FIGURES

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STATE-OWNED BANKS, PRIVATIZATION, AND MACRO-FINANCIAL PERFORMANCE IN SUB-SAHARAN AFRICA[1]

This paper investigates state-owned financial institutions (SOFIs)' performance in developing economies, the difficulty to ensure their long-term viability, and the conditions for their successful privatization. It focuses on Sub-Saharan Africa, zooming in on the Togolese experience with SOFIs and privatization, at a time when the Togolese government has decided to further disengage from the financial sector. Typically set up with a public interest and financial inclusion mandate, SOFIs tend to weaken financial stability and fiscal discipline in developing economies, especially if they are not typically regulated and supervised on the same basis as other banks. Togo's and cross-country experiences suggest that performance improves more after privatization when the government fully relinquishes control, when banks are privatized to strategic investors rather than through share issues, and when bidding is open to all, including foreign banks. The success of privatization also hinges on the business environment for competition, governance, and entry, on banks' valuation and how policy concerns are dealt with, as well as on owner's prudential review quality.

A. Theoretical Background: Rationale for, and Pitfalls of, State-Owned Financial Institutions (SOFIs)

1. State-owned financial institutions have typically been set up with a public interest and financial inclusion mandate. SOFIs have been established either as specialized development financial institutions or as commercial institutions, often due to a legacy of central planning or nationalization, and in which the state has total or majority direct ownership. Many public banks in Sub-Saharan Africa started life in the post-colonial period, with explicit mandates to serve the entire nation, for nation-building and sometimes socialist policy, or development reasons. They are therefore often the largest –or at least, relatively large– institutions with the only nationally-present branch network stretching to rural areas. The focus of the paper is on public commercial banks that take (demand) deposits and therefore can have systemic implications. They typically have a mandate for commercial viability, although sometimes less clear, which may conflict with their social and development objectives. In addition to direct bank ownership, political interference has also taken then form of loan guarantees, interest rate ceilings, or contract savings schemes to further encourage savings and investment.

2. According to the "development view" (Gerschenkron, 1962), in the absence of developed capital markets, publicly-owned banks spur the expansion of certain economic sectors or regions that the private sector cannot finance. In several SSA countries (e.g., Ghana, Tanzania, Madagascar), the nationalization of private financial institutions led to the emergence of rural development banks, industrial development banks, or national banks for commerce– with the

[1] Prepared by Irina Bunda. The author would like to thank Ivo Razafimahefa, Alvaro Piris, Luc Eyraud, as well as the participants at the CASEF presentation, Lomé, Togo, March 29, 2019, for their useful comments and suggestions.

purpose of extending loans to investors operating in these priority sectors. By channeling long-term investments into productive sectors, SOFIs promote growth and productivity gains, while extending banking services to underserved populations.

3. **According to the "social view" (Atkinson and Stiglitz, 1980), SOFIs can overcome the market failures inherent to the banking sector by financing socially-desirable and welfare-enhancing investments.** The existence of SOFIs is theoretically justified in the presence of financial market imperfections that make some socially-profitable investments and some parts of the population to be rationed. SOFIs should therefore finance investments in sectors with widespread market failures, namely, those associated with costly information asymmetries (e.g., agriculture), intangible assets, large external financing needs (e.g., aerospace industry), and significant spillovers (e.g., R&D).

4. **State-owned banks can also be used countercyclically to smooth credit cycles ("macroeconomic view")[2]– which, in fact, is interfering in arms-length, market-based lending decisions.** Private banks tend to boost lending in boom times and cut back in a bust, potentially exacerbating an economic slowdown. A public bank which supports lending in a downturn may thus play a useful role in stabilizing the banking sector. Using public banks to spur lending when the economy shows signs of weakening could have some potentially beneficial short-term effects, namely, maintaining the flow of credit; yet it increases the risks to the public bank's balance sheet. Interfering with prudent credit risk management will undermine asset quality and must be paid for in the end, with the additional risk of a financial–not just a fiscal– crisis.

5. **Public sector banks have also been used in a non-transparent way as crisis resolution tools.** Large public banks can help manage financial crises–another form of market failure–as a place for depositors to fly to safety, or as potential acquirers for failing banks. SOFIs can also be instrumental in absorbing bad loans from restructured banks, or in distributing subsidies to politically- sensitive sectors. However, their potential role in crisis management is certainly no substitute for rigorous regulation and supervision, as well as for deposit insurance.

6. **The expectation that public banks should maintain loss-making services for policy reasons ends up eroding their viability.** To the extent that publicly-owned, or newly-privatized banks are required to continue providing loss-making services in the public interest (such as loans to farmers or other sectors deemed policy priorities, a rural branch network, or to maintain staffing levels), this should be explicitly recognized in their business plan and budget funds provided. The reason for clearly delineating the subsidy elements is partly fiscal transparency, but also that using public banks to subsidize favored groups or activities not only leads to repeat recapitalizations and higher debt but generates also an additional externality through raising financial stability risks. The stabilization costs– potentially large in case of banks' recapitalization/failure –crowd out other desirable public policies, increasing the scope of resource misallocation and inefficiency– going against their development objective.

[2] See Yeyati, Micco, and Panizza (2004), Hallerberg and Markgraf (2018).

7. Government's conflict of interests in owning and supervising SOFIs weakens banks' governance system and eventually impedes on their ability to carry out their mandate. According to the "agency view" (Banerjee, 1997), the agency costs within government bureaucracy more than offset the social gains expected from state-ownership. The resulting weak managerial incentives, resource misallocation, and inefficiencies are exacerbated at a low level of development. The directly-appointed boards of directors – typically lacking independence and professional skills –are not adequately empowered to assume their strategic guidance and corporate performance role, while the government typically has extensive powers to override regulatory decision (regulatory capture).

8. Another strand of literature argues that market failures can be better addressed by regulation and subsidies than by the direct ownership of banks. According to the "political view" (Shleifer and Vishny, 1994, La Porta et al., 2002) the source of inefficiencies lies in the use of publicly-owned banks as a financial tool for politically-motivated projects. Public officials do not face incentives to ensure well-functioning public banks– rather, they are rewarded politically–leading to poorly supervised lending and risk management practices and to pervasive insider lending.

9. In the presence of weak supervision (with limited powers over commercial SOFIs), the policy choices –by the bank or the government– pose macro, financial stability, and fiscal risks.

- By lending to areas where they lack strong underwriting skills or by taking on excessively large exposures, SOFIs tend to underprice risks, accumulate NPLs, and build up losses. SOFIs' growing clout –often the result of preferential treatment (for instance, if the regulations have special provisions for SOFIs)– hinders competition, prevents new private entry, and ultimately retards market development. Even non-systemic institutions can undermine creditor discipline and sound practice among other banks, through example of bad behavior having no consequences.

- SOFI's financial distress can dent confidence and spill over to the rest of the financial system and onto the corporate/real sectors. Weak banks with poor portfolio quality are more likely to curtail lending, thus hurting growth and leading to higher NPLs. If the banks are systemic, the failed privatization or liquidation impose a heavy fiscal burden on the government, in the absence of an operational and well capitalized deposit insurance system. This creates incentives to delay addressing the difficulties.

- Losses tend to be carried over to other public entities, with no burden sharing for banks' creditors. Government's ownership of banks with weak governance softens the financing constraints of public sector entities themselves, thus hampering fiscal discipline.

10. To guard against the above-mentioned risks, the principle of viability should govern publicly-owned banks, against the background of strong institutional infrastructure and regulation and supervision of all financial institutions. The institutional infrastructure matters for the sound financial sector development for all banks, either public or private, namely, macroeconomic stability, legal infrastructure (particularly with respect to contract law and measures

for pledging collateral and enforcing security agreements), accounting standards and an appropriate safety net (lender-of-last-resort facilities, and, possibly, deposit insurance). To make government ownership sustainable, commercial viability should govern public banks. To prevent a vicious cycle of repeated recapitalizations or forbearance to deal with recurring losses of inefficient SOFIs, several principles can be observed: (i) a mandate to operate on a commercial basis; (ii) fiscal transparency; (iii) a governance structure to insulate the SOFIs from overt political influence;[3] and (iv) implementation of the same supervisory regime that is applicable to private banks. Several codes of conduct on e.g., limits on activities, internal control, audit or reporting could be put in place to further alleviate the conflict of interest in both owning and supervising public banks.

11. In practice, it has been hard to ensure long-term viability of public banks in developing countries in Sub-Saharan Africa for the many reasons noted, thus making privatization a reasonable strategy for the government to restore their viability, save budgetary resources, and increase economic efficiency.

B. Cross-Country Evidence: SOFIs vs. Private Banks' Performance

12. In developing countries, public banks post significantly lower performance than their private counterparts. In a large panel of banks in 100 emerging economies, Mian (2005) found that state-owned banks perform uniformly poorly, and only survive due to strong public support. Micco, Panizza, and Yañez (2006) showed that in developing countries, SOFIs tended to have lower profitability and higher costs than their private counterparts, with the difference in performance mostly driven by political economy considerations, namely the electoral cycle.

13. SOFIs' corporate governance systems are also weaker than their private counterparts, with board structure often unable to provide a check on political control. In an analysis of the corporate governance of public banks in Spain, Italy, and Germany, before and after the global financial crisis, Hallerberg and Markgraf (2018) pointed out that the unitary board structure of Spanish *Cajas* did not provide a check on political control, with the conflict of interests making effective supervision difficult. In contrast to the Spanish savings banks, German public banks had a two-tier board structure, in which the supervisory board and management were (and are) clearly separated from each other without any personal ties between board and management. Moreover, public sector banks with a clear mandate and with regulatory constraints that clearly delineate their activities from those of commercial banks did better in the crisis.

14. At a macro level, empirical evidence suggests that fiscal discipline is weaker in countries with significant government participation in the banking system. In a dataset of 123 countries, Gonzalez-Garcia and Grigoli (2013) found that state-owned banks may help to soften the financing constraints of public sector entities and consequently become a factor that hampers fiscal

[3] The governance structure of the bank is important in ensuring that the SOFI's commercial mandate can be fulfilled, with a balance of independence and accountability. A board comprised of independent directors serving for fixed terms can serve as important buffer between government and the SOFI and provide similar stewardship to that provided by directors of privately-owned banks.

discipline. The crowding-out effects are significant: a one p.p. additional share of government-owned banking assets is associated with a decrease in the share of credit to the private sector of about 0.5 p.p., an increase in public debt of 0.2–0.3 percent of GDP, and an increase in overall public deficit of about 0.15 percent of GDP.

15. Several examples from Sub-Saharan Africa suggest that the timely restructuring and resolution of state-owned banks are often delayed. In the D.R. Congo, three SOFIs have faced liquidity difficulties for the last ten years, which limited their economic programs and contribution to growth. Efforts to divest Ghana's first development bank –set up in 1963 to promote rapid industrialization in all sectors of the economy– failed, despite management, institutional, and financial restructuring. In Kenya, the National Bank of Kenya–the main SOFI set up in 1989– has become severely undercapitalized and cash-strapped, recently prompting divestiture actions (together with two other SOFIs). Also, in Zimbabwe, the government has sought to merge or partially privatise the SOFIs struggling with high debt and poor levels of corporate governance. Finally, in 2018, the Bank of Tanzania closed five critically undercapitalized community banks and approved the merger of two small state banks, as part of a plan to improve financial stability and reduce the number of state-run lenders.

16. Togo's SOFIs have encountered similar financial difficulties and restructuring delays. In the 1980s-90s when public banks used to dominate the banking sector (accounting for 55 percent of total banking assets), a volatile economic environment often led to widespread bank insolvencies. The Togolese banking sector has since expanded considerably with the entry of several pan-African banking groups headquartered in Togo. Nevertheless, SOFI's systematic recapitalizations in absence of operational restructuring, and the failure to divest some of them as planned, have perpetuated their difficulties, posing financial stability and fiscal risks (Box 1).

Box 1. Costs and Relative Performance of SOFIs

In the 2000s, following another domestic crisis, the Togolese banking system became almost completely insolvent, with elevated levels of NPLs to state-owned enterprises (SOEs). During the mid-2000s' financial crisis, some private banks– *Banque Internationale pour l'Afrique* (BIA), for instance– were bailed out by the government and became public. The public banks had since been recapitalized several times to no avail, as for instance, in 2004, with funds equivalent to 4.4 percent of GDP. Additional resources were injected in late 2008 to bring prudential ratios back to acceptable norms for the three state-owned banks–*Banque Togolaise pour le Commerce et l'Industrie* (BTCI), *Union Togolaise des Banques* (UTB), and BIA– and to remove NPLs to SOEs from the balance sheet of a large private bank (Ecobank Togo). Only the latter underwent restructuring. The securitization of NPLs required that the government issue bonds eligible for refinancing at the BCEAO equivalent to 6.2 percent of GDP. The NPLs were to be recovered by the newly-established *Société de Recouvrement du Togo* (SRT), which is a temporary state-owned entity with weak powers to effectively collect the loans.

Box 1. Costs and Relative Performance of SOFIs (continued)

A few years later, the authorities sought to offset the marked budgetary impact of recapitalization and improve governance by divesting the three problem SOFIs and a fourth one (*Banque Togolaise de Development*, BTD) which did not need financial restructuring in 2008. Financial intermediation deepened thru several measures to promote entry and regional integration. However, the financial restructuring of the public banks was not accompanied by rigorous asset quality reviews while their operational restructuring and privatization were consistently delayed. Three SOFIs had to again raise funds at end-2010 to meet newly established minimum capital requirements. The publicly-owned social security fund (*Caisse Nationale de Sécurité Sociale*, CNSS)–shareholder in two large SOFIs and with financial and governance problems on its own–injected CFAF 4.3 billion in the public banks.

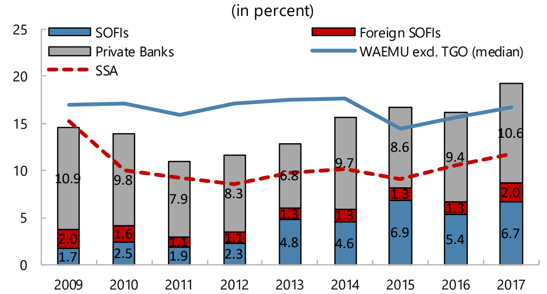
Two public banks (UTB, BTCI) could not be privatized and their financial situation has steadily deteriorated. The process of privatizing UTB by public tender in 2012 was initiated but failed on procedural grounds during the selection phase of the offers and was not renewed soon afterwards. Following its recapitalization in 2008, net income has been somewhat volatile but was on average negative. BTCI's difficulties have been more severe and long-lasting. The early 2013 privatization attempts were undermined by poor governance and disclosure of the actual losses, and inadequate risk management capacity. BTCI did not meet most prudential requirements, including capital adequacy, liquidity, and borrower concentration, and was placed under several back-to-back provisional administration regimes until September 2017, with no palpable improvement. Following its last recapitalization in 2008, net income has mostly been negative (Box 1 Figure).

The two public banks have expanded credit, opened branches, hired additional staff and fulfilled a public mandate, despite their longstanding difficulties. Their loan portfolio expanded at 14-15 percent per year during 2014-16 despite BTCI's many provisional administrations and the Banking Commission's close surveillance of UTB. Concentration risk, NPLs, and cost-to-income ratios at the two banks have systematically been above the banking sector average. Complications have arisen from a longstanding coordination problem between the national authorities and the WAMU Banking Commission with regards to the situation of the two problem state-owned banks. The weak resolution powers (on the side of the regulator) and regulatory forbearance/conflict of interests (on the authorities' side) have perpetuated banks' difficulties.

The 2015 external shock and the end of prefinancing one year later found the two state-owned banks in a weak position: thin capital, high loan concentration and leverage, exposure to the main export-oriented sectors trade and manufacturing. Togo's widening fiscal deficits up to 2017 had partly been financed by the banking sector. The two banks were heavily involved in government's prefinancing schemes –an unorthodox way of financing public investments, which had led to a steep increase in public debt and was discontinued in late 2016. After a period of excessive risk-taking, the two banks saw a rise in dud loans and declining profitability.

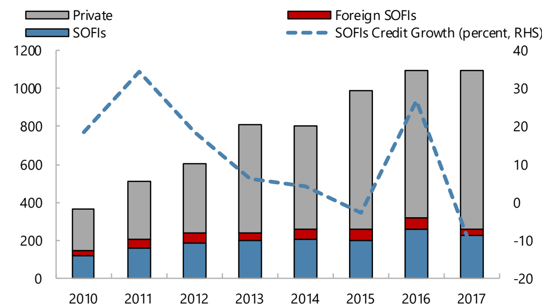
Box 1. Costs and Relative Performance of SOFIs (concluded)

Non-Performing Loans, 2009-17
(in percent)

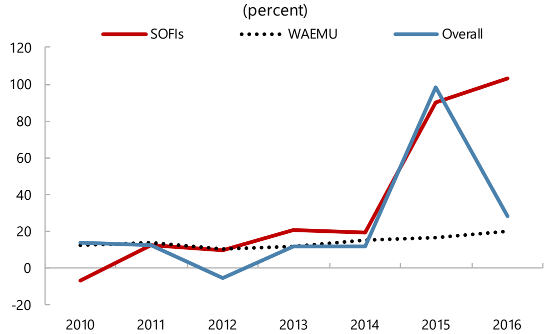


Note: TGO_SOFIs (20 percent of Total Banking Assets); TGO_Foreign SOFIs (4 percent of Total Banking Assets).

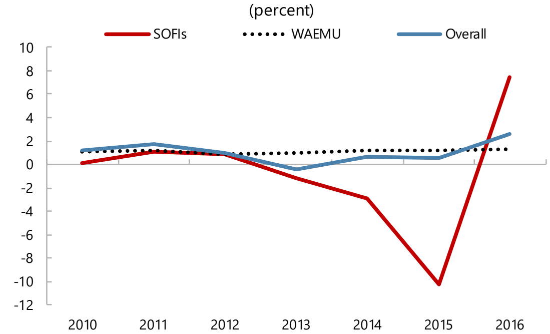
Loans by Ownership, 2010-17
(billion CFAF)



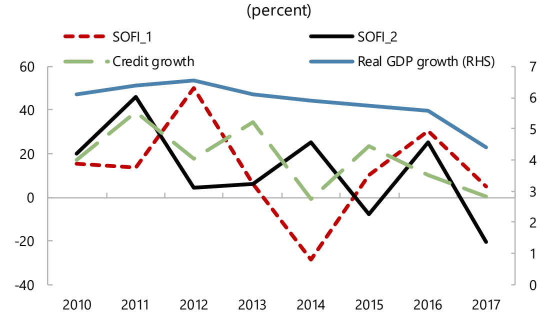
ROE, 2010-16
(percent)



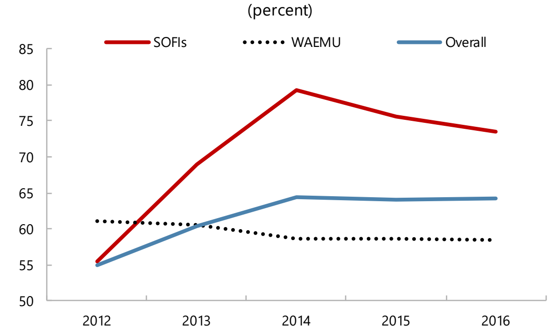
ROA, 2010-16
(percent)



SOFIs Credit and the Business Cycle, 2010-16
(percent)



Cost-to-Income, 2012-16
(percent)



Sources: BCEAO; Togolese authorities; and IMF staff estimates.

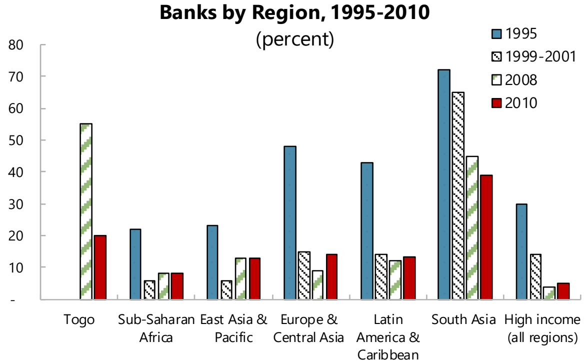
Over 2013–16, several strategies to resolve the two banks were considered. In 2016, given the balance of risks and following expert advice, the merger of the two banks (with the bigger and better one, absorbing the weaker one) and thorough operational restructuring was retained. Although the authorities later changed strategy to privatizing the two banks separately, moving ahead with the merger and restructuring plans in 2017 allowed putting an end to BTCI's provisional administration and has led to a change in direction, on sounder bases, at the two banks. The requirements for an upgraded governance system at the absorbing bank (UTB), in line with best principles, has led to an internal reorganization and a more prudent strategy for the bank.

C. State-Owned Bank Privatization in SSA

17. State participation in the SSA financial system declined following the financial sector liberalization in the 1990s-early 2000s. By 2010, the region had the lowest median foreign bank share of assets (73 percent) and lowest median government bank share (8 percent) in the developing world (Text Figure 1). These trends hide cross country heterogeneity, for instance, at end-2017, Togo has the highest government ownership of banks in the WAEMU (20.5 percent of total banking assets). The state accounts for more than 50 percent in Ethiopia and between 30 to 50 percent in Burundi, and Sierra Leone. In 2018, several SSA countries (Togo, Kenya, Zimbabwe, D.R. Congo) announced the privatization of some of the remaining public banks in financial difficulty.

Text Figure 1. Government Ownership of Banks, WAEMU and SSA, 1995–2007

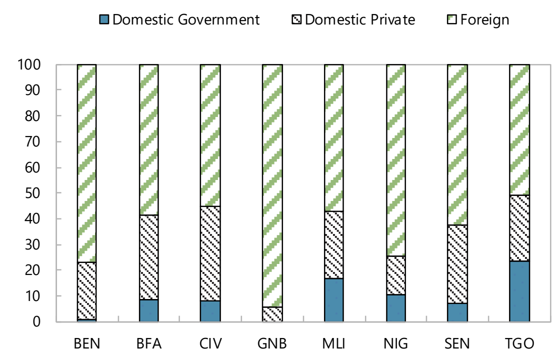
Median Asset Share of Government-Owned Banks by Region, 1995-2010
(percent)



Source: Cull et al (2017), "Bank Ownership: Trends and Implications," IMF Working Paper, WP/17/60, March. and author's calculations

Note: The bars represent the median country in each region. High-income countries are grouped together in one category and excluded from the five regions. Ownership is defined as the asset share of banks that are more than 50% controlled by the government, except for 1995 where ownership reflects the actual share owned by the government.

WAEMU: Bank Ownership: Asset Shares, end-2017
(percent of total)



Source: BCEAO and staff calculations

18. In Sub-Saharan Africa, the privatization programs, including in the financial sector, occurred in successive waves, with some countries privatizing much earlier than others (Bennell, 1997, Estrin and Pelletier, 2018). Several WAEMU countries (Benin, Guinea, Niger, Senegal, and Togo) were the first to initiate privatization programs in the late 1970s to early 1980s–although with limited progress. A heterogenous mix of countries followed (Ghana, Nigeria, Ivory Coast, Mali, Kenya, Malawi, Mozambique, Madagascar, and Uganda) in the late 1980s, also with limited progress, until the late 1990s, except for Nigeria. Finally, the third group of SSA countries started in the first half of the 1990s, with Tanzania, Burkina Faso and Zambia showing strong political commitment to privatization.

19. In the late 1990s, a growing number of Sub-Saharan Africa governments started to undertake significant economic reforms, which facilitated banks' privatization. The institutional infrastructure, namely, macroeconomic stability, legal infrastructure (particularly with respect to contract law and measures for pledging collateral and enforcing security agreements), accounting standards and appropriate safety net are key constraints for sound financial sector development for all banks, public and private. Political liberalization and the need for fiscal adjustment in the wake of

the 1990s fiscal crisis facilitated the implementation of privatization programs. Large privatization programs took place in Uganda, Kenya, Nigeria, and Malawi. For instance, Nigeria undertook a major privatization program in the early 1990s, divesting a total of 14 banks, which accounted for more than 50 percent of total banking sector assets.

20. The empirical literature on the impact of banks' privatization highlights that post-privatization performance tends to increase conditional on several clearly identifiable governance factors:

- **Ownership share retained by the government**: Otchere (2005) found that in the case of partially-privatized banks, continued government ownership might have hindered managers' ability to restructure the banks. The first round of privatization in the Czech Republic and Poland also showed that privatization produced few or no performance benefits in cases where the government retained majority control or even a sizable minority ownership stake in the bank (Clarke, Cull, and Shirley, 2005). These results also hold in a concentrated and under-developed banking system like Uganda. Clarke, Cull, and Fuchs (2009) showed that UCB's second privatization, in which government fully relinquished control, was a vast improvement over the first attempt, in which the government maintained a controlling share and did not attract a high-quality purchaser.

- **Type of transaction** (strategic investors or share offerings): In weak institutional environments share offerings produce lower performance gains than direct sales to strategic investors (Clarke et al, 2005). Cross-country analysis in Otchere (2005) also pointed out to few or no performance gains in banks sold through share offerings.

- **The extent to which foreign ownership was permitted**: Boubakri et al. (2005) used various measures of performance before/after privatization on a panel of 81 bank privatizations occurring during 1986-1998, in 22 low-and middle-income countries, to assess various categories of controlling owners. Whether profitability increased post-privatization depended on the type of owner (banks owned by local industrial groups and foreign owners exhibited higher economic efficiency); while environmental factors also played a role. Clark et al (2005) and Megginson (2005) showed that foreign ownership had been associated with superior business performance post-privatization, especially relative to "insider" ownership. Foreign bank entry can make domestic markets more efficient by forcing local banks to operate more efficiently, providing long-run benefits for banking customers in the form of lower intermediation and service charges

21. There have been cases in SSA when privatization has been beneficial in terms of restoring the credit flow and for the quality of credit extended to the economy. Clarke et al. (2009) studied the privatization of Uganda Commercial Bank to Stanbic (South Africa) during 1996-2005. The authors assessed the evolution of UCB, Stanbic, and the post-merger bank in terms of profitability, portfolio quality, operating efficiency, and credit growth, and highlighted improvements in profitability and rate of credit growth compared to pre-privatization for UCB. Moreover, Cull and Spreng (2011) examined the privatization of Tanzania's National Bank of Commerce (NBC) in a

sample of 42 banks operating in Tanzania during 1998- 2006 and showed that its sale to a foreign strategic investor (Rabobank) resulted in improved profitability and reductions in non-performing loans, along with an increase in the ratio of loans to total assets.

22. Privatization tends to boost competition in the banking sector. Otchere (2005) examined share-issue privatizations in middle and low-income countries and find that privatization announcements led to abnormally negative returns for rival banks–a sign of enhanced competition–with the effects being more pronounced for the remaining tranche sales.

23. In some cases, privatization can improve bank performance, despite an inhospitable macroeconomic and regulatory environment, and despite selling the weakest banks, provided the state fully withdraws from banks' capital. Beck, Cull, and Jerome (2005) examined Nigerian banks' privatization in the 1990s– a volatile macroeconomic and financial environment –on an unbalanced sample of banks three years before and eight years after privatization. They showed that performance improved following privatization (although it took place in the aftermath of economic recession and political instability), but the negative effects of the continuing minority government ownership on the performance of many Nigerian banks have persisted.

24. A strong, independent regulatory agency is not only essential to safe financial development for all banks but can also ensure that privatized banks play an efficient role in financial development. Because of broader institutional weaknesses, developing countries face many challenges in establishing a strong regulation. Azam, Biais and Dia (2004) examined the case of the WAEMU countries during 1990-97 by running panel regressions on profits, bad loans and ownership. In the late 1980s, there was a severe crisis in the West African banking system, partly due to government interference. The restructuring of the banking system entailed privatization and foreign share ownership, as well as the creation, in 1990, of the WAMU Banking Commission, the independent regional regulatory body–whose establishment was credited for the reduction in bad loans in the 1990s.

Box 2. Togo's Experience with Bank Privatization

Togo's share of SOFIs has declined since mid-2000s, following privatization initiatives, but remains higher than the Sub-Saharan Africa average. Bank privatization efforts were initiated in 2004, with the sale of a smaller public bank, SNI, to Financial Bank (which became Orabank in 2011). The privatization of the four remaining SOFIs was stepped up under the first 2008-11 ECF-supported program. The objective was to restore confidence in the Togolese financial sector, reduce the risk of new macro instability linked to the large loss-making banks (46 percent of total banking sector assets), and promote financial sector development and expansion of financial intermediation.

The 2008 banking system was characterized by low financial intermediation, with the loan-to-deposit ratio below WAEMU, SSA, and LICs averages. NPLs ratios in 2008 stood at 20 percent for SOFIs and at 7 percent for private banks. Following a public tender for the four banks, at end-2012, Orabank, a large regional group, bought 56 percent of BTD capital and in September 2013, the State further sold 55 percent of its shares in BIA to Attijarwafa banking group. At end-2017, SOFIs accounted for 20.5 percent of the total banking system assets, still higher than the SSA median.

While the Togolese authorities had committed to substantial progress in banks' privatization by December 2009, the call for expression of interests was only issued in July 2011. The delays were linked to difficulties in updating the legal framework for privatization and in obtaining certain financial and balance sheet information for some of the banks, and political hesitation to assume ownership of the bank privatization process. Potential buyers demonstrated strong interest in the SOFIs, but expeditious actions by the Togolese authorities were necessary to avoid undermining the credibility of the process by further delays. The delays undermined the validity of financial data underlying the final call for bids. Thus, the privatization advisors were advised to rapidly update the financial data collected in 2010 to ensure that the intermediate steps leading to the final call for bids were not further delayed.

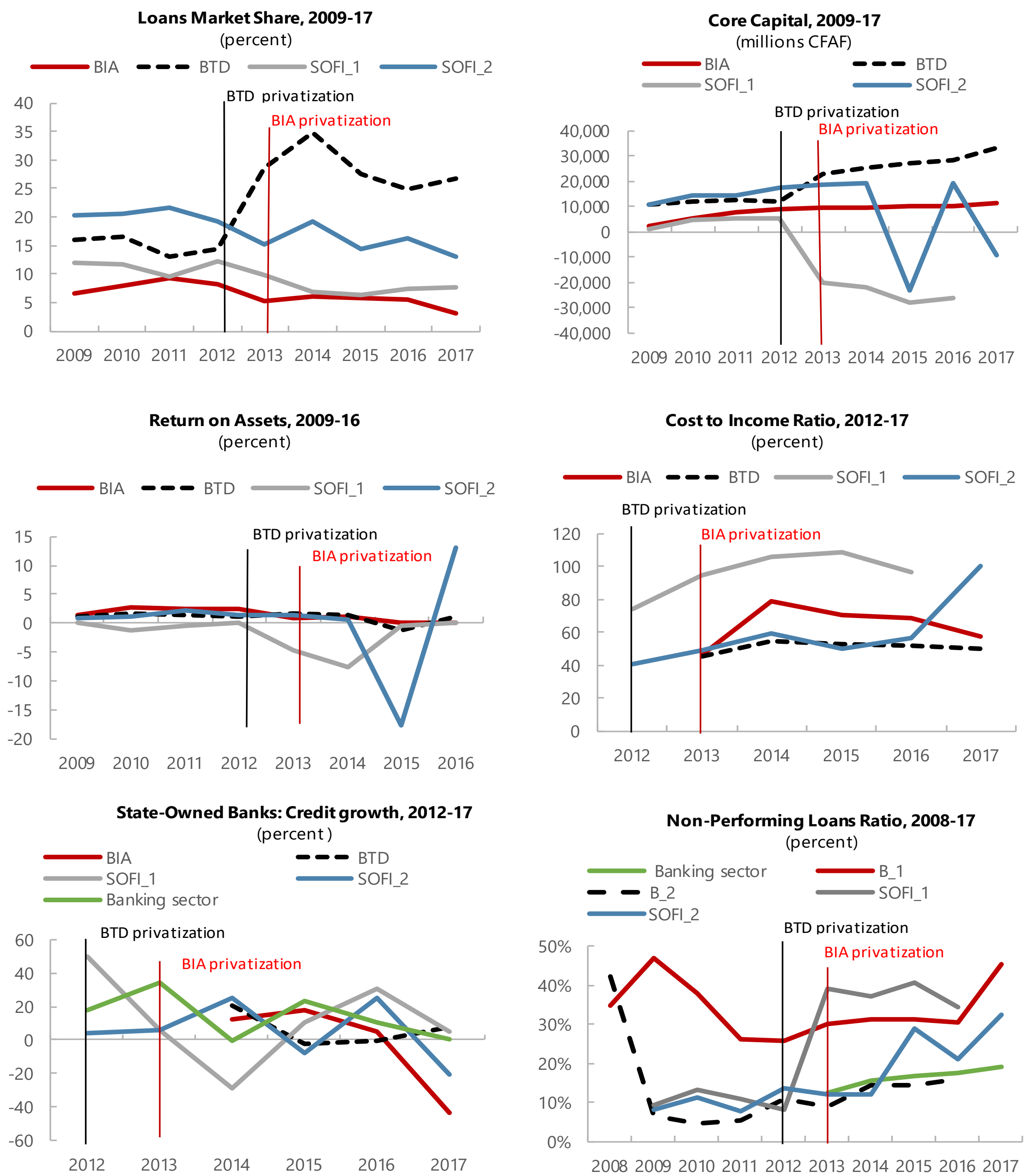
The process was further complicated by rising political tensions due to social pressures and disputes over electoral reforms. In early 2013, the privatization of BTCI was aborted and the financing from privatization and budget support fell well short of plans. The overall deficit more than doubled, to 7 percent of GDP.

Togo's experience with bank privatization was positive for the bigger bank (BTD) and broadly neutral for the smaller one (BIA). The privatization of BTD and subsequent merger with Orabank yielded 0.6 percent of GDP. The new bank became the biggest Togolese bank, with 29 percent of loans and 23.5 percent of deposits in 2013. Lending has expanded at a fast pace, and earnings and profitability indicators have continued to improve. Its market share had stabilized at around 27 percent of total loans at end-2017. The privatization of BIA to a foreign government-owned bank yielded 0.7 percent of GDP. Lending expanded immediately following privatization in 2014-15, but the upward trend stalled subsequently. BIA has experienced profitability difficulties and declining market share. The difficulties are possibly related to imperfect cost adjustments (as shown by the relatively high cost-income ratio, of 0.66 on the average, after privatization, compared with 0.54 for BTD) as well as a legacy of high NPLs kept on its balance sheet from before privatization. The NPL ratio at Orabank has been lower or close to the banking sector average; whereas BIA has experienced a further deterioration of asset quality over time. Both banks have comfortable core capital cushions and satisfy the new Basel 2-3 regulations.

Box 2. Togo's Experience with Bank Privatization (concluded)

During the current privatization round, the authorities sought to avoid several flaws that thwarted the previous divestiture of the two banks. A more recent law on state divestiture and privatization (2014) was further modified in September 2018 to allow the National Assembly to define the general legal framework of the procedures for the conduct of privatization operations –thus simplifying and making the privatization operations for the two banks more transparent. Unlike in the past –when an ad-hoc Privatization Commission had total discretion in deciding on each step –the authorities have now ensured stronger political support of the privatization process.

Togo: Selected Indicators for Former and Existing SOFIs



Sources: BCEAO and IMF staff estimates.

D. Policies for Successful Bank Privatization

25. Several lessons can be learnt from Togo's first privatization round. During that round, about half of the public portfolio in the banking system could be privatized. For the other half, delays, inaction, conflict of interests, and weak controls prevented the finalization of the privatization transactions. These experiences point to the need for a strong political support of the privatization process. A multiplication of privatization agencies with vested interests should be avoided. Actions should be undertaken swiftly as political pressures are high and the financial situation of SOFIs quickly deteriorates. High-quality expert advice on the privatization process and a realistic/up-to-date evaluation of the banks' value are important elements for success. The authorities need to carefully monitor the liquidity situations of the public banks engaged in a lengthy privatization process and with significant execution risks. Contingency plans should be put in place to prepare for an unsuccessful privatization, because the situation of the SOFIs which fail privatization surely deteriorates. In such a case, prompt corrective measure should be implemented, with strong resolution powers for the regulator, otherwise temporary administration may drag on for a very long period. The government should not plan on and spend the expected privatization proceeds as they may not materialize. Any financial restructuring needs to be accompanied by operational restructuring to ensure long-term financial viability and minimize the cost for the State. An efficient non-performing loans collection mechanism should be set up to minimize liquidation costs.

26. Other SSA case studies and cross-country analysis provide further lessons for a successful privatization. In developing countries, past experiences show that privatization of SOFIs does not automatically lead to higher performance, there are several preconditions for success.

Prior to Privatization

27. The institutional infrastructure shapes the design and the outcomes of privatization. An adverse macroeconomic environment reduces the benefits of privatization. Fiscal discipline is important. For instance, in Nigeria, Beck et al. (2005) showed that, after the privatization of the 1990s, the underlying distorted incentive structure coming from adverse macroeconomic conditions and regulatory arbitrariness led to high returns on investment in government bonds and non-lending activities, which seem to have penalized the private/newly-privatized banks focusing on retail lending. Moreover, the system of multiple exchange rates created arbitrage opportunities for financial institutions that had privileged access to foreign exchange, fostering a banking sector focused on rent-seeking rather than financial intermediation- and these incentives continued to influence the behavior of privatized banks. In the case of transition economies, Bonin, Hasan, and Wachtel (2005) described how the unstable macroeconomic situation made privatization infeasible in Bulgaria and Romania until the late 1990s. By the time, the situation of the state-owned banks had deteriorated so much such that substantial recapitalization was necessary to make the banks attractive to investors.

28. The regulatory framework—a product of the institutional and political environment—is a key factor of a successful privatization. The country needs to create regulatory capacity to enable successful privatization experiences. Privatization improves performance even in poor

regulatory environments, although poor regulations reduces the gains from privatization. For instance, the Nigerian banks' share issue privatization in the 1990s brought about only limited performance improvement in a relatively weak institutional environment (Beck et al., 2005).

29. Institutional setup for the privatization process. Governments must streamline the privatization process by creating a strong, lean, centralized, and transparent process by setting up a small yet effective focal point to privatize while keeping the process public and fair (Shirley, 1992). For instance, in Lesotho, despite early difficulties, the authorities advanced quite firmly with the privatization program after some crucial institutional reforms. In 1995, the parliament approved a Privatization Act, critically bringing privatization under the responsibility of one privatization agency, thus replacing the previous setup whereby relevant ministries— and their vested interests—played major and often conflicting roles in privatization.

30. Business environment fostering competition, good governance, and entry. Lessons can be learnt from privatization experiences in nonbank sectors (e.g., telecoms, Megginson, 2005). Privatization has greater benefits on firm performance in stronger business environments because the success of the process relies on effective corporate governance of the privatized entity, as well as effective market competition (Estrin and Pelletier, 2018). The absence of barriers to entry ensures that the bank can benefit from the best offers—including from foreigners. Therefore, policymakers must tackle obstacles in this area, namely, barriers to new domestic firm entry, quality of the legal system concerning corporate governance, and openness to foreign direct investment. This can be a constraint for many SSA public banks with a dominant rural network and little competition in many areas of the country. It is often the case that these dominant rural networks are loss- making, despite being the sole financial services provider. The bank typically collects few savings and must provide basic banking services at low cost to the user, while incurring high cost in salaries and overheads. Therefore, the government should create the right environment by undertaking other reforms designed to encourage competition and growth.

31. Timely and prompt corrective actions and implementation of pre-privatization plans. Many bank privatizations have been long delayed or aborted. Key issues to be managed include the cost[4], sequencing of other reforms (e.g., business environment), and achieving political consensus. Policymakers should avoid the vicious cycle of repeated recapitalizations or forbearance to deal with recurring losses of inefficient SOFIs by putting in place several measures (namely, on regulation and supervision, clearly delineated mandate, sound governance system) to make government ownership viable, sustainable, and pave the way for ultimate privatization. For instance, the Bank of Mauritius vets the credentials of the external auditors of both private sector banks and public-sector banks before giving its approval for their appointment. The offsite surveillance and the onsite examination were conducted in the same manner for private sector banks and public-sector banks. Governance reform, new professional management and strengthened prudential regulation have all been used

[4] Privatization entails various costs and contingent liabilities for the government. For instance, the government may need to provide guarantees for NPLs before being able to sell the bank. Organizational restructuring may entail various costs, such as packages provided to laid- off staff.

to stabilize state-banks in Central Europe and Latin America as part of the process leading to privatization (Hawkins and Mihaljek, 2001).

Privatization Process

32. Preparing a bank for privatization. An "as is" sale is theoretically preferable, because it can be completed quickly; but this will almost certainly not be possible if the bank is insolvent. SOFIs are frequently in poor condition and financial restructuring is required if reputable private investors are to be attracted (Andrews, 2003). For instance, in Uganda, the portfolio of the privatized bank was cleaned prior to sale; the bank remained relatively strong and profitability and credit growth are now on par with other Ugandan banks, while access to credit has improved for some hard-to-serve groups (Clarke et al, 2007).

- **Design of financial restructuring.** Since investors may be unwilling to pay anything for an insolvent bank, government (the owner) must provide the bank with enough quantity of good quality assets to equal its liabilities to attract new equity investors. One frequently used restructuring model is the "good bank-bad bank" split with nonperforming loans left in the bad bank, and government providing the good bank with assets, usually bonds, to fill the balance sheet gap (e.g., Argentina, 1990s). A variation of this approach used in Ghana, Tanzania, and Uganda, is to transfer the dud assets to a specialized asset management company. When the volume of bad assets is smaller, or if the decision is made that the bank should work out the problem loans itself, government as shareholder may subscribe to new equity issues; or, if the bank is already on a reasonably sound financial footing, the government may issue subordinated debt to bolster the capital base prior to privatization (Andrews, 2003).

- **Timing of operational restructuring.** There may also be situations where new owners are reluctant to take on the burden of staff reductions and branch closures. Particularly where strong political pressure is anticipated, new owners may require certain closures or lay-offs to occur prior to privatization. However, Welch and Fremond (1998) recommended that the pre-privatization restructuring should be brief and defensive, and limited to balance sheet and organizational changes such as closures, workforce reductions, and transfers of social services. Technology changes, capital investment, and major purchases should be left to the new owners, not to government officials.

- **Risks associated with sequencing of operational/financial restructuring prior to privatization.** When dealing with insolvent SOFIs, a delayed financial restructuring (e.g., delayed recapitalization) will almost always lead to higher losses and make operational restructuring more complicated since reorganizing bank activities requires additional liquidity. Also, an insolvent bank can lack enough income from its earning assets to cover its costs, and without the new earning assets acquired through recapitalization, it may not be possible to return to profitability regardless of the amount of operational restructuring undertaken, which may eventually jeopardize the privatization. On the other hand, when a

bank has been recapitalized, failed operational restructuring and long privatization delays can lead to further recapitalization expenses when the bank is finally ready for divestiture. To take into account these complementarities and synergies, a solution is to advance progressively on both the operational and financing restructuring fronts, by providing recapitalization in stages, contingent on meeting operational restructuring objectives (e.g., Indonesia following the Asian financial crisis).

33. **Quality of the new owners.** Performance improves more when government fully relinquishes control, when banks are privatized to strategic investors rather than through share issues, and when bidding is open to all, including foreign banks, as showed by Clarke et al. (2005) and Megginson, (2005). Transparency, fairness, and a level playing field are essential. Foreign ownership has been associated with superior business performance post-privatization, as successful privatizations in Madagascar (BNI-Crédit Lyonnais and BFV in the 1990s) and Tanzania (CRBD in the 1990s, National Bank of Commerce and National Micro Finance Bank in the 2000s) showed. Foreign owners also face regulation in their own country, which may lead to greater prudence.

34. **Prudential review of the new owner.** The regulator should play a key role in the privatization process, and only approve the transaction if the potential buyers (new owners) are fit and proper, management is competent and experienced, the source of capital is verified, and the business plan is viable. Pressure to approve a transaction despite prudential concerns, lack of capacity to undertake a suitable review or proceeding with privatization without the regulator's involvement have all resulted in the need for subsequent intervention in failed privatizations in Croatia, the Czech Republic, Mozambique, and Uganda, among others (Andrews, 2003). In Mozambique, after Banco Austral was privatized in 1996, it started recording heavy financial losses, which led to the withdrawal of the successful bidder. It was then intervened, successfully restructured and re-privatized, and sold to the Amalgamated Banks of South Africa (ABSA) group in 2002. In 2005, Barclays acquired a 56 percent stake in ABSA, thus becoming the majority shareholder of Banco Austral. Barclays Bank Mozambique went on to have the second largest banking network in the country at end-2006.

35. **Policy concerns and financial inclusion implications.** The implications of the new bank strategy should be managed ex ante (Andrews, 2013). Policy concerns include the maintenance of services in all areas served by SOFIs prior to privatization (for instance, if the SOFI has financial inclusion functions by serving rural areas), continued servicing of specific sectors, and preserving employment. These concerns can go against efficiency, as new private owners typically look to close unprofitable locations, eliminate policy-driven lending to state-owned enterprises, and improve operating efficiency through staff retrenchments. The state-owned banks are typically systemically important elements of the payment system, as well as systemically large. This large branch network and staffing is often a source of high costs and loss-making, and yet, simply privatizing them and letting the new owners close the inefficient branch network could have high costs from an inclusion perspective. The privatization process will need to take these concerns into consideration ex ante, for instance by forcing the new bank to keep some branches in rural areas. These considerations may explain some of the conditions sometimes imposed on buyers during the privatization process.

At the same time, mobile banking may now offer a better route to financial inclusion–suggesting that such conditions should be balanced against the benefits from privatization (increased competition, financial market deepening).

36. Fair valuation. Expert advice plays an important role in the privatization process (Shirley, 1992). Often, the book value of a company bears no resemblance to the company's market value, especially if the company has a poor track record, redundant layers of employees, and a host of operating problems. Valuation is a difficult concept, and buyers will value a bank differently, depending on the synegrgies they perceive between their own bank (network) and a potential acquisition. The bank should be sold at fair market price, and the sale should not entail a net transfer of wealth from the public to the private sector. In practice, state assets have frequently been undervalued (Estrin et al., 2009). Examples are Czech Republic or Russia, where significant state assets were transferred to private hands at nominal or zero prices (Andrews, 2003).

37. Togo has several preconditions in place, for instance regarding the business environment, competition and entry, and the general environment conducive to privatization and economic efficiency. Bank privatization follows the privatization of the main Telecom company, while the privatization of other SOEs has been envisaged. The private sector is expected to play an increasing role as the engine of growth. However, if the direct sale of the first bank does not succeed, several options are available, each of them with costs and benefits: (1) equity sale (tender); (2) Purchase& Assumptions with a tender set up for the “good bank” while the “bad bank” is transferred to a legal entity for liquidation; (3) merger and restructuring of the two public banks; (4) deposit payoff and liquidation. Several measures can be put in place immediately to prevent further deterioration (e.g., prohibit accepting new deposit applications).

Annex I. SOFIs' Privatizations in SSA

Cameroon	Standard Chartered Bank (1994)
Cape Verde	Caixa Econômica Cabo Verde (1999); Banco Comercial do Atlântico (1999, trade sale
Central African Republic	Union Bancaire en Afrique Centrale (1998)
Congo, Democratic Republic	Union Zairoise de Banques (1995)
Côte d'Ivoire	BIAO (2000, trade sale); SGBCI (1999, public offering)
Ghana	Merchant Bank (1995); Barclays Bank Ghana Ltd (1998, direct sale); Social Security Bank (1995, private sale); National Investment Bank (2000, partial divestiture)
Kenya	Kenya Commercial Bank Ltd (1988, IPO); National Bank of Kenya (1994, 1996, partial, PO)
Lesotho	Lesotho Bank (1999, IPO)
Madagascar	BNI-Crédit Lyonnais Madagascar (1991); National Bank of Commerce (1998, shares Sale on non-competitive basis); Bank for Rural Development (1999)
Mali	Banque Malienne de Crédits et de Dépôts (2000, partial divestiture)
Malawi	Malawi Savings Bank Limited (2015)
Mauritius	State Bank of Mauritius (1995, IPO, SEO)
Monzambique	Banco Commercial de Moçambique (1996, tender) ; Banco Populaire de Desenvolvimento (1997, private sale); Banco Austral (2002, tender)
Nigeria	Merchant Bank of Africa (1992, Private placement); Allied Bank (1993, PO); First Bank of Nigeria (1993, PO); Savannah Bank of Nigeria (1993, tender); FSB International Bank (1993, tender); Afribank Nigeria (1993, tender); Assurance Bank (2001); Union Bank of Nigeria (1993, 2007, tender); United bank for Africa (1993, tender)
Senegal	Banque Senegalo-Tunisienne (1999, 2007)
Tanzania	National Bank of Commerce (2000); CRBD (1996); National Micro Finance Bank (2005, divestiture)
Togo	Société Nationale d'Investissement (2004); BTD (2012, tender); BIA (2013, tender)
Uganda	Stanbic Bank (1997, direct sale), Uganda Commercial Bank (1997, 2001, direct sale, divestiture); Barclays Bank (1998, PO)
Zambia	Zambia National Commercial Bank (2007)
Zimbabwe	Commercial Bank of Zimbabwe (1998, IPO)

Sources: Andrews (2003), World Bank Privatization database (1988-2008), and banks' websites.

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