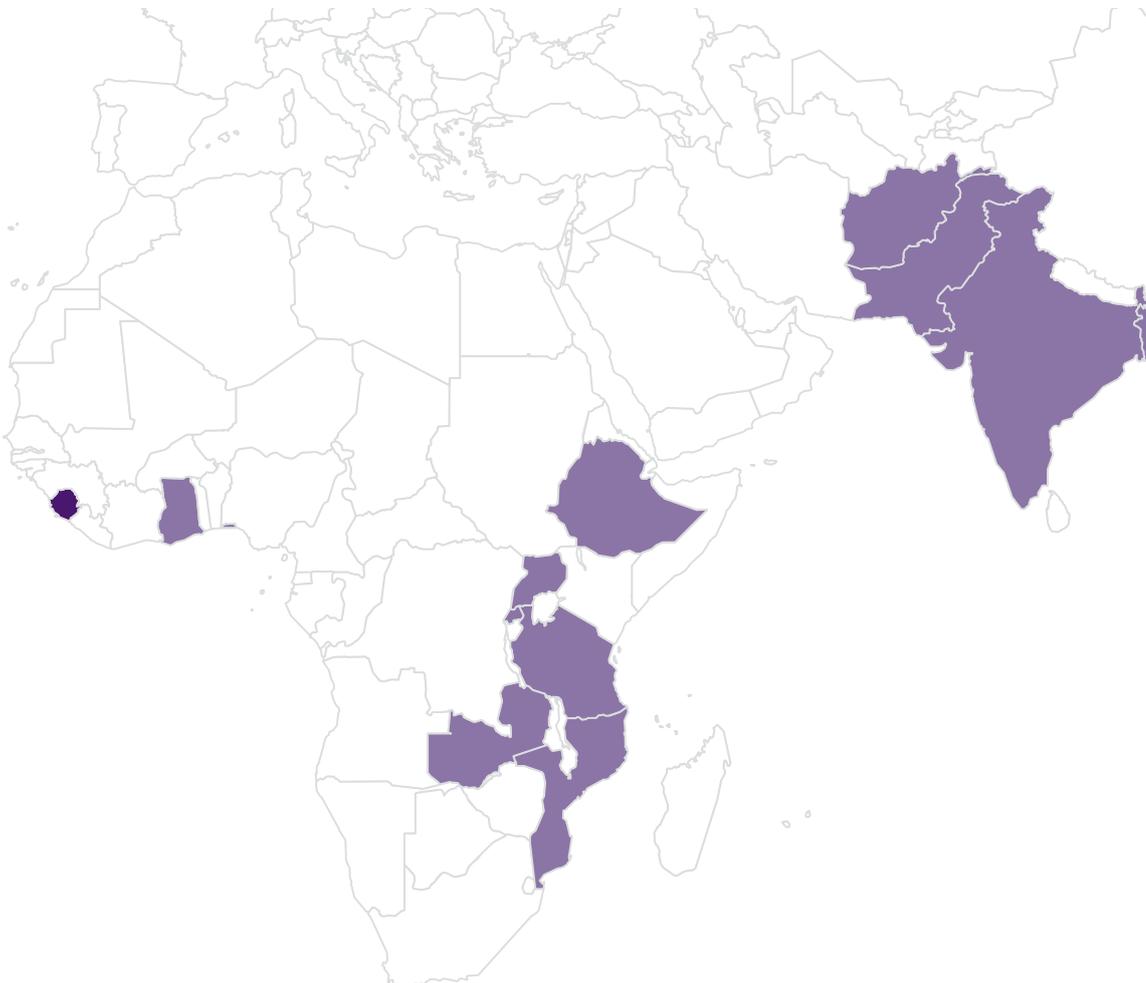


Financial Sector Reform and Development in Sierra Leone

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1. Introduction

Financial instruments, markets and firms influence saving rates, investment decisions, technological innovations and long-run economic growth rates. From a functional perspective, financial systems perform five basic functions that 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 within financial systems can be observed advising clients, structuring and arranging deals, providing finance to borrowers and equity issuers, and managing the 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 with well-developed banks and securities markets than in countries with poorly developed financial systems (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 the legal and political institutions of countries (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 kind of cluster containing a substantial number of fair-sized financial-services firms, major international accounting firms, legal services and telecommunications and computer engineering firms (including consultancies). The financial-services firms in such a centre will be highly diverse, with some of them engaged in activities covering the whole spectrum of activities in major areas such as banking, securities, foreign exchange trading, insurance, derivatives, fund management, and various specialized professional financial services.

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Such a financial centre will often also be an exporter of financial services, in addition to responding to local demand for such services (Johnson 2009a).

As with so many institutional and organizational developments, financial systems emerge and develop through a mixture of spontaneous order and central direction or official policies. Many writers have raised the question of what the structural factors are that make for a reputable world-class financial centre, apart from simply being a developed financial system. The 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;
- a fair, transparent and efficient legal and regulatory regime;
- a sound and fair tax regime;
- implementation of international standards and best practices;
- low cost of doing business;
- high-quality, reliable and appropriate physical infrastructure;
- a stable political and economic environment.

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

In this paper, starting from the very rudimentary financial system currently existing in Sierra Leone, we outline a strategy for financial-sector reform and development that 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.

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 a dynamic sense. Static efficiency means that 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 given the institutional framework, the preferences of the individuals in the society and the distribution of wealth. In other words, there exists intra-sectoral efficiency in terms of 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 would be 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, property rights; norms, rules and conventions of behaviour; and 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 at which 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 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 are mobile among sectors and, thus, that they 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 the following groups:

- (1) the institutional environment;
- (2) market structure and size;
- (3) the nature, level and evolution of transaction costs.

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, and the internalization of costs and benefits from one's activities). This is one reason why the legal and regulatory framework is extremely important. So, too, are clubs and associations (e.g. foreign exchange clubs, bankers associations, accounting associations, etc.). Hence, either by law, 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:

- (1) rules, codes of conduct (including fiduciary obligations) and procedures in interactions;
- (2) uniform guidelines in formulating different types of contracts;
- (3) uniform standards and measurements for commodities and services;
- (4) assessment and evaluation standards (such as credit ratings, for example);
- (5) common technical language in communications, common value dates for money, exchange and securities transactions, and uniform computer codes and languages for financial transactions;
- (6) charts of accounts for use by banks.

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

2.2. Market Size and Structure

The social efficiency of financial markets tends to be enhanced the more competitive markets are, the higher the level of expertise of market participants, 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), and the faster market participants respond to price signals using all the information at their disposal efficiently. 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 that 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 tends to look at a number of indicators. These include

- (1) barriers to entry (and, hence, openness of the market),
- (2) 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,
- (3) the number of firms in a particular market,
- (4) the stock of financial assets held relative to gross domestic product (GDP),
- (5) the variety of financial instruments in the market,
- (6) the diversity of participants (brokers, dealers, market makers) and the degree of specialization by functions and by assets,
- (7) 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.

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 with 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. Developing the Financial Sector in Sierra Leone

Sierra Leone is at a very low level of financial development. It is a country of about six million people, with a per capita annual income currently around US\$315. Sierra Leone currently has thirteen commercial banks, nine community banks, nine insurance companies, three housing finance companies that are non-deposit-taking, two savings and loans, the Finance and Trust Corporation, two discount houses, some forty-two foreign exchange bureaus, and six microfinance institutions, which are also non-deposit-taking. Total bank assets at the end of 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 national 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 activities of the banking system are not government-dominated. However, there are cash and liquidity requirements that banks have to follow, constraining the structure of banks' asset portfolios somewhat.

3.1. The Challenges

Banks in Sierra Leone are small (assets average about US\$45 million), efficiency is low (non-interest expense averages 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 to be low on average. It will take some time for the new stock exchange to obtain a significant number of listings.

The 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 current state of banking supervision is rudimentary. One certainly does not see any attempt to explicitly organize the approach to assessing the soundness and management of a financial firm in light of risks and risk management. This would emphasize the importance of a clear understanding of financial risks and optimal assignment of the responsibility for managing different types of risk (namely, liquidity, credit, interest rate, market, foreign exchange, operational, sovereign, legal, and fraud risk). 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 cheques or internet banking, and, of course, no electronic large-value payment system. There is also no credit rating agency. Although there is no generally available empirical evidence on the matter, it is also very doubtful that the commercial banks have the data or the sophistication to have developed internal processes going beyond so-called traditional approaches to credit risk management.¹ Furthermore, the normal financial markets (short-term credit, medium- and long-term credit, foreign exchange, etc.) are very rudimentary and do not function well.

¹ Saunders (1999) classifies the traditional approaches into *expert systems*, *rating systems* and *credit scoring systems*. In *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: character, capacity, capital, collateral and cyclical or economic conditions (Saunders 1999, pp. 7-9). This approach is criticized for not ensuring consistency and objectivity across clients, offices and types of borrower. *Rating systems* can 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. This involves building databases, benchmarking, constant review and backtesting. The models use financial and market data, sector-specific information (data and variables) and qualitative information. When making decisions on rating grades, they estimate probability of default, 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 that affect the probability of default and weight them into a score. Thus, the credit scoring system can be used as an element in the rating system. Another way of interpreting it is that one can fit a model for default probability as a function of several variables and then use the coefficients as weights to determine 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 representing 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.

There is a lot of work to be done on what we shall term the ‘fundamentals’ in Sierra Leone. By this we mean, in particular, the innovation system, human capital, financial capability of the populace, infrastructure and public services, various factors affecting microeconomic incentives to enterprises (e.g. openness, taxation, administrative barriers and the legal environment), and general governance (e.g. macroeconomic policies, socio-political governance and compliance with international standards and codes).

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

3.2. The Authorities’ Financial-Sector Development Plan

Sierra Leone’s financial-sector development plan (FSDP) emphasizes eight major areas:

- (1) building commercial banking sector capacity;
- (2) increasing access to finance;
- (3) improving mobilization and investment of long-term funds;
- (4) strengthening banking supervision and regulation;
- (5) improving the macroeconomic environment, *inter alia* to bolster financial system stability;
- (6) modernizing the payment system;
- (7) strengthening short-term financial markets and monetary policy;
- (8) strengthening the central bank infrastructure.

The action plan of the FSDP does not include any provision for sequencing these policies. It would be useful to make such provision, 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 non-financial-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 now 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.

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 a good reputation. Having the 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 the capacity of the people and organizations in the financial system to perform their tasks well. We would argue that this capacity building is 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 the effectiveness and efficiency of cooperation among the firms concerned.

4.1. Innovation System

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

The concept of a national innovation system is useful for ordering thinking in this regard (see, for example, Nelson 1993). 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 and procedures that are new to them.

The innovation system comprises the whole set of institutions and organizations whose interactions determine the innovative performance of the markets and firms in the financial system. Innovation involves copying and catching up with others' products and practices, the 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 of mathematics and statistics, finance, economics, etc.), and adopting new approaches to marketing and cooperation with other financial centres around the world. The 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; programs 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 that will influence the innovation system and that the authorities must influence. Among these, the habits and practices of major actors in the financial system are important. Firms must be motivated to inculcate habits and practices that encourage innovation. In that regard, the incentive structures within the financial organizations matter.

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

4.2. Human Capital

The quality of the human capital in the financial system is 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 the attraction of high-quality personnel in mind. The indispensability of high-quality people for creating a high degree of competitiveness has forced all financial centres seeking to compete on the international stage to be open in their recruitment policies, acquiring people from wherever they can be found. Sierra Leone would no doubt benefit from adopting such an attitude.

Within a relatively short period of time, given a sound government policy that includes support for education and training of Sierra Leoneans in top universities around the world, Sierra Leoneans should have no problem having a substantial share of the top positions in the leading financial firms in the country without sacrificing quality. However, for rapid financial development, the country should be open to firms—especially banks, insurance companies, rating organizations and accounting firms—from all over the world. Hence, all firms will be free to enter the financial markets as they see fit subject to criteria that are common to all. 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 in terms of efficiency gains.

Labour policy and personal income taxation are two areas with thorny issues that all financial sectors around the world have had to address. In the case of labour policy, the main issue is the degree of freedom and flexibility that the

top management has 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 to adopt a mix of policies that are sufficiently flexible and also fair to the workers in light of normal practices in the leading centres. 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, at least with those countries where the risk of double taxation exists. In regard to the level of taxation, the advice would again be to carry out a survey of the leading financial centres to obtain a good idea of their personal taxation, both of nationals and of foreign nationals who are residents in the country. An attempt should then be made to modify domestic taxation laws in order to become competitive.

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 those with little 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 degree of financial capability should motivate more business for a national financial system than would otherwise be the case. This will help to build a solid demand base, which is useful for sustaining a national financial system and, hence, instilling good practice among its financial-services personnel. In addition, the population of young persons from which future financial-services experts could emerge would become greater.

The UK 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 and to 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 considering Sierra Leone, planning for retirement and old age has always been a challenge, moderated only by the willingness and ability of the younger generation to care for their old relatives voluntarily. The introduction of the National Social Security and Insurance Trust (NASSIT) goes some way to remedying this problem. However, by its very nature, NASSIT mostly covers the formal sector, which still remains smaller than the informal sector of the economy. One could argue, of course, that the

relationship between, on the one hand, participation and/or the form of participation in the financial system and, on the other, financial capability 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 initiative and apply some of the same tactics, including, most notably, an 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 from 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 be of great social value.

As is the case in other programmes, with this sort of planning it is always useful to undertake a survey in order 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 the UK initiative to organize a benchmark survey of this kind.

4.4. Infrastructure and Public Services

The physical and technological infrastructure are important elements of the capacity 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 the postal system,
- (3) financial-system-related infrastructure (e.g. trading facilities, clearing and settlement systems for money and securities, other electronic linkages among participants).

Some of the decisions and investments regarding infrastructure will, of course, be left to the financial-services markets and firms themselves. In regard to 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 could be enhanced if some explicit coordination was arranged within the public sector to focus on the requirements of the financial system. In the case of Sierra Leone, this could be one of the tasks of the Financial Sector Steering Committee that has been proposed to oversee the implementation of the FSDP.

5. Getting the Fundamentals Right: Microeconomic Incentives for Enterprises

The policy environment will affect 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 that they would earn elsewhere. To make matters worse, even the human capital developed within Sierra Leone could actually flow out of the country if the policy environment is unfavourable. 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 in discussing human capital. We mention here that quality of life also matters in attracting talent. Hence, making the country an attractive place in which to live would 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.

5.1. Openness

The financial sector would benefit from the presence of strong firms (firms that can survive in open competitive markets and are capable of exporting their services). In order to attract such firms and keep them, the maintenance of an open economic environment is an overarching requirement (this applies to markets, institutions, immigration laws, information flows, ideology and access to the authorities).

An open environment exhibits several obvious characteristics. First, there are 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, to bring 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 are not overly restric-

tive (that is, not out of line with the leading financial centres of the world).² Third, innovation is encouraged, that is, there are not regulatory and other obstacles which are more stringent than those found in the leading financial centres. 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. Authorities must also demonstrate that they have seriously considered the views and analyses of financial-sector organizations before finalizing their decisions. Fifth, there must be a high degree of freedom and flexibility given to 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,³ 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.

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 that are not labelled as 'taxes'. Instead, they may be called registration fees, stamp duties or transfer fees (such as when shares are transferred).

Government 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), to 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 damage

² In its argument urging the Japanese authorities to remove certain firewall restrictions, International Bankers Association 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 and other financial-services-related business.

³ Capital mobility has a positive impact on financial-market development. Among other things, it improves the range of investment outlets available to suppliers of funds, while users of funds have access to cheaper and more sophisticated financing, and 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 (Sundararajan *et al* 2002). In order to address the complications, two fundamental policy responses have been found to be 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 (Sundararajan *et al* 2002).

the competitiveness of the financial sector in all of 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 particularly great for some decades to come. Thus, 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 fifty 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.⁴ Some 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 example, as mentioned before, should be signed where useful. Many countries have also been re-assessing and revising certain specific taxes in this area. Benefits can be gained from observing the practices of those countries and, where relevant, copying them in order to be competitive.

In examining taxation to remove elements that would be discouraging to the development of a sound financial sector, Sierra Leone could 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 could be to make the financial sector an enclave, which would allow it to enjoy special tax privileges not enjoyed by firms, organizations and individuals outside the enclave. We would not recommend this approach for Sierra Leone however.

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 they are for many other sectors of 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 business in the financial sector. For example, any lingering, recurrent problems with utility companies, 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.

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

5.4. Legal Environment

The law, the courts and the police all need to be reviewed in light of the requirements for growth, efficiency and the competitiveness of the financial sector in Sierra Leone. It would be advisable to carry out a formal review of the legal system in light of the experience of the top international financial centres to ensure that the legal framework is adequate. Even a casual observation reveals that the regular courts in Sierra Leone are way below the normal level of efficiency of operations required to support the financial system instead of representing 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. If the hard evidence indicates that the court system is not up to the task, especially in terms of speed and decisiveness, then thought must be given to creating a special court system for the financial sector.

For example, the FSDP suggests setting up 'an effective court system' to strengthen debt collection, *inter alia*. This is a step in the right direction. There seems 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 all impose constraints on the use of real estate as collateral. A further aspect that is generally ignored is the absence of an orderly and well-functioning real-estate market, even in the areas of the country that have fee-simple ownership of land. This greatly reduces the liquidity of real estate and, hence, its utility as collateral in the credit market.

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 beneficial for their reputation to operate or work in a country that is considered poorly governed, or even to have 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.

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 the 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 the payment-systems facilities that it controls should also be no more onerous than those in leading financial centres. As argued earlier, capital mobility will also pose challenges. A country cannot truly be a big player in the financial-systems business if it has stringent inward and outward capital controls. 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 (which are discussed below) are consistently taken care of, the basic strategy for addressing these complications and challenges is twofold. First, a macroeconomic policy framework that ensures low inflation and exchange rate stability must be put into place. Second, it must 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 the following:

- (1) there should be a clear understanding of the 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 (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 would 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 well-thought-out policy response 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 (see Vällilä (2002) for a discussion of the basic analytical issues involved in considering fiscal support).

6.2. Socio-Political Governance

One of the problems that policymakers in Sierra Leone must 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 the rule of law and sustainability of policies. Strategies must therefore be developed to build credibility for political stability and to encourage low levels of corruption and other elements of good governance.

When assessing countries on corruption and socio-political governance on the whole, many analysts resort to surveys and indices purporting to measure, for example, *risk of expropriation*, *general governance indicators* and *constraints on the executive*.⁵ Analysts also look at the global corruption reports of Transparency International. It seems 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 attempt to understand what goes into these reports and what they can do to improve their ratings. This will help them to 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, then implement it resolutely. In designing the plan, the authorities should remember that they will need to consider 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, Johnson 2007, pp. 155–61).

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 the actions of other countries. 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

⁵ 'Risk of expropriation' comprises survey indicators of institutional quality from the *International Country Risk Guide*. The data includes 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 World Bank 'governance indicators' currently comprise six dimensions: voice and accountability, political stability/absence of violence, government effectiveness, regulatory quality, the rule of law, and control of corruption. The 'constraints on the executive' measures come from the Polity IV data set (*Polity IV Project*). The aim is to directly measure the limits of executive power. Constraints on the executive refer to the extent of institutionalized constraints on the decision-making powers of chief executives, with concern for the checks and balances between the various parties in the decision-making process.

adopting practices that have improved risk management, efficiency and governance in other countries.⁶ For these reasons, countries have been cooperating, in various venues and organizational settings, to agree on standards and codes that could 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, been 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.⁷

In trying to develop its financial system, Sierra Leone, then, must clearly demonstrate that it is resolutely implementing relevant norms such as 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 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 Appendix A.

First and foremost, it would 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, in order to ensure credibility, it will have to arrange for peer reviews by experts from the leading financial centre countries of the world and/or from appropriate international organizations. This is required, in essence, to validate the country's own self-assessment and implementation of compliance.

7. Regulatory Strategy

Sierra Leone, like other African countries, needs a high-quality regulatory environment, not only to avoid financial crises but also to foster financial development. There are at least three major benefits 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 would be the case if the regulatory standards were suspect. Second, financial firms outside the country will look favourably upon building relationships with the financial firms and markets in the country. Third, authorities in

⁶ In Ghana, for example, Asembri (1996) was proud of the high standards for listing and trading that the young stock exchange in the country had set, as confirmed by a visiting team from the Commonwealth Secretariat in October 1992.

⁷ See Johnson (2002), who makes these points in the case of the compliance with the Core Principles for Systemically Important Payment Systems.

other countries will be less prone to imposing tight regulatory standards on the dealings of their local financial firms and markets with financial firms and markets in Sierra Leone (Johnson 2009b).

The regulatory strategy in a high-quality regulatory environment must achieve two overriding objectives. First, it must ensure that regulators and financial firms have a clear understanding of the risks faced by the financial firms and how those risks should be managed. Second, the regulatory strategy must be clear regarding the roles of regulation and 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.

7.1. Financial Risks and Their Management

Until recently, banking supervisors talked only about ‘CAMEL’, an acronym standing 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. Nowadays, however, there is an 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, have transformed the CAMEL into CAMELS or CAMELOT, without being unanimous about what the ‘S’, ‘O’ and ‘T’ stand for. Sometimes the ‘S’ (in CAMELS) stands for systems and control, but it stands more generally for sensitivity to market risk. Similarly, the ‘O’ and ‘T’ in CAMELOT sometimes stand for quality of operations and treasury management, whereas, in other cases, they stand 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 available—within the regulatory community and the financial firms—to understand and manage the financial risks in the markets in which the country’s financial firms operate. An important component of human capacity is knowledge of the analytics of risk management. Complementary resources include computers, data, libraries and research budgets. Firms have their own internal processes. The regulatory agencies must set standards, sometimes in great detail, and must also oversee internal processes of firms to ensure that they are appropriate and sound.

Many different types of risk 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).

7.2. Regulation versus the Market

Since financial firms have an incentive to survive, it might seem that market discipline will do a satisfactory job of forcing the 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, the traditional response has been threefold. The first is that market discipline can be effective if there is full and accurate information disclosure and transparency. Given this 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-level viewpoint 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 the 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-level viewpoint, 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 regarding 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 are superior (from the perspective of firms' risk-return profiles) to the standardized regulatory 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 the only involvement from authorities being in an oversight capacity. Perhaps no other regulatory move was more energizing to the financial firms than the accord by the Bank for International Settlements 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 a 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 on 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 example, 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. Llewellyn stresses the central issue of 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 of 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.

In practice, how one determines 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 the 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 during the Greenspan era: opposition by politicians, opposition by big banks, and the effect on the erosion of Federal Reserve 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. For a given country, some of the determining factors 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 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 that have guided 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 that 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 that they were allowed to before the recent financial crisis, as some have suggested. But at least these banks will most likely end up losing some of the trust that 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.

7.3. Corporate Governance

Starting 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 have shareholder interests as one's sole concern 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 insufficient.

Nowadays, 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 simply maximizing the value of the firm for shareholders. The loyalty of the organization's officers to shareholders should not have external harmful effects on the larger community for which those shareholders are not made to compensate. 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.⁸

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 judgment or wrong decisions, but rather for actions and inactions that manifest fraud, illegality, gross negligence and conflicts of interest 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 therefore 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

⁸ Macey and O'Hara (2003) also take a view along these lines 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'.

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.

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 (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 such as 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 rare and less bloated in the African economies compared with more developed economies. Yet, occasionally, it is surprising to see bank personnel systematically permit dangerously high concentration of exposure to a few sectors, as was the case for the recent banking problems in Nigeria (Sanusi 2009), without some initial motivation to exploit perceived possibilities for quick and/or certain substantial profit in the hope of being rewarded with salary hikes and other forms of compensation (bonuses, promotion, etc.).

In April 2010, the Financial Stability Board (which was known as the Financial Stability Forum until April 2009) 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 (Financial Stability Forum 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 that 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.

7.5. Early Warning Signals

Public policy towards crisis prevention and resolution has included concerted efforts to improve early warning signals and promptness of response to crises. Policy in the area of early 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 to 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 programs tailored to the specific needs of each category. Statutory supervisory requirements must be sufficiently flexible to accommodate such an approach.

7.6. Organizational Structure: Unified or Not?

It is obvious that, from an organizational perspective, a regulatory/supervisory agency must have clear objectives, the autonomy and expertise to do its job, and must be accountable to government, parliament, the financial sector/industry and the populace at large. Autonomy includes budgetary and instrument autonomy. Instrument autonomy includes the authority and power to enforce 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 a levy on the regulated firms and markets, rather than by government. South Africa, for example, has a Financial Services Board that supervises non-bank-related financial services. The Financial Services Board is financed by the financial-services industry itself, with no contribution from government. The UK Financial Services Authority (FSA) 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 ‘recognised 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.

An important issue is whether there should be a unified supervisory agency, as in Australia, Canada, Denmark, Iceland, Japan, Korea, Norway, Singapore, Sweden and the UK, for example, or whether, instead, one should adopt various models of splintered agency arrangements as in the majority of countries (for a discussion of this, see, for example, Abrams and Taylor (2000)). 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 that 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;⁹ an 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 (the clustering effect). Second, it makes sense to encourage financial conglomerates¹⁰ 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 increasingly 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 only have to deal with one supervisory agency, and the accountability problem will be simplified since everyone will know the agency that is responsible for the supervision of the

9 Michael Foot (2005), for example, notes that there were eight different ‘principal’ regulators in the UK before the FSA and that they

all had support services for Information Services and Human Resources that were seriously suboptimal in size. It also proved 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.

10 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 ways across subsectors.

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 FSA, which deals with a global financial centre, demonstrates that the challenges can be met comfortably. First of all, there will be a challenge to balance the multiple objectives of a unified supervisory agency. Surely, however, these objectives will all revolve around risk management, efficiency, consumer protection and corporate governance issues. Second, possible diseconomies may arise. One diseconomy 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. Clearly, though, the direct solutions to these problems are not difficult to find. Third, it may be challenging to create a single agency culture, since the mindsets 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.

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.

In the unified structure, as well as having direct contact with banks, the central bank should also 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 remaining independent.

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

A developed financial system will have certain well-functioning architectural and organizational structures. 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 viewed as finding a socially optimal way to put such structures in place and to have them functioning well. The important questions include where the focus over the next decade or so should be in a country with a highly underdeveloped financial system like Sierra Leone, and what the appropriate roles of the public sector and the private sector are. In addition, the issue of the nature of cooperation between the private and the public sectors is important. In this context, selective intervention policies should be carefully thought through. Financial markets should generally be given the 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.

8.1. Money-Market Development

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

In regard to *monetary policy*, problems and shocks relevant to monetary policy formulation are revealed more quickly the more developed money markets become, as they show up in market variables such as interest rates. The monetary transmission process is also smoother and has shorter lags the more integrated and efficient money markets are. 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 money markets are. Moreover, with well-developed money markets, low-risk instruments become available to portfolio managers and banks, and diversification and intermediation are made easier, with the ultimate benefit being made 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, macroeconomic stability (all of which are discussed elsewhere in this paper) and 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. 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 between countries, even with well-functioning money markets. The relative importance of market makers (who take positions and quote two-way interest rates) and of brokers (who do not take up positions and charge commissions for their services) also differs widely from place to place. Generally, in well-functioning markets, trading via brokers is limited (around 10–20%); the rest is done on a bilateral basis. The nature of the trading also differs (e.g. 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, tends 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 to 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 borrowing.

The interbank market itself could 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),¹¹ certificates of deposits (CDs),¹² or commercial paper¹³ could be useful in the development of the money market. But they can differ greatly in credit risk and the authorities may have little or no control over their supply. Discounting them would be a challenge for the central bank. For BAs, there are typically at least two names: 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.

As the central bank, the Bank of Sierra Leone can have substantial leverage over the money market because it can decide the standards for participating in any open market operations, to come to its discount window, and to settle on 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 can play is as the provider of settlement services for the banks. That way, banks do not have to use correspondent banking arrangements and can 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 also be important in market 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 can 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 example, 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 aspects such as positions, transaction 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 effectively sells 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 operate an interbank

11 A 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).

12 A certificate of deposit is a negotiable claim issued by a bank in return for a term deposit.

13 A commercial paper is an unsecured note issued by companies for borrowing (typically in the short term).

market for, say, overnight funds. At the moment, the discount houses in Sierra Leone do not appear to be doing a satisfactory job in this area, and the level of activity in the interbank market is low.

In order to encourage banks to continue to look first to the interbank market as that market develops, the Bank of Sierra Leone could lend only at penalty rates, sometimes even backed by securities (the 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 certainly has the ability to further develop its money markets, particularly by aiding in the evolution of bonds, BAs, commercial paper and bond repos. Banks could issue CDs, and large non-financial firms could issue commercial paper and 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 to accept bills of exchange/time drafts could be restricted to sound banks (i.e. banks declared safe and well run) by the banking supervision department of the Bank of Sierra Leone. Given the limited trust in banks that potential depositors have, 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, only be able to attract participation in CDs of short duration (say three, six or nine months). Having gained 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 begin with. In the current environment in Sierra Leone, 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, in fact, the issuing banks are never called upon to repurchase the bonds before maturity.

In addition to standing ready to repurchase their own bonds outright, 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.

8.2. Payment System Development

Sierra Leone has a very rudimentary payment system. In order to have efficient and well-functioning financial markets, it would be desirable to have at least one large-value payment system that satisfies the ten core principles for systemically important payment systems (Committee on Payments and Settlement Systems 2001). The Bank of Sierra Leone would no doubt own and manage this system. The settlement among domestic banks for all financial-market transactions would also take place on the books of the Bank of Sierra Leone. The Bank of Sierra Leone simply must address a number of organizational issues as it strives to lead the modernization process and to develop the payment system. Typically, countries find it useful to set up a National Payments Council, comprising at least the central bank and a number of commercial banks, and probably some 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 can be obtained, and a consensus can be reached on important public policy issues related to institutions (including the legal framework), competition policy, and the role of the central bank. Furthermore, discussion can also take place regarding technological and other choices for major (especially large-value) systems (e.g. types of payment instruments, queueing 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 the use of collateral and backup and contingency plans (Johnson *et al* 1998). Support from the National Payments Council 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 that 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; Committee on Payments and Settlement Systems 2006). This is made more complicated by the fact that, despite the slow progress being made in realizing the objective, a monetary union has been proposed between The Gambia, Ghana, Guinea, Liberia, Nigeria and Sierra Leone, which will ultimately form a monetary

union with the countries of the Banque des Etats de L’Afrique de L’Ouest, in order to create a 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 real-time gross settlement system in order to facilitate cross-country transfers within such a union. Such a real-time gross settlement system would, no doubt, be more sophisticated than one that would be optimal for purely domestic payments purposes for some time to come. The uncertainty of timing regarding the fruition of the monetary union 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 any 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 (as discussed below).

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, instead of simply pressing on with development of the banking system. Overall, financial structure per se does not seem to matter very much for economic growth compared with financial development pure and simple (see, for example, Demirgüç-Kunt and Levine 2001). Despite this, 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’s 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 Leonean 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 liquidity¹⁴ in Sierra Leone is unlikely to be significant for the foreseeable future. Many obstacles lie in the way. The development of the stock market will be challenging for the Sierra Leonean authorities and the financial-sector participants themselves, given the small size of the Sierra Leonean economy. Such development will require policies and investment, particularly for the 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 Régionale Des Valeurs Mobilière, 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).¹⁵

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 market listings, 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 to 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 (Yartey and Adjasi 2009).¹⁶ Indeed, despite the strong case for co-evolution, one would suspect that, particularly at this early stage of stock market development, the evolution of the banking system is likely to be of greater help to the development of the stock market than vice versa.

In regard to reliance on the government bond market to be the backbone of development of the capital market in general, one problem is that it can encourage undesirable government budget deficits not financed by foreign grants. Government bonds are also typically more expensive as a 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.

14 Two measures of liquidity that have been found to be 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. In addition, Levine (1997) 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'.

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

16 The evidence suggests 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.

This does not mean, of course, that government bond issuance should be discouraged, only that it should not be expanded aggressively as a means of helping to develop the capital market. The government could, for example, 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.

However, in general, as potential major investors in long-term debt instruments (such as the NASSIT) increase their demand for bonds and long-term bank deposits, ways should be found to enable private-sector firms and public enterprises to develop 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' could 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 faced 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 will need to depend on their own internal rating systems more heavily than would be the case in fully developed financial systems. Since such internal rating systems always have value, no matter how developed the financial system, it makes sense to stress the importance, to the early stages of financial-market development, of capacity building of financial firms, particularly banks, in order 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 seriously increase 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 (Johnson 2004) and good prospects 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 through which foreign

investors come to Sierra Leone to invest outside of the minerals sector, including investing in the country'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 implementation of the financial development programme. Promotion of some kind of bond market association, as has been found to be 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 (Mboweni 2006), or some other arrangement may be equally satisfactory in the Sierra Leone context.

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 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 were suboptimally allocated, for a long time it seemed logical to many policymakers 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 were considered rather indirect attempts to solve the underlying problems (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 the 'neglected borrowers'. This second approach has gained much currency because high administrative costs and the fear of high default rates (in light of adverse selection and/or moral hazard) are seen as important reasons for certain borrowers being 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 example, and the internal rating systems of the banks are not designed—in light of profitability considerations—to help solve screening and monitoring problems related to lending to microborrowers, for example.

The informal financial sector in Sierra Leone is also seen to function badly, 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 micro-finance institutions and on community banks, which also accept deposits, unlike the microfinance institutions.

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 such as the US, 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, the personal characteristics of the borrowers are likely to be taken into account, including family history. One advantage that is often cited for such banks is that, being small businesses themselves, they understand the needs and constraints of small businesses.

But community banks in a country like the US are large 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, many think 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 of achieving whatever benefits are seen to ensue from promoting so-called community banks.

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, the welfare of those borrowers and, in some cases, 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 micro-credit 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 example, the enormous amount of research that has been carried out in the microcredit area has provided evidence that group lending, which seemed like the preferable way to lend to the poor, to enable group enforcement of obligations, may not be as essential as was once thought to be the case. 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 to be essential. The structuring of incentives (e.g. a gradual increase in lending ceilings, threats to cut off credit for repayment failures, and varying interest charged with repayment record) has been experimented with in several locations around the developing world (see, for example, Karlan and Morduch (2010) for a review and some references). Furthermore, experimentation has also taken place with diversity in the structuring of repayment schedules, 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, for 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. An important issue in these investigations would be whether it is possible to ensure the viability of microcredit programs without subsidies and financial aid. On the face of it, this possibility seems realistic given the 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 that 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 example, 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. It would be good 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 in regard to 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 programs (for discussions of some of the issues involved see Armendáriz de Aghion (2005), Banerjee and Duflo (2010), Khandker (1998) and Yunus (1999)).

9.3. Long-Term Finance for Small and Medium-Sized Non-Micro Enterprises

The measures discussed earlier for improving the enabling environment for financial firms by getting the fundamentals right and developing the capital markets would all help to increase access to long-term investment funds, including long-term bank 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, and 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-scale and small-scale enterprises in the private sector in Sierra Leone, there is a 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-sized enterprises 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.

9.4. Saving Facilities For the Lowest-Income Individuals and Groups

The preoccupation with access to finance for the so-called underserved in most African countries, including Sierra Leone, emphasizes the importance of credit. However, it is useful to keep in mind that the supply of insurance services and the supply of instruments, mechanisms and products for financial saving are also elements of access to finance that are important to financial development and to economic growth in general. It can be argued that the latter 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 savings are made up of cash held in homes, including foreign exchange and 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 are used in commerce as well as in other businesses people operate, such as tailoring or taxi services. When these are the only saving outlets, savers can typically benefit from greater flexibility, liquidity and diversity in their savings portfolios. More importantly, and in a related way, 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 is possible. Furthermore, 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 be.

Hence, countries like Sierra Leone want to design and effectively market financial-sector products that can attract the savings of the poor into the financial system (see, for example, Consultative Group to Assist the Poor 2010; World Savings Bank Institute 2004, 2008). In the formal sector, an effective tool that has recently been introduced in Sierra Leone is the 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 the NASSIT on a voluntary basis, and the trust should be encouraged by the authorities to look into ways of making this a reality.

A successful previous initiative was the Post Office Savings Bank (POSB). The objective stated in the FSDP of separating the POSB from the Post Office and rejuvenating it, 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 (World Savings Bank Institute 2004, 2008), the POSB of Sierra Leone could also enter the microcredit business profitably, 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 even easier for commercial banks to design and build up flexible saving accounts in the population as a whole. These accounts could earn interest and, hence, be 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, constant accessibility to savings accounts is an important incentive contributing to success in saving drives directed at low-income individuals and groups. The availability and increasing use of mobile 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 wanting to withdraw money before the next regular meeting of depositors.

In the nearer future, the government and banks (but not other private firms) 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 interest. In the early stages, an innovative bank could offer safe deposit facilities for especially low-income persons residing in certain neighborhoods.

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, thereby avoiding the risk of forgery, which could 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.

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 Insurance Act of 2000 by, *inter alia*, incorporating microinsurance and crop insurance, and creating the conditions for its speedy implementation, particularly by putting in place the necessary institutional and organizational framework. The supervisory authority (the Sierra Leone Insurance Commission) will be strengthened. To meet the challenge, the Sierra Leone authorities propose to work closely with the Sierra Leone Insurance Association, which they will try to make more effective as an organization by using various devices to enhance its capacity to support the industry as a whole as well as with the individual firms/companies themselves. Methods will also be used to ensure that the industry serves the public better, including 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 of these are steps in the right direction. However, 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. The suboptimality of insurance in these areas is clear. Hence, the Sierra Leone Insurance Association should be encouraged, perhaps in cooperation with the Bank

of Sierra Leone, the Ministry of Finance and Development, and the Sierra Leone Insurance Commission, 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 upon their well being. There are traditional devices that the poor use to address these risks. In farming, for example, multi-crop farming is one. Generally, mutual and communal assistance arrangements, especially for dealing with adversities such as 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*.

10. Keeping Track of Progress and Programme Evaluation

We have indicated that an action plan would be an essential element of the reform and development plan. This would no doubt be a rolling plan. In conclusion, we now highlight the important issues with tracking progress in implementation and with 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 and valuable research projects, we would highly recommend that systematic data collection and storage begin as early as possible. In particular, we would recommend that data be collected 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 county's stock exchange divided by the value of listed shares on the country's exchanges.

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.¹⁷ 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 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, it is hoped that the changes will be made in a direction that reflects success in financial-system reform and development.

Appendix A. International Standards and Codes that Are Useful for Financial Services Supervision and the Enabling Environment

Banking Supervision: Basel Committee, *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*.

¹⁷ See Imbens and Wooldridge (2009) for an introduction to the econometric evaluation of programmes.

Anti-money laundering/combating the financing of terrorism: Financial Action Task Force (FATF), *40+8 Recommendations*.

Corporate governance: OECD, *Principles of Corporate Governance*; Basel Committee on Banking Supervision, *Enhancing Corporate Governance for Banking Organisations*.

Accounting: International Accounting Standards Board, *International Accounting Standards (IAS)* and *International Financial Reporting Standards (IFRS)*.

Auditing: International Federation of Accountants, *International Standards on Auditing*.

Data transparency: International Monetary Fund (IMF), *Special Data Dissemination Standard/General Data Dissemination System (SDDS/GDDS)*.

Fiscal transparency: International Monetary Fund, *Code of Good Practices on Fiscal Transparency*.

Monetary and financial policy transparency: International Monetary Fund, *Code of Good Practices on Transparency in Monetary and Financial Policies*.

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