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Eastern and Southern Africa

COMESA Monetary Institute

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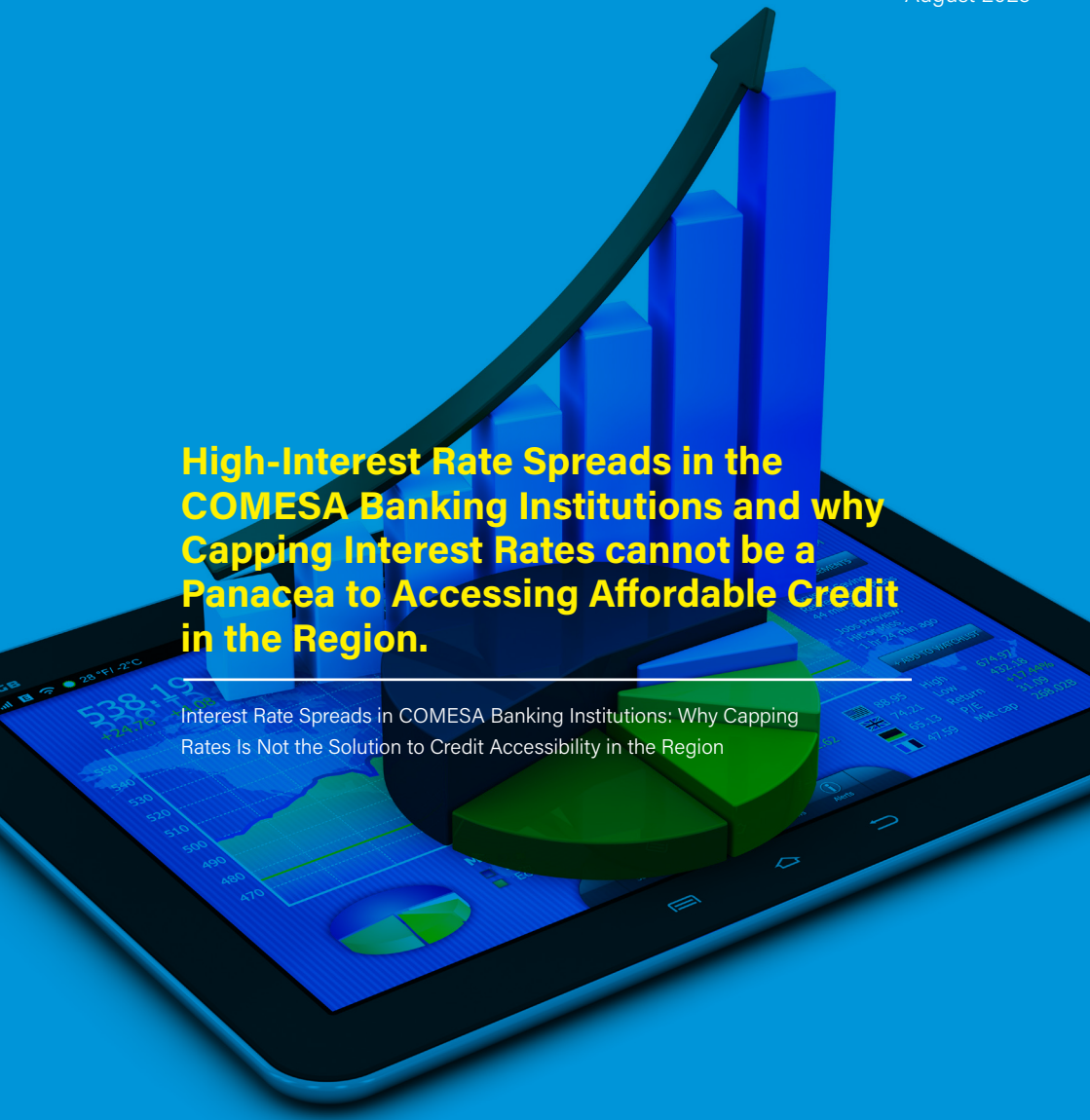

High-Interest Rate Spreads in the COMESA Banking Institutions and why Capping Interest Rates cannot be a Panacea to Accessing Affordable Credit in the Region.

Interest Rate Spreads in COMESA Banking Institutions: Why Capping Rates Is Not the Solution to Credit Accessibility in the Region

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Thomas Bwire
Senior Economist, COMESA Monetary Institute

Executive Summary

It is a common bank borrowers cry, across the COMESA region, that the real interest rates charged by banks are very high. High real interest rates charged by banks continue to surface and remain a widespread concern among borrowers in the COMESA region. These high lending rates are a combination of the cost of funds, the Treasury bill rates on the risk-free public-sector borrowing, the country's risk rating from an investor perspective and the high cost of doing business in the region. Driven by the need to reign on high lending rates, some countries, inclusive of those in the region, have moved to legislate for lending interest rate caps to protect borrowers from high interest rates charged by banks. However, legislating for interest rates on loans cannot improve access to affordable credit because it does not address the binding constraints to credit expansion, it is therefore not surprising that jurisdictions that have implemented them have ultimately revoked them soon after.

Lower lending rates can still be achieved, but through dialogue aimed at addressing structural drivers of the cost of credit and a deliberate policy effort to deepen and broaden (i.e., diversify) the domestic financial system. Institutional reforms, such as liberalisation of the pension industry and reforms to the commercial justice systems and the land registries offer the best prospects for achieving these objectives. Policy makers in addition should continue to embrace the safe adoption of digital financial services that supports competition, innovation and financial inclusion for both individual and small firms.

Introduction

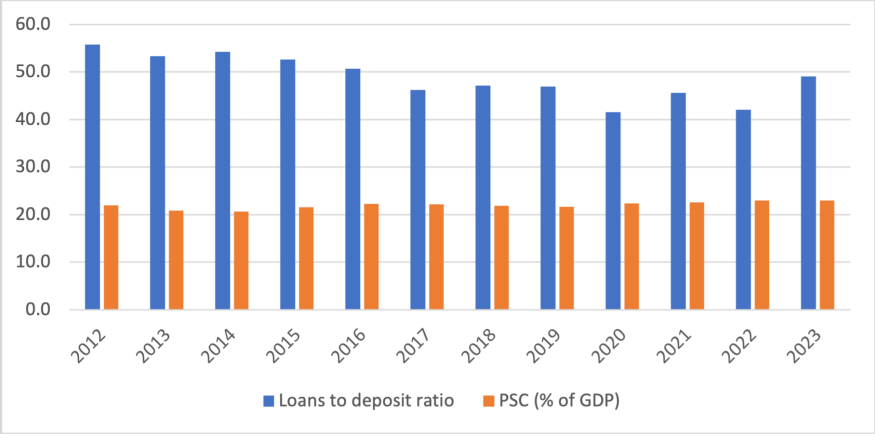
The financial system in developing countries have undergone considerable reforms since the late 1980's. Earlier in the days, the financial sector was highly regulated with direct government control over credit and interest rates—a practice known in the literature as financial repression. Reflecting the undesirable consequences of this, narratives conclude that during that time, credit to GDP shrunk to the lowest levels, deeply affecting growth outcomes. The financial sector reforms, including the removal of interest rate caps initiated in late 1980s, have bolsted the banking sector, leading to its rapid expansion. Reflecting these reforms, in the COMESA region, many foreign and regional banks[1] have been attracted, while at the same time, local banks have been helped to strengthen their capabilities and expand their branch network and the range of banking products they offer.

As shown in **Figure 1**[2], the region-wide level of savings mobilization and financial intermediation, defined as the extent to which banks convert deposits mobilized from the public into loans—has remained relatively low compared to Asian countries, but has been steadfast, averaging 48.8 percent over the period 2012 to 2023. "In some COMESA countries such as Eswatini, Uganda, and Mauritius, the loan-to-deposit ratio averaged as high as 76.6%, 67.6%, and 63.3% respectively, over the period 2012–2023. However, this ratio remained notably low in a few other member states. Reflecting similar trends, private sector credit as a share of GDP averaged 22 percent annually across the region during the same period, with Tunisia recording the highest average at 75 percent."

1 Foreign banks are those with a parent bank outside of Africa, while regional banks are those with a parent bank in Africa

2 The Statistics reported are based on data submitted by 8 out of the 21 COMESA countries for the compilation of the 2023 COMESA wide Financial Stability Report (FSR)

Figure 1: COMESA region average Loans to deposit ratio and private sector credit as a share of GDP



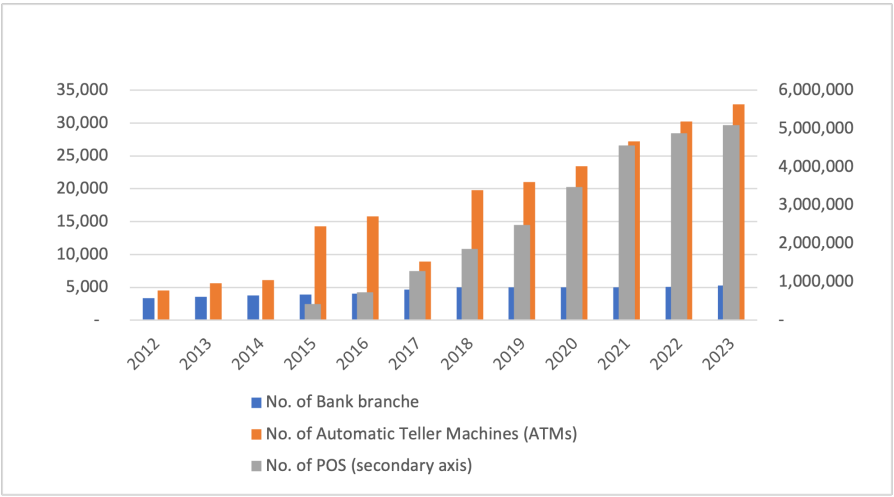
Source: Country data submitted for the compilation of the 2023 COMESA wide FSR and author's own computations.

Overall, real lending has risen to about 7 times what it was two decades ago because a liberalized financial sector has enabled banks to widen access to credit on a commercially viable basis. The expansion of outreach has also been phenomenal. Moreover, over the last one decade to 2023, the bank branch network in the region rose to 5,263 from 3,373 and the number of Automatic Teller Machines (ATMs) more than tripled from 4,501 to 32,856. Equally, the number of Points of Sale (POS)[3] has experienced exponential expansion to 5,093,640 from 426,939 in 2015 (**Figure 2**[4]).

3 In payment systems, "POS" stands for Point of Sale, referring to the place and time where a retail transaction is completed, where a customer makes a payment for goods or services

4 The Statistics in the figure are based on data submitted by member countries for the compilation of the 2023 COMESA wide FSR <(https://cmi.comesa.int/wp-content/uploads/2025/02/FSR-2023-red.pdf)>.

Figure 2: Number of bank branches, ATMs and POS in COMESA



Source: Country data for 2023 COMESA wide FSR and author's own computations

All these developments have led to an increase in access to financial services. The percentage of the population aged 16 years and above accessing financial services has risen from about 30 percent in 2006 to over 85 percent in 2023 – a good sign of financial inclusion, for which credit could largely be owed to the phenomenal growth of mobile money services in the COMESA region.

Gauged on Basel III reforms (first issued by the BCBS in 2010) benchmarks[5], first, on capital requiring banks to hold both more capital in relation to the risks that banks face and capital of higher quality, the COMESA region's banking sector is adequately capitalized to withstand any shocks, implying that its financial health and soundness is solid. As at end of 2023, the capital adequacy ratio (CAR)—a measure of the ability of banks to meet financial obligations and absorb potential losses, performed above the Basel III regulatory requirements of 10.5 percent— with an aggregate industry-wide tier 1 (core) CAR of 20.5 percent (2023 COMESA FSR, p. 27). This, by and large, is an indication of sufficient capital buffer to absorb shocks and sustain lending without breaching the regulatory minimum capital requirement. It also signals a reduction in the likelihood of banks being in distress and requiring capital injection.

5 Bwire and Brownbridge (2025), Dewatripont and Tirole (1993) and Rajan (2018) dive into the rationale for these uniform global standards

Secondly, on liquidity requirements—the liquidity coverage ratio (LCR) and the net stable funding ratio (NSFR). The LCR stipulates that banks should hold sufficient high-quality liquid assets to meet all potential demands for liquidity over a 30-day period under stressed conditions; while the NSFR aims to safeguard liquidity over a longer period—up to one year—by requiring banks to hold sufficient stable sources of funds to back assets with a residual maturity of one year or more (Bwire and Brownbridge, 2025).

The COMESA FSR (2023) indicates that banks in the region hold adequate liquidity buffers to withstand any liquidity constraints, with the industry wide liquid assets to total deposits ratio of 48.8 percent, which is over and above the Basel III minimum regulatory requirement of 20.0 percent. Similarly, the banks' LCR stood at 327.1 percent, relative to the minimum Basel III regulatory requirement of 100 percent. Moreover, bank funding conditions also remain stable, with deposits contributing on average 83.2 percent of the total funding of the banking sector, while banks' annual after-tax profits have continued to improve, with return on asset and return on equity at 4.4 and 29.7 percent in 2023, relative to 2.5 and 17 percent, respectively in 2020, surpassing the average for the past 5 years.

Despite the region's banking sector phenomenal expansion and financial health and soundness, one of the key challenges limiting access to financial services is the issue of high interest rates charged on loans by banks, which continues to raise public outbursts, in part because it is perceived to have locked out a large segment of the population from the credit market. In this article, we delve into the possible causes of high-interest rate spreads, whether this has actually hindered real investment and whether legislating for interest rate caps can deliver affordable credit to the borrowing public. In what follows, first, we explore why lending rates remain persistently high in almost all COMESA jurisdictions.

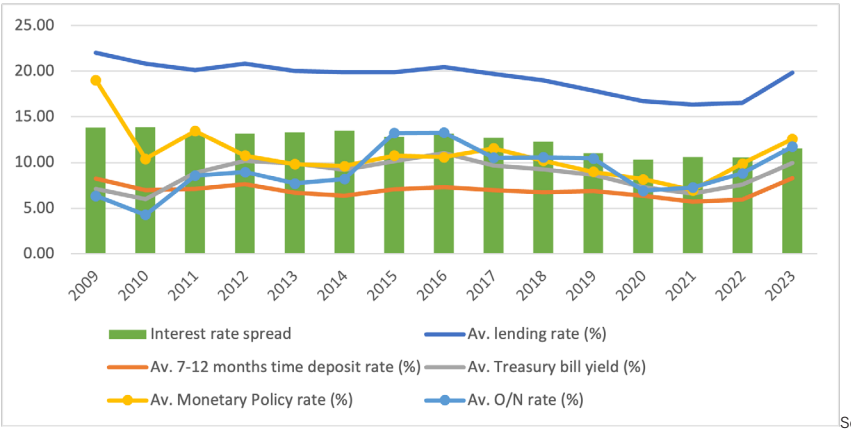
The high spread between saving and lending rates in the COMESA Financial Institutions: Is it justified?

For the start, two ends of interest rates define the interest rate spread. First, is the deposit rate, i.e., the interest rate that deposit taking institutions compensate their depositors in opportunity cost for holding their savings on the banks account for period usually ranging from 7 to 12 months without making a

withdraw. The second is the lending rate, i.e., the interest rate that banks charge borrowers upon accessing the bank loan facility. The difference between the two, i.e., the lending and 7 to 12 months' time deposit rates is what constitutes the interest rate spread.

Turning to the consolidated data[6] shown in **Figure 3**, the average interest rate spread in COMESA, over the past one and a half decade has been in the region of 10.3 - 13.9 percent and 12.4 percent on average, which, by every standard measure, is high, compared to, over the same period, an average of 4.7% for East Asia and Pacific countries and/or 6.0% for the world (IFS data). Commentators, largely the business practioneers, activists and politicians in most of the COMESA jurisdictions as indeed elsewhere in low-income developing countries, have attributed the high lending rates—the single largest driver of high-interest rate spreads to the central banks' inability to whip commercial banks to the corner of low market lending rates particularly when loose monetary policy is pursued by the regulators. Effectively, this amounts to the argument that central banks are not ensuring effective transmission of especially accommodative monetary policy to the market interest rates, particularly commercial bank's lending rates. The question, however, is how, in practice, the transmission of monetary policy signals to the real economy works.

Figure 3: COMESA Av. Interest rate structure (2009-2023)



Source: Authors computations from COMESA country's data submitted for the compilation of the 2023 FSR. Data on time deposit rate is from the IFS.

6 All data are constructed from country data submitted for the compilation of the 2023 COMESA wide FSR <(https://cmi.comesa.int/wp-content/uploads/2025/02/FSR-2023-red.pdf)>.

Bwire (2024) describes, in succinct detail, the path to ensuring transmission of the policy rate to market interest rates. A snap shot of it is that once the central bank has set the monetary policy rate, it then implements the same through the domestic money market space using the policy tools at its disposal—discount rate, standing lending facility, repurchase agreements (Repos), deposit facilities and open market operations (OMOs), whichever is appropriate, in what we call liquidity management — to ensure that the short-term risk-free—mostly the O/N interbank interest rate—stays close to the policy rate most of the time if not all the time such that it sets a benchmark for other interest rates in the economy. Short-term interbank interest rates serve as a benchmark for the broader structure of interest rates in the economy—such as deposit and lending rates—making interbank markets a key channel for the transmission of monetary policy.

Reverting to the data in **Fig. 3**, it can be inferred whether or not changes in the monetary policy over time has had any bearing on the interest rate spread in the COMESA region. The link between the policy rate and the O/N interbank rate is the first stage in the interest rate transmission mechanism. Since 2017, the average O/N interbank rate has been close to the policy rate—firmly establishing, in effect, the first stage in the interest rate transmission mechanism.

The second stage in the interest rate transmission mechanism involves changes in the O/N interbank rate affecting longer term interest rates, notably time deposit rates and bank lending rates. Average time deposit rates, which are heavily influenced by a few wholesale depositors, have also tracked the policy rate quite closely over the entire data time horizon.

However, central banks in the region have been less successful so far in influencing the bank lending rates, which are stickier than deposit rates. Estimates by Sande and Apaa (2013), research staff at Bank of Uganda, indicate that the bank lending rate responds to a 100-basis point change in the policy rate by slightly less than 50 basis points (incomplete transmission of the policy rate), which implies that lending rates are generally sticky downwards, which is consistent with the empirical findings of asymmetric transmission of changes in the interbank rate to longer term interest rates (Kanyumbu, 2020; Bwire, 2023).

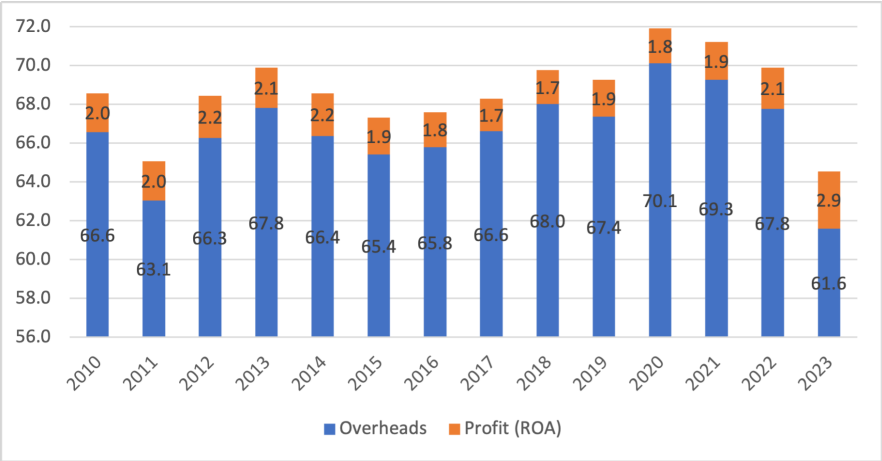
From the above, one can argue that the high-interest rate spread is due to high lending rates amidst well anchored time deposit rates. Indeed, while in the last

15 years, since 2009, the region wide central bank monetary policy rate, O/N interbank and time deposit rates have on average rallied in close proximity at 10.9, 9.1 and 6.95 percent, respectively, the lending rate on the other hand, has remained stubbornly elevated at an average of 19.3 percent, averaging, in some jurisdictions, as high as 35 percent per year, over the same period. Therefore, any explanation for the high lending rates must focus on the causes of high-interest rate spreads. In the East African region, the Economist (March 21, 2020) has attributed over 80 percent of the interest rate spread to high overhead costs and profits, adding that "banks in East Africa are the most profitable in the world, while being the least efficient". This is not different from what pertains to the COMESA jurisdiction, particularly with respect to overheads.

The largest single contributor to total expenses of banks, over the period 2010 – 2023, are overhead costs, at an average of 66.6 percent (**Fig. 4**). Overheads are high because of the structural features of the COMESA economies and the banking system. In particular, the financial systems in the region are generally still quite shallow, poorly developed and dominated by commercial banks (Bwire and Brownbridge, 2025) —this account for over 80 percent of the system in most jurisdictions (COMESA region FSR, 2023). As a result, banks are not achieving the economies of scale which would allow them to operate more efficiently and therefore reduce their overheads.

Moreover, the institutional environment in developing countries as a whole is often less conducive for bank lending, because of weaker accounting standards in business and difficulties in foreclosing on loans through the legal system (Bwire and Brownbridge, 2025). As such, the risk of loan defaults are higher, and when defaults occur, the losses incurred by banks are greater as a share of the nominal value of the loan.

Figure 4: Overhead costs to total expenses and ROA (%)



Source: Country data for 2023 COMESA wide FSR and author's own computations

Bwire and Brownbridge (2025) have shown that the median share of non-performing loans (NPLs) to total loans in SSA during 2015-22 was 8.2 percent, relative to 2.2 and 6.5 percent for banks in advanced economies (AEs) and the middle east and north Africa (MENA), respectively. It has also been established that smaller banks,a common feature of the banking system in the region—are more vulnerable to high NPL ratios by international standards and that loan impairment in individual banks is persistent through time, and that loan growth is also high, which increases vulnerability to financial fragility of these banks, which suggests the benefits of size for loan diversification (Kedir et al (2018). The loan loss provisioning component of the spread increases as asset quality deteriorates because it signals a rise in default risk. Clearly, under these circumstances, lending rates may not be expected to fall to levels consistent with consumer expectations.

Equity markets are poorly developed, and only large and well-established firms can realistically raise finance on equity markets. As a result, most firms seeking finance for investment on the domestic market have to rely on loan finance, for which the most important source is the banking system. There are two major constraints to the growth of the stock market in the region. First,

companies can only issue equity on the stock market if they are well managed, with good corporate governance, have a strong track record of profitability and have published credible financial statements. Few private sector companies can meet these requirements. Even some of those which could meet the requirements to issue equity are often reluctant to do so because their owners do not want to dilute their ownership by selling shares to outsiders, and in some cases, fear that the disclosure requirements could expose them to greater (and more accurate) tax liabilities.

The second constraint is the lack of long-term financial resources in the COMESA jurisdictions. The main source of financial resources for investment in the capital markets are non-bank financial institutions which mobilise long term savings, such as pension providers and life assurance companies. These non-bank financial institutions have long term liabilities and hence require a diversified basket of long-term assets in which to invest. Stock and bond markets offer the ideal assets for such investors.

However, as noted above, COMESA region's non-bank financial sector is still very small and, outside of the National Social Security Funds (NSSFs), long term financial savings are very scarce. The stock and bond markets will not be able to provide a major source of finance for capital investment until there is major expansion of long-term financial savings, which requires the growth of a competitive liberalised pension industry. In this instance institutional reforms such as the liberalization of the pension industry, reforms to the commercial justice system and the land registry offers the best prospects for achieving low lending rates in the region.

It is evident from the numbers in **Fig.2** , competition in the COMESA region's banking sector has intensified over the past three decades, primarily driven by the expansion of branch networks and aggressive efforts to mobilize deposits through attractive time deposit rates. However, both strategies significantly raise banks' operational costs, particularly when expanding branch networks beyond major urban centers; costs which must be passed onto borrowers in form of high lending rates. The operating costs of financial institutions also include the cost of utilities such as telecommunications, energy, and rent; costs of security services; and human resources. Like all businesses in the region, commercial banks face high costs of doing business; costs which increase rapidly if banks extend their branch networks outside of the main cities

(Brownbridge and Bwire, 2014).

A major concern is that the default risk reduction benefits due to Credit Reference Bureaus (CRB) and the associated Financial Card System (FCS) that some of the central banks in the region have put in place since mid-2000's seem not to be filtering through to lower lending rates. As seen in **Fig. 3**, lending rates have remained stubbornly elevated for decades. Moreover, in as many cases, even moral suasion by Governors of central banks to the executives of their supervised financial institutions to lower lending rates in response to overly accommodative monetary policy stances have not yielded much either.

Interest rate spreads are also driven up by the costs which banks incur in screening potential borrowers for creditworthiness, in valuing assets pledged for loan security and in taking possession and selling these if the borrower defaults. Property prices in the region are very volatile and valuations of property are often an unreliable guide to the actual value which a property can be sold for on the market. Banks rely heavily on loan security because of the difficulty in evaluating the creditworthiness of loan applicants, which stems from the fact that many loan applicants lack documentary proof of a good record of profitable business activities. Because of the inefficiencies in the land registries, there are often long delays in verifying ownership of land, which in turn delays the disbursement of credit. Banks also face long delays in the commercial courts to foreclose on loan security. All these factors raise transactions costs for the banks and the risks which they face (Brownbridge and Bwire, 2014).

Additionally, the high spread also reflects, to some extent, the banks' business model, in which a large share of assets is devoted to investments in risk free assets. In the past 15 years to 2023, the 364-day Treasury bill rate in the region has averaged 8.8 percent, hitting highs of 11.0% in 2016 (**Fig. 3**). Clearly, the return to investment in government securities is by all means tempting, and in a profit driven environment, this anchors market lending rates to the risky segments of the economy, i.e., borrowers are charged the Treasury bill rate plus a risk premium. Therefore, providing the governments' borrowing from the domestic market remains substantial, even if the central bank's policy rates were to be lowered to the minimum consistent with the growth objective (setting worries about inflation aside), it is probable that lending rates would still

remain elevated. Moreover, significant holdings of government debt by banks tend to limit lending to the private sector—a phenomenon known as 'crowding out,' which in turn hampers economic growth. Despite this, current regulatory frameworks that assess banking risks often fail to account for the potential tail risk of government debt defaults, which remains substantial in some countries (Finance and Prosperity, 2024).

How about Capping Interest Rates? Can it be a panacea to accessing affordable credit in the region

The rationale for caps on loan prices is to protect borrowers from high interest rates charged by banks thereby making loans more affordable and improve access to credit. Driven by the need to reign on the old age problem of high lending rates, some of the countries across the globe, including countries in the Africa region, have attempted legislating for interest rate caps. We argue in this paper that capping interest rates on loans is not a panacea to improving access to affordable credit because it does not address the afore-mentioned binding constraints to credit expansion. We make a case that what countries need are long term solutions to address the credit supply side constraints as well as dealing with the issue of Government borrowing and the relatively high cost of doing business. Under the current business as usual environment, capping interest rates only results inadverse consequences for the economy, including financial inclusion and socio-economic transformation.

It could potentially lead to a slowdown in monetary policy transmission and dampen credit growth especially to riskier segments of borrowers—borrowers who are costly to serve, those who are less credit worthy, and those who require banks to undertake high levels of due diligence—categories in which most of the borrowers in region fall. In effect, credit supply may instead shrink, hurting growth. Such controls actually force commercial banks to start to lend to only very large prime borrowers with a good credit history, who are the least costly to serve.

This was the case in Ecuador after introduction of rate caps in 2007. It also happened in the West Africa Monetary Union countries and has unfolded recently in Kenya when a cap on lending rate was introduced in August 2016. In Nicaragua, the annual growth in credit dropped from 30 percent to just 2 percent after interest ceiling was introduced in 2001, largely because banks

tightened their credit parameters, which excluded high risk borrowers from the formal financial system (Bwire, 2018). It means banks are no longer in position to correctly price credit risk, which is likely to fuel accumulation of non-performing assets and banks could eventually find it unprofitable to intermediate funds and could, actually, end up closing.

Caps on lending interest rate instead offer a fertile ground for shylocks and other unregulated lenders to thrive. These often offer credit at very exorbitant rates in a predatory manner. It could also encourage lending in foreign currency because foreign currency lending rates are much lower than local currency lending rates, which exposes the borrowers to foreign currency risk. In addition, it shifts the commercial banks asset portfolio towards government securities, as these are safer and involve minimal transactions costs, shrinking further private sector credit. It may also discourage the current level of innovations in the banking sector which is aimed at high risk and low scale credit segment of the population, which includes mainly the Micro, Small and Medium Enterprises and low income and first-time borrowers.

This, in turn, may rapidly reverse the gains that countries have so far registered in deepening their financial markets, strengthening intermediation, and promoting financial inclusion and investor confidence. Moreover, it could pose a danger to the employment of the employees working for the banking sector, as a case in point, when interest rate caps were introduced in Zambia, two financial institutions laid off close to 50 people within a period of one month. It is not surprising therefore that these challenges have ultimately led to the repeal of the interest rate caps in those jurisdictions that have attempted their implementation.

As mentioned above, one of the biggest challenge banks in the region face is lack of long-term source of funding on account of stock markets that are very shallow and underdeveloped. As a result there is a huge mismatch in funding in the banking sector. The banking systems are still characterized by a traditional banking model, with banks' liabilities dominated by short-term retail deposits, while on the other hand, most borrowers are looking to the bank to provide short-and medium-term loans (mortgages, personal and household loans, building and construction loans and others).

As a result, banks have to find alternatives sources of funding to bridge the gap

but this comes at high cost. This suggests the need to mobilise more long-term capital from the market through pooling of funds and long-term savings and the deepening of the capital markets, which may require governments to consider introducing a tax incentive to encourage a culture of long-term saving—as is, COMESA citizens are taxed when they earn, taxed when they save and taxed when they consume. Although there have been important innovations in the last decade, notably the rapid expansion of mobile money in many countries (Aryvazyan, 2024; Ndungu'u & Ogusu, 2021) and while these innovations may have unintended side effects on other aspects of the financial system, such as financial development, credit availability and the efficiency of banks, we do not delve into these issues, some of which are analyzed in Triki et al (2017) and Centre for Global Development (2019).

From the foregoing, we argue that it is the volume of funds which can be mobilised by the domestic financial system which determines how much finance can be made available for investment by the private sector, together with the quality of private investment projects (e.g. their financial viability), rather than solely the cost of credit per se. Thus, policy reforms to stimulate the supply of domestic finance for investment in the region could focus on measures to deepen and broaden (i.e. diversify) the domestic financial system. Institutional reforms offer the best prospects for achieving these objectives. In particular, the liberalisation of the pension sector will make a vital contribution to boosting resources available for investment finance because it will stimulate the growth of an industry (the pension industry) which mobilises long term savings and thus requires long term assets (such as equities and bonds) in which to invest its resources.

Conclusion and Policy Insights

It is a common cry for borrowers, across the region, that the real interest rates charged by banks are very high. High lending rates are a confluence of the cost of funds, the Treasury bill rates on the risk-free public-sector borrowing, the country's risk rating from an investor perspective and the high cost of doing business in the region.

Driven by the need to reign on high lending rates, some countries including those in the region, have moved to legislate for lending interest rate caps to protect borrowers from high interest rates charged by banks. However, interest rate

caps, where they been implemented, have discouraged players from investing in the sector; reduced commercial banks intermediation and transparency and shifted commercial banks' asset portfolio towards government securities and typically stopped lending to borrowers who are costly to serve, those who are less credit worthy, and those who require banks to undertake high levels of due diligence– fermenting even more credit sharks who offer credit at very exorbitant costs and terms. All this, combined, led to dampened credit growth in such countries. Realistically therefore, legislating for interest rates on loans cannot improve access to affordable credit because it does not address the binding constraints to credit expansion, and it is not surprising that jurisdications that have implemented them have ultimately repealed the same soon after.

Lower lending rates can still be achieved, but through dialogue aimed at addressing structural drivers of the cost of credit and a deliberate policy effort to deepen and broaden (i.e., diversify) the domestic financial system. Institutional reforms, such as liberalisation of the pension industry offer the best prospects for achieving these objectives because it will stimulate the growth of an industry (the pension industry) which mobilises long term savings and thus requires long term assets (such as equities and bonds) in which to invest its resources. In addition, reforms to the commercial justice systems and the land registries offer the best prospects for achieving low lending rates in the region. Policy makers should continue to embrace the safe adoption of digital financial services that has supported competition, innovation and financial inclusion for both individual and small firms.

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COMESA SECRETARIAT
COMESA Center
Ben Bella Road
P.O. Box 30051
Lusaka Zambia

+260 211 229 725

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info@comesa.int

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