Transforming Ethiopia's financial sector: Lessons from Emerging Market Economies

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Abstract

The structure of the Ethiopia's financial sector has evolved over the past 40 years, from financial repression to emphasis on financial inclusion. However, while access to finance has increased, the financial sector remains concentrated. The productive sector (agriculture, industry, housing and construction, and mines, power and water resources) accounts for the largest share of new loan disbursements although this share has decreased during the period 2011/12 – 2017/18. Emerging market and other countries offer important lessons for Ethiopia to accelerate access to finance. First, a phased approach to liberalizing the financial sector facilitates the development of requisite institutional and regulatory frameworks while promoting competition and deposit mobilization. Second, measures to increase access to credit should be anchored on a comprehensive reform agenda to promote financial sector development. Third, a robust legal, regulatory, and institutional framework for protecting creditor rights and facilitating the use of alternative forms of collateral increases access to credit particularly for small businesses and accelerates economic transformation. Fourth, policy-based or earmarked lending is complex and requires rigorous evaluation of its effectiveness, beneficiaries and impact. Fifth, market-based approaches to allocating credit to priority sectors, small businesses, and start-ups are less distortionary.

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Executive Summary

1. **Ethiopia has achieved strong economic progress in line with its 2025 middle-income vision.** Reforms have been implemented to improve the business enabling environment and support industrialization, contributing to average real GDP growth of 10.4% during the period 2003/04–2017/18. The services and agriculture sectors led growth during this period and the industry sector's contribution to GDP has increased steadily. On the demand side, FDI and public infrastructure spending have driven growth. However, external resources have largely financed these public infrastructure investments. Thus, domestic resources mobilization is an urgent priority and the financial sector has a central role.

2. **The structure of the Ethiopia's financial sector has progressed over the past 40 years, from financial repression to emphasis on financial inclusion.** The financial sector has transitioned through three main phases. The first phase, the socialist era (1974-91), was a period characterized by financial repression and preferential allocation of credit to spur state-led industrialization and agricultural growth. The second phase, the period after 1991, marked the beginning of financial liberalization and deregulation. The third phase, which began during the second half of the 1990's, was marked by the Government's emphasis on financial inclusion, with legislation being enacted to facilitate private sector participation in banking and insurance.

3. **Access to finance has increased, although the financial sector remains concentrated.** The banking sector accounts for the largest share of the financial sector in terms of value and services provided but concentration remains high. The two largest banking institutions accounted for 53% and 64.4% of total banking sector capital in 2010/11 and 2016/17, respectively. Access to financial services has grown steadily, with the branch-to-population ratio decreasing from 1:65,415 in 2010/11 to 1:22,164 and 1:20,758 in 2016/17 and 2017/18, respectively. The productive sector (agriculture, industry, housing and construction, and mines, power and water resources) accounted for the largest share of new loan disbursements but this share has reduced from 63.8% in 2011/12 to 47.2% % in 2017/18.

4. **Progress has been made in establishing securities and money markets, although the fixed income market remains unattractive to the private sector.** A stock market is yet to be established. The Ethiopia Commodity Exchange was launched in 2008 and the interbank money market was established in 2001, although it currently features a few participants and the volume of transactions is thin. In the fixed income market, the central bank (National Bank of Ethiopia – NBE) conducts weekly Treasury Bills (T-Bills) auctions but the yields are pegged below the minimum bank deposit interest rate and over 95% of the T-Bills being held by state-owned enterprises. The Development Bank of Ethiopia (DBE) introduced a public bond for the Grand Ethiopian Renaissance Dam in 2010/11 and corporate bonds are steadily emerging as a source of financing.

5. **The banking sector regulatory framework has evolved since 1994 following the ratification of proclamations on monetary and banking as well as on licensing and supervision of banking business**. These proclamations effectively removed state monopoly in the banking sector. However, the investment legislation prohibits foreign investment in the financial sector. In addition, policy lending through the Development Bank of Ethiopia (DBE), although designed to channel credit to priority sectors, could potentially crowd out lending to the private sector. In particular, private commercial banks might respond to the mandatory requirement of investing an equivalent of 27% of each new loan disbursement in low yield 5-year NBE bonds by raising lending rates as a compensatory measure.

6. **Emerging market countries offer several lessons for Ethiopia, which can be used to transform the country's financial sector**. First, a robust legal, regulatory, and institutional framework for protecting creditor rights and facilitating the use of alternative forms of collateral, particularly for small businesses, can support enterprise growth and employment creation. Experiences from Asia and other countries in Africa confirm that movable asset registries have reduced transaction costs and facilitated access to finance. Second, regulation of credit markets can be beneficial especially where market failures constrain credit allocation to financially viable or socially valuable investments. However, earmarked lending could also lead to undesirable outcomes, such as crowding out bankable but high risk operations and leveraged expansion as a result of financial arbitrage. Third, the monetary policy transmission mechanism is affected by earmarked lending, with larger monetary policy changes necessary to generate the desired policy impact. Since preferential credit is not evenly distributed across economic sectors and/or firms, implementation of monetary policy could also generate distortive effects on the cost and allocation of credit. Fourth, liberalization of the financial sector fosters competition and catalyzes deposit mobilization. However, such liberalization should be matched with adequate regulation and supervision prior to full capital account liberalization.

A. Economic Context

1. **Real GDP growth in Ethiopia has been robust, driven mainly by expansion in public infrastructure investments.** Real GDP growth averaged 10.4% during the period 2003/04–2017/18. On the supply side, growth was driven by the services and agriculture sectors, which accounted for 39.2% and 34.9% of GDP, respectively, in 2017/18. The share of industry in GDP has increased steadily from 11% of GDP in 2003/04 to 27% in 2017/18, although manufacturing accounts for only 6.8% of GDP. Ethiopia is steadily recovering from the 2015/16 and 2017 droughts, on the back of sustained expansion of its services and industry sectors and a rebound in the agriculture sector. However, real GDP slowed to 7.7% in 2017/18 from 10.7% and 8.0% in 2016/17 and 2015/16 respectively. This slowdown is in part due to policy adjustments, including government's fiscal consolidation strategy to stabilize the public debt. On the expenditure side, foreign direct investments (FDI) and public investments notably in energy, transport and water infrastructure have led growth during the past 14 years. Ethiopia's economic expansion has been inclusive, with GDP per capita increasing from USD 142 in 2004/05 to USD 863 and USD 883 in 2016/17 and 2017/18 respectively. In addition, poverty has been reduced from 38.7 in 2004/05 to 23.5 in 2015/16, whereas income inequality as measured by the Gini coefficient increased from 0.3 in 2004/05 and 2010/11 to 0.32 to 2015/16.

2. **The Government has implemented several reforms to sustain economic progress and firmly set Ethiopia on its path to middle income status by 2025.** The key reforms include investments in energy and transport infrastructure and other enablers to reduce the cost of doing business. The country has also implemented reforms to facilitate the development of industrial parks. These reforms aim to promote export growth and diversification, notably in light manufacturing, to reduce the impact of external shocks on the economy. The key infrastructure projects include the USD 250 million Hawassa export industrial park, which was launched in July 2016 and the 1,870MW Gibe III hydropower plant that was inaugurated in December 2016. The 656 km Addis Ababa-Djibouti electric railway linking Ethiopia to the Port of Djibouti commenced commercial operations in January 2018. External resources have largely financed these transformative infrastructure investments. However, given Ethiopia's increased risk of external debt distress, sustaining the high public investments will require increased domestic resources mobilization, with the financial sector playing a leading role.

3. **The economic outlook is positive, but key downside risks remain.** Growth in industry and services sectors and the sustained recovery in the agriculture sector are projected to lead real GDP growth on the supply side. Industrial park development across the country will drive growth in the industry sector whereas the agriculture sector will benefit from measures to improve productivity, particularly investments in improved seed varieties, fertilizers, and irrigation. On the demand side, public investment is expected to slow down as the Government implements measures to stabilize the public debt. Climate change and its impact on agriculture productivity, vulnerability of debt sustainability to weak export performance, and rising inflationary pressures are among the other key downside risks. Nonetheless, strong growth in FDI, ongoing reforms to increase credit allocation to export and manufacturing sectors together with the improved political stability outlook have the potential to offset the impact of reduced Government spending on real GDP growth. In addition, the ongoing reforms to privatize state-owned enterprises, particularly telecommunications, air transport, railway, maritime, electricity, and logistics are expected to boost private investment. Improvements in national and regional peace and stability, notably following the historic normalization of relations with Eritrea, are upside risks. Consequently, real GDP growth is projected to recover from the estimated 7.7% in 2017/18 to 8.2% in 2018/19 and 2019/20.

B. Financial Sector Developments

4. The structure of the Ethiopia's financial sector has evolved over the past 40 years, from financial repression to emphasis on financial inclusion[2]. The financial sector has transitioned through three main phases. The socialist era (1974-91), which could be designated as the first phase, was a period characterized by financial repression and preferential allocation of credit to spur state-led industrialization and agricultural advancement. The second phase, the period after 1991, marked the dawn of financial liberalization and deregulation. The third phase, which effectively began during the second half of the 1990's, was marked by Government's emphasis on financial inclusion. Legislation allowing for private sector participation in banking and insurance (Proclamation No. 84/1994) and creation of microfinance institutions (Proclamation No. 40/1996) was enacted. These developments signaled the beginning of Ethiopia's transition to financial inclusion.

5. Access to finance has increased, although the financial sector remains concentrated and dominated by public banks. As of June 2018, Ethiopia's financial sector comprised 17 commercial banks (one state-owned and 16 private), a state-owned development bank, 17 insurance companies (one state-owned and 16 private), 35 microfinance institutions, and 5 capital goods finance companies. The banking sector accounts for the largest share of the financial sector in terms of value and services provided. For instance, banking accounted for 78% of total financial sector assets in 2016/17. In addition, the share of banking sector capital in total financial sector capital was 77.5% and 83.8% in 2015/16 and 2016/17, respectively, compared to the 80.3% recorded in 2010/11. The commercial banking sector accounted for 92.6% of the total financial sector assets in 2011/12. Concentration in the banking sector remains high, with the two largest banking institutions—the state-owned Commercial Bank of Ethiopia (CBE) and Development Bank of Ethiopia (DBE)—accounting for 64.4% and 53% of total banking sector capital in 2016/17 and 2010/11, respectively. CBE accounted for 64.4% and 66.1% of total banking system deposits in 2016/17 and 2015/16, respectively up from 58.3% in 2010/11, due to its expansive branch network across the country. In addition, public banks[3] accounted for 64.5% of total deposits and 44.4% of loan advances in 2016/17 compared to 68.1% and 52% respectively in 2010/11. Access to financial services has grown steadily, with the branch-to-population ratio decreasing from 1:65,415 in 2010/11 to 1:22,164 and 1:20,758 in 2016/17 and 2017/18, respectively. Growth in financial services has been inclusive, with more bank branches being established outside of the capital city Addis Ababa. For instance, Addis Ababa's share of bank branches decreased to 35.3% in 2017/18 from 51% in 2010/11. In addition, private banks accounted for 68.8% of the total branch network in 2017/18 compared to 49% in 2010/11. However, while the share of account holders at a bank or other financial institution among older adults[4] has more than doubled during 2014-17 in Ethiopia, it remains below the Sub-Saharan Africa average (Fig. 1).

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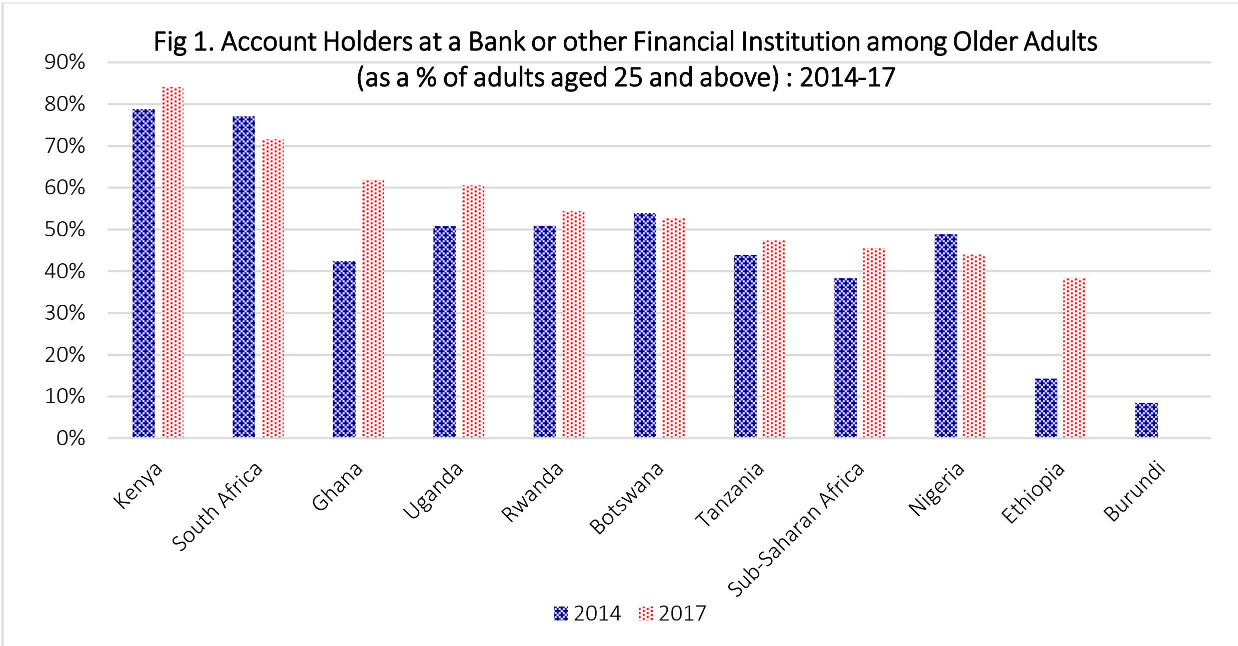
[2] Prior to 1974, Ethiopia had private and foreign owned banks. These banks were nationalized in 1975 and consolidated into three state-owned banks, namely Commercial Bank of Ethiopia, Housing and Savings Bank (which was later renamed 'Construction and Business Bank of Ethiopia), and Agricultural and Industrial Development Bank (later renamed 'Development Bank of Ethiopia').

[3] Public banks in 2010/11 comprised the Commercial Bank of Ethiopia (CBE), Construction and Business Bank (CBB), and the Development Bank of Ethiopia (DBE). CBB was merged with CBE in 2015/16, which leaves only two public banks.

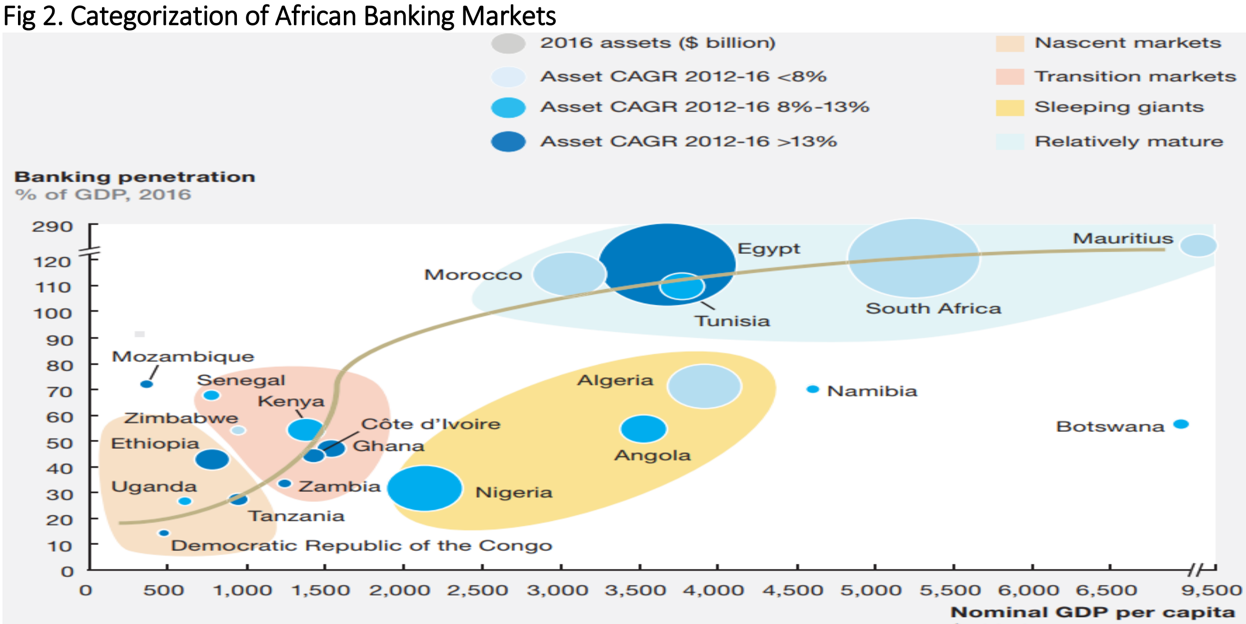
[4] This indicator is defined in the 2017 Global Findex Database as: 'the percentage of respondents who report having an account (by themselves or together with someone else) at a bank of another type of financial institution or report personally using a mobile money service in the past 12 months for older adults (% of population aged 25 years and above)'



Source: Global Findex Database 2017

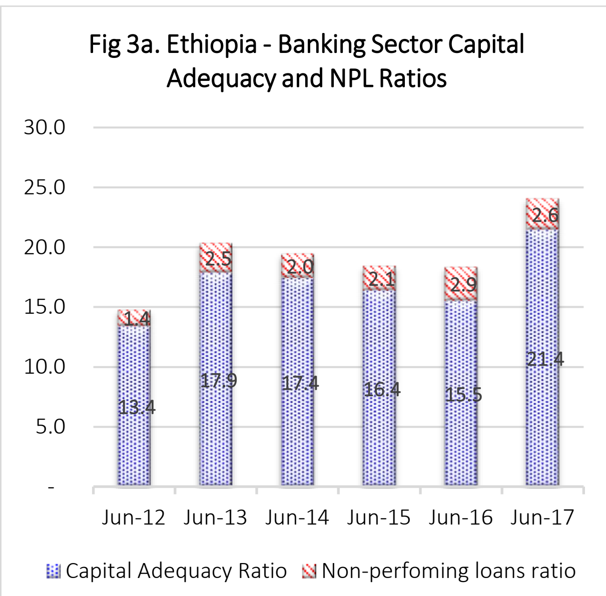
6. **Ethiopia's banking sector demonstrates strong potential for growth in spite of the current market entry restrictions.** Chironga et al. (2018) categorize Ethiopia as a nascent banking market (Fig 2) in part due to the low GDP per capita and asset penetration. In addition to being a nascent market, Ethiopia presents challenges for foreign investors, for instance due to market entry restrictions in the financial sector. However, Ethiopia's large market size (a population of close to 100 million) and high asset growth rates (compound annual growth rates exceeding 13% during 2012-16) signal strong potential in terms of profitability and return on investment.

Fig 2. Categorization of African Banking Markets

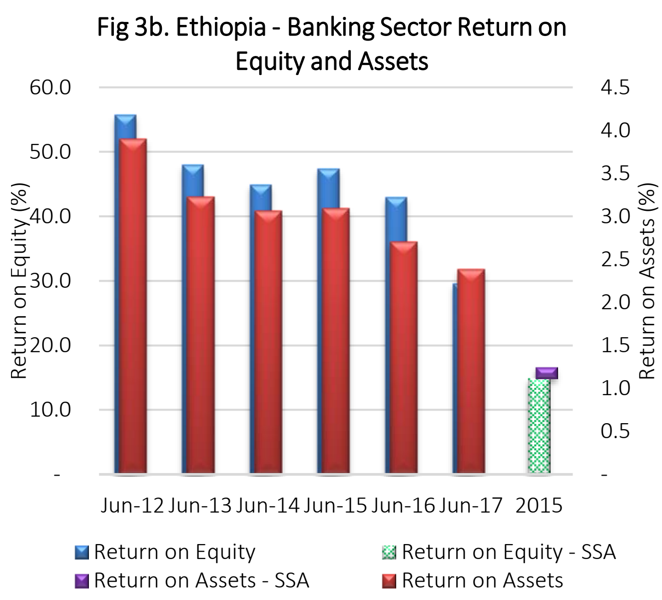


Source: McKinsey & Company, 2018.

7. **The financial sector is sound and stable.** The capital adequacy ratio (capital to risk-weighted assets) of the commercial banking sector stood at 21.4% as of June 2017, above the 13.4% and 15.5% recorded in June 2012 and June 2016, respectively (Fig. 3a). The return on assets (ROA) and return on equity (ROE), which indicate the level of earnings and profitability, decreased to 2.4% and 29.6%, respectively, in June 2017 from 3.9% and 55.7%, respectively in June 2012 (Fig.3b). The reduction in the ROA and ROE is due to several factors, including commercial banks' increased reliance on owners' equity capital, as opposed to debt, for their business operations. However, the ROA and ROE were higher than the 2015 averages for Sub-Saharan Africa (SSA) of 1.7% and 14.9%, respectively. The Asset quality in the commercial banking sector is strong. The non-performing loans ratio at 1.4% and 2.6% in June 2012 and June 2017 respectively remained below the 5% statutory requirement. However, the low NPLs could be due to commercial banks' focus on relatively less risky activities, such as trade as opposed to manufacturing and agriculture (Figures 6 and 7). In addition, a large share of credit is allocated to the public sector (State-Owned Enterprises) with low default rates. The central bank (National Bank of Ethiopia – NBE) regularly monitors banks' adherence to Basel II capital adequacy requirements and virtually all commercial banks' risk adjusted capital adequacy ratios are well above the regulatory 8% threshold.



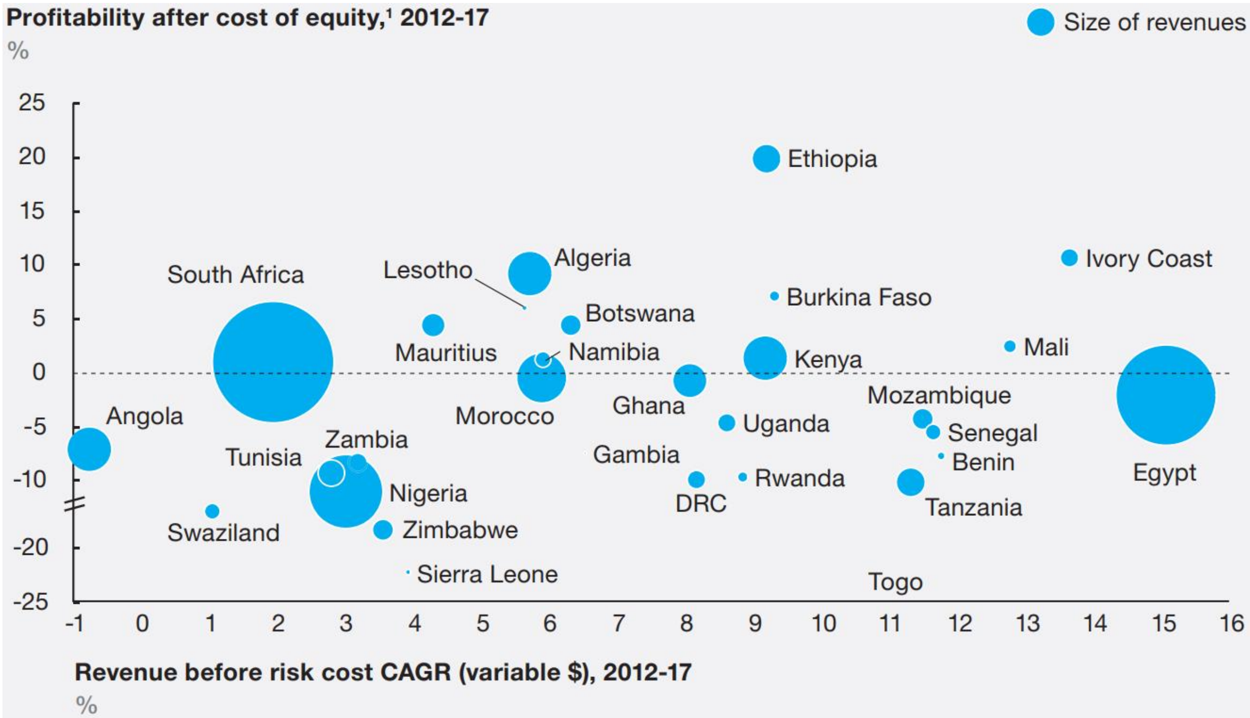
Source: National Bank of Ethiopia, various reports



Source: National Bank of Ethiopia, various reports

8. **Ethiopia compares favourably with other African countries in terms of banking sector profitability.** Fig. 4 illustrates banking sector profitability in selected African countries, with Ethiopia comparing favourably with the largest banking markets in terms of profitability and revenue growth.

Fig. 4. Profitability and Revenue Growth in Selected African Banking Sector Markets



Source: McKinsey & Company, 2018. [1]Return on equity after cost of equity has been deducted. Cost of equity is defined as local 10-year bond or equivalent + (average bank beta*average Sub-Saharan equity risk premium).

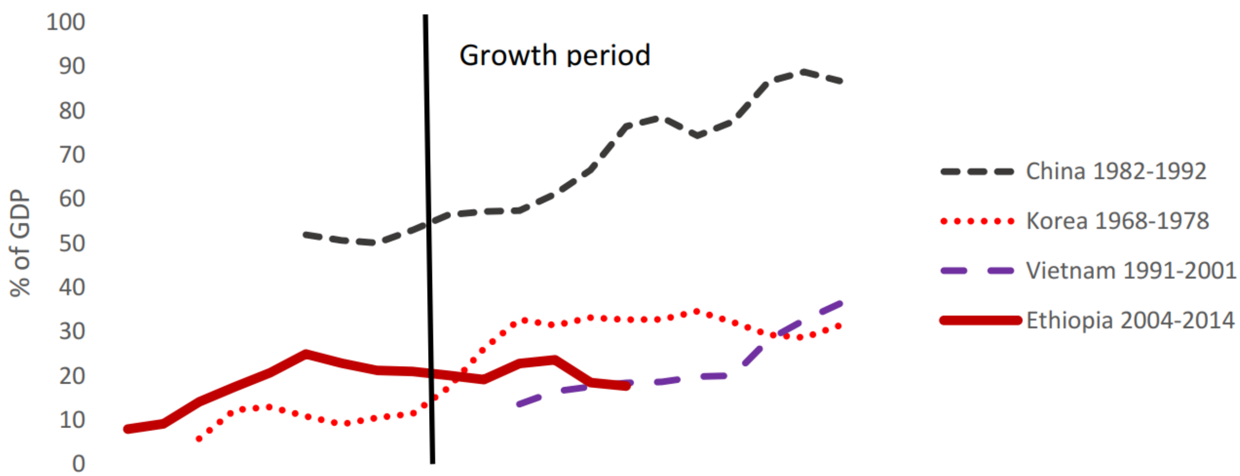
9. **Deposit mobilization has slowed and the financial sector is still shallow. However, financial sector disintermediation in Ethiopia mirrors trends in SSA.** Annual growth in deposits although still robust at 21.8% and 31.9% in 2015/16 and 2016/17, respectively, was lower than the 42.5% registered in 2010/11. Limited competition, and the resulting lack of incentives for innovation by commercial banks, is a major driver of the reduced deposit growth[5]. Furthermore, the financial sector remains shallow, with a limited range of financial instruments. For instance, total banking sector capital remains low in spite of increasing from 2.8% of GDP in 2010/11 to 3.1% and 4.9% in 2015/16 and 2016/17, respectively. The share of broad money (M2) in GDP increased slightly from 28.2% in 2010/11 to 29.1% and 31% in 2015/16 and 2016/17, respectively, although still below the 40% recorded in 2002/03. In addition, the private sector credit to GDP ratio decreased from 19.3% in 2004 to 13.9% and 10.8% in 2011 and 2013/14 respectively. Following the easing of monetary policy in 2012/13 (Section C), the private sector credit to GDP ratio increased from 11.4% in 2014/15 to 13.5% and 15.4% in 2016/17 and 2017/18, respectively. However, while Ethiopia's financial sector remains shallow, the aforementioned disintermediation trends mirror developments in SSA, where the GDP share of domestic credit to the private sector has decreased steadily from 64.2% in 2007 to 45.6% in 2015[6]. Fig. 5 reveals that growth in domestic credit to the private sector in Ethiopia during its growth period (2004-2014) lags trends in other emerging markets, notably China, Korea, and Vietnam, an

[5] Figure 8 shows that deposits have continued to increase during the period 2004/05 – 2016/17 in spite of the negative real deposit interest rate environment (due to the low minimum deposit rates—currently at 7%—and high inflation—average annual headline inflation at 13.0% in 2017/18).

[6] According to the IMF Country Report 15/332, the share of firms using banks to finance working capital and investment in Ethiopia stood at 16.4% and 12.9% respectively in 2015, compared to 20.9% and 17.1% respectively for Low Income Countries.

indication that more needs to be done to increase access to credit for the private sector[7]. Foreign investments in the financial sector are prohibited and capital markets are yet to be developed. Lending is primarily collateral based, which constrains access to finance for most of the small entrepreneurs who lack the necessary collateral. According to the *Global Competitiveness Report (GCR)*, Ethiopia scored ranked 109 out of 137 countries and 126/140 countries in 2017 and 2018, respectively, in terms of financial market development. However, this reflects some improvements in financial market development when compared with the *2012/13 GCR* where Ethiopia ranked 129 out of 144 countries. The 2019 and *2018 Doing Business* ranking on getting credit is also low at 175 and 173 out of 190 countries, respectively, compared to 150 out of 183 countries in 2012.

Fig. 5 Domestic credit to the private sector (% of GDP)



Source: World Bank (2016). Fig. 5 illustrates the indicated 10-year growth period (right of the vertical black line) and 10 years before that period (left of the vertical black line). The legend indicates the growth period applicable to each of the illustrated countries.

10. The microfinance sector plays a key role in financial inclusion, particularly for small businesses and farmers. According to the most recent available data, microfinance institutions (MFIs) accounted for 5.2% of the total financial sector assets in 2011/12, up from 4.4% in 2005/06. The number of licensed MFIs has increased from 31 in 2010/11 to 35 in 2016/17. The share of MFIs in total financial sector capital increased from 14.8% in 2010/11 to 16% in 2015/16, but dropped to 11.5% in 2016/17 following the capitalization of CBE, which increased banking sector capital by 81.1% by the end of June 2017. In addition, there were 16 million MFI accounts as of December 2017, up from 13.6 million accounts in December 2016, which represents close to 60% of banking sector accounts. Consequently, MFIs are a key provider of financial services to small businesses and farmers. Like the banking industry, the MFI sector is also highly concentrated, with the 5 largest MFIs accounting for 90% and 89% of the total MFI sector assets in June 2017 and June 2012, respectively. However, these 5 largest MFIs are owned by regional state governments and thus do not compete with each other as they operate in different geographic jurisdictions. High concentration in the MFI sector is an impediment to further advancements in financial inclusion due to the

[7] The 2016 World Bank Country Diagnostic estimated that the marginal products of private and public investment were 22.5% and 7.5%, respectively, in 2011.

absence of incentives for innovation. A National Financial Inclusion Strategy was launched in October 2017 and seeks to expand access to financial services[8].

11. **The non-banking financial sector is still nascent and plans are underway to establish domestic debt and capital markets.** The non-banking financial sector consists of insurance and capital goods finance companies. Insurance companies grew from 14 in 2010/11 to 17 in 2013/14 and have since remained stable, increasing the share of insurance sector capital in total financial sector capital from 4.8% in 2010/11 to 6.5% in 2015/16. This share dropped to 4.7% in 2016/17 due to strong growth in banking sector capital. The branch network more than doubled from 221 in 2010/11 to 426 and 492 in 2015/16 and 2016/17, respectively. However, insurance penetration is low at 0.44% of GDP for both nonlife and life insurance programs. The lease finance sector is nascent and comprises five capital goods finance companies. These five companies extended loans of USD 17.4 million and USD 7.3 million as of December 2017 and in 2015/16, respectively, up from USD 2.3 million in 2014/15 when lease financing was introduced. The lease finance loans aim to equip industries, including the small-scale ones, with machinery and other capital goods under a long-term lease arrangement. In December 2016, the NBE announced a plan to launch a secondary market for Government bonds as well as other debt instruments and work is underway to establish this market. The NBE indicates that successful implementation of the secondary market for Government debt will inform the establishment of a stock exchange.

12. **Progress has been made in establishing securities and money markets, although the fixed income market remains unattractive to the private sector.** A stock market is yet to be developed. The Ethiopia Commodity Exchange was launched in 2008 to trade in coffee, grains and cereals. An interbank money market was established in 2001, although it currently features a few participants and the volume of transactions is thin, with interest rates ranging between 7 and 11% and maturities spanning from overnight to 5 years. In the fixed income market, the NBE conducts weekly Treasury Bills (T-Bills) auctions for four maturities (28-day, 91-day, 182-day, and 364-day). The yields on these instruments are pegged below the minimum bank deposit interest rate and thus, the fixed income market remains unattractive to the private sector, with over 95% of the T-Bills being held by state-owned enterprises. Longer-term securities including bonds have not been widely used. Further development of the long-term securities market, notably to increase financial depth and liquidity, will be necessary for the successful implementation of the envisaged secondary market for Government debt. The Development Bank of Ethiopia (DBE) introduced a public bond for funding the Grand Ethiopian Renaissance Dam (GERD) in 2010/11, with interest rates of up to 6% depending on the maturity[9]. Corporate bonds are gradually emerging as a source of financing. NBE data show that state-owned enterprises and regional governments are currently the sole issuers of corporate bonds. The state-owned CBE is currently the only holder of corporate bonds, with their share in CBE's total outstanding lending increasing from 57.6% at the end of June 2015 and to 60.7% at the end of June 2017. As explained earlier, CBE's dominance of the commercial banking sector and the large share of corporate bonds in CBE's loan portfolio is one of the key drivers of the low NPLs.

13. **The relevant regulatory instruments for technology-based financial services are in place and strong growth potential for these services exists due to a relatively large untapped market.** The NBE's Directive No. FIS/01/2012 aimed to promote the use of technology and innovation in the delivery of financial services.

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[8] The National Financial Inclusion Strategy proposes four main strategies for improving financial inclusion, namely: (i) strengthening financial and other infrastructure; (ii) ensuring supply of an adequate range of suitable products, services, and access points; (iii) building a strong financial consumer protection framework; and (iv) improving financial capability levels.

[9] It is expected that returns on Government Bonds, including the GERD bond, will be revised upwards by 200 basis points following the increase in the minimum deposit interest rate by a similar magnitude in October 2017.

As a result, the NBE has implemented core-banking reforms leading to increased adoption of core banking services by the banking financial institutions. While Directive FIS/01/2012 paved the way for 'channel' banking services; such as internet banking, card payment system, mobile banking and point of sales; the uptake of these services has been slow due to to human resource capacity gaps in financial institutions and weaknesses in IT infrastructure, which affects product innovation. An estimated 7.7 million debit cards had been issued by commercial banks as of September 2017, compared to 4.3 million in the same period in 2016. In addition, Ethiopia is yet to harness the mobile banking innovations experienced elsewhere in the Eastern Africa region, in part due to low mobile phone penetration. As of June 2017, 12 commercial banks had 2.4 million mobile banking service subscribers. According to the 2017 Freedom on the Net report, Ethiopia's low mobile phone penetration (at 43% and 51% in 2015 and 2016, respectively, compared to Kenya's 88.2% and 87.7%, respectively) is due to the underdeveloped telecommunications infrastructure, which also excludes the rural areas where 85% of the population resides. However, nine commercial banks were offering agent and mobile banking services, as of September 2017, through 4,745 agents, up from 3,689 agents the previous year. Internet banking users increased by 68% to 89,295 as of September 2017 compared one year ago[10].

14. Monetary policy has influenced access to credit for the private sector. The diverse monetary policy instruments employed by the NBE such as reserve and liquidity requirements and caps on bank lending have affected banks' liquidity and thus, their ability to lend to the private sector. For instance, total loan disbursements increased from USD 1.09 billion in 2004/5 to USD 3.12 billion in 2009/10, with the private sector's share of these disbursements also increasing from 73% to 81.1%. However, the NBE adopted a contractionary monetary policy stance in 2010/11 to reduce inflationary pressures. Consequently, while total loan disbursements increased to USD 4.35 billion in 2011/12, the private sector share decreased to 54.1%. As discussed under section C, the reserve and liquidity requirements were eased in 2012/13 following the reduction in inflationary pressures, increasing the private sector's share of new loan disbursements to 54.9% and 60.3% in 2015/16 and 2016/17, respectively. This share decreased to 56.3% in 2017/18 in line with the Government's contractionary monetary policy. The private sector's share of total outstanding loans grew steadily from less than 30% in 2004/5 to 39.5%, 41.2% and 41.5% in 2015/16, 2016/17 and 2017/18 respectively.

15. The productive sector accounts for a high share of new loan disbursements, although this share has decreased over time. The share of new loan disbursements to the real sector (agriculture, industry, housing and construction, and mines, power & water resources[11]) remains high, but has decreased from 63.8% in 2011/12 to 60% in 2015/16 and further to 47.8% and 47.2% in 2016/17 and 2017/18, respectively. Figures 6 and 7 illustrate the sectoral distribution of new loan disbursements in 2017/18. While trade accounts for the single largest share of new loan disbursements, the high proportion of loan disbursements in the real sector is consistent with Ethiopia's structural transformation objectives and is expected to increase job creation, particularly for the youth. Figures 6 and 7 indicate that corporate bonds are a key financing source for mines, power, and water resources sectors.

[10] Automated teller machines and point of sale terminals increased to 2,899 and 9,098, respectively as of September 2017, which represents growth rates of 50% and 14.4%, respectively, relative to the same period in 2016.

[11] For 2011/12, real sector loan disbursements exclude loans to mines, power and water resources due data limitations.

Fig. 6. Loan Disbursements (including Corporate Bond Purchases) by Economic Sector: 2017/18

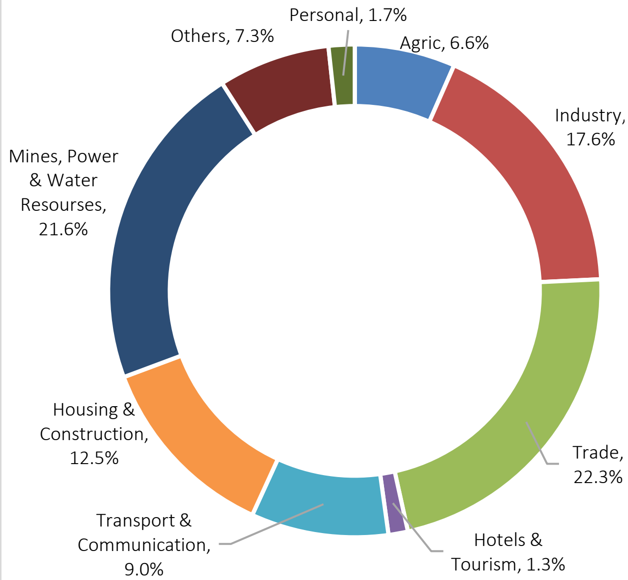
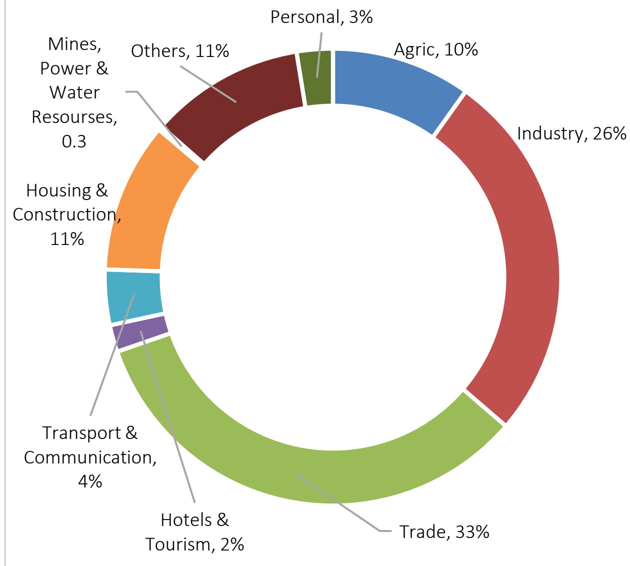


Fig. 7. Loan Disbursements (excluding Corporate Bond Purchases) by Economic Sector: 2017/18



Source: National Bank of Ethiopia, various reports

16. **Policy lending through the Development Bank of Ethiopia (DBE), although designed to channel credit to priority sectors including the private sector, could potentially crowd out lending to the private sector.** DBE was established in 1909 to finance medium- and long-term investments in priority export oriented sectors such as floriculture, leather, textiles and garments, and agro-processing at subsidized interest rates. DBE's special loan fund channels credit to priority activities, particularly in strategic manufacturing and export generating sectors, at preferential lending rates. Project sponsors can borrow up to 70% of the project cost without collateral security after presenting viable business proposals and 30% in personal equity. DBE also provides trade financing through export credit guarantees and is a major vehicle for the Government's rural financial intermediation program, through which low interest funds are provided to MFIs for on-lending to small businesses. A major source of DBE loanable funds is NBE bonds purchased by commercial banks[12]. As discussed in Section C below, private commercial banks are required to invest the equivalent of 27% of each new loan disbursement in 5-year low-yield NBE bonds. The share of new DBE loans allocated to the private sector increased from 94.7% in 2014/15 to 97.9% and 98.9% in 2016/17 and 2017/18, respectively, with the share of outstanding DBE loans going to the private sector increasing from 86.9% in 2014/15 to 88.6% and 89.5% in 2015/16 and 2017/18, respectively. However, DBE's non-market approaches to mobilizing loanable funds could potentially reduce the private sector's access to credit. For instance, it is plausible that private commercial banks might respond by raising lending interest rates to compensate for the low yields on the mandatory NBE bonds.

[12] NBE bonds are issued at an interest rate of 5% and the proceeds are on-lent to DBE at the same interest rate. Thus, the 2% subsidy (difference between the minimum deposit interest rate of 7% and the interest rates on the NBE bonds) is borne by the private commercial banks' shareholders.

C. Institutional, Legal, and Regulatory Framework

17. Overview. The banking sector regulatory framework has evolved since January 1994 following the ratification of the Monetary and Banking Proclamation No. 83/1994 (as amended through Proclamation No. 591/2008) and Proclamation No. 84/1994 (as amended via Proclamation No. 592/2008) on Licensing and Supervision of Banking Business[13]. These Proclamations effectively removed state monopoly in the banking sector by allowing entry of domestic investors into the industry. Proclamation No. 83/1994 established the powers and responsibilities of the NBE whereas Proclamation No. 84/1994 provided for the licensing and supervisory framework for commercial banks. NBE directives on banking businesses have progressed in tandem with the changes in the structure and sophistication of economic activity. For instance, the initial NBE directives, such as SBB/1/94 only required evidence of paid-up capital for a new banking business without specifying minimum paid-up capital requirements. In addition, banking supervision and regulation continues to be strengthened following the implementation of reforms to improve financial reporting, external audits, and risk-based supervision. Selected banking sector legal and regulatory instruments are discussed in the subsequent paragraphs.

18. Ethiopia's investment legislation prohibits foreign investment in the financial sector. Investment Proclamation No. 769/2012 and amended Proclamation No. 849/2014 forbid foreign investment in some sectors including banking, insurance and other financial services. This Proclamation has several implications, notably insulating domestic financial institutions from the benefits of foreign competition. In particular, foreign banking sector capital mobilization is not possible while opportunities for international banking technology and skills transfer are very limited. However, foreigners are allowed to participate in lease financing. NBE Directive FXD/47/2017 allows exporters, domestic, and foreign investors to acquire external loans or supplier's credit provided that these loans will be used to finance exports and/or projects that generate foreign currency.

19. Paid-up capital requirements have been adjusted to mirror the expanding economy. NBE Directive No. SBB/50/2011 raised the minimum paid-up capital requirements for establishing a new bank from the Birr 75 million (USD 7.5 million) to Birr 500 million (USD 31.05 million)[14], with commercial banks being given until June 2016 to meet this requirement. In September 2015, the NBE advised commercial banks to increase paid-up capital to Birr 2 billion (USD 94.78 million) by June 2020[15]. While some observers have interpreted NBE's actions as an attempt to restrict entry of new banks, it could also be argued that the aforementioned NBE initiatives seek to improve financial sector stability and ensure that commercial banks can effectively respond to the financing needs of an expanding economy.

20. Reserve and liquidity requirements have been adjusted in line with the monetary policy stance. The NBE, through Directive No. SBB/42/2007, raised the reserve requirement on the commercial banking sector from 5% to 10% in July 2007 and further to 15% in April 2008 via Directive No. SBB/45/2008. The upward revision in the reserve requirement was aimed at controlling inflationary pressures. To augment the higher reserve

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[13] A complete list of NBE Directives is available at: https://www.nbe.gov.et/directives/bankingbusiness.html

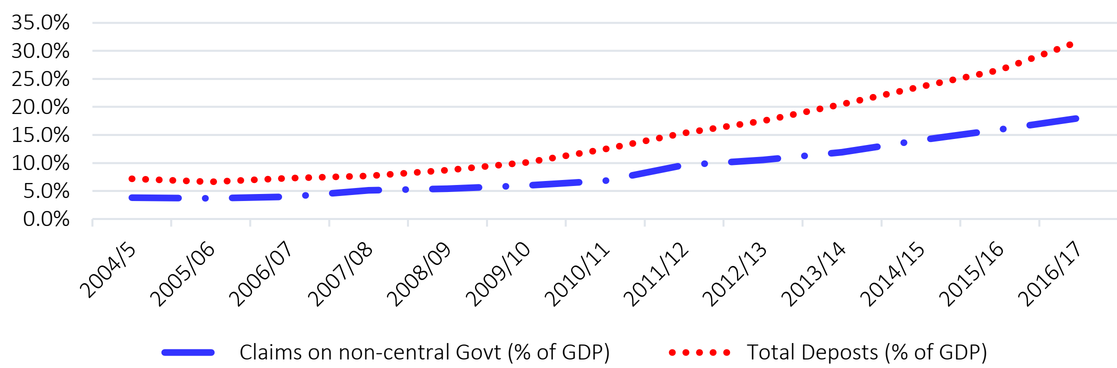
[14] Through Directive SBB/1/94, NBE increased the paid-up capital from Birr 10 million (USD 1.6 million at prevailing exchange rates) in 1995 to Birr 75 million (USD 10 million at prevailing exchange rates) in June 1999. Fifteen of the current 16 private commercial banks had met the Birr 500 million paid-up capital requirement by the end of June 2016. At the end of December 2017, all 16 private commercial banks had met the Birr 500 million paid-up capital requirement.

[15] NBE sent letters to commercial banks (as opposed to issuing a Directive) advising them to increase their paid-up capital to Birr 2 billion by 2020. As of December 2017, 6 of the 16 private commercial banks had achieved total capital in excess of Birr 2 billion.

requirements, the liquidity requirement was effectively increased[16] from 20% in July 2007 to 25% in April 2008, indicating that commercial banks were required to hold 25% of total reserves (such as, T-Bills and cash comprising foreign exchange) in liquid form (cash deposits). With the easing of the inflationary pressures, NBE through Directive No. SBB/46/2012 reduced the reserve requirement to 10% in January 2012 and 5% in March 2013, via Directive No. SBB/55/2013. The liquidity requirement was also effectively reduced to 15%.

21. The NBE determines the minimum bank deposit interest rate, which currently stands at 7%, while the lending rates are market determined. Real deposit interest rates remain negative due to high inflation, with average headline inflation at 13.0% in 2017/18, up from 7.2% a year earlier, in part due to rising food prices. However, in spite of the negative real deposit rates, the GDP share of total deposits (demand, savings, and time deposits) has consistently exceeded the GDP share of claims on non-central Government as illustrated in Figure 8. The sustained growth in total deposits is in part explained by the expansion in economic activities as reflected by the high real GDP growth rates and increased financial intermediation by banking institutions in line with the growing branch network across the country[17].

Fig 8. Loan Claims (non-central Government) Vs Total Deposits (% of GDP)



Source: National Bank of Ethiopia, various reports

22. The mandatory purchase of NBE bonds by private commercial banks has implications for private sector access to credit. Effective April 2011[18], NBE Directive No. MFA/NBE Bills/001/2011 requires private commercial banks to invest an equivalent of 27% of each new loan disbursement in 5-year low-yield NBE bonds[19]. The bond proceeds are channeled through DBE and are used to finance strategic investments, including commercial agriculture and manufacturing. To ease the resulting liquidity constraints, NBE Directive No. MFA/NBE Bills/002/2013 modified the application of the 27% requirement to disbursements

[16] The liquidity requirement is established at 10% plus the reserve requirement. The reserve requirement is part of the liquidity requirement, with the reserve requirement being calculated on all deposit types whereas the liquidity requirement is computed only on current deposits (total deposits less fixed/ time deposits).
[17] According to the 2017 Global Findex data, the share of the population over the age of 15 with an account at a financial institution in Ethiopia stood at 34.8% in 2017, above the SSA and low-income country averages of 32.8% and 24.5%, respectively.
[18] Commercial banks (excluding the Commercial Bank of Ethiopia) where required to apply this Directive retrospectively, starting on 1st July 2010.
[19] The yield on NBE bonds is currently established at 5% which is lower the 7% minimum bank deposit interest rate.

related to short term loans with maturities of less than 1 year (such as trade finance and T-Bills)[20]. However, private commercial banks are required to hold at least 40% of their total loan portfolio in short term loans[21]. This non-market approach to mobilizing resources for DBE could potentially increase the cost of credit for the private sector. As discussed earlier, commercial banks could opt to offset the purchase of low yield NBE bonds by raising their lending interest rates.

23. **The largely collateral based lending impedes access to credit.** Lending rates are market determined, although the 100% collateral requirement constrains access to credit and the ability of some entrepreneurs to pursue potentially profitable business opportunities. In addition, a more robust legal, regulatory, and institutional framework for securing creditor and debtor rights as well as facilitating the use of alternative collateral (including movable assets) is key to increasing access to credit. In particular, strong collateral legislation allows firms to utilize their assets, notably movable property, as security for business capital and is generally linked to a higher GDP share of private sector credit. However, according to the 2019 World Bank Doing Business report, Ethiopia scores 3 on the legal rights index (0 = lowest, and 12 = best), which is unchanged from 2018 and an indication that collateral and bankruptcy laws have weaknesses that limit access to credit.

24. **A credit registry is in place, although its coverage is very low at 0.3% of the adult population.** An online credit information sharing platform was established in 2012 to facilitate prudent lending decisions by consolidating comprehensive, timely, and reliable credit information on borrowers. Borrowers are also able to view their personal data via this online credit platform. However, since Ethiopia's credit registry covers 0.3% of the adult population (94,739 individuals and 7,656 firms as of 2016), the country scores 0 out of 8 on the 2018 and 2019 Doing Business depth of credit information index. A higher score would indicate that adequate credit information is available via the credit registry to inform lending decisions. All 17 commercial banks are covered by the credit registry, although the enrollment of MFIs, savings and credit cooperatives (SACCOs), and leasing companies is yet to be completed.

D. Transforming Ethiopia's Financial Sector: Lessons from emerging market countries

25. **A robust legal, regulatory, and institutional infrastructure for protecting creditor rights and facilitating the use of alternative collateral, particularly for micro, small, and medium enterprises (MSMEs), can support enterprise growth, employment creation, and economic transformation.** India has demonstrated that with the appropriate legal, regulatory and institutional framework, various assets can be used as collateral, including machinery and equipment, stocks, receivables, livestock, financial instruments and cash, and intellectual property (patents, copyright, trademark, and designs). These movable assets are estimated to account for over 80% of India's MSMEs' assets and their use has allowed enterprises to access capital. India's Central Registry of Securitization Asset Reconstruction and Security Interest (CERSAI), a central database established in 2011, allows financial institutions to secure their lending by registering their interests on borrowers' movable assets. CERSAI, which is underpinned by legislation for the creation,

[20] In order to facilitate credit expansion to export promoting sectors, short-term loans are treated less stringently in the application of the 27% requirement. For instance, the 27% requirement is applied to the change in the weekly outstanding balance, as opposed to new loan disbursements as is the case for longer-term loans.

[21] The requirement to invest 27% of new loans in DBE bonds and the 40% minimum share of short-term loans in total loan portfolios of private commercial banks implies that these banks are effectively investing a minimum of 10.8% of their total deposits in NBE bills.

registration and enforcement of security interests, registers all security interests in movable (and immovable) collateral, making it easier for MSMEs to use movable assets as collateral.

26. Experiences from China and other countries in Africa demonstrate that movable asset registries are reducing transaction costs and facilitating access to finance. China established a movable assets registry for small businesses, which facilitated financing of over USD 10 trillion. In Sub-Saharan Africa, a few countries including Ghana, Liberia, and Malawi have established collateral registries, easing access to credit for small businesses. To maximize benefits, these collateral registries have been launched jointly with online business registration systems to improve efficiency in business permit registration processing times and to reduce transaction costs. Therefore, benchmarking Ethiopia's legal, regulatory, and institutional infrastructure against best practices will be useful in informing the establishment of an integrated legal framework for secured transactions. Such a framework will facilitate the creation, publication, and enforcement of security interests in alternative collateral, ideally through an electronic registry[22].

27. Regulation of credit markets can be beneficial especially where market failures constrain credit allocation to financially viable and/ or socially valuable investments. However, earmarked lending could also lead to undesirable outcomes, such as crowding out bankable but high risk operations and leveraged expansion as a result of financial arbitrage. Evidence from Brazil[23] revealed that firms that benefitted from earmarked or subsidized credit from public banks were larger, older, and less risky, an indication that these firms were well placed to access alternative sources of private sector financing. In addition, firms that benefitted from earmarked credit increased their indebtedness without a corresponding increase in investment, also referred to as leveraged expansion. In particular, beneficiary firms used tax-payer subsidized loans to substitute for and/or refinance other more expensive sources of private financing. Therefore, this leveraged expansion was driven by the underlying opportunities for financial arbitrage. Lazzarini, Musacchio, and Marcon (2015) found that Brazil's National Development Bank (BNDES) mostly financed large and profitable firms, leading to a reduction in financing costs for these firms but with no corresponding impact on their investments and performance. The authors concluded that BNDES loans were simply resource transfers from the national treasury to firms' shareholders. Lage de Sousa and Otaviano (2014) revealed that firms that benefited from BNDES credit did not perform any better than the non-beneficiary firms. Martinez (2006) reported that the Government of Zambia's efforts to increase access to finance through financial system interventions, such as subsides and credit allocation, did not achieve their objectives. For instance, subsidized credit for housing largely benefited the middle class and other creditors who would have been in a position to access credit even without the subsidizes.

28. Although earmarked lending is associated with several undesirable outcomes, it can also generate some benefits for small business, particularly through lower interest rates and the reduced debt service requirements. Pazarbasioglu, Byskov, Bonomo, Carneiro, Martins, and Perez (2017) found that the average interest rates on earmarked loans was 1 percentage point higher for small businesses compared to the 50 largest firms in Brazil. However, the interest rate differential was 13 and 24 percentage points for non-earmarked loans from public banks and private banks, respectively. In addition, subsidized credit eases credit risks for both small and large businesses through the reduced debt service requirements. This confirms that the benefits from earmarked loans in terms of reduced interest rates and the implicit subsidy are greater for small businesses compared to the large firms.

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[22] Ethiopia's Ministry of Transport maintains a registry for a selected range of assets, such as machinery, that could be deployed as movable collateral. However, automating this registry to, among other things, increase its coverage of movable asset types and improve accessibility to creditors would improve efficiency and effectiveness.

[23] Pazarbasioglu, C., Byskov, S., Bonomo, M., Carneiro, I., Martins, B., and Perez, A. (2017).

29. **Nonetheless, earmarked credit can increase the overall cost of credit, thereby reducing access to credit for the private sector**. Banking institutions are likely to compensate for the reduced profitability on earmarked credit, due to the lower lending interest rates, by increasing the interest rates in the non-earmarked market. Pazarbasioglu et al. (2017) found that 82% of nominal interest income in Brazil was derived from non-earmarked loans in spite of these loans accounting for 50% of total credit. Furthermore, when interest rates were adjusted for inflation, the authors found that nearly all real interest income was attributed to non-earmarked loans.

30. **Government's intervention in the pricing and allocation of credit should increasingly favor the private sector.** Demetriades and Luintel (2001) revealed that the South Korean authorities extensively intervened in the pricing and allocation of credit as is currently the case in Ethiopia. However, in South Korea's case, the largest share of the earmarked credit was channeled to priority private sector activities such as steel, electronics, shipbuilding, and automobile manufacturing, among others. Ethiopia's export led industrialization strategy emphasizes private investment in key sectors such as leather and leather products, textiles and apparel, and agro-food processing. However, as illustrated in Fig. 3, the share of credit to the private sector during Ethiopia's growth period (2004 – 2014) is markedly lower when compared to South Korea's take-off period (1968 – 1978), an indication that a larger share of earmarked credit in Ethiopia has been used for public infrastructure financing.

31. **The monetary policy transmission mechanism is affected by earmarked lending, with larger adjustments in monetary policy necessary to generate the desired policy impact.** In addition, given that preferential credit is not evenly distributed across economic sectors and/or firms, implementation of monetary policy could generate distortive effects on the cost and allocation of credit. Pazarbasioglu et al. (2017) established that a 1% increase in the policy rate led to a 3 percentage points' reduction in the growth rate of corporate loans in Brazil, with this effect being reduced by one third for firms that benefited from earmarked lending. Similar distortionary effects were reflected in employment growth. Therefore, firms in the earmarked credit segment are only partially affected by changes in monetary policy, which distorts the cost of credit, its demand, and allocation across sectors and firms. As a result, monetary policy generates outcomes beyond its primary objective of ensuring price stability in the presence of earmarked lending.

32. **Liberalization of the financial sector, including the deregulation of interest rates, fosters competition and catalyzes deposit mobilization.** Devidas (2007) reported that banking sector reforms in India during the second half of the 1990's were in part driven by the realization that inefficiencies in the banking system were encouraging diversion of domestic financial savings away from the banking sector. Consequently, banking sector reforms focused on structural issues, such as the diversification of ownership of public sector banks, consolidating weak banks, and strengthening corporate governance. The specific reforms ranged from increasing banking sector capital adequacy to the deregulation of interest rates, notably ensuring that the interest rate on Government borrowing is aligned with the market-determined interest rates. Liberalization of the financial sector increased competition from diverse savings instruments, with interest rate deregulation providing an incentive for banks to mobilize deposits at competitive rates. In addition, competitive interest rates incentivized banks to develop products suited to the demands of various savers, thereby facilitating the redistribution of domestic savings from unproductive physical holdings to income generating assets. Shirai (2002) also noted that regulation of deposit interest rates in China prevented the wholly state controlled banks from operating in accordance with market principles.

33. **The establishment of an effective legal, regulatory, and supervisory framework should precede financial sector liberalization**. Shirai (2002) reported that a key lesson from the East Asian financial crisis was that excessive risk taking by domestic banks and inadequate monitoring functions were directly associated with weaknesses in risk management and prudential regulations, particularly following capital account

liberalization. Consequently, the crisis underscored the importance of matching financial liberalization with sufficient regulatory and supervisory improvements prior to achieving full capital account convertibility. Martinez (2006) noted that limited access to financial services in Zambia during the 1990s and early 2000s was in part due to financial policy failures, notably the inappropriate sequencing of financial sector reforms. The author argued that Zambia's financial system was liberalized[24] before the establishment of an efficient legal, regulatory, and supervisory framework as well as the appropriate market incentives and monitoring structures. As a result, financial sector liberalization proceeded in the absence of a framework necessary to promote prudent risk-taking and market discipline in the banking system, leading to several bank failures in Zambia during 1995-2001.

E. Policy options to increase access to finance for Ethiopia's priority sectors

34. **Measures to increase access to credit should be implemented within the broader framework of financial sector reforms**. Preferential access to credit, even for priority sectors, should be anchored on a comprehensive reform agenda to promote financial sector development. Key elements of such a reform process could comprise measures to improve financial sector regulation, stability, competitiveness, depth, and deposit mobilization strength. Implemented in isolation, earmarked lending is likely to distort the credit market and complicate the implementation of monetary policy, with additional unintended negative effects on overall access to credit for the private sector.

35. **A phased approach to liberalizing the financial sector needs to be explored.** Examples from emerging markets including China and India as well as other countries, such as Zambia demonstrate that financial sector liberalization generates several benefits to both savers and borrowers, including promoting competition and facilitating deposit mobilization. However, in line with the key lessons from the East Asian financial crisis and Zambia's experience, a strong legal, regulatory, and supervisory framework with adequate institutional and other capacities should be developed prior to embarking on full financial sector liberalization. Such an approach will ensure robust risk management, monitoring functions, and the implementation of necessary prudential regulations. The minimum set of prudential rules comprises a framework and capacities for adequate loan classification and provisioning, internal controls, corporate governance, credit risk management and anti-money laundering, among others.

36. **Earmarked lending is complex and can result in unintended outcomes, which calls for comprehensive evaluation of its effectiveness, beneficiaries, and impact.** A cost-benefit analysis should underpin the design of preferential lending schemes. Pricing, eligibility, and financing of the earmarked lending obligations require rigorous evaluation. The pricing of earmarked credit determines the magnitude of the subsidy and the corresponding fiscal costs. The criteria for defining eligibility influences the resulting dichotomy (earmarked vs non-earmarked segments) in the financial sector and the subsequent outcomes of the preferential lending instruments. In addition, financing approaches and/or options for mobilizing funds or deposits for earmarked lending define the incidence of the subsidy. Therefore, the costs and benefits to savers and borrowers as well as the fiscal costs require rigorous assessment to ensure sustainability and avoid any unintended negative spillovers to the economy. Furthermore, the objectives and beneficiaries of

[24] Zambia embarked on financial sector liberalization reforms in 1992, with the deregulation of the borrowing and lending interest rates and transition to market determined exchange rates. In particular, most foreign exchange controls on current account transactions had been removed by March 1993 and the capital account liberalized in February 1994. Commercial banks were allowed to hold foreign currency deposits by the central bank in 1995 and full liberalization of the foreign exchange market was achieved in 1996 when the Zambia Consolidated Copper Mines was allowed to retain its foreign currency receipts and supply its earnings directly to the foreign exchange market.

earmarked lending should clearly be defined to facilitate evaluation of the outcomes. As an example, earmarked credit typically targets infrastructure related operations, low-income urban housing, small businesses and small-scale high value added farmers, among others. However, due to the distortionary effects of earmarked lending, the aforementioned beneficiaries may not maximize the envisaged returns.

37. **Market-based approaches to allocating credit to priority sectors, small businesses, and start-ups should be explored.** In line with South Korea's experience, more credit should be allocated to higher value added private sector activities. Risk sharing instruments, such as partial credit guarantees (PCGs) and partial risk guarantees (PRGs)[25] are less distortionary compared to earmarked lending and can be used to channel credit to underserved and riskier but productive high value added sectors. For instance, PCGs can be deployed to underwrite lending to export oriented higher valued added enterprises, including businesses owned by the youth and women. In particular, the risk-sharing instruments can increase access to credit for priority sectors without the negative outcomes associated with earmarked lending, such as the large fiscal subsidies, distortions in returns to savers, and increased borrowing costs in the non-earmarked credit market.

38. **In addition to benchmarking Ethiopia's legal, regulatory, and institutional framework for creditor rights and alternative collateral against international best practice, this framework should be implemented jointly with business regulatory reforms.** Experiences from emerging market and Sub-Saharan African countries demonstrate the additionality of robust legal and regulatory frameworks for movable collateral in increasing access to credit for small businesses whose movable assets account for over 80% of total assets. An online collateral registry secures creditor rights while allowing small business to transform their assets into capital. Capacity development for financial institutions to develop the required skills in movable asset based lending is equally important. In addition, complementing the online collateral registry with reforms to improve the business regulatory environment; such as automation and simplification of business registration processes; reduces transaction costs, facilitates business growth, fosters job creation, and accelerates economic transformation.

39. **In conclusion, a holistic approach to promoting investments in priority sectors that also includes reforms to improve the business-enabling environment is necessary.** Diagnostics such as the *Doing Business* and *Global Competitiveness Reports* indicate that credit is only one of the factors impeding business growth, including in Ethiopia. For instance, bottlenecks in logistics, inadequate skills, limited employability, and insufficient progress in the implementation of business regulations are among the important constraints to business growth. Therefore, an all-inclusive approach to supporting business growth is more likely to generate the desired structural transformation outcomes. Key components of such an approach include easing bottlenecks to starting and operating a business, tailored business development services, and skills development and training programmes with emphasis on skills required to drive higher value added production. Therefore, financial sector reforms should be embedded within a country's national development agenda to create the enabling eco-system for inclusive and sustainable economic transformation.

[25] In addition to the PCGs and PRGs, the African Development Bank provides other risk sharing instruments such as the Private Sector Credit Enhancement Facility (PSF). The PSF is designed to catalyze private sector financing in low income countries by providing guarantees of up to 50% of exposure on selected non-sovereign operations. PCGs and PRGs guarantee lenders/ providers of debt against non-payment due to political risk (PRGs) and both political and commercial risk (PCGs). However, only countries at low or moderate risk of external debt distress are eligible for PCGs.

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