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## FINANCIAL REFORMS IN THE MEDITERRANEAN: IDEAS AND POLICIES TO INSPIRE CHANGE



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The IEMed is a think tank for the identification and interpretation of the challenges in the Euro-Mediterranean area and for the preparation of proposals to confront them. It offers spaces for reflection and debate as well as advice and assistance to cultural and cooperation projects in the Mediterranean. Moreover, it promotes the participation of civil society in the Euro-Mediterranean space through several networks and in collaboration with entities from the social, economic and cultural worlds.

The **PapersIEMed.** collection seeks to approach the study of key issues on the current Euro-Mediterranean agenda. Its objective is to provide a new and original view of these issues through the publication of painstaking analyses by recognised experts and researchers in this field.

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## Introduction

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In a moment of deep-rooted socioeconomic and political change in the Mediterranean, the need to reinforce cooperation, promote knowledge and inspire new ideas and actions has never been greater.

In this difficult context, several major Mediterranean think tanks and financial institutions have decided to establish a new organisation to help the region grow better by growing together. This organisation is called the MED Confederation, its main objective being to develop projects that induce and strengthen cooperation and economic integration, social progress and cultural exchange between Mediterranean countries.

The MED Confederation's founding members are the European Institute of the Mediterranean (IEMed, Spain), "la Caixa" Foundation (Spain), the World Savings Banks Institute (WSBI, Brussels), the Institut de Prospective Économique du Monde Méditerranéen (IPEMED, France), the Caisse des Dépôts et Consignations (Tunis), the Caisse de Dépôt et de Gestion (Morocco), Al Barid Bank (Morocco) and the Economic Policy Research Foundation of Turkey (TEPAV, Turkey).

In the framework of the projects established under the umbrella of the MED Confederation, the IEMed leads the conception and organisation of several high level working groups to promote value added analysis of the most relevant challenges the region faces today. Based on the topic of study in each of these working groups, the IEMed puts together a group of the most relevant international experts, whether individuals, think tanks, institutions, businesspeople or multilateral organisations, to exchange their points of view and experiences. The result of these meetings are policy-oriented documents prepared by several of the participating experts that contain the main ideas analysed in order to inspire policies that could improve the performance and impact of the fields debated.

This document is the result of the high level working group on financial reform held on the 16th and 17th of June 2014 in Promos – Milan Chamber of Commerce. On this occasion, more than 30 international experts debated how to reform the banking sector in the Mediterranean neighbourhood as a key need to better contribute to the socioeconomic and business development of these economies. They also analysed how to improve the performance and impact of private equity in these countries to consolidate their development and their international cooperation. Finally, mobile banking was the third financial segment studied as a way of improving financial inclusion in these societies.

Central banks, commercial banks, international financial institutions and networks, private equity funds, independent experts and business associations and chambers of commerce, among others, were represented in this working group, guaranteeing the diversity of perspectives, experiences and value added knowledge on the topics covers.

## **The Financial Context in Arab Mediterranean Countries**

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Contrary to what has happened in the US and the EU, the financial system has not been in recent years the main source of distress and economic problems in Arab Mediterranean countries. At the end of 2008, there were certainly some repercussions of the global financial crisis in these countries, mainly felt in stock exchange prices, sovereign risk premia and a contraction in cross border lending to the region, but on the whole the first round of financial reactions was limited. The real side effects of the global crisis – via lower exports, tourism revenues and FDI, and weaker internal demand – were more acute, and most countries in the region registered a severe reduction in their growth rates in 2009. But with a globally more benign international scenario and the domestic financial conditions not severely affected, the 2010 growth rebound in the region was intense.

The economic downturn that the region has been witnessing since 2011 is also not a direct consequence of specific, systemic problems in the domestic financial systems. Although difficulties are being registered in some countries, linked in particular to traditionally high non-performing loans ratios, until now at least no banking crisis or broad-based financial disruptions can be signalled as causes of the protracted period of subdued growth the region is suffering. As is well known, the reasons for such an outcome have to be found in the political transitions related to economic disruptions, the unclear political outlook in some cases, the still low level of confidence of economic agents and the difficult international environment, particularly in the EU, the main economic partner of the region.

However, there is an extended opinion that the financial systems of Arab Mediterranean countries are not contributing to economic growth in the way they should be. Indeed, there is evidence that the intermediary function between savers and investors that the financial systems have to play needs to be improved. In particular, in most countries of the region the financial systems are not able to ensure access to finance in adequate conditions to vast parts of the population, and the difficulties of corporate and small and medium size companies in obtaining financing appear to be more pressing than in other emerging regions. Moreover, the quality and diversity of products and services offered by the financial system appears to be lagging behind the general economic development of the region.

Consequently, the financial system reform is an essential element of the broader and bold economic reform agenda in Arab Mediterranean countries, as advocated by international institutions (Finger, Gressani et al., IMF, 2014). There is also wide consensus on the main targets of this financial system reform (see, for example, Ayadi, MEDPRO Policy Paper 7, 2013): it has to be pro-growth; the resulting financial system has to be more inclusive; and it has to maintain financial stability.

With this in mind, the purpose of this document is first to summarise the main characteristics of the financial systems of Arab Mediterranean countries. This summary is kept short and concise, and deliberately emphasises the aspects which call for reform and action. This is intended to be the

preamble for some specific reform proposals in the banking sector, the private equity sector and in mobile banking activities.

## Key Features of Arab Mediterranean Countries' Financial Systems

### Generally large banking systems

Banking systems of the region are relatively large compared to other emerging countries, although there is also a great heterogeneity. Taking bank assets/GDP ratio as a measure of financial depth, the average for the region (Table 1) is double the emerging countries' average, and about half the euro area figure. A similar conclusion is reached when looking at the size of the deposit base, which in terms of GDP amounts on average to 79% in the region, compared to 35% in emerging economies and to 105% in the euro area. Finally, Arab Mediterranean countries also compare favourably with other emerging economies when considering the relative size of private credit, although clearly less well than in terms of assets or deposits: the average private credit/GDP ratio stands at 44%, compared to 29% and 122% in emerging countries and the euro area, respectively.

Average figures of the region hide a very clear distinction between two groups of countries. The first group, comprising Lebanon first, but also Jordan, Morocco, Tunisia and Egypt, is characterised by larger banking sectors, whereas in the second group, which includes Algeria, Libya and Syria, the depth of the banking system is much smaller, especially when looking at private credit/GDP indicators, which in these three countries are particularly low (14%, 9% and 20%, respectively). The first group of countries could also be labelled (as done by Rocha et al., WB, 2011) private-led banking systems versus state-led banking systems for the second group, although the presence of public banks, to varying degrees, is widespread through the region.

### Low access to finance

There is a wide consensus between experts that the generally large size of the banking sectors is not matched by an adequate provision of finance and financial services to the private sector, and especially to SMEs and for investment purposes. Although surveys and data are incomplete and need to be updated, low access to finance can be seen in different ways (Table 2). For example, the proportion of firms identifying access to finance as a major constraint in the region, 35% on average, is higher than in other regions like Latin America (27%) and East Asia (16%). These constraints appear to be very intense for small firms, as shown by the fact that on average only 23% of them have bank loans in the region, compared to 39% in Latin America and 35% in Europe and Central Asia. Surveys also indicate that it is particularly difficult to finance corporate investment through banks, given that only 11% of firms use banking institutions for this purpose, compared to 44% in South Asia, and 41% in Latin America, for example.

Correspondingly, firms have to rely more on internal resources, not always available, which means that possibilities of increasing the productive capacity of the economy can be lost.

A relatively wide deposit base combined with a limited availability of credits for households and private companies is a symptom of inadequate functioning of the intermediation role of the banking sector in Arab Mediterranean countries. This is also suggested by the excessively low credit/deposits ratio prevailing in the region of 56% compared to an average of 82% for emerging countries. The capacity to transform savings into investment is particularly low again in Libya, Algeria and Syria, and also in Lebanon, although in this case mainly as a result of its very wide deposit base (including diaspora and non-resident deposits). In contrast, the credit/deposit ratio is above 100% in Tunisia, mainly as a result of public banks' lending activity.

One of the possible reasons<sup>1</sup> that the literature has identified for explaining this poor capacity to provide access to finance and to transform deposit into credits is a comparative lack of competition in Arab Mediterranean banking systems (Anzoategui, Martinez Peria and Rocha, WB, 2010). In turn, insufficient banking competition appears to be related with relatively strict obstacles to entry into the banking market, with the underdevelopment of the non-bank financial institutions and with the deficient quality of credit information.

#### **Concentration of credit**

The level of concentration in the banking industry, as measured by the share in total assets of the three largest banks, varies depending on the countries but on average (70%) is considered to be high by international comparison. There is also evidence of a high loan concentration and of connected lending in Arab Mediterranean countries. In particular, the exposure of banks to their twenty prime clients, in terms of capital, is higher than in any other region in the world.<sup>2</sup>

Interconnectedness with large private conglomerates in some cases, and public companies pre-eminence in others, contribute to explaining this high level of credit concentration in larger companies, and its counterpart, i.e. restrained availability to SMEs and households.

#### **Large share of public assets in banks' balance sheets**

Loans to the public sector and government securities also account for a large share of the balance sheets in most Arab Mediterranean countries, especially in state-led banking systems, but also in Egypt, Lebanon and Jordan. In these three countries, the stock of public debt relative to GDP is very high by international comparative standards (92%, 138% and 79%, respectively)<sup>3</sup> and, as has been the case in Morocco (75%) and Tunisia (46%), hugely increased public deficits after the Arab Spring have required growing financing requirements from the banking domestic systems, crowding out the private sector.

1. Insufficient solvent demand for credit as a result of obstacles to the adequate functioning and profitability of the real sector of the economy could be another reason for the low credit/deposit ratio.

2. In non-Gulf Cooperation Council MENA countries, which include Arab Mediterranean countries, this share amounts to 242%, compared to 223% in Europe and Central Asia, 147% in Western Europe, 131% in Asia, 77% in Latin America and 58% in North America. Data from S&Ps in various years, taken from Rocha et al., World Bank, 2011.

3. Public debt/GDP data refer to end 2013.

### **Weak financial infrastructure**

Credit reporting systems, collateral regimes and insolvency laws are important elements of the financial infrastructure. In particular, if adequate information regarding the potential borrowers is not available, lenders will tend to follow more stringent policies, increasing interest rates, rationing credit and relying more on collateral and less on risk assessment analysis. There are two basic types of institutions that provide credit information: public credit registries (PCR) – normally managed by bank supervisors and collecting information from supervised institutions –, and private credit bureaus (PCB), which generally use broader sources for information, financial and non-financial. Most Arab Mediterranean countries rely on PCRs, although Morocco and Egypt (and soon Jordan) have introduced PCBs (Rocha et al., WB, 2011). Generally speaking, coverage of companies and persons is low and data quality insufficient. In most cases there is a need to modernise and improve the functioning of the systems, to enlarge the sources of information, and to generalise the use of credit scoring systems, also in banks. A better capacity of non-financial companies, and especially of SMEs, to provide the required legal, fiscal and financial information will also reduce information asymmetries and make risk assessment easier.

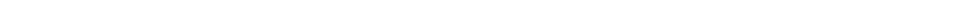
Problems are reported by banks in all the steps of the chain of secured lending – especially in the enforcement and selling stages, and particularly for movable collateral. In the registration of collateral stage, public registries still need to be computerised and information needs to be made public more easily. In the enforcement stage, when property of the collateral by the creditor is implemented, judicial court enforcements are time consuming and expensive in many cases, and out of the courts enforcement procedures are almost non-existent. Finally, the selling of collateral is generally made costly by complicated rules in judicial auctions.

Finally, insolvency and bankrupt regimes appear to be outdated in many cases, focusing only on the liquidation of the company and not on its possible reorganisation. A lack of professional expertise in this field is also reported.

### **Public banks**

Although in a declining trend during the last decade as a result of privatisations, state owned-banks still account for about 70%-90% of total bank assets in Algeria, Libya and Syria, close to 40% in Egypt and Tunisia, 16% in Morocco and are almost non-existent in Jordan and Lebanon.

The financial performance of state banks appears to be significantly weaker than that of private banks in terms of profitability, as a result of higher holdings of government assets, higher overhead costs to assets (although with lower average wages) and higher ratios of non-



performing loans. On the other hand, the effectiveness of state banks in achieving their development goals (finance housing and SMEs, expanding access to finance in rural areas...) appears to be uneven and mixed (Farazi, Feyen and Rocha, WB, 2011).

In the present post-Arab Spring context, a rethinking of the role of these institutions, better corporate governance standards (preventing political interference in the decision-making process) and efforts to enhance risk management capabilities seem to be necessary lines of action.

#### **Limited integration in the international financial system**

Given their reduced loans-to-deposits ratios, the banking systems of Arab Mediterranean countries are little dependant on foreign funding. This is also translated in the small share of banks' foreign liabilities relative to total liabilities, with the exception of Lebanon, which has wide but stable non-resident's deposits, and Jordan. Moreover, foreign bank lending in terms of GDP is on average lower than in other regions, like Latin America and Emerging Europe (Table 2). The direct presence of foreign banks is not significant in state-led systems, whereas foreign banks operating in Lebanon, Tunisia and Morocco, mostly of EU origin in the case of the last two countries, have assets which account for between 20% and 30% of total bank assets (Frewer, Betz and Stölting, EIB, 2013). Regarding Mediterranean banks' investment abroad, a recent expansion of Moroccan banks in Sub-Saharan countries is to be noted. Besides, with the exception of a significant presence of Lebanese banks in Syria, Jordan and Egypt, national financial systems in the region appear to be basically disconnected from each other.

The prevailing relatively closed capital control regimes and low dependence on foreign bank lending can have in some circumstances positive implications from a financial stability perspective, sheltering the financial system from sudden stops in capital flows, for example. However, this limited integration in the global financial system also has very significant costs, in terms of lower competition in the domestic financial systems, and of lower transfer of technology and knowhow coming from abroad, from example.

Furthermore, limited access to foreign private finance is indeed a problem when, as happens to be the case now, most countries register high current account deficits: in terms of GDP, IMF projections for 2014<sup>4</sup> are -1.3% for Egypt, -12.9% for Jordan, -15.8% for Lebanon, -6.6% for Morocco, -6.7% for Tunisia, and a surplus of 0.5% for Algeria. In fact, the limited capacity of the domestic financial sectors, and of most sovereigns too, to finance the associated external financing requirements is making it necessary to resort to official external financing to fill the gap. Under this heading, and following the Deauville Initiative, Arab Countries in Transition<sup>5</sup> were expected to receive up to \$51.3 billion from bilateral and multilateral sources in 2011-2013.

4. IMF, Regional Economic Outlook Update, May 2014.

5. Countries included in this group are Egypt, Jordan, Libya, Morocco Tunisia and Yemen.

**Banks' performance and asset quality**

Arab Mediterranean banks are generally well capitalised and have good profitability. However, in several countries there is a structurally large stock of non-performing loans, especially in public banks. Efforts were made in previous years to control this problem, speeding the procedures for realising real estate collateral or injecting capital into state companies to enable them to repay their loans. However, the economic slowdown during the post-Arab Spring political transitions has added pressure in this field and banks' asset quality is a real concern in some countries. Non-performing loans account for more than 10% of total loans in Egypt and Tunisia. In the last case, non-performing loans are particularly high in public banks and the government has decided to recapitalise some of them. In the region as a whole, and given the important share of public assets in banks' balance sheets, feedback loops between sovereign and banking solvency should be taken into consideration and prevented.

**Development of capital markets**

In private-led systems, equity markets registered a buoyant activity in the pre-global crisis years, but more recent years have witnessed a decline. Stock market capitalisation is still high by international comparison, especially in Jordan (100% of GDP) and Morocco (66%), with Egypt, Lebanon and Tunisia ranging between 27% and 22% of GDP, compared to an emerging countries average of 24%.<sup>6</sup> However the sectoral distribution of market capitalisation – biased in favour of financial institutions and against industry and services sectors –, the relatively low percentage of free float of the companies listed and the fall in the number of listed companies and indicators of market liquidity in recent years reveal that the role of stock markets in financing new corporate investment is very limited.

Notwithstanding large public debts in most countries, government bonds markets have not fully realised their potential, leading the way for private fixed income markets development. The reasons for incomplete public bonds markets (Rocha et al., WB, 2011) are related to a lack of predictability of the auctions, a term structure excessively biased to long-term maturities to reduce roll over risks but which means lack of short-term price references, captive demand coming from state banks and public pension funds, which predominantly trade in over-the-counter wholesale markets and marginally on exchanges, illiquid secondary markets, and, generally speaking, a lack of investability, which makes foreign participation in these markets marginal. In the absence of well-established benchmark yield curves for pricing, and with insufficiently developed institutional market infrastructure, including clearing, settlement and registry functions, and also oversight and regulation, the private market has not grown either. Lack of regulation of covered bonds and securitisation, with some exceptions, like Morocco and Tunisia, also explains the difficulties for these markets to grow. The volume of private bond issues has been small and largely originated by banks, while for corporates the market is in its infant stage.

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6. World Bank Global Financial Database, data corresponding to 2011.

**Domestic institutional investor base**

Non-bank financial institutions – like insurance companies, the asset management industry, pension funds, and leasing and factoring companies – play a crucial role in modern financial systems, widening the financial services and instruments offered to the public and competing in many respects with banks. At the same time, as institutional investors, they can also contribute to the development of capital markets. However, for a variety of reasons, non-bank financial institutions are still not well developed in most Arab Mediterranean countries (Rocha et al., WB, 2011). On average, insurance companies and mutual fund assets account for less than 5% of GDP each, and less than 1% for the rest of non-banking financial institutions, including private pension funds, private equity funds and the microfinance industry. However, there are also strong differences between countries, with state-led systems generally lagging behind, and some other cases, like Morocco, where insurance and mutual funds are more developed.

Some of the reasons that make the expansion of these activities more difficult are related to regulation, for example lack of compulsory insurance and reinsurance in some cases, or lack of supportive tax treatment for life insurance and private pension funds. In contrast, public pension funds have accumulated an important volume of reserves in some countries – in particular, Egypt, Morocco and Jordan, above 20% of GDP – in their management of the pay-as-you go pension systems. The disclosure regime of public pension funds varies greatly, as does their investment policies, ranging from passive strategies and investment only in public bonds to more diversified and professional approaches.

Leasing can be potentially very attractive in a regional environment where creditor rights are weak and enforcement of collateral difficult, as leasing companies retain ownership of assets. It is also easily compatible with Islamic finance principles. However, mainly as a result of regulatory and tax problems, the leasing industry is still small by international comparison, being most developed in Tunisia and growing fast in Egypt, Jordan and Morocco.

**Regulation and supervision**

There is scope to make further progress in strengthening the capacities of bank supervisors, in all cases the central banks. In this regard, complete compliance with the Basel Principles regarding governance, resources and operational independence of bank supervision will be paramount. At the micro supervision level, in line with international practices, a transition towards a more risk-based approach, including asset quality reviews and stress tests, also appears to be necessary. Besides, regulatory provisions limiting large exposures and credit concentration need to be streamlined and better enforced. There is also ample room for improvement in the regulation and enforcement of banks' corporate governance (including composition of Boards) and disclosure policies (including information about bank ownership).

Finally, to safeguard the stability of the financial systems, macro prudential policies to detect and prevent the building up of systemic risks are needed. As in most countries, this is still a work in progress in Arab Mediterranean countries, and although specific measures of a macro prudential nature have been adopted in different countries a comprehensive approach is still lacking. Publishing regular financial stability reports, for example, is still rare in the region.

### Conclusion

Although with relevant differences depending on the countries, the financial systems of Arab Mediterranean countries can be described as relatively large and mainly based on the activity of banks. Their main problem is a poor capacity to transform deposits into credit to the private sector, with a strong bias to maintain liquid and government assets and to finance large corporates. The result is generally positive in terms of banks' capitalisation and profitability, but the private sector as a whole is not financed to the extent that deposits could allow, and households and SMEs in particular remain underfinanced. Banks' loan portfolios seem to be excessively concentrated and, in several cases, there are high and rising non-performing loans ratios, especially in public banks.

Another problem is little diversification and sophistication of the financial products and financial services offered to the public. This is also related to the reduced presence and activity of non-bank financial institutions, whose development could contribute to increasing competition with banks, enlarging the institutional investor's base and supporting capital market activity. Changes in regulation and tax systems, and in the institutional setting, could contribute to strengthening non-bank financial institutions and to increasing the supply of new products and services.

Finally, Arab Mediterranean financial systems are not fully realising the benefits of globalisation as a result of their limited international and regional integration. With mostly fixed or pegged exchange rate regimes, capital controls and limited presence of foreign banks and investors, the financial systems remain isolated to a large extent, with important costs in terms of efficiency, competition and access to foreign financing.

**Table 1.** Bank assets, deposits and credits. Concentration (%)

	Deposit money banks assets <sup>(1)</sup> to GDP	Bank deposits to GDP	Private credit by deposits money banks to GDP	Bank credit to bank deposits	Concentration ( <sup>2</sup> )
<b>Algeria</b>	35.0	42.4	13.9	31.8	75.5
<b>Egypt</b>	64.6	62.3	30.4	49.5	60.7
<b>Jordan</b>	101.4	95.6	69.7	73.3	88.2
<b>Lebanon</b>	134.2	199.7	70.3	36.2	51.3
<b>Libya</b>	13.3	39.1	9.3	21.2	98.2
<b>Morocco</b>	86.5	87.5	68.7	80.1	71.2
<b>Syria</b>	44.4	50.8	20.4	42.1	75.4
<b>Tunisia</b>	72.4	53.5	67.7	131.3	41.1
<b>West Bank and Gaza</b>	-	-	-	40.5	-
<b>Regional Average</b>	69.0	78.9	43.8	56.2	70.2
<b>Low &amp; Middle Income</b>	35.2	35	28.6	82.4	69.1
<b>Euro Area</b>	152.8	105.2	121.8	136.1	74.2

Source: WB Global Financial Development Database. 2011 or latest year available.

(1) Claims on the domestic real non-financial sector

(2) Assets of the three largest banks in total banking assets.

**Table 2.** Access to finance and foreign claims (%)

	Firms identifying access to finance as a major constraint	Small firms with bank loan	Firms using banks to finance investment	Consolidated foreign claims of BIS reporting banks to GDP (2011)
<b>Algeria</b>	50.1	16.4	8.9	5.1
<b>Egypt</b>	31.0	5.1	5.6	16.7
<b>Jordan</b>	25.2	15.8	8.6	13.4
<b>Lebanon</b>	-	66.5	23.8	13.8
<b>Libya</b>	-	-	-	1.4
<b>Morocco</b>	31.6	20.0	12.3	29.3
<b>Syria</b>	34.1	26.7	20.7	0.8
<b>Tunisia</b>	-	-	-	17.5
<b>West Bank and Gaza</b>	36.7	11.2	4.2	-
<b>Regional Average</b>	34.8	23.1	12.0	12.2
<b>Latin America</b>	27.0	38.9	34.5	25.3
<b>South Asia</b>	30.3	35.0	43.6	6.7
<b>Sub-Saharan Africa</b>	40.6	16.0	20.0	7.7
<b>East Asia</b>	16.1	29.5	21.9	22.9
<b>Europe and Central Asia</b>	27.7	34.5	34.7	12.9

Source: WB Global Financial Development Database. Latest year available.

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# **Banking Reform in the Southern Mediterranean**

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The views expressed in this chapter are those of the author and do not necessarily represent those of the European Investment Bank

Financial sectors in the Southern Mediterranean region are dominated by banks. Non-bank financial institutions have hardly developed. Banking sectors perform well according to measures of financial depth (EIB, 2013) but their capacity to provide access to finance remains limited, especially for SMEs. Lending to the private sector tends to be concentrated in large corporates, leaving SMEs deprived of credit. According to the World Bank (2011), SME loans account for only 13% of total loans,<sup>1</sup> compared to an average of 16% for middle income countries. Enterprise surveys fielded in the region corroborate the picture suggesting that only a small share of SMEs does have access to bank lending.

The deterioration in macroeconomic fundamentals associated with the Arab Spring has led to increased refinancing needs on the side of governments. In some countries, high deficits have put upward pressure on interest rates leading to a crowding out of private sector lending. While the cyclical dimension further aggravates structural impediments to financial access, the focus here is on the structural problems that will remain relevant even after government has undertaken the necessary steps towards fiscal consolidation.

SME lending in the region remains constrained by weak investor protection and poor credit information. Insufficient coverage of credit bureaus is amplified by the poor quality of financial reporting on the side of firms. Inadequate frameworks governing secured lending unnecessarily constrain the set of feasible transactions between borrowers and lenders. Moreover, lack of competition leaves banks content with their existing business models focused on lending to corporates and the government rather than forcing them to expand activity in market segments such as SME lending. Prudential regulation can be harnessed to promote both financial stability and access to finance by penalising high loan concentration ratios and improving bank risk management.

There are 5 specific proposals for reform in these domains:

## Financial Infrastructure

### Credit information systems

The quality of credit information systems in the region is comparable to those in other emerging markets according to the World Bank (2013). However, coverage of existing public credit registries and private bureaus is low, and some countries do not have a private credit bureau at all. This may illustrate the difficulty of reforming credit information systems as it involves securing the buy-in of a wide range of stakeholders such as banks, microfinance institutions, utilities, retailers and mobile phone companies. The region will likely be best served by both public credit registries and private credit bureaus.

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<sup>1</sup> In non-GCC MENA.

Countries that wish to introduce a private credit bureau should do so based on specific legislation. The World Bank (2011) has issued a series of related recommendations. All regulated entities should be obliged to submit loan data to the system. The data should cover all loans and include both positive and negative data. Unregulated entities, such as microfinance institutions, should be encouraged to participate. Reports should be provided at the account level and also include historical data. Lenders should be required to launch inquiries before granting credit.

**Collateral Regimes**

In addition to incipient credit information systems, the extension of credit in the Southern Mediterranean countries also suffers from the weak protection given to borrowers and lenders, notably through collateral and bankruptcy laws. According to the World Bank (2013), the region lags by a wide margin behind the world’s major regions. A thorough overhaul of the frameworks governing secured lending is thus of the utmost importance. The EBRD (2013) has issued a set of principles that a modern secured transactions law should meet: see Table 1.

**Table 1.** EBRD core principles for a secured transactions law

<p><b>1. Reduce risk of credit</b></p> <p>Security should reduce the risk of giving credit, leading to an increased availability of credit on improved terms.</p>	<p><b>6. Low cost</b></p> <p>The cost of taking, maintaining and enforcing security should be low.</p>
<p><b>2. Non-possessory security, easy and cheap to create</b></p> <p>The law should enable the quick, cheap and simple creation of a proprietary security right, without depriving the person giving the security of the use of his assets.</p>	<p><b>7. All types of assets/debts/persons/Security should be available</b></p> <ul style="list-style-type: none"> <li>• over all types of assets,</li> <li>• to secure all types of debts and</li> <li>• between all types of persons.</li> </ul>
<p><b>3. Satisfaction through realisation in case of default</b></p> <p>If the secured debt is not paid, the holder of security should be able to have the charged assets realised and to have the proceeds applied towards satisfaction of his claim, prior to other creditors.</p>	<p><b>8. Publicity</b></p> <p>There should be an effective means of publicising the existence of security rights.</p>
<p><b>4. Effective enforcement</b></p> <p>Enforcement procedures should enable prompt realisation at market value of the assets given as security.</p>	<p><b>9. Priority</b></p> <p>The law should establish rules governing competing rights of persons holding security and other persons claiming rights in the assets given as security.</p>

**5. Effective in insolvency**

The security right should continue to be effective and enforceable after the bankruptcy or insolvency of the person who has given it.

**10. Commercial flexibility**

As far as possible, the parties should be able to adapt security to the needs of their particular transaction.

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There are two ways to modernise a collateral framework: drafting a new law, or modifying the existing framework. The former approach is associated with higher switching costs but typically results in a more coherent outcome. The World Bank (2011) recommends that countries in the region draft a new law that regulates every aspect of the chain of secured lending and thus move away from the current system of fragmented provisions in different bodies of the law.

Countries in the region should also bring their movable collateral registries up to date. Such registries notify parties about the existence of a security interest in movable property and establish the priority of secured creditors. The World Bank (2011) recommends that registries be centralised in a single secure electronic database that covers all types of movable assets. The database should be accessible to the public for real-time consultations.

Enforcement should also be strengthened, ideally through the introduction of effective out-of-court enforcement mechanisms. The procedures governing enforcement should allow for parties to agree on rights and remedies upon default, including seizure and sale of collateral outside the judicial process. Fast and efficient procedures are especially important for movable property, which is subject to rapid depreciation.

**Competition**

Bank competition in the region is perceived as too weak and banks have on average more market power than banks in other regions of the world. Anzoategui et al. (2010) show that that market power arises from a lack of market contestability. Entry requirements are generally demanding and the region has the highest share of rejected bank licence applications among emerging economies. Increased competition could incentivise banks to seek new potential clients such as SMEs. SMEs may not be attractive to a bank focusing on large corporates, if the appropriate organisational structure is not in place. Competition could trigger the necessary organisational and procedural changes and in this way promote access to finance.

Thus, bank regulators should give greater weight to sound competition when implementing licensing criteria. Concerns that the system is overbanked appear misplaced in most countries. In case the banking system turns out to be overbanked, it is best to deal with the problem through the exit of weaker banks. It appears that bank licensing could be revised without jeopardising the quality of entrants.

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### **Prudential Regulation and Access to Finance**

#### *Credit concentration*

Maintaining financial stability obviously is the primary aim of prudential regulation. It may appear that tightening prudential rule to promote financial stability will necessarily come at the expense of financial access. Not so in the Southern Mediterranean, a region exhibiting loan concentration ratios that are among the highest in the world. Penalising credit concentration can improve banks' resiliency and promote access to finance for SMEs.

High credit concentration entails significant risks for the banks concerned. Though large borrowers tend to be well known and considered low risk, they are not immune to failure. Poor disclosure practices make it difficult to identify all members of a business group and monitor their links. A stricter definition and enforcement of the large-exposure regime could help reduce risks associated with credit concentration. Supervisors should initiate the gradual reduction of maximum credit concentration limits. Concentrated loan portfolios should be penalised with additional capital requirements. These measures would improve the resiliency of the banks concerned and possibly make lending to SMEs more attractive.

#### **Corporate Governance / Risk Management**

It appears that the lending practices of banks appear unduly focused on the availability of collateral, neglecting the importance of risk management. Using prudential regulations to strengthen the risk management function inside banks may have benefits not only in terms of improved financial stability but also access to finance.

Few banks in the region have chief risk officers – World Bank (2011). Those that do tend to lack the necessary authority to warn the board against potential risks the bank may be facing. The board should be sufficiently involved in selecting and determining the compensation of the CRO to prevent the CRO's observations and concerns becoming overly subservient to operational concerns. Equally important risk management functions should be endowed with the budget and staff needed for the size and complexity of the bank's activities. They would also benefit from independent reporting lines to the board and management.



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## **Policy Design for Private Equity in North Africa**

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1. Was Minister of Finance of Tunisia in January 2011 and served in the two interim governments formed following the Tunisian revolution.

Financing SMEs, or lack thereof, is a recurrent topic in both academic and professional literature. SMEs represent the bulk of the economic fabric of the emerging economies of North Africa but benefit from only a modest share of credits being disbursed to the economy. That led some analysts to believe that the problem lies squarely on the commercial banks resisting going down-market, particularly if other lower-risk assets are within reach. Whilst this may be partly true, a host of other factors carry equal importance. Some of these factors pertain to failure by SMEs to improve their governance, ensure full disclosure and transparency, provide adequate security, or simply carry out their businesses according to professional standards. However, with proper policy guidance these shortfalls can be adequately addressed. The one factor remaining which, in our view, is absolutely essential if SMEs are to reach their developmental potential is access to equity financing. This is particularly so as banks, the world over, have raised the gearing ratio to an average of 50% since the 2008 financial crisis. In their early stage of development, SMEs will likely find it difficult to raise equity on a listed stock exchange and will have little choice but to revert to the private equity (PE) industry to acquire their capital needs.

Policy-makers must understand the critical importance of private equity as a powerful tool that can help address the pressing need of SMEs for capital. Private equity helps budding entrepreneurs get started on a solid footing. It helps smaller companies grow larger. It helps the economy create jobs. It contributes by professionalising investment initiatives, thus unlocking the real potential of economic agents. And it helps raise their level of proficiency in a way that will help them meet today's challenges in an increasingly competitive environment.

The critical importance of private equity is so obvious that one wonders why historically it did not get the priority attention of policy-makers in the southern shores of the Mediterranean. Indeed, by some estimates, private equity is 10 times less developed in North Africa compared to other emerging markets in Asia, Latin America or Eastern Europe.

#### **Fundamentals to Promote Private Equity**

Six fundamental building blocks are necessary to properly promote a private equity industry: willingness on the part of entrepreneurs to open up their capital; an enabling regulatory, legal, and fiscal framework; a motivated pool of institutional or private investors; a liquid and well-functioning stock exchange; a favourable business environment; and the existence of highly proficient teams of investment professionals.

#### **Opening Shareholding**

First and foremost, **entrepreneurs** must be persuaded of the benefits of **opening up their shareholding to professional investors**. In so doing, and particularly in circumstances where they insist on maintaining control, they must be prepared to abide by certain professional standards,

such as good business ethics, full transparency, and proper governance in the conduct of their businesses. They must also be mindful of environmental issues, social responsibilities and civil duties. They must be persuaded that in the long run their businesses will reap great benefits from such positive transformations. However, experience has shown that this cultural transformation may take some time to be inculcated, particularly amongst family-based businesses. Successful experiences in Latin America have shown that mezzanine finance, or quasi-equity, may be suitable for such family businesses to beef-up their capital base without opening up shareholding to third parties. It is surprising that thus far in the North African region we have not witnessed the emergence of mezzanine funds in consideration of the tremendous available opportunities.

#### **Favourable Regulatory and Fiscal Framework**

Second, the role of policy-makers should not be limited to setting forth a favourable **regulatory and fiscal environment**, but must also consist of designing strategies aimed at encouraging the creation of investment funds and other investment vehicles, particularly in the nascent stage of the PE industry. This role should preferably be entrusted to national investment vehicles, such as the Caisse de Dépôt et de Gestion (CDG) in Morocco or the Caisse de Dépôt et de Consignation (CDC) in Tunisia.

#### **Develop Government-Backed Seed Money Instruments**

Third, by injecting seed money in “De Novo” investment funds, such government-backed vehicles profuse a level of trust and credibility that would encourage other **institutional or private investors**, such as insurance companies, pension funds, and asset managers, to join in.

The proliferation of investment funds will ultimately foster the emergence of a deep and well-diversified equity market providing access to SMEs to raise their capital needs. However, as indicated above, certain other conditions must prevail if this market is to mature.

#### **Improve Business-Friendly Economic Environment**

Fourth, the overall **economic environment must be conducive to the burgeoning of private equity initiatives**. Studies have shown that countries that pursue pro-business and pro-growth environment stand a better chance to develop their private equity market. Furthermore, foreign investors, both private and multilateral, are attracted to markets displaying a good ranking on the “ease-of-doing business index”, a solid legal framework, a reliable judicial system, accommodative labour laws, and stable foreign exchange. Historically, Morocco has fared better than the other North African countries on most of these criteria, which partly explains its relative advance in developing its private equity industry.



**Key Role of the Stock Exchange**

Fifth, the existence of an active stock exchange will greatly facilitate investors to exit their investments under fair and mutually acceptable conditions. Such a market is relatively well developed in Morocco, but is far less developed in Tunisia and Egypt, and hardly existent in the other North African countries. In circumstances where the stock exchange is non-existent, shallow or unreliable, other exit strategies would have to be contemplated, such as equity buy-back arrangements with the business owners, trade sales to third parties, or placements with other PE players.

**Develop the needed human capital skills**

Sixth, in all such circumstance, proper legal expertise must be available as the structuring of such transactions can be quite complex. Hence the importance to develop a new breed of **private equity professionals specialised** in both financial and legal matters.

**A comprehensive and sophisticated approach is needed.**

A well-developed and proficient private equity market should be able to cater to the capital needs of enterprises throughout their evolving stages of development. Venture capital funds address the needs of early stage businesses; whereas development capital funds, by far the most prominent in the region, invest in existing and relatively mature companies. Other specialised funds would likely emerge to address specific situations such as the inter-generational transfer of businesses (from parents to sons, for example) requiring the structuring of leveraged buyouts (LBOs). By definition, such transactions involve a relatively high level of leverage and would hence require the participation of banks endowed with the proper corporate finance expertise. Buyout opportunities, including management LBOs (or MBOs), abound in North Africa but have thus far been disparaged for lack of expertise and proper focus.

Similarly, restructuring ailing businesses, such as those prevailing in the tourism sector in Tunisia, would require launching remedial funds of capital restructuring (Fonds de Capital Retournement) whose role consists in initiating corrective corporate actions, often organisational and financial, with the aim of turning around such impaired businesses. That may necessitate, in certain instances, an outright change of their business model (e.g. transforming a hotel into a health centre), but would require in all instances fresh equity injections and new bank credits.

The sophistication of investment in any market is reflected not only by the number of investment vehicles and equity players but also by their level of expertise in structuring specialised equity deals across different sectors of the economy. For instance, Morocco witnessed the launching in 2005 of the first professionally managed real estate fund in the region which has hence contributed to attracting some of the top international real estate players into its market. It has also recorded the

structuring of the first tourism, infrastructure and agricultural funds in the Maghreb. Such vehicles greatly contributed to enhancing the level of professionalism displayed in carrying out investment activities in that country.

Furthermore, the variety and sophistication of investment funds can contribute in serving specific strategic policy purposes. For instance, regional funds (Fonds Régionaux or Fonds de Proximité) were proven to promote economic activities in the less developed regions. To be successful, such funds may have to be initially structured with a relatively higher level of seed money provided by government controlled investment vehicles (e.g. CDC). Specialised funds (Fonds du Terroir) may also be structured to promote locally grown farm produce, such as essential oil, organic food, or agro-ecological products.

Understandably, governments of the Arab Spring countries of North Africa have been struggling of late trying to sort out pressing issues facing their economies, such as high unemployment, mounting social demands and widening budget deficits. In the medium run, a robust revitalisation of their economies is absolutely necessary if they are to successfully address the challenges they are presently facing. Indeed, achieving a high rate of economic growth will ultimately alleviate tensions in the labour market, enhance the fiscal space, and improve the overall social and political environment. Promoting private investments in general, and private equity in particular, should represent, in our view, the backbone of such policy orientation.

# **Mobile Financial Services in Mediterranean Partner Countries**

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Mobile finance is a way to solve the supply-related problems that explain the low access to finance rates in Mediterranean Partner Countries (MPCs). In the MPCs analysed, only 35.83% of the population older than 15 have an account at a formal financial institution. Excluding Israel, whose access to finance is much higher than the other countries studied (90.47%), the average of the remaining seven MPCs studied is 28.03%, lower than the average for the upper middle income group of countries (Algeria, Tunisia, Jordan and Lebanon) and approximately the same as the average for the low middle income group of countries (Morocco, West Bank/Gaza and Egypt). Thus, the MPCs studied face an important challenge in terms of access to finance that jeopardises their economic development and income equality.

On the other hand, mobile cellular penetration rates in the MPCs studied are very high, almost 100% or above in some cases. Only in Lebanon, due to the more restrictive definition, the use of active lines, mobile cellular penetration is only 81% of the population. Thus the mobile penetration average rate for these countries is 105.63% while average access to finance for the countries studied is only 35.83%. The combination of high mobile penetration and low access to financial services means that there is an opportunity for transformational mobile financial services in all the countries of the region analysed except Israel, where there is no financial inclusion problem. However, potential customers need to see the value proposition before using a new service. This suggests a need for extensive customer-awareness campaigns for the uptake of mobile financial services.

#### **Adapting the Regulatory Framework**

**Adapting the regulatory framework is the most important challenge for the uptake of mobile financial service initiatives.** The regulatory framework in the MPCs studied promotes the development of bank-led business models. It can be considered enabling in Egypt and Jordan, evolving towards enabling in Morocco, and restrictive in Lebanon and Tunisia. In Israel, it is also enabling, although there is no interest in launching transformational business models. In the West Bank/Gaza and Algeria it does not exist.

E-money and agent regulation are the key elements of the regulatory framework needed for mobile financial services. All financial regulators of the region are looking into these issues in order to better understand how mobile financial services can be used, thereby increasing access to financial services while maintaining the stability of the financial system. Definitions of electronic money vary by jurisdiction, but a common definition is monetary value stored on an electronic device that is issued on receipt of funds and accepted as a means of payment by parties other than the issuer. The key question is whether non-bank organisations are permitted to issue e-money as well and, if so, under what conditions and subject to what prudential and non-prudential regulation.

The use of retail agents introduces new or enhanced risks that policy-makers and regulators should seriously consider. For example, agents present a variety of operational risks to the provider (particularly reputational risk, given that the agent is the public face of the provider) and to the consumer (particularly in terms of agent liability). Moreover, the use of agents adds a special dimension to the challenge of satisfying AML/CFT norms and to consumer protection, two other topics critical to mobile financial services.

**Mobile financial service business models expand access to finance to the unbanked by reducing transaction costs through the use of prepaid platforms, agents' networks, alternative risk management policies, optimisation of remittances, and new or reformed retail payment architectures.** The use of prepaid platforms reinforces access to the retail payment systems, which is one of the financial institution's basic functions. Moreover, the dual nature of these products as payment and savings products solve the consumer's liquidity needs. This added liquidity is reinforced in the business model of mobile financial services with the inclusion of immigrant remittances.

Retail payment infrastructure is not yet widely developed throughout MPCs. Only Morocco, Algeria, Tunisia and Israel have fully operational retail payments and card switches. Egypt's retail payments and card switch is not fully operational yet for all payment services. Lebanon is currently implementing its retail payments switch, through which card systems will be interconnected. Jordan and the West Bank/Gaza are also willing to implement retail payment switches after successfully implementing Real Time Gross Settlement (RTGS) systems. The Postal Service, through its financial services unit, is a major provider of retail payments in all the countries studied.

#### Use of Dense Distribution Networks

**The second key element for the success of mobile financial service business model is the use of dense distribution networks alternative to bank branches.** Physical access to financial services in the MPCs measured as the number of bank branches per 100,000 adults (15 or older) was 16.08 in 2011. This ratio for OECD countries was 33.4 branches in 2009, which shows the lack of density of bank branches in MPCs.

A very distinctive characteristic of the majority of MPCs is that the postal service has a dominant position in the distribution of retail financial services and payments. As a result, if we include the network of postal branches in order to obtain the ratio of branches per 100,000 adults, including banks and postal services, the result is 23.56 for all MPCs (22 without Israel). Money exchanges, payment service providers and microfinance institutions also have important networks in MPCs. However, the density of mobile network operator network franchises is by far the highest in the region, although the potential of these networks for cash in/cash out purposes is yet to be exploited in the region.

**Tailored Risk Analysis Databases and Methodologies**

**The third key element for the success of mobile financial services is the use of tailored risk analysis databases and methodologies.** Databases such as credit bureaus collect not only economic and payment information, but also socio-demographic variables, which require large infrastructures to process and analyse information. Their development strengthens the ability to select customers and therefore expand, solving the Know Your Customer, Anti Money Laundering and Counter Financing Terrorism risks. Additionally, these databases use systems that, thanks to the use of electronic payment methods, allow mobile financial services operators to track credit risk very efficiently using systems such as behavioural scoring.

In the MPCs studied, while the quality of credit reporting has improved in recent years, especially in Morocco, Egypt and the West Bank and Gaza due largely to the introduction of new credit bureaus, much remains to be done, both in terms of design and coverage. Six of the countries studied have Public Credit Registries (PCR) while only three have Private Credit Bureaus (PCB). PCRs are administered by central banks or bank supervisors and basically collect information from supervised institutions. PCBs constantly seek to expand the scope of their information and thus develop a more complete picture of a borrower's financial dealings. Because participation in PCRs is mandatory, they can build a picture of the regulated financial system relatively quickly, and support the oversight functions of the regulators. As a result, if PCR's coverage were large enough, they could help non-bank mobile financial service operators enter the mobile financial services market.

**Workers' Remittances: A Key Factor**

**The fourth critical element for the uptake of mobile financial services is banking workers' remittances.** Through the reception of remittances into a bank account, the system acquires greater liquidity and exploits scope and economies of scale fundamental to reducing transaction costs. Besides, the operational synergies generate important efficiency gains since the value chains of remittances and mobile financial service operators have common elements, such as distribution networks and databases to process information.

International remittances could be one of the mobile financial services more demanded in MPCs, due not only to the importance they have for the economies of the region in terms of GDP, especially for the lower income segments of their populations, but also because prices of remittances in the region are still high compared to other regions.

In the MPCs studied, remittance inflows are important in terms of GDP in Morocco (7.04%), Tunisia (4.45%), Egypt (3.53%), the West Bank and Gaza (15.39%), Jordan (13.78%) and Lebanon (19.38%). In Algeria and Israel, remittance inflows are not relevant. In terms of prices, sending remittances to MPCs costs approximately the same as sending remittances to the other corridors

followed by the World Bank's remittances database. The average cost of sending 500 USD to MPCs was in the first quarter of 2012 of 5.56%, while the worldwide average for all corridors was 5.57%. As a result, there is room for incoming players using mobile financial services to offer international remittances at a lower price.

#### **New Retail Payment Architectures: A Needed Tool**

**The last element required for the uptake of mobile financial services is the creation new retail payment architectures that ensure interoperability and therefore allows for the exploitation of the economies of scale necessary to decrease transaction costs while encouraging competition.** Microeconomic theory tells us that financial institutions will not share their technological infrastructures, in spite of all of the savings that could be generated, due to competitive pressures, unless there is public intervention. As a result, public policies are needed in order to create interoperable nodal network systems that ensure widespread adoption and cost efficiencies. This kind of public intervention could come from the creation of a state-owned switch such as the Central Bank of Jordan is currently implementing and the Palestinian Monetary Authority would like to set up; or through public incentives that favour joining an existing network (Egypt, Tunisia, Lebanon, Algeria); or by increasing competition through multiple interoperable networks (Morocco, Israel).

Central banks in all MPCs studied are currently working in new retail payment architectures that will allow them to integrate mobile financial services initiatives while ensuring interoperability. They are also reviewing their mandate and regulatory powers in order to make sure that mobile financial services initiatives fall under their supervision.

#### **Microfinance: A Beneficiary of Mobile Banking**

**Finally, mobile financial services could greatly favour the development of the microfinance sector.** In the current context of transformation of Microfinance Institutions (MFIs) in the region, their performance and profitability ratios are likely to worsen due to the required operational investments and additional equity. As a result, the use of mobile financial services by MFIs cannot only be useful in order to keep delinquency ratios at bay by improving microcredit payments mechanisms, but also by improving the efficiency of their operations and as a result their profitability and sustainability.

However, serving the microfinance industry will be successful when MFIs are allowed to offer not only microcredit payments through the electronic wallet but also the disbursement of the microcredit. Similar experiences in other countries prove that the receiver will keep approximately 15 to 20% of the microcredit balance in the e-wallet if they are offered useful payment services and trust in the system. The most important obstacle to widespread adoption of mobile financial



services for microfinance is, however, MFI's lack of understanding of mobile financial services. As a result, assistance in training MFIs on how to use and offer mobile financial services to their customers is needed.

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