Regional Financial Integration (RFI) in sub-Saharan Africa (SSA) has usually taken two different, though not mutually exclusive, paths. For some regional economic communities (RECs), institutional initiatives including, a common currency, an overarching regulatory authority, and supranational financial markets, are the building blocks of regionalization in financial markets. This applies to West and Central Africa where the two CFA franc zones, regional central banks (BCEAO and BEAC), and a regional stock exchange (the BRVM in the WAEMU) are the cornerstones of regionalization. For other RECs, integration is a more market driven process, following the movement of people, businesses and goods across fluid borders. South African and Kenyan banks have led this model of integration in the southern and eastern parts of SSA. Of course, this distinction serves only to highlight the more visible drivers of integration rather than suggesting that market forces are at standstill in the WAEMU and CEMAC regions, or that institutional arrangements are irrelevant in the SADC or EAC regions. WAEMU has a growing regional bond market and the recent signing of the Common Market Protocol in the EAC in 2009 is a significant institutional step forward in the regionalization process.

In the East African Community (EAC) commercial banks have generally been ahead of the curve in assessing the potential of the regional financial market. Several banks have to some degree adopted a regional business model motivated by a range of factors including client-demand, their own corporate structures, or by opportunities perceived along the regional trade corridors. These banks display a fair degree of operational integration not just within EAC markets but all the way along the trade corridors to southern Sudan and the eastern Democratic Republic of Congo (DRC).

Institutional initiatives are perhaps more significant for the development of the non-banking financial sector and capital markets in the EAC. With the exception of motor
insurance, insurance products in the region generally have very low penetration rates. Weak regulatory frameworks for the insurance sector and low incomes have hindered the development of markets in all EAC countries, with penetration rates being especially low for life insurance products. Capital markets are also widely disparate in size, investor base, infrastructure, and regulatory and supervisory capacity. Highly publicized initial public offerings (IPOs) have in the recent past been enthusiastically received by the public and institutions within the EAC, even where the rules on intra-EAC cross-border investment have not been clear. Despite this, cross-listings and cross-border investments are still in their infancy, and several de facto hurdles remain for businesses wishing to raise capital on a regional basis.

Extending the EAC to include Burundi and Rwanda in 2007 has greatly added to the diversity of the membership. The three founding members of the EAC have a long history of trade and administrative cooperation (stretching back nearly a century), and as a result of their colonial history have all inherited legal systems based on English common law. Both Rwanda and Burundi are former Belgian colonies and as a result follow the civil law tradition.

This note focuses on two aspects of scaling-up trade in financial services within the EAC:

- Documenting and building on financial integration in the EAC as it is actually taking shape on the ground; and,
- Elaborating on the challenges specific to the further integration of Burundi and Rwanda

The note concludes by discussing a new capacity building initiative that the World Bank is implementing with the EAC Secretariat to support the deepening of financial integration in east Africa.

**Cross-Border Financial Linkages in the EAC**

**Banking Sector**

Kenya-based banks are leading regional integration in the EAC banking sector. About 11 multinational and Kenyan owned banks use Kenya as a hub to expand their operations into the EAC region.

**Regionalized Banking Operations in the EAC**

There are four indigenous Kenyan banks with branches within the region. These banks include Kenya Commercial Bank (KCB), Equity Bank, Fina Bank, and Commercial Bank of Africa. These banks have a total of 63 branches outside Kenya (16 in Tanzania, 31 in Uganda and 16 in Rwanda). Ugandan and Tanzanian banks do not have a regional presence and operate exclusively in their home markets:

- Since 2006 KCB has been expanding extensively in the EAC region. It has 164 branches in Kenya, and 36 branches in other countries in East Africa — Tanzania (10), Uganda (11), Rwanda (9) and Southern Sudan (6). KCB’s Tanzanian operation is the oldest of its
regional subsidiaries having been established in 1997;

- In March 2009 Commercial Bank of Africa merged with First American Bank that has a Tanzanian subsidiary United Bank of Africa (the bank has since been renamed Commercial Bank of Africa – Tanzania);

- Fina Bank began its regional expansion into Rwanda in 2004 and has recently entered Uganda in 2009 with five branches already established. The bank now has a total of 11 branches regionally; and,

- In 2009 Equity bank completed the acquisition of Uganda Microfinance in a deal worth US$26.9 million. The microfinance institution had over 45 field offices and branches. Equity Bank Uganda currently operates 15 branches.

A survey conducted to gauge the operational integration of banks operating in the EAC revealed that 56 percent of the banks interviewed have their operations in the East African region hubbed, mostly in Kenya. Most of the banks surveyed have yet to achieve full integration of their operations in the region, but partial integration has taken place in the areas of ICT, risk management, customer service, and treasury operations. A few banks have not significantly integrated their operations with most of their operations carried out at the individual country level.

For the purposes of this report it is especially significant that two-thirds of the banks state that regionalization has facilitated the introduction of financial products and services that would not have been possible in the absence of scale. Establishment of a single licensing regime (which would remove barriers to entry posed by separate capitalization requirements for each subsidiary and enable cross-border branching) is favored by a majority of the banks as a measure which would promote integration.

The major impediments to attaining full integration cited by banks are: the lack of a common tax regime; resistance from bank supervisors (particularly in Tanzania and Uganda, who are averse to banks under their jurisdiction being managed by Kenyan parents); IT connectivity problems (caused by weak physical infrastructure); differing regulatory requirements; restrictions on the mobility of labor; and, the existence of differing capital movement polices within the EAC.

**Non-banking Financial Sector**

There are indigenous Kenyan insurance companies with branches within the region. These include: APA Insurance, Insurance Company of East Africa, (ICEA), Jubilee Insurance, Phoenix of East Africa, Real Insurance, and UAP Insurance. The estimated number of Kenyan insurance company branches within the region is about 30. There are no Tanzanian or Ugandan insurance companies with a regional presence. Similarly, several Kenyan stock broking firms have subsidiaries within the EAC region. These include, Dyer and Blair Investment Bank (Uganda and Rwanda), Faida Securities (Rwanda), and Kingdom Securities (Rwanda). Each of these stockbrokers has only one branch in the regional countries they operate in.
The integration of the EAC stock exchanges is planned to take place in 2012. The first move to integrate the exchanges was to develop common automated trading and clearing platforms. This adoption is currently underway, with Uganda adopting the same automated trading system (ATS) that is used by Kenya, and Tanzania and Rwanda expected to follow suit (Burundi does not yet have a stock exchange).

Prior to implementation of a common trading platform, cross-listing of shares in the EAC is already occurring and has increased private capital flows within the region. The total market capitalization for cross listed shares in the EAC region stands at about US$2.88 billion with 99.84 percent being taken up by the Nairobi Stock Exchange (NSE) whilst 0.16 percent is shared between Dar-es-Salaam Stock Exchange (DSE) and the Uganda Stock Exchange (USE). All companies cross-listed and traded regionally are from Kenya. To date there have been no cross-listings of companies based in other EAC countries. Kenya defines a local investor as an EAC citizen and allows foreign participation of up to 75 percent. Tanzania allows foreign participation of up to 60 percent of shares in primary or secondary issues. There are no restrictions in Uganda or Rwanda.

Unlike Kenya, Tanzania does not allow foreign participation in IPOs. Rwanda and Uganda require citizens to seek approval from their central bank to buy foreign IPOs. Sale or issue of shares by foreigners is not restricted in Kenya, Uganda, and Tanzania but Rwanda requires central bank approval. There are no restrictions for foreigners to buy debt instruments in Kenya, Uganda, Rwanda and Burundi. Tanzania however restricts purchase of government bonds but allows foreign participation for corporate debt instruments.

Participation in EAC stock and bond markets is usually dominated by institutional investors, national pension funds, fund management firms and insurance companies. Information provided by Kenyan investment banks suggest that the participation of Kenyan investors in other EAC markets is about 10 percent, whereas that of Uganda investors in other EAC markets is between two and five percent, and of Tanzania a maximum of 0.5 percent. Due to the lack of restrictions on capital flows from Kenya, a greater number of its retail investors participate in EAC markets, and this contrasts to Tanzania and Uganda where mainly institutional investors participate. Indeed, in 2008 citizens from all EAC countries were able to participate in the Kenyan IPO of Safaricom with the same status as Kenyan local investors. EAC citizens were allowed to take up 40 percent allotment for local investors and pay 5 percent withholding tax on dividend income as opposed to the 10 percent that foreign investors are required to pay.

Path to Deepen Regional Financial Integration

Several factors have come together to propel the regionalization of financial markets in the EAC. The signing of the Common Market Protocol and the initiatives of the private sector banks together create a favorable climate for further integration, especially between the three original members of the EAC (issues pertaining to the integration of Rwanda and Burundi are dealt with separately in the following section). However, several factors still constrain the growth and integration of the regional market. At the same time there is reason to stay alert to the risks that come with increasing cross-border financial links. Thus, the path forward should involve taking steps that on the one hand facilitate the movement of
funds between EAC members, and on the other ensure a more careful oversight of the volumes and consequences of these flows:

**Harmonization of legal and regulatory frameworks:** The banks surveyed cited differential tax regimes and other regulatory discrepancies as a major hindrance to further integration. Further work needs to be done to align regulatory and supervisory frameworks and reporting requirements to address this issue.

**Adopting single licensing regime:** Banks surveyed during in the preparation of this report cite single licensing as an important aid to further integration. If introduced for banks, single licensing should also be extended to other market participants such as brokers and insurance companies in order to significantly reduce cross-border transaction times and costs and barriers to entry.

**Mutual recognition among regulators:** Adopting single-licensing will have to be accompanied by mutual recognition among regulators and this will require that national regulators converge around some broadly defined international principles such as the Basle core principles for bank supervision, the International Organization of Securities Commissions (IOSCO) and others.

**Building-up regionally compatible financial infrastructure:** Kenya, Tanzania and Uganda have already made substantial progress in integrating their real time gross settlement systems (RTGS). Rwanda and Burundi also need to align their payments systems with the regional system. Similarly, it is necessary to ensure that other parts of national financial infrastructure, including central securities depositories (CSDs) and trading platforms for national exchanges, are compatible at the regional level.

**Strengthening cross-border supervisory practices:** Deepening links between financial institutions warrants a similar deepening of cooperation between supervisors. As indicated by surveyed banks instances of scrutiny by supervisors in other countries are rare. Home-host supervisory communication and consolidated supervisions are important to ensuring that weaknesses in one financial institution/market do not put the regional financial system at risk.

**Strengthening data gathering:** Information on current volumes of cross-border trade in financial products is generally sketchy and incomplete. This data gap is problematic, not just because policymakers are working with limited information on the issues and opportunities that lie ahead, but also since it also masks the benefits and costs of further integration by obscuring the extent of cross-border linkages. Porous borders, high volumes of unrecorded informal trade, and the widespread use of physical cash in transactions, further compound these issues. There is ample scope to build additional capacity on this front both at the national level and at the EAC Secretariat.

**Integrating Burundi and Rwanda**

The financial sectors in both Burundi and Rwanda are at a lower level of development than those in other EAC countries - in Burundi, the financial sector consists of seven banks, of which three are commercial banks, with four very small insurance companies; in Rwanda, the 12 banks operating also dominate the financial sector, but with a more developed insurance sector compared to Burundi. Overall, the
The financial sector in Rwanda is larger, offers a broader range of financial services and products, and is developing faster than Burundi’s. The degree of cross-border banking sector integration with the rest of the EAC is also higher in Rwanda than in Burundi, with three EAC-headquartered banks operating in Rwanda versus one in Burundi.

The integration of Burundi and Rwanda into the EAC’s financial system brings the problems posed by small scale into sharp relief. Of the two countries, the awareness of the need to achieve scale to support high quality regulation and supervision, to support capital markets development, and to build physical infrastructure such as payments and settlement systems, is clearly most advanced in Rwanda. Burundi still lacks a coherent vision of how its financial system will be integrated with the EAC and as a consequence needs to do much work to formulate a strategic vision and move forward with implementing its strategy. The alternative is to see the direction and development of the financial system largely passed to institutions in other EAC countries.

Unlike communities such as the European Union, the EAC has worked on a post-membership convergence principle, with countries joining and then seeking to harmonize their laws and regulations for the financial sector with other member states. One consequence of this approach is that parts of the financial sector may be exposed to cross-border activity and competition before the regulatory and supervisory frameworks are in place (as in the Rwanda and Burundi insurance sectors), another is that financial institutions may enter from larger markets with a degree of sophistication greater than that of the host regulator, posing a risk that supervision will be inadequate. As a result, countries – such as Burundi and Rwanda – may be called upon to build capacity on a “crash basis”. These circumstances in turn may require a greater willingness to seek capacity-building solutions which may require some willingness to surrender a degree of sovereignty in order to gain the benefits of scale: as discussed above, both Burundi and Rwanda could benefit from forming joint regulatory institutions.

**Going Forward**

The following are key steps towards integrating Rwanda and especially Burundi into the emerging EAC financial system:

**Develop an EAC Integration Strategy for the Burundi Financial Sector.** Burundi needs assistance in developing a coherent strategy for integrating the financial sector with the EAC. This assistance should focus critically on assessments of: (a) the financing needs of the real sector, including manufacturing, housing, agriculture, and trans-shipment trade, (b) the capacity the financial sector as presently constituted to meet financing needs and identification of capital shortfalls and financial products needed, (c) government strategy towards inward investment in the financial sector and an associated licensing policy for foreign entrants from within the sub-region.

**Support to Accelerate Burundi’s Convergence with EAC Financial Sector Law.** Given the work already done in Rwanda to prepare an EAC convergent laws and regulations for the financial sector, it would make sense – given the common legal heritage of the two countries – for Burundi to use these laws (on banking, payments, collective investment schemes, and
capital markets functions) as models for its own reforms. Technical assistance could therefore be provided to draft new laws and regulations for Burundi using the Rwandan models.

**Financing for Supervisory Development.** For both Burundi and Rwanda flexible technical assistance credits could be created to deliver capacity building support on a flexible basis, using a framework contract. This would allow the regulators in both countries – over a period of three to four years – to draw technical assistance and finance equipment and software on an *ad hoc* basis.

**Financing for Burundi’s Payments System.** As discussed above, the Burundi authorities see the logic of purchasing a payments system which is fully compatible with that procured by Rwanda. A substantial cost has already been absorbed by the Rwandan authorities in preparing the specifications for a new system, and financial support could be given to Burundi to “piggyback” on the Rwandan procurement. This might also enable the costs of the Rwandan procurement to be reduced by increasing the total size of the hardware, software and services contract(s) by the addition of duplicated systems for Burundi.

**The EAC Financial Sector Development and Regionalization Project**

Drawing extensively on this analysis and in response to strong interest expressed by the EAC, the World Bank is implementing the Financial Sector Development Regionalization Project I (FSDRP I), which comprises a three-year US$ 16 million regional technical assistance grant to the EAC to support the move towards a single market in financial services. The project development objective of FSDRP I is to establish the foundation for financial sector integration among EAC Partner States.

FSDRP I consists of six components as follows:

**Component 1 – Financial Inclusion and Strengthening Market Participants** will leverage the establishment of a single market and the benefits of scale associated with regionalization to make a broader range of formal financial services/products available to a more diversified client profile, including those that are currently unserved.

**Component 2 – Harmonization of Financial Laws and Regulations** will move towards legal and regulatory harmonization in banking and accounting, securities markets, insurance, pensions, investment funds critical to achieve an effective functioning of a single market in financial services via EAC Acts.

**Component 3 – Mutual Recognition of Supervisory Agencies** will support the establishment of a system in which a financial institution or market intermediary licensed by the supervisory authority in one Partner State will be allowed to operate in all Partner States upon simple notification to the supervisory authority of the host State.

**Component 4 – Integration of Financial Market Infrastructure** will support the establishment of an efficient market infrastructure, compatible at the regional level.

**Component 5 – Development of the Regional Bond Market** will support the development of the Government bond market in each Partner States, to ensure bond issuers in individual EAC Partner States having access to a deeper pool of liquidity in a single market.
**Component 6 – Capacity Building** will strengthen capacity at both the regional and the national level to ensure that the integrated market functions effectively and that all economic agents in the regional area aware of and able to realize the benefits from the process of integration.

FSDRP I is envisaged as part of a broader program of continued engagement with the EAC the higher-level objective of which is to support the broadening and deepening of the financial sector through the establishment of a single market in financial services among EAC Partner States, with a view to making a wide range of financial products and services available to all, at competitive prices. This higher-level objective will be achieved through two back-to-back Projects over a nine-year period. Financial Sector Development and Regionalization Project I (FSDRPI) will span 2011 to 2014, and FSDRP II will span 2014 to 2019.

**About the Authors**

Smita Wagh, Andrew Lovegrove and John Kashangani are consultants in the Africa finance and private sector development unit. This work is funded by the Multi-Donor Trust Fund for Trade and Development supported by the governments of the United Kingdom, Finland, Sweden and Norway. The views expressed in this paper reflect solely those of the authors and not necessarily the views of the funders, the World Bank Group or its Executive Directors.