Main Factors Limiting Access to Finance

This chapter identifies the main factors that have hindered access to finance in the MENA region. Chapter 3 provided an overview of the size and structure of MENA’s financial systems, showing how these systems are heavily bank based and undiversified. Chapter 4 showed that access to finance is very restricted in MENA in comparison with other emerging regions. This chapter examines the institutional, legal, and regulatory factors that have contributed to poor access outcomes in the region. It pulls together various pieces of research and diagnostic work in order to analyze the causes of poor access outcomes. Chapters 6–9 provide more detail on the institutional and regulatory weaknesses identified in this chapter.

The chapter argues that MENA’s access problems are the result of a variety of factors, including weak financial infrastructure, weak banking competition, and flaws in the institutional and legal framework that have hindered the growth of nonbank financial institutions, instruments, and markets. Moreover, these factors are closely connected. Various policy interventions have mitigated the problems of access, but they have not addressed the roots of the problem.

The analysis is not a judgment of the merits and drawbacks of bank-based and market-based systems. The long-standing debate on this issue is largely inconclusive (Levine 2002). Policy makers have instead focused on building resilient, competitive, and inclusive financial systems. These efforts have increased the diversification of financial systems, including bank financing, market financing backed by institutional investors, and alternative sources of finance, such as leasing and factoring. It is important to stress in this regard the deep transformation of financial systems in the European Union (EU) in the past three decades, from bank-based systems to diversified systems combining elements of bank and market finance, including a solid base of nonbank financial institutions (Rajan
The chapter is structured as follows. The first section discusses financial infrastructure and the lack of competition in the banking system, providing selected examples of the regulatory factors underlying the absence of nonbank financial institutions and the absence of markets. The second section assesses the effectiveness of the policy interventions that have been introduced to improve access, including the use of state banks, credit guarantee schemes, and other types of interventions. The last section sums up the chapter’s findings and conclusions.

**Main Factors Hindering Access to Finance**

**Inadequate Financial Infrastructure**

*Credit reporting systems*

Credit reporting systems comprise public credit registries and private credit bureaus. They play two key functions in a financial system: supporting banking supervision and promoting access to finance by reducing risks for lenders. Supervisors use credit reporting systems to predict bank portfolio performance. Lenders use credit reporting systems to screen potential borrowers and monitor their performance. Public credit registries usually jumpstart credit reporting in a country, but the substantial gains in coverage and depth of information are usually achieved by private credit bureaus. In the absence of solid credit information, lenders adopt defensive positions, requiring substantial collateral, increasing interest rates, or rationing credit, all of which hinder the growth of segments such as the small and medium enterprise sector.

Credit reporting has improved in recent years, but MENA is still overly dependent on traditional public credit registries, and both the coverage and the quality of information need improvement. MENA’s credit reporting systems have improved in recent years with the upgrading of public credit registries (in Lebanon, Oman, Tunisia, the West Bank and Gaza, and the Republic of Yemen) and the introduction of new private credit bureaus (in the Arab Republic of Egypt, Morocco, Saudi Arabia, and the United Arab Emirates). These improvements increased the region’s credit information index (see chapter 6). However, almost 60 percent of countries in the region still rely entirely on public credit registries, a much higher share than in all other regions except Africa (table 5.1). The excessive reliance on traditional public credit registries may be one reason that MENA still compares poorly with other regions in credit information coverage (figure 5.1).
TABLE 5.1

Number and Percentage of Countries with Public Credit Registries and Private Credit Bureaus, by World Region, 2010

<table>
<thead>
<tr>
<th>Region</th>
<th>Both public credit registry and private credit bureau</th>
<th>Private credit bureau only</th>
<th>Public credit registry only</th>
<th>Not available/negligible coverage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Organisation for Economic Co-operation and Development (OECD)</td>
<td>7 26.9</td>
<td>17 65.4</td>
<td>2 7.7</td>
<td>0</td>
</tr>
<tr>
<td>Latin America and the Caribbean</td>
<td>13 72.2</td>
<td>3 16.7</td>
<td>2 11.1</td>
<td>3</td>
</tr>
<tr>
<td>South Asia</td>
<td>1 200</td>
<td>3 60.0</td>
<td>1 20.0</td>
<td>2</td>
</tr>
<tr>
<td>Europe and Central Asia</td>
<td>7 33.3</td>
<td>7 33.3</td>
<td>7 33.3</td>
<td>2</td>
</tr>
<tr>
<td>East Asia and Pacific</td>
<td>1 11.1</td>
<td>4 44.4</td>
<td>4 44.4</td>
<td>4</td>
</tr>
<tr>
<td>Middle East and North Africa</td>
<td>3 17.6</td>
<td>4 23.5</td>
<td>10 58.8</td>
<td>1</td>
</tr>
<tr>
<td>Africa</td>
<td>0 0.0</td>
<td>8 26.7</td>
<td>22 73.3</td>
<td>13</td>
</tr>
<tr>
<td>All regions</td>
<td>32 25.4</td>
<td>46 36.5</td>
<td>48 38.1</td>
<td>25</td>
</tr>
</tbody>
</table>


FIGURE 5.1

Coverage of Private Credit Bureaus and Public Credit Registries, by World Region, 2010


Note: Averages are computed only for countries with operating private bureaus or public registries.
Countries in the Gulf Cooperation Council (GCC) have taken the lead in introducing private credit bureaus. Bahrain, Kuwait, Saudi Arabia, and the United Arab Emirates have introduced private credit bureaus and generally gained more coverage as a result, particularly in the case of bureaus introduced early in the 2000s (Bahrain and Kuwait) (figure 5.2). This increase in coverage facilitated the expansion of retail lending in the GCC during the decade. The Saudi private credit bureau started as a consumer bureau but now also operates as a commercial bureau, which has recently made impressive gains in coverage (not yet reflected in the coverage statistics). By contrast, only two non-GCC countries, Egypt and Morocco, have introduced private credit bureaus in recent years. These young private credit bureaus are likely to increase the coverage and quality of credit information in coming years, but improvements will ultimately depend on efforts to expand the number of reporting entities (especially microfinance institutions, utilities, and retailers) and to widen the type of data collected.

Most public credit registries in MENA have played the traditional and limited role of collecting information from regulated entities and disseminating the data in an aggregate format. A few new public credit registries, such as those in Oman and the West Bank and Gaza, seem to operate like private credit bureaus; others (in Algeria, Lebanon, Libya, the Syrian Arab Republic, and the Republic of Yemen) are undergoing upgrades. It is too early to assess whether these efforts will generate the required gains in coverage and depth of information, but the experience of other countries

**FIGURE 5.2**

*Maximum Coverage of Private Credit Bureaus and Public Credit Registries, by Economy, 2010*

![Graph showing coverage of private credit bureaus and public credit registries by economy, 2010](source: World Bank 2011)
suggests that effective credit reporting systems are rarely limited to public credit registries. Most countries have either maintained both types of entities or have introduced and regulated a private credit bureau to serve the functions of supervision and credit information. Improvements in credit information also depend on how the private credit bureau is designed and regulated. Credit reporting is further discussed in chapter 6.

**Creditor rights**

MENA lags other emerging regions in the introduction of effective collateral regimes that strengthen creditor rights and promote lending to underserved sectors. This is possibly the weakest component of the financial infrastructure. As one indication of the severity of problems in this area, the region ranks last in a cross-regional comparison of the legal rights index of *Doing Business*; the MENA country that scores best ranks 106th overall.

Most countries in the region have severe weaknesses in all the components of the chain of secured lending, including serious problems with the following:

- **Scope of the law** (the types of movable collateral that can be used are limited)
- **Creation of secured rights** (the legal requirements to create a right against property are cumbersome)
- **Priority given to secured creditors in case of default** (unlike other regions, secured creditors in MENA do not have clear priority rights outside or inside bankruptcy)
- **Registration of collateral** (most countries lack a unified electronic database with all information on existing security rights, accessible to all lenders for a reasonable fee in real time)
- **Enforcement of security rights** (the process of seizing collateral when the debtor defaults is difficult; there are no established procedures for out of court enforcement)
- **Final sale or disposition of the collateral** (the rules guiding the sale of the collateral can be cumbersome, requiring public auctions with minimum prices set by the courts).

The weaknesses in almost all of the components of collateral regimes in countries in the region reveal the need for an overhaul of these regimes. This fundamental weakness in financial infrastructure has been identified in recent surveys and research as a major constraint to bank lending to small and medium enterprises (Rocha and others 2011); it also affects other areas of finance, such as mortgage finance and leasing. The collateral regime has been improved in some countries for fixed collateral,
especially in the area of registration, but enforcement and disposition of fixed collateral remain difficult. All components of the collateral regime for movable collateral remain weak. Chapter 6 provides further analysis of collateral regimes (see also Alvarez de La Campa 2010).

**Financial infrastructure for mortgage finance**

The financial infrastructure required for an effective mortgage finance system includes all the elements listed above plus additional ones that are lacking in some MENA countries. In addition to effective credit information and collateral regimes, mortgage finance requires physical identification of properties (cadastres) and clear definition of owners (titling). These components are generally of high quality in GCC countries and some non-GCC countries, such as Lebanon and Jordan. Algeria and Egypt have also made improvements in these areas. Elsewhere in the region, the cadastre and titling functions require improvements.

In addition, the development of mortgage finance in MENA has also been hindered by a number of non-financial constraints whose discussion is out of the scope of this report, but that have to be briefly mentioned because of their importance. In particular, the lack of availability of land in many MENA countries has had an adverse impact on housing prices often affecting their affordability. Constraints on land availability can be due to physical factors and/or to policy weaknesses. For example, the large extension of desert areas and the use of scarce land for agriculture have constrained physically the areas available for residential or commercial construction. In some cases, however, land scarcity is primarily due to policy weaknesses reflected in the narrowness of free land markets, speculative investments in land, or inefficient use of the available land (reflected in the large number of low density developments). Hassler (2011) provides a detailed analysis of housing finance in MENA.

**Weak Competition in Banking Systems**

Weak bank competition is another plausible explanation for the strong loan concentration and restricted access to finance in most countries in the region. Despite low net interest margins in most of the region, especially non-GCC countries and positive trends in market structure; the decline in the market share of state banks; and the increase in the market share of foreign banks (see chapter 7), there is evidence that the region’s banking systems are still less competitive than those in other regions. The reduction in the share of state banks in non-GCC countries and the entry of foreign banks in recent years bodes well for the future, but these changes in structure may have not been sufficient to increase competitive pressures in the main credit markets. Moreover, empirical estimates of banks’ market power suggest that banking systems in MENA
remain less competitive than banking systems in other regions, because of stricter entry requirements, weak credit information systems, and lack of competition from capital markets and nonbanking institutions, among other factors (box 5.1).

The results of empirical research identifying the factors that restrict banking competition provide a useful and credible roadmap for enhancing competition. They suggest that improving competition may require a package of reforms that includes relaxing licensing requirements and procedures without sacrificing the quality of entrants, improving financial infrastructure, and developing alternatives to bank lending. Although the share of foreign banks has increased in many countries, many of these banks remain small and do not seem to be challenging incumbent banks in their main credit markets. Their failure to do so could reflect a deliberate strategy of exploring a niche (upscale consumer lending, trade finance), but it could also be a result of the lack of credit information.

More effective credit information systems would level the playing field between large and small banks (including new foreign banks) and allow these banks to expand more rapidly. Small banks would expand more rapidly if they had access to reliable information on the creditworthiness of potential borrowers. Therefore, improvements in financial infrastructure would increase access through two channels: reducing risks for all lenders regardless of their size and enabling smaller banks to compete more effectively. Competitive pressures could be applied on all segments of the credit market by offering leasing and factoring as alternative sources of finance to small and medium enterprises and by strengthening institutional investors (mutual funds, insurance companies) as a means of broadening the investor base for corporate issues.

Reducing loan concentration may also require stricter supervision of large exposures and connected lending. In many cases, the high loan concentration in MENA reflects long-established connections between large banks (including state banks and family-controlled private banks) and industrial groups. Such lending frequently entails large exposures and connected lending that may not have been well regulated or supervised. Therefore, a stricter approach to regulation and supervision of large exposures and connected lending may need to be included in a package of reforms aimed at reducing loan concentration and improving competition.

**Missing Institutions and Markets**

One of the key questions addressed in this report is why nonbanking financial institutions and markets have been so slow to develop in MENA. The sections above discussed how financial infrastructure and nonbanking financial institutions and instruments could contribute to access by
BOX 5.1

Bank Competition in the Middle East and North Africa

Higher levels of bank competition are associated with lower prices for banking products, greater efficiency, and wider access to finance. Traditional measures of competition, such as the Herfindahl index and the share of the top banks, are not reliable, because they do not capture market contestability. Measures such as net interest margins are not reliable either, because they do not take into account concentrated lending to favored sectors (government, state-owned enterprises, large and connected enterprises), which can result in low lending interest rates and low margins.

Preferred indicators of competition include the Lerner index (a markup measure) and the $H$-statistic, defined as sum of the elasticities of a firm’s revenue with respect to the firm’s input prices. A value of 1 indicates perfect competition; a negative value indicates a monopoly. Estimates of the Lerner index and the $H$-statistic suggest that competition in MENA is lower than in most emerging regions (Anzoategui, Martinez Peria, and Rocha 2010).

Moreover, cross-country regressions designed to explore the determinants of the $H$-statistic provide insights on the factors restricting bank competition in MENA. The results suggest that MENA banking systems have been less competitive as a result of an inferior credit information environment, stricter regulations and practices governing bank entry, and lack of competition from nonbanking financial institutions and capital markets.

**BOX TABLE 5.1.1**

**Determinants of the $H$-Statistic of Banking Competition**

<table>
<thead>
<tr>
<th>Explanatory variable</th>
<th>Dependent variable: $H$-statistic</th>
</tr>
</thead>
<tbody>
<tr>
<td>Dummy MENA = 1</td>
<td>-0.11 [-1.97]</td>
</tr>
<tr>
<td>Concentration (share of assets held by top three banks)</td>
<td>-0.035 [-0.20]</td>
</tr>
<tr>
<td>Credit information index</td>
<td>0.02 [1.87]</td>
</tr>
<tr>
<td>Minimum capital requirement (billions of dollars)</td>
<td>-0.17 [-1.05]</td>
</tr>
<tr>
<td>Percentage of bank license applications denied</td>
<td>-0.27 [-2.25]</td>
</tr>
<tr>
<td>Number of entry requirements</td>
<td>-0.11 [-3.30]</td>
</tr>
<tr>
<td>Stock market capitalization</td>
<td>0.14 [3.21]</td>
</tr>
<tr>
<td>Nonbank financial institutions</td>
<td>0.17 [3.10]</td>
</tr>
</tbody>
</table>

| Observations (number of countries)       | 45 43                          |
| $R^2$-squared                            | 0.50 0.46                      |

Source: Anzoategui, Martinez Peria, and Rocha 2010.

Note: Robust $t$-statistics in brackets.

* significant at 10 percent; ** significant at 5 percent; *** significant at 1 percent.
reducing risks to lenders, providing alternative financing sources on their own right, and enhancing competition. The weaknesses in infrastructure were briefly discussed above. This section provides illustrative examples of the factors that have hindered the emergence of nonbank financial institutions, markets, and instruments. Chapters 6–9 provide more detailed analysis of these factors.

To a large extent, the slow development of nonbank financial institutions, instruments, and markets has been a result of the lack of enabling legislation in some key areas. The absence of legislation reveals the lack of interest by incumbent institutions in promoting alternatives to bank finance and enhancing competition in their own markets. It also reveals the lack of more proactive policies for financial development and financial access by policy makers and regulators. The situation differs from country to country; in some countries regulators have been very active, drafting new legislation and making efforts to promote new institutions, markets, and instruments. However, the number of cases in which enabling primary legislation or key secondary regulations are missing merits highlighting.

The leasing sector has not been developed in many countries in the region, as a result of basic flaws in legislation, including the absence of legislation that introduces clear definitions of leasing and rights and responsibilities of the parties to a lease. The lack of registries for leased assets and the problems of repossessing leased assets in the case of default have also hampered the growth of the sector. Tax rules that do not recognize leasing as a financing mechanism have created an uneven playing field between leasing and other forms of finance, hindering the sector’s growth. These are important findings, because countries in Central Europe and other regions have shown that it is feasible to address these flaws and develop a leasing industry that serves small and medium enterprises and compensates for the lack of bank lending as a result of weak creditor rights (Bakker and Gross 2004). Chapter 8 reviews the main issues in the leasing sector.

The lack of development of the insurance sector is also a result of a wide range of regulatory and supervisory gaps, including the absence of mandatory insurance in key areas; the predominance of state companies in some countries, which stifles competition and innovation; basic gaps in supervision, including the lack of enforcement of compulsory insurance, such as auto insurance; controls on insurance premiums; unsupportive tax regimes; fragmented market structures; and the lack of products that reflect cultural and religious preferences. The case of Morocco described in chapter 3 illustrates the possibility of developing the insurance sector more rapidly. Chapter 8 provides a more detailed diagnostic of this sector.
The lack of private fixed-income instruments is also a result of factors that are within the reach of policy makers. One of the preconditions for the development of private fixed-income securities is the development of a reliable benchmark yield curve for government securities. No MENA country has been able to build a reliable yield curve. The agenda for the development of a government debt market may be challenging, but it is within the reach of policy makers, as demonstrated by small countries in Central Europe and Latin America. The development of fixed-income instruments also depends on enabling legislation that in some cases has not been drafted. As mentioned in chapter 3, MENA country has drafted legislation on mortgage covered bonds, the instrument used by many EU countries to fund their mortgage loans. Chapter 9 provides a more detailed analysis of the development of markets and instruments in MENA.

Policy Interventions to Expand Access: Have They Been Effective?

The restricted access to finance in MENA has led many countries to introduce policy interventions to expand access. This has included the active use of state banks, credit guarantee schemes, interest subsidies, and exemptions on reserve requirements. This section provides a brief review of these interventions and an assessment of their effectiveness.

The Financial Performance of State Banks and their Contribution to Access

The share of state banks in MENA has declined in the past decade, although there are significant differences across countries, ranging from no state banks in Jordan and Lebanon to a 70–90 percent market share in countries like Algeria, Iraq, Libya, and Syria. State banks still play an important role in many countries but their contribution to access has been mixed and uneven across countries as indicated below.

The financial performance of state banks has been significantly weaker than that of private banks. A study of nine non-GCC countries shows that state banks have much lower levels of profitability, as a result of larger holdings of government securities (which reduces their interest income), higher ratios of overhead costs to assets (despite lower average wages) as a result of much higher ratios of employment to assets, and higher ratios of loan loss provisions to loans, which reflect the much larger shares of nonperforming loans in their loan portfolios (Farazi, Feyen, and Rocha 2011). Chapter 7 provides further discussion of these results.

Financing of government deficits helps explain the poor financial performance of state banks. It may also have generated other negative
effects. Large state banks providing a captive market for government securities may have undermined fiscal discipline in some non-GCC countries, contributing to persistently large deficits and reducing the room for private sector financing. The dominant presence of state banks may also have contributed to the limited development of government debt markets, reflected most clearly in the lack of reliable and liquid yield curves (see chapter 9).

Development mandates could also explain the poor financial results of state banks, but the evidence that they actually executed these mandates is both mixed and uneven across countries. State banks tend to have large branch networks and may provide essential financial services in remote areas, where access to finance is constrained by high fixed costs. They may also address market failures resulting from asymmetric information and poor enforcement of contracts that ultimately restrict access to credit by enterprises and individuals. However, the effectiveness of state banks in fulfilling these mandates has been mixed and uneven, as noted below.

There is no evidence that state banks have made a significant contribution to expanding access to financial services in remote areas, despite their large employment base. The large employment base and overhead costs could reflect the maintenance of branches in remote areas with low density. However, as explained in more detail in box 5.2, a larger presence of state banks in the banking system does not translate into a larger number of deposit accounts per adult, controlling for other relevant factors, such as per capita income, the number of branches per population, and the share of the urban population. It is possible that some state banks fulfill this mandate more effectively; the exercise described in box 5.2 does not include agriculture banks, postal services, or postal banks, which have more penetration in rural areas. However, these results show that the large staffs of state banks are probably a result of outdated technologies and labor redundancies rather than a well-articulated strategy to promote access in remote areas. Pearce (2011) also shows the limited contribution of state banks to access in remote areas.

State banks in some countries have contributed to financing small and medium enterprises, although they do not seem to have developed the capacity to manage the associated risks. The average share of small and medium enterprise lending of state banks (9 percent of the loan portfolio) is similar to that of private banks (11 percent of the loan portfolio) and are not significantly different controlling for other factors (box 5.3). Moreover, state banks have taken on more risks in this area than private banks, by being less selective in their targeting strategies and maintaining a lower share of collateralized loans and a higher share of investment loans in total small and medium enterprise lending. Evidence shows that state banks have contributed to access in a segment where private banks are
still reluctant to lend as a result of the weak financial infrastructure. There are significant differences across countries, however, and in some countries their contribution has been limited. Moreover, state banks have weaker lending technologies and risk management systems: a smaller share of state banks has dedicated units for small and medium enterprises, makes use of credit scoring, or conducts stress tests (Rocha and others

**BOX 5.2**

**State Banks and Banking Penetration in the Middle East and North Africa**

There is a widespread assumption that state banks increase access, through extensive branch networks, especially in remote areas not covered by private banks. This hypothesis was tested for MENA using a simple regression analysis in which the dependent variable is the number of deposit accounts per 1,000 adults, an indicator of access widely used in empirical research. The explanatory variables include the logarithm of GDP per capita; the share of the urban population in the total population; the total number of branches per capita; and the share of state banks in total bank assets, which is used as a proxy for the share of state bank branches in total branches, under the plausible assumption of a high correlation between the two variables. The regression also controls for country fixed effects. The results suggest that state banks in MENA have not contributed to banking penetration or greater access to financial services. These results do not take into account the possible contribution of agriculture banks, postal services, or postal banks in some MENA countries.

**BOX TABLE 5.2.1**

**Main Determinants of Number of Deposit Accounts**

<table>
<thead>
<tr>
<th>Explanatory variable</th>
<th>Dependent variable: Deposit accounts per 1,000 adults</th>
</tr>
</thead>
<tbody>
<tr>
<td>Log GDP per capita</td>
<td>556.9</td>
</tr>
<tr>
<td></td>
<td>[7.4]**</td>
</tr>
<tr>
<td>Urban population as share of total population (percent)</td>
<td>1.2</td>
</tr>
<tr>
<td></td>
<td>[0.3]</td>
</tr>
<tr>
<td>Number of branches per 100,000 adults</td>
<td>7.1</td>
</tr>
<tr>
<td></td>
<td>[1.9]*</td>
</tr>
<tr>
<td>Share of state banks in total assets (percent)</td>
<td>-2.4</td>
</tr>
<tr>
<td></td>
<td>[11.4]**</td>
</tr>
<tr>
<td>Observations</td>
<td>31</td>
</tr>
<tr>
<td>R-squared</td>
<td>0.99</td>
</tr>
<tr>
<td>Number of countries</td>
<td>9</td>
</tr>
</tbody>
</table>


Note: Robust t-statistics in brackets. * significant at 10 percent; ** significant at 5 percent; *** significant at 1 percent.
Determinants of Bank Lending to Small and Medium Enterprises

Enterprise surveys show that only 20 percent of small and medium enterprises in MENA have a loan or line of credit—a smaller share than in other regions. These results motivated the design of a survey conducted by the World Bank and the Union of Arab Banks in 2009. The survey confirms that the share of small and medium enterprise loans in total loans is smaller in MENA than in other comparator group.

The survey also enabled the statistical analysis of the factors promoting lending to this sector. The main dependent variable is the share of small and medium enterprise loans in total loans. The results suggest that large banks are less involved in small and medium enterprise lending, a result that probably reflects the presence of large wholesale banks that do not lend to this sector. Banks in GCC countries are less engaged in small and medium enterprise lending than their non-GCC counterparts. However, there is no significant difference between lending by state and private banks. There is evidence of relationship lending, based on the results for the number of branches and the existence of a separate unit for small and medium enterprises. The coverage of credit bureaus or registries has a positive impact, but it does not significantly explain small and medium enterprise lending (it has a greater impact on the amount of investment lending to the sector, not shown in table 5.3.1). The quality of the legal

BOX TABLE 5.3.1

<table>
<thead>
<tr>
<th>Dependent variable: Share of small and medium enterprise loans in total loans</th>
<th>(1)</th>
<th>(2)</th>
<th>(3)</th>
<th>(4)</th>
<th>(5)</th>
<th>(6)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Explanatory variable</td>
<td>Log total loans</td>
<td>GCC dummy</td>
<td>State ownership dummy</td>
<td>Log number of branches</td>
<td>Separate unit for small and medium enterprise clients dummy</td>
<td>Maximum coverage of registry or bureau</td>
</tr>
<tr>
<td></td>
<td>–2.53</td>
<td>–6.14</td>
<td>2.00</td>
<td>1.20</td>
<td>0.01</td>
<td>5.25</td>
</tr>
<tr>
<td></td>
<td>[4.59]**</td>
<td>[2.80]**</td>
<td>[1.18]</td>
<td>[1.43]</td>
<td>[0.22]</td>
<td>[2.56]**</td>
</tr>
<tr>
<td></td>
<td>–2.26</td>
<td>–7.44</td>
<td>0.96</td>
<td>1.72</td>
<td>0.08</td>
<td>6.12</td>
</tr>
<tr>
<td></td>
<td>[4.08]**</td>
<td>[3.46]**</td>
<td>[0.60]</td>
<td>[2.16]**</td>
<td>[1.69]**</td>
<td>[3.05]**</td>
</tr>
<tr>
<td></td>
<td>–1.33</td>
<td>–11.71</td>
<td>1.54</td>
<td>0.69</td>
<td>0.03</td>
<td>4.45</td>
</tr>
<tr>
<td></td>
<td>[2.48]**</td>
<td>[4.98]**</td>
<td>[0.96]</td>
<td>[0.94]</td>
<td>[0.61]</td>
<td>[2.18]**</td>
</tr>
<tr>
<td></td>
<td>–2.53</td>
<td>–6.21</td>
<td>2.23</td>
<td>5.25</td>
<td>0.03</td>
<td>0.01</td>
</tr>
<tr>
<td></td>
<td>[6.51]**</td>
<td>[3.61]**</td>
<td>[1.39]</td>
<td>[2.56]**</td>
<td>[0.32]</td>
<td>[1.12]</td>
</tr>
<tr>
<td></td>
<td>–2.14</td>
<td>–8.14</td>
<td>1.65</td>
<td>6.12</td>
<td>–0.02</td>
<td>0.06</td>
</tr>
<tr>
<td></td>
<td>[5.36]**</td>
<td>[4.23]**</td>
<td>[1.10]</td>
<td>[3.05]**</td>
<td>[0.02]</td>
<td>[0.21]</td>
</tr>
<tr>
<td></td>
<td>–1.72</td>
<td>–9.79</td>
<td>1.75</td>
<td>4.45</td>
<td>0.06</td>
<td>**</td>
</tr>
<tr>
<td></td>
<td>[4.22]**</td>
<td>[4.75]**</td>
<td>[1.12]</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

(Box continues on the next page.)
The policy framework (measured by three variables) has a significant impact on small and medium enterprise lending. Although countries in the region are generally weak in this area, the result shows that countries that have strengthened creditor rights have been rewarded. Credit guarantee schemes have contributed to small and medium enterprise lending. This robust result holds after controlling for endogeneity bias.

The result shows that many countries in the region have used state banks and partial credit guarantee schemes to increase small and medium enterprise lending in a region characterized by weak financial infrastructure. Although these interventions have achieved some positive results, sustained expansion of sound small and medium enterprise lending will require the strengthening MENA’s credit information and creditor rights systems.

<table>
<thead>
<tr>
<th>Explanatory variable</th>
<th>(1)</th>
<th>(2)</th>
<th>(3)</th>
<th>(4)</th>
<th>(5)</th>
<th>(6)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Legal Rights Index</td>
<td>1.92</td>
<td></td>
<td></td>
<td>1.53</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>(2.27)**</td>
<td></td>
<td></td>
<td>(1.79)*</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Time to register property</td>
<td>–0.07</td>
<td></td>
<td>–0.06</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>[4.27]**</td>
<td></td>
<td>[3.78]**</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Time to enforce contracts</td>
<td>–0.03</td>
<td></td>
<td>–0.02</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>[5.91]**</td>
<td></td>
<td>[4.17]**</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Credit guarantees as percentage of GDP</td>
<td>10.31</td>
<td>8.51</td>
<td>7.19</td>
<td>12.47</td>
<td>10.98</td>
<td>10.12</td>
</tr>
<tr>
<td>Observations</td>
<td>239</td>
<td>239</td>
<td>239</td>
<td>220</td>
<td>220</td>
<td>220</td>
</tr>
<tr>
<td>R-squared</td>
<td>0.37</td>
<td>0.37</td>
<td>0.42</td>
<td>0.41</td>
<td>0.41</td>
<td>0.42</td>
</tr>
<tr>
<td>Number of countries</td>
<td>15</td>
<td>15</td>
<td>15</td>
<td>15</td>
<td>15</td>
<td>15</td>
</tr>
<tr>
<td>Number of banks</td>
<td>96</td>
<td>96</td>
<td>96</td>
<td>88</td>
<td>88</td>
<td>88</td>
</tr>
</tbody>
</table>

Source: Rocha and others 2011.

Note: Robust t-statistics in brackets.

* significant at the 10% level. ** significant at the 5% level; *** significant at the 1% level.
Egypt, Morocco, Syria, and Tunisia. This development mandate was critical in the early stages of market development, when financial infrastructure was extremely weak and private banks were reluctant to lend for housing. However, the quasi-monopoly, political interference in pricing and client screening, and transfer of risks to the state eventually led to large losses and bailouts in many of these countries. Most MENA governments are now trying to create the enabling conditions for a mortgage market with many private suppliers, and the role of the state is shifting from one of direct provider to one of maturity refinancer, guarantor, and regulator. The new mortgage markets have been growing, but many challenges lie ahead, as discussed in chapters 7 and 10 (see also Hassler 2011).

State banks have contributed to investment financing, although in some countries such financing seems associated with large stocks of non-performing loans. As discussed in chapter 4, in many countries state banks or institutions still dominate long-term finance for investment, partly as a result of the lack of long-term funding instruments and derivatives that would allow private banks to manage the associated risks. Private banks also provide investment financing, especially where state banks do not exist. They have traditionally managed these risks by providing loans with shorter tenors and charging variable rates, which may discourage investment in many cases. Therefore, the contribution of state banks or institutions to investment finance remains important in many countries, but the effectiveness of investment projects financed by these institutions is open to question, as indicated by their much larger shares of non-performing loans, especially in countries where they dominate financial intermediation (see chapter 7).

**Contribution of Partial Credit Guarantee Schemes**

Ten MENA countries have already established partial credit guarantee schemes to facilitate access to finance by small and medium enterprises. A recent survey examined the objectives, rules, operating procedures, and preliminary outcomes of these schemes (Saadani, Arvai, and Rocha 2011). These schemes seem to have played an important supporting role in many countries, especially in a period in which banks operate with weak financial infrastructure.

Credit guarantee schemes seem to have contributed to more lending to small and medium enterprises in MENA. Countries that have larger credit guarantee schemes (Lebanon, Morocco, and Tunisia) also have larger shares of loans to small and medium enterprises in total loans and larger shares of investment lending to small and medium enterprises. Moreover, a larger share of small and medium enterprises in these countries has a loan or a line of credit (see Rocha and others 2011). This result
holds, controlling for other factors as well as for endogeneity bias (box 5.3 illustrates the empirical results; Rocha and others 2011 provide detailed results). The result shows that these schemes may have mitigated the weaknesses in credit information and creditor rights and facilitated small and medium enterprise finance.

At the same time, these results do not necessarily imply that partial credit guarantee schemes in MENA are cost-effective, are additional, or promote good-practice lending to small and medium enterprises. The results do not show whether the partial credit guarantee schemes are able to target effectively the more constrained small and medium enterprises and reach the maximum number of credit-constrained enterprises with the volume of guarantees offered. The larger volumes of small and medium enterprise lending could reflect lending to very constrained enterprises or to less constrained enterprises as well (for example, a medium enterprise that could have obtained a loan without a guarantee).

The analysis of outreach of MENA partial credit guarantee schemes suggests that there is ample room for improvement in outcomes for the same volume of guarantees. The average size of guarantee schemes (0.3 percent of GDP) is in line with the international average. However, the number of guarantees issued per year (scaled by the population) is low by international comparison (figure 5.3), and the average value of

FIGURE 5.3
Number of Guarantees per Year in Selected Economies in the Middle East and North Africa, 2009

Source: Saadani, Arvai, and Rocha 2011.
guarantees (scaled by per capita income) is high (figure 5.4). These results suggest that guarantees may still be concentrated in a relatively limited segment of firms (perhaps medium-size firms) and do not yet reach a significant number of smaller and more constrained firms. The assessment of the design of these schemes suggests that there is scope for calibrating their rules and achieving gains in outreach and additionality (see chapter 10).

**Other Types of Policy Interventions**

State banks and partial credit guarantees are the most common interventions used to address perceived market failures and promote access to finance. Some countries in the region have also introduced other types of interventions, such as subsidized interest rates (Lebanon) and exemptions on reserve requirements (Egypt and Lebanon).

Exemptions on reserve requirements may not be an effective instrument for inducing small and medium enterprise lending when the fundamental problems constraining access stem from weak financial infrastructure. Exemptions on reserve requirements linked to small and medium enterprise lending tend to reduce spreads and lending rates for all small and medium enterprises, failing to target enterprises that are
credit constrained. The reduction in interest rates resulting from the exemption would probably be small relative to the risk component of interest rates to small and medium enterprises (box 5.4). Therefore, expansion in lending triggered by the decline in lending rates may include a very small share of credit-constrained small and medium enterprises. If the fundamental cause of credit rationing is the lack of credit information and weak creditor rights, the problem may be more effectively addressed by a well-designed credit guarantee scheme (that reduces creditor losses upon default). Small and medium enterprise lending in Egypt has remained small despite exemptions on reserve requirements in place for many years (Rocha and others 2011). Lebanon has generated more small and medium enterprise lending, but the increase may be a result of other types of interventions.

Lebanon provides a battery of incentives that seems to have induced more lending to favored sectors. Within the region, Lebanon, which has no state banks, has introduced the largest number of interventions to induce private banks to lend to small and medium enterprises and housing. Credit guarantees, interest subsidies, and exemptions on reserve requirements probably contributed to the positive access outcomes

**BOX 5.4**

**Exemptions on Reserve Requirements and Lending Rates: A Stylized Example**

In a simple balance sheet structure in which \( L + R = D \), where \( L \) = loans, \( R \) = compulsory reserves (equal to \( rR \), where \( r \) is the reserve ratio), and \( D \) = deposits, the zero profit condition for a bank is \( i_L = i_D + fD \), where \( i_L \) = lending rate, \( i_D \) = deposit rate, and \( f \) = operating costs per unit of deposits. The equilibrium lending rate is \( i_L = (i_D + f) / (1 - r) \).

Assuming \( i_D = 5 \) percent a year, \( f = 1.5 \) percent, and \( r = 15 \) percent (reasonable assumptions for many MENA countries), the annual lending rate would have to be 7.6 percent to cover funding and operating costs as well as the costs of reserve requirements. Exemptions on reserve requirements in this case would reduce the lending rate by about 1.1 percent (from 7.6 percent to 6.5 percent a year) or 110 basis points. Although this reduction is not negligible, it would probably be small relative to the risk component of the interest rate to small and medium enterprises, which can amount to several hundred basis points for enterprises perceived as risky. If the small and medium enterprise is perceived to be very risky, creditors will not lend at any rate.
described in chapter 4. However, the cost-effectiveness of these schemes has not been evaluated. Lebanon is a unique case in many aspects, as a result of an overfunded banking system and a sovereign that is poorly rated because of its high level of debt and perceived high political risk. This has resulted in high interest rates on government securities and a high floor on lending rates, which penalizes the entire private sector. The battery of incentives, designed largely to neutralize these adverse conditions, may well be justified in the Lebanese case. However, it is costly, probably entails cross-subsidies, and can hardly be justified for other countries.

**Summing Up**

MENA’s access problems are a result of many factors, including inadequate financial infrastructure, weak banking competition, and flaws in the institutional and legal framework that have hindered the growth of nonbank financial institutions and markets. Poor financial infrastructure is one of the weakest components of its financial systems. Weak infrastructure has not only a direct adverse impact on access (by raising creditor risks) but also an indirect impact (by reducing banking competition). Weak competition in banking is also a result of entry restrictions, lenient regimes of large exposures and connected lending, and lack of competition from capital markets and nonbank financial institutions. The lack of development of nonbank financial institutions and markets reflects a variety of factors, including the lack of enabling legislation in these areas. Chapters 6–9 examine these problems in greater detail.

State banks have mitigated some access problems, but their interventions have sometimes come at a cost. The performance of state banks in fulfilling development mandates has been both mixed and uneven across countries. State banks do not seem to have made a significant contribution to expanding access to remote areas. They have contributed to small and medium enterprise finance but do not seem to have the capacity to manage the associated risks. State banks have contributed to the development of housing finance, but they have suffered losses and have had to be financially rescued in several countries. They have contributed to investment finance in many countries, but the results in are mixed and uneven across countries. The large stock of nonperforming loans held by state banks in many countries suggests that the selection of these investments has been poor, especially when they involve state enterprises. These experiences indicate that state banks can mitigate access constraints caused by a weak enabling environment but that these interventions frequently entail a
significant cost. This report did not conduct a detailed valuation of the performance of individual state banks, but chapter 10 provides examples of better-governed state banks and discusses the conditions under which state banks may better perform their development mandates.

Other interventions, such as credit guarantee schemes, seem to have fared better, although there is scope for improving the design of these schemes. Partial credit guarantees have increased lending to small and medium enterprises, but there is evidence that the number of guarantees per person is small and the average value high in comparison with other countries. These results indicate that MENA guarantee schemes are not yet targeting smaller and more constrained firms, suggesting scope for improvements in scheme design.

Chapters 3–5 identified the countries in the region that have made most progress in developing the financial sector and expanding access. Morocco has been particularly successful in this area. It has a high ratio of private credit to GDP and the lowest loan concentration ratio in the region. It also has one of the largest shares of small and medium enterprises with a loan, the largest share of small and medium enterprise loans in total loans, and mortgage loans in total loans, as well as the highest microcredit penetration rate. It has made more progress in developing the insurance sector and other nonbanking financial institutions and diversifying its financial system than any other country in the region. Box 5.5 summarizes Morocco’s experience with financial reform and financial development.

**BOX 5.5**

**Morocco’s Experience with Financial Reforms and Financial Development**

Morocco has made impressive progress in financial development, as illustrated by the indicators in chapters 3 and 4. It has been able to build a deep and diversified financial system, as shown by the comparatively large assets of its banking system, nonbanking financial institutions, and microfinance sector. These positive developments have translated into increased access in many areas, including small and medium enterprise finance, microfinance, housing finance, consumer lending, and long-term finance. Financial sector soundness has been maintained as new risks have emerged.

Such progress was made possible by financial sector reforms in recent decades. Policy makers and regulatory authorities demonstrated the ability and readiness to

(Box continues on the next page.)
continuously monitor the evolution of the financial system, identify flaws in regulation and supervision, and address these flaws. These reforms have generally entailed a shift from direct state interventions toward more market-based mechanisms accompanied by effective regulation and supervision. The supportive macroeconomic environment (moderate fiscal deficits, low inflation, large remittances) has also contributed to positive outcomes. The government has better targeted interventions to expand access, including the use of state banks and guarantees, and made them more effective.

Key reforms in the past decade included the restructuring of state-owned specialized banks and an enhanced regulatory and supervisory framework. Pragmatic approaches were adopted for restructuring the three main public banks: one was wound down, and two were converted into commercial banks (one privatized and the other restructured by a new management tasked with cleaning its portfolio and making it profitable). The share of state banks declined from about 65 percent to less than 40 percent of banking assets as a result of privatization, new entry, and the expansion of private banks. A 2006 law gave the central bank increased independence and broader regulatory and supervisory powers. The central bank engaged in close supervision to ensure swift restructuring of state banks, including full regulatory compliance. Such reforms helped create a level playing field for all institutions and promote competition.

Morocco is one of the few countries in the region with sizable nonbank financial institutions. The life and nonlife insurance sectors developed as a result of the dominance of private companies; the enactment of a modern regulatory framework that has tracked EU developments; the authorization of banc assurance, accompanied by market conduct rules; effective regulation and enforcement of mandatory insurance classes, such as motor third-party liability, workman’s compensation, professional liability, and mortgage insurance. Public pension funds have made reasonable progress in disclosure and adoption of modern asset liability management (ALM) approaches, although more needs to be done. The insurance and pension sectors contributed to the development of mutual funds, which was also facilitated by an improved regulatory framework for the securities sector (the 2004 UCITS law, the 2006 Supervisor Law, initiatives on corporate governance) and more forceful enforcement of regulations. The regulation and supervision of the microfinance sector is being substantially strengthened in response to excessive credit growth, multiple borrowings, and the emergence of nonperforming loans.

Beyond regulatory initiatives, the state continues to directly support financial development, in a more targeted and market-friendly fashion. A large public bank (Crédit Populaire du Maroc) has contributed to small and medium enterprise finance

(Box continues on the next page.)
Notes

1. This section is based on Madeddu (2010).
2. Jordan approved new legislation creating a private credit bureau in 2010.
3. Bank regulation surveys indicate that the percentage of rejections of applications for bank licenses was larger in MENA than in other regions during the mid-2000s (Anzoategui, Martinez Peria, and Rocha 2010).
4. This “privileged” position of incumbents is discussed in World Bank (2009), in the context of the development of the private sector in MENA. Rajan and Zingales (2002) discuss the history of financial development in the United States and the European Union during the past century and make similar remarks on the opposition of incumbents to reform and innovation.
5. Lebanon is rated “B” by Standard & Poor’s, three notches below investment grade.
6. Within the region, Lebanon has paid the second-widest spreads on its bonds (after Iraq) and its credit default swap spreads (after Dubai) (see figure 2.2 in chapter 2).

References

Main Factors Limiting Access to Finance


