The study in fact shows that branches affiliated with a privately-owned bank tend to rely on better management frameworks compared to branches affiliated to publicly-owned banks. Finally, empirical results suggest that the adoption of management practices is not correlated with aggregate local economic activity. This phenomenon is likely due to the fact that a strong local economy affects positively both the marginal revenue of adopting stronger practices (by increasing the expected return on this asset), but can also increase the marginal cost of stronger practices (by increasing the cost of retaining talented employees that support them). Figure 3 summarises these findings.

Figure 3: Determinants of the adoption of good management practices

Branch competition	+	Promotes the adoption of good management practices
State ownership	–	Hinders the adoption of good management practices
Economic activity		No effect on the adoption of good management practices

Policy recommendations

This study produced novel insights on the contribution of management practices to the credit provision of the Ethiopian banking sector. The empirical results presented above highlight critical characteristics of the financial industry in a developing context, which critically depends on the role of banks for its economic development. Such evidence points at several paths that can be followed to improve the operational efficiency of Ethiopian bank branches and of banking sectors in other developing countries. More research on these topics is needed to validate these recommendations and provide a stronger body of evidence towards their effectiveness:

Promote branch competition. A critical factor that favours the adoption of good management practices is the level of branch competition within cities. As the economic literature suggests, the lack of competing entities prevents branches from experiencing the need to increase their operational efficiency through the improvement of their management framework. This problem remains particularly relevant in remote and rural areas where the market for banking services tends to be small, hence failing to attract different players to satisfy its demand.

Government intervention designed to favour the opening of competing branches in such areas may constitute a starting point for the provision of better financial services in developing scenarios.

Promote the private ownership of banks. The nature of bank ownership deeply impacts the type of management practices adopted by banks in Ethiopia. State-owned banks in fact tend to get stuck with inferior management practices, leading to a sub-optimal quality of their financial services. This issue remains particularly serious in Ethiopia where the largest bank serving the market, the Commercial Bank of Ethiopia, is owned by the government. As a consequence, in evaluating the trade-offs of privatisation, we highlight that the positive effects on management and credit should be taken into consideration.

Provide platforms to promote management practices in the banking industry. We cannot exclude the possibility that certain bank branches may simply lack the knowledge of what constitutes a good management practice and how to implement it in day-to-day operations. The high degree of variation of management quality within the same bank suggests that best practices are indeed available but unevenly implemented across branches under the same ownership. In this respect, bank headquarters may promote the dissemination of good management practices across their network through corporate coaching programs.